SYMPOSIUM ON FINANCIAL CRISIS & BANK RESOLUTION

Cross-Border Insolvency: The Case of Financial Conglomerates

by Prof. Rosa M. Lastra & Dr. Rodrigo Olivares-Caminal

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A Quotation

"The Emperor Tiberius halted a bank run in Rome in 33 A.D. by transferring funds from the Treasury to the banks for them to lend on concessional terms".

A. W. Ferrin "The Business Panic of A.D. 33"

A Fact

During the Great Depression in the US in the 1930s, 9036 banks failed.

Bank Insolvency: Some General Considerations

- Absence of an international insolvency regime ⇨ 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.

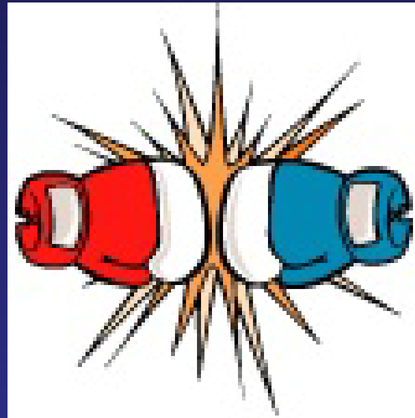
- Cooperation is often uneasy and the division of responsibilities between home and host country authorities remains a disputable matter.

- Insolvency laws differ greatly from country to country and in various ways.
  - Common law v. Civil law
  - pro-creditors v. pro-debtor (pro-liquidation v. pro-rescue
  - *lex generalis* v. *lex specialis*

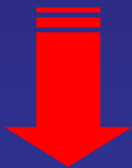
- Contagion risk: special vulnerability (fractional reserve system)

INSOLVENCY VS. ILLIQUIDITY

- Insolvency is a financial condition.
- 'balance-sheet' test: liabilities exceed assets
- *'cash-flow' test: failure to pay obligations as they fall due*



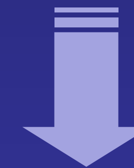
- The company is solvent although it is experiencing temporary cash flow liquidity problems
- Liquidity test: the debtor is unable to pay its mature debts when they become due



INSOLVENCY

Bank Insolvency Procedures (Adm./Judicial)

- Liquidation
- Deposit Insurance



RESOLUTION

- LOLR
- TBTF Doctrine
- Bridge Banks
- Sale or merger as a going concern
- Assets sales and liabilities assumptions

Insolvent?

- Banks ⇨ difficulties: the line of demarcation between illiquidity 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 banks (inability to honour the convertibility guarantee of deposits is not proof of insolvency, but rather illiquidity).

- A bank is considered to have failed when the competent authorities order it to cease operations and activities.

- The authorities are often wary of liquidating a bank:

(1) an "orderly liquidation of assets" is not always easy

(2) the possible contagion effect on other institutions

- PCA rules are only effective if they are enshrined in law (particularly the mandate to initiate early closure when the bank still has capital).

- 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*".

