



# Northern Rock, UK bank insolvency and cross-border bank insolvency

Rosa M. Lastra

Centre for Commercial Law Studies, Queen Mary University of London, 67-69 Lincoln's Inn Fields,  
London WC2A 3JB, UK  
e-mail: r.lastra@qmul.ac.uk

**Rosa M. Lastra** is Professor of International Financial and Monetary Law at the Centre for Commercial Law Studies (CCLS), Queen Mary, University of London. She is a member of the Monetary Committee of the International Law Association (MOCOMILA), a founding member of the European Shadow Financial Regulatory Committee (ESFRC) and a senior research associate of the Financial Markets Group of the London School of Economics and Political Science. She has consulted with various governmental and intergovernmental institutions, including the International Monetary Fund, the World Bank, the Asian Development Bank and the Federal Reserve Bank of New York. She has written extensively in the field of monetary and financial law; her two authored books *Legal Foundation of International Monetary Stability* (Oxford University Press, 2006) and *Central Banking and Banking Regulation* (FMG of the LSE, 1996) are considered authoritative reference on the subject matter, nationally and internationally.

## ABSTRACT

*This paper deals with bank crisis management in light of the Northern Rock debacle on the one hand and the ongoing credit crisis on the other. Following a brief narrative of the events from September 2007 (with the run on Northern Rock) to February 2008 (when the government announced its nationalisation), the paper examines the legislative and regulatory responses in the UK, and assesses some features of what is expected to be a new special*

*resolution regime (SRR) to deal with banks in distress (including both pre-insolvency measures and insolvency). Although financial markets and institutions have become international in recent years, regulation remains constrained by the domain of domestic jurisdictions. This dichotomy poses challenges for regulators and policy makers. If at the national level, bank crisis management is complex (with the involvement of several authorities and the interests of many stakeholders), this complexity is far greater in the case of cross-border bank crisis management, both at the EU level and at the international level. In any financial crisis, it is necessary to have a clear and predictable legal framework in place to govern how a financial institution would be reorganised or liquidated in an orderly fashion so as not to undermine financial stability. We do not have such a framework yet with regard to cross-border banks, neither at the European level nor at the international level. This paper analyses some of the European and global initiatives to confront these cross-border challenges, which affect lender of last resort, deposit insurance arrangements and insolvency proceedings.*

*Journal of Banking Regulation* (2008) **9**, 165–186.  
doi:10.1057/jbr.2008.12

## INTRODUCTION

Banking crises are a recurrent phenomenon in the history of international finance. Bank crisis management comprises an array of official and private responses that extends beyond the



insolvency proceedings that are the only tool typically available to deal with corporate bankruptcy in other industries. As regards the official responses, when confronted with failed or failing banks, public authorities have at their disposal: (1) the lender of last resort role of the central bank; (2) deposit insurance schemes; (3) government policies of implicit protection of depositors, banks (the ‘too-big-to-fail doctrine’) or the payment system; (4) insolvency laws (*lex specialis vs lex generalis*), (5) prompt corrective action, and other preventive measures (including supervision). This paper deals mostly with bank insolvency laws, considering the current and prospective law in the UK as well as some issues surrounding cross-border bank insolvency, both at the European level and internationally. Where appropriate, references are also made to other instruments, such as deposit guarantee schemes, prompt corrective action and emergency liquidity assistance. A well-designed legal framework is important for the functioning of financial markets, particularly in times of trouble.

The starting point of my analysis is the consideration of the Northern Rock debacle. Throughout the paper, a case for *lex specialis* for banks — nationally and internationally — is made. The legislative reform in the UK needs to be both consistent with the wider framework for the regulation and supervision of banks and aligned with EU law and international efforts.

### **NORTHERN ROCK, AN ENGLISH ‘BANK RUN’ IN THE TWENTY-FIRST CENTURY**

Northern Rock, the UK mortgage lender, has become a household name, which will forever be associated with old-fashioned bank runs, following the events of September 2007. Northern Rock was not a major bank (ie it was not systemically important nor too-big-to-fail) nor an international bank (ie it had no significant cross-border operations).<sup>1</sup>

The announcement of the emergency liquidity assistance by the Bank of England on 13th September, 2007 (revealed by the BBC),<sup>2</sup>

coupled with an ill-designed and insufficiently publicised deposit insurance scheme, led to a ‘bank run’ from 14th September to 17th September, with queues of anxious depositors wishing to withdraw their money forming outside Northern Rock branches around the country. This bank run brought headlines not only in the *Financial Times* or in the *Times*, but in all tabloids and television stations around the world. It was claimed that the UK had not witnessed such an event since Overend, Gurney & Co. in 1866. Certainly, the UK had never witnessed such a publicised bank run, one in which the media played a magnifying role. It was embarrassing for the city of London and embarrassing for the government. The tripartite arrangement (an otherwise sound structure when supervision is transferred from the central bank to a supervisory agency) involving the Treasury, the Financial Services Authority (FSA) and the Bank of England<sup>3</sup> did not function smoothly, promptly or efficiently.

An attempt had been made — it later emerged — that the Bank of England had been in talks with Lloyds TSB about possibly buying Northern Rock, but these discussions had foundered.<sup>4</sup>

On 17th September, 2007, the Chancellor of the Exchequer, Alistair Darling, agreed to guarantee all deposits held by Northern Rock, bringing the bank run to a halt.

### **THE NORTHERN ROCK SAGA FROM SEPTEMBER 2007 TO FEBRUARY 2008**

The Northern Rock bank run caught the authorities by surprise. Political considerations always come into play in a banking crisis. The authorities are keen to stop problems in one bank from spreading to other parts of the banking system, acknowledging the real risk of contagion. The offer of guarantees (in itself a distortion of competition) is sometimes warranted on the basis of public interest considerations.

Northern Rock has been offered all sorts of public assistance since September 2007: emergency liquidity assistance, guarantee of all deposits (including new deposits made after

19th September) and eventually nationalisation. This despite the fact that a private market solution was the preferred solution from the beginning by the bank and by the government.

