

# SUPERVISORY AND ACCOUNTING STANDARDS IN INSURANCE: AN ON-GOING REVOLUTION

## Presentation to IAFICO



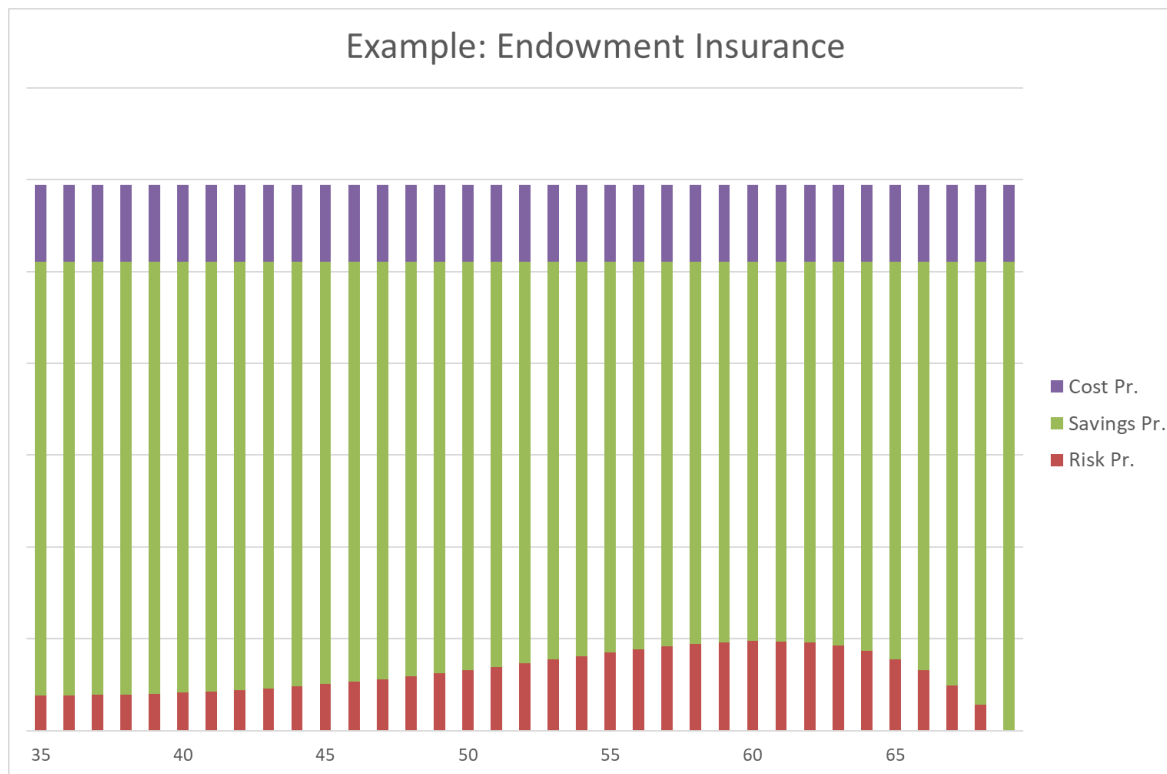
# LIFE INSURANCE GUARANTEES

- Life insurance policies are contracts implying long-term guarantees, for instance the payment of life-long annuities.
- Various standards prescribe the way to estimate the corresponding liabilities (mathematical provisions): statutory, MCEV, regulatory, accounting (US GAAP, IFRS, etc).

# WHAT IS AN INSURER'S INCOME?

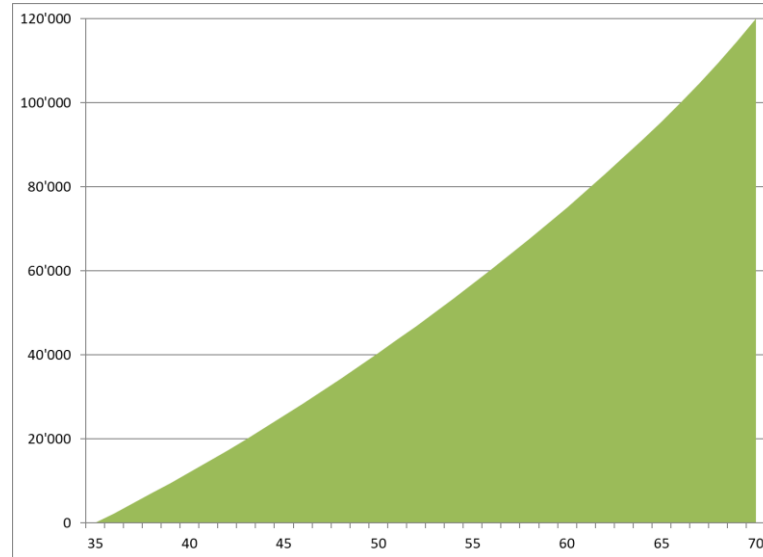
- Premiums (single and annual premiums);
- Investment Income (interest, dividends and capital gains on financial investments, renting income, etc);
- Other income: commissions, revenue from reinsurance treaties, fees.

# DECOMPOSITION OF PREMIUMS



# MATHEMATICAL PROVISIONS

- Final value of accumulated savings premium;
- For an endowment insurance, they have following shape:
- «Policy Reserves» in the balance sheet



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# PROFIT & LOSS ACCOUNT (IFRS 4)

## CONSOLIDATED FINANCIAL STATEMENTS

### 2. Consolidated Statements of Income

Nippon Life Insurance Company and its Consolidated Subsidiaries

For the years ended March 31	Millions of Yen			Millions of U.S. Dollars (Note 1)
	2017	2016	2015	2017
<b>ORDINARY INCOME:</b>				
Revenues from insurance and reinsurance	¥5,236,045	¥6,262,042	¥5,370,865	\$46,671
<b>Investment income:</b>				
Interest, dividends, and other income	1,458,328	1,421,721	1,373,699	12,998
Gain from assets held in trust, net	—	—	4	—
Gain on sales of securities	287,182	95,288	242,571	2,559
Gain on redemptions of securities	6,000	7,121	5,039	53
Reversal of allowance for doubtful accounts	1,351	2,361	726	12
Other investment income	1,919	829	525	17
Gain from separate accounts, net	50,432	—	154,187	449
<b>Subtotal</b>	<b>1,805,215</b>	<b>1,527,321</b>	<b>1,776,754</b>	<b>16,090</b>
<b>Other ordinary income</b>	<b>260,555</b>	<b>268,229</b>	<b>262,474</b>	<b>2,322</b>
<b>Total ordinary income</b>	<b>7,301,817</b>	<b>8,057,594</b>	<b>7,410,093</b>	<b>65,084</b>



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# BALANCE SHEET (IFRS 4)

