CROSS-BORDER BANK INSOLVENCY

EDITED BY

ROSA M. LASTRA

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Rosa M Lastra

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FOREWORD

by
C A E Goodhart

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However assiduously the authorities may try to prevent financial crises, by regulations and constraints on the operations of banks and other financial intermediaries, such crises are bound to recur. Greed, speculation, and even mass manias are part of human nature. Even those who think that they know better are tempted to go along for the ride, in the belief that they can get out before or near the top, the theory that a greater fool can be found in time.

So, the response to the dangers of financial crises, dramatically reinforced by recent happenings, has to be two-handed, involving improvements to crisis *resolution*, as well as enhancements for crisis prevention. Most of the emphasis, so far, has been put on revising and reforming crisis prevention. Much more needs to be done on reforming and improving crisis resolution. This latter is the focus of this welcome and needed book.

In truth, the measures available to the monetary authorities in most countries, with the partial exception of the United States, for handling the resolution of financial crises were woefully lacking. The central bank could inject liquidity into banks which were short of cash; but illiquidity normally goes hand in hand with fears about solvency, because otherwise the temporarily illiquid bank could borrow its way out of its liquidity problems in the (wholesale) financial markets. But there was no way that the authorities in most countries could deal with looming problems of insolvency/illiquidity until the bank, or systemic financial institution, was put into bankruptcy, when the general laws of insolvency, *lex generalis*, would apply. Various forms of prompt corrective action, to check a bank's downwards path before it was too late to avert massive losses, to prevent amplifying downwards spirals of asset prices from forced (fire sale) asset sales, to restart the good parts of such banks and ring-fence the bad parts, were just not available. The *lex generalis* of standard bankruptcy codes was horrendously slow and totally unsuited to the immediate need to halt a stampeding panic. In the circumstances there seemed often no alternative for resolving the crisis, apart from the use of taxpayer funds to support the financial system.

There must, surely, be better ways for trying to resolve such crisis. This book provides a major contribution to the search for such better methods of crisis resolution. A financial crisis occurs when a debtor cannot repay his debts as contracted and in full, a state of actual, or potential, bankruptcy. Under these circumstances what are the respective rights of the creditors, the debtors, and of the authorities themselves? This is a legal issue. One of the main purposes of the legal structure should, however, be to achieve an outcome that will maximize social welfare, and how that might be done is an economic issue. So those best placed to advise on crisis resolution will need to combine professional skills in law and economics. Beyond that they will need a deep knowledge and understanding of the complex and evolving institutional details of the financial system.

There are not that many experts in the world who have this combination of skills, but Rosa Lastra, the editor, has managed to get a large proportion of the best of these under one roof for the purpose of completing this book. I do not know all of them personally, but those whom I do know are at the very top of the tree. And before I leave personalities to one side, I must express my profound admiration for Rosa herself, not just her great scholarly qualities but also her exceptional energy and drive. This is the second book that she has been editing on issues relating to the financial crash, and in each she has multiple contributions, no less than eight chapters either alone or in conjunction here. How she combines this with bringing up a large family of school age children is beyond my imagining!

Let us, however, move on quickly from personalities to substance. The normal form of insolvency proceedings, *lex generalis*, is inappropriate for dealing with banking crises. Instead what is needed is a special resolution regime (SRR), or *lex specialis*, which is to be applied to an appropriately chosen set of systemically important financial intermediaries (SIFIs). Let us put on one side the question of what distinguishes a SIFI from a non-SIFI (partly because no one else has yet really faced up to this question). Be that as it may, the case for establishing such a *lex specialis*, for all banks and SIFIs, is cogently made at several points in this book.

This argument is being, perhaps already has been, won. The authors of this book are influential as well as expert and cogent. But a remaining problem is that the SRRs, the *leges speciales*, are all being brought through independently under each country's national laws. And such laws are not only *not* harmonized; they are sharply distinct in certain key respects, for example in treating foreign entities in bankruptcy as a separate entity (territoriality) or a single entity (universality) and in their application of laws of offset. This would not matter, of course, if all banks and SIFIs operated only in their home country, but instead the set of SIFIs overlaps almost one for one with the set of cross-border financial intermediaries.

