

## **The Failure of Cross-border Financial Firms: New Thinking in the Aftermath of the Financial Crisis**

The development of rules for handling insolvencies of financial and non-financial firms with operations in a number of countries (cross-border insolvencies) is a long-standing item on the international regulatory agenda. Progress has been slow owing to the difficulty of achieving agreement concerning the required harmonization of significantly different existing national laws and definitions and the distribution of the costs of the insolvencies among the countries in which firms affected by the insolvency have a commercial presence. Since the outbreak of the financial crisis the issue has become more urgent. The insolvency of Lehman Brothers brought home with a vengeance the disruptions of financing and payments which can be caused by the failure of a large financial firm with multiple connections (in Lehman's case 2,985 legal entities in 50 countries). Rescue operations for other large financial firms since the outbreak of the crisis have involved recourse to ad hoc measures which have highlighted the absence of smoother procedures for dealing with such situations that would have entailed lower levels of potentially destabilising uncertainty and possibly lower fiscal costs.

Development of rules for the cross-border insolvencies of financial firms is closely linked to the issue of how to handle financial firms too big to fail (TBTF). Classification of a financial firm as TBTF reflects a view of the systemic risk posed the failure of such a firm, i.e. the risk that its failure will reverberate through a large part of the financial system, threatening economic activity, values, and confidence. The operations of TBTF financial firms in most cases extend beyond the borders of their parent countries, as also does the systemic risk posed by their failure.

A menu of pre-crisis proposals for containing the systemic risks of large cross-border financial firms was set out in the 1997 report of the Group of Thirty (Group of Thirty, 1997:) which covered the risk management of such firms, transparency, strengthening the financial infrastructure (exchanges, clearinghouses, and payments and settlement), greater consistency of the supervisory requirements for such firms and improved cross-border supervisory cooperation, and strengthening national laws governing netting, contract enforceability and the insolvency of financial institutions. The more novel proposals in this report were for the establishment of a standing committee to develop global principles for managing risk at such firms, the submission of their worldwide operations to an independent external audit of both financial performance and management controls, and agreement on a lead coordinating supervisor.

Regarding the containment of systemic risk more recent proposals are arguably an extension and development of those of the Group of Thirty. However, three recent reports have also addressed more explicitly and fully the development of greater international consistency of the relevant parts of national insolvency regimes.

The report of the Financial Stability Board (FSB) is a preliminary response to the call of the G20 to propose measures to address the TBTF problems associated with systemically important financial institutions (SIFIs), i.e. cross-border financial conglomerates whose failure could pose

systemic risks (FSB, 2010). Proposals with a similar thrust to those of the 1997 report of the Group of Thirty include strengthening the regulatory framework and the core financial market infrastructure and a peer review process (including supervisory colleges and crisis management groups) to promote policies addressing the risks posed by SIFIs. The proposals of the FSB also address explicitly the TBTF dimension of SIFIs through differentiated prudential requirements, structural constraints, and special levies for financial firms according to the systemic risk which they pose. The supplementary prudential requirements suggested include capital and liquidity surcharges, limits on large counterparty exposures, and mandatory holdings of contingent capital which would convert into equity before the occurrence of intervention by the authorities in cases of financial distress. Structural constraints would be directed at excessive complexity. They could take the form of measures reducing intra-group connectivity through intra-group exposure limits, segregation of various activities within a group's legal and organisational structure such as requirements concerning separate incorporation and stand-alone capacity for operations which are systemically important, and simplifying structures to align them more closely with applicable regulatory and resolution frameworks.

The FSB paper also outlines several actions required for a framework which would enable safe resolution of failing financial firms. These include the following instruments: powers to dilute or extinguish equity to absorb losses and, once equity has been exhausted, to impose losses on unsecured creditors as well as to hold management accountable; powers to facilitate the restructuring of capital and other liabilities so long as the financial firm can still be considered a going concern; and arrangements for winding-down and balance-sheet restructuring as well as for the provision of temporary financing for financial firms no longer so considered ("gone concerns"). In themselves these are suitable features of a national insolvency regime but the FSB acknowledges that cross-border insolvencies also require additional adaptation of these regimes so that national authorities are able to mount coordinated resolution of failing cross-border financial firms. Particular emphasis is also given in the FSB report to procedures for assuring the continuity of operations of the SIFI crucial to the financial stability of the different national jurisdictions of its various entities, and to the drawing-up by the SIFIs of plans for orderly resolution, should this become necessary, without the necessity of taxpayer support.

