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**Institute of Advanced Legal Studies**  
School of Advanced Study  
University of London

**Insolvency of Internationally Active Banks:  
The Harmony between Ex-Ante Regulations and Ex-Post  
Insolvency Laws**

Supervisor : Dr. Mahmood Bagheri

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Author Student ID : 1341146

Supervisor : Dr. Mahmood Bagheri

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## Introduction

Emerging economies vary in size, resources and characteristic. Nevertheless, they share similar challenges to create a sustainable growth and development by having an effective and efficient financial transaction. This awareness was captured as in globalization era; people, capital and services are moving rapidly all around the world, and this make the urgency to establish a viable and secure financial system to open global market and foreign investment. Furthermore, the rapid growth was spread all around the world. It was worldwide spread because of the development of financial transaction which make the trading system easier, which then influence the growth of international active banks. Unfortunately, the 1997 Asian Financial Crisis came up and the momentum was lost. It did not only threaten the economic stability in Asia but also the global economy.

The Asian financial crisis was the first crisis which encourages international organization and states all around the world to develop an established financial system. Further, the second crisis was occurred during the case of The Lehman Brothers bank insolvency in 2008. It was known as the greatest bankruptcy in the U.S. history and caused a great global financial crisis.<sup>1</sup> When the insolvency happened, The Lehman Brothers, Inc enterprise group has approximately 8.000 corporate entities in forty countries, which it's headquarter is located in New York City.<sup>2</sup> Despite of that, this issue raised the development of international bank insolvency, such as the conflict of law issue regarding the regulation, legal regime, assets distribution, and forum selection.

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<sup>1</sup> Anthony Connerty, "The Credit Crunch: the Collapse of Lehman Brothers – and Hong kong Scheme to handle Lehman claims" available at < [http://sas-space.sas.ac.uk/2915/1/Amicus83\\_Connerty.pdf](http://sas-space.sas.ac.uk/2915/1/Amicus83_Connerty.pdf) > accessed 14 August 2013.

<sup>2</sup> Samuel L. Bufford, "Coordination of Insolvency Cases for International Enterprise Groups: A Proposal" (2012) 86 Am. Bankr. L.J 689-690.

The ASIAN crisis was the point that G7 were pressed to restructure the international financial architecture.<sup>3</sup> It was led to awareness to provide an integral role of bankruptcy systems in national and global area, which then raises international institutions to consider insolvency law to be a particular hard case for harmonization.<sup>4</sup> The awareness was raised because of the unsuccessful process in separately in every single jurisdiction. Moreover, the recent financial crisis 2007-2009, has renewed the urgent attention to the importance of resolution systems for financial institutions, which is safeguard financial stability and moral hazard. And this resolution would only be effective if there is a development made in a framework that applies on a cross border basis. As a response to this matter, the G-20 leaders, International Monetary Fund, the Financial Stability Board, World Bank and The Basel Committee of Banking Supervision (BCBS) cross border bank resolution group held a meeting at the London Summit 2009.<sup>5</sup> They envisaged the possibility of harmonization of insolvency law. The proposal is to develop an international framework for cross border bank resolution arrangement.<sup>6</sup> Hence, in the absence of formal law, soft law fills the vacuum.

However, bank management crisis is complex at the national level, and the complexity will be greater in the case of an internationally active banks. It will involve the principles of multinational enterprises which will subsequently raise a jurisdictional problem issue, to determine the assets and liability of an internationally active bank. Regarding to this matter, the speed of financial transaction within the multinational companies itself is moving

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<sup>3</sup> Terence C. Halliday and Bruce G. Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis*, (Stanford University Press, 2009) p. 1.

<sup>4</sup> The G7 was set up in Tokyo in 1986 to strengthen the effective co-ordination of international economic policy. The members of G7 are Canada, France, Germany, Italy, Japan and The United States. Following the G7 summit, Basle Committee issued the "*promoting financial stability-submission for the G7 Head of Government at the 1998 Birmingham Summit*". Key point of this report is to strengthening international financial system in the area of transparency and accountability, domestic financial system and also managing international financial crisis. See Basle committee *promoting financial stability-submission for the G7 Head of Government at the 1998 Birmingham Summit*, p 3-15.

<sup>5</sup> International Monetary Fund, *Resolution of Cross-border Banks : A proposed Framework for enhanced Coordination*, available at :<http://www.imf.org/external/np/pp/eng/2010/061110.pdf> , accessed : 14 march 2013.

<sup>6</sup> *Ibid*

very fast, this condition in some point cause a vague to determine the assets between parent company and its subsidiary. The importance to establish this point is to protect the creditors of the banks and to ensure the predictability of the proceeding if there is a declaration of insolvency. Further, the debatable principle of Universalism and territorialism will answer the question.

In addition, bank business faces 2 (two) acute vulnerability. First, they will have to face a risk of illiquidity. Because of the transformation gap that occurred as a result of the bank supply of liquid assets will never be sufficient to meet the demands of all depositors at once. This problem will lead to the exhaustion of bank supply for liquid assets.<sup>7</sup> And the second vulnerability is that the risk of insolvency, which comes from the bank's highly leveraged balance sheet which banks maintain relatively little capital in relation to the size of their operations. Moreover, there is also a loan loss that will drive a bank swiftly into an insolvent condition.<sup>8</sup>

Against this background, it is my intention to raise a question on how do we prevent the future insolvency in internationally active banks? And how is the current international insolvency law in banking sector? This research will study the harmonization between preventive and curative action regarding the international banking insolvency. Thus the question arises from the growth of globalization that has made market to grow closer with lesser barrier.

This research focuses on the harmonization framework between ex-ante regulation to avoid insolvency and ex-post regulation of insolvency proceeding after the declaration of insolvent has given by the court or the authority to the bank. This research is also divided into seven chapters. In the first place, the introduction acknowledge us to bank insolvency of an

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<sup>7</sup> Heidi Mandanis Schooner and Michael W. Taylor, *Global Bank Regulation: Principles and Policies*, (Elsevier 2010) p 23

<sup>8</sup> *Ibid*, p 24.

internationally active bank with an example of bank crises momentum and special attention on jurisdictional problem related to internationally active bank insolvency.

Chapter one, deals with bank insolvency, which will raise the theoretical issue on bank insolvency. The discussion begins to determine the nature of international banking transaction and international trade which then make a bank as a multinational group entity. It also examines the issue of insolvency and introduced bank insolvency as *Lex Specialis* of the general insolvency. Further, it also identifies the failure in international bank regulation regarding insolvency.

The second chapter describes international bank regulations and bank levy as the preventive action to avoid bank insolvency. The international regulations involve International Monetary Fund (IMF), The Basel Committee of Banking Regulation and The European Regulation on Insolvency Proceeding. The historical background and the development of regulation in those international organizations relating to cross border insolvency problems will be discussed. Beside that the issue of taxation policy in banking sector to avoid future insolvency which known as of bank levy, is also arise because there is a debatable concept to implement this policy, which is double tax and the moral hazards.

Next, in the third chapter, this dissertation discusses the Bailout as an action against a failure of ex-ante banking regulation, banking supervision and market turbulence which is frequently used by local government to safe a financial institution in order to avoid a financial crises that occur because of bank insolvency proceeding.

The fourth chapter of this dissertation examines insolvency proceeding, including an analysis on the public and private law in banking insolvency. Further, the following discussion is about multistate insolvency debating the universalism principle and territorialism principle. The result of the debate is to figure out the best principle to use in cross-border insolvency.



Subsequently, chapter five reviews the ambiguity of international insolvency law's implementation. The review is about legal regime treatment arising from the issue of cross-border insolvency.

And finally the last chapter is proposing the international harmonization of insolvency in an internationally active bank as a part of integrating ex-ante and ex-post approaches. Concerning that currently, there is no appropriate international law regarding insolvency in an international active bank, the lesson from general corporate insolvency will be examined. The problem to implement cross-border coordination in international active banks is the determination of COMI which also will be reviewed in this chapter. And ultimately, the dissertation will propose features for ex-ante and ex-post harmonization in insolvency of international active banks.

