European Bank
for Reconstruction and Development

Cross-border bank insolvency

The growth in cross-border banking activities presents a number of challenges for regulators around the world. These challenges, such as the division of responsibilities between home and host country, are certainly relevant for countries in eastern Europe, the Commonwealth of Independent States and Mongolia, where the framework for financial regulation and supervision is an emerging issue.[1]

Rosa María Lastra
Professor,
Queen Mary,
University of
London

In the absence of an international insolvency legal regime, the solution to the liquidation of a bank with branches and subsidiaries in several countries needs to be based on national legal regimes and on the voluntary cooperation between different national authorities. This cooperation is often uneasy and the division of responsibilities between home and host country authorities remains a matter of controversy. For instance, the issue of foreign ownership of banks makes some host jurisdictions (where foreign ownership is high) reluctant to rely on home country control. Benston and Eisenbeis (2006)[2] have studied this issue, which has relevant implications in many eastern European countries.

The challenge is further compounded by the fact that insolvency laws differ greatly from country to country and they differ in various ways. Given the intimate link between insolvency law and other areas of commercial law, different legal traditions 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* (general law) and *lex specialis* (more specific law) leads to different approaches to bank insolvency. In some jurisdictions banks are treated like other corporations (*lex generalis*), in other words they are subject to the general insolvency law. This is the case in England, where ordinary insolvency principles are applied to banks (with some modifications for financial contracts, netting and set-off) under court-administered proceedings. In other jurisdictions, banks are subject to a special insolvency regime (*lex specialis*), administered by the bank supervisor or the depositor protection agency (for example, in Canada, Italy and the United States).

The case for a lex specialis

Differences between corporate and bank insolvencies

The case for a *lex specialis* with regard to bank insolvency can be supported by the fact that bank insolvency proceedings have different goals from those in corporate insolvencies.[3] According to Schiffman,[4] corporate insolvency laws should seek to fulfil two principal objectives: (i) fair and predictable treatment of creditors; and (ii) maximisation of the debtor's assets in the interests of creditors. However, the main goals in bank insolvency proceedings are the safety and soundness of the financial system at large and the integrity of the payment systems (that is, the payment clearing for cheques, bank transfers, etc). Furthermore, prompt payment to depositors and minimising the costs to the insurance funds are also important considerations (certainly in the United States).[5]

Besides the specificity of the goals, there are other differences between the insolvency of a corporation and the insolvency of a bank. Some of these differences are rooted in the specialty of banks (given their role as credit providers, deposit takers and payment intermediaries), the risk of contagion in the case of bank failures (special vulnerability – under a fractional reserve system a bank will be unable at any time to honour the convertibility guarantee) and the public interest associated with sound banking and the smooth functioning of the payment systems.

Creditors have a more active role in general insolvency than in a bank insolvency.[6] They can initiate insolvency proceedings and act individually (under the right to be heard) or collectively (through creditor committees) but bank supervisors typically have the power to commence the insolvency proceedings.

Definition of insolvency

In banking, the definition of insolvency (the trigger point for an insolvency proceeding) is sometimes controversial. As acknowledged, there are two traditional definitions of insolvency in commercial bankruptcy laws:

- failure to pay obligations as they fall due (known as equitable insolvency)
- the condition when liabilities exceed assets (known as balance sheet insolvency).[7]

The controversy lies in the fact that, in banking, the line of demarcation between illiquidity (lack of liquid funds) and insolvency is not always clear. An economically insolvent bank is not always declared legally insolvent by the responsible authorities and may be offered financial assistance instead. The test of insolvency as the inability to meet payments as they fall due is not applicable to banking since the inability to honour the convertibility guarantee of deposits is not proof of insolvency, but rather evidence of illiquidity (Hüpkes, 2003).

