CHAPTER

25 Insolvency: Why a Special Regime for Banks?

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A 1995 study by the IMF, frequently cited in writings on bank insolvency, concluded that almost three-quarters of IMF member countries encountered significant banking sector problems between 1980 and 1996.[1] During the banking crisis in Asia, it was observed that a factor that aggravated the crisis was the absence of adequate mechanisms for dealing with insolvent banks.[2] The existing legal framework proved inadequate and revealed the need for rules that were better adapted to the special nature of bank insolvencies. The debate regarding the necessity of special rules for banks is not new, but was already under way early in the 20th century when a wave of bank failures swept across the United States and Europe. The banking crisis of the 1930s led to the recognition that some form of oversight and control was necessary to protect national economies from financial instability and individual depositors against losses.

At that time, a number of countries adopted banking laws and created new authorities to exercise the functions of banking supervision. They introduced a special entry regime for banks to make sure that only institutions with adequate capital and organization could enter the market[3] and required continuous compliance with a set of prudential rules, in order to ensure that banking activities were conducted in a sound manner. In Belgium, Germany, and Switzerland the legislation created new supervisory authorities, which—even though their function and organizational structure changed—exist to this day.[4] In the United States a banking agency had existed since 1863 in the form of the Office of the Comptroller of the Currency. The Banking Act of 1933 created a new agency with supervisory powers, the Federal Deposit Insurance Corporation (FDIC). In other countries, such as Italy and the Netherlands, special banking legislation was adopted, but the supervisory responsibilities remained with the central bank.[5] In the United Kingdom, beginning in 1935, the Bank of England stepped up its informal supervision of the main merchant banks (although it was not until 1979 that laws were enacted that gave statutory backing to this function on the part of the Bank of England).

Since the 1930s, the responsibilities of bank supervisors have been expanding continuously, often, however, in a reactive mode.[6] Technological developments, product innovation, globalization, and structural changes have brought about further regulatory demands, including the protection of customers against improper business conduct and the protection of society at large against money laundering and associated criminal activities.

Can the same arguments that led initially to the introduction of an *ex ante* regime to prevent bank failures, which is a special entry regime and prudential regulation, also be mustered in favor of a special exit regime for insolvent banks through reorganization or liquidation? This chapter will review some of the common arguments for and against a special bank insolvency regime. It will also discuss the features that distinguish bank insolvency rules from general insolvency rules. Finally, it will consider the areas in which special rules appear most necessary.

The Debate: A Special Regime for Insolvent Banks?

Why should banks be accorded special treatment in insolvency? The common answer is that banks play a special role in a country's economy,[7] in that, collectively, their functions are so important as to constitute a sort of public service.[8] In order to justify this special attention, reference is commonly made to three characteristic functions of banks:[9]

- First, banks typically hold highly liquid liabilities in the form of deposits that are repayable at par on demand. On the asset side, they generally hold long-term loans that may be difficult to sell or borrow against on short notice.[10] Under normal circumstances, this mismatch of maturity does not pose a major problem. Whereas withdrawals are subject to the law of large numbers, loans are held until maturity and repaid at face value. A bank's required capitalization covers the risk of loan loss, and a cushion of liquid assets ensures its ability to cover withdrawals in normal times. If, however, something happens to disturb confidence in the bank's ability to meet its payment obligations, massive withdrawals of deposits risk causing liquidity problems that may threaten the bank's solvency.

- Second, banks perform financial services that are fundamental to the functioning of an economy, such as the extension of credit, the taking of deposits, and the processing of payments. Despite the complementary role of capital markets in the credit intermediation process and their capacity to mobilize capital, banks remain the primary source of liquidity for most financial and nonfinancial institutions.[11] They provide direct and standby sources of credit and liquidity to the economy of a country, either by supplying money in the form of loans, or by providing guarantees in the form of loan commitments.

- Third, banks constitute the means of transmission for monetary policy, that is, the link between the monetary policy process and the economy.

While it is true that nonbank financial institutions may engage in one or the other of the above functions, only banks perform all of them.[12] Although the financial landscape is changing rapidly, and the distinction between banking and nonbanking institutions is becoming more blurred, these special characteristics of banks remain valid.

What makes banks most vulnerable is their susceptibility to the loss of public confidence. As a consequence, a bad bank that enjoys the public's confidence may operate in peace (at least for a little while), whereas a good bank can risk failure if it becomes subject to a bank run and all its deposits are withdrawn on short notice. Depositors are not generally in a position to monitor and assess the financial condition of their bank on a continuous basis. Thus, any suggestion, even a rumor, that a particular bank is no longer in a position to meet its liabilities is likely to lead to a bank run.[13] Depositors will withdraw their deposits as quickly as possible because they believe that those who do so will sustain the least loss. Moreover, any suggestion that one bank is in trouble may be taken (reasonably or unreasonably) as evidence that other banks are likely to face similar problems.[14] Globalization and technological progress have increased access to information and the speed with which it spreads. Hence, news of a bank's problem can spread faster than ever. This may not only precipitate an overreaction on the part of a bank's customers, but also—and more significantly—trigger a market reaction that will make it even more difficult and costly for the affected bank to obtain funding in the markets. Due to this dependence on public confidence, a bank failure involves the potential for damaging repercussions on the economic system as a whole.[15] The risk of contagion is further increased by interbank exposures arising from any one bank's role in the payment system.[16]

Recent crises in financial systems worldwide have demonstrated the close linkages between financial stability and the health of the real economy. Economists therefore consider financial stability a public good,[17] warranting the attention of national legislatures. The public good is clearly served by lowering the probability of bank failures.[18] Nevertheless, despite the best efforts of prudential regulation and oversight, bank failures can and do happen. Mismanagement, fraudulent activities, excessive risk-taking, or adverse market conditions can cause serious or even fatal financial problems.[19] Thus, the regulatory framework must deal not only with the *ex ante* problem of how to prevent bank failures, but also with failing banks and those on the road to failure.

Whereas there is extensive international guidance on prudential regulation, in particular capital adequacy and risk management procedures,[20] there is little on exit mechanisms for unviable banks. The Basel Committee's Core Principles for Effective Banking Supervision acknowledge that a prompt and orderly exit of banks that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system and that supervisors should be responsible for, or assist in, such an orderly exit.[21] Yet, the Core Principles, as well as the Core Principles Methodology,[22] do not discuss the specific modalities for an effective exit policy. The recently published Supervisory Guidance of the Basel Committee, which is based on experiences in different countries, contains guidance for supervisors and describes possible corrective measures for dealing with weak banks.[23] Again, however, it offers no specifics regarding an appropriate legal framework for dealing with insolvent banks. The legal frameworks in many countries lack clarity regarding procedures for dealing with distressed banks, and, as a result, such procedures are often determined on an ad hoc basis.[24] The reason for these lacunae—apart from the rarity of bank insolvencies in the past due to massive involvement by the State both as owner of banks and provider of emergency bail-out funds—may be that, in any jurisdictions, general insolvency law is, unless otherwise stated, deemed also applicable to banks. This is still the case in many jurisdictions.[25]

But does general insolvency law actually work for banks? A priori there is no reason not to apply general insolvency rules to banks. In fact, many aspects of a bank liquidation, such as the calculation of assets, the verification of claims, the adjudication of disputed claims, and the distribution of assets, will need to be handled largely in the same manner as the liquidation of a commercial company. In most European countries the insolvency law, therefore, applies to banks as *lex generalis,* while special rules (*lex specialis*)[26] or exemptions from the general regime[27] apply when called for by the specifics of bank insolvency procedures.

For example, in Italy, the banking law sets forth several special rules for bank insolvency while the provisions of the Italian bankruptcy law continue to apply, "*insofar as they are compatible,*" with respect to matters not expressly provided for in the banking law.[28] Norwegian law sets out a special public administration regime for banks and provides that the general insolvency rules contained in the Act on Debt Settlement Proceedings and Bankruptcy apply in case of a winding-up and liquidation, "*insofar as appropriate.*"[29] U.K. law treats banks in the same way as any other type of company and does not provide specific provisions for the reorganization or liquidation of financially distressed banks.[30]

Contrary to the majority of European legislators, who chose to apply ordinary insolvency rules to banks, the U.S. Congress opted very early for a special bank insolvency regime. Under the National Bank Act of 1864, it was the Comptroller of the Currency, rather than the judiciary, who was empowered to appoint a receiver for national banks.[31] Alongside federal regulation, most U.S. states established their own statutory regimes for supervising banks and resolving bank insolvencies. The Bankruptcy Act of 1898 explicitly excluded banks from its coverage and continues to do so.[32] At its creation in 1933, the FDIC became the exclusive receiver for failed national banks, as well as the receiver for state-chartered banks at the discretion of state authorities. The existence of deposit insurance created additional reasons for special bank insolvency rules, such as saving the insurance fund and deferring to FDIC expertise.[33]

Should other countries do as the United States and adopt a separate body of rules for bank insolvencies? Who should be in charge of the resolution of bank failures: the banking supervisor or, as under general insolvency law, the courts, or should there be some form of division of labor between them?

Some maintain that bank supervisors should deal only with living banks, while fatally ill or dead banks should be turned over to the mortician, the bankruptcy court. This argument goes as follows: because an insolvent bank can no longer conduct the business of banking, it is no longer a bank and thus should be treated just like any other bankrupt corporation.[34] Yet this argument holds only in part. Banks are already subject to special regulation that determines the conditions of their operation; it is, therefore, only the bank supervisor—and not a bankruptcy judge or a meeting of creditors—who is in a position to determine whether a bank is viable. Thus, the bank supervisor must have a voice in the insolvency procedure.

Should the bank supervisor be in charge of the entire insolvency procedure? Or should the procedure be turned over to a bankruptcy court? If so, at what stage in the process? While insolvency regimes differ widely from country to country with respect to the extent to which they rely on special procedures for resolving bank failures, there is a marked trend toward providing the supervisor with wider powers and to either complement or replace powers previously exercised by judicial authorities.[35] To understand the rationale for such special procedures, it is useful to look at the key differences between banking rules and corporate insolvency rules.

Special Rules Versus General Rules

The approach to insolvency by the bank supervisor differs from the approach under general corporate insolvency law in two important respects:

- First, the triggers for supervisory action precede the state of insolvency and the conditions for commencement of proceedings under general insolvency law. Also, the triggers are more likely to be related to safety and soundness requirements. Under general corporate insolvency law, by way of contrast, it is more commonly the creditor or the debtor who instigates action, and not a supervisor.

- Second, there are procedural differences between the banking act and general insolvency law. The role afforded to stakeholders is generally more restrictive in a regulatory procedure than in a general insolvency procedure because it is more centered on the supervisory authority and involves less negotiation.