## CHAPTER ONE

### 1. Bank Insolvency

Banking and financial market sector had an explosive growth since 1950s and early 1960s.<sup>9</sup> Most legal definition defines banks from their activities. In 1899, the United States Supreme court in *Auten V. United States National Banks of New York*, recognize the definition of banks as follows:

*“A bank...is an institution, usually incorporated with power to issue its promissory notes intended to circulate as money (known as bank notes); or to received the money of others on general deposit, to form a joint fund that shall be used by the institution, for its own benefit, for one or more of the purposes of making temporary loans and discounts; of dealing in notes, foreign and domestic bills of exchange, coin, bullion, credits, and the remission of money; or with both this powers, and with the privileges, in addition to these basic powers, of receiving special deposits and making collections for the holders of negotiable paper, if the institution sees fit to engage in such business.”<sup>10</sup>*

Meanwhile, English law considered the concept of deposit-taking as the core activity of banks, which first incorporated in the banking act 1979 and it continued in its successor statutes. Mainly, the provision of deposit and loan products distinguishes it from other financial institutions. From the same definition could be concluded that banks have an intermediary function which apply between depositors and borrowers. Further, this function makes banks as the most highly regulated institution, due to the complexity and the systemic effect of the public interest. Banks are commercial firms which have a special character. They have to maintain a riskiness of the business, by ensuring that there will be a profit margin which is sufficient to cover any loss due to the high risk borrower.

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<sup>9</sup> George Alexander Walker, *International banking regulation : law, policy and practice*, (1<sup>st</sup> publish 2001, kluwer 2001) 1.

<sup>10</sup> Schooner (n7), p 2.

Furthermore, bank balance sheet has a special dynamic nature due to the activity of incoming and outgoing transfer and the securities transaction which made the intraday larger than overnight balance sheet.<sup>11</sup> The illiquidity of banks depend on the incoming payment, if the incoming payment experience a problem and affected the other banks in the system, it will cause a systemic financial risk. Recognizing the fragility character of this business, banks become the most supervised institution. Therefore, to prevent the failure in bank, another body is needed to examine the solvency. Supervision in banking business related with financial risk and risk management.<sup>12</sup> Moreover, in some jurisdictions, bank supervisor is able to declare bank insolvency. This power is in accordance with the examination function that they have to perform in order to ensure the bank stability.

When the solvency of bank is threatened, supervisory measure is taken to ensure its insolvency and capital adequacy. This measure should be consistent between the banking law measure for dealing with distress bank and the supervisory policy to ensure that the banking policy is effective and coherence to resolve the crisis. Those coherent systems have not generally applied currently because of two reasons.<sup>13</sup> The first one is because the absent of appropriate disclosure system to the public. And the second one is the subsidy which is given by the government. The first reason occurs because of the sensitiveness information related to bank, if the solvency of a bank is known to be in disturbance, the market will not has the confidence to the financial institution, and further it will end with panic situation in the market. Meanwhile, the second reason arise because in several cases of the insolvent bank, the risk to declare the insolvency in a large firm is too risky for macro-economic stability

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<sup>11</sup> Thomas C. Baxter, Jr., Joyce M. Hansen and Joseph H. Sommer, "Two Cheers for Territoriality: an Essay on International Bank Insolvency Law" (2004) 78 Am. Bankr. L. J. 63

<sup>12</sup> Ibid, p. 64.

<sup>13</sup> Henry N. Schiffman, "Legal Measures to Manage Bank Insolvency in Economies in Transition", in Rosa M. Lastra (ed), *Bank Failures and Bank Insolvency Law in Economies in Transition* (Kluwer Law International, 1999) P. 84

which known as “too big to fail”. Therefore, government supported it by giving funding to absorb failing banks.

### 1.1 International Banking Transaction and International Trade

The growth of international banking activity has been substantial and significant. It has been expanding in various aspects in international trading system. In addition, the rapid increase in the scale of the banking sector by establishing a global operation through an extensive network attracted a special attention. Further, it subsequently became an important and complex subject with regard to the nature and conduct of international trading business. Banking is needed by the trade as for financing their business, it will then operate in various jurisdictions on the demand of business transaction.

There are various definitions for International banking. For instance, it is said to be international if the bank has branches or subsidiary in a foreign country.<sup>14</sup> Another terminology is given by the current denomination of the loan or deposit.<sup>15</sup> GA. Walker defines internationally active banking by defining the overall activity itself, as follows:

*“International banking is understood to refer to any form of banking activity, either conducted through an overseas operation of any form including branch, subsidiary, consortium or joint venture, any cross border provision of financial service and any transaction in a foreign currency.”<sup>16</sup>*

The definition is therefore considers that the international banking may be classified as a cross border activity, cross currency or having an overseas office. In particular, the distinction in terminations which given by Walker may divided into two part of understanding which is international and multinational term. The first term relates to cross

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<sup>14</sup> Shelagh Heffernan, *Modern Banking*, (2007, John Wiley & Sons 2005) p. 64.

<sup>15</sup> Walker (n9)

<sup>16</sup> Ibid, p.4.

border and cross currency transaction or operating through an overseas office. Meanwhile, the second part relates solely to the conduct of banking business through overseas offices or networks. The operation of international market has been widely practiced and it makes financing and financial instruments become a non-separable aspect in international commercial law. Thus make the banking sector as an undeniably international business.

The basic principle for international trade, especially in banking services is comparative advantage.<sup>17</sup> Applying the comparative advantage principle to this sector, the banks are maximizing competitive advantage if they could offer their customers a global portfolio diversification service, global risk management and international money transmission facilities. These benefits are offered as a competitive attraction to gain more depositors internationally. Therefore, to make it easier the formation of a multinational enterprise in banking business would be the best way to attract the market. A multinational enterprise is defined as any firm which has plants extending national boundaries.<sup>18</sup> In addition, a multinational bank is a bank with cross border representative offices, cross border branches which means that it is legally dependent and also cross border subsidiaries which is legally independent.

Internationally active banks have several options for conducting their business overseas. First, they could make local subsidiaries by having a branch office, which means that the subsidiary is maintained fully in accordance with the local law and has general banking activity, such as taking deposits. Second, they can have a representative office, which has limited banking activities, especially because they are only allowed to give funding, but unable to have depositors. And the last, they can simply maintain their assets by correspondent account. Further, the ambiguity in cross border bank insolvency is to separate the assets between the parent company and the subsidiary or to incorporate all the assets.

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<sup>17</sup> Heffernan (n14) p. 65.

<sup>18</sup> Ibid, p. 67.

The implication on the stability of banking system<sup>19</sup> on banks which operate in multinational legal jurisdiction for host country is that they are able to contribute to the benefit of the host states macroeconomic environment. In addition, banking sector is regulated by the World Trade Organization (WTO) under General Agreement on Trade in Services (GATS). GATS regulate these banks under the prudential concern and the rest will be regulated by the regulatory framework which relies on the international cooperation, such as International monetary fund (IMF), The International Bank for Reconstruction and Development (World Bank), The Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS), BASEL Committee on Banking Supervision, The International Organization for Securities Commission (IOSCO), The International Association of Insurance Supervisors (IAIS), and various of governments or G-initiatives.<sup>20</sup>

Eventually, international lending continues as the trading system evolves, while the global financial markets have been growing rapidly. However, there is instability in the financial sector that would make borrowers to come back to the banks.<sup>21</sup> As such, a short term project financing of merger, acquisition and leverage buyout transaction. Nevertheless, foreign direct investment is one of the most important economic activities. But, it is effectively regulated by the Bilateral Investment Treaties and the primary national level regulation based on the state responsibility for injuries to aliens.<sup>22</sup>

International banking transactions are complex sector to be regulated, due to the character of banking itself which is mainly regulated by domestic regulation on the grounds of their impact on the national macroeconomic development. Yet, the attention to

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<sup>19</sup> Lazaros E. Panourgias, *Banking Regulation and world trade law: GATS, EU and 'Prudential' Institution Building*, (Hart 2006) p. 2.

<sup>20</sup> *Ibid*, p. 24.

<sup>21</sup> Roy C. Smith and Ingo Walter, *Global Banking*, (OUP 1997) p. 19.

<sup>22</sup> Panourgias (n19) p. 27

international financial crises has directed attention to international banking regulation, especially to set up an ex-ante and ex-post insolvency regulation. It recognizes extraterritoriality of law which is an extensive context of “conflict of law”. The conflict of law literary determines how a court decides to determine which law to be applied in different jurisdictions. Further, the problem with banks which are international and operate in various jurisdictions is that they will affect the public interest both in individual and society at large in various countries.

### ***1.2 Bank Insolvency and Lex Specialis***

Banks are particularly special. This has been indicated by the recent global financial crises. Further, after analyzing the theoretical background of banking business, several indicator had been found as follows:

Firstly, because of the role of banks in the economy of a country is significant considering their function as an intermediary institution between depositors and borrowers. This is the reason of why bank has to be followed by the strict protection to the interest of bank depositors. Second, banks are responsible of the payment system and to the well functioning of the system, considering that the failure of this system will caused a chaos in financial business. Thirdly, the imbalance condition between the assets which tend to be long term in nature and the liability which tend to be short term will cause a problem, in that manner the activities have to be supervised strictly in order to monitor the balance. And the most significant of banking business problem is that the issue of systemic risk which could spread rapidly and destabilize the financial system of a country, even to a cross border basis.