As of March 31	Millions of Yen			Millions of U.S. Dollars (Note 1)
	2017	2016	2015	2017
<b>LIABILITIES:</b>				
<b>Policy reserves and other reserves:</b>				
Reserve for outstanding claims	¥ 394,243	¥ 353,480	¥ 202,171	\$ 3,514
Policy reserves	58,930,878	57,490,828	49,202,876	525,277
Reserve for dividends to policyholders (mutual company) (Note 11)	1,001,102	1,015,013	1,037,472	8,923
Reserve for dividends to policyholders (limited company) (Note 12)	67,847	69,681	—	604
<b>Subtotal</b>	<b>60,394,071</b>	<b>58,929,002</b>	<b>50,442,520</b>	<b>538,319</b>
<b>Reinsurance payables</b>	<b>9,590</b>	<b>761</b>	<b>557</b>	<b>85</b>
<b>Corporate bonds</b> (Notes 6 and 13)	<b>920,825</b>	<b>650,825</b>	<b>399,590</b>	<b>8,207</b>
<b>Other liabilities</b> (Notes 6, 14 and 17)	<b>2,243,231</b>	<b>2,291,459</b>	<b>1,707,220</b>	<b>19,994</b>
<b>Accrued bonuses for directors and audit and supervisory board members</b>	<b>79</b>	<b>87</b>	<b>74</b>	<b>—</b>
<b>Net defined benefit liability</b> (Note 15)	<b>450,558</b>	<b>460,449</b>	<b>411,416</b>	<b>4,016</b>
<b>Accrued retirement benefits for directors and audit and supervisory board members</b>	<b>5,246</b>	<b>5,208</b>	<b>4,397</b>	<b>46</b>
<b>Reserve for program points</b>	<b>9,013</b>	<b>9,420</b>	<b>13,171</b>	<b>80</b>
<b>Reserve for price fluctuations in investments in securities</b>	<b>1,135,765</b>	<b>963,730</b>	<b>778,723</b>	<b>10,123</b>
<b>Deferred tax liabilities</b> (Note 23)	<b>620,563</b>	<b>697,450</b>	<b>1,223,642</b>	<b>5,531</b>
<b>Deferred tax liabilities for land revaluation</b>	<b>106,432</b>	<b>109,383</b>	<b>115,440</b>	<b>948</b>
<b>Acceptances and guarantees</b>	<b>39,935</b>	<b>36,110</b>	<b>33,801</b>	<b>355</b>
<b>Total liabilities</b>	<b>65,935,313</b>	<b>64,153,887</b>	<b>55,130,557</b>	<b>587,711</b>



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# WHY A NEW STANDARD IFRS 17?

- The premium income should be split and isolate its components for transparency;
- Assets and liabilities should be valued in a consistent and comparable way by the various insurance companies.



# GROUP OF CONTRACTS

- An entity shall:
  - divide the contracts into groups that it will recognise and measure;
  - recognise the profit from a group of insurance contracts over the period the entity provides insurance cover, and as the entity is released from risk.
- If a group of contracts is or becomes loss-making, the entity recognises the loss immediately.

# NEW CONCEPTS / DEFINITIONS

- Contractual Service Margin: ← «Present value of future profits»
  - A component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned profit the entity will recognise as it provides services under the insurance contracts in the group.
- Fulfilment Cash Flows: ← «Policy Reserves»
  - An explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows minus the present value of the future cash inflows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk.
- Risk Adjustment for non-financial risk: ← «Risk Margin, Cost of Capital»
  - The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

# BUILDING BLOCK APPROACH

- The value of a contract is measured as the sum of:
  - Block 1: Sum of the future cash flows that relate directly to the fulfilment of the contractual obligations;
  - Block 2: Time value of the future cash flows. The discount rates used to determine the time value reflect the characteristics of the insurance contract.
  - Block 3: Risk adjustment;
  - Block 4: Contractual service margin (CSM).

# STATEMENT OF INCOME

- It will give a separate presentation of
  - insurance revenue (that excludes the receipt of any investment component),
  - insurance service expenses (that excludes the repayment of any investment components) and
  - insurance finance income or expenses.

# VALUATION OF CONTRACTS

- A group of contracts shall be recognised and measured at:
  - a risk-adjusted present value of the future cash flows (the **fulfilment cash flows**) that incorporates all of the available information about the fulfilment cash flows in a way that is consistent with observable market information;  
plus (if this value is a liability) or minus (if this value is an asset);
  - an amount representing the unearned profit in the group of contracts (the **contractual service margin**).

# IMPLEMENTATION COMPLEXITY

- IFRS 17 is effective for annual reporting periods beginning on or after 1 January 2021;
- The interpretation of the standard is not yet fully clear;
- Other standards also modified that apply to insurance companies for annual periods beginning on or after 1 January 2018:
  - IFRS 9 Financial Instruments;
  - IFRS 15 Revenue from Contracts with Customers.

# SEVERAL REPORTING STANDARDS

- Besides IFRS standards, companies also measure their performance and balance sheet according to
  - national accounting standards (GAAP);
  - solvency standards (Solvency II, FSA, SST, etc.);
  - US GAAP standards (those listed in NYSE);
  - Market Consistent Embedded Value (CFO Forum);
  - Local statutory requirements

# WORK IN PROGRESS...

- According to PwC, an estimated US\$5 billion on accounting, actuarial modelling, and finance transformation initiatives is expected to be incurred worldwide.
- Sources:
  - [www.ifrs.org](http://www.ifrs.org)
  - Sites of consultants (PwC, Deloitte, EY, KPMG, etc.)
  - Questions: philippe.maeder@unil.ch





# **Comparison of Loss Reserve Models in Korean Workers' Compensation Insurance**

**Chan Mi Lee  
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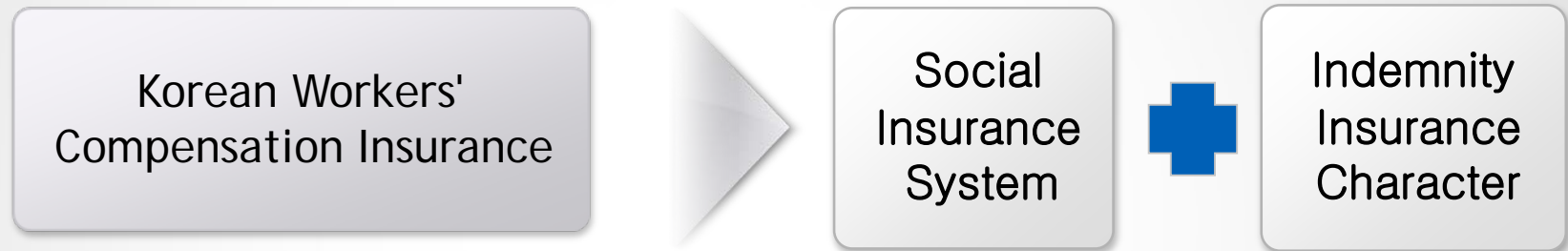
# 1. The research purposes

## The research purposes

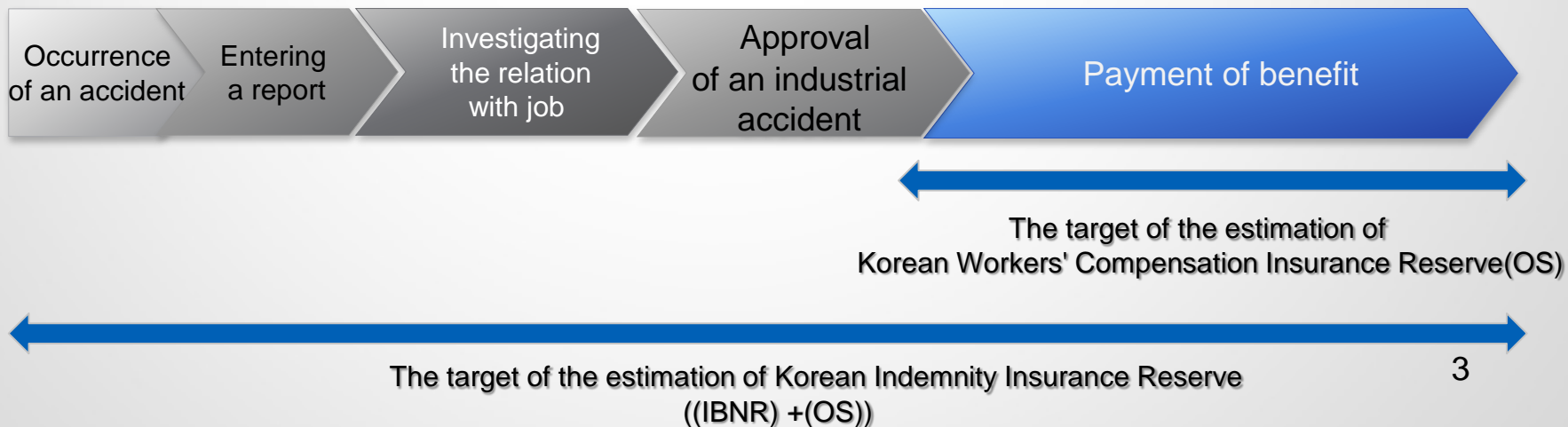
- To compare models for the estimation of loss reserves between a cash basis and an accrual basis
- To estimate the loss reserves of Korean Workers' Compensation Insurance, using the estimation method on an accrual basis