Triggers for Intervention

The banking law typically confers extensive powers, permitting the bank supervisor to intervene, to take corrective actions, and, where such action fails to restore a bank to financial soundness, to close the bank in a timely fashion. Under bank regulatory law, supervisors can exercise broad discretion to decide whether or not to close a bank,[36] while insolvency law defines narrowly the specific conditions that must be satisfied before proceedings can commence. A trigger point under insolvency law is when the debtor institution has ceased to meet its liabilities as they fall due.[37] In the case of banking, however, the inability to honor a liability is not necessarily proof of insolvency and may be due to a temporary shortage of liquidity (which, in and of itself, may reveal a violation of legal liquidity requirements and constitute an early indicator of solvency problems). Thus, the insolvency concept under general law proves somewhat dysfunctional for banks. The regulatory determination that the bank's capital is impaired generally occurs before the determination of insolvency, as it is understood according to insolvency law.[38] Another facet of banks that renders the application of general corporate insolvency concepts more difficult is that, unlike other companies, banks—even while experiencing financial difficulties—can continue paying creditors because they typically have an ongoing source of cash flow from, and no ongoing payment obligations to, depositors. Since it is the role of the bank supervisor to assess the bank's capital and to evaluate the quality of its assets, it is also the bank supervisor who determines at what point a bank is no longer viable and must be closed; in other words, a bank is insolvent when the supervisor says it's insolvent.[39] Thus, insolvency is not the first relevant trigger for bank intervention. In fact, once a bank is proven insolvent, it would be too late to intervene effectively. It is the purpose of prudential regulation and supervision to ensure close monitoring of a bank's financial condition. Growing financial losses, management failures, and shortcomings of internal systems and controls should prompt the supervisor to intervene before such weaknesses develop into a situation where the bank becomes overindebted and creditors incur losses. This is the raison d'être of prudential regulation and supervision. Given this involvement of the bank supervisor in evaluating assets and determining solvency, in many jurisdictions it is the bank supervisor who has the authority, to the exclusion of individual creditors, to initiate insolvency proceedings. The banking laws of Austria, Germany, and Luxembourg, for example, reserve to the supervisory authority the right to petition for bankruptcy.[40]

Rules are therefore needed to clarify the applicable regime, whether general insolvency law or specific banking legislation. Such rules would reconcile the grounds for intervention under bank regulatory law versus the triggers for general insolvency procedures and would define the role of the bank supervisor relative to other authorities, in particular the courts, in the initiation of insolvency procedures.

Role of Stakeholders

In the context of bank intervention, supervisors are often accused of acting in an autocratic manner and not giving due consideration to the rights of individual bank creditors. Corporate insolvency law generally provides creditors with a more active role than is the case under bank regulatory law.[41] In ordinary insolvency proceedings, creditors have a right to be heard and have access to the court if they feel that their rights are not adequately protected. In a number of key areas creditor consent is usually required as a matter of law. Creditors may form creditors' committees through which they can act collectively and are generally empowered to challenge the actions of administrators or liquidators in court, or to dismiss them outright.[42]

A regulatory decision to suspend or restrict banking activities or to close a bank constitutes a regulatory measure addressed to the bank and is intended to sanction a violation of safety and soundness requirements. Even though they may well be affected by these proceedings, the bank's creditors and shareholders (as opposed to the bank itself and its managers and directors) generally do not have standing in the proceedings.[43] As a consequence, they need not be heard or served with documents pertaining to the proceedings. To take action against a measure imposed by the banking supervisory authority against the bank, they will have to have recourse to other legal remedies.[44] The absence of creditors' participation in proceedings administered by the bank supervisor is sometimes perceived as a lack of due process.

Publicity requirements and other procedural requirements in formal judicial insolvency proceedings, such as creditors' meetings, however, tend to lengthen the bankruptcy process and can have adverse effects on the value of assets and destroy liquidity. In the United States, it has been observed that, because it typically causes significant delays in returning the assets of failed companies to the private sector, the bankruptcy system could not have acted as quickly as did the FDIC in the Savings & Loan crisis.[45] As a general rule—and this has been stressed over and over again in writings on bank insolvency—prompt action is of the essence.[46] Even setting aside for the moment the important question of public confidence, it must be noted that financial assets, as opposed to material assets such as merchandise, can be dissipated secretly and very quickly. For this reason alone the bank supervisor needs to be able to intervene rapidly to prevent losses to depositors. News of financial problems travels fast, and there is a danger that, for instance, in the event of a hearing, even at short notice, the public may get wind of the trouble, and lose confidence, causing a run on the bank. In light of these concerns, the unitary decision-making process under regulatory law appears faster and more efficient than the negotiated process under ordinary insolvency law. The bank supervisor needs to be able to take action in an emergency without a full-scale hearing of the parties[47] and should be able to satisfy all procedural requirements shortly after the necessary measures have been taken.[48]

Concern for due process and the rights of creditors must be seen in the context of the objective of general bankruptcy rules, which is to maximize the return for creditors and to ensure their fair treatment. General bankruptcy law seeks to resolve creditors' claims in an orderly and collective manner. In contrast, the primary objective of the banking law is to ensure the stability of the financial sector as a whole and to prevent systemic problems. Whereas the receiver of a bankrupt company seeks to maximize assets in the interest of creditors, the foremost objective of the receiver of a failed bank is to minimize the impact of the failure on the banking system as a whole. Hence, in addition to creditor and debtor interests, bank insolvency law must consider the public interest. In certain circumstances this consideration may also justify a departure from the pari passu principle (the equal treatment of all creditors), which holds in general insolvency law. For instance, depositors and small creditors may be paid out in full while larger creditors are forced into a renegotiation of their claims. Likewise, it may be necessary to sell assets in an unfavorable market, or sell a business in a manner that does not maximize its value, in order to avoid market disruptions.

The challenge for architects of a special bank insolvency framework is to reconcile the differing objectives of bank regulatory law and insolvency law. Where the legislature opts for the inclusion of special insolvency rules in the banking act, it will have to adapt general insolvency rules to the special nature of bank insolvency while making sure that certain aspects of creditor protection are also included. Where the legislature prefers to separate bank regulation and insolvency proceedings, it will have to ensure a smooth interplay between those two bodies of law.

Special Rules: Where, When, and in What Form?

Given the distinct features of bank insolvency, namely, the involvement of the bank supervisor and the deposit protection agency, as well as the need to consider objectives other than maximization of the value, most countries have chosen to treat bank insolvencies differently from ordinary commercial insolvencies.

If one compares the various legal systems, one generally finds two models: in the first, the legislature has adopted special rules for a bank insolvency, which are administered by the supervisor or the deposit protection agency. This is the case in Canada,[49] Italy,[50] and the United States.[51] The second model, which is prevalent in Europe, is built on the general insolvency framework and administered by bankruptcy courts.[52] Since the conduct of bankruptcy proceedings in Europe is traditionally a judicial function, there is some reluctance to transfer certain of those judicial functions to the bank supervisor. At the same time, the special role of the bank supervisor in the process will need to be acknowledged in the applicable law. The most common approach is to provide for special rules to deal with the specifics of bank insolvency, while general bankruptcy rules continue to apply elsewhere. The extent to which special rules are necessary may differ from country to country and depends to a large extent on the form and flexibility of the general insolvency framework in the particular jurisdiction.

To determine the advisability and nature of special rules for banks, it is useful to differentiate three stages in the insolvency process: the preinsolvency phase, the insolvency phase, and the liquidation phase.

Preinsolvency Intervention

In order to address financial weaknesses and violations of prudential requirements at an early stage, bank supervisors typically have at their disposal a large variety of tools for intervention, ranging from the informal to more intrusive measures. The bank supervisor generally has broad authority to take remedial action and to direct a bank to cease and desist from unsafe or unsound business practices.[53] Many banking laws contain a list of such measures the supervisor can take, for example,[54] appoint an observer;[55] order an audit by an auditor chosen by the supervisor;[56] remove or suspend a bank official;[57] order changes in the organizational or management structure and the internal control system;[58] appoint a temporary officer or manager;[59] remove an auditor of the bank and appoint another one;[60] instruct the bank to observe restrictions regarding, for example, dividend payments, management fees, loans, and other investment contracts;[61] restrict the acceptance of deposits;[62] prohibit certain business operations, such as the acquisition of interests in other undertakings;[63] order an increase in security measures; order the bank to call certain loans; order the bank to increase its capitalization; and require branch closures.[64] As this list demonstrates, intervention can be quite intrusive. This is especially so when the bank supervisor takes control of a problem bank by requiring the management to obtain approval from the supervisor or an appointed administrator before taking any action.

Various forms of such controlled management exist. In Austria, the Austrian Financial Market Authority[65] may appoint a lawyer or an auditor as a special supervisor to a bank, with the power to prohibit the bank from entering into transactions deemed detrimental to the interests of the bank's creditors.[66] Under Belgian law, the Banking, Finance and Insurance Commission has the power to appoint a special inspector whose written authorization is required for each and every action by all decision-making bodies within the bank, including the general assembly of shareholders.[67] Both the appointment of the special inspector and the list of activities and decisions to be submitted for his or her approval must be published in the *Belgian Official Gazette*.[68] Acts carried out without the special inspector's approval are null and void unless subsequently ratified by him or her.[69] While the inspector does not have the power to take action on his or her own initiative, he or she can veto any management decision and submit his or her own proposals.[70] In Canada, the Bank Act establishes a system whereby the Superintendent may take control of the bank's own assets as well as those under its administration.[71] Where the Superintendent has control of such assets, he or she may do all that is necessary or expedient to protect the rights and interests of the depositors and creditors of the banks. Dutch banking law authorizes the supervisor, De Nederlandsche Bank, to appoint a trustee to a bank, by whom all decisions taken by the management, board of directors, and shareholders must be approved.[72] In Spain, the bank supervisor, which is the Bank of Spain, has the ability to place the management of a distressed bank under the control of appointed officials (*interventores*).[73] Any action taken without the prior approval of this official is considered null and void.[74] In Switzerland, a recent amendment to the Banking Act introduced the instrument of an investigator who can be appointed for investigatory or monitoring purposes and, under certain conditions according to the mandate defined by the Swiss Federal Banking Commission (SFBC), can act in lieu of the bank's managers or directors.[75] U.S. law establishes a particular regime to control management action and defines in detail the types of transactions that become subject to authorization, should the bank become what is termed "undercapitalized"[76] or "significantly undercapitalized."[77] Where a bank is found "critically undercapitalized"[78] it will no longer be able to carry out significant business transactions without the prior approval of the federal banking agency.[79]

The measures described above are regulatory intervention measures that a supervisor uses to address such concerns as violations of licensing and operating requirements, a deterioration in the quality or value of assets, undue exposure to off-balance-sheet risk, poor earnings and operating losses, poor liquidity management, or defects in management procedures. Intervention by means of controlled management may assist the supervisor in determining whether or not more drastic measures are necessary. In a very serious situation, controlled management may be combined with a moratorium against debt enforcement and thus comes to resemble an insolvency measure. While such measures are not insolvency measures per se, they could be qualified as a hybrid of regulatory intervention and preinsolvency measures, the objective of which is to encourage an early restructuring or resolution of the bank. As such, they play an important role as a substitute for reorganization procedures under ordinary insolvency law and constitute a necessary component of the general framework for dealing with problem banks.