There is an ambiguity in popular usage between “insolvent” and “bankruptcy”. Some view that those term have the same meaning which are treated the same for each other, and on the other hand, some experts believe that “insolvency” and “bankruptcy” have different

legal meaning. A long debate has been taken to clarify the meaning of those terminations. The term insolvency is generally signifies as “the inability to pay debts’.<sup>23</sup> The condition means that there is no adequate assets and property to pay the debts. In other words, this is an ultimate condition of inability to meet financial commitments.<sup>24</sup>

The action to justify a bank in an insolvent condition is taken to limiting the creditors and others stake holders loses. Further, the general measurement to identify insolvency in general corporation is by taking the “balance sheet” test of insolvency.<sup>25</sup> Or a “cash-flow” test which is more familiar in financial distress, the test applies in a debtor inability to pay obligations at the falling due.<sup>26</sup> Meanwhile, “bankruptcy” refers to a legal status that had been imposed in consequences of a formal legal process to which the debtor has been a party.<sup>27</sup> Conclusively, after the declaration of insolvent condition, a firm will have to proceed into a bankruptcy proceeding in order to execute the decision. In the meantime, “insolvent” or “insolvency” has no legal consequences. It is frequently employed in business terminology. Nevertheless, the term “insolvent” or “insolvency” is use in the title of legislation to define the insolvent condition. Further, “bankruptcy” followed the technical process intended to resolve the insolvency. Some important substantive and procedural provision of bankruptcy are not unitary and various. Such as some laws provide to avoid any material transactions with insider or third party which could endanger the assets.

Bank insolvency regimes are varies. Some countries apply special bank insolvency rules which are different from the general corporate insolvency rule.<sup>28</sup> Others use the same some important insolvency rules as for general firms. For countries which use general

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<sup>23</sup> Andrew Campbell and Rosa M. Lastra, “Definition of Bank Insolvency and Types of Banks Insolvency Proceedings”, in Rosa M. Lastra, *Cross Border Bank Insolvency*, (OUP, 2011) p. 29.

<sup>24</sup> Ian Fletcher, *The Law of Insolvency*, (Sweet & Maxwell, 2009), p.1.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid, p. 6.

<sup>28</sup> Heidi Mandanis Schooner, “Bank Insolvency Regimes in the United States and the United Kingdom” (2004-2005) 18 *transnat’l law*. 385



insolvency law for their bank insolvency, will extend their insolvency test for banking activity. Likewise, some countries even make combination on balance sheet and cash flow test.<sup>29</sup> Countries which use *lex specialis* in their bank insolvency law will need authorities who can step in the process and lead it. The supervisory body could be the authorities who declare the insolvency while they carrying out their examination. This action is the further step than the balance test and the cash flow test.<sup>30</sup>

Further, in the case of having insolvency situation there are two principles that they have to meet, that is fair and predictable treatment of creditors and debtor assets maximization.<sup>31</sup> If the general bankruptcy does not provide these two principles, then there should be a special treatment in bank insolvency regulation. In addition, public interest in banking sector is a major problem in banking insolvency. Therefore, any action which is done by the authority for the distribution process has to be done very carefully. This includes any transaction during the process.

There are many parties involves in bank insolvency proceeding, the bank supervisory authorities, conservators, receivers, creditors and depositors. And from all of those elements the main objective in bank insolvency proceeding is the protection of the creditor's interest. The creditor's interest even has to be protected more than the shareholders. Another important legal provision is the conservator power to gain the assets and sell it in a good faith and appropriate condition.<sup>32</sup>

Ultimately, there are two basic understanding about insolvency, the first is failure to pay debt or obligation as they fall due and the second is the condition when liabilities exceed assets. Based on this understanding, the appropriate measure to examine the bank condition is through the balance sheet measure which could possible identify directly and effectively by

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<sup>29</sup> CF Lastra (n23) p. 29-30

<sup>30</sup> Ibid, p. 30

<sup>31</sup> Schiffman (n13) P. 82.

<sup>32</sup> Ibid, p. 94.

having the supervisory body. However, if the declaration of insolvency is giving out by the court, the judges have to ensure their expertise in this region. The reason of this matter is because insolvency is a complex financial transaction. Therefore, an impartial court with an assistant from the expertise and the banking authorities to manage this case is needed to have a certain aspect of proceeding and claims.

### **1.2.1 Conservation of Bank's Assets**

In insolvency process, the asset protection is important to avoid further loses because of any transactions, being theft from the employees and officers and also from being transferred to other place. Prior to this matter, the disclosure of insolvency declaration to the public has to be done. This action could protect the assets of the bank from theft and from the third party who has an intended business with the bank, this could limiting loses from continuing banking activities.

### **1.2.2 Priorities in Distribution of Assets**

Insolvency proceeding is a collective action which involve a large number of creditors. The basic principle for asset's distribution in insolvency law is "proportional" or also known as "*Pari-Passu*" principle (equality of distribution) which means that creditors from the same rank have to be treated equally.<sup>33</sup> In the case of bank insolvency, the small amount creditors could be given high priority due to protect the vulnerable household depositors.

### **1.3 Identifying the Problem and the Role of International Bank Regulation**

The significance discussion of cross-border insolvency was initiated during the UNCITRAL's twenty-fifth anniversary in 1992.<sup>34</sup> It was found out to be a hard discussion

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<sup>33</sup> Bufford, (n2) p. 695.

<sup>34</sup> Jenny Clift, "United Nation Commission on International Trade Law (UNCITRAL) : The UNCITRAL Model on Cross-Border Insolvency-A Legislative Framework to Facilitate Coordination and Cooperation in Cross-Border Insolvency" (2004) 12 Tul. J. Int'l & Comp. L. 307

since the member concern that the project would find difficulties in agreeing the solution and finalizing text that could widely accepted by various jurisdictions. Later, a joint meeting to discuss further issues to identify the possibility of managing harmonization rules on cross-border insolvency was held by UNCITRAL and INSOL<sup>35</sup> international in 1993 and 1995.<sup>36</sup>

The result of the investigation shows as follows:

*“The national laws frequently produced approaches that neither supported the rescue of financially troubled businesses nor were conducive to the fair and efficient administration of insolvency.”<sup>37</sup>*

The fact that national law was discovered to unsolve the insolvency problem based on the fair and efficient administration, become the major concern of all the members of discussion. And yet, insolvency law was realized to be a hardly political problem to solve, and as the consequence it become disaster and creates financial crises because of the improper resolution scheme. In addition, the uncertainty of the rule implementation and the delay of the cost affected the capital flow and cross-border investment activity.

In the initial scheme of insolvency proceeding was territorialized regime. It is understand as different countries treated insolvency proceeding without recognizing the foreign claims. This framework was ineffective to cross-border insolvency proceeding, because of the globalization and the free trade, trading and foreign investment rapidly exploded. This condition creates Multinational enterprises which operate in multiple jurisdictions. Further, the 1994 colloquium identified the need to create the system to facilitate the liquidation process and the reorganization including the recognition to foreign court.<sup>38</sup> In brief, the need for cooperation among national lawmakers with recognition to

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<sup>35</sup> INSOL is an international insolvency lawyer organization.

<sup>36</sup> Clift (n34) p. 309.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

foreign assets and the implementation of principles of universality is an urgent problem to be solved.

In banking business, the problem becomes even more complicated. Learning from a few crises recently, a number of bank failures have made contribution to insolvency for bankers and the state. Several reasons were become the base of this failure. First, with regard to the special character of banking sector, the bank failure has an adverse impact to macroeconomic sector. Nonetheless, bank financial condition as reflected on its balance sheet is rarely an issue to overview to contribute the failure of a bank.<sup>39</sup> The failure situation could be determined by the bank regulator who overviews the financial record and examines it based on the loan loses and other write-downs on its call reports.<sup>40</sup> When it comes to a conclusion to insolvency declaration, a disagreement about the financial record may occurs between the internal bank management and the regulators. However, the effort to decline the justification from the banks supervisor is rarely a success.

Second, in the case of global financial collapse each jurisdiction take various approaches to resolve the problem, based on the understanding that each country has its own knowledge, characteristic and apply different system to solve the problem. Despite of that, a general insolvency was found to be not popular resolution to overcome the insolvent problem. A financial institution has a greater risk which could contribute to a great financial disaster. Therefore, authorities either use public money to bailout banks or ring-fenced bank's assets within their territory. In essence this pictures the condition that authorities tend to settle bank insolvency with their national regulation tools. Subsequently, this leads to legal uncertainty and high bailout cost which is paid by taxpayers.