On 25th September, the bank announced that it was in preliminary talks with people who wanted to buy all or part of its business. A consortium led by Sir Richard Branson's Virgin Group put forward a proposal to rescue Northern Rock on 12th October. Another bid came from Olivant (an investment company), although it was subsequently withdrawn.

On 21st January, 2008, Chancellor Alistair Darling announced a plan that would have converted Northern Rock's £25bn Bank of England loan into bonds (in what seemed at the time a twist of destiny, the excesses of securitisation were to be corrected with another securitisation). The bonds would have been guaranteed by the government to speed up a private sale of the troubled lender.

Following Olivant's withdrawal on 4th February, the government had only two bids to consider: the one from Richard Branson's Virgin Group and the one from Northern Rock's own board. The government, with the assistance of advisers Goldman Sachs, decided that it was in the public interest to assume control over the bank rather than proceed through a private sale.

On 17th February, 2008, Chancellor Alistair Darling announced the nationalisation of Northern Rock, bringing forward legislation 'to take Northern Rock into a period of temporary public ownership'. The Chancellor explained that Northern Rock would 'continue operating as a bank on a commercial basis' and that 'savers' and depositors' money' would remain 'safe and secure'. He also explained that the 'guarantee arrangements' put in place in the fall of 2007 would remain in place. The Banking (Special Provisions) Bill was summarily introduced to the House of Commons on 19th February, 2008 and received the Royal Assent on 21st February, 2008.<sup>5</sup> This interim legislation provides the

government with temporary powers until new legislation gets adopted later this year. The Treasury announced on 22nd February, 2008 that it had acquired all the shares in Northern Rock, including its preference shares, and that all share options and other entitlements to shares issued by the company had been extinguished by a Transfer Order made under the Banking (Special Provisions) Act 2008.<sup>6</sup>

## **THE REGULATORY AND LEGISLATIVE RESPONSES TO NORTHERN ROCK<sup>7</sup>**

Parallel to the actions specific to Northern Rock, the authorities embarked on a programme of legislative reform, which is expected to lead to a major overhaul of banking law in the country with the likely introduction of a special resolution regime (SRR). It has become widely accepted during the last months that the authorities in the UK need to have a wider range of instruments in their toolkit to confront banking crises.

Before the summer of 2007, the FSA's 'principle-based' approach to regulation was commended for attracting financial activity to London. This approach contrasts with the 'rules-based' approach of US financial regulators (Securities and Exchange Commission (SEC) and others). The costs of compliance with Sarbanes-Oxley and SEC rules are cited as driving some foreign companies and investors away from US capital markets.

After the summer of 2007, in light of the handling of Northern Rock (a banking crisis), the FSA has been the subject of criticism (together with the other two members of the tripartite arrangement, the Bank of England and the Treasury). The reputation of London as a sophisticated financial centre has become tarnished.<sup>8</sup> Further comparisons between the US and the UK have been made, to the detriment of the UK, following the speedy rescue package the Federal Reserve Bank of New York arranged for Bear Stearns in March 2008,<sup>9</sup> which contrasts with the lengthy, slow and rather inefficient resolution procedure for Northern Rock. In their defence, the UK

authorities can argue that they did not have the tools to tackle the problem promptly (though this is also debatable in the eyes of some commentators).<sup>10</sup>

A review of the regulatory responses that have been put forth in recent months is presented in the ensuing paragraphs.

On 1st October, 2007, the FSA announced an increase in the coverage of deposits up to £35,000 equal to 100 per cent of the loss incurred. Partial insurance was deemed to have been a major flaw in the design of deposit insurance in the UK and a contributor to the bank run.

A first discussion paper on *Banking Reform: Protecting Depositors* was published on 11th October, 2007 by the Bank of England, the FSA and HM Treasury.<sup>11</sup> Parallel to this initiative, at the EU level, ECOFIN, in the conclusions of its October 2007 meeting, called for an enhancement of the arrangements for financial stability in the EU and a review of the tools for crisis prevention, management and resolution, in particular, a revision of the directive on the reorganisations and winding up of credit institutions<sup>12</sup> and a clarification of the Deposit Guarantee Directive.

The House of Commons Treasury Committee published a report on 26th January, 2008 entitled 'The Run on the Rock',<sup>13</sup> recommending that a single authority, akin to the US FDIC, be created (the Deputy Governor of the Bank of England and Head of Financial Stability and a corresponding Office), with powers for handling failing banks (Chapter 5) as well as the Deposit Insurance Fund (Chapter 6).

The Chancellor of the Exchequer launched, on 30th January, 2008, a consultation outlining proposals to strengthen the current framework for financial stability and depositor framework.<sup>14</sup> This is a joint publication by HM Treasury, the FSA and the Bank of England, and the government intends to follow this consultation (which ended 23rd April, 2008) by introducing legislation into Parliament later in this session.<sup>15</sup>

The objectives of the reform, according to the consultation document, *Financial stability and depositor protection: strengthening the framework*, are as follows: (1) to strengthen the financial system (risk management, liquidity management, functioning of securitised markets); (2) to reduce the likelihood of bank's failing (by introducing 'heightened supervision' and strengthening the ability of the Bank of England to provide covert emergency liquidity assistance *inter alia*); (3) to reduce the impact of failing banks (by introducing a SRR and a sufficient range of tools within this SRR); (4) to create effective compensation schemes in which the consumers have confidence (designing such schemes in a way that foster credibility, introducing a one-week payout and increasing consumer awareness); (5) to strengthen the Bank of England (by anchoring in statute its responsibility for financial stability and by reforming and empowering the Court of the Bank of England); and (6) to improve co-ordination between the authorities in the tripartite arrangement on the one hand, and between national and supra-national and international authorities on the other hand.