I have not yet given up hope for using this window of opportunity, when most of those involved can see the need for introducing or reforming their own SRR, to get a worldwide harmonized SRR, *lex specialis*, for SIFIs. But getting senior lawyers and judges, let alone politicians, in each country to accept changes to their own legal structures in the wider interest of global unification and comity is almost certainly a losing battle. Instead, the authors here, notably Eva Hüpkes, propose the more pragmatic course of 'modified universalism'; that is to say that one deals with each cross-border SIFI on a case-by-case basis, applying a universal approach where one can, and using 'living wills' ('funeral plans') for pre-planning how to proceed in a crisis in those parts of the SIFI where universalism cannot be applied.

One problem facing anyone trying to produce a book on financial regulation at this juncture is the sheer pace of developments. In the last few months alone there has been the incoming UK government's refashioning of the structure of the regulatory bodies (June 2010), eviscerating the FSA, and the Dodd–Frank Act in the USA (July 2010). In the next few months we expect decisions at the BCBS (Basel Committee on Banking Supervision) and FSB (Financial Stability Board) on what proposals for international crisis prevention to put to the G-20 Summit Meeting in Seoul in November 2010. A year ago some commentators were bemoaning a loss of momentum in pushing forward financial regulation reform; that was always nonsense. The greater problem is keeping up with events. In preparing a book like this, a punctuation mark, a line in time, has to be drawn somewhere. Whenever it is drawn, events and developments will soon make a small part of the institutional detail out of date.

But the much more important issues relate to the larger questions of the underlying approach to crisis resolution. On this front the book gives first-class value; it provides an important signpost along the route to improve methods of crisis resolution. I recommend it wholeheartedly to all readers.

London, 1 September 2010

FOREWORD

by

Sean Hagan
General Counsel and Director of the Legal Department,
International Monetary Fund

This book makes a timely and important contribution to the ongoing debate regarding the resolution of complex, internationally active financial institutions. The global financial crisis brought into sharp relief not only the inadequacy of many domestic bank insolvency regimes but also the complete absence of any coherent international resolution framework. During the crisis, gaps in the domestic and international legal architecture impeded the orderly resolution of financial firms, fuelling concerns regarding moral hazard. Lacking appropriate resolution mechanisms, competent authorities and governments were frequently faced with two equally undesirable options: either to initiate an expensive public bail-out or, alternatively, allow for a disorderly liquidation of a systemically important firm, with destructive consequences for the financial system and wider economy.

As is described by a number of the contributors to this book, many jurisdictions have begun to take important steps to reform their domestic laws. There is growing recognition that the general insolvency framework applicable to corporations does not adequately address the systemic consequences of a distressed financial institution and that, accordingly, bank-specific resolution frameworks are necessary. Moreover, steps are being taken to ensure that these frameworks are sufficiently robust to enable resolution authorities to act swiftly and in a manner that enables them to preserve the critical functions of the institution and avoid contagion.

Notwithstanding these improvements, it has become clear that even the most sophisticated domestic resolution system will not be effective unless progress is also made in developing resolution frameworks that apply on a cross-border basis. Financial globalization has led to the emergence of a large number of international financial groups. These institutions rely on a global network of branches and subsidiaries, operating across borders, in multiple currencies and time zones. The legal form of these institutions may not reflect the operational functions of a group. For example, the group may organize itself with centralized functions in the area of capital or liquidity management in the home office, meaning that the subsidiaries, while legally separate, are not autonomous.

However, while these institutions operate globally, the mechanisms that are in place to handle their distress or failure are local: the resolution of these institutions is subject to different national frameworks, and, accordingly, national authorities must proactively coordinate their actions to avoid a piecemeal approach. Unfortunately, and as is well described in this book, pro-active coordination is presently hampered by the tendency of a number of jurisdictions to adopt a 'territorial' rather than a 'universal' approach to bank resolution.

The costs of such a fragmented approach have become painfully clear. Uncoordinated actions may actually cause or hasten the failure of a financial group. This may occur when, during a period of stress, the host jurisdiction requires a transfer of assets to cover the liabilities of the branch, thereby destabilizing the bank in the home jurisdiction. Moreover, once it becomes clear that some form of regulatory intervention is necessary, efforts by the home jurisdiction to preserve some continuity of operations (through, for example, purchase and assumption transactions) may be frustrated if the host jurisdiction refuses to allow for, or recognize, the transfer and, instead, focuses exclusively on the liquidation of the branch. The ensuing collapse will not only destroy value but may result in contagion and financial instability in both jurisdictions. Even where the host jurisdiction recognizes the potential benefits of a coordinated approach, the present uncertainties surrounding how such coordination would take place may prevent it from happening in a sufficiently timely fashion.