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<sup>39</sup> Joseph T. Lynyak III, "The Failing Bank Scenario : An Explanation and Suggested Analysis for a Bank's Board of Directors and Management" (2009) 126 Banking L.J. 771

<sup>40</sup> Ibid

Third, there is no special legal framework for cross border bank insolvency. The current framework is addressed for the international corporate insolvency. Moreover, the current international insolvency depends on an *ad hoc* cooperation without a supporting legal structure. An effective structure is needed to facilitate international insolvency proceeding especially for a multinational enterprise banking group.

At this end, those reasons had awakened the international society to establish a framework of international bank insolvency law. A great effort has to be taken in first place to set up an acceptable agreement that could be implemented by various jurisdictions. An effective scheme of policy to prevent bank insolvency was realized to be one of the successful key factors on the framework. Following the prevention scheme, a coordinative framework of international bankruptcy law has to be prepared cautiously.

## CHAPTER TWO

### 2. International Application of Preventive National Measures

International preventive law in bank insolvency could be implementing by having an international convention or agreement from an international organization. The configuration of this law could be in the form of international policy for a cross-border bank activity.

#### 2.1 International Bank Regulation

Cross border bank activities has expanded substantially over the last decades. There are some positive influence and also the negative side of this development. First of all, the contribution of an internationally active bank is the development of the financial structure in host countries, the spread of economic development acknowledge to be in wider scope after the globalization. However, with positive effect there also comes the negative impact of this development. The impact is when an international active bank determines to be insolvent; it caused a greater impact nationally and internationally in financial sector. Therefore, these activities require a cross border banking supervision. The standard was developed by the Basel Committee of Banking Supervision (BCBS). However, until the financial crises existence in 2007-2009, the BCBS provide limited guidance concerning the bank exit policy and problems involved in it.<sup>41</sup> The committee initially published a document concerning multinational bank insolvency in 1992.<sup>42</sup> This document is the first lead to formulate a regulation for multinational bank insolvency. Meanwhile, the initial purpose of the document is to assess supervisor responsibility and refines supervisory practices in the light of issues of multinational bank failures.

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<sup>41</sup> Look Chan Ho and Rosa M. Lastra, "International Developments" in Rosa M. Lastra, "Cross Border Bank Insolvency", (OUP, 2011) p.204.

<sup>42</sup> The Basel Committee of Banking Supervision, "The Insolvency Liquidation of a Multinational Bank, 1992" <<https://www.bis.org/publ/bcbssc333.pdf>> accessed 1 August 2013.

Further, the attention to work out an international agreement on international insolvency attracts the United Nations. In May 1997, the United Nations Commission on International Trade Law (UNCITRAL) published a model law on cross border insolvency. Nevertheless, the work has not been accomplished yet. It needs a further research and approach that could simplify the agreement. To gain this goal the United Nations was supported by INSOL<sup>43</sup> and the international bar association which specialized their work in corporate insolvency to complete the document. Soon after, the collaboration was also supported by the World Bank which then successfully prepared a document of unified insolvency and creditor rights standard (ICR Standard) in 2010. This standard integrated the World Bank principle for effective creditor's rights and insolvency systems.<sup>44</sup> The ICR standards recognize that bank and insurance company may require a special insolvency treatment. Meanwhile, in the level of regional area a development on this matter arises, such as the EU directives, bilateral agreements between countries and Memorandum of Understanding that issued by the company and host countries.

### **2.1.1 International Monetary Fund**

Following World War II the United Nations held a conference at Bretton Woods and successfully passing three pillars in international commerce: the IMF, the International Bank for Reconstruction and Development (World Bank) and the General Agreement on Tariffs and Trade (GATT). The International Monetary Fund (IMF) was designed to establish its member

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<sup>43</sup> A worldwide federation of national associations for insolvency accountants and lawyers which practices all over the world

<sup>44</sup> Cf Chan Ho (n 41) p. 205

state's balance of payment post war international monetary system.<sup>45</sup> Despite of the initial proposal of the work of IMF within the member states, which is excluding to interfere in domestic governance, nowadays the borderline between domestic and international policies is hard to maintain. The ambiguity was as the result of the globalization and the free trade area.

Currently, IMF working area is to ensure the financial stability. Further, recognizing the emergence of bank insolvency makes a broader work agenda of IMF and World Bank staff on issues of financial stability is the bank insolvency. The emergence to this work is the financial crisis and the lessons concerning macroeconomic policy and regulation. In 2009, IMF provided an overview of the legal, institutional, and regulatory framework for bank insolvency in domestic level. This study is based on the previous work of the "Global Bank Insolvency Initiative" which were drafted in 2003-2004 and benefited from broad consultative process from The Basel Committee of banking Supervision, international financial institutions, and leading international experts on bank insolvency. The cross border problem is not an issue of this study, because the main point of this research is to provide an overview to the member states concerning bank insolvency problem. So, the application of this policy is still at the domestic level. An interesting point in this study is to find out that the choice of bank insolvency regime is not define clearly. Due to this reason, each authority has to choose the most suitable regime to apply within their country.

One of the recent developments that have been made internationally is that IMF had published a paper on July 2010 entitled "Resolution of Cross Border Banks: A Proposed Framework for Enhanced Coordination".<sup>46</sup> This paper is as a response of the G-20 leaders in London Summit, 2009.<sup>47</sup> This is the initial work that takes into account the Report and

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<sup>45</sup> Catherine H. Lee, "To Thine Own self Be True : IMF Conditionality and Erosion of Economic Sovereignty in The Asian Financial Crises" (2003) 24 U. Pa. J. Int'l Econ. L. 875

<sup>46</sup> IMF Executive Board Discusses Cross Border Bank Resolution, " Resolution of Cross Border Banks: A Proposed Framework for Enhanced Coordination, July 2010", available at <<http://www.imf.org/external/np/pp/eng/2010/061110.pdf>> accessed 5 august 2013

<sup>47</sup> Cf Chan Ho (n 41) p. 210.



Recommendations of the Cross Border Bank Resolution Group by the Basel Committee<sup>48</sup> and the UNCITRAL. The works proposed that the national legal frameworks of operating countries to have a common rule on:

*“Non discrimination against foreign creditors, appropriate intervention tools, appropriate Creditors safeguards and Robust Rules on depositor priority”.*<sup>49</sup>

Meanwhile, the robust rules means consolidated home country’s supervision to convince host countries to accept the leadership of the home country in designing and implementing resolution strategies.

### **2.1.2 Basel Committee of Banking Regulation**

The European Union on banking regulation directives started with the single European Act (SEA) in 1992 which recognizes the principle of mutual recognition.<sup>50</sup> Further, the principles were consolidated in banking consolidation directive. This consolidation principle formed the three pillars in the European Union: the single market, an effective monetary arrangement and an expanded community budget.<sup>51</sup> The European single market strategy principle is projected to settle the global capital adequacy set by the Bank for International Settlement (BIS). Meanwhile, as the turn key of the international insolvency, the case of the Bank of Credit and Commerce International S.A. (BCCI S.A.) has led Basel

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<sup>48</sup>Basel Committee “Report and Recommendations of the Cross Border Bank Resolution Group, March 2010” available at <<http://www.bis.org/publ/bcbs162.pdf>> accessed in 5 August 2013.

<sup>49</sup> Ibid, p. 4.

<sup>50</sup> Adrienne Coleton, “Banking insolvency regimes and cross-border banks – complexities and conflicts: is the current European insolvency framework efficient and robust enough to effectively resolve cross-border banks, can there be a one size fits all solution?” (2012) J.I.B.L.R. 63

<sup>51</sup> Marco Buti, Mario Nava, and Peter M. Smith, “Making the EU Economic System Deliver: Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission”, (2003) available at <[http://www.escap.asia/tid/artnet/mtg/gmscb\\_growingeurope.pdf](http://www.escap.asia/tid/artnet/mtg/gmscb_growingeurope.pdf)>

Committee to make an analysis of multinational banking insolvency.<sup>52</sup> The case involved the jurisdiction of banking insolvency in Luxemburg, the United Kingdom and The United States. There are five key legal concepts which are examined in this document. Those are the separate entity doctrine, the single entity doctrine, the applicable law of bank liquidation, set off and the impact of criminal and civil penalty proceeding of bank liquidation.<sup>53</sup> The discussion of separate entity and single entity doctrine is the initial discussion to promote the issue of supervisory regime following that a multinational bank is likely to have branches in many jurisdictions.