The reports of the Basel Committee on Banking Supervision (BCBS) and of the International Centre for Monetary and Banking Studies/CEPR provide greater detail concerning the prerequisites of an effective regime for the cross-border insolvencies of financial firms (BCBS, 2010; Claessens, Herring, Schoenmaker, and Summe, 2010, henceforth referred to as the ICMBS study). That of the Basel Committee contains a thorough review of problems posed by cross-border banking insolvencies and a series of recommendations which incorporate lessons from the financial crisis, while recognising the difficulties of achieving international agreement concerning far-reaching rules for a coordinated approach to cross-border insolvencies. The ICMBS study covers similar ground but with greater emphasis on the requirements of effective national resolution regimes and with a proposal for a new Concordat for international banks under which the granting of market access for foreign banks would become dependent on the existence of effective resolution regimes in the banks' home and host countries. Much of the interest of this proposal lies in the way in which it highlights the difficulties of accommodating within the WTO regime for banking services likely major features of the reforms of the international financial system which are currently being negotiated as a response to the financial crisis.

The studies of both the Basel Committee and the ICMBS studies contain case studies of institutions which failed or had to be bailed out during the crisis – Fortis, Dexia, Kaupthing, and Lehman Brothers in the case of the former and the same institutions plus AIG and other Icelandic banks in that of the latter. The extent of ad hoc cross-border cooperation varied among these cases. In the case of AIG and Lehman Brothers the United States authorities acted alone. A higher degree of cross-border cooperation was achieved in the case of Dexia. This institution, originally the result of a merger between a French and a Belgian bank, was threatened by an eventually unsustainable maturity mismatch with a portfolio of long-term assets financed largely by short-term funding and by the losses of an insurance subsidiary in the United States. The authorities of Belgium, France and Luxembourg agreed to share the burden of guarantees designed to ensure Dexia's continued access to financing and to give the institution time to sell certain operations and to undertake other restructuring.

A similar level of coordination was not achieved in the case of Fortis, a Belgian/Dutch conglomerate with subsidiaries in Belgium, the Netherlands and Luxembourg. Fortis was deemed to be systemically relevant in the three countries because of the size of its positions in their markets and its function as a clearing member at major domestic and foreign stock exchanges. Intervention by the public authorities was triggered during the autumn of 2008 when Fortis, dependent like Dexia on short-term financing, lost its access to the overnight interbank market. After the purchase by the Dutch government of Fortis entities in the Netherlands, the Belgian government raised its holdings in Fortis Bank Belgium, purchased Fortis's Belgian insurance activities, and took a majority stake in Fortis Bank Luxembourg.

However, the attempt of the Belgian government to sell a large part of its interest in Fortis to BNP Paribas was initially frustrated by the decision of a Brussels Appeal Court that sales undertaken as part of the bail-out had to be approved by a general assembly of the shareholders. An initial rejection by shareholders was followed by renegotiation of the transactions and their financing, and in May 2009 the revised version of the transactions was finally approved by the shareholders. The Fortis case highlights the way in which resolution can be complicated by differing assessments of available information about a financial firm in difficulty even by regulators with a history of supervisory cooperation and information sharing as well as by conflicts between financial stability and the legal rights of shareholders.

As the Basel Committee puts it, "Overall, this crisis has illustrated that it is national interests that are most likely to drive decisions particularly where there is an absence of pre-existing standards for sharing the losses from a cross-border insolvency. National resolution authorities will seek, in most cases, to minimise the losses accruing to stakeholders (shareholders, depositors and other creditors, taxpayers, deposit insurer) in their specific jurisdiction to whom they are accountable" (BCBS, 2010: 16). Complicating the situation still further is the absence in most countries of adequate frameworks for the resolution of financial conglomerates. Much attention in the press at the time of the bail-out of AIG focussed on the way in which AIG Financial Products, an entity at the heart of AIG's problems, evaded oversight by the United Kingdom Financial Services Authority thanks to AIG's purchase of a United States thrift institution which enabled it to be subject to consolidated supervision by the United States Office of Thrift Supervision, a supervisory body incapable of fulfilling such a responsibility. But the problem is more general. Insolvency rules mostly apply on a legal-entity basis and thus differ according to the types of business carried out by the conglomerate.