In summary, the main legislative changes that are going to take place are as follows: the introduction of an SRR, the granting of new powers to the FSA with regard to 'heightened supervision' and to the Bank of England with regard to financial stability and covert emergency funding to troubled banks, and the introduction of a faster and more credible compensation arrangement.

A credible deposit insurance system requires *inter alia* prompt payment of depositors (next business day as in the US is ideal, although a one-week payout may be more feasible in the UK in light of international practice) and a reasonable amount of coverage (neither too meagre to be non-credible nor too generous to incur into moral hazard incentives). In my opinion, only deposits ought to be covered. The Financial Services Compensation Scheme (FSCS), set up under the Financial Services and Markets Act 2000 (FSMA) as the UK's

compensation fund for customers of financial services according to the Directives on Deposit Guarantee Schemes and Investor Compensation Schemes, also covers insurance policies and investment business. (FSCS has no real 'powers' as opposed to FDIC in the US which acts as insurer, supervisor and receiver of failed or failing institutions.) Now that co-insurance has been abandoned in the UK, market discipline can be enhanced by having a system that is at least partially pre-funded with contributions from the banks, since they and their clients are the main beneficiaries.

### **SPECIAL RESOLUTION REGIME**

Northern Rock exposed the deficiencies of the UK regime to deal with banks in distress. Some of those deficiencies concern the workings of emergency liquidity assistance, others the workings of deposit insurance and others the insolvency and pre-insolvency arrangements. As stated in the consultation document 'The authorities currently have limited tools available to maximize the chances of a successful resolution of a failing bank prior to formal insolvency'.<sup>16</sup> A *special resolution regime* (the term coined in the consultation document) is indeed needed. This regime refers to pre-insolvency (SRR is to be available to all failing banks, prior to insolvency) as well as to actual insolvency (with the proposed introduction of a new stand-alone bank insolvency procedure).<sup>17</sup>

In banking, however, the dividing line between illiquidity and insolvency is not always clear. A banking crisis tends to be a fluid process in which illiquidity often leads to insolvency (and an insolvent institution, if allowed to continue operations, is likely to become illiquid).

The following paragraphs will discuss some of the features that in my opinion the new SRR ought to have.

The goals of the SRR should be: (1) financial stability and (2) minimisation of costs in the light of public interest considerations (cost to taxpayers/public purse, cost to the real

economy). The ultimate goal is the protection of the confidence in the banking system. Depositor protection is an important goal that can be better achieved via deposit insurance, since in a resolution procedure a number of competing interests and several stakeholders are to be taken into account in addition to depositors: creditors, shareholders, managers, employees, pensioners and potential taxpayers. For instance, the rights of shareholders under an SRR raises issues under the European Convention on Human Rights that the new legislation ought to take into account.<sup>18</sup>

The SRR should confer upon the competent authorities a wide range of tools that can be applied with flexibility and regulatory discretion, such as bridge bank, assisted or unassisted mergers (transfer of the whole business or part of its business), sale of assets to a third party, deposit transfers to a third party, liquidation (including pay-off to insured depositors), government infusion of equity, other government guarantees, nationalisation and others. The law should foresee that, at times, the authorities need to use several tools, including the combination of government assistance and private assistance. The law also should include tools that can remain 'dormant' in the legislation for a long time.<sup>19</sup> For instance, it might be useful to include some reference to the possible creation of special funds or of a temporary restructuring agency.<sup>20</sup> This legislative reform is a unique opportunity to build a good toolkit to confront banking crises. In this light, a residual clause (or clauses) empowering the competent authorities to act in circumstances not foreseen in the new law — but that threaten the goals of the SRR — ought to be considered. The next crisis may be quite different from the current one.

Reference is also made to the need to comply with EU state aid rules and competition law (point 4.19). This is a thorny issue because the law in this area is somewhat unclear,<sup>21</sup> and because the demands of competition and the demands of regulation, supervision and crisis management are not always

aligned (indeed the prudential carve-out in the GATS Annex on Financial Services is a good example of how prudential regulation and financial liberalisation are at times antagonists).

The SRR should cover banks (credit institutions in the EU terminology), with a provision that, in exceptional and exigent circumstances, systemically important financial institutions could be covered. The definition of what is 'systemically important' should be made at the national level by the national tripartite authorities in consultation with the European Central Bank (ECB) and a yet-to-be-created European Observatory for Systemic Risk (as advocated by the European Shadow Financial Regulatory Committee in 1998).

The principles that should inform the new SRR are as follows: prompt resolution, so as to minimise credit and liquidity losses, as well as costs to taxpayers/public purse; market discipline and safeguard of public confidence (which requires access to critical banking functions in a crisis).

The governance of the SRR is the main issue yet to be decided by the UK government. The FSA would take the decision to subject a bank to an SRR, following consultations with the Bank of England and Her Majesty (HM) Treasury, based upon some triggers yet to be decided (a mix of quantitative and qualitative measures is under consideration). There are two separate issues in this governance debate: (1) the governance of the SRR itself and (2) the governance of the bank if it is subject to some form of reorganisation/administration.

The House of Commons Treasury Committee report, *The Run on the Rock*, suggests that the Bank of England should be given powers with regard to the new SRR. The January 30 consultation document on financial stability and depositor protection also seems to favour an administrative procedure, without specifying who the competent authority for overseeing the SRR should be. 'The Government proposes that the bank insolvency procedure should be a stand-alone process and it is therefore envisaged that the bank

liquidator will have similar powers to those that currently exist both for administrators and for liquidators'.<sup>22</sup> According to point 4.48, the authorities are consulting on whether the SRR should be overseen by one of the existing authorities — HM Treasury, the Bank of England, the FSA or the FCSC. Whichever authority implements the regime will make use of market professionals, such as experienced bankers and professionals, where appropriate. This is certainly necessary, because it is one thing to run a bank (such as a bridge bank) and a different thing to oversee SRR. The authorities are also considering the possibility of keeping the normal insolvency proceedings alongside the bank insolvency procedure.