The Basel committee on Bank Supervision (BCBS) is an international advisory authority on bank regulation who has issued guidance to ensure the health in banking systems across the world.<sup>54</sup> However, the financial crisis indicates that there were serious faults in regulatory and supervisory arrangements. BCBS issued a set of recommendations on banking regulations in regards to capital risks, market risk and operational risk to ensure financial institution meet their obligation and endure the unexpected loss. The first Basel accord was agreed in 1988 which then known as Basel 1. Basel 1 is appointed to strengthen the financial stability through requiring a high capital ratio. Further, in 2004 BCBS issued Basel II framework which introduced the concept of three pillars. Those three pillars promote the risk management in liquidity, market and operational. Subsequently, since the 2008-2009 crises the Basel Committee published Basel III. The Basel III proposals sought to strengthen the regulatory regime applying to credit institutions in the following areas:

*“Enhancing the quality and quantity of capital, strengthening capital requirements for counterparty credit risk (and in CRD III for market risk) resulting in higher Pillar I requirements for both, introducing a leverage ratio as a backstop to risk-based capital, introducing two*

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<sup>52</sup> Cf clift (n34) p. 1

<sup>53</sup> Cf the Basel Committee of Banking Supervision (n48)

<sup>54</sup> Joe Larso, “The Basel Capital Accords, April 2011” available at <<http://ebook.law.uiowa.edu/ebook/sites/default/files/Basel%20Accords%20FAQ.pdf>> accessed 8 august 2013.

*new capital buffers: one on capital conservation and one as a countercyclical capital buffer.”<sup>55</sup>*

The Basel guidance 2010 is the underlying guidance to published Basel III, the main objective of which is to strengthening global capital and liquidity rules with the goals to promote a resilient banking system.<sup>56</sup> It requires banks to increase the capital totaling 7 percent of their risk bearing. It also express the goal to reduce the change of another financial crisis with some element to measure the level of bank solvency through a leverage ratio, a capital buffer and the proposal to deal with pro-cyclicality through dynamic provisioning based on expected loses.<sup>57</sup> Nonetheless, difficulty on implementing this guidance is to research the risk mitigation and maintaining it. This process will acquire a costly process and resources. To overcome this problem a consolidated coordination between the board of directors and supervisory body would be more efficient. However, this practice is an important element to gain public confidence in banking system. In addition, the lack of integrated bank supervisory system has put an absent to determine the solvency ratio. Therefore, the best solution is to focusing the solvency issues and resolution regime to the supervisor in order to deal insolvency problem effectively when the insolvency occur.

The financial crisis 2007 has given a lesson for the Basel Committee to develop recommendation on cross-border bank resolution group. An important consideration to proposing national resolution for financial firms is to avoid further reliance of public support to which has known as “too big to fail”. The challenge in having a resolution scheme in international banks insolvency is that the crisis resolution frame work generally deals with

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<sup>55</sup> Brief explanation about Basel Accord available at < <http://www.fsa.gov.uk/about/what/international/basel>> accessed in 7 august 2013.

<sup>56</sup> KPMG.com, Basel III: Issues and Implications, available at <<http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/basel-III-issues-implications.pdf>>

<sup>57</sup> Adrian Blundell – Wignall and Paul Atkinson, “Thinking Beyond Basel III: Necessary Solution for Capital and Liquidity” (OECD Journal: Financial market trends, 2010) available at <<http://www.oecd.org/finance/financial-markets/45314422.pdf>> accessed 10 August 2013

domestic failures and minimize losses.<sup>58</sup> The option to reform this condition is by having an enforceable agreement on the sharing of financial burdens by stakeholders in different jurisdictions for crisis management and resolution for cross-border financial institution and groups.<sup>59</sup>

The following progress later was related with the objective of The Group of Twenty Leaders summit, which was held in April 2009, to strengthen cooperation, on crisis prevention, management and resolution and to examine the resolution regimes and bankruptcy law. This meeting was followed the previous work of an international cooperation and promoting integrity in financial market, which is currently known as the financial stability board and the Basel committee. The work of the taskforce is to set up a cooperation scheme on crisis management and commitment to cooperate by the relevant authorities, including the supervisory body, central banks and finance minister.

The collapse of Lehman brothers group which consisted of 2.985 legal entities which operated in multiple jurisdictions provided a great lesson for financial crisis management.<sup>60</sup> The insolvency proceeding proceeded under host country national regulation with the supervision by the Securities and Exchange Commission (SEC) through consolidated supervised entitled. The Lehman group was organized so that the most essential function, such as the management of liquidity, were centralized in Lehman Brothers Holdings, inc (LBHI), New York.

When firms face a liquidity problem, it needs resources to fund the ongoing business while they seek for an acquirer. The liquidity problem which was face by Lehman Brothers began with the US Broker dealer (LBI) which instead filed as bankrupt; the Federal Reserve Bank of New York provided its liquidity and the London Investment firm (LBIE). The LBIE

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<sup>58</sup> The Basel Committee on Banking Supervision, "Report and Recommendations of the Cross-Border Bank Resolution Group", (2010) available at < <http://www.bis.org/publ/bcbs169.pdf> > accessed 10 august 2013.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid, p. 14.; David N. Crapo, "Lehman Brothers Dismantles in Bankruptcy" (2008) 4 Pratt's J. Bankr. L. 702

relied for its liquidity on LBHI. When LBHI declared to be insolvent, subsequently it had multiple impacts to all its subsidiaries, such as Switzerland, Japan, Singapore, Hong Kong, Germany, Luxemburg, Australia, The Netherland and Bermuda. Each Jurisdiction applied special Insolvency law based on legal regime in their territory. Following the crisis, The Basel Committee on Banking Supervision released the Report and Recommendations of the Cross Border Bank Resolution Group in March 2010. The recommendations give guidance to coordinate the insolvency problem as follows:<sup>61</sup>

1. Effective national resolution power
2. Frameworks for a coordinated resolution of financial groups
3. Convergence of national resolution measures
4. Cross-border effects of national resolution measures
5. Reduction of complexity and interconnectedness of group structures and operations
6. Planning in advance for orderly resolution
7. Cross-border Cooperation and information sharing
8. Strengthening risk mitigation mechanism
9. Transfer of contractual relationship
10. Exit strategies and market discipline

The implementation of those frameworks requires a large scale reform in national legal framework. Further, a major problem in this framework is that it also has to deal with multinational enterprise group principles and various legal regimes.

### **2.1.3 The European Regulation on Insolvency Proceedings**

The European Union has increasingly cross border activities in business transactions due to freedom, security and justice in its territory. Hence, this condition acquires a cross border insolvency proceedings that efficiently and effectively operate. The European Union

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<sup>61</sup> Ibid. p. 22-43.

first draft on insolvency regime was initiated in 1960. Further, The European treaty on insolvency law was signed in 1995<sup>62</sup>, it was then converted into the European Union Regulation which was issued on May, 2000 which then come into force in 2002. This regulation regulates as follows:

*“(1). Requiring the recognition of any insolvency case opened in any other EU State; (2). Determining the choice of law for insolvency issues; (3). Authorizing the opening of secondary proceeding to protect legal interests; (4). Providing for the coordination of claims; (5). Requiring information about related proceedings; and (6) resolving the question of which language will be used.”<sup>63</sup>*

Nevertheless, this regulation could only apply if the parties are EU member states, which means that if there is a non EU member state involved in the insolvency case, this regulation would not be applied in such case.

The EU insolvency regulation does not provide a guidance on a concurrent insolvency proceeding which made it difficult to apply in such situation. This guidance then comes up in The European Communication and Cooperation Guidelines for Cross-Border Insolvency (The CoCo Guidelines) which codify best practices and suggest non binding provision for protocols and describe certain basic requirements and specific provision to addressed in cross-border insolvency protocols.<sup>64</sup> This guideline contain of eighteen principles for court to court communication and coordination within the European members to the European Court of Justice. Nevertheless, this guideline has influence the development of protocols involving the aspect of European multinational company which primary operation are elsewhere.<sup>65</sup>

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<sup>62</sup> Bufford (n33) p. 704.

<sup>63</sup> Ibid. p. 704-705.

<sup>64</sup> Paul H. Zumbro, “Cross-Border Insolvencies and International Protocols – An Imperfect but Effective Tool” (2010) 11 Bus. L. int’l 167.

<sup>65</sup> Ibid.

## 2.2 Bank Levy

Preventing bank insolvency could be done by creating strict policy for banking sector, supervise the banking sector with internationally supervisory body and domestic supervisory body within the national jurisdiction and implementing bank levy. In conjunction with this matter, the United Kingdom, the United States, Germany, Portugal, Sweden, France, Hungary and Austria have introduced Bank Levies.<sup>66</sup> The purpose of bank levy is to establish that banks will make contribution on their potential risk. Further, it will ensure the banks to consider a serious calculation of their branches liability. The framework of bank levy considered to be the best solution for the bank crisis and their short term funding with high potential risk. However, there is an effect of this framework that has not been addressed. The issue of a potential double taxation for the tax payers which applies on profits does not cover a levy based on liabilities.<sup>67</sup>

Double taxation applied in different jurisdictions that impose levies on banking branch or subsidiary operations within the local territory. In addition, the UK bank levy regulation charged the total chargeable consolidated balance sheets. To overcome this matter, an international coordination or at least a bilateral agreement is needed. Nevertheless, this agreement does not guarantee the uniform implementation of the regulation in different countries. The similarity among that divergence is that the base of their application is commonly based on the balance sheet of the financial institution. Meanwhile, the divergence is whether they claim it on the balance sheet liabilities or from the assets side of the balance sheet. Additionally, other significant divergence may exist in scope, perimeter, rate and

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<sup>66</sup> "Running Out of Options: Double Taxation Heightens Bank Levy Risks" (2011) 22 int'l tax rev. 12.