Insolvency: Interface of Special and General Rules

Where the situation is so serious that there is a danger that the bank may default on payments or a bank run may occur, more drastic measures become necessary. Typically, a full or partial suspension of payments and a stay of enforcement action (moratorium) will be needed to protect depositors' interests and to avoid the dissipation or the attachment of assets by certain creditors to the detriment of others.[80] A moratorium is a critical instrument in an insolvency procedure in that it allows some time to consider available resolution options while fending off pressure from creditors. Given that the supervisory authority will be the first to recognize the need for such measures, it should have the power either to impose such a measure directly or to apply to the competent authority for its imposition. In certain jurisdictions with substantial involvement of the courts in the bank insolvency procedure, such as France, Luxembourg, Spain, and the United Kingdom, the bank supervisor must apply to the courts for protection against creditor action. In other jurisdictions, such as Germany, Italy, and Switzerland, the bank supervisory authority itself has the power to impose a moratorium against creditor action.[81] Which solution is preferable? The first option has the potential for causing delays if the application to the court is anything more than a formality, whereby it is granted in all cases without deliberation. The bank supervisor is generally better placed than the courts to decide what action needs to be taken (e.g., whether an immediate suspension of payments and stay on enforcement is necessary). Also, court action is inevitably associated with a bankruptcy procedure and may frustrate any reorganization attempts, short of bankruptcy.

The moratorium has far-reaching effects on creditors in that they cannot enforce their claims for its duration. A general moratorium that blocks all payment streams will be inappropriate in most cases, given the needs of bank customers and households. Even in a situation of severe financial difficulty it is not possible to halt all bank activities. The bank must continue to operate, even as it scales down the size of its books to reduce the potential for systemic risk. A moratorium is therefore generally combined with some form of controlled management or provisional administration, whereby the bank supervisor directly or indirectly takes control of the management of the bank and has the power to authorize exemptions from a suspension of payments.[82]

There are different forms of provisional administration. For example, in France, the Banking Commission can appoint a provisional administrator with all the powers for administering, managing, and representing the bank, including the power to petition for bankruptcy proceedings.[83] The Bank of Spain likewise has the capacity to replace the management of a distressed bank and to appoint provisional administrators (*administradores provisionales*).[84] Under Portuguese banking law, the Bank of Portugal can appoint one or more provisional administrators to a bank with serious financial difficulties[85] and confer upon them all powers and duties of the board of directors and managers.[86] Whereas in France and Spain such power is reserved to judicial authorities, the Portuguese supervisor has the power, concurrent with the appointment of provisional administrators, to impose a moratorium on all enforcement action.[87] The German supervisor (BaFin) has similar powers and can impose a system of controlled management in combination with the institution of a moratorium.[88] The Bank of Italy has the ability, in urgent situations, to suspend the powers of a bank's management and board of directors and to assume temporary management of a bank (*gestione provisoria*) for itself.[89] In all other cases involving serious violations of prudential regulations, the Bank of Italy can request the Ministry of the Treasury to place a bank under special administration (*amministrazione straordinaria*).[90] Upon authorization by the Bank of Italy, and with the approval of the oversight committee, the provisional administrators can impose a moratorium on the bank's payment of its liabilities; there is no need for judicial intervention.[91] In Norway, under the Act on Guarantee Schemes for Banks and Public Administration, and upon recommendation by the Banking, Insurance and Securities Commission, the Ministry of Finance can place a bank under public administration.[92] The Banking, Insurance and Securities Commission then appoints a board to assume all the powers of the bank's corporate bodies.[93] When the public administration is put into force, a moratorium automatically comes into effect. A similar procedure is provided for under a recent amendment to the Swiss Banking Act. If there are prospects for reorganization, the SFBC can initiate reorganization proceedings (*Sanierungsverfahren; procedure d'assainissement; procedura de risanamento*) and charge an administrator with the elaboration of a reorganization plan.[94] The SFBC has the power to impose a moratorium as a protective measure at, or even prior to, the formal initiation of a reorganization procedure.

The measures described above, which are provided for under bank regulatory law, can be qualified as quasi-insolvency procedures. To some extent they replace procedures provided for under the general insolvency law, as well as illustrate some of the options for special insolvency rules for banks. Of course, the ability to effectively carry out a reorganization through such procedures varies from one jurisdiction to another. For instance, not all bank supervisors have the power to impose a moratorium. A distinction must be drawn between, on the one hand, provisional administration as a temporary regulatory measure and, on the other, forms of provisional administration that amount to insolvency proceedings.

In the first model, owners retain their rights (although possibly in restricted form). The provisional administrators must carry out their functions within the corporate structure of the bank and are not vested with the powers of bank owners. Shareholder consent must be obtained for all actions when it is normally required by company law. According to the second model (which emulates a typical procedure available under general insolvency law) the administrator assumes exclusive control and the owners lose their ownership rights.

In the second model, all powers and competencies of the corporate bodies of the bank, including those of the general meeting of shareholders, lapse and become vested in the administrator appointed by the bank supervisor. The appointed administrator will have wide-ranging powers to dispose of the bank's assets. Any resolution option[95] affecting the capital structure (e.g., a new share issue, or the transfer of ownership) can be carried out without the approval of the general meeting of shareholders. The Norwegian and the Swiss regimes allow for a financial restructuring to be carried out outside of the framework available under general corporate law. In Norway, the Finance Ministry may decree that the share capital of a distressed bank be written down against the bank's losses[96] and order a new share subscription specifying the parties who are eligible to subscribe to the new share issue, notwithstanding former shareholders' preferential rights.[97] In Switzerland, the reorganization plan can likewise impose changes to the capital structure of a bank, and the law makes clear that such a plan is not subject to shareholder approval.

This distinction between provisional administration as a temporary regulatory measure and provisional administration as a quasi-insolvency measure must be kept in mind when considering the decision of the European Court of Justice (ECJ) in *Panagis Pafitis and Others v. Trapeza Kentrikis Ellados AE and Others*[98] (a case often cited to prove that a provisional administrator appointed by the bank supervisor must not exercise powers in disregard of shareholder rights).[99] The ECJ was asked to address the prejudicial question of whether the rules of Second Company Law Directive 77/91[100] were applicable to a bank that had been placed under provisional administration by the bank supervisor, the Central Bank of Greece. The provisional administrator had decided upon a capital increase without a decision of the general assembly of shareholders. The ECJ stated that member states must not adopt bank reorganization measures that violate the minimum level of protection for shareholders, and the Court held that any changes in the capital structure of a banking corporation without a resolution of the general meeting of shareholders were contrary to Article 25(1) of the Directive. The ECJ might have decided otherwise had the appointment of the provisional administrator occurred in the context of formal insolvency proceedings, which, as a general rule, entail the divestiture of the shareholders' ownership rights. The requirement of full shareholder participation, as provided for in corporate law, creates additional obstacles (more cost, more time) to the swift restructuring of a bank on the verge of failure, and it can even make that failure more likely. Lawmakers therefore must make sure that special bank reorganization rules do not conflict with other laws, corporate law in particular.[101]

Liquidation

As observed in the case of reorganization procedures, there are also two approaches to liquidation in bankruptcy. Some jurisdictions rely on general insolvency law for the appointment of a receiver or liquidator whose task is to realize assets and distribute the proceeds among creditors and shareholders, while other jurisdictions confer upon the bank supervisor the power to appoint a liquidator with a mandate to resolve the failing bank under supervisory oversight. The latter regime is illustrated by the forced administrative liquidation regime under Italian law.[102] In some jurisdictions, such as the United States[103] and Canada,[104] the deposit protection agency can be appointed as receiver or liquidator. The first regime is found in most European jurisdictions, where the administration of bank insolvency proceedings is regarded as a judicial function. Some jurisdictions provide for special court-administered bankruptcy proceedings under the banking law; among these are Austria,[105] Luxembourg,[106] and the Netherlands.[107] In other jurisdictions, for instance, France, Germany, and the United Kingdom, banks are subject to general court-administered bankruptcy proceedings. The French system, which allows for the coexistence of administrative proceedings directed by the bank supervisor and judicial proceedings administered by the courts, illustrates the challenges of superimposing a bank regulatory regime on a general insolvency framework. French law requires the competent bankruptcy court to hear the Banking Commission prior to the commencement of judicial rehabilitation or liquidation proceedings.[108] However, prior to the commencement of insolvency proceedings, all corrective measures available under the banking law as well as mediation attempts will have already been exhausted. Thus, by the time a judicial procedure has commenced, the survival of the bank in question is highly unlikely. The rehabilitation plan may often serve only to mask liquidation.[109] Judicial liquidation of a bank is therefore much more likely than rehabilitation.[110] Where the Banking Commission has appointed a provisional administrator prior to the initiation of insolvency proceedings, the appointment continues throughout the judicial proceedings alongside the appointment of the judicial administrator *(administrateur judiciaire)*. Whereas the Banking Act of 1984 did not draw a clear line between the powers and duties of the appointed officials, the amendments introduced in 1999 clarify the division of tasks between a court-appointed administrator and a provisional administrator[111] or liquidator.[112] The French system illustrates to what extent the fate of a banking institution lies in the hands of the supervisor. Where the Banking Commission withdraws the banking license, the court is bound by this decision and cannot overrule it, for example, by approving a rehabilitation plan requiring a continuation of operations.

For this reason, one might conclude that the banking supervisory authority and not the judicial authority should make the decision of whether and how to rehabilitate a bank. The involvement of judicial authorities alongside the supervisory authorities risks conflict arising from disparate assessments and recommendations. This conflict may slow down the proceedings, causing inefficiencies that, in the end, can do damage to the interests of creditors. On the other hand, shifting more responsibilities to the supervisory authority could increase efficiency. Especially to be avoided are conflicting competencies among the authorities involved, in particular between the bank supervisor and judicial authorities.[113]

The United Kingdom provides an example of a jurisdiction in which the banking law does not provide for a special regime, but where the general corporate insolvency regime applies to banks.[114] The procedure that is typically used is an administration order.[115] It was used to good effect in the Barings case.[116] The court issues an administration order and appoints an administrator, typically on application by the bank directors with support of the Financial Services Authority (FSA). The FSA, however, also has the power to make such application. In the course of the procedure both the FSA and the court may give directions to the court-appointed administrator. Thus, the U.K. system also bears the potential for conflict should these authorities differ, although to date this has not occurred.[117]

Special rules must ensure a smooth transition between regulatory procedures and judicial liquidation procedures, should such apply to banks. As long as there are prospects for continued operation, for example, by means of a merger, takeover, assumption of all or part of the bank's assets and liabilities, and so on, powers should remain with the bank supervisor, because only the bank supervisor can determine whether the prerequisites for continued operations are being met. However, where there are no prospects for continued operation, there is a need for coordination with other competent authorities, such as the bankruptcy courts and the deposit insurance agency. The interplay between bank regulatory law and general insolvency law and cooperation of the authorities involved needs to be explicitly addressed in the law.

Special Rules for the Protection of the Financial System

As mentioned above, what distinguishes a bank insolvency from a commercial bankruptcy is that the former may entail risk to the entire economic system,[118] propagated through the insolvent bank's counterparties. If the counterparty is unable to absorb the shortfall resulting from a bank's defaulting on a contract (a foreign exchange contract, repurchase agreement, securities trading, swaps option, forward transactions, etc.), it may default on its own contracts with other banks. That could lead to further defaults, and the stability of the entire financial system could thereby be threatened.