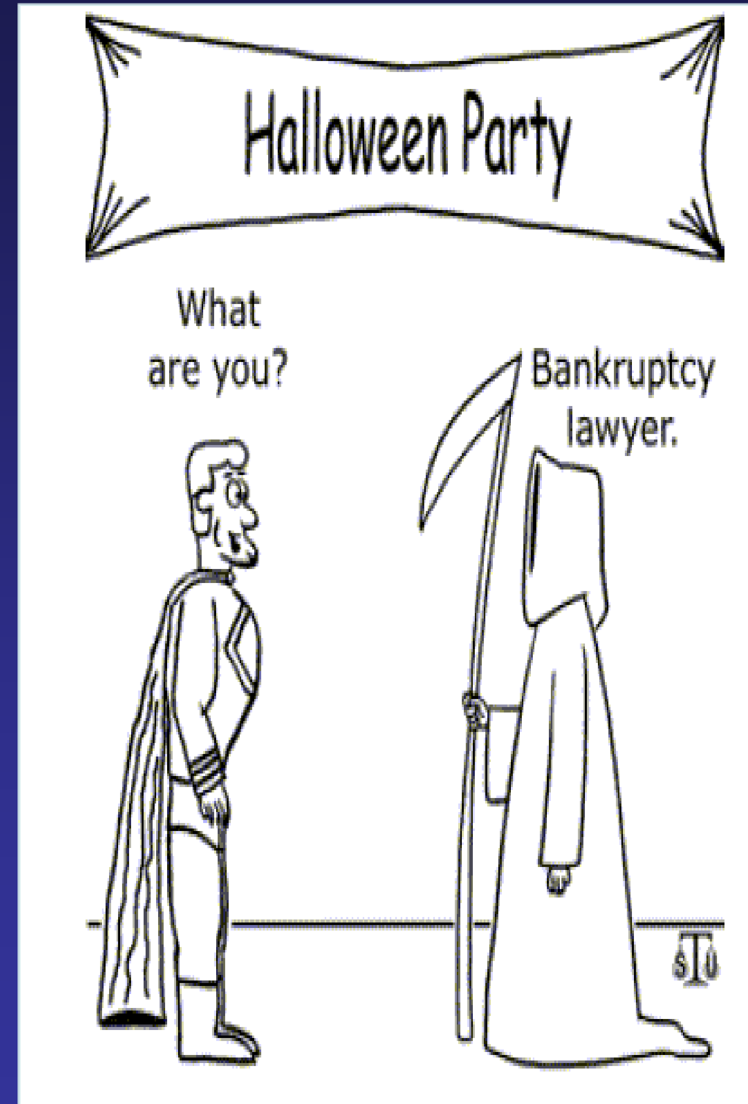
Liquidation v. Reorganisation

Deposit Insurance: 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.

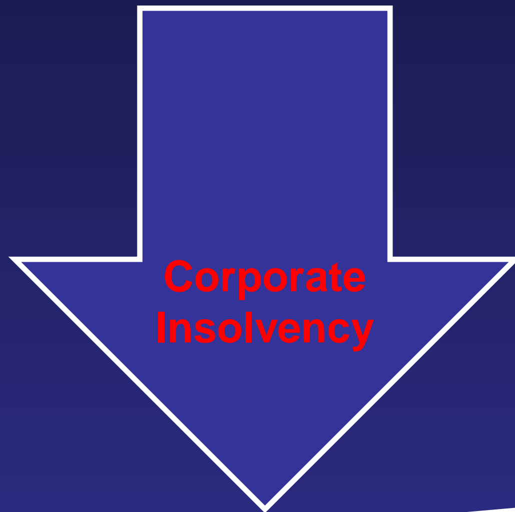
Merger: A takeover or merger (also called purchase and assumption, i.e. unassisted/whole bank's acquisition or assisted/"clean bank's acquisition") and the bad assets are subject to special administration.

Bridge Banks: 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.

TBTF Doctrine: 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 (e.g. Continental Illinois, Credit Lyonnais, etc.). Moral Hazard?



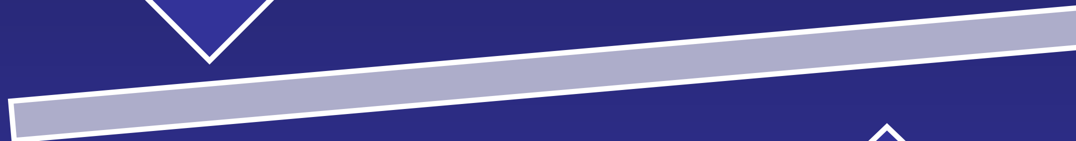
Bank Insolvency v. Corporate Insolvency: Different Goals



(1) fair and predictable treatment of creditors

(2) maximisation of the debtor's assets in the interests of creditors

(3) creditors can initiate insolvency proceedings and act individually or collectively (through creditor committees)