With regard to the governance of the SRR, in the case of the stand-alone 'bank insolvency procedure' considered in the consultation document, the idea of a judicial bank insolvency procedure in the UK is appealing, in the light of the competence, resources and ability of the courts in this country. Some commentators have suggested a minimalist insolvency reform in the UK, drawing on the Insolvency Act of 1986 and on existing procedures. According to Walker, the SRR could be introduced with limited revisions and corrections of the existing UK system. In particular, he argues that Sections 359 and 362 of the Financial Services and Markets Act could have been applied as soon as Northern Rock ran into difficulties, and that an administrator could have gone in immediately and replaced the existing management. This solution would have implied the conversion of the FSA's existing right — under Sections 359 and 362 if FSMA — to appoint an administrator (or intervene in administration proceedings) into a full special 'financial or regulatory administration' regime. Walker also points out that 'court involvement would secure the necessary validation and finality which other administrative options lack'<sup>23</sup> (thus addressing the risk of litigation by angry depositors or angry shareholders). Andrew Campbell also wonders 'why the administration procedure that already exists,

with the addition of some provisions for dealing with failing banks would not be sufficient'.<sup>24</sup>

In banking, the pre-insolvency phase is crucial. The need for effective supervision (including heightened supervision when specific trigger ratios are reached) is fundamental for an effective resolution regime. Preventive measures can go a long way in alleviating the cost and pain of corrective and protective measures. The efficiency of bank insolvency law and procedures would be greatly enhanced by the adoption of a formal system of prompt corrective action linking the intensity of supervision to trigger ratios related to the level of capitalisation, and to other indicators of liquidity and sound banking (including risk management). Discretionary powers to discipline banks are not sufficient. The need for legal certainty and transparency suggests the need to adopt some mandatory trigger ratio for intervention that, no doubt, will focus the minds of bank managers, and will influence their incentive structure.

Supervision and crisis management are in my opinion a seamless process. This ought to be taken into account in the reform because supervision of healthy institutions can quickly become supervision of troubled or even failing institutions, thus leading to crisis management. The axiom of assisting in rainy days but monitoring in sunny days should to be remembered.

### **THE CASE FOR *LEX SPECIALIS***

Banks are still special as the current credit turmoil amply evidences. They are special given their unique role as providers of credit, deposit takers and payments intermediaries (no chain is stronger than its weakest link). Bank failures are also special, because they create externalities (contagion to other healthy institutions; under a fractional reserve system a bank will be unable, at any time, to honour the convertibility guarantee) and affect the stability and integrity of the payment system. They often become a matter of public interest. Bank

resolution procedures should take into account the speciality of banks and the speciality of bank failures. This is the background behind the case for a SRR.

The case for *lex specialis* with regard to bank insolvency can be further supported by the existence of specific goals. Corporate insolvency laws typically seek to fulfil two principal objectives: fair and predictable treatment of creditors, and maximisation of assets of the debtor in the interests of creditors. The main goals in a bank insolvency proceeding are, however, the safety and soundness of the financial system at large and the integrity of the payment systems. Furthermore, the prompt payment to depositors and the minimising of costs to the insurance funds are also mentioned as important considerations (certainly in the US).<sup>25</sup>

The role of creditors is more active in general insolvency.<sup>26</sup> They can initiate the insolvency proceeding and can act individually (right to be heard) or collectively (creditor committees). Bank supervisors typically have the power to commence the insolvency proceedings.

In banking, the definition of insolvency (the trigger point for an insolvency proceeding) is sometimes a matter of controversy. As acknowledged, there are two traditional definitions of insolvency in commercial bankruptcy laws: failure to pay obligations as they fall due (equitable insolvency) and the condition when liabilities exceed assets (balance sheet insolvency). As stated above, in banking, the line of demarcation between illiquidity (lack of liquid funds) and insolvency is not always clear (indeed, a situation of illiquidity can quickly turn into insolvency). An economically insolvent bank is not always declared legally insolvent by the responsible authorities and may be offered financial assistance instead.

A bank is considered to have failed when the competent authorities order the cessation in its operations and activities. The authorities are, however, often wary of liquidating a bank (in part because an 'orderly liquidation of assets' is not always easy, due to the possible contagion effect on other institutions) and therefore



choose instead to rehabilitate the bank. As a matter of 'good policy', the bank should be closed as soon as the market value of its net worth reaches zero, because at this moment, direct losses are only suffered by shareholders. If the bank is declared legally insolvent when the market value of its net worth is already negative, losses will accrue not only to shareholders, but also to uninsured creditors and/or to the insurance fund/the government.

In recent years, PCA (prompt corrective action) rules, including SEIR (structured early intervention and resolution) have been advocated. In the US, these rules (including the trigger ratios) are mandatory and legally binding since the enactment of FDICIA (Federal Deposit Insurance Corporation Improvement Act) in 1991. PCA rules are only effective if they are enshrined in the law, in particular the mandate to initiate early closure when the bank still has capital (even if it is critically undercapitalised). As Goodhart points out, 'the window of opportunity between closing a bank so early that the owners may sue and so late that the depositors may sue may have become vanishingly small'.<sup>27</sup>

Insolvency proceedings typically imply liquidation or reorganisation (sometimes they are carried sequentially, that is liquidation proceedings will only run their course if reorganisation is unlikely to be successful or if reorganisation efforts have failed). Since the failure of a bank is often a matter of public interest and can cause a disruption in the payment system if not properly handled, and since the bank supervisor has the power to initiate insolvency, bank insolvency proceedings exhibit idiosyncratic features.

Though liquidation is the simplest resolution procedure, it is not necessarily the least costly, as a valuable depositor base gets dissipated, vital banking services in a community may be disrupted, and confidence in the banking system may be seriously damaged. In banking, liquidation some times entails a system of depositor preference, that is, depositors' claims are typically paid before those of

general creditors. If the country has a deposit guarantee scheme, the insured depositors are paid off up to the insurance limit; uninsured depositors and other creditors are likely to suffer losses in their claims.