<sup>67</sup> Ibid.

revenue.<sup>68</sup> Despite of this fact, other problems that may occur is that this matter will cause a lengthy and time-consuming process.

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<sup>68</sup> Ibid, p.13.



## CHAPTER THREE

### 3. Bailout

Regulating insolvency is essential in a market economy to gain an efficient market. However, it has not change the reality that in some circumstances the government has to interfere in the process to support the private company. The role of the government has to be counted as a provider for a regulatory framework that serves public goods and to set up insolvency law.<sup>69</sup> In other words, the governmental role is to set up the rules for the market conducted and also to consequences of failure. However, there is no clear definition on the proper scope of the intervention, which become the reason that this term become an open-ended concept throughout the financial crisis. In this manner, this condition becomes an urgent situation of regulating insolvency. The main objective of having an appropriate insolvency law is to control “Moral Hazard” in the market. Avoiding to regulate insolvency will lead to a highly risky business which result in a fewer market participant. The failure of this frame will result in the next systemic crisis which is the core of “Too big to fail problem”.

The failure in banking business demand for internalize of their protection mechanism, for example through their pre-funding of insurance or resolution scheme. However, this might be a less efficient solution. Further, when the failure occurs, the burden between the private and public sector have to be lifted by the bailout mechanism by the government. This solution frequently have various consequences. The popular problem that occurs behind the bailout mechanism is the “Moral Hazard”.<sup>70</sup> The common argument to seek bailout mechanism is that the failing of the company is so large that a broader economic system

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<sup>69</sup> Michael Krimminger, “Ending Too Big To Fail: A Practical Resolution Alternatives For Financial Conglomerates”, in Rosa M. Lastra, *Cross Border Bank Insolvency*, (OUP, 2011) p.282.

<sup>70</sup> Michael Huemer, “Bailout in Context : The True Costs of Government Bailout” (2013) 11 *Geo. J.L. & Pub. Pol’y* 335

would be affected by the failure of this business. The support is normally available for banks due to the involvement of public interest and the macroeconomic effect of banking crisis.

Bank is highly regulated institution by the domestic government because of the importance for financial safety and to protect bank shareholders and depositors which means the public interest. The real economic activity will be affected by the banking crisis. In addition, political and social repercussions will become a side effect of those crises. One example of this condition could be learned from Indonesian great depression and economic collapse in 1997, which governments choose to bailout the banks rather than let them to take the route of insolvency.<sup>71</sup> Meanwhile, the US economy experienced a major intervention by the government on September 2008.<sup>72</sup> The US Treasury announced a bailout plan of domestic financial institution.

This initiative developed into a proposal of using taxpayer money to buy the equity of the country's largest banks. However, thus action discredits banks credibility because they receive the bailout from taxpayers. Considering recent case on tax off matter, we could see from the Cypriot Banks. The original agreement between the European Union and International Monetary Fund recognizes that all customers of Cypriot Banks were to face a one-off tax on their deposits to raise 5.8 billion Euros for the cost of bailout.<sup>73</sup> The tax that would be taken from the public would be a security asset for the bank, to apply this policy could encourage banks to take even riskier business.

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<sup>71</sup> Charles W. L. Hill., "The Asian Financial Crisis" Available at < <http://www.wright.edu/~tdung/asiancrisis-hill.htm>> accessed 10 august 2013

<sup>72</sup> Jefferey A. Miron, "Bailout or Bankruptcy?" (2009) Cato J. 1

<sup>73</sup> BBC News Business, "Q&A Cyprus deals" (28 march 2013) Available at < <http://www.bbc.co.uk/news/business-21922110>> accessed 15 august 2013.

## CHAPTER FOUR

### 4. Bankruptcy Law in Bank Insolvency

Banks and financial institutions have made a great contribution to economic development. Therefore, the collapse of a wall street journal becomes the most important lesson to maintain the business activity more properly. Based on both the EU regulation on insolvency law and the UNCITRAL model law recognizes the international judicial jurisdictional based on the location of the centre of main interest (“COMI”) and in the country where an insolvency proceeding is commenced.<sup>74</sup>

#### 4.1 When Public and Private Law Meet

Recognition in the public and private law distinction has a great significant implication on international law in order to reconcile the individual, territorial and a broader community commitment as well as to create the harmonization. The private law aspect in banking business is in the transaction framework that involves firms and individuals. Yet, considering the neutrality of private law and the flexibility of private law rules, it is exceptionally the private law could bring conflict of law. Thus, make the extraterritoriality legislative jurisdiction could be tolerated, as in international trade law. In other respect, the public law aspect in banking business is the role of government through the banking regulation to achieve macroeconomic policy goals which intended to prevent domestic failures. The role of government in insolvency law is as a supervisory over economic activity. Further, an efficient legislation can create an effective market and financial stability. Due to this reason, banking sector especially insolvency problem is regulated rigidly.

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<sup>74</sup> Ibid.

In insolvency law public and private law are supporting each others. Private law is recognized when private interest is at stake, because private law represents a relation between equal legal standing persons.<sup>75</sup> Meanwhile, in public law the sovereignty is highly relevant this appears in judicial, legislative and administrative jurisdiction. The state sovereignty is manifested through the national legislation, thus create conflict of laws. This approach is hard to implement with respect to an internationally active bank, because it links a bank to different jurisdictions. Cooperation to regulate the business has to meet by recognizing the minimum standard within all states, because they are equal in the eyes of international law.

#### 4.2 Multistate Insolvency

An international active bank also known as an international enterprise group is composed of a number of corporate entities. Due to this reason, the insolvency of multinational enterprise is difficult and complex.<sup>76</sup> They dominate the international financial activities. Despite of the fact of their domination, there is a lack of regulation that regulates these businesses. The consequence of this matter is the difficulties in managing the creditors and shareholders. In addition, the fundamental of corporate principle; separate corporate personality and limited liability of the firm and made this envisaged any potential interfere from the local state entity may also contribute to the complexity of insolvency problem.<sup>77</sup>

The trend of cross border insolvency follows the increase of international trade and foreign investment. The framework of cross border insolvency is an urgent work to be completed. Otherwise, a fraud by insolvent creditors in particular by concealing assets or

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<sup>75</sup> Mahmood Bagheri and Chizu Nakajima, "Ex ante and ex post allocation of risk of illegality: regulatory sources of contractual failure and issues of corrective and distributive justice" (2002) E.J.L. & E.5

<sup>76</sup> Irit Mevorach, "Towards a Consensus on the Treatment of Multinational Enterprise Groups in Insolvency" (2010) 18 Cardozo J. Int'l & Comp. L. 359

<sup>77</sup> Ibid, P. 362-363.

transferring them to foreign jurisdiction will increase.<sup>78</sup> The effort of insolvency law harmonization requires all domestic legislatures to agree to adapt all of the recommendations. The progressive work of UNCITRAL to harmonize and unify trade law<sup>79</sup> come with a shift in goal through UNCITRAL's work on the Legislative Guide on Insolvency Law.<sup>80</sup> The definition of harmonize may conceptually thought to be as the process through which domestic laws may be modified to enhance predictability in cross-border commercial transaction. In a deeper understanding, it is an effort to unify the adoption of common legal standard governing particular aspects of business transaction by states.<sup>81</sup> However, this is a debatable resolution which may threaten national legislature or another argument which said that the resolution will fill in the gap on the existing law.<sup>82</sup> The UNCITRAL Model Law on Cross-border Insolvency with Guide to enactment (1997)<sup>83</sup> achievement is to create a sophisticated rule that could be implemented and recombined universally.

The insolvency law provides the court to require the applicant to compensate, pay for the cost and impose sanctions with regard to applicant provisional measures.<sup>84</sup> But, this rules also come with an exception law as said in the recommendation clause, such as in recommendation 188 the exception is as follows:

*“The insolvency law should specify should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law.”<sup>85</sup>*

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<sup>78</sup> The UNCITRAL Model Law on Cross-border Insolvency with Guide to enactment (1997) available at <<http://www.uncitral.org/pdf/english/texts/insolven/insolvency-e.pdf>>

<sup>79</sup> Susan Block-Lieb and Terence Halliday, “Harmonization in UNCITRAL’s Legislative Guide on Insolvency Law” (2006-2007), 42 Tex. Int’l L. J. 475

<sup>80</sup> UNCITRAL Legislative Guide on Insolvency Law, U.N. Sales No. E.05V.10 (2005) available at <[http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf)>

<sup>81</sup> Cf Halliday (n79) p. 477.