# 1. The research purposes

## (1) Methodological Background



< Fig. 1 > The process of the payment

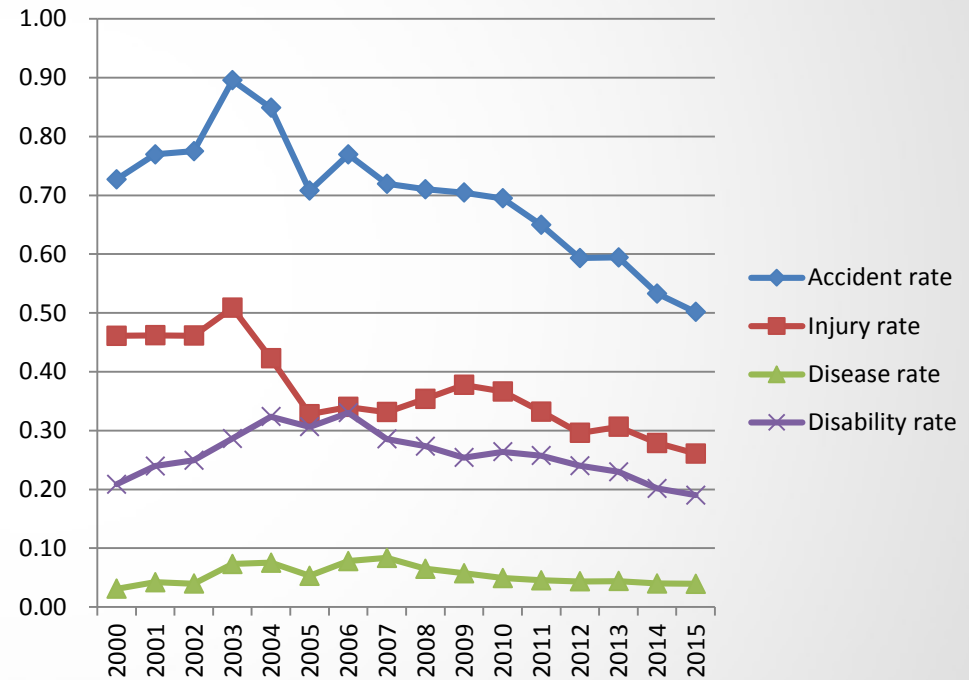


# 1. The research purposes

## Risk of underestimation without IBNR Losses

- Implementation of a Pension System
- The Aging Trend
- Operation of an Additional Medical Care System after the Completion of Recuperation
- Increase of Recipients with Job-Related Diseases who get medical care for a Long time

< Fig. 2 > The Trend of Accident rates



# 1. The research purposes

## (2) Social Background

- The introduction of accounting standards of IFRS4 in 2011, criteria for the recognition of debt changed from cash basis to accrual basis.  
=> Government Employees Pension, Military pension

### <National Accounting Standards>

#### Insurance Business

: “Insurance Business”  
calculates debt on an  
accrual basis

=> Automobile Insurance  
=> Life Insurance

#### Social Insurance

: “Social Insurance”  
calculates debt (amount  
of benefit payment for the  
next year) on a cash basis

=> Workers' Compensation  
Insurance

# 1. The research purposes

## (3) Institutional Background

- The pension benefit shows the scale of about 44% as of 2014.
- The scale of the reserves accumulated now about three times of mandatory reserve regulations.
- But pay-as-you-go system causes an issue of unfairness between the present generation business owners and the future generation business owners.

<Fig. 3> Trend of Benefit



## 2. Loss Reserve Models

### (1) Loss reserve Model - on a cash basis

#### 1. Estimation of the Future Population

- The number of Future Population
- The number of Economically Active Population
- The number of Workers to which WCI applies

#### 2. Estimation of the Benefit Recipients

- The number of New Benefit Recipients
- The number of Continuous Benefit Recipients

#### 3. Estimation of the Benefit Amount

- Reflecting the Growth rate of Wage or Inflation rate

# 2. Loss Reserve Models

## (2) Loss reserve Model - on an accrual basis

### 1. IFRS4 Phase(2011)

- (1) Chain Ladder Method(Paid Loss Development Method)
- (2) Average Payment Method
- (3) Bornhuetter-Ferguson Method

### 2. IFRS17 Phase(2021)

- (1) Mack Model
- (2) SCLM Model(Stochastic Chain Ladder Method)
- (3) Bootstrap Mack's Model



# 3. Overseas Case

<Table1. Comparison of Overseas Case>

	Accounting standards	Methods
Canada / Australia	Accrual Basis	It includes IBNR in calculating the reserve fund of Workers' Compensation Insurance
United States	Accrual Basis	(1) Public insurance (2) Private insurance => The reserve fund is calculated including IBNR by accrual basis for both
Japan	Cash Basis Model	(1) Public insurance => Mixed Method · Short-term benefit follows the pay-as-you-go system · Long-term pension benefit follows the accumulative method

# 4. The Results of the Analysis

## 1. Data

- Medical care expenses were analyzed for data protection.
- When workers recuperate themselves for job-related injuries or diseases for more than four days, the medical care expenses are paid to medical institutions until they recover themselves.
- As for the period of recuperation, a majority of people on medical care benefits for less than six months and more than 10 years account for about 10% of those on medical care benefits.

=> Most of them are patients with pulmonary diseases that occurred while working in the mining industry like coal mining in the 1960s through the 1970s

# 4. The Results of the Analysis

## 2. Methodology

- The medical care expenses paid by the company from 1998 through 2015 were used and inverse-estimated from 1964 through 1997 when no data were built up.
- The life table of disability pensioners was used in the tail part.
- PLDM, BFM and CAPE COD M were used by on an accrual basis.

# 4. The Results of the Analysis

## 3. Results(1)

- As a result of the estimation with on a cash basis, about 780 billion won is needed, and about 13.3 trillion won, in that with on an accrual basis, which is a difference of 17 times.

	1	2	3	4	5
FYD-3	P11	P12	P13	P14	E15
FYD-2	P21	P22	P23	E24	E25
FYD-1	P31	P32	E33	E34	E35
FYD	P41	E42	E43	E44	E45

# 4. The Results of the Analysis

<Table 2. PLDM Results(1964~2015)>

**(million won)**

Occurrence Year of the Accident	Paid Loss	Ultimate loss ratio	Ultimate losses	Indicated loss reserve
	(1)	(2)	(3) = (1) x (2)	(4) = (3) - (1)
2010	561,392	2.135	1,198,340	636,948
2011	525,794	2.198	1,155,886	630,092
2012	504,233	2.282	1,150,750	646,517
2013	505,475	2.409	1,217,751	712,276
2014	447,753	2.663	1,192,213	744,460
2015	249,378	4.773	1,190,227	940,849
<b>Sum</b>	<b>15,150,697</b>		<b>28,455,315</b>	<b>13,304,618</b>

# 4. The Results of the Analysis

## 3. Results(2)

- The difference between the estimated value and the actual value on the cash basis and the accrual basis, the difference was 0.3% to 6% from the actual value on an accrual basis, and 12% to 16%.
- This shows that the estimation with on an accrual basis was more accurate.

Year	Actual Value (Medical Care)	Estimated Value (Accrual Basis)	Gap	Estimated Value (Cash Basis)	Gap
2013	7,233	7,674	6.1%	8,109	12.1%
2014	7,406	7,800	5.3%	8,572	15.7%
2015	7,833	7,858	0.3%	9,025	15.2%

# 4. The Results of the Analysis

## 3. Results(3)

- As for the difference between the estimated value and the actual value on the accrual models, the difference was 0.9%, followed by 6% in PLDM and 10% in Cape Cod M.
- This shows that BFM technique using progress tendency and loss ratio together is the most appropriate for the Korean Workers' Compensation Insurance.