In the case of bank rehabilitation, reorganisation or restructuring, the laws and the terminology vary widely from country to country. At times failed banks may be placed under special administration in the form of bridge banks, new banks, special funds or other arrangements. This is often meant to be a temporary solution in order to take over the operations of a failed bank and preserve its going-concern value while the government fiduciary seeks a more permanent solution to the problems or until an acquirer is found.

In some cases, an implicit or explicit 'too-big-to-fail' policy is applied. That was the case in Continental Illinois in the US and in Credit Lyonnais in France. Government-led rescue packages may not only induce moral hazard behaviour, but may also pose questions of fair competition, particularly when the too-big-to-fail doctrine is applied, as other smaller or less troubled institutions may have to navigate through crises or problems on their own. In the US, FDICIA (1991) requires the resolution of bank failures on a 'least cost basis' to the insurance fund, unless it threatens to trigger a payment system breakdown or serious adverse effects on economic conditions or financial stability (systemic risk exception, Section 141 FDICIA) in which case FDIC and Fed may recommend a more costly solution (FDICIA, 12 USC 1823 (c)(4)).

In the recent case of Bear Stearns in the US (leaving aside the fact that Bear Stearns was an investment bank rather than a commercial bank), the test applied by the Federal Reserve Bank of New York was not 'too-big-to-fail' but 'too inter-connected' to be allowed to fail suddenly at a time when markets are fragile. This 'new' test brings about important considerations for European and international policy-makers and regulators working on cross-border issues in a single market in financial services.

The Basel Committee on Banking Supervision acknowledges that in a market economy failures are part of risk-taking and that a prompt and orderly liquidation of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system, as forbearance normally leads to worsening problems and higher resolution costs. The Committee explicitly, however, states that ‘in some cases the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholder. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements that are realistically achievable in a short and determinate timeframe and, that, in the interim, depositors are protected’.<sup>28</sup>

### WHO IS TO BLAME FOR THE CRISIS?

To apportion blame, one needs to look at the general credit turmoil on the one hand and to the specific problems of Northern Rock (or specific problems of other institutions) on the other. With regard to the former, some economists say that the mis-pricing of risk (Greenspan put) is the *causa remota*. Others would point to macro-economic imbalances. The credit turmoil, although certainly related to under-pricing of risk and macroeconomic considerations, is also the result of the folly and greed of bankers and the impotence (and sometimes incompetence) of regulators.<sup>29</sup> This, of course, becomes aggravated in a general downturn of the business and economic cycle, when a banking crisis is not an isolated event but becomes a generalised credit crisis. With regard to the apportioning of blame in the specific case of Northern Rock, the following ‘culprits’ are worth considering.

#### The bank of England

Mervyn King, in his testimony in front of the Treasury Select Committee (20th September, 2007), cited a number of legal obstacles that had made it impossible for the bank to act as

lender of last resort in the way it would have preferred. In particular, the City Code on Takeovers and Mergers and the 2004 Market Abuse Directive (as implemented under Section 118 of the FSMA) were cited as significant reasons why the bank had been unable to avert the run on Northern Rock.<sup>30</sup> The governor said that he would have preferred to give covert aid to Northern Rock, without the public being aware of the bank’s intervention, but that would have been illegal. He pointed to Article 6 of MAD, which states that ‘an issuer [such as Northern Rock] may under his own responsibility delay the public disclosure of inside information [such as support from the Bank of England] ... such as not to prejudice his legitimate interests provided that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information’. Legitimate interests include ‘the event that the financial viability of the issuer is in grave and imminent danger’. ‘In any event, and whatever the merits of the competing views on the Directive, it is singularly unfortunate that a measure designed to promote investor confidence has apparently helped to precipitate blind panic and the first run on a UK bank for over a century’ (Charles Proctor).

With regard to emergency liquidity assistance, it is important to differentiate between market liquidity and lending to individual institutions (collateralised credit lines at penalty rates for illiquid but solvent banks, ‘lender of last resort’).<sup>31</sup> Back in August–September 2007 the Bank of England was somehow more reluctant than the Federal Reserve System and the ECB to extend liquidity to the markets and to widen the range of collateral acceptable in its lending policies. With the announcement by the Bank of England of a Special Liquidity Scheme on 21st April, 2008 however,<sup>32</sup> offering to swap mortgage-backed and other securities (around £50bn) for UK Treasury Bills, the Bank has arguably gone further than the Federal Reserve or the ECB in extending liquidity to the markets. The swaps represent



purchases of the assets from banks with a legally binding commitment from the banks to buy them back after one year, extendable by the bank to three years.<sup>33</sup>

### The FSA

In its report, the Run on the Rock, the Treasury Committee says the FSA was guilty of a 'systematic failure of duty' over the Northern Rock crisis and that the FSA should have spotted the bank's 'reckless' business plan.

In its own internal audit of 26th March, 2008, the FSA admits failures in its supervision of Northern Rock (*mea culpa*). The internal audit review identifies the following four key failings specifically in the case of Northern Rock: (1) a lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions; (2) a lack of adequate supervision and review by FSA line management of the quality, intensity and rigour of the firm's supervision; (3) inadequate specific resource directly supervising the firm, and (4) a lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions'.<sup>34</sup>

An operational review will address these weaknesses. The main features of the FSA's supervisory enhancement programme are the following: (1) A new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure procedures are being rigorously adhered to. (2) The numbers of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum level of staffing for each firm. (3) The existing specialist prudential risk department of the FSA will be expanded following its upgrading to divisional status, as will the resource of the relevant sector teams. (4) The current supervisory training and competency framework for FSA staff will be upgraded. (5) The degree of FSA senior management involvement in direct supervision

and contact with high-impact firms will be increased. (6) There will be more focus on liquidity, particularly in the supervision of high-impact retail firms. (7) There will be raised emphasis on assessing the competence of firms' senior management.<sup>35</sup>

### Northern Rock

In its report, the Run on the Rock, the House of Commons Treasury Committee stated that the directors of Northern Rock were 'the principal authors of the difficulties' that Northern Rock has faced since August 2007. 'The high-risk, reckless business strategy of Northern Rock, with its reliance on short and medium-term wholesale funding and an absence of sufficient insurance and a failure to (...) cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007'.<sup>36</sup>

Northern Rock was not a victim of the sub-prime crisis but of its own funding structure.<sup>37</sup> The credit squeeze in August 2007 following the sub-prime mortgage crisis in the US,<sup>38</sup> caused serious liquidity problems in many banks that had come to rely on wholesale capital markets (markets for securitised assets) for their funding needs. Northern Rock suffered more than others because it was heavily reliant on such markets at a time when they were drying out.