In contemplating a way forward, it is natural for lawyers to think in terms of the establishment of an international legal and institutional framework that would ensure that future resolutions would take place on a truly global basis, where a single jurisdiction would exercise control over the resolution process. As is recognized by Professor Lastra in Chapter 7 of this book, such a solution is unlikely to be implemented in the short term. Apart from the legal complexity, there is no evidence that major jurisdictions hosting branches of large financial groups will be willing to confer such authority to the home jurisdiction. In light of these difficulties, there has been some discussion for a very different approach: one that would effectively adopt the 'territorial' approach in which financial institutions would be de-globalized; namely, where they would be separately structured for capital, liquidity, assets, and operations within each national jurisdiction. While such an approach would address costs associated with the uncoordinated resolution of a transnational institution, it would create other costs: it would not only eliminate the efficiencies created by cross-border integration, but would also restrict cross-border capital flows, particularly to the detriment of developing countries.

Given the difficulty posed by the above approaches, there is considerable focus on a 'middle approach' that would seek to enhance cross-border coordination in a manner that did not involve a surrender of authority by national authorities. As a means of trying to give some further content to such an approach, the staff of the International Monetary Fund recently developed a proposal that is described in a paper that is attached as an Appendix to this book. In essence, the proposed approach envisages establishing an enhanced coordination framework that would be put in place through a non-binding understanding among those countries that are in a position to adhere to its elements, which would include the following. First, domestic laws would be modified so as to require national authorities to coordinate with national jurisdictions, but only to the extent that, in the judgment of the national authority in question, such coordination would be consistent with the interests of creditors and domestic financial stability. Second, countries would ensure that their domestic laws and institutional capacity conform to 'core coordination standards', so as to ensure that there is a minimum level of harmonization regarding their domestic bank insolvency regimes. Third, since public funding in the resolution process may be necessary (if only on a temporary basis), there would need to be agreement on principles that set forth the criteria and parameters that guide the burden sharing process. Finally, given the need for rapid action, it would be important that *ex ante* agreement be reached on the coordination procedures that would be applicable among the members that are operating within the enhanced coordination framework. It is recognized, that, at least at the outset, only a limited number of members would be in a position to adhere to this framework. However, to the extent that these countries include the world's principal financial centres, such cooperation would represent a major step forward. Other countries could participate when they are in a position to do so.

Of course, a number of difficult operational issues will need to be addressed in order for the above proposal to be implemented. Fortunately, some of these issues are addressed in the contributions to this book. For example, in Chapter 8, Professor Westbrook identifies approaches that have been implemented in the context of cross-border corporate insolvency (particularly with respect to the development of procedural frameworks) that are also of relevance in the context of financial institutions. More generally, this book provides comprehensive coverage of all of the challenging legal and operational issues that are relevant to bank insolvency. The book's diverse authorship—bringing together experts from academia, private practice, and international organizations—ensures that the key issues are given a rich and thorough treatment. For practitioners and policy makers alike, the insight offered in these pages should prove most instructive.

Washington DC, 21 September 2010

PREFACE

Insolvency procedures have traditionally been nationally based and entity-centric. The demise of national frontiers in today's global financial markets and the increasing number of financial conglomerates and complex financial groups show the limitations and inadequacies of these principles to deal with cross-border bank insolvency. Financial institutions may claim to be global when they are alive; they become national when they are dead. The bankruptcy of Lehman Brothers is a clear example of this dichotomy between global markets and national regulation, supervision, and resolution. In the aftermath of Lehman, no one wishes another 'chaotic' resolution. The alternative, i.e. a 'bail-out' package, is equally unpalatable. There is, however, a viable solution between chaos and bail-out and that is an orderly resolution. Such a solution poses innumerable challenges and countless difficulties. However, as Einstein famously remarked: 'We can't solve problems by using the same kind of thinking we used when we created them.'

Bank insolvency laws vary widely across countries. They differ in various ways. Given the intimate link between insolvency law and other areas of commercial law, different legal traditions (civil law, common law) have given rise to different insolvency rules. Some laws are more favourable to creditors, while others are more pro-debtor. The choice between *lex generalis* and *lex specialis* also leads to different approaches to bank insolvency.

If at the national level, bank crisis management is complex (with the involvement of several authorities and the interests of many stakeholders), this complexity is far greater in the case of cross-border bank crisis management. In any financial crisis, it is necessary to have a clear and predictable legal framework in place to govern how a financial institution would be reorganized or liquidated in an orderly fashion so as not to undermine financial stability. However, such a framework has so far been lacking at the international level.