A bank is considered to have failed when the competent authorities order it to cease operations and activities. However, the authorities are often wary of liquidating a bank (in part because an "orderly liquidation of assets" is not always easy, due to the possible contagion effect on other institutions) and therefore choose instead to rehabilitate the bank. As a matter of good policy, the bank should be closed as soon as the market value of its net worth reaches zero because at this moment, direct losses are only suffered by shareholders. If the bank is declared legally insolvent when the market value of its net worth is already negative, losses will accrue not only to shareholders, but also to uninsured creditors and/or to the insurance fund/government.

In banking, the pre-insolvency phase is fundamental and in recent years prompt corrective action (PCA) rules, including structured early intervention and resolution, have been advocated. In the United States, these rules are now legally binding since the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991. PCA rules are only effective if they are enshrined in law, in particular the mandate to initiate early closure when the bank still has capital (even if it is critically undercapitalised). As Goodhart (2004) points out, "the window of opportunity between closing a bank so early that the owners may sue and so late that the depositors may sue may have become vanishingly small".

Liquidation or reorganisation?

Insolvency proceedings typically imply liquidation or reorganisation (sometimes they are carried sequentially, that is, liquidation proceedings will only run their course if reorganisation is unlikely to be successful or if reorganisation efforts have failed). Bank insolvency proceedings take on unique features which are not present in general insolvencies because the failure of a bank is often a matter of public interest and can disrupt the payment system if not properly handled, and because the bank supervisor has the power to initiate insolvency.

Though liquidation is the simplest resolution procedure, it is not necessarily the least costly; as a valuable depositor base dissipates, vital banking services in a community may be disrupted and confidence in the banking system may be seriously damaged. In banking, liquidation typically entails a system of depositor preference, i.e., depositors' claims are typically paid before those of general creditors. If the country has a deposit guarantee scheme, the insured depositors are paid off up to the insurance limit; uninsured depositors and other creditors are likely to suffer losses in their claims.

In the case of bank rehabilitation, reorganisation or restructuring, the laws vary widely from country to country. A takeover or merger (also called purchase and assumption, that is, purchase of assets and assumption of liabilities) generally preserves the going-concern value of an institution, as the acquirer succeeds to both a deposit base and a base of loan customers. In contrast with a straight liquidation, a takeover or merger eliminates the danger that vital banking services in a community will be disrupted.

A merger can be "unassisted", which is when the acquirer assumes all assets and liabilities (also called "whole bank's acquisition"), and "assisted", when only the good assets go to the acquirer (also referred to as “clean bank’s acquisition”) and the bad assets are subject to special administration. Sometimes, failed banks may be placed under special administration in the form of bridge banks, new banks, special funds or other arrangements. This is often meant to be a temporary solution in order to take over a failed bank’s operations and preserve its going-concern value while the government fiduciary seeks a more permanent solution or until an acquirer is found.

In some cases an implicit or explicit “too big to fail” policy is applied, whereby large banks are propped up by government or regulatory activity to ensure that they do not fail. That was the case with Continental Illinois in the United States and Credit Lyonnais in France. Government-led rescue packages may not only induce moral hazard behaviour, but may also pose questions of fair competition, particularly when the too-big-to-fail doctrine is applied, as other smaller or less troubled institutions may have to navigate through crises or problems on their own. In the United States, the FDICIA requires the resolution of bank failures on a “least cost basis” to the insurance fund, unless it threatens to trigger a payment system breakdown, in which case FDIC and Federal Reserve may recommend a more costly solution (FDICIA, 12 USC 1823 (c)(4)).

The Basel Committee on Banking Supervision acknowledges that in a market economy, failures are part of risk-taking and that a prompt and orderly liquidation of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system, as forbearance normally leads to worsening problems and higher resolution costs.

However, the Committee explicitly states that “in some cases the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholder. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements, that it is realistically achievable in a short and determinate timeframe and that, in the interim, depositors are protected”.[8]

International law principles governing insolvency

“Most nations currently apply a territorial approach to cross-border insolvencies. This simply is a consequence of the domestic focus of most insolvency laws.” (Krimminger, 2005)

Sovereignty as a supreme power is typically exerted over the territory of the state (known as the principle of territoriality). The demise of national frontiers in today’s global financial markets highlights the limitations and inadequacies of the concept that a state may exert sovereign control over financial conglomerates, international holding structures and cross-border banking and finance.[9] These inadequacies are particularly evident in the case of insolvency (although this paper does not address the challenges involved in the liquidation of a financial conglomerate).