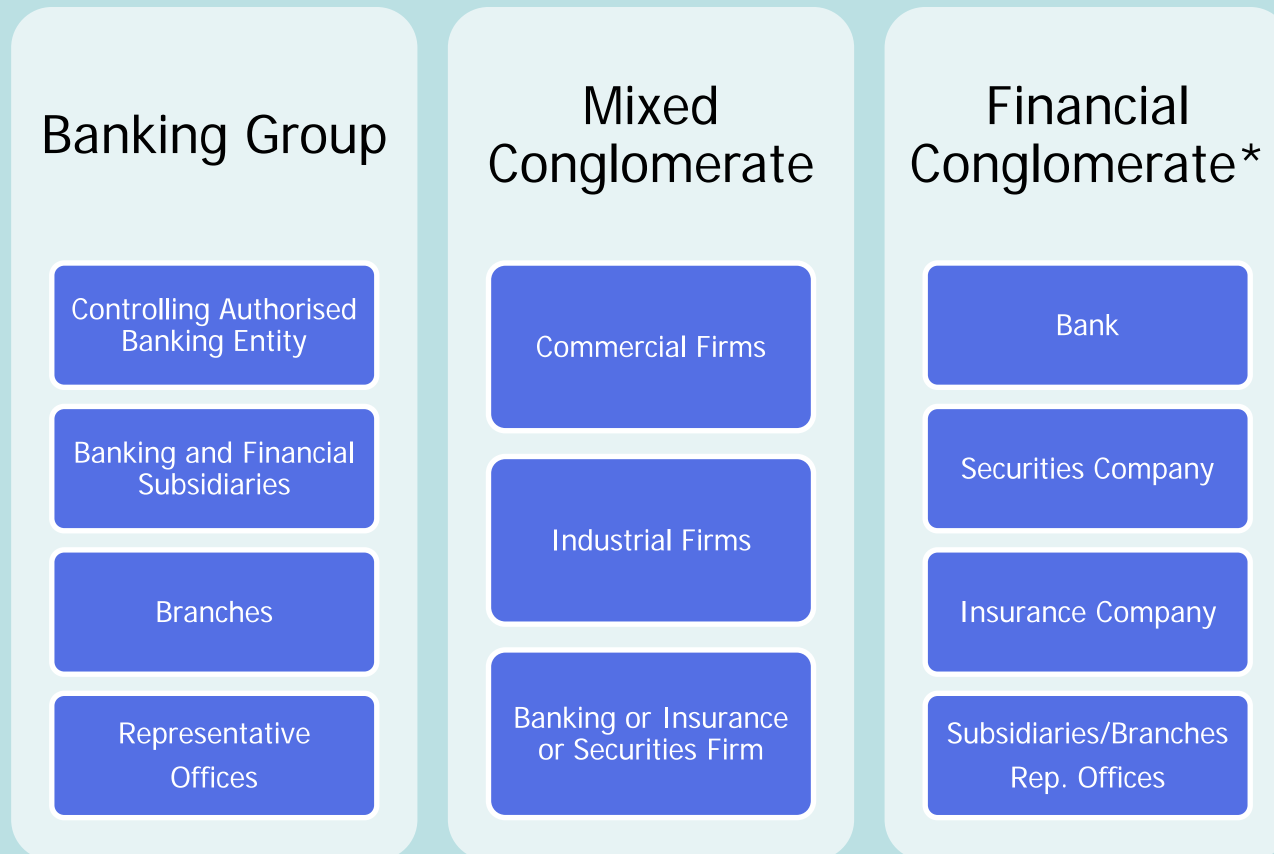


(1) the safety and soundness of the financial system and the integrity of the payment systems

(2) prompt payment to depositors and minimising the costs to the insurance funds

(3) Bank supervisors typically have the power to commence the insolvency proceedings

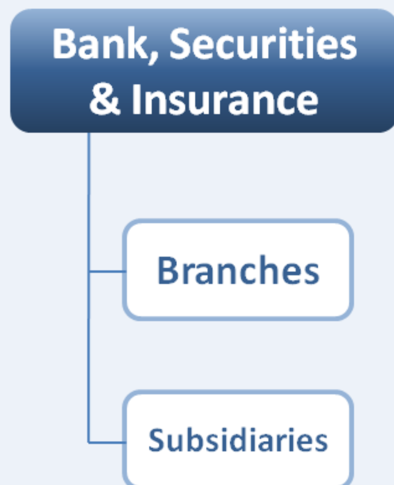
Differences between a Banking Group and a Mixed and a Financial Conglomerate