<sup>82</sup> Ibid.

<sup>83</sup> Cf UNCITRAL (n.80) p.21

<sup>84</sup> Cf Halliday (n79) p. 504.

<sup>85</sup> Ibid, p. 505

From the recommendation, we could recognize the importance of classifying the creditors into classes in the term of priority they should be accorded. However, they have to be set up clearly in the insolvency law. The priority in insolvency process have to be minimized because the main objective in insolvency proceeding is to have an equal treatment among creditors. Nevertheless, less regulation specifies and technically regulates this topic. In addition, distribution terms are influenced by the norm of disclosure which then applied in recommendation 187.<sup>86</sup>

The discussion of international cross-border insolvency law is generally related to two approaches – Universalism and territorialism – to describe the insolvency theory. Those theories are quite difficult to determine because it could has a subjective understanding for each person. The explanation of those approaches will be discussed as follows:

#### 4.2.1 Universalism

Universalism theory is taken from the concept of universal process of bankruptcy. Based on this concept there should be a unified process of administration in the event of insolvency.<sup>87</sup> The universality theory is widely held in cross-border insolvency field. Nevertheless, there is a difficulty to apply this regime. In a modified universality the divergence of choices of law and choices of forum will be dealt with the international perspective. This concept demands for a single court for a multinational insolvency proceeding which uses a single law in order to ensure the legal certainty for the parties. In other words, this concept requires states to give their sovereignty through a treaty or transnational organization.

However, the concept has developed into a “modified universality” under which of all the sovereignty incompletely surrendered therefore it is more feasible to apply. The example

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<sup>86</sup> Ibid.

<sup>87</sup> Irit Mevorach, *Insolvency within Multinational Enterprise Groups*, (OUP, 2009) P. 65.

of this concept is the UNCITRAL Cross-Border Model Insolvency Law, which demands that a jurisdiction recognizes a foreign proceeding if the case related with cross border aspect, especially if the main interest is the jurisdiction of foreign representative.

Modified universality regime's goal is to design an interim solution on various legal matters that occurs in international insolvency law. However, an international insolvency case may demand for more than one state proceeding which means a multi-forum, multi-law and multi-courts. For that reason, modified universality intended to maximize the cooperation proceeding in international insolvency process. However, the domestic courts will still have discretion to evaluate the fairness and to protect the interest of local creditors.<sup>88</sup> The achievement of this regime is to create a balance between insolvency proceeding in global level and the domestic level. In spite of that the coordination process would need a review on the structure concept of multinational enterprise in a way that certain subsidiaries will remain bankruptcy remote with consequence that a choice of bankruptcy law should respect.

#### 4.2.2 Territoriality

The territorial approach deals with the understanding that debtors can satisfy the local insolvency law in the insolvency proceeding.<sup>89</sup> This approach is based on the fact that the power of national financial regulation plays the most important role to macro-economic stability. This is the reason for bank and financial institution to be rigidly regulated and highly supervised sector. Therefore, domestic financial regulator dominate financial activity within their jurisdiction, because commonly assert that territoriality theory relies on state

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<sup>88</sup> Ibid, p.69.

<sup>89</sup> Nigel John Howcroft, "Universal VS. Territorial Models for Cross-Border Insolvency: The Theory, The Practice, and The Reality That universalism Prevails" (2007-2008) 8 U.C. Davis Bus. L.J. 366.

sovereignty. But, as the consequence of this approach the authority of insolvency process is unable to act on assets outside the jurisdiction.<sup>90</sup>

By law, foreign firm and domestic company have to comply with the national law, especially for highly risky business such as banking and securities. In the case of foreign companies, the effect is not only for the subsidiary but also to the parent company which is required to comply with host state regulation. For example, the US Financial Services Modernization act of 1999 has required all foreign banks to be licensed as financial holding companies safety risk-based capital standards on a global basis and satisfy the Federal Reserve that its global operation are well capitalized.<sup>91</sup>

Under territorial principle the insolvency declaration is required in each country in the branch or assets of the insolvent debtor. In this respect, territorialism principle underlines the distinction of legal regimes and strives to ensure minimum interference with domestic policy. Thus resulted the plurality of the insolvency proceeding. Under this principle there are two possibilities related to the collectivity of the corporate assets. Firstly, if a local branch of a multinational enterprise declared to be insolvent based on territorial basis, the asset which will be collected is only those within the related jurisdiction. And secondly, for the same fact if a branch of a multinational enterprise is being liquidated the entire foreign bank's assets will be collected for the benefit of the branch creditors. In spite of that, there is a development in this theory which called "modern territoriality" which recognizes Cross-Border cooperation in international insolvency proceeding, harmonization in choices of law, and foreign security interest.<sup>92</sup>

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<sup>90</sup> Thomas C. Baxter, Jr., Joyce M. Hansen and Joseph H. Sommer, "Two Cheers for Territoriality: an Essay on International Bank Insolvency Law" (2004) 78 Am. Bankr. L. J. 57

<sup>91</sup> Chris Brummer, "Territoriality as Regulatory Technique: Notes From The Financial Crises" (2010) 79 U. Cin. L. Rev. 504.

<sup>92</sup> Rosa M. Lastra, "International Law Principles Applicable to Cross-Border Bank Insolvency" in Rosa M. Lastra, *Cross Border Bank Insolvency* (OUP, 2011) p. 171.



Thus far, the debate between universalism and territorialism has focused on the strength and weakness of each approach. Development in universalism and territorialism theory both was inspired to the urgency of international need of an efficient and effective Cross-Border insolvency proceeding. Likewise, the modern territoriality and modified universality is an effort to mutual recognition and the middle ground. Because the coordination between the two approach will gain efficiency, cost saving and predictability of the process. The problem with a multinational corporation is that the idea of separate territorial proceedings may diverge. In a multinational enterprise insolvency case both the universalism and territorialism theories have their own role play. Furthermore, the flexibility of the approach and mechanism that use in the proceeding is the most important step to promote insolvency goals.

## CHAPTER FIVE

### 5. Ambiguity as to Legal Regimes Approach to Groups in the Context of Insolvency

There are inconsistencies and obscurities in legal regime treatment arising from the issue of cross border insolvency in an internationally active bank. This problem occurs because of the various applications of enterprise concepts regarding assets and debts. The relation of parent-subsidiary companies and jurisdictional problems are the main focus of international level of groups in insolvency treatment. The importance of defining this area of group of entities regime is for the application of legal regime that applies to the insolvent bank, since banking insolvency law is commonly regulated under domestic law. The reason for this matter is because of the extensive effect of domestic macroeconomic situation.

The absence of an international regime of insolvency on financial institutions, leads to the reliance on various national regulations. This situation makes the authorities to have voluntary cooperation. The example of the failure of the Bank of Credit and Commerce (BCCI) case serves the challenges of cross border bank insolvency. At the time of its collapse BCCI was operating in more than seventy jurisdictions.<sup>93</sup> The Luxemburg and the United Kingdom liquidators attempted to unify all of the BCCI's assets into one pool for worldwide distribution which is known as the single entity approach. Meanwhile, the New York, French and California state banking supervisors were against this approach and preferred to localize the assets for local creditor's distributions.<sup>94</sup> Hence, the reason of Luxemburg, New York and California is the same which is to protect the creditor's interest from inequality treatment.<sup>95</sup>

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<sup>93</sup> Andrew Campbell, "Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding-Up of Credit Institutions, 2002" <<http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/campb.pdf>> accessed 14 August 2013.

<sup>94</sup> Adrienne Coleton, "Banking insolvency regimes and cross-border banks – complexities and conflicts: is the current European insolvency framework efficient and robust enough to effectively resolve cross-border banks, can there be a one size fits all solution?" (2012) J.I.B.L.R. 63

<sup>95</sup> Schooner (n28) p. 393.

The difference between the European Union (EU) directive on insolvency and The US system is that the US system allow the supervisors to have tremendous flexibility to create the resolution. On the other hand, The EU avoids giving supervisory body to overreaching through its reliance on the judiciary process.<sup>96</sup> Nevertheless, the BCCI case had illustrated the rigidity of European directive, because of the absent of harmonization in the substantive law of insolvency law proceeding. The commission's of 2007 review the directive that acknowledge the issue of differently participants of multinational enterprise group demand further examination.<sup>97</sup> The result of insolvency in a multinational company triggers an uncoordinated legal proceeding which imposes substantial cost in the bankruptcy process.