# 4. The Results of the Analysis

<Table 3. Comparison of the Ultimate losses(1986~2015)>

(million won)

Occurrence Year of the Accident	PLDM	BFM	Cape-cod
1986	376,073	307,104	313,284
1987	279,318	244,242	251,962
1988	319,603	275,114	283,931
1989	364,437	309,051	319,129
1990	412,164	350,315	362,609
	•		
	•		
	•		
2010	1,198,340	1,259,167	1,368,331
2011	1,155,886	1,242,666	1,354,819
2012	1,150,750	1,255,945	1,373,548
2013	1,217,751	1,294,945	1,418,456
2014	1,192,213	1,337,166	1,476,313
2015	1,190,227	1,448,064	1,635,596
<b>Sum</b>	<b>26,810,842</b>	<b>26,098,404</b>	<b>28,012,161</b>



# Thank You

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## FATCA and the Republic of Korea

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### Abstract

This article analyzes the intergovernmental agreement between the United States and the Republic of Korea focusing on the Foreign Account Tax Compliance Act. The agreement has impacted the tax reporting obligations to both Korean nationals living in the United States and the U.S. citizens and corporations in Korea. This article examines the changes of the Korean legal framework, prospective anti-money laundering laws, and the impacts on the Korean inheritance law. Also, several hypotheticals are introduced for the tax amount computations particularly in cases related to passive foreign investment firms.

### INTRODUCTION

The Republic of Korea (South Korea)<sup>1</sup> and the United States of America entered into Model 1 Intergovernmental Agreement<sup>2</sup> (IGA) which took an effective date on June 10, 2015.<sup>3</sup> The bilateral FATCA agreement signifies mutual commitment of two countries to enhance the effectiveness of information exchange.<sup>4</sup>

When the Internal Revenue Service announced FATCA policy, Korea has been integrating compliance requirements to the domestic law. Prior to the IGA formulation, Korea newly established the Anti-money laundering/Know Your Client anti-avoidance laws, and designated June as “the month for reporting accounts in the overseas”.<sup>5</sup> Korea did not oppose to the implementation automatic information exchange under the FATCA compliance. FATCA was perceived as a momentum to strengthen the AML and KYC due diligence procedures in Korea. Immediately after the FATCA agreement in 2013, offshore accounts held by the Korean citizens were extensively investigated.<sup>6</sup> The bilateral FATCA agreement states that the reporting financial institutions in Korea should “confirm the reasonableness” of self-certification with new individual accounts including “any documentation collected pursuant to AML/KYC Procedures.” For purposes of determining whether the account holder is a Passive NFFE, the Reporting Korean

<sup>1</sup> The Republic of Korea is usually called South Korea and The Democratic Republic of Korea is North Korea. See Central Intelligence Agency, The World Factbook, <https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html>

<sup>2</sup> The Treasury maintains a list of jurisdictions treated as having an IGA in effect at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx> accessed September 2, 2015.

<sup>3</sup> U.S. Treasury, AGREEMENT BETWEEN THE GOVERNMENT OF THE REPUBLIC OF KOREA AND THE GOVERNMENT OF THE UNITED STATES OF AMERICA TO IMPROVE INTERNATIONAL TAX COMPLIANCE, June 10, 2015. (here after, AGREEMENT) <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-South%20Korea-6-10-2015.pdf>

<sup>4</sup> National Tax Law Information System, Korean Government Document No. 15976, 2015.

<sup>5</sup> National Tax Service, *Haewe shingo (June as the Month of Reporting Accounts Held in Overseas)*, [www.nts.go.kr/wtsnts\\_skin/board\\_skin/mdl/mdlFileDownload.asp](http://www.nts.go.kr/wtsnts_skin/board_skin/mdl/mdlFileDownload.asp) (Kr).

<sup>6</sup> Ministry of Strategy and Finance, International Tax Law, Data Protection Law, <http://www.mosf.go.kr/law/law02b.jsp>

Financial Institution “must obtain a self-certification” on an IRS Form W-8 or W-9 from the account holder.<sup>7</sup>

Model 1 IGAs establish local information reporting regimes pursuant to which FFIs that are subject to the IGA report FATCA-relevant information to the local taxing authorities. An FFI that is subject to a Model 1 IGA and that is required to report FATCA-relevant information to the partner-country taxing authority will not need to enter into an FFI Agreement, but will be required to register with the IRS and obtain a GIIN.<sup>8</sup> For documentation of accounts maintained as of June 30, 2014, the U.S. Financial Institutions are “to obtain and report the Korean TIN of each account holder,” and the Reporting Korean Financial Institutions “to obtain and report with the U.S. TIN.”<sup>9</sup>

Pursuant to the Act on the Immigration and Legal Status of Overseas Koreans Article 2, “a Korean national residing abroad in whose case the total period of having a residence in the Republic of Korea from two years before the end of the relevant year are subject to report.”<sup>10</sup> For those who had failed to report overseas accounts, the National Tax Statistics has been disclosing a roll list of “high and habitually delinquent taxpayers” with the name, age, and delinquent tax amount in the homepage.<sup>11</sup>

Penalty for unreported or under-reported amount is based on the tax amount and the percentage of the excess amount.<sup>12</sup>

Below 200 million	corresponding amount	× 4% (3%)
Over 200 million	80,000,000 + excess amount of 200 m	× 7%
Below 5 billion	(60 million + excess amount of 200 m	× 6%)
Over 5 billion	240 million + excess amount of 5 billion	× 10%
	(240 million + excess amount of 5 billion	50 × 9%)

The National Tax Service (NTS) in Korea also announced that it has begun the preparation for FATCA compliance identifying accounts related to depository account with a balance of \$50,000 or less, review procedures for preexisting “lower value” individual accounts with a balance or value as of June 30, 2014.<sup>13</sup>

## SELECTED LEGAL FRAMEWORK

The immediate impact of the IGA Model I in Korea has been dynamic and efficient. Changes in legal framework related to information exchange have occurred. Since the National Tax Service in Korea has been aiming at transparency, the use of real name for financial institution adopted in 1996 functioned as the basis for anti-avoidance and self-certification. Real name disclosure policy means that the name of nominal owner and the actual owner of an account have to be identical, both are subject to reporting. If the account has joint owners, all of the owners are subject to

<sup>7</sup> U.S. Treasury, AGREEMENT, ANNEX I, 2015, p. 4.

<sup>8</sup> <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx>

<sup>9</sup> U.S. Treasury, AGREEMENT, ANNEX I, 2015, p.15.

<sup>10</sup> Act on the Immigration and Legal Status of Overseas Koreans Article 2

<sup>11</sup> National Tax Statistics, Article 85 (5) Publication of Roll of High and Habitually Delinquent Taxpayers, [http://stats.nts.go.kr/national/major\\_detail.asp?year=2015&catecode=A02011](http://stats.nts.go.kr/national/major_detail.asp?year=2015&catecode=A02011)

<sup>12</sup> National Tax Service, HAEWAE GUMYUNG KYAEJAW SHINGO JAEDO (FOREIGN FINANCIAL ACCOUNTING REPORTING) June, 2015.

<sup>13</sup> National Tax Service, HANMI SAEGUM SANGSHIK (TAX KNOWLEDGE IN KOREA AND IN THE U.S.) March 2015, <https://www.nts.go.kr/inc/download.asp p. 95>, (Kr.).

reporting.<sup>14</sup> Beginning in 2010, Korea went through changes in related national tax laws and launched on a nationwide campaign by declaring June as a month for tax compliance month especially for Korean nationals having banking accounts in overseas.