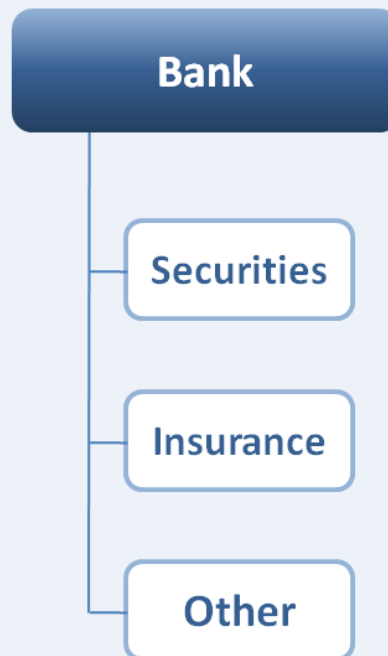


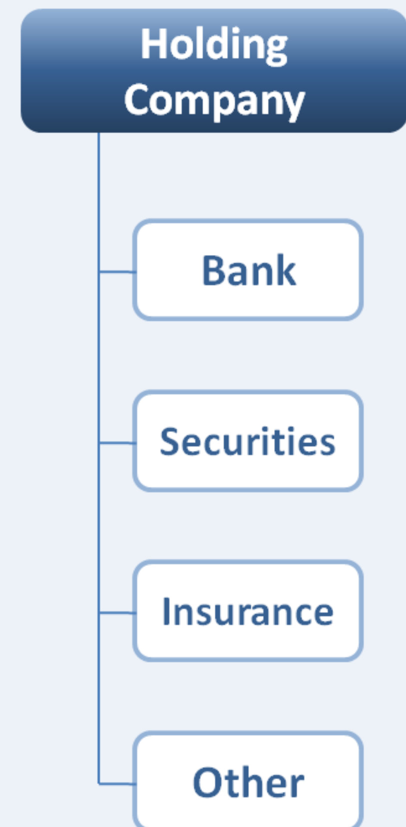
* at least two financial sectors

Structure of a Financial Conglomerate

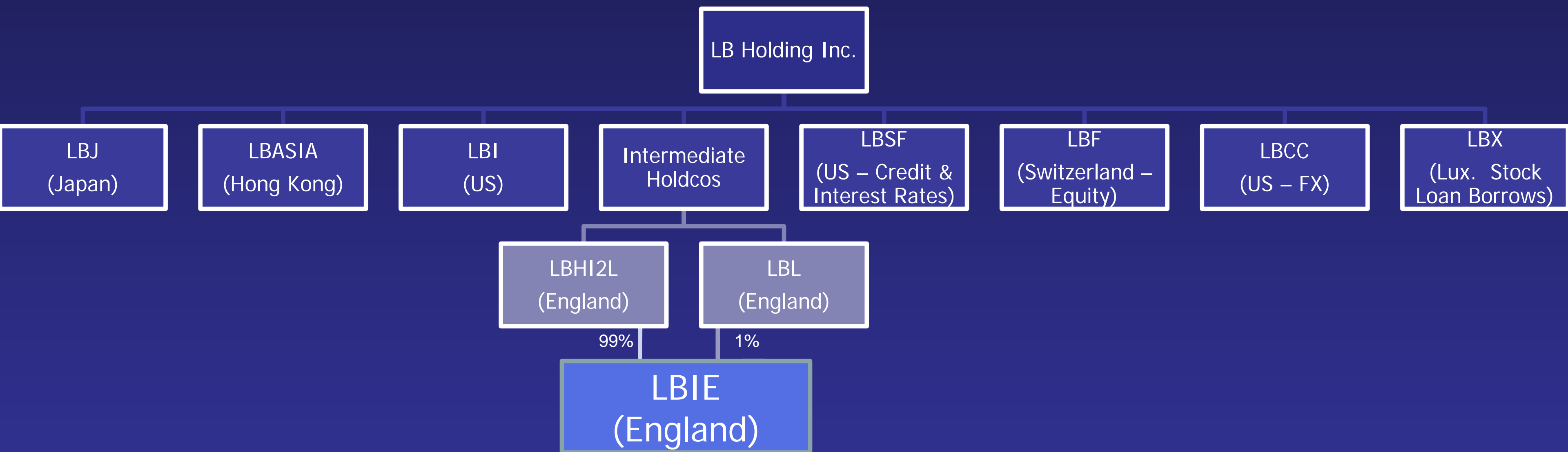
German Model | UK Model | US Model







Lehman UK's Position

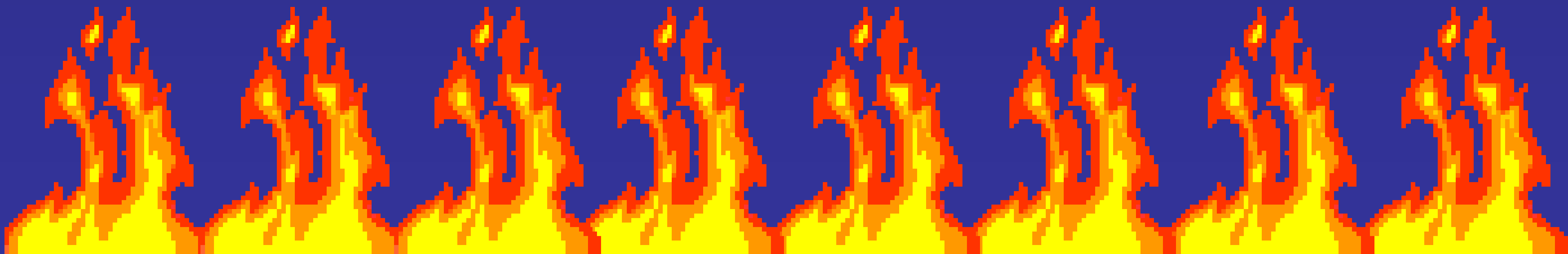


Financial Conglomerates: Main Issues (a.k.a. "Hot" Topics)

- If some organizations are too big, too complex or too interconnected to be allowed to fail, then it naturally suggests that those organizations are safer than others distorting the market because they will have an *ex ante* competitive advantage ⇨ moral hazard + they fail !