Conceptually a distinction is drawn in discussion of rules for cross-border insolvencies between a universal approach and a territorial approach. In practice, however, resolutions are not generally based exclusively on either of these principles but are pragmatic, incorporating features of each of the two approaches according to the circumstances of the case. This middle way can take a number of forms varying with the balance of principles adopted from the universal and territorial approaches. The version of the middle way supported in the ICMBS study is denoted as “modified universalism”.

The *universal approach* denotes resolution of insolvencies in according to the law of one country, generally that of the financial firm’s head office. The decisions of the resolution authority in this jurisdiction extend to branches and other operations and assets of the insolvent firm in other jurisdictions.

Under the *territorial approach* (sometimes referred to as ring fencing), which is based on the principle of the territoriality of insolvency, national authorities apply their own laws governing insolvency proceedings for the entities, operations and assets of the insolvent firm in their jurisdictions. Thus a declaration of insolvency is required in each country where the insolvent firm has a branch or assets. Territorial insolvency normally applies only to assets in the jurisdiction involved.

The universal approach is prescribed in the European Parliament and Council Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions which are either European Union parent financial firms or their branches. However, in practice the national authorities in the EU (as, for example, in the cases of Dexia and Fortis described above) have chosen not to resort to the procedures of this directive but to other rescue and resolution measures, involving different degrees of cross-border cooperation, often with the objective of providing time for restructuring and renewal of access to private financing. The costs of such alternative measures are typically distributed on an ad hoc basis determined by the different national authorities’ interests in the rescue and restructuring operations. In other words, even in cases where the directive’s universal approach might apply, national authorities have chosen procedures involving features of the territorial approach.

There are arguments for and against both the universal and the territorial approaches, and the Basel Committee acknowledges differences of opinion within its Cross-border Bank Resolution Group (CBRG) (BCBS, 2010: section III). Some members of the group are of the view that the territorial approach and effective ring fencing measures encourage early intervention in cross-border financial entities by the host national authorities when necessary, and increase their incentives to ensure that the local assets of a branch remain above its local liabilities, thus sustaining its capacity to meet the claims of local stakeholders. Ring fencing is also believed by some members to increase the pressures on the authorities in a firm’s parent jurisdiction to resolve promptly problems besetting an institution. The case of the opponents of ring fencing is that the resulting restrictions on capital flows can exacerbate problems elsewhere in a cross-border banking group, lead to inefficiencies in the group’s management of capital and liquidity, and complicate orderly resolution by the home authority.

The Basel Committee enumerates the following features which would have to be included in a binding legal instrument or international treaty incorporating the universal approach:

- Terms and condition for the sharing of the financial burdens of the resolution which may include public funding, deposit insurance and other guarantees.
- Determination of the competent authority for the resolution of the component parts of the cross-border financial group and of coordination of administration and supervision.
- Determination the applicable rules governing crisis management and resolution.
- Commitment by the national authorities covered by the legal instrument or treaty to undertake what in some cases may be far-reaching legal reforms required at national level.
- A process to ensure the equitable treatment of creditors, depositors, other counterparties, and shareholders of group entities, regardless of the jurisdiction in which they are located.

In the likely continuing absence of adoption of rules incorporating such a universal approach outside the EU the Basel Committee recommends a “middle ground” alternative that accepts the likelihood of ring fencing and combines measures designed to enhance the resilience of national arrangements with resolution frameworks that achieve greater cross-border complementarity of national rules and facilitate cross-border cooperation. The measures include more consistent approaches to official intervention in financial firms, more complete exchanges of relevant information among regulators, and the protection of systemically significant functions of a failing institution, if necessary separately from the institution itself at least in its current ownership and corporate structure.

