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INTERNATIONAL BANKING

Expert Analysis

Cross-Border Resolution And International Banks

By **Kathleen A. Scott**

The myriad reports issued on this past year's economic crisis—what went wrong and how to prevent it in the future—make it clear that improvement in international cooperation and coordination is essential. As I mentioned in my last column,[1] on Sept. 6, 2009, the Basel Committee, which develops international banking standards, issued a set of guiding principles to strengthen the regulation, supervision and risk management of the banking sector.[2] One of those guiding principles was to issue recommendations to reduce the systemic risk associated with the resolution (that is, liquidation or receivership) of cross-border banks. On Sept. 17, 2009, its Cross-Border Bank Resolution Group issued a report and recommendations (CBRG report) regarding resolutions of financial institutions that have cross-border activities.[3] Comments on the CBRG report are to be submitted by Dec. 31 of this year.

Banks operating internationally would do well to review the report. The report serves as a good summary of legal, logistical and other issues that can occur in the resolution of a financial company that conducts cross-border activities in several countries. This month's column will discuss the CBRG report and its recommendations, and compare them to the laws in the United States for liquidating U.S. banking offices and subsidiaries of non-U.S. banks.

Background

An important point to keep in mind is that, at least in the United States, liquidation of a bank is not covered by bankruptcy laws applicable to the resolution of other companies. Banks are different: a bank with insured deposits (whether or not it is owned by a U.S-based or non-U.S.-based holding company), generally would be closed by the chartering authority, and the Federal Deposit Insurance Corporation (FDIC), which insured the bank's deposits, would be appointed the receiver. If the bank is not insured, such as is the case with most of the direct U.S. offices of non-U.S. banks, then the licensing authority would be responsible for the resolution.[4] New York, which licenses most of the offices maintained in the United State by non-U.S. banks, has the most experience with liquidating U.S. branches and agencies in the United States, and I will use New York bank liquidation law as an example of laws applicable to the liquidation of an uninsured branch or agency of a non-U.S. bank.[5]

Key issues in the CBRG report's recommendations are discussed below.

Resolution Legislation

The CBRG report recommends that countries have effective laws regarding resolutions of financial companies with the appropriate tools to resolve a financial institution in distress in a way that "minimizes systemic risk, protect[s] consumers, limit[s] moral hazard and promote[s] market efficiency."

> The Cross-Border Bank Resolution Group issued recommendations regarding resolutions of financial institutions that have cross-border activities.

As noted above, if an internationally based financial institution had a U.S. bank subsidiary that maintained FDIC-insured deposits, the usual course for resolution is for the chartering authority to close the bank and turn it over to the FDIC to liquidate. The Federal Deposit Insurance Act's detailed provisions on receivership give the FDIC broad authority in liquidating an insured bank.

At the state level, the New York Banking Law also has detailed procedures on liquidating the New York state-licensed branch or agency of a non-U.S. bank, and gives the Superintendent of Banks broad authority in handling the liquidation. One key provision deals with the collection of assets. In liquidating the New York state-licensed office of a non-U.S. bank, the superintendent takes possession not only of all the assets of the New York state-licensed branch or agency wherever located, but also all the assets of the non-U.S. bank that are in New York.[6] That would include correspondent accounts maintained in New York banks by the head office or other branches of the non-U.S. bank. This could lead to a substantial asset base for use by the superintendent. However, in the claims process that takes place, only claimants that can show that their claims are based on a transaction with the New York branch or agency may receive payment in New York from the New York liquidation.

The CBRG also expressed its concern for situations where a financial group has several legal entities formed under various laws and a failure of the group could lead to a number of individual receiverships, but there are no special rules applicable to dealing with the resolution of the financial group as a whole.

Pending federal legislation would give the FDIC the authority to liquidate systemically important financial companies, such as at the holding company level, with powers similar to those it has with respect to liquidating insured banks.

Coordination

Countries take different approaches to liquidations of financial institutions in their jurisdictions—some may be pro-debtor, some pro-creditor, even the prioritization of payment of claims can differ. In the resolution of a large financial group with individual receiverships being conducted in several countries, it could be a logistical nightmare keeping all the moving parts straight. The CBRG encourages countries to seek more similarity in their approaches to liquidation so as to facilitate coordinated solutions across borders.

For an ongoing entity, comprehensive supervision of a financial group on a consolidated basis (CCS) is sought. In a liquidation of such a financial company, however, that process breaks down, with the various legal entities in a financial group being subject to individual liquidation proceedings, oftentimes by governmental units that may not have been the CCS supervisor. The CBRG recommends that countries consider putting in place procedures to allow for some form of recognition of foreign resolution proceedings, recognizing that legal and policy issues could prevent a consolidated liquidation of a company operating in several countries, but even enhancements in coordination and cooperation among countries would be an improvement.

There also should be better procedures on sharing of information among countries regarding financial companies in their respective jurisdictions, while the companies still are operating as well as during the course of a liquidation. Bilateral and multilateral confidentiality and information-sharing agreements

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among countries should be strengthened to allow the flow of information about a financial company to continue even when it is being liquidated and even when the information needed might not necessarily have been shared while the financial company was operating.

In the past with liquidations of U.S. branches or agencies of non-U.S. banks, there has been an informal coordination effort, with the liquidator in the United States, often New York, keeping the head office of the non-U.S. bank apprised of developments; reciprocity from head office liquidators in such information-sharing often has been very limited. There clearly is room for improvement in cooperation and coordination among international regulators. While U.S. regulators may be willing to negotiate enhanced confidentiality and information-sharing agreements, other countries may need to change their laws and regulations before they could be authorized to disclose information.