### Tripartite arrangement

Why did the tripartite arrangement fail in Northern Rock? Certainly, the three authorities involved should share the blame. The lack of effective and timely communication, the apparent lack of a clear leadership structure (shared power leading to muddled policy), together with the uncertainties surrounding the resolution procedures (questions of EU law, timing, etc) and an ill-designed deposit insurance system contributed to the debacle.

The tripartite arrangement is a good structure to respond to the problems of transferring supervision from the central bank

(Bank of England) to a separate supervisory agency (FSA), while keeping the Treasury involved. The wisdom of separating the monetary and supervisory responsibility of the central bank, however, remains a matter of controversy. Given that supervision is a key instrument in the maintenance of financial stability, depriving the central bank of this instrument makes the pursuit of the goal of financial stability more difficult.

### THE MANAGEMENT OF CROSS-BORDER BANKING CRISES<sup>39</sup>

In any financial crisis, it is necessary to have a clear and predictable legal framework in place to govern how a financial institution would be reorganised or liquidated in an orderly fashion so as not to undermine financial stability. There is no such framework yet with regard to cross-border banks, neither at the European level nor at the international level.

The field of cross-border bank insolvency is still in its infant stage; some progress has been made with regard to conflict of laws or private international law rules (an example of which is the Directive 2001/24/EC on the reorganisation and winding up of credit institutions), but so far there is no international substantive harmonised standard for banks.

Bank insolvency laws vary widely across countries. Given the intimate link between insolvency law and other areas of commercial law, different legal traditions (civil law, common law) have given rise to different insolvency rules. Some laws are more favourable to creditors and others are more pro-debtor. The choice between *lex generalis* and *lex specialis* leads to different approaches to bank insolvency.

— *Lex generalis*. In some jurisdictions banks are treated like other corporations, that is, subject to the general insolvency law. This has been the case in the UK (though new legislation to be introduced in May 2008 is expected to introduce a SRR for banks, as explained above) and other European

countries, where judicial proceedings or court-administered proceedings prevail.

— *Lex specialis*. In other jurisdictions, banks are subject to a special insolvency regime, administered by the bank supervisor or the depositor protection agency.

In the absence of an international insolvency legal regime, the solution to the liquidation of a bank with branches and subsidiaries in several countries needs to be based on national legal regimes and on the voluntary cooperation between different national authorities. This cooperation is often uneasy and the division of responsibilities between home and host country authorities remains a matter of controversy.<sup>40</sup>

The need for a coordinated liquidation of multinational banks would be best served at the international level by the adoption of an international convention or regime on cross-border insolvency, based upon the work of the United Nations Commission on International Trade Law (UNCITRAL) and, at the European level, by the adoption of a new legal framework on the reorganisation and winding up of banks and banking groups, consistent with the rules of state aid and with the rules concerning emergency liquidity assistance and deposit insurance, as well as with the other related EC Directives and regulations in the fields of insolvency and prudential supervision. *What is needed is an internationally agreed definition and understanding of bank insolvency, similar to the international agreement on bank capital.*

### INTERNATIONAL LAW PRINCIPLES GOVERNING INSOLVENCY

‘Most nations currently apply a territorial approach to cross-border insolvencies. This simply is a consequence of the domestic focus of most insolvency laws’.<sup>41</sup> Sovereignty as a supreme power is typically exerted over the territory of the state: the principle of territoriality. Sovereignty has a territorial dimension. The demise of national frontiers in today’s global financial markets shows the limitations and inadequacies of this principle (territoriality



— sovereignty) to deal with financial conglomerates, international holding structures, and cross-border banking and finance. These inadequacies are particularly evident in the case of insolvency.

The principle of ‘*plurality of bankruptcy*’,— which typically goes hand-in-hand with the ‘*separate entity*’ approach to liquidation, means that bankruptcy proceedings are only effective in the country in which they are initiated and that there is a plurality of proceedings, as they need to be initiated in every country in which the insolvent bank holds realisable assets or branches. Thus, this principle assigns *territorial effect* to the adjudication of bankruptcy. Under a separate entity approach, a domestic branch of a foreign bank receives a liquidation preference, as local assets are segregated for the benefit of local creditors (practice of ‘ring fencing’). Ring fencing is contrary to the *pari passu* principle, because some creditors receive more favourable treatment than others.<sup>42</sup> Under the separate entity approach, local branches of the foreign bank are treated as separate entities. This is the approach the US applies to the liquidation of US branches of a foreign bank. US bank insolvency law is territorial for US branches of a foreign bank.

The principle of the ‘*unity and universality of bankruptcy*’ — which typically goes hand-in-hand with the unitary or ‘*single entity*’ approach to liquidation — means that there is only one competent court to decide on the bankruptcy of the bank (unity), and that the bankruptcy law of the country in which the insolvency has been initiated is effective in all other countries in which the bank (parent entity) has assets or branches (universality). All assets and liabilities of the parent bank and its foreign branches are wound up into one legal entity. Thus, this principle assigns extraterritorial effect to the adjudication of bankruptcy. All assets and liabilities of the parent bank and its foreign branches are wound up into one legal entity (single entity approach). Under this unitary system it is impossible to start separate insolvency proceedings against a domestic

branch of a bank, which has its head office in another country. US law applies this unitary principle to the liquidation of a US bank with foreign branches. The Federal Deposit Insurance Corporation as receiver of a failed bank collects and realises all assets, and responds to all claims of the institution regardless of their situs. US bank insolvency law is universal with respect to US banks. (As mentioned above, US law, however, applies a different regime to the liquidation of US branches of a foreign bank and their holding companies).