Existing laws have been extensively revised and new clauses are inserted since 2013. Data protection law, ethnic-Koreans related law, and privacy law. Ministry of Strategy and Finance announced 2015 tax reform proposals, aimed at the foundation for an advanced taxation system. Against anti-avoidance and for income deduction scheme, “cash-based receipt” policy was implemented in 2004 under Special Tax Treatment Control Act Article 126 (3).<sup>15</sup>

Major changes related to information exchange were made according to Adjustment of International Taxes Act Article 31 and Article 49. Article 31 relates to Exchange of Tax and Financial Information, and Article 49 relates to Report on Overseas Financial Account.<sup>16</sup>

Article 31 on Exchange of Tax and Financial Information includes

- (1) Obtaining tax information required for the imposition and collection of taxes, and review of tax appeals under the Real Name Financial Transactions and Confidentiality <Amended by Act No. 10410, Dec. 27, 2010>
- (2) When the competent authority demands financial information, under Article 36 of Adjustment of International Taxes Act, the filed information will be kept confidential except for the cases listed in the Article 81-13 of the Framework Act on National Taxes
- (3) Based on the principle of reciprocity under a tax treaty, a competent authority may request the head of a financial company to provide financial information, Article 4 of the Act on Real Name Financial Transactions and Confidentiality. <Newly Inserted by Act No. 11606, Jan. 1, 2013; Act No. 12164, Jan. 1, 2014>
- (4) No tax payer unreasonably obstruct or delay the exchange of tax or financial information. <Newly Inserted by Act No. 10410, Dec. 27, 2010; Act No. 11606, Jan. 1, 2013>
- (5) Financial institutions offering financial information when a taxpayer is in violation of paragraph Article 31 (2) or (3). <Amended by Act No. 10410, Dec. 27, 2010; Act No. 10854, Jul. 14, 2011; Act No. 11606, Jan. 1, 2013>
- (6) Report on learned divulged financial information <Amended by Act No. 10410, Dec. 27, 2010; Act No. 11606, Jan. 1, 2013>
- (7) Article 31 (7) relates to FATCA U.S. indicia certification (Amended by Act No. 12849, Newly inserted on Dec. 23, 2014)<sup>17</sup>

<sup>14</sup> National Tax Service, HAEWAE GUMYUNG KYAEJAW SHINGO JAEDO (FOREIGN FINANCIAL ACCOUNTING REPORTING), Document 11-1210000 -000451-14, 2014, 69-70.

<sup>15</sup> National Tax Service, <http://www.taxsave.go.kr>, <http://www.yesone.go.kr>

<sup>16</sup> Korean Legislation Research Institute, *The Statutes of Republic of Korea*, [http://elaw.klri.re.kr/eng\\_mobile/viewer.do?hseq=31814&type=new&key=Enforcement Date 01. Jan, 2015, Act No.12845, 23. Dec. 2014..](http://elaw.klri.re.kr/eng_mobile/viewer.do?hseq=31814&type=new&key=Enforcement Date 01. Jan, 2015, Act No.12845, 23. Dec. 2014..)

<sup>17</sup> Article 31 (7) specifies the U.S. Indicia: 1. Individual’s name, address, tax identification number, and other items indicated in tax treaties, 2. Name of the corporation, address, all relevant information related to identity confirmation including a) The account holder’s nationality or residence status, b) The account holder’s residence address and mailing address, c) The account holder’s telephone number(s) currently on file with the Reporting Korean Financial Institution.

(8) Limitation on the offer of financial information to a Contracting State on the principle of reciprocity. <Amended by Act No. 10410, Dec. 27, 2010; Act No. 11606, Jan. 1, 2013>

(9) The head of a financial company requesting the counter-party's financial transaction to submit data necessary to confirm personal information pursuant to the tax treaty.

#### Article 49 (Report on Overseas Financial Account)

(1) "Amount prescribed by Presidential Decree" in the part other than each subparagraph of Article 34 (1) of the Act means one billion won.

(2) "Financial company prescribed by Presidential Decree" in Article 34 (2) of the Act means any financial company, etc. or financial company, etc. similar thereto, among the financial companies, etc. established under any finance-related Acts or subordinate statutes of foreign countries. <Amended by Presidential Decree No. 24365, Feb. 15, 2013>

(3) Deleted. <by Presidential Decree No. 24365, Feb. 15, 2013>

(4) "Methods as prescribed by Presidential Decree" under Article 34 (5) 1 of the Act means the method of calculating the period of residence in accordance with Article 4 (1) and (2) of the Enforcement Decree of the Income Tax Act.

While the National Tax Service worked on amendment of tax information exchanges, another legal framework focused on Koreans living in overseas. Registration of Korean Nationals Residing Abroad Act, Overseas Korea Foundation Act, and Act on the Immigration and Legal Status of Overseas Koreans either have been updated pursuant to banking compliance.<sup>18</sup>

FATCA requirements made an immediate impact to Korean-Americans living in the United States. The U.S. citizens with Korean heritage and permanent residents living in the United States have been estimated 2,000,000.<sup>19</sup> A temporary capital withdrawal affected Koreans living in the United States. Some were using family members' name to transfer asset in Korea.<sup>20</sup> Some were diversifying the insurance savings program to make each financial account to be below USD 50,000. However, the aggregation of all financial accounts is subject to FATCA reporting.

For purposes of determining the aggregate balance or value of Financial Accounts held by a person to determine whether a Financial Account is a High Value Account, a Reporting Korean Financial Institution is also required, in the case of any Financial Accounts that a relationship manager knows, or has reason to know, are directly or indirectly owned, controlled, or established by the same person, to aggregate all such accounts.<sup>21</sup>

The high value account holders who are both residents in the U.S. and in Korea elected to abandon their US citizenships without realizing the tax consequences. Reporting requirements to the

<sup>18</sup> Korean Legislation Research Institute, [www.klri.re.kr/eng](http://www.klri.re.kr/eng)

<sup>19</sup> Ministry of Foreign Affairs, KOREANS IN NORTH AMERICA, Sept. 18, 2015.

<sup>20</sup> *New tax has some Korean Americans wondering: Is U.S. citizenship worth retaining?* March 25, 2014.

<sup>21</sup> U.S. Treasury, AGREEMENT, ANNEX I, 2015, p.17.

National Tax Service in 2013 were applied to both residents in Korea as well as Koreans in overseas who have foreign accounts.

#### THE INTERGOVERNMENTAL APPROACH

The determination of whether an entity is an FFI or an NFFE and the requirements with which an FFI must comply to avoid FATCA withholding depends on whether the entity is resident in or organized under the laws of a jurisdiction with which the United States has entered into an intergovernmental agreement (IGA).

In cases of small and limited scope financial institutions with low value accounts in banks like National Credit Union Federation of Korea, Korean Federation of Community Credit Cooperation, or MG Community Credit Union (*Saemaul Gumgo*), re-determination of the status of the account would become necessary.

A Korean Financial Institution satisfying the following requirements in order to qualify as Deemed-Compliant FFI small or limited scope financial institutions.

1. The Financial Institution is not an Investment Entity;
2. No Financial Account maintained by the Financial Institution or any Related Entity has a balance or value in excess of \$50,000, applying the rules set forth in Annex I for account aggregation and currency translation; and
3. The Financial Institution does not have more than \$50 million in assets on its balance sheet, and the Financial Institution and any Related Entities, taken together, do not have more than \$50 million in total assets on their consolidated or combined balance sheets.<sup>22</sup>

Re-determination of the status of account include whether “the Account Holder is: (i) a Specified U.S. Person; (ii) a Korean Financial Institution or other Partner Jurisdiction Financial Institution; (iii) a participating FFI, a deemed-compliant FFI, or an exempt beneficial owner, as those terms are defined in relevant U.S. Treasury Regulations; or (iv) an Active NFFE or Passive NFFE.”