A solvent counterparty may be put in a difficult position if contracts are repudiated or postponed. This could occur if ordinary insolvency rules applied, which typically enable liquidators to cherry-pick the contracts of the insolvent by executing the profitable ones and disclaiming the others.[119] A counterparty could experience liquidity problems if insolvency law were to prevent it from setting off its own payment obligations against payments owed by the defaulting bank. Netting and closeout arrangements[120] should therefore be legally protected; that is, national laws need to recognize as enforceable the contractual protection afforded to the nondefaulting party by such provisions and must not interfere with closeout and netting of financial contracts.[121] It may also be necessary to make an exception to rules that enable insolvency representatives to interfere with contract termination provisions.[122]

Here there is a need for special rules for banks that give preferential treatment to financial market participants, even though such rules seem to conflict with the goal of fairness to all creditors, which is the underlying principle of general corporate insolvency law. Yet it is generally agreed that such special treatment is warranted on account of its potential to limit contagion in the financial sector. Following initiatives with regard to netting arrangements, in particular under the auspices of the Group of Ten (G-10) central banks or the Basel Committee on Banking Supervision and the adoption of the European Settlement Finality Directive,[123] many countries have enacted legislation securing the enforceability of netting arrangements in insolvency.[124]

Similar considerations can be applied to the treatment of collateral under general insolvency law. In some jurisdictions,[125] insolvency law includes collateral in the insolvency estate and disallows its enforcement by the creditor. The inability to enforce collateral immediately upon default of the debtor (the provider of the collateral) may expose creditors to serious losses and render them incapable of meeting their own obligations. To avoid a situation in which the failure of one market participant causes others to default on their obligations, it is important that collateral arrangements be protected from rules that would inhibit effective foreclosure.[126] Upon default by the collateral provider, the collateral taker must have the ability to liquidate the collateral speedily and according to the terms of the agreement.

The exceptions to general insolvency law discussed above are particularly important for the orderly functioning of payment and securities settlement systems, in which banks are major participants. Transfer orders entered into a payment or securities settlement system and irrevocable according to the rules of the system must not be reversible under the application of general insolvency law, otherwise the result could be that the netting of these orders would have to be unwound, which would affect other participants in the payment system and possibly trigger further defaults. Entries to or payments out of accounts of payment systems must be final and irrevocable, and insolvency proceedings should not be retroactive with regard to the rights and obligations of participants in a system. Also, it is important that collateral provided in connection with the participation in the payment or securities settlement system can be realized immediately. The European Settlement Finality Directive sets forth those special rules and exemptions from general insolvency law that are necessary for the orderly functioning of payment and securities settlement systems.[127] The application of the carve-out provisions discussed in this section, a primary purpose of which is to protect against systemic risk, is, however, not restricted to banks but extends to all participants in the financial market.[128]

Cross-Border Insolvency

In most jurisdictions, there are no rules to address the failure of a bank with foreign branches. The United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency, for instance, exempts banks from its scope.[129] Is the absence of special rules for dealing with banks that have establishments in foreign jurisdictions a sign that such rules are not necessary? Several failures of international banks suggest the contrary. The kinds of problems that arise in a cross-border bank insolvency are well documented. Several reports, drawn up in the wake of recent failures, have recommended further action. Following the bankruptcy of Bank of Credit and Commerce International (BCCI), the Basel Committee on Banking Supervision prepared a report on the implications of international bank insolvencies,[130] identifying a number of issues and potential areas of conflict. The report notes the many complexities and uncertainties that the interaction of different liquidation regimes presents for the disposition of a failed multinational bank's assets.

In 1995, following the collapse of the Barings Bank, the Group of Thirty (G-30), in cooperation with the International Federation of Insolvency Practitioners, formed a study group to look into the supervisory, legal, and financial problems arising from such events. The study group issued 14 recommendations for strengthening the legal, and regulatory frameworks for dealing with this type of insolvency.[131] Apart from recognizing the need for enhanced cooperation among authorities, these recommendations focus mainly on improving the legal framework for netting. The G-10 Study of Financial Sector Consolidation,[132] which was released to the public in January 2001, pointed out the issues arising from the creation of increasingly complex financial groups, the failure of which would have damaging effects on the world financial system. To minimize those consequences, the report concluded that it would be necessary to step up contingency planning and to improve communication and cooperation among central banks, finance ministries, and other financial supervisors—both domestic and international. The study, however, provided no details on how such communication and cooperation would take place, and what would actually need to be done to deal effectively with a large financial group in distress.

So far, little progress has been made in the implementation of those calls for action. This may be due to the very complexity of the matter and to the divergent interests and overlapping competencies involved. As we have seen above, devising a legal framework for bank insolvency is already complex enough on a national level with the various authorities involved—regulatory, supervisory, and judicial. The complexity is even greater in an international context.

In like manner, the differences between general insolvency law and bank regulatory rules are even more striking in the international context. National insolvency rules are based predominantly on the principle of territoriality, whereas in banking regulation the principles of consolidated supervision apply. Insolvency measures, such as moratoria, apply only within the jurisdiction in which the measure was imposed. The extent to which foreign authorities will recognize these measures depends on local law. While some jurisdictions recognize an insolvency decree issued abroad against the head office and allow assets of local branches to be included in the foreign proceedings (single-entity or universal approach), other jurisdictions take a more restrictive view and liquidate local branches of the foreign bank as separate entities with the intent to pay out local creditors first (separate-entity approach). In such a case, creditors may be treated differently, depending on whether they have business relations with the head office or a foreign branch.[133]

The principles of consolidated supervision, which were laid down in the 1983 Concordat[134] and the 1992 Minimum Standards,[135] place the major supervisory responsibilities for both the head office and foreign branches on the home country supervisor. However, given the realities of the bankruptcy law, it can be observed that bank supervisors supervise branches of foreign banks differently, according to the way such branches would be treated in a bankruptcy proceeding in the supervisor's country. Whereas a host supervisor in a single-entity jurisdiction tends to act in the interest of the bank as a whole, a host country supervisor in a separate-entity jurisdiction is likely to place greater emphasis on the protection of creditors transacting business with the host country branches. Thus, bank insolvency resolution is very much a matter of international supervisory concern and, therefore, should not be left to bankruptcy courts.

The single-entity approach appears more consistent with the principles of consolidated supervision in that it places the major responsibility for the liquidation on the authorities of the home country. The separate-entity approach is motivated by the concern that the creditors in the host country, who under a single-entity approach would be treated the same as the creditors in the home country, may not be well protected if supervision in the home country is weak; applying a single-entity approach in such a situation would reward creditors who transacted business in jurisdictions where bank supervision is weaker. Thus, a necessary precondition for a wider application of the single-entity approach would be to ensure that effective consolidated supervision is practiced in all relevant jurisdictions.

Professor Andrew Campbell[136] describes the regime under the European Directive on the Reorganization and Winding-up of Credit Institutions,[137] which implements the principles of unity and universality for bank insolvency proceedings on a regional level. Such would not be possible without the general framework of EU banking law already in existence, which integrates the principles of home country control and mutual recognition introduced by the First and Second Banking Directives.[138] The Directive sets forth a regime for the mutual recognition within the EU of reorganization measures and winding-up procedures applicable in a bank's home country.

However, this regime does not apply to third-country institutions. The Directive respects the widely accepted principles of supervisory cooperation based on home country control drawn up by the Basel Committee on Banking Supervision and, as such, could provide inspiration for a more ambitious international bank insolvency regime. An intermediate approach could follow the model of the European Insolvency Regulation[139] or that set forth in the UNCITRAL Model Law.[140] The introduction of a harmonized legal framework for the resolution of international bank insolvencies would not be possible without a binding international agreement. Unfortunately, however, none is likely to be achieved in the foreseeable future. A more realistic approach may be to facilitate international cooperation by providing in national laws the legal basis for cooperation among the authorities involved and for recognition of foreign administrative and judicial decisions.[141]

The situation of a cross-border insolvency is made even more complex in the case of a multinational banking group with sister companies, subsidiaries, branches, and financial sector participations in several countries. The principle of consolidated supervision means that the home country supervisor is responsible for monitoring a banking group's risk exposure and capital adequacy on the basis of the totality of its business, wherever conducted. The underlying idea is that an international group is to be looked at as one economic entity. The fact that there are various independent legal entities is simply ignored. It is recognized that if one member of the group encounters financial difficulties, it can trigger a loss of confidence, affecting other members of the group. Moreover, there is a de facto obligation on the part of the other members to come to the rescue of the failing member.[142] Given the existence of such obligations of mutual assistance across the borders of different legal systems and across the borders of corporate law concepts, the home supervisor looks at the group as one entity. The home supervisor must therefore make sure that capital adequacy requirements are fulfilled on a consolidated basis.

In contrast to this supervisory scenario, the assumption that a group composed of separate legal entities, including business units cutting across these legal entities, forms a single economic entity no longer holds in a bankruptcy scenario. Under the applicable insolvency law in the respective jurisdictions, the group is split into its many legal entities. Authorities treat subsidiaries of foreign banks as domestic institutions with their own legal identity. In the event of a crisis at a foreign subsidiary, the host country supervisor—that is, the subsidiary's home country supervisor—can take any measures available in the host jurisdiction. The authorities of the place of incorporation of the affiliated subsidiaries claim jurisdiction over the local part of the group's insolvency to the benefit of the creditors of that jurisdiction.[143] These stand-alone solutions for individual group companies are in opposition to the approach of consolidated supervision. Moreover, they may not be very effective, given the intertwined activities within the group and the potential for spillover effects from other companies in the group. For instance, there is a tendency for foreign subsidiaries and branches to centralize core operational capacity at the head office in their home jurisdiction. As a consequence, the host supervisory authority's ability to resolve the failure of the foreign branch or subsidiary in a way that minimizes damage to its jurisdiction's financial system is significantly limited. A common resolution would appear more efficient. However, as seen above, there are many legal and institutional obstacles to achieving such a special regime on an international level. Another failure of a large international banking group may be required before such changes come to pass.

The complexity of problems potentially arising from the insolvency of an international banking group illustrates the mismatch between global players and parochial supervisors. In the absence of common international rules, it has been recognized that effective crisis management requires close cooperation and information sharing among all the supervisors involved, both at the domestic and international levels.[144] While for crisis management purposes, supervisory authorities need to have up-to-date information on the organizational and management structure of such global players—as well as on the activities in all the markets and countries in which they operate; their involvement in clearing, settlement, and payment systems; their assets and liabilities; their liquidity needs, exposures, and so forth—information sharing alone does not resolve a crisis. More is needed; that is, the authorities involved need to be willing to cooperate and coordinate action in an emergency situation. Information sharing is typically based on nonbinding memoranda of understanding among supervisory authorities. While such memoranda provide an adequate framework for cooperation in normal times, in a crisis situation they may not ensure that all necessary information is exchanged on a timely basis and that action is coordinated accordingly. For such a situation, a more binding framework would be necessary, not only providing a basis for information sharing but also clearly laying out the respective tasks of the supervisors, along with the requirements for coordinated action.

The obstacles to establishing such a framework should not be underestimated. There is much public sensitivity to bank failures. In a crisis situation, a supervisor's primary concern will be the impact on the local economy and the treatment of local creditors. From a political perspective, the local perceptions of crisis resolution are more relevant than the wider international ramifications. However, the systemic impact of a bank failure should not be obscured by local issues. The need for international cooperation may appear more compelling in a situation in which the failure of a large financial group has relatively little systemic impact in the home country but much more in the host country. In such a scenario, consideration may need to be given to an arrangement between the home and the host central bank as regards the task of maintaining liquidity. However, any special rules that address such scenarios would need to be agreed upon at the international level.