Cross-border banking and finance has expanded significantly over the last decades. Cross-border banking supervision—mostly via the soft law standards developed by the Basel Committee of Banking Supervision and other international standard setters—has resulted in some considerable progress, notably via the principle of 'consolidated supervision'. But the field of cross-border bank insolvency is still in its infant stages. While we have some conflict of laws or private international law rules (an example of which is the Directive 2001/24/EC on the reorganization and winding-up of credit institutions), we do not yet have international substantive harmonized standards for the insolvency of cross-border banks and financial institutions, nor do we have 'consolidated resolution' aligned with the supervisory process. We need adequate harmonization of bank insolvency rules and regimes, as well as effective coordination between insolvency proceedings involving different jurisdictions.

In response to the financial crisis 2007–9, a number of international initiatives—from the International Monetary Fund, the Financial Stability Board, and the Basel Committee of Banking Supervision (BCBS) Cross-Border Bank Resolution Group, as well as the important work of UNCITRAL (the United Nations Commission on International Trade Law)—are paving the way for the adoption of soft law standards in this field (the IMF and BCBS 2010 documents surveyed in this book can be considered seeds of soft law in this area). These initiatives respond to calls from the G-20 leaders who, at their London Summit in April 2009, agreed 'to support continued efforts by the International Monetary Fund, the Financial Stability Board, the World Bank, and the Basel Committee of Banking Supervision to develop an international framework for cross-border bank resolution arrangements'.

Rule harmonization in this area (first via soft law, then via hard law) is likely to be a lengthy and protracted process, limited in its aspirations by political necessities and legal constraints. These difficulties notwithstanding, we must continue to do progress to advance towards better resolution frameworks. We must reach an international agreement on the definition and understanding of bank insolvency, similar to the international agreement (soft law) on bank capital. At the European level we need to adopt a bank insolvency framework consistent with the rules of state aid and with the rules on emergency liquidity assistance and deposit insurance, as well as with the other related EU Directives and regulations in the fields of insolvency, prudential supervision and crisis management.

In the absence of formal law, soft law fills the vacuum. In the long run, however, we need an international convention or treaty on cross-border bank insolvency.

The book analyses and discusses the various legal and policy issues associated with cross-border bank insolvency. Quite often, financial law specialists lack in-depth expertise on insolvency law and insolvency law specialists lack in-depth expertise on financial law. This book aims to bridge these two areas of law. The book also combines legal and economic considerations, and relies on a methodology, often characterized as multi-level governance, that considers the existence of overlapping jurisdiction and relies on an inter-jurisdictional approach, combining the national, the regional (European), and the international dimensions, in order to understand this complex subject.

The book is divided into sixteen chapters and has two forewords, one written by Professor Charles Goodhart and the other one by Sean Hagan, General Counsel of the IMF. The first chapter, co-authored by the editor and by Professor Geoffrey Wood, provides an introduction to bank insolvency in the context of bank crisis management, with special attention to the lender of last resort role of the central bank, deposit insurance schemes, government rescue packages, and systemic risk considerations. Chapter 2, co-authored by the editor and by Professor Andrew Campbell, deals with the definition of bank insolvency, the case for *lex specialis*, and the types of insolvency proceedings. Chapter 3, co-authored by the editor and by Michael Krimminger (adviser to the FDIC chairwoman and co-chair of the Cross Border Resolution Group of the Basel Committee of Banking Supervision), considers early intervention and prompt corrective action; the pre-insolvency phase is crucial in banking. Chapter 4, co-authored by the editor and Charles Proctor, examines the multiple actors in the process, in particular supervisors and regulators, administrators and courts of justice. Chapter 5, written by Eva Hüpkes (currently with the BIS and co-chair of the Cross-Border Resolution Group of the Basel Committee of Banking Supervision or BCBS), analyses the allocation of the costs of failure resolution, the thorny issue of who should bear the losses and who should not, considering the interests of shareholders, creditors, management, and taxpayers. Chapter 6, written by Georgina Peters, covers developments in the EU, in particular Directive 2001/24/EC on the reorganization and winding-up of credit institutions and the proposals for reform. Chapter 7, written by the editor (Professor Lastra), deals with the international law principles that apply in the context of cross-border bank insolvency (territoriality, universality, as well as a 'middle-ground' approach). Chapter 8, written by Professor Jay Westbrook, examines what cross-border bank insolvency can learn from corporate insolvency and the elements of coordination in international corporate insolvencies. Chapter 9 deals with international developments and is co-authored by Look Chan Ho (who wrote the part on UNCITRAL) and by the editor (covering other international initiatives, notably the work of the IMF and the BCBS). Chapter 10, co-authored by Thomas Huertas (Banking Sector Director at the UK Financial Services Authority) and by the editor, considers the 'perimeter issue', i.e. to what extent *lex specialis* should be extended to systemically significant financial institutions, and the need to move away from too-big-to-fail. Chapter 11, authored by Michael Krimminger, explores the special problems of the insolvency financial conglomerates, and elaborates further on the need to end too-big-to-fail. Chapter 12, written by three IMF lawyers, Sean Kerr, Ross Leckow, and Thomas Laryea, examines important operational issues in the context of cross-border bank insolvency, including counterparty credit risk mitigation, netting, collateral, clearing, and settlement. Chapter 13, written by Michael Waibel, considers the relationship between bank insolvency and state insolvency, or sovereign insolvency, with the example of Iceland and other historical cases providing interesting lessons on the fiscal costs of implicit guarantees for the financial sector and the sovereign fiscal capacity. Chapter 14, authored by Look Chan Ho, is a study of bank insolvency law in the United Kingdom, and in particular of the Special Resolution Regime (SRR). Chapter 15, written by Professor Heidi Mandanis Schooner, presents the reforms of the US Resolution Regime. Chapter 16, co-authored by James L. Bromley and Tim Philips (both with Cleary, Gottlieb, Steen and Hamilton), reflects upon the lessons from the Lehman Brothers' failure, a fitting end to this volume. The book also includes as an Appendix the IMF document (dated 11 June 2010) which proposes a framework for enhanced coordination in the resolution of cross-border banks.