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<sup>96</sup> Ibid, p. 394

<sup>97</sup> Coleton (n94) p. 5.

## CHAPTER SIX

### 6. International Harmonization of International Bank Insolvency

Insolvency is a complex area of the procedural and substantive issue of the law and its practitioners. The complexities include debtor-creditor, employment and administrative regulations. The increasing scope of the global economic has resulted in the increasing number of multinational companies which operates in multiple jurisdictions. Moreover, this development influences the growth of internationally active banks which can support the business. Assessing an international active bank could be also related to multinational banks which operate in multiple jurisdictions. The challenging part of proceeding is on determining the real assets of the insolvent company.

The contemporary bank supervisory has led to the creating the Committee on banking regulation and supervisory practices: Report to the Governors on the Supervision of Banks Foreign Establishment (Basel concordat 1975).<sup>98</sup> This agreement has provided the basic distinction between host-country and home-country supervision which gave the home country supervisor the lead role. Meanwhile, the host country supervisor is mainly responsible for the liquidity over the local branches.<sup>99</sup>

Issues in international insolvency might involve debtor's assets that located in multiple jurisdictions or multiple members of cross border group which resulted in multiple proceeding in various jurisdiction. An effective coordination of insolvency which involves an internationally active bank which operates in multiple nations is an unsolved problem in international insolvency law. Neither UNCITRAL model law on Cross-border insolvency nor the European Union Regulation on Insolvency engages this matter exclusively.

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<sup>98</sup> The Committee on Banking Regulation and Supervisory Practices : Report to the Governors on the Supervision of Banks Foreign Establishment, (1975) Available at <<http://www.bis.org/publ/bcbs00a.pdf>> accessed 10 august 2013

<sup>99</sup> Ibid.

## 6.1 Learning from Corporate Insolvency

The absence of an international cross-border bank insolvency regulation does not mean that there is a vacuum of law in this area. This is due to the reason that corporate cross border insolvency experience is the closest contribution to the initiative for working on a regulation in cross-border bank insolvency. However, the initiate proceeding becomes problem in both corporate and bank insolvency, as well as in international and national insolvency. In corporate insolvency the debtors might discourage to claim an insolvency proceeding because it may cause them lose their business cooperation. Meanwhile, the problem is getting more difficult in banking sector because bank would not fully disclose their financial condition, because when public know the instability of a certain bank, a panic situation will arise. Due to the sensitiveness of banking insolvency which could directly contribute to macro-economic stability, the government will always interfere with the process.

It is important that general bankruptcy law have to be consistent and coherence with bank regulation and supervision. This coherence is also important to gain a confidence at bank supervisor's credibility. It is implied that the supervisory body is very important to guard the savings and credit flows in banking activity. In some countries, the power of bank supervisor is also empower to declare insolvency, since they examine the balance sheet of bank, an efficient process will be gain through the process of auditing. In addition, the corporate insolvency court or the insolvency administrator has to be more than *primus inter pares*,<sup>100</sup> because in cross border insolvency case the negotiation is needed to cooperate with other courts.

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<sup>100</sup> Jay Lawrence Westbrook, "The Elements of Coordination in International Corporate Insolvencies: What Cross-Border Bank Insolvency Can Learn From Corporate Insolvency" in Rosa M. Lastra, *Cross Border Bank Insolvency* (OUP, 2011) p. 195-196.

## 6.2 The enterprise group COMI

To identify Centre of Main Interest (COMI) concept in a multinational company which is internationally active need a great effort to coordinate among the parties and the authorities to understand the most fundamental determining factor. First of all, this principle has to be accepted and apply in a wider scope of jurisdiction in order to make the coordination easier. Without the recognition, it would make the process difficult for the other jurisdiction to recognize the claims and respect other foreign proceeding. The concept of COMI is still developing, which explain that there is no clear definition related to COMI. Despite of that, this concept could be used for global consolidation. The concern from defining this concept recognizes that it would only concentrate the proceeding in only one jurisdiction rather than having a parallel proceeding in several jurisdictions. In addition, the goal of identifying COMI while also allowing coordination on international insolvency process would be easier if the group is integrated. Common practice of implementing COMI currently is by the courts determination of the debtor's true location.<sup>101</sup> Instead, it should be understand as the main central activity interest of a multinational company's activity.

Ultimately, the effort to gain harmonization could be secured by recognizing the concept of COMI to determine the centre of main interest. Further, this recognition could secure the assets and make the insolvency proceeding easier, especially in cross-border insolvency.

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<sup>101</sup> Cf Mevorach (n87) p. 401

### **6.3 Proposal for ex-ante and ex-post harmonization in insolvency laws of an internationally active banks**

It is the thesis of this dissertation that there should be a harmonization in insolvency laws related to internationally active banks. In the previous chapter it was discussed that most of all the harmonization has to be found in the supervisory policy and the insolvency proceeding. So far, the Basel committee for banking supervisory has worked together with the UNCITRAL to work out a framework for a cross-border bank insolvency regime. Unfortunately, the framework has not yet prevailed. The existing framework that could be use in internationally active bank insolvency is by using the UNCITRAL model law on Cross-Border Insolvency with guide to enactment. This document is actually regulate the cross-border insolvency for corporation. Meanwhile, bank has it special character which is very sensitive in the sense of its solvency measure and the effect that resulted from the insolvency problem.

Briefly, this harmonization system should have the following features:

1. There have to be an international supervisory body to supervise banks activities and regulate the banking sector which is recognized internationally. The recognition is important to ensure that the policy is applicable in various jurisdictions. This international body could cooperate with the domestic supervisory body in each jurisdiction to gain an effective supervisory coordination. The emergence of having this body is because the rapid growth of international bank which operates in multiple jurisdiction. This is the reason of having unified supervisory body to supervise and regulate this sector effectively, because further they would have the same measurement of insolvency. The supervisory body could also declare the insolvency if there is a finding from their examination.

2. The appropriate measurement of bank solvency has to be identified appropriately. It has to be started with having an appropriate disclosure. Further, the risk management and capital adequacy leverage measures have to be coherent between the supervisory policy and banking regulation.
3. A coherence regulation between supervisory policy and banking law. The emergence of this point is to gain confidence and certainty in financial system.
4. In the case of the declaration of insolvency, the COMI of a multinational bank has to be determined to ensure the security of the assets and creditor's protection. Moreover, any transactions which might be endangered and caused losses have to be blocked.
5. The regime should permit a common administrator for all of the cases commenced for the entire member of the multinational banks.
6. Cooperation and communication should be authorized and encourage to the maximum level of possibility between the courts, judges and office holders among all related cases.<sup>102</sup>

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<sup>102</sup> Cf Bufford (n2), p. 692.



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## CHAPTER SEVEN

### 7. Conclusion

International legal regimes to deals with insolvency in international active banks remain the unsolved problem in international banking system. This regime becomes an important matter in international financial regulation because of its systemic effect on the banking system which involves a great number of public interest. Moreover, lack of an appropriate resolution for financial problem could cause a financial disaster. Previously, insolvency was not a very a big issue. This is because the financial system has a greatly direct impact to macro-economic stability, which caused government tends to bailout the banks in order to avoid the effect. But instead of making a better financial stability, this solution gives more encouragement to banks to take even a riskier business in the future. The risk management would not be effective because the financial sector rely on government assistance.

Major efforts had been done by various international organizations in ex-ante and in ex-post insolvency, such as the Basel Committee on banking supervision, International Monetary fund, European Union, and UNCITRAL. The most recent developments that have been taken are the work of the Basel Committee on banking supervision which has released the report and recommendations of the cross border bank resolution group. This document proposes recommendation to address the challenges arising in the resolution of cross border bank. Further, the main key provision in the proposal is the coordination and communication.

This dissertation proposes features that indicate the goals of the harmonization between ex-ante provision and ex-post provision are best realized through an integrated system with the following features:

1. There have to be an international supervisory body to supervise banking activities and regulate the banking sector which is recognized internationally.
2. The appropriate measurement of bank solvency has to be identified appropriately.
3. A coherence regulation between supervisory policy and banking law.
4. The COMI of a multinational bank has to be determined to ensure the security of the assets and creditor's protection.
5. The regime should permit a common administrator for all of the cases commenced for the entire member of the multinational banks.
6. Cooperation and communication should be encouraged to the maximum level of possibility.

These features could lead to adoption of a coherent and integrated legal regime for regulation and liquidation of insolvency in internationally active banks which operate in multiple jurisdictions that meet the main objective in the system, which is providing clarity and predictability, the equal treatment for all creditors and the protection of national issues.

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