Non-Reporting Korean Financial Institutions and as exempt beneficial owners for purposes of sections 1471 and 1472 of the U.S. Internal Revenue Code, other than with a Specified Insurance Company, Custodial Institution, or Depository Institution.

Income does not inure to the benefit of private persons if such persons are the intended beneficiaries of a governmental program, and the program activities are performed for the general public with respect to the common welfare or relate to the administration of some phase of government. Notwithstanding the foregoing, however, income is considered to inure to the benefit of private persons if the income is derived from the use of a governmental entity to conduct a commercial business, such as a commercial banking business, that provides financial services to private persons.<sup>23</sup>

A sample income tax computation of a dual tax status US person shows the increased total taxable income excluding the foreign tax credit since the dual status person is assumed to have spent more than 180 days in the United States.

An example of a U.S. and Korea dual status taxpayer income tax computation for FATCA is used based on a household with taxable income \$74,000 filed under Married Joint. Currency

<sup>22</sup> U.S. Treasury, AGREEMENT, Annex II, 2015, p.7.

<sup>23</sup> U.S. Treasury, AGREEMENT, Annex II, 2015, p.3.

translation was made \$1 = KRW1,100 Won.<sup>24</sup>

(1) Tax amount in Korea

Income from interest 15.4% \$74,000 x 15.4% = 169,400 Won (\$154)  
 Income from wage withholding 6.6% 7,260,000 Won (\$660)  
 Total income in Korea 12,100,000 Won (\$11,000)  
 Total tax amount 895,400 Won (\$814)

(2) Tax amount in the United States

Federal : 25% bracket -> \$10,358  
 California: 6% bracket -> \$2,468  
 Total tax amount: \$12,826

(3) Total income tax in Korea plus in the US 12,100,000(\$11,000)

Taxable Income: \$85,000  
 Federal : 25% bracket -> \$13,108  
 California: 8% bracket -> \$3,279 (6% bracket ends \$77,452)  
 Total income in Korea prior to US total taxable income \$16,387  
 Tax amount paid - Credit (\$814) = \$15,573

(4) Tax amount increased \$2,747 (= \$15,573 – \$12,826)

When reported and tax paid in Korea and also pay federal and state tax in the United States, difference between the US only reported ends in additional payment in the amount of \$2,747.<sup>25</sup>

PASSIVE FOREIGN INVESTMENT (PFIC)<sup>26</sup>and FATCA in KOREA

Passive foreign investment companies with respect to ownership and shareholder reporting obligations in FATCA regime are application of the US tax principles. The PFIC withholding will apply to all payments made by a FATCA-compliant FFI to any non-FATCA compliant FFI or any recalcitrant account holder.

The Korean notion of partnership may have to be adjusted to the U.S. PFIC rules for the purpose of FATCA reporting. In the U.S. PFIC, a US shareholder is subject to tax and interest charges on either the disposition of appreciated PFIC stock or on the receipt of an 'excess' distribution.<sup>21</sup>

The FATCA-compliant FFIs and PFIC may not be identical to the current pass-through entity<sup>27</sup> and pass-through' payments<sup>28</sup> in Korea. Filing requirement of pass-through entities in Korea are indicated in Special Limitation Tax Law revised on March 14, 2014.<sup>29</sup> The Special Limitation Tax Law<sup>30</sup> Article 135 under the Restriction of Special Taxation Act define pass-through entities

<sup>24</sup> Choi, Kim & Park, LLP. International Alert, 2015, p.6. See <http://www.ckpcpas.com/>

<sup>25</sup> Foreign tax credit can be used as a deduction if the 180 days condition is met.

<sup>26</sup> A PFIC is defined as any foreign corporation that meets either of the following two tests: (i) 75 per cent or more of its gross income for the taxable year is passive income, or (ii) the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 per cent.

<sup>27</sup> Private equity funds are regulated according to The Capital Markets Act, Article 249, Regulations on Foreign Exchange Transactions.

<sup>28</sup> IRC §1297(b)(1), IRC §1298(b)(2), (3).

<sup>29</sup> Form 104

<sup>30</sup> Ministry of Strategy and Finance, <http://www.mosf.go.kr/law/law02b.jsp>

in Korea in reference to Income Tax Law Article 87 related to common business place or taxation under the special taxation based on the like-kind entities.<sup>31</sup>

PFIC related laws include Income Taxation Article 4 (2) and Income Tax Law Article 17 (5) which state profits from investment trust. If a Korean entity is a pass-through in a U.S. owned company, individuals would be treated as collective investment organizations, and Report on overseas financial account Article 49 (6) will be applied to related entities.

The definition of PFIC within the U.S. tax principle can be related to “institution prescribed by Presidential Decree” in Korea.<sup>32</sup>

"Institution prescribed by Presidential Decree" in Article 34 (5) 5 of the Act means:

1. An institution related to financial investment business, collective investment organization, collective investment organization appraisal company, bond appraisal company under the Financial Investment Services and Capital Markets Act;
2. A financial holding company under the Financial Holding Companies Act,
3. A foreign exchange agency and foreign exchange brokerage company under the Foreign Exchange Transactions Act;
4. A credit information company under the Use and Protection of Credit Information Act.

For the FATCA reporting, any distribution received by the shareholder on PFIC stock in a taxable year that is greater than 125 per cent of the average annual distributions in the three preceding taxable years is an excess distribution.<sup>33</sup>

An FFI's pass-through percentage dividing the sum of the FFI's US assets held on each of the last four quarterly dates by the sum of the FFI's total assets held on. US assets for purpose of calculating an FFI's pass-through percentage are any assets that can give rise to a pass-through percentage. An FFI's equity or debt interest in a US corporation will be treated as a US asset. US assets also include interests in another FFI.<sup>34</sup>

Based on the definition of a collective investment vehicle, mutual funds or real estate investment trusts are classified as Passive Foreign Investment companies (PFIC) if they are not registered with the US Securities Exchange Commission (SEC). The taxation on the collective investment vehicles requires the submission of Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.<sup>35</sup>

The FATCA compliance requires all taxpayers that directly or indirectly own shares in a PFIC at any time during the year to report their ownership by filing a Form 8621. Beneficiaries of foreign estates and foreign non-grantor trusts that have not made a QEF or mark-to-market election with

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<sup>31</sup> FATCA and partnerships in Korea can be complex since in Korea, a foundation theory on partnership is based on collective notion. Differences in Limited Liability Partnership and Limited Liability Company are based on the notion of collectivity rather than economic over substance theory in the US notion of partnership.

<sup>32</sup> Amended by Presidential Decree No. 23600, Feb. 2, 2012.

<sup>33</sup> Aamir Mahboob, *FATCA and the Fat Cats: Foreign Passthrough Payments and the Blocker Problem*, TAX NOTES INTERNATIONAL, Sept. 16, 2013, 1133-1145, p.1145.

<sup>34</sup> *Id.*

<sup>35</sup> Treatment of Shareholders of Certain Passive Foreign Investment, Companies, 57 Fed. Reg. 11024 , 26 U.S.C. § 1295(b)(1) (2012) on QEF regime.



respect to PFIC stock held by the estate or non-grantor trust are exempt from filing Form 8621 for taxable years in which the beneficiary is not treated as receiving an excess distribution or gain with respect to the PFIC stock.<sup>36</sup> PFIC related forms to be submitted are Form 1042 for Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, Form 1042-S for Foreign Person's U.S. Source Income Subject to Withholding, and Form 8966 for FATCA Report. Form W-8BEN-E Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities), and Form 8938 for Statement of Specified Foreign Financial Assets have to be submitted to the IRS.

## CONCLUSION

Under the Model I FATCA agreement, self-certification, withholding logic, and reporting requirements are interpreted under the U.S. tax law principles. If the differences in the tax principles have to be reconciled between the U.S. tax law and the local tax law principles, international taxation theories can be a good tool for an analysis. Fundamental theories such as fact and circumstance, beneficiary ownership principle, substantial or economic ownership principle, or asset or income approach in PFIC would have to be interpreted from a common theoretical ground.