The inconsistency of the US legal approach to the liquidation of multinational banks, depending on whether it is dealing with foreign branches in the US or with US branches of a foreign bank, illustrates the difficulties of reaching a common international platform with regard to the liquidation of multinational banks.

## CROSS-BORDER BANK INSOLVENCY

There are three possible approaches to deal with the problems of cross-border insolvency.

1. *Creation of an international authority.* The idea of an international bankruptcy court, however, appears far-fetched and, even at the EC level, the idea of a single authority appears distant (if not impossible).
2. *Establishment of common rules.* Rule harmonisation and regulatory convergence appear to be the solution. Some rules are procedural and some others are substantive. In the field of insolvency, some conflict of laws/private international law/division of labour types of rules have been harmonised, but so far there is no international substantive bank standard applicable to cross-border insolvency.
3. *Cooperation and information sharing, through memoranda of understanding (bilateral and multi-lateral Memorandum of Understandings (MOUs)) and other mechanisms.* Resolution procedures (in particular if they imply burden sharing), however, cannot be expected to rely upon ‘ex post cooperation’. They need *ex ante* rules.

Although there is no international treaty on insolvency law, there have, however, been some attempts at reaching some commonly agreed upon international rules (mostly 'soft law'). Throughout its 33 years of existence, the Basle Committee has addressed various issues concerning the allocation of supervisory responsibilities (home-host), capital regulation and other principles for the effective supervision of international banks. The Basel Committee, however, provides little guidance concerning bank exit policies and the problems involved in the resolution of cross-border banking crises.<sup>43</sup>

## INTERNATIONAL RULES ON INSOLVENCY

UNCITRAL adopted the Model Law on Cross-Border Insolvency in Vienna in May 1997. This model law, however, contains an optional clause whereby special insolvency regimes applicable to banks may be excluded from its scope.<sup>44</sup> The model law deals with the recognition of foreign insolvency proceedings, the cooperation between judicial authorities and administrators, and other issues concerning the coordination of concurrent insolvency proceedings in multiple jurisdictions.

In 1999, UNCITRAL commenced work on the Legislative Guide on Insolvency Law, considering corporate insolvency. Work proceeded through a joint colloquium with INSOL (a worldwide federation of national associations for accountants and lawyers who specialise in insolvency) and the IBA. The Legislative Guide was completed in 2004 and adopted by the United National General Assembly on 2nd December, 2004.<sup>45</sup>

The World Bank has coordinated the effort of the UNCITRAL Legislative Guide with its own Global Bank Insolvency Initiative to articulate a set of standards on insolvency and creditor rights for the purposes of the bank/fund initiative on Standards and Codes. Accordingly, the World Bank, in collaboration with staff of the Fund and UNCITRAL and other experts, has prepared a document, setting out a unified Insolvency and Creditor Rights

Standard (the 'ICR Standard'), which integrates the World Bank Principles for Effective Creditor Rights and Insolvency Systems (one of the 12 areas under the joint World Bank and International Monetary Fund initiative on standards and codes) and the UNCITRAL Recommendations (included in the UNCITRAL Legislative Guide on Insolvency). This document was published on 21st December, 2005.

UNCITRAL Working Group V on insolvency has started working on the treatment of corporate groups in insolvency in 2006, examining both domestic and cross-border issues. This could be the right forum to develop common principles concerning bank insolvency.

This ICR standard (one of the 12 areas identified by the bank and the fund in their joint initiative)<sup>46</sup> will be used for the purposes of assessing member countries' observance in the Reports on the Observance of Standards and Codes (ROSCs). The ICR standard recognises that banks may require special insolvency laws when it talks about 'exclusions' (in point 3): 'Exclusions from the application of the [general] insolvency law should be limited and clearly identified in the insolvency law'. The explanatory footnote concerning these 'exclusions' further states

Highly regulated organizations such as banks and insurance companies may require specialized treatment that can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law.

A recent welcome development is the establishment of a new Basel Working Group — set up in December 2007 — and co-chaired by Michael Krimminger and Eva Hüpkens to study the resolution of cross-border banks. This group, working together with UNCITRAL, could provide a degree of harmonisation (legislative convergence) with regard to some key issues such as the definition of triggers for commencement of proceedings, the role of



supervisors, minimum rights and obligations of debtors and creditors, right to set-off, netting, treatment of financial contract and the protection of the payment system.

### **REGIONAL RULES: THE EU INSOLVENCY REGIME**

The EU insolvency regime consists of one regulation on insolvency proceedings (Council Regulation (EC) No. 1346/2000 of 29th May, 2000) and of two directives: a directive on the reorganisation and winding up of credit institutions (Directive 2001/24/EC of 4th April, 2001), and a directive concerning the reorganisation and winding up of insurance undertakings (Directive 2001/17/EC of 19th March, 2001).

The EU insolvency regime is binding for all EU Member States. As such, the EU regime is the clearest example of binding supranational/regional rules in the field of insolvency law in general and of bank insolvency law in particular. The EU rules are, however, mainly of a private international law character. They introduce the principles of unity and universality of bankruptcy, conferring exclusive jurisdiction to the home Member State, but they do not seek to harmonise, in a substantive way, national legislation concerning insolvency proceedings, which remain different across the Member States of the EU.

Under Directive 2001/24/EC, where a credit institution with branches in other Member States is wound up or reorganised, the winding up or reorganisation is initiated and carried out under a single procedure by the authorities of the Member State where the credit institution has been authorised (known as the home Member State). This procedure is governed by the law of the home Member State. This approach is consistent with the principle of home Member State supervision pursuant to the EU Banking Directives.