Neither the general bankruptcy law nor rules applicable to individual bank failures address the problems associated with a crisis of a large banking group or financial conglomerate. A possible framework for the management of such a crisis is set out in the recommendations of the Joint Forum on Financial Conglomerates,[145] which have been implemented in the European Directive on Financial Conglomerates.[146] The directive provides for the mandatory appointment of a coordinator for any financial conglomerate falling within its scope and requires the conclusion of clear coordination arrangements, laying down the specific tasks for the coordinator of each conglomerate. Supervisors must have appropriate access to information within a conglomerate, assured by the member states. In the situation of an emergency restructuring of a bank, the role of the coordinator is not a simple one, because not only supervisors, but also other authorities, such as the central bank, the Ministry of Finance, judicial authorities, and even competition authorities, play a part, with each of them having distinct legal responsibilities in their respective countries. Even on a national level, it might be difficult to determine which authority assumes the role of coordinator. However, with due regard for the problems of such a role, there must be coordination of both information and action among the authorities directly concerned.

Another approach sometimes proposed has been to set up a supranational supervisor for a super-league of global financial institutions.[147] The supranational supervisor would exercise the same functions as a home supervisor under the present framework of consolidated supervision. A special set of rules building on the principles and standards of the relevant international organizations and standard setters, namely the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the International Organization of Insurance Supervisors, and the Joint Forum, would be applied to financial groups with global reach.[148] The supranational supervisor would be solely responsible for crisis management and the coordination of a global winding-up or liquidation of the group. There is no doubt that the realization of such an idea would encounter many obstacles.[149] Considering the time it took supervisors to agree upon internationally accepted general principles, best practices, and nonbinding recommendations, the project would seem an almost unattainable undertaking—at least for the foreseeable future.

Conclusions

In the interest of preserving financial stability, banks warrant special treatment. Bank insolvencies are different from others and require special rules. The extent to which such rules are needed depends on the infrastructural circumstances in each country, in particular the interplay between banking and insolvency laws as well as the flexibility of the judicial system.

Should those special rules apply only to banks? The contemporary reality is that financial problems and systemic risk can also originate in financial markets, and such markets are populated not only by banks but also by a large number of nonbank financial institutions and conglomerates that combine banking, insurance, and securities activities. This raises the question of whether those institutions also deserve special treatment in insolvency in the same way as banks. As observed by Professor Arthur Wilmarth,[150] further consolidation is likely to occur, domestically as well as cross-border, single category as well as cross-category (*Bancassurance*, *All-Finanz*, financial conglomerates). Such consolidation is likely to result in a relatively limited number of huge financial institutions worldwide. Many of them will remain engaged in banking only, but a growing number will combine the different sectors of financial services. At the same time, it can be expected that smaller commercial or retail banks with local or regional presence, as well as specialized niche providers, will continue to exist.[151] Furthermore, there are now nonfinancial companies that undertake financial activities on a scale that approaches those of major financial institutions.

These developments will further complicate the work of bank supervisors and regulators. On the one hand, there will continue to be a need for bank insolvency rules to address the failures of smaller local banks. On the other hand, there will be a growing number of *megabanks* or conglomerates, and specific rules will need to be devised for the proper handling, both preventive and corrective, of those institutions. Such rules will have to provide for effective coordination and cooperation not only among supervisors within one country, but also among the various national supervisors. A further convergence of supervisory and regulatory practices, including insolvency rules, would simplify this task. In recent years considerable progress has been achieved in cross-sectoral financial supervision as well as cross-border financial supervision. It is reflected in the changes in the supervisory landscape and the creation of single regulators in various countries[152] and also the cooperation among supervisors internationally, which has been increasing in recent years largely due to the work of the Basel Committee. However, there is more work to be done. In particular, in the cross-border context a number of issues need to be resolved in relation to the different approaches to cross-border bank insolvency. Reminding ourselves of the interdependence of the various national regulatory systems in preserving stability and soundness in the world's financial systems may help to lower the perceived obstacles to increased cooperation.

Notes

[1] Carl-Johan Lindgren, Gillian Garcia, and Matthew Seal, *Bank Soundness and Macroeconomic Policy*, International Monetary Fund (1996), Table 2, at 21–23.

[2] *See* Carl-Johan Lindgren, Tomás J.T. Baliño, Charles Enoch, Anne-Marie Gulde, Marc Quintyn, and Leslie Teo, *Financial Sector Crisis and Restructuring Lessons from Asia,* IMF Occasional Paper No. 188 (2000), http://www.imf.org/external/pubs/ft/op/opFinsec/op188.pdf.

[3] *See* Principle 3 of the Basel Core Principles for Effective Banking Supervision of September 1997, http://www.bis.org/publ/bcbs30a.pdf.

[4] The Belgian Banking and Finance Commission was created—originally under the name "Banking Commission"—in 1935 by "Royal Decree 185 on the supervision of banks and the rules governing the issue of securities." The Swiss Federal Banking Commission was created in 1934 by the Federal Act on Banks and Savings Banks of 1934. In Germany, the first banking law, which introduced banking supervision in Germany, dates from 1932.

[5] The Bank of Italy acquired supervisory functions in 1936. In the Netherlands, the Dutch Act on the Supervision of Credit Systems, which was first adopted in 1952, formalized the supervisory tasks of De Nederlandsche Bank.

[6] *E.g.*, following the collapse of the German Herstatt Bank in 1974, the Basel Committee on Banking Supervision was established. In 1975, the Basel Committee adopted the Basel Concordat, which was revised in 1983, following another bank failure, that of Banco Ambrosiano, the effects of which were felt in many jurisdictions. The Basel Committee's July 1992 minimum standards for the supervision of international banking groups and their cross-border establishments, as well as the European Council Directive 92/30/EEC of April 6, 1992, on the supervision of credit institutions on a consolidated basis, were adopted following the BCCI failure.

[7] *See, e.g.,* Edward W. Kelley, Jr., "Are Banks Still Special?—Comment" *in Banking Soundness and Monetary Policy* 263 (Charles Enoch and John H. Green, eds., 1997); E. Gerald Corrigan, "Are Banks Special?" *in Federal Reserve Bank of Minneapolis Annual Report 1982*, at 5–7 (1982), http://minneapolisfed.org/pubs/ar/ar1982a.html.

[8] In its message to Parliament recommending the adoption of the Swiss Banking Act of 1934, the Swiss Federal Council stated that the significant influence of those who dominate the financial market and distribute credit is not contestable and that therefore banking had become a form of public service ("Der unbeschränkbare Einfluss derer, die den Geldmarkt beherrschen und den Kredit verteilen, ist unbestreitbar einer der grossen Machtfaktoren der Gegenwart. Bei diesen Verhältnissen ist die Banktätigkeit eine Art öffentlicher Dienst geworden.") BBl 1934 I 171/172.

[9] Lindgren, *supra* note 1, at 6 (1996).

[10] In the European Union a bank is qualified as a credit institution and defined as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account." *See* Article 1 of Directive 2000/12/EC of the European Parliament and Council of March 20, 2000, relating to the taking

up and pursuit of the business of credit institutions, 26.5.2000 L 126/1 Official Journal of the European Communities, http://europa.eu.int/eur-lex/pri/en/oj/dat/2000/l_126/l_12620000526en00010059.pdf.

[11] *See* E. Gerald Corrigan, "Are Banks Special? A Revisitation," *in The Region*, Special Issue 2000, Federal Reserve Bank of Minneapolis 2000, http://www.minneapolisfed.org/pubs/region/00-03/corrigan.html, where the author states that it remains highly unlikely that nonbanks can provide very large amounts of liquidity on short notice.

[12] *E.g.*, money market mutual funds, as well as stock and bond mutual funds, have attracted large sums of money that formerly had been placed in bank investments such as certificates of deposit. In the United States, for instance, most mutual funds now also offer some banking services such as check-writing privileges. According to Sir Edward George, Governor of the Bank of England, three factors distinguish money-market mutuals from banks: first, investments in money-market mutuals are not capital certain and are not covered by deposit insurance. Second, money-market mutuals are not at the heart of the payments mechanism, and, third, money-market mutuals do not undertake maturity transformation by making illiquid loans. The nonbank financial institutions do not offer capital-certain and immediately available liabilities to the public at large in the form of bank deposits, nor do they offer payment services. Thus, the many traits of the deposit-gathering function remain unique to banks. *See* E.A.J. George, "Are Banks Still Special?" *in Banking Soundness and Monetary Policy* 251, at 258 (Charles Enoch and John H. Green, eds., 1997).

[13] The existence of deposit insurance may to a certain extent moderate such effect. If customers know that their deposits are protected, they will be unlikely to withdraw their funds. Yet evidence suggests that the general public is often not aware of the scope and extent of deposit protection. Andrew Campbell and Peter Cartwright, "Deposit Insurance, Consumer Protection, Bank Safety and Moral Hazard," *European Business Law Review* (1999) vol. 10, no. 3-4, at 96, however, argue that knowledge that deposits are partially protected may not be enough to prevent a bank run.

[14] Following the Barings collapse, a number of small to medium-sized investment banks in London and elsewhere reported to have suffered deposit withdrawals, even though there was nothing to suggest that they had incurred losses similar to Barings'. *See* Andrew Crockett, "Why Is Financial Stability a Goal of Public Policy?" *Federal Reserve Bank of Kansas City Economic Review*, Fourth Quarter 1997, 5, at 11 (1997).

[15] On contagion among banks, see Benton E. Gup, *Bank Failures in the Major Trading Countries* at 6 (1998) (with further references).

[16] *See* George, *supra* note 12.

[17] *See* Charles Wyplosz, "International Financial Instability," *in Global Public Goods: International Cooperation in the 21st Century* (Inge Kaul, Isabelle Grunberg, and Marc A. Stern, eds.) New York, Oxford University Press, 1999, and Crockett, *supra* note 14.

[18] *See* David T. Llewellyn, "The Optimum Regulatory Environment," paper presented at De Nederlandsche Bank conference *Banking Supervision at the Cross Roads*, Amsterdam, April 25, 2002, http://www.dnb.nl/english/e_toezicht/index.htm.

[19] According to the study of the Center for the Study of Financial Innovation (CSFI) "Banana Skins 2002: The CSFI's Annual Survey on the Risks Facing Banks," a survey that identifies major threats facing banks over the next few years, credit risk is often the strongest concern because of the likelihood of severe loan losses resulting not just from recessionary forces, but from what are seen as poor lending decisions in the 1990s, http://www.csfi.fsnet.co.uk.

[20] *See* papers of the Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework,* at http://www.bis.org/publ/bcbsca.htm.

[21] *See* explanatory note accompanying Principle 22 of the Basel Core Principles for Effective Banking Supervision of September 1997, http://www.bis.org/publ/bcbs30a.pdf.

[22] The "Core Principles Methodology" (1999), http://www.bis.org, is a detailed guidance, divided into essential criteria and additional criteria, for assessing compliance with the Core Principles.