More specifically the Basel Committee makes a number of recommendations of which some concern primarily national resolution powers and frameworks. Others, listed below, concern the cross-border dimensions of insolvency or are directed at aspects of risk management, regulation and resolution of systemically important financial firms which are likely to be important features of measures directed at the threats and realities of cross-border as well as national insolvencies:

- National authorities should seek the convergence of national resolution tools and measures to facilitate coordinated resolutions of financial institutions in multiple jurisdictions. Also for the purpose of improved coordination national authorities should consider the development of procedures to facilitate the mutual recognition of crisis management and resolution proceedings and measures. Key home and host authorities should also agree on arrangements consistent with national law and policy to ensure the timely production and sharing of needed information.
- Supervisors should work closely with home and host authorities to understand how group structures and their components would be resolved in a crisis. If national authorities believe that financial institutions’ group structures are too complex to permit orderly and cost-effective resolution they should consider the imposition of capital and other prudential requirements designed to encourage simplification of the institutions.
- Contingency plans of all systemically important cross-border financial institutions and groups should include in contingency planning measures in response to periods of severe financial distress and instability as well as plans appropriate to the size and complexity of the institutions or groups to preserve the firm as a going concern,

promote the resiliency of key functions, and facilitate rapid resolution or wind-down, should that prove necessary.

- Risk mitigation techniques of the financial firms should target systemic risk and enhancing the resiliency of critical financial functions. The techniques mentioned here include enforceable netting agreements, collateralisation, segregation of client positions, greater standardisation of derivatives contracts and the migration of standardised contracts on to regulated exchanges and the clearing and settlement of such contracts through regulated central counterparties, and greater transparency in reporting for OTC contracts through trade repositories.
- National resolution authorities require various powers (of transfer, stay, etc.) vis-à-vis the contracts of insolvent financial firms. Moreover industry groups should be encouraged to explore the development of standardised contract provisions to reduce the risk of contagion in a crisis.

The ICMBS study accepts that adoption of the universal approach outside the EU is not a realistic prospect. In view of the difficulty of developing detailed and wide-ranging rules for cross-border insolvencies of financial firms this study places its emphasis on enhanced national regulation, supervision, and resolution to minimize the pressure for international cooperation. The international cooperation which would still be necessary even after the strengthening of national regimes through the measures suggested in the study would require greater harmonization of national approaches to reduce the scope for conflicts of interests and strengthening of the incentives for cooperation between national authorities by increasing the scope for international cooperation regarding cross-border insolvencies.

As part of the intermediate approach recommended the ICMBS study proposes a new or revised version of the 1983 Basel Concordat which enunciated rules for the allocation of different supervisory responsibilities between the home- and host-country supervisors of cross-border banking groups. Under the new Concordat proposed by the ICMBS study the granting of market access would be subject to the existence of effective resolution arrangements in both the home and the host countries of the different entities of the banking group. Internationally agreed common standards would provide criteria for determining whether a foreign financial firm would be permitted to enter a country's market in any way other than as "a stand-alone entity" (a phrase not defined by the authors but presumably denoting a subsidiary as opposed to a branch or joint venture, though it is unclear why the standards recommended should not also apply to the granting of market access to a subsidiary). The common standards would be wide-ranging, covering effective arrangements for supervision and information sharing, the systemic nature of the financial firm's operations – its structure, resolvability, and access to liquidity facilities – , the existence of credible resolution processes ensuring equal treatment of creditors, and wind-down plans (sometimes denoted as "living wills") for individual firms.

While there are good arguments for including such standards in the rules for granting market access to foreign banks, like other measures likely to be proposed for the purpose of strengthening financial markets and supervision as part of the current agenda for international financial reform currently being developed such a step may require far-reaching revision of the regime for banking services under the WTO General Agreement on Trade in Services (GATS).

Relevant parts of the GATS in this context are the following:

- Article VI on domestic regulation which states that in sectors (such as banking) in which a country has undertaken specific commitments, pending the entry into force of disciplines yet to be negotiated which would cover, *inter alia*, technical standards and licensing requirements, the country should not apply requirements and standards which nullify or impair these commitments in a manner which is inconsistent with objective and transparent criteria or which could not reasonably have been expected of the country at the time when the specific commitments were made. In determining whether a country is applying technical standards and licensing requirements consistently with objective and transparent criteria, account is to be taken of international standards of relevant international organisations applied by the countries – “relevant international organisations” being defined as those open to at least all member countries of the WTO.
- Article XXI which treats the modification of specific commitments undertaken in accordance with Article XX specifying terms, limitations, and conditions on market access and national treatment (i.e. non-discriminatory treatment of services supplied cross-border from other countries or within the country by foreign firms).
- The so-called “prudential carve-out” of the Annex on Financial Services of the GATS which states that, notwithstanding other provisions of the Agreement, a country shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a supplier of financial services, or to ensure the integrity and stability of the financial system.