The principle of “plurality of bankruptcy” – which goes hand-in-hand with the separate entity approach to liquidation – means that bankruptcy proceedings are only effective in the country where they are initiated and so there is a plurality of proceedings, as they need to be initiated in every country in which the insolvent bank holds realisable assets or branches. Thus, this principle assigns territorial effect to the adjudication of bankruptcy.

Under a separate entity approach a domestic branch of a foreign bank receives a liquidation preference, as local assets are segregated for the benefit of local creditors (the practice of “ring fencing”).[10] Ring fencing is contrary to the *pari passu* principle, since some creditors receive more favourable treatment than others.[11] Under the separate entity approach, local branches of the foreign bank are treated as separate entities. This is the approach the United States applies to the liquidation of US branches of a foreign bank. US bank insolvency law is territorial for US branches of a foreign bank.

The principle of “unity and universality of bankruptcy” – which goes hand-in-hand with the unitary or single entity approach to liquidation – means that there is only one competent court to decide on the bankruptcy of the bank (unity), and that the bankruptcy law of the country in which the insolvency has been initiated is effective in all other countries where the bank (that is, the parent entity) has assets or branches (universality). All assets and liabilities of the parent bank and its foreign branches are wound up as one legal entity. Therefore this principle assigns extra-territorial effect to the adjudication of bankruptcy.

Under this unitary system it is impossible to start separate insolvency proceedings against a domestic branch of a bank that has its head office in another country. US law applies this unitary principle to the liquidation of a US bank with foreign branches. The FDIC, as receiver of a failed bank, collects and realises all assets and responds to all claims of the institution regardless of their situs. US bank insolvency law is universal with respect to US banks. (However, US law applies a different regime to the liquidation of US branches of a foreign bank, as explained above).

The inconsistency of the US legal approach to the liquidation of multinational banks,[12] depending on whether it is dealing with foreign branches in the United States or with US branches of a foreign bank, illustrates the difficulties of reaching a common international platform regarding the liquidation of multinational banks.

Cross-border bank insolvency

Bank insolvency laws vary widely across jurisdictions. Cross-border insolvency adds a layer of complexity to the resolution of a failed bank. Since complexity frustrates accountability, it is important to reach a clear understanding of what the applicable rules are before things turn sour. Institutions with global operations and aspirations may wish to explore the opportunities presented by legal arbitrage. Conflicts or inconsistencies may arise and, in some cases, the temptation to exploit legal inconsistencies or possible legal vacuums with fraudulent intentions cannot be ignored (take, for example, the case of BCCI). In addition, some jurisdictions present important deficiencies or gaps in their legal systems (for example, offshore centres and some emerging economies).[13]

Although there is no international treaty on insolvency law, there have, however, been some attempts to agree on common international rules (mostly "soft law"). Throughout its 31 years of existence the Basel Committee has addressed various issues concerning the allocation of supervisory responsibilities between home countries and host countries, capital regulation and other principles for the effective supervision of international banks. However, the Basel Committee provides little guidance on bank exit policies and the problems involved in the resolution of cross-border banking crises.[14]

International rules on insolvency

UNCITRAL (the United Nations Commission on International Trade Law) adopted the Model Law on Cross-Border Insolvency in Vienna in May 1997. However, this Model Law contains an optional clause whereby special insolvency regimes applicable to banks may be excluded from its scope.[15] The Model Law deals with the recognition of foreign insolvency proceedings, the cooperation between judicial authorities and administrators and other issues concerning the coordination of concurrent insolvency proceedings in multiple jurisdictions.