[23] *See* Basel Committee on Banking Supervision, *Supervisory Guidance for Dealing with Weak Banks*, March 2002 [hereinafter "Supervisory Guidance"], http://www.bis.org/publ/bcbs88.pdf.

[24] *See* Thomas Glaessner and Ignacio Mas, "Incentives and the Resolution of Bank Distress," 10 *The World Bank Research Observer* 53 (1995).

[25] Most laws, however, are silent as to the extent to which the general insolvency law applies to banks. Section 52 of the Irish Central Bank Act 1989, http://www.irishstatutebook.ie, which provides that "[t]he rules of court relating to the winding up of companies shall, pending the making of rules of court for the purposes of this Part, apply for such purposes with such adaptations as may be necessary," reflects the current state of law in many European countries.

[26] For instance, Belgian banking law contains special avoidance provisions. *See* Article 29 of the Act of 22 March 1993 on the legal status and supervision of credit institutions.

The banking laws of Austria, Germany, and Luxembourg reserve the right to petition for bankruptcy to the bank supervisor:

Germany: Banking Act Section 46b (providing that the petition for the initiation of insolvency proceedings over the institution's assets may be filed by the BaFin only).

Luxembourg: Financial Sector Act Article 61(1) (authorizing only the prosecutor or the Luxembourg Monetary Institute to initiate bankruptcy proceedings).

Austria: Banking Act 1993 (as amended in 2000) Sec. 82(4) (authorizing only the Austrian Financial Market Authority to petition for bankruptcy if a bank had been placed under supervision).

[27] Austrian banking law declares that a bank cannot be subject to composition for creditors' proceedings (*Ausgleichsverfahren*), which apply to commercial companies; *see* Austria: Banking Act Section 82. Similarly, the Portuguese banking law declares the general law relating to preventive bankruptcy measures and to measures of reorganization of undertakings and protection of creditors inapplicable to banks; *see*

Portugal: Decree-law 298/92 on the Legal Regime for Credit Institutions and Financial Companies 1992 Article 139 (2).

[28] Italy: Consolidated Banking Act 1993 Art. 80 (6).

[29] Norway: Act on Guarantee Schemes for Banks and Public Administration, etc. of Financial Institutions § 4-10 (2). A translation of the Act is reprinted in *International Bank Insolvencies: A Central Bank Perspective* (Mario Giovanoli and Gregor Heinrich, eds., Kluwer, 1999), at 174–87.

[30] When the Insolvency Act 1986 was enacted in the United Kingdom, it initially applied only to nonbanks. The situation changed with the adoption of the Banks (Administration Proceedings) Order 1989, which declared the administration order procedure applicable to banks. To date, this procedure has been applied in connection with several cases of distressed banks. *See* case studies in Andrew Campbell and Peter Cartwright, *Banks in Crisis: The Legal Response* (Ashgate, 2002), at 154–59.

[31] *See* Peter P. Swire, "Bank Insolvency Law Now That It Matters Again," 42 *Duke L.J.* 469 (1992); also available via the Internet at http://www.acs.ohio-state.edu/units/law/swire1//psduke.htm.

[32] 11 U.S.C. § 109(b)(2), (3), http://uscode.house.gov/usc.htm.

[33] *See* testimony of Chairman Alan Greenspan before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 23, 2002, http://www.federalreserve.gov/boarddocs/testimony/2002/20020423/. Mr. Greenspan observes that deposit insurance weakened the market discipline to control risks that insured depositors would otherwise have imposed on banks and thrifts and that the ensuing reduced market discipline and increased moral hazard intensified the need for government supervision to protect the interests of taxpayers and, in essence, substitute for the reduced market discipline.

[34] J. Ashmead, "In Re Colonial Realty Co.," 60 *Brooklyn Law Review* 517, at 519 (1994). (The author compares the relevant rules under the Bankruptcy Code with the procedure under the Federal Deposit Insurance Act governing bank insolvencies.)

[35] In France, the amendments to the Banking Act of 1999 strengthened the powers of the Banking Commission in dealing with problem banks. *See, e.g.*, the revised Article 45 of the Banking Act of January 24, 1984 (updated September 1, 1999). The amendment also gives greater recognition to the role of the Banking Commission and the liquidators appointed by the Banking Commission in a judicial insolvency proceeding. For a thorough discussion of the increased powers of the Banking Commission, see Christophe Léguevaques, *Droit des défaillances bancaires* (2002), at 454. A recent amendment to Switzerland's Banking Act considerably expands the supervisory competencies in insolvency by transferring all powers to administer bank reorganization or liquidation proceedings from the courts to the bank supervisor, the Swiss Federal Banking Commission. For a synopsis of the proposed new framework, see Eva Hüpkes, "Dealing With Distressed Banks—Some Insights from Switzerland," 17 *Journal of International Banking Law* 153 (2002).

[36] Eva Hüpkes, *The Legal Aspects of Bank Insolvency* (Kluwer, 2000), at 13.

[37] *See Orderly & Effective Insolvency Procedures: Key Issues*, Legal Department, International Monetary Fund (1999), http://www.imf.org/external/pubs/ft/orderly/index.htm.

[38] This is sometimes referred to as "regulatory insolvency." *See* Hüpkes, *supra* note 36, at 13.

[39] William A. Ryback, "Comment," *in Current Developments in Monetary and Financial Law* (International Monetary Fund, 1999), at 226.

[40] *See supra* note 26.

[41] *See* UNCITRAL, "Draft Legislative Guide on Insolvency Law," September 2003, A/CN.9/WG.V/WP61, http://www.uncitral.org/en-index.htm.

[42] *See Orderly & Effective Insolvency Procedures: Key Issues, supra* note 37, Sec. 5 (1999).

[43] For instance, when a supervisor intervenes early to close a bank, the bank's capital may not have been fully exhausted, but the shareholders will suffer losses because the residual shareholder value will erode due to the closing. A bank closure, while it does not modify their claims against the bank, affects them significantly by preventing them from withdrawing money from their accounts.

[44] One possible remedy for bank creditors is a liability suit against the bank supervisor and/or the state for failure to carry out the supervisory function properly. The circumstances under which such an attribution of liability is admitted are, generally, limited. *See* Hüpkes, *supra* note 36, at 123–38.

[45] *See* Remarks by Ricki Helfer, Chairperson of the Federal Deposit Insurance Corporation, before the Group of Thirty Conference on International Insolvency in the Financial Sector, London, May 14, 1997 (citing U.S. bankruptcy statistics that show that from 1982 through 1995 only 491 companies in the United States successfully emerged from bankruptcy proceedings under Chapter 11, which gives companies protection from creditors while they reorganize—the average length of time for a company to emerge from this process being 17.2 months).

[46] *See, e.g.*, Tobias M.C. Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress*, International Monetary Fund, 2001, at 67–8.

[47] In the United States, a temporary cease-and-desist order can be issued without a prior hearing. It becomes effective upon service and remains effective until the completion of permanent cease-and-desist proceedings or until a court sets aside the order; *see* 12 USC § 1818(c) (1).

[48] The French Banking Act contains a provision (Article 48 para. 2) to this effect for the appointment of a provisional administrator (Article 44) and the appointment of a liquidator (Article 46), which provides "when special circumstances warrant it, the *Commission* can take the measures provided for in Articles 44 and 46 without hearing both sides. The measures referred to in the preceding paragraph are withdrawn or upheld by the Commission after hearing both sides within a time limit fixed by a decree of the *Conseil d'Etat*."

[49] In Canada, the federal bankruptcy legislation does not apply to banks. The liquidation of insolvent banks is regulated in the Winding-up and Restructuring Act of 1985 (available via the Internet at http://laws.justice.gc.ca/en/W-11/). The Bank Act

provides the Superintendent with significant powers to take control of a bank with a view toward restructuring the bank. The Canada Deposit Insurance Corporation has the power to acquire the assets, shares, or debt of a bank and act as a receiver. For more details, see Deborah M. Duffy, "National Report on Canada," *in International Bank Insolvencies: A Central Bank Perspective* (Mario Giovanoli and Gregor Heinrich, eds., Kluwer, 1999), at 35–53.

[50] The Consolidated Banking Act 1993 sets forth special administration and liquidation proceedings for banks that supersede the general corporate insolvency regimes. The proceedings are administered by the bank supervisory authorities. The role of the judicial authorities is limited to certain adjudicative functions, for instance, in connection with objections to the closing statement of accounts. For more details, see L. Cerenza and E. Galanti, "National Report on Italy," *in International Bank Insolvencies: A Central Bank Perspective* (Mario Giovanoli and Gregor Heinrich, eds., Kluwer, 1999), at 105–16.

[51] In the United States, the general insolvency law does not apply to banks. U.S. law provides the bank regulators with significant intervention powers and crisis management tools. The applicable framework also depends on the license of the bank, that is, whether it has a state charter or whether it is federally chartered. For more details, see J. Virgil Mattingly, et al., "National Report on the United States," *in International Bank Insolvencies: A Central Bank Perspective* (Mario Giovanoli and Gregor Heinrich, eds., Kluwer, 1999), at 259–82.

[52] This model is found in Austria, England, Germany, Luxembourg, and the Netherlands. For more details, see Hüpkes, *supra* note 36, at 68–80.

[53] The French Banking Act, for instance, provides in Art. 43 that "[t]he *Commission Bancaire* may issue a recommendation to a credit institution calling upon it to take appropriate steps to restore or strengthen its financial situation, improve its management methods or ensure that its organization matches its activities or development objectives. The institution concerned is required to respond within two months, giving details of measures taken following the recommendation. Independently of the provisions set forth in the previous paragraph, the *Commission Bancaire* may issue an injunction to any credit institution, [...] calling upon it, *inter alia* to take all necessary measures within a given period to restore or strengthen its financial situation, improve its management methods or ensure that its organization matches its activities or development objectives." *See also* Canada: Sec. 645 (1) of the Bank Act; Netherlands: Article 28 (2) of the Act on the Supervision of the Credit System; and Switzerland: Article 23quarter of the Banking Act.

[54] *See also* Supervisory Guidance, *supra* note 23, sec. 96 *et seq.*

[55] Australia: Secs. 13A–13B of the Banking Act 1959, http://www.gbld.org/downloads/Australia/BA.pdf; Germany: Sec. 46 para. 1 of the Banking Act; Switzerland: Article 23quarter of the Banking Act.

[56] Australia: Sec. 11CA (2) (b) of the Banking Act 1959.

[57] Australia: Sec. 11CA (2) (c) of the Banking Act 1959.

[58] *See, e.g.*, Belgium: Act of 22 March 1993 on the legal status and supervision of credit institutions Art. 57 Sec.1; Germany: Sec. 46 of the Banking Act; Norway: Sec.

3-2(2)(b) of the Act on Guarantee Schemes for Banks and Public Administration, etc. of Financial Institutions.

[59] Australia: Sec. 11CA (2) (c) (iii) of the Banking Act 1959.

[60] Australia: Sec. 11CA (2) (b) of the Banking Act 1959.

[61] *See, e.g.*, Belgium: Art. 57 Sec.1 of the Act of 22 March 1993 on the legal status and supervision of credit institutions; Germany: Sec. 46 of the Banking Act 1997; France: Art. 45 of the Banking Act; Austria: Art. 70 para. 2 of the Banking Act; and Australia: Sec. 11CA (2) (j) of the Banking Act 1959.