The goals set out in the New York Banking Law in the liquidation of a New York state-licensed branch or agency of a non-U.S. bank are clear: collect the assets and pay those creditors that had transactions with the New York branch or agency. Any funds left over are remitted to the head office of the non-U.S. bank, or to its liquidator (after being first offered to the liquidators of other U.S. offices of the bank). This type of liquidation procedure is called ring-fencing because the law effectively draws a fence around the New York branch or agency and it is liquidated as if it were a separate legal entity. In the past, due to a perceived ambiguity in the U.S. bankruptcy law, there had been attempts by head office liquidators to bring an ancillary proceeding in U.S. Bankruptcy Court to assert control over the assets of a New York branch or agency of a non-U.S. bank in New York; the law has been changed to make it clear that there is no such possibility.

From a high-level international perspective, the notion of one consolidated liquidation of a financial company with extensive international operations seems logical. However, ring fencing protects the assets of the bank in New York for creditors of the New York branch or agency, and there are supervisory measures that the superintendent can take to ensure that sufficient assets are maintained in New York to protect creditors. In a global liquidation, these measures are useless to protect New York creditors because all the funds go into a global pot, funding a liquidation by a home country liquidator that may have failed in its own supervisory duties.

Large Financial Groups

Many large financial companies have complex structures that are not transparent to regulators. The CBRG recommends more knowledge on the part of regulators of the global structure of these financial groups, not just of those entities operating in the regulators' countries, and how the various parts of the financial group would be liquidated in the event of failure. If the structure is too complex to permit an orderly resolution, countries should consider implementing "regulatory incentives" for these institutions to simplify their structures, such as through enhanced capital requirements or other prudential supervisory requirements. Moreover, systemically important cross-border financial institutions should develop and maintain plans that address a variety of financial distress scenarios, including plans for both maintaining all or parts of the company as a going concern, and swiftly closing all or part of the company should circumstances prove that necessary. These plans should be reviewed by regulators on a regular basis.

The failures of several large financial companies over the past year have proved that regulators need to understand the structure of an entire financial group, not just that which is subject to their particular jurisdiction. Regulators taking preventive measures now could forestall later having to face resolving a financial company with a complex organizational structure about which it knows little. Pending federal legislation in the United States would require that a systemically important financial company maintain an orderly resolution plan that would be examined at regular supervisory examinations.

Risk Mitigation Mechanisms

The CBRG recommends that countries enhance risk mitigation requirements for financial companies in order to reduce systemic risk. This is particularly so in the area of qualified financial contracts (QFCs) such as various forms of derivatives contracts. The CBRG urges requiring enforceable netting agreements, collateralization, segregation of client positions, greater standardization of derivatives contracts, and clearing and settlement of such contracts through regulated central counterparties. In addition, countries should be able to avoid immediate close-out of QFCs and instead allow a temporary delay giving the liquidating regulator time to transfer a QFC to another, financially sound, party. If the QFC is not transferred, then contractual rights to terminate, net, and apply pledged collateral should be preserved.

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For many years, both the FDIC and the New York Superintendent of Banks have had extensive authority to handle QFCs in a liquidation. Pending federal legislation would require comprehensive regulation of the over-the-counter derivatives marketplace, including moving toward standardized forms of QFCs.

Effective Exit Planning

As a final recommendation, the CBRG recommends that programs to provide government assistance to companies in economic distress, such as the ones by which the United States has become an equity holder in banks, insurance companies and automobile manufacturers, include an exit strategy. Private sector resolutions, with losses allocated to shareholders and other creditors, should be preferred over public intervention and expenditures of public funds.

Concern by some in Congress about some of the equity investments that the United States has made over the past year, in some cases apparently without a planned exit strategy, has led to the inclusion of provisions in pending federal legislation that would restrict the broad authority to make these equity investments in the future.

Conclusion

The United States has already addressed many of the issues raised in the CBRG's recommendations, but there is always room for improvement. Pending legislation would indeed provide some needed enhancements. But the idealistic goal of a universal liquidation of a large financial company with worldwide operations remains, in my opinion, unattainable so long as the concern remains that creditors in a jurisdiction that prepared for the eventuality of a liquidation recover less because other jurisdictions did not.

1. New York Law Journal, Sept. 16, 2009, "Will Strengthening Capital Standards Forestall the Next Banking Crisis?"

2. See http://www.bis.org/press/p090907.htm.

3. Basel Committee on Banking Supervision, Consultative Document, "Report and Recommendations of the Cross-border Bank Resolution Group," September 2009, which can be accessed through the Bank for International Settlements Web site, www.bis.org.

4. Prior to 1991, a U.S. branch of a non-U.S. bank could receive federal deposit insurance, but after the 1991 Foreign Bank Supervision Enhancement Act, any non-U.S. bank wishing to maintain or accept deposit accounts with balances of less than $100,000 must establish a separate subsidiary bank and receive federal deposit insurance. See Section 214 of Title II of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, Dec. 19, 1991. Those U.S. branches and agencies that were insured at the time could remain insured; currently, there are fewer than 10 banks that continue to maintain one or more insured U.S. branches.

5. Insured branches of non-U.S. banks would be liquidated by the FDIC. A U.S. office of a non-U.S. bank licensed by the Office of the Comptroller of the Currency (OCC) would be liquidated by the OCC under the National Bank Act. Other states also have similar liquidation laws with respect to the liquidation of state-licensed branches and agencies of non-U.S. banks in their jurisdictions.

6. New York Banking Law, §606(4)(a).