In 1999, UNCITRAL began work on the Legislative Guide on Insolvency Law, considering corporate insolvency. Work proceeded through a joint colloquium with INSOL International (a worldwide federation of national associations for accountants and lawyers who specialise in insolvency) and the International Bar Association. The Legislative Guide was completed in 2004 and adopted by the United Nations General Assembly on 2 December 2004.[16]

The World Bank has coordinated the effort of the UNCITRAL Legislative Guide with its own Global Bank Insolvency Initiative to articulate a set of standards on insolvency and creditor rights for the purposes of the World Bank/International Monetary Fund (IMF) initiative on standards and codes. Accordingly, the World Bank, in collaboration with IMF and UNCITRAL staff and other experts, has prepared a document setting out a unified insolvency and creditor rights standard (the "ICR standard"), which integrates the World Bank Principles for Effective Creditor Rights and Insolvency Systems[17] and the UNCITRAL recommendations (included in the UNCITRAL Legislative Guide on Insolvency). This document was published on 21 December 2005.[18]

This ICR standard (one of the 12 areas identified by the World Bank and the IMF in their joint initiative on standards and codes)[19] will be used in assessing member countries' observance of these standards and codes. The ICR standard recognises that banks may require special insolvency laws when it talks about 'exclusions' (in point 3): "Exclusions from the application of the [general] insolvency law should be limited and clearly identified in the insolvency law."

The explanatory footnote concerning these "exclusions" further states that: "Highly regulated organizations such as banks and insurance companies may require specialized treatment that can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law."

The EU insolvency regime

The EU insolvency regime consists of one regulation on insolvency proceedings (Council Regulation (EC) No. 1346/2000 of 29 May 2000) and two directives: Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions, and Directive 2001/17/EC of 19 March 2001 concerning the reorganisation and winding-up of insurance undertakings.

The EU insolvency regime is binding for all EU member states. As such, the EU regime is the clearest example of binding supranational/regional rules in insolvency law in general and of bank insolvency law in particular. However, the EU rules are mainly of a private international law character. They introduce the principles of unity and universality of bankruptcy, conferring exclusive jurisdiction to the home member state, but they do not seek to harmonise in a substantive way national legislation concerning insolvency proceedings, which remain different across the EU member states.

The difficulty in reaching common standards in this area of law is illustrated by the hurdles and delays that the European Union has faced over the years in trying to agree on some common principles on bank insolvency. Indeed, only in 2001 has the Directive on the Winding-Up and Liquidation of Credit Institutions been adopted (Directive 2001/24/EC), though the proposed directive was published in 1988. This Directive does not seek to harmonise national legislation on reorganisation measures and winding-up proceedings, rather it ensures mutual recognition and coordination of these procedures by the member states, based on the principle of home-country control.[20] It embraces the principles of unity and universality, single entity approach to liquidation and the equal treatment of creditors.

Given the differences in bankruptcy laws in the EU member states, large banking institutions and financial conglomerates should be incorporated as European companies and a specific insolvency regime should apply to them.

Bilateral rules

In the absence of a formal international insolvency legal regime, countries resort to bilateral agreements, often in the form of a memorandum of understanding, to establish some principles of cooperation in the regulation of cross-border establishments.

Conclusion

The need for a coordinated liquidation of multinational banks would be best served by the adoption of an international convention or regime on cross-border bank insolvency, based on the principles of lex specialis, single entity approach to liquidation and unity and universality. However, these last two principles can only be accepted in an environment of mutual trust and recognition, a prerequisite of which is a minimum harmonisation of essential rules. In the European Union, mutual recognition presupposes the equivalence of the objectives of national legislations and the existence of similar public interest goals. At the international level, the rules to be agreed by the national regulators should be preceded by an agreement on the objectives to be pursued, which in turn will generate mutual trust. Some rules and objectives must be harmonised to foster mutual trust.

What is a European company?

A European company – known formally by its Latin name “Societas Europaea” (SE) – is a company set up in the territory of the European Union under the European Company Statute.