The editor is most grateful to the distinguished contributors to this volume for their outstanding work. The combined expertise of the authors of the chapters is truly unique. This book is destined to become the essential reference in the field of cross-border bank insolvency. Fiona Richardson and the editorial team of Oxford University Press did, as usual, a terrific job in helping bring this work to fruition, while Roman Chapaev provided excellent research assistance. My thanks also extend to my colleagues at CCLS, Queen Mary University of London (it was Joseph Norton that first recommended me to take up this subject back in 2002), the European Shadow Financial Regulatory Committee (chaired by Harald Benink), and MOCOMILA (Monetary Committee of the International Law Association, under the leadership of William Blair), from whom I have learnt so much over the years. I am very grateful to Baroness Cohen of Pimlico and to the members of the Sub-Committee A of the European Union Committee of the House of Lords in the UK for the opportunity they gave me to work with them in 2009 in their inquiry into the future of EU financial regulation and supervision and for their enthusiasm and wisdom in approaching with an independent spirit the complex issues involved in such inquiry. Also, I should also like to thank Sean Hagan (author of one of the forewords) for having invited me to provide advice to the International Monetary Fund on legal and policy issues associated with cross-border bank insolvency. It was a pleasure to work with him, with Ross Leckow, and with other IMF staff members in this project.

I always like to thank my students, for they remain a constant source of inspiration. And, of course, my mentors; gratitude to one's 'maestros' does not cease with the passage of time. Here again, I must show my deepest appreciation to Charles Goodhart, truly an intellectual father, and to Gaspar Ariño, who always encouraged me to explore new legal horizons. A big thank you also to Thomas Baxter and Antonio Sainz de Vicuña, whose friendship I treasure and whose professionalism I admire, in particular their work at the helm of the legal departments of the Federal Reserve Bank of New York and the European Central Bank respectively during the financial crisis. I must also thank other dear colleagues who have become part of my 'professional family', with whom I work, write, and teach frequently, in particular, Lee Buchheit and René Smits. Over the last months, I have had the privilege of working together with John Jackson and Thomas Cottier in putting together a Special Issue of the *Journal of International Economic Law* on 'The Quest for International Law in Financial Regulation and Monetary Affairs'. The conversations

I held with them sparked off lines of thought and contributed in no small way to clarify my own ideas.

A tribute goes to the memory of those who have left us, in particular Sir Joseph Gold and Manuel Guitián. And last, but not least, very many thanks to my family, to my parents, to my husband, Mats Kummelstedt, and to our four children, Alejandro, Eric, Roberto, and Anna. They are always there in the lights and in the shadows of my life. To them I dedicate my work.

Rosa María Lastra
Professor of International Financial and Monetary Law
London,
15 September 2010

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