The 2015 bilateral FATCA agreement aims at “reporting U.S. financial institutions to obtain and report the Korean Tax Identification Number of each account holder of a Korean reportable account” by January 1, 2017. At the same time, Korea has met the timeline on January 1, 2017 “to obtain and report the U.S. TIN of each Specified U.S. Person.” The Agreement also indicated suspension of rules relating to recalcitrant accounts<sup>37</sup> that “the United States shall not require a Reporting Korean Financial Institution to withhold tax under section 1471 or 1472 of the U.S. Internal Revenue Code.” The bilateral FATCA agreement signed in June, 2015 has paved open channels of tax information exchange between the U.S. and Korea.

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<sup>36</sup> Treas. Reg. §1.1295-3(f)(1) (2013) on PFIC filing requirements, §1295(b)(2) on QEF election.

<sup>37</sup> U.S. Treasury, AGREEMENT, 2015, p.13.

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# **Bail-in in Korea and financial consumer protection issues** *– crossborder issue –*

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# Why consumer protection issues in bail-in?

- ▶ **G-SIBs**
  - Globally significantly important banks
- ▶ **Cross-border issue**
  - G-SIBs typically have multinational business across many countries
  - And Korean D-SIBs have their subsidiaries, branched, etc. overseas
- ▶ **Bail-in**
  - Pursued strategy than bail-out since the Lehman Brothers Holdings, Inc.
  - Creditors become responsible for their failed financial companies before taxpayers' money input

# What is Bail-in?

- ▶ **Statutory bail-in** is a resolution tool that enables the recapitalization of a failed financial firm through cancellation, conversion, transfer, or write-down of claims of equity holders and unsecured and uninsured creditors, to the extent necessary to absorb losses on its balance sheet.
- ▶ **Contractual bail-in** is another way to impose losses on private stakeholders to recapitalize a bank in resolution. Not all jurisdictions have adopted mandatory bail-in requirements.
- ▶ **Contingent convertible bonds (CoCos)** are hybrid capital securities that absorb losses when the capital of the issuer falls below a certain threshold. They carry two defining features: (1) a mechanism that specifies how losses will be absorbed (conversion into common equity or principal write-down) and (2) a trigger that activates this mechanism (often a given level of the common equity Tier 1 (CET1) ratio and sometimes a “point of nonviability trigger” (PONV) left at the discretion of the supervisor).
- ▶ **The scope of bail-in:** Bail-in-able claims must be clearly specified in legislation or contract. While some jurisdictions specify claims that cannot be bailed in, others provide general discretion to exclude on a case-by-case basis claims that will not be bailed in. Bail-in must respect the order of priorities of claims established in a given jurisdiction for bank liquidation, meaning that typically, equity must bear losses first, followed by subordinated debt.

<source: IMF, “Trade-offs in Bank Resolutions”, IMF Staff Discussion Note, SDN/18/02 (9 Feb. 2018)>

# Bail-in regime in Korea now developing

- ▶ Bail-in regime in Korea is now developing
  - Contingent convertible bonds (CoCo bonds) are actively being issued since 2013
  - Korean act has provisions for special restructuring financial companies
    - Act on the Structural Improvement of the Financial Industry (ASIFI)
  - However, some essential regimes recommended by FSB Key Attribute have not been introduced
    - No recovery plan and resolution plan
    - No statutory bail-in regime yet
    - No right of temporary stay

# Inevitable cross-border issues for G-SIBs resolution

- ▶ Korean authority (FSC) announced that it would introduce soon followings:
  - recovery plan and resolution plan
  - statutory bail-in regime
  - right of temporary stay
- ▶ Strategies and authorities in charge of implementing
  - single point of entry (SPE) and multiple points of entry (MPE)
  - Home authority vs host authority
- ▶ Cross-border context
  - For cross-border banks, recognition and enforcement of bail-in is achieved through statutory mechanisms (such as automatic mutual recognition within the European Union or specific powers to recognize and to give effect to bail-in by foreign resolution authorities) or through contractual approaches to recognition of resolution actions.  
<source: IMF, “Trade-offs in Bank Resolutions”, IMF Staff Discussion Note, SDN/18/02 (9 Feb. 2018)>

# SPE/MPE: explanation

## ▶ SPE

- Under the SPE approach, the home resolution authority of the apex holding company of the cross-border financial group resolves the holding company—typically using the bail-in power under its legal framework.
- Shareholders and eligible creditors of the holding company absorb losses of the entire group through a write-down or restructuring of their equity and/or debt claims against the apex entity.
- Capital freed up from this exercise is passed down to subsidiaries operating at a loss and used for their recapitalization and liquidity provision.

## ▶ MPE

- Under the MPE approach, home and relevant host authorities resolve nonviable parts of the financial group in separate proceedings using a range of resolution tools available to them in their respective jurisdictions.
- Resolution planning is expected to include ex ante agreement among home and key host jurisdictions on resolution strategies and the amount and location of LAC, in the context of CMGs and CoAgs.

← source: IMF, “Trade-offs in Bank Resolutions”, IMF Staff Discussion Note, SDN/18/02 (9 Feb. 2018)>

# A hypothetical case

- ▶ A G-SIB called a Parisbank has its headquarter in Paris. Parisbank consists of many multinational branches across borders. Among them there is a big active branch in Seoul.
- ▶ One day, Parisbank Seoul branch suffers lots of loss from failing in its swap position and it would default within a few days without any assistance from outside.
- ▶ The French and/or Korean authorities want to solve this situation without stopping its critical functions and with least impact on each country's market.



# Case: choosing between SPE or MPE strategy

- ▶ The authorities take consideration of the living will prepared in advance by Parisbank and begin to take necessary measures
  - Where the LAC (loss absorption capacity) is located in France, under a SPE strategy, the French resolution authority resolves directly Parisbank for its restructuring and recapitalization.
- ▶ Under SPE, to implement bail-in, the French authorities order loss absorption by debt instruments issued by Parisbank (headquarter).
  - Under SPE strategy, home authorities are in charge of bail-in.
  - The home authorities implements the resolution plan – conversion/write-down debt instruments by bail-in power, setting up a bridge institution to transfer assets and liabilities of Parisbank.

# Case: Bail-in implementation

- ▶ According to the bail-in strategy, after transferring essential assets, liabilities and business, the original Parisbank winds down. The new bridge institution is still doing the critical parts of banking business with least impact on the financial system and waiting for somebody to takeover it.
- ▶ *Let's suppose statutory/mandatory bail-in scheme has been adopted by both jurisdictions!*

# Case: home and host authority

- ▶ Potential issues
  - From difference in priority among creditors to bear loss from bail-in and in depositor preference, there might be conflicts between home and host authorities, as each jurisdiction has different domestic law about related legal issues
- ▶ Related legal issues can be like a scope of insured depositors, insured amounts, treatment (priority) of uncovered depositors, and recognition of other resolution authorities' measures, etc.
  - Broader scope and more money amount for the insured deposit the deposit insurance fund provides for deposit protection, better to the other unsecured creditors
  - Lower preference for uninsured depositor, better to the other unsecured/general creditors
  - Recognition of measures treating creditors unequally can be refused by other jurisdiction.

# Policies over deposit preference/creditor priority

## ▶ Korean rule

- **Host** state principle
  - Host state principle applies when all insurers operating in the country, regardless of where they are headquartered, are required to participate in the scheme
- senior liability > uninsured deposit liability, general liability

## ▶ EU rule (directive/regulation)

- **Home** state principle under EU Deposit Guarantee Scheme Directive (DGSD)
  - depositors at branches in a host state will be in principle covered by the scheme of the HOME state.
- As part of Banking Union, there is a Deposit Insurance Scheme (DIS) which would reduce the vulnerability of national DGS to large local shocks.