- Dealing with different industries: subject matter + convenience of a subsidiary or business line v. convenience of the whole group, etc.

- Different jurisdictions
  - different aim in the regulators or insolvency laws
  - general law v. special law
  - pro-debtor v. pro creditor
  - plurality of insolvency v. universality of insolvency.
  - stay v. continue trading of OTC derivatives to smoothly unwind positions.
  - *pars condictio creditorum* and *pari passu* v. set-off



PLURALITY OF INSOLVENCY

- Separate entity approach to liquidation (insolvency proceedings are only effective in the country where they are initiated) ⇨ there is a plurality of proceedings (initiated in every country in which the insolvent bank holds realisable assets or branches).

- 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 ("ring fencing").

- Ring fencing is contrary to the *pars condictio creditorum* and the *pari passu* principle, since some creditors receive more favourable treatment than others (US approach to the liquidation of US branches of a foreign bank).

INCONSISTENCY

UNIVERSALITY OF INSOLVENCY

- There is only one competent court to decide on the insolvency of the bank (unity), and that the insolvency law of the country in which the insolvency has been initiated is effective in all other countries where the bank has assets or branches (universality).

- All assets and liabilities of the parent bank and its foreign branches are wound up as one legal entity (extra-territorial effect to the adjudication of insolvency).

- 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-FDIC)

Lessons Learnt (from “big” and “noisy” collapses)

The lessons that can be learnt from previous episodes, which should be taken into account for possible recommendations for an insolvency framework to deal with an insolvent financial conglomerate, are:

(1) An entity with international operations in different time zones can cause substantial damage to other entities (Herstatt).

(2) The market not always is able to differentiate between solvent and insolvent entities within the same group of companies (DBLG).

(3) Orderly unwinding of positions is a desired outcome (DBLG and LTCM).

(4) Supervision is essential to prevent ‘unpleasant’ surprises. The host country (or the *de-facto* host country acting on an ad-hoc basis) should coordinate a mechanism for proper supervision to avoid regulation arbitrage (BCCI).

(5) Different jurisdictions have different insolvency regimes with different aims (BCCI).

(6) There is a conflict between the traditional insolvency stay and the actual need of the derivative markets to actively trade to hedge positional risk (Barings).

(7) Sometimes insolvency is not the only option (LTCM).

International Initiatives

- UNCITRAL Model Law on Cross-Border Insolvency: 1997 (recognition of foreign insolvency proceedings, cooperation between judicial authorities/administrators and other issues concerning coordination of concurrent insolvency proceedings in multiple jurisdictions) ⇨15.

- Optional clause whereby special insolvency regimes applicable to banks may be excluded from its scope.

- UNCITRAL began work on the Legislative Guide on Insolvency Law, considering corporate insolvency, which was completed in 2004 and adopted by the United Nations General Assembly on 2 December 2004.

- The WB, in collaboration with IMF and UNCITRAL 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 and the UNCITRAL recommendations

- The ICR standard recognises that banks may require special insolvency laws when it talks about 'exclusions'.

European Union

- EU insolvency regime:
  - Regulation on insolvency proceedings (Council Regulation (EC) No. 1346/2000
  - Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions
  - 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 ⇨ is the clearest example of binding supranational/regional rules in insolvency law in general and of bank insolvency law in particular.

- EU rules 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.

- Directive 2001/24/EC (winding up of credit institutions) was adopted after 13 years:
  - it does not seek to harmonise national legislation
  - it ensures mutual recognition and coordination of procedures (principle of home-country control).
  - it embraces unity and universality (single entity approach) and equal treatment of creditors.

Which is the way forward?

➢Solve the **multi-jurisdictional legitimacy** issue.

➢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.

➢This can only be accepted in an environment of mutual trust and recognition, a prerequisite of which is a minimum harmonisation of essential rules.

➢Small and steady steps !

- Not another SDRM/UNCITRAL
- *Ad-hoc* coordination (Maxwell)?
- Regulatory Colleges (BCCI)?
- MoU?
- EU Directive?

Questions, Comments and Suggestions?