It means that companies that operate in more than one EU member state can be established as an SE in order to operate throughout the European Union with one set of rules and a unified management and reporting system, rather than under all the different national laws of each member state where they have subsidiaries, saving time and administration costs.

The Statute consists of two pieces of legislation: a Regulation (Council Regulation 2001/2157/EC of 8 October 2001 on the Statute for a European Company) and a Directive (Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company on employee involvement).

See http://ec.europa.eu/internal_market/company/se/index_en.htm#legislation for further details.

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Endnotes

1. This paper draws on Lastra, "Cross-Border Resolution of Banking Crises" forthcoming in Douglas D. Evanoff, John Raymond LaBrosse and George G. Kaufman (editors), International Financial Instability: Global Banking and Banking Regulation, to be published by World Scientific Publishing, Singapore, 2007, and on chapters 4 and 14 of Lastra, Legal Foundations of International Monetary Stability (Oxford University Press, 2006).

2. See bibliography at the end of this article.

3. See E. Hüpkes (2003).

4. See H. Schiffman, "Legal Measures to Manage Bank Insolvency" in R. Lastra and H. Schiffman (eds.), Bank Failures and Bank Insolvency Law in Economies in Transition, Kluwer Law International, The Hague, 1999, at pp. 89-90.

5. See M. Krimminger (2005).

6. See E. Hüpkes (2003).

7. See Schiffman (1999), pp. 96-97.

8. Basel Committee on Banking Supervision. Core Principles for Effective Banking Supervision (Basel Core Principles), www.bis.org/publ/bcbsc102.pdf.

9. See Lastra (2006), chapter 1.

10. According to Curtis, "This manner of segregating local assets to pay local claims is known as the 'separate entity' approach to multinational bank liquidation. 'Balkanisation' might be a more appropriate term". See C.T. Curtis, "The Status of Foreign Deposits under the Federal Deposit Preference Law", 21 University of Pennsylvania Journal of International Economic Law No. 2, Summer 2000, p. 254. See Campbell (2003).

11. See Campbell (2003). Article 13.1 of UNCITRAL's Model Law on Cross-border Insolvency does not permit ring-fencing.

12. Baxter et alii (2004) consider, however, that this difference in approach is a good policy choice, which takes account of the fact that financial services are different and that they are highly regulated and supervised.

13. Group of Ten Contact Group on the Legal and Institutional Underpinnings of the International Financial System, "Insolvency Arrangements and Contract Enforceability", 2002.

14. In December 1992, the Basel Committee published a document entitled "The Insolvency Liquidation of a Multinational Bank". This document is included in the Compendium of Documents produced by the Basel Committee on Banking Supervision (February 2000), Vol. III, International Supervisory Issues, chapter III, Other Supervisory Issues, and is available at www.bis.org/publ/bcbsc333.pdf.

15. Article 1(2) of the UNICTRAL Model Law.

16. The text of UNCITRAL Legislative Guide on Insolvency Law is available at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html.

17. The text of the principles is available at http://worldbank.org.gild.

18. The ICR Standard has been posted for public review and comment since December 2005. See http://siteresources.worldbank.org/GILD/ConferenceMaterial/20774191/ICR_Standard_21_Dec_2005_Eng.pdf.

19. The other 11 areas are: accounting, auditing, anti-money laundering and countering the financing of terrorism (AML/CFT), banking supervision, corporate governance, data dissemination, fiscal transparency, insurance supervision, monetary and financial policy transparency, payment systems and securities regulation. See Lastra (2006), chapter 14.

20. For an analysis of the Directive, see Campbell (2003), Hadjiemmanuil (2005) and Nierop and Stenström (2002).

Rosa María Lastra
Professor in International Financial and Monetary Law
Centre for Commercial Law Studies
Queen Mary University of London
13-14 Charterhouse Square
London EC1M 6AX

Tel: +44 (0)20 7882 3458
Fax: +44 (0)20 7882 5791

Email: r.lastra@qmul.ac.uk