[62] *See, e.g.*, Germany: Sec. 46 (1) of the Banking Act and Australia: Sec. 11CA (2) (f) of the Banking Act 1959.

[63] *See, e.g.*, Germany: Sec. 46 of the Banking Act and Norway: Sec. 3-2(2)(c) of the Act on Guarantee Schemes for Banks and Public Administration, etc. of Financial Institutions.

[64] *See, e.g.*, Italy: Art. 78 of the Consolidated Banking Act 1993.

[65] The Austrian FMA assumed its powers and responsibilities under the Financial Market Supervision Act on April 1, 2002. The FMA is now the single statutory supervisory body directly responsible for banking, insurance and pension funds, securities, and stock exchange supervision.

[66] Austria: Sec. 70 para. 2 (2) of the Banking Act.

[67] Belgium: Act of 22 March 1993 on the legal status and supervision of credit institutions Art. 57 Sec. 1.

[68] *Id.*

[69] *Id.*

[70] *Id; see also* Austria: Sec. 70 (2) 2 of the Banking Act. The appointed supervisor can prohibit "all bank operations that may increase the risks for the bank's creditors."

[71] Canada: Sec. 648 (1) (a) and (b) (i) and (ii) of the Bank Act 1991, c. 46, http://laws.justice.gc.ca/en/B-1.01/text.html. Bank management is placed under the control of the Superintendent, and "no director, officer or employee of the bank has access to any cash or securities held by the bank unless a representative of the Superintendent accompanies the director, officer or employee, or the access has been previously authorized by the Superintendent or the Superintendent's representative." The Bank Act explicitly stipulates that "the bank shall not make, acquire or transfer any loan or make any purchase, sale or exchange of securities or any disbursement or transfer of cash of any kind without the prior approval of the Superintendent or a representative designated by the Superintendent."

[72] Netherlands: Act on the Supervision of the Credit System Sec. 28, http://www.gbld.org/downloads/The%20Netherlands/ASCS.pdf.

[73] Spain: Law 26/1988 on the Regulation and Supervision of Credit Institutions Art. 31.

[74] *Id.*, Art. 35.

[75] *See supra* note 35.

[76] For the definition of "undercapitalized," see 12 U.S.C. § 1831o (b) (C).

[77] For the definition of "significantly undercapitalized," see 12 U.S.C. § 1831o (b) (D). As such, a prior written approval from the Federal banking agency is necessary "to pay any bonus to any senior executive officer or to provide compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses, stock options, and profit-sharing) during the 12 calendar months preceding the calendar month in which the institution became undercapitalized." 12 U.S.C. § 1831o (f) (4) (A).

[78] For the definition of "critically undercapitalized," see 12 U.S.C. § 1831o (b) (E).

[79] Without the banking agency's prior written approval a "critically undercapitalized" bank is prohibited from "entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action with respect to which the depository institution is required to provide notice to the appropriate Federal banking agency; extending credit for any highly leveraged transaction. Amending the institution's charter or by-laws, except to the extent necessary to carry out any other requirement of any law, regulation, or order; making any material change in accounting methods; engaging in any covered transaction (as defined in section 371c(b) of this title); paying excessive compensation or bonuses; paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the institution's normal market areas." 12 U.S.C. § 1831o h (3) (c) (i) (2).

[80] The moratorium is a measure that is automatically imposed at the initiation of a bankruptcy procedure. It is a measure typically provided upon application to a bankruptcy court by the creditors or the managers, directors, and owners of a corporation. *See Orderly & Effective Insolvency Procedures*, *supra* note 37, "Protection against creditors."

[81] *See* Hüpkes, *supra* note 36, at 52.

[82] "Provisional administration" refers to the appointment of administrators by the bank supervisor for the purpose of managing a bank in the short term. The existing management will be dismissed or have its powers suspended during the period in which the provisional administrator is in control.

[83] France: Art. 44 of the Banking Act.

[84] Spain: Art. 31 of Law 26/1988 on the Regulation and Supervision of Credit Institutions.

[85] Portugal: Art. 143 (1) Decree-law 298/92 on the Legal Regime for Credit Institutions and Financial Companies.

[86] *Id.,* Art. 143 (2). The administrators also have the power to veto decisions of the shareholders.

[87] *Id.,* Art. 147.

[88] Germany: Banking Act § 46a.

[89] Italy: Art. 76 of the Consolidated Banking Act 1993. Temporary management must not, however, exceed two months.

[90] This measure dissolves the bank's administrative and supervisory bodies and suspends the general meeting of shareholders. The latter can be convened only upon the initiative of the special administrator. The Bank of Italy appoints one or more special administrators and an oversight committee. The special administrators' primary duty is to manage the bank, to eliminate irregularities, and to suggest appropriate remedies. The oversight committee has a consultative role and exercises the functions previously carried out by the bank's dissolved supervisory bodies. *See* Arts. 70 to 72 of the Consolidated Banking Act 1993.

[91] Italy: Art. 74 of the Consolidated Banking Act 1993. The moratorium can be ordered for one month and extended for two additional months. During this time, bank creditors cannot file or continue any enforcement actions against the bank's assets, nor can they acquire any preferred rights on the bank's assets.

[92] Norway: Secs. 4-4 and 4-5 of the Act on Guarantee Schemes for Banks and Public Administration.

[93] *Id.,* Sec. 4-6 (1). This board has a mandate to assess the bank's financial condition and draw up a plan of action (Sec. 4-8(4)).

[94] *See supra* note 35. Prior to the entry into force of the new Swiss bank insolvency framework on July 1, 2004, Swiss law did not provide for provisional administration. A bank that was no longer compliant with the licensing requirements and that was experiencing financial difficulties had its license withdrawn. License withdrawal is followed by liquidation. There was no alternative reorganization option or intermediate solution, such as provisional administration.

[95] In order to replenish the bank's capital, its owners have several options. Namely, they may decide upon a debt discharge; waive the bank's obligations to certain shareholders, the parent company, or sister companies; restructure or downsize business operations; or decide upon the divestiture of branches or subsidiaries. A financial restructuring may further consist of an increase of the share capital, or a reduction of the subscribed capital concurrent with the increase of the capital through a new subscription of shares. The latter procedure is envisioned by Art. 34 of the Capital Directive, *infra* note 105, which provides: "The subscribed capital may not be reduced to an amount less than the minimum capital laid down in accordance with Article 6. However, Member States may permit such a reduction if they also provide that the decision to reduce the subscribed capital may take effect only when the subscribed capital is increased to an amount at least equal to the prescribed minimum." *See also* France: Corporate Law Art. 71; Germany: Stock Corporation Act Sec. 228 (1); Switzerland: Law of Obligations Art. 732.

[96] Norway: Sec. 3-5 (1) of the Act on Guarantee Schemes for Banks and Public Administration, etc. of Financial Institutions, 6 December 1995, No. 75.

[97] Norway: Sec. 3-5 (2) of the Act on Guarantee Schemes for Banks and Public Administration, etc. of Financial Institutions, 6 December 1995, No. 75. Hence, in Norway a governmental decree can override the shareholders' fundamental right of making changes to the capital structure of the company and, thereby, the composition of its shareholding.

[98] *Panagis Pafitis and Others v. Trapeza Kentrikis Ellados AE and Others* (Case C-441/93), *CMLR*, July 9, 1996.

[99] *See* David G. Mayes, Liisa Halme, and Aarno Liuksila, *Improving Banking Supervision* 212 (Palgrave Macmillan, 2001).

[100] Second Council Directive of 13 December 1976 on coordination of safeguards that, for the protection of the interests of members and others, are required by member states of companies within the meaning of the second paragraph of Article 58 of the Treaty, with respect to the formation of public limited-liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent ("Capital Directive") (77/91/EEC) (OJ No. L 26, 31 January 1977, p. 1), http://europa.eu.int/eur-lex/en/consleg/main/1977/en_1977L0091_index.html.

[101] The debt-equity swap is seemingly a simple reorganization tool whereby creditors' claims are transformed into ownership rights, existing over-indebtedness is eliminated, and the balance sheet shows the equity capital intact again. Some jurisdictions pose stringent requirements for such transactions, which therefore need to be assessed carefully in order to ensure legal certainty of the restructuring. In most European jurisdictions, corporate law requires that every capital contribution be equivalent to the issue price of the subscribed shares (cf. Art. 8 of the Capital Directive, *infra* note 103) and the intact value of the claims be taken into account in the settlement. If the company is insolvent or overindebted, the claims of the creditors against it are, however, no longer of intact value, and the question may arise whether the subscribed capital has been fully paid up. German corporate law, for instance, requires that to carry out a financial restructuring by means of converting external capital resources into equity capital, it must be proven by an appraisal (which may contain an adjustment of value of the claims) that the payment of the shareholder does actually correspond to the nominal value of the subscribed shares and is therefore equal in value to a cash investment or a contribution in kind. In the absence of such clear settlement, there is a considerable legal risk involved. As such, a subscriber may run the risk that a claim will be brought against him by the company or (in the event of a subsequent failure) by the liquidator on the grounds that he failed to fully pay up the subscribed shares.

[102] Italy: Art. 84 of the Consolidated Banking Act 1993.

[103] John F. Bovenzi and Mike Spaid, "The FDIC's Role as Receiver," *in Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience 1980–1994*, 211 (1998); Barry S. Zisman and Hugh D. Spears, "FDIC/RTC Powers: Their Effect on Creditors and Shareholders," 7 *The Review of Banking and Financial Services*, 41 (1991).

[104] Canada: Sec. 39.1 Canada Deposit Insurance Corporation Act.

[105] Austria: Sec. 83 (1) of the Banking Act. Under Austrian banking law, the bankruptcy court can, either upon request of the bank itself, or upon application by the FMA, place the bank under provisional administration and suspend payment of its obligations.

[106] Luxembourg: Art. 60 of the Financial Sector Act. Luxembourg banking law provides for a court-administered provisional administration measure similar to the Austrian procedure. Upon request by the Luxembourg banking supervisory authority (Luxembourg Monetary Institute), the District Court can order a suspension of payments and appoint one or more supervisory auditors.

[107] The emergency procedure (*noodregeling*) is a special procedure applicable to banks that is administered by the District Court. The Netherlands Bank can, upon finding a bank to be "in a dangerous situation" or "unable to honor all or part of its obligations," apply to the District court for the commencement of the emergency procedure. The court appoints one or more judicial administrators (*bewindvoerders*) and entrusts them with the management of the bank. All enforcement actions are suspended. Netherlands: Sec. 74 of the Act on the Supervision of the Credit System.

[108] France: Banking Act Art. 46-3.

[109] *See* Bernard Grelon, *Les Etablissements de Crédit en Difficulté, Rapport de Synthèse,* 55 Revue de Droit Bancaire et de la bourse 109 (1996).

[110] Léguevaques, *supra* note 35, at 456–70 (considering the judicial liquidation the preferential mode for the treatment of insolvent banks).

[111] France: Banking Act Art. 46-4. Whereas the provisional administrator assumes the task of managing the bank, the court-appointed administrator has a mere monitoring and oversight function.