The “prudential carve-out” is designed to provide authorities with scope for the prudential measures which they require in various situations including those where the stability of the financial system is threatened, subject to a provision designed to forestall recourse to such measures for the purpose of circumvention. There is as yet no WTO case law concerning the coverage and limits of the “prudential carve-out”. Some measures taken by countries in response to the financial crisis which might be considered as having features in conflict with their specific commitments, including those involving bail-outs of insolvent cross-border financial firms, have not so far been submitted to dispute settlement. However, the “prudential carve-out” is directed at measures taken in response to situations as they arise and not at limitations regarding licensing and market access in countries’ specific commitments such as those as part of the new Concordat proposed in the ICMBS study.

Additional conditions for the granting of market access of foreign access to foreign financial firms (and possibly also for permitting cross-border transactions with suppliers of financial services in other countries) would normally fall within the scope of Article XXI - even in the case of those which meet the criteria of transparency and objectivity specified in Article VI. The common standards proposed in the ICMBS study as part of the new Concordat cover the subjects specified earlier. If the list were extended to the risk mitigations techniques in the recommendations of the Basel Committee, the additional conditions would also include enforceable netting agreements, collateralisation, segregation of client positions, greater standardisation of derivatives contracts and the migration of standardised contracts on to regulated exchanges and the clearing and settlement of such contracts through regulated

central counterparties, and greater transparency in reporting for OTC contracts through trade repositories.

Under Article XXI modification of schedules of commitments (such as those which would be required for the additional conditions of the new Concordat for the granting of market access to foreign financial firms) is to be accompanied by negotiations among the WTO member countries involved with a view to reaching agreement on any necessary compensatory adjustment. Article XXI provides that the Council for Trade in Services has the responsibility for establishing procedures for rectification or modification of schedules of commitments (subject to ratification of its recommendations by the WTO Ministerial Conference or General Council).

Nevertheless, negotiations concerning changes as wide-ranging as the rules proposed for handling cross-border insolvencies of financial firms would be a daunting prospect and one which, one suspects, goes beyond anything anticipated during the original drafting of the GATS framework. Compensation between countries following renegotiation of specific commitments under Article XXI would be complicated by the absence of statistics on trade in financial services. The lack of such statistics means that the initial negotiating rights, with respect to which the results of the renegotiation would be assessed, have never been properly determined. This would mean that agreement on compensation would have to be reached between countries affected on an ad hoc basis or, failing such agreement, affected countries would have to seek arbitration.

It should be noted that the provision in Article VI according to which, in consideration of conformity of domestic regulation with the GATS, account should also be taken of international standards of “relevant international organisations” applied by the member country would not cover standards agreed within the FSB or the Basel Committee owing to the limitations of these bodies’ membership to a much smaller group of countries than WTO members. A further negotiation within the WTO or elsewhere would be required to enable acceptance of these standards by the whole WTO membership before this provision of Article VI would become applicable to such standards.

A final point concerning the ICMBS study – but not the more circumspect report of the Basel Committee – seems worth making. The reasonable proposals in the study for strengthening licensing requirements for foreign financial firms are presented as serving the underlying objective of resolving the “trilemma” involving the following three principal policy objectives: preserving national authorities, fostering cross-border banking, and maintaining financial stability. Yet many might find incongruous the elevation of the fostering of cross-border banking to an international policy objective in the light of the frequently grotesque failures of risk management, internal controls, and fulfilment of fiduciary responsibilities in systemically important financial institutions which have been disclosed during the financial crisis. This is not to deny the benefits to a country which may result from granting market access to foreign banks – subject, for example, to licensing requirements such as those proposed in the ICMBS study. But these benefits can usually be best assessed by the country in question and do not require the promotion of cross-border banking as an international policy objective.



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