## ▶ US rule

- **Host** state principle
  - general depositors (whether insured or not) have priority over other unsecured creditors (12 U.S.C. §1821(d)(11)(A)(ii))
    - deposit liability > other general or senior liability > obligation subordinated to depositors or general creditors > obligation to shareholders or members
- <source: OECD, “Policyholder Protection Schemes: Selected Considerations”, OECD Working Papers on Finance, Insurance and Private Pensions, No. 31, OECD Publishing (2013)>

# Contractual bail-in: uncertainty

- ▶ In most APAC jurisdictions, authorities still lack statutory powers to bail in creditors, but public discussions on the design of such regimes are taking place in several markets.
- ▶ For the more, for Tier 2 contractual PONV securities, there is **uncertainty over the timing** of loss absorption, given **potential regulatory discretion over** the determination of the PONV. (Moody's)
  - For example, the securities may be forced to absorb losses before the PONV as a way for a bank to avoid bank-wide resolution. If regulators want to forestall a broad market disruption event, all banks within a system could be forced to trigger loss absorption at the same time.
- ▶ At the end of November 2017, APAC banks accounted for 50% of Basel III securities issued worldwide, in terms of size.

<source: Asian Banking & Finance, “Basel III contractual PONV securities will still dominate APAC banks”, (5 Feb. 2018); Moody’s investor services, Moody’s: Progress in Asia Pacific on bank resolution and bail-in varies across region (20 Nov. 2017)>

# Contractual bail-in: risk

- ▶ Contractual approaches to the stays and the write-down or conversion of instruments may enhance the efficiency of resolution in other jurisdictions
- ▶ However, contractual approaches also have limitations:
  - (i) a contractual approach in isolation may not achieve the level of legal certainty compared to the statutory frameworks consistent with KA 7.5.
  - (ii) to materially enhance the resolvability of a firm, a contractual approach needs to be widely adopted by the firm and its counterparties in relation to all relevant cross-border contracts.
  - (iii) if contractual provisions recognizing temporary stays on early termination rights or the exercise of bail-in powers are not included in all relevant cross-border contracts, there is a risk that similarly situated creditors may have different rights and be treated differently in resolution.

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

# Contractual bail-in: enhancing enforceability & investor protection

- ▶ Capital or debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity should include legally enforceable provisions recognizing bail-in by the relevant resolution authority if the entity enters resolution.
- ▶ **(a) Clear agreement**
  - Clearly agreed by the debt holder to be bound by the terms of a bail-in under the statutory powers of the relevant resolution regime
- ▶ **(b) Consistency with the statutory bail-in regime**
  - The contractual provisions should be drafted in a manner that is consistent with and supports the applicable statutory bail-in regime. For example, the contractual provisions should make it clear that the terms of the bail-in will be determined by the relevant resolution authority (→ appropriate disclosure).

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

# Contractual bail-in: enhancing enforceability & investor protection

## ▶ (c) Disclosure

- The consequences of a bail-in should be disclosed prominently to debt holders in accordance with applicable disclosure requirements under local law (the offering documents and any statements contained therein).
- In particular, applicable securities regulation is likely to require clear disclosure about the potential effect that a statutory bail-in under the home resolution regime could have on the value of the instrument and the claim of the debt-holder.

## ▶ (d) Enforceability under the local law

- Firms should be expected to be able to demonstrate to the relevant authorities in their home jurisdiction prior to issuing the instrument under foreign law that a statutory bail-in of the instrument by home authority will be enforceable as a result of the its contractual recognition provisions.

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>



# Int'l contractual frame for uniformity/recognition: ISDA protocol

- ▶ To aid contractually the cross-border enforceability of resolution actions, there is a widespread adoption of appropriate contractual language in the derivative market.
  - This is particularly relevant in the context of contractual agreements to stay or limit the exercise of early termination rights
- ▶ For OTC bilateral derivatives documented under the ISDA Master Agreement (1992 and 2002 versions), the ISDA (International Swaps and Derivatives Association) developed a Resolution Stay Protocol.
  - The Protocol contractually opts adhering parties into provisions within certain qualifying special resolution regimes that limit the exercise of termination rights.

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

# Limitation of bail-in: cross-border implementation

- ▶ Among jurisdictions which have statutory resolution regimes which impose a stay on termination rights in the event a bank is subject to resolution action in its jurisdiction.
  - For instance, Title II of the Dodd-Frank Act and the EU Bank Recovery and Resolution Directive have a temporary stay on termination
  - If the resolution is successful, then counterparties would face a creditworthy institution and no longer have the right to terminate their transactions.
- ▶ The problem is that US & EU statutory regimes don't typically contain provisions that recognize the resolution regimes of other jurisdictions.
  - This could potentially be a big problem for regulators trying to resolve a big globally active bank with multiple overseas subsidiaries.
  - Usually swap counterparties of a big banking group would likely be located in different jurisdictions and transacting under the laws of a variety of jurisdictions
- ▶ Buy-side firms are unable to voluntarily adopt the protocol due to fiduciary responsibilities to their clients.
  - By voluntarily giving up advantageous contractual rights, they potentially leave themselves open to lawsuits.
  - Therefore, FSB members have committed to encourage broader adoption of the protocol by imposing new regulations in their jurisdictions throughout 2015.

<source: ISDA, "Resolution Stay Protocol- Background">

# Cross-border implementation: equitable creditor treatment (1)

- ▶ Relevant domestic authorities should have legal capacities to recognize and enforce foreign resolution measure.
- ▶ Foreign measures are subject to clearly specified conditions relating, for example, to:
  - (i) equitable treatment of domestic creditors in the foreign resolution proceeding; and (ii) protection of local financial stability
- ▶ Grounds for refusing recognition of any foreign resolution proceeding and/or enforcing the foreign resolution measure should be clearly defined and generally limited to cases
  - Those cases for rejection of recognition can be where the foreign resolution proceeding or measure in question would contravene local public policy
  - For example, if the effects of the foreign resolution measure could result in inequitable treatment of domestic creditors as compared to third-country creditors with similar legal rights or the procedure does not adequately ensure due process.
- ▶ Recognition of foreign resolution proceedings should in principle not be contingent on reciprocity

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

# Cross-border implementation: equitable creditor treatment (2)

- ▶ The process for giving effect to foreign resolution measures should be guided by the principle of equitable treatment of creditors.
  - The equitable treatment of creditors provides a foundation for effective cross-border cooperation and for coordination of different resolution proceedings.
- ▶ Any perception that creditors may be discriminated against, whether based on their nationality, residence, or the location of their claim or other factors (and whether de facto or de jure), may affect authorities' incentives to cooperate in the implementation of an agreed resolution strategy and give rise to risk of litigation.
- ▶ What constitutes equitable treatment?
  - It may need to be determined on a case-by-case basis considering outcomes under different scenarios
  - For example, comparing treatment under foreign and domestic proceedings and considering treatment of similarly situated creditors across different legal entities of the same firm.

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

# Cross-border implementation: equitable creditor treatment (3)

- ▶ Automatic recognition within EU
  - EU BRRD: a framework for recognition and enforcement of resolution decisions within the EU and between EU Member States and third countries.
  - Within the EU
    - resolution measures taken by a resolution authority are automatically recognized and must be enforced by resolution authorities of other Member States.
- ▶ Recognition of **non-EU** resolution proceedings
  - decisions regarding the recognition of resolution proceedings of non-EU countries that concern groups
  - As regards both group resolution measures/decisions from non-EU countries in relation to institutions located in their territories, the BRRD provides that resolution authorities may refuse recognition on specified grounds
    - Among specified grounds, unequitable creditor treatment is included.
    - creditors located or payable in a Member State would not receive the same treatment as creditors of the non-EU country.

<source: FSB, “Principles for Cross-border Effectiveness of Resolution Actions”, (3 Nov. 2015)>

**Thank you!**