[112] France: Banking Act Art. 46-5.

[113] In Switzerland, colliding competencies among the officials involved in the resolution of a bank failure led to considerable delays. In October 1991, the Swiss Federal Banking Commission (SFBC) ordered a provisional closure of Spar- und Leihkasse Thun and appointed an observer. It later withdrew the banking license and appointed a liquidator. At the same time, the bankruptcy court of the Canton of Berne initiated judicial insolvency proceedings granting a moratorium and appointing a commissioner. The coexistence of the liquidator and the commissioner caused friction due to conflicting competencies and responsibilities and, eventually, led to the needed reform of the legal framework.

[114] *See* Andrew Campbell and Peter Cartwright, *Banks in Crisis: The Legal Response*, at 115 *et seq.*, 2002.

[115] When a bank has become insolvent or is about to become insolvent, the FSA generally has two choices: it can either present a petition for an administration order or a petition for the winding up of the bank where there is no realistic prospect of avoiding insolvent liquidation. *See* Campbell and Cartwright, *supra* note 114, at 126 *et seq.*

[116] Campbell and Cartwright, *supra* note 114, at 141.

[117] *Id.*, at 161 (pointing out the general willingness of the judiciary to cooperate with the FSA).

[118] Systemic risk is the risk that the failure of a market participant to meet its contractual obligations may in turn cause other market participants to default, with the chain reaction leading to broader financial difficulties.

[119] *Supra* note 41, para. 47, and *Orderly & Effective Insolvency Procedures: Key Issues, supra* note 37, at 26–30.

[120] Under a contractual netting arrangement, on the occurrence of an event of default, such as a moratorium order or the initiation of insolvency proceedings, all contracted but not yet due obligations are closed out at the current market value and

settled by one net payment owed either to or by the defaulting party. A bank faces only the risk that its counterparty will default on payment of a net amount, not a larger gross amount.

[121] Group of Thirty, "Global Institutions, National Supervision and Systemic Risk," July 1997 (calling upon national legislatures to strengthen laws regarding the enforceability of netting).

[122] *See supra* note 41, para. 66.

[123] *See infra* note 127.

[124] A major incentive was that netting would be taken into account in the calculations of capital requirements, provided that certain qualifying factors were met, among these the obtaining of a reasoned legal opinion regarding the enforceability of netting in the event of counterparty insolvency. *See, e.g.*, Switzerland: Implementing Ordinance to the Federal Law on Banks and Savings Banks of 1972 Art. 12f; USA 12 C.F.R. Part 208 A § III.E.3. The Basel Capital Accord 1988 initially recognized only the netting of off-balance sheet items in cases where the netting was supported by a novation agreement and subsequently extended the recognition to other forms of bilateral netting agreements.

[125] Prior to the reform of the framework for financial insolvencies in Switzerland, upon the commencement of bankruptcy proceedings the holder of collateral security could not obtain the immediate realization thereof. As soon as bankruptcy proceedings were commenced, the right to realize collateral security was excluded. Pledged assets belonging to the debtor formed part of the bankrupt institution's estate, and secured claims were satisfied directly out of the proceeds from the realization of the collateral security. The amendment, *supra* note 35, ensures that financial collateral arrangements remain unaffected by insolvency measures imposed by the SFBC. *See also* Inwon Song, "Collateral in Loan Classification and Provisioning," IMF Working Paper WP/02/122, 8 (2002) (stating that in several jurisdictions creditors may encounter legal impediments such as prolonged foreclosure and significant costs attached to foreclosure).

[126] *See also* the Directive of the European Parliament and of the Council on Financial Collateral Arrangements ("Collateral Directive"), the implementation of which will create a uniform EU legal framework to limit credit risk in financial transactions through the provision of securities and cash as collateral, http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_168/l_16820020627en00430050.pdf.

[127] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ("Settlement Finality Directive"). The EC Insolvency Regulation (Council regulation (EC) No. 1346/2000 of May 29, 2000, on insolvency proceedings, Official Journal L 160, 30/06/2000 P. 0001–0018), which was adopted by the EU Council on May 29, 2000 and came into force on May 31, 2002, has a direct effect in all member states of the European Union, with the exception of Denmark. It states in Recital 27 that special provisions of the Settlement Finality Directive take precedence over the general rules contained in it. Recitals 5 and 26 of the Winding-up Directive, *infra* note 137, refer to the Settlement Finality Directive, also confirming that bank insolvency proceedings must not have

any effect on the enforceability of orders validly entered into payment or securities settlement systems, or on collateral provided for a system.

[128] The Collateral Directive (*see supra* note 126) covers not only prudentially supervised financial institutions but also entities whose capital base exceeds €100 million or whose gross assets exceed €1 billion at the time when financial collateral is actually delivered according to the most recently prepared account published within a period no greater than two years prior to that time (Art. 2 (4)(c)).

[129] The UNCITRAL Model Law on Cross-Border Insolvency was adopted in 1997 by the United Nations Commission on International Trade Law (UNCITRAL) and aims to help States equip their insolvency laws with provisions to address more effectively and efficiently instances of cross-border insolvency. It is published in *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17* (A/52/17, annex I) (*UNCITRAL Yearbook,* Vol. XXVIII: 1997, Part Three).

[130] Basel Committee on Banking Supervision, "The Insolvency Liquidation of a Multinational Bank" *in BCBS Compendium of Documents—Volume III, International Supervisory Issues* (December 1992), Bank for International Settlements (April 1997), at 106.

[131] Group of Thirty, "International Insolvencies in the Financial Sector," A Study Group Report (1998).

[132] In September 1999, Finance Ministers and central bank Governors of the G-10 asked their Deputies to conduct a study of financial consolidation and its potential effects. To conduct the study, a Working Party was established under the auspices of finance ministry and central bank deputies of the G-10. G-10, "Report on Consolidation in the Financial Sector" (January 2001), http://www.imf.org/external/np/g10/2001/01/Eng/.

[133] *See* Hüpkes, *supra* note 36, at 142 *et seq.*

[134] Basel Committee on Banking Supervision, "Principles for the Supervision of Banks' Foreign Establishments (the "Concordat")," *in BCBS Compendium of Documents—Volume III, International Supervisory Issues* (May 1983), http://www.bis.org/publ/bcbsc312.pdf. The Concordat defines the respective responsibilities of home and host supervisors for monitoring the prudential conduct and soundness of the business of banks' foreign establishments. The Concordat states the principle of consolidated supervision according to which parent banks and parent supervisory authorities monitor the risk exposure (including concentrations of risk and the quality of assets) of the banks or banking groups for which they are responsible, as well as the adequacy of their capital, on the basis of the totality of their business, wherever conducted.

[135] Basel Committee on Banking Supervision, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (July 1992), http://www.bis.org/publ/bcbsc314.pdf.

[136] *See* the contribution by Andrew Campbell on the cross-border aspects of bank insolvency in Part VII of this publication.

[137] Directive 2001/24/EC of the European Parliament and of the Council of April 4, 2001, on the reorganization and winding up of credit institutions, OJ L 125, May 5, 2001, at 15 ("Winding-up Directive").

[138] "Home country control" refers to home country administration of rules. Under the Second Banking Directive, which is not incorporated in Directive 2000/12/EC, a bank established in any member state may, subject to the minimum requirements set forth in EU legislation, provide services across borders or operate branches throughout the EU, subject to home country rules and supervision. *See* Articles 13, 17, 20(1) to (6), 22, and 26 of Directive 2000/12/EC of the European Parliament and of the Council of March 20, 2000, relating to the taking up and pursuit of the business of credit institutions.

[139] Council regulation (EC) No. 1346/2000 of May 29, 2000, on insolvency proceedings. The Regulation came into force on May 31, 2002. Its aim is to improve the efficiency and effectiveness of insolvency proceedings that have cross-border dimensions by providing a unified set of rules relating to the jurisdiction to commence insolvency proceedings, the recognition of insolvency proceedings and related judgments, the law applicable to insolvency proceedings, and the provision of information for creditors. The Regulation has direct effects in all member states of the EU, with the exception of Denmark.

[140] *See supra,* note 129.

[141] Such an approach is taken under the recent amendment to Switzerland's Banking Act (*see supra* note 35). With a view toward leaving as much leeway as possible for coordination between local and foreign proceedings, the proposal states as a general principle that the local liquidators should coordinate their actions with foreign liquidators should there be parallel proceedings under way in order to achieve the most efficient realization of the assets in a timely fashion. Due consideration should be given to the pari passu principle, that is, the equal treatment of all creditors. Creditors that participate in foreign proceedings must not be treated better than those that participate only in Swiss proceedings. The amendment further provides that if a foreign bank with branches in Switzerland becomes subject to foreign reorganization or insolvency proceedings, the SFBC has the power to formally recognize these measures taken by foreign regulatory or judicial authorities.

[142] Under the "source-of-strength" principle in U.S. law, a holding company must act as a source of strength to its subsidiary banks, 12 C.F.R. § 225.4. *See also* the decision of Switzerland's Federal Supreme Court, BGE 116 Ib 337, 338, 339, 342 (finding that there is a de facto obligation [faktischer Beistandszwang] on the part of the other members to come to the rescue of the failing member).

[143] Given that many jurisdictions lack special rules for addressing the insolvency of a group of companies, the problem of splitting up a group into many individual legal entities, which become subject to separate insolvency proceedings, occurs not only on the international level but also on the national level.

[144] *See* Group of Ten, "Report on Consolidation in the Financial Sector," *supra* note 132, and also the Brouwer Report on Financial Crisis Management (adopted at the ECOFIN Council in April 2001), http://europa.eu.int/comm/economy_finance/publications/economic_papers/2001/ecp156en.pdf.

[145] BCBS, International Organization of Securities Commissions, and International Association of Insurance Supervisors, "Supervision of Financial Conglomer-

ates," Joint Forum on Financial Conglomeration (February 1999), http://www.bis.org/publ/bcbs47.pdf.

[146] *See* Directive 2002/87/EC of the European Parliament and of the Council of December 16, 2002, on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

[147] *See* "The Financial Industry in the 21st Century," introductory remarks by Daniel Zuberbühler, Director of the Secretariat, Swiss Federal Banking Commission, at the 11th International Conference of Banking Supervisors, Basel (September 2000), http://www.bis.org/review/rr000921c.pdf.

[148] An article in *The Economist* of April 6, 2002, citing a study on the future of European corporate and institutional banking by Olivier, Wyman, a New York firm of management consultants, and Morgan Stanley, noted that upheavals and mergers among the top global banks will go on "until four or five giant firms look something like Citigroup today."

[149] *See* Andrew Crockett, "Issues in Global Financial Supervision," remarks by Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, at the 36th South East Asian Central Banks Governors' Conference, Singapore, June 1, 2001, reprinted in *BIS Review* 49/2001.

[150] *See* the contribution by Arthur E. Wilmarth, Jr., on controlling systemic risk in an era of financial consolidation in Part VII of this publication.

[151] *Id. See also* Group of Ten, "Report on Consolidation in the Financial Sector," *supra* note 132.

[152] Following the creation of the FSA in the United Kingdom, proposals have been put forward in a number of European countries to set up a single supervisory authority in charge of all financial institutions. In 2002, Austria and Germany established a single regulatory authority.

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