The directive does not aim at harmonising national legislation, but at ensuring mutual recognition of Member States' reorganisation measures and winding up proceedings as well as

the necessary cooperation between authorities. Owing to the mere coordinating nature of the directive, Member States have different reorganisation measures and winding up proceedings. Consequently, insolvency proceedings for credit institutions differ. Some Member States use the same general company and insolvency law for the reorganisation and winding up of credit institutions as for other businesses, while others have special reorganisation proceedings for credit institutions.

The directive covers only the insolvency of branches of credit institutions in other Member States, but does not cover subsidiaries of banking groups in other Member States.

Directive 2001/24/EC is limited to procedural aspects concerning each legal entity within a cross-border banking group. This limited scope does not allow synergies within such a group, which may benefit all creditors in case of reorganisation. This lack of group-wide approach to winding up and reorganisation could lead to the failure of subsidiaries or even the group, which could otherwise have been reorganised and remained solvent in whole or part.

As stated above, the October 2007 ECO-FIN conclusions called for an enhancement of the arrangements for financial stability in the EU and a review of the tools for crisis prevention, management and resolution, including a revision of the Directive reorganisation and winding up of credit institutions<sup>47</sup> and a clarification of the Deposit Guarantee Directive. The aim of the ongoing public consultation launched by the commission with regard to the Winding Up Directive for credit institutions is to examine whether the directive completely fulfils its objectives, whether it could be extended to cross-border banking groups, and how obstacles related to asset transferability within such groups can be addressed.

I have previously proposed<sup>48</sup> that given the differences in bankruptcy laws in the Member States of the EU, large banking institutions and financial conglomerates could be incorporated

as *Societas Europaeae* (as Nordea proposed) and that a special insolvency regime could apply to them.

### BILATERAL RULES AND MOUS

In the absence of a formal international insolvency legal regime, countries resort to bilateral agreement, often in the form of an MoU, to establish some principles of cooperation in the regulation of cross-border establishments. MoUs are, however, voluntary arrangements, not legally binding. Moreover, in the case of the multilateral MoUs agreed on so far (MoU on cooperation between the banking supervisors, central banks and finance ministries of the European Union in Financial Crisis situations, 18th May, 2005; MoU on high-level principles of cooperation between the banking supervisors and central banks of the European Union in crisis management situations, 10th March, 2003; MoU on cooperation between payment systems overseers and banking supervisors in Stage Three of Economic and Monetary Union, 1st January, 2001), only a press release was published. A new MoU will become effective later this year, following the informal ECOFIN meeting in Slovenia on 4–5th April, 2008, in which the implications of market turmoil for financial institutions with cross-border operations were considered.<sup>49</sup> The aim of the new MoU is to provide general principles, practical guidelines for crisis management and an analytical framework for preparing responses.

### THE STATUS QUO IN THE EU

Although it is argued that the ECB has successfully provided liquidity to the market in recent months to alleviate the ‘credit squeeze’, the arrangements for managing and resolving a cross-border financial crisis in the EU remain untested and are, in our opinion, insufficient. Cross-border crisis management in Europe presents additional challenges for policy makers and regulators

for the following reasons:

- (1) European Monetary Union. The ECB has no European fiscal counter-part, which means that the relevant fiscal authorities are, by definition, at the national level. This presents a dire problem for rescue operations, given that the fiscal costs of resolving a banking crisis can be large. Who should bear the costs of any failures that may occur in large cross-border banks? The *ex post* allocation of the fiscal burden of the costs of recapitalisation is a most controversial issue.
- (2) The complex ‘European Financial architecture’.
- (3) The ‘patchy’ and scattered legal framework.
- (4) Supervision and crisis management remain at the national level, based upon the principle of home country control and consolidated supervision.

Consolidated supervision is based on the assumption that financial groups form a single economic entity. When one, however, comes to the question of the resolution of a failed multinational bank, or of a complex financial group with activities and business units with different legal entities incorporated in various jurisdictions, the assumption that financial groups form a single economic entity appears to be not always valid in a bankruptcy scenario where the group is split up into its many legal entities and where foreign branches are some times liquidated as separate units.<sup>50</sup>

With regard to the ‘patchwork’ of rules related to the management and resolution of banking and financial crises in the EU, there are a few primary law rules (notably, Article 105 EC Treaty and Articles 18 and 25 ESCB Statute as well as the rules on state aid, Articles 87–89 EC Treaty) and there are a number of directives (secondary law, pursuant to Article 47 (2) EC Treaty) that ought to be considered.

— Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (‘Recast Banking Directive’).



- Directive 2006/49/EC, ‘Capital Requirements Directive’.
- Directive 2002/87/EC, ‘Financial Conglomerates Directive’.
- Directive 2001/24/EC on the reorganisation and winding up of credit institutions.
- Directive 2004/39/EC on markets in financial instruments (‘MiFID’).
- Directive 94/19/EC, ‘Deposit-Guarantee Schemes Directive’.
- Directive 97/9/EC, ‘Investor Compensation Schemes Directive’.
- Directive 2003/6/EC, ‘Market Abuse Directive’.

Articles 130 of Directive 2006/48/EC of 14th June, 2006 (The ‘Recast Banking Directive’) refers to a mechanism for coordination for the competent authority responsible for consolidated supervision. There are other coordinating provisions in the Recast Banking Directive, MiFID, the Financial Conglomerates Directive and the Winding-up Directive. Cooperation and coordination are, however, not enough in a crisis. Clear rules, procedures and allocation of responsibility are needed.

National competence implies that one jurisdiction is in charge: typically the jurisdiction of the home country (responsible for licensing or authorisation, closing a bank and providing deposit insurance), although important exceptions are made in the case of liquidity management and a ‘cloud’ still surrounds the allocation of responsibilities for lender of last resort.<sup>51</sup>

According to some commentators, a degree of ‘constructive ambiguity’ is desirable in the case of lender of last resort and crisis management. Ambiguity and uncertainty as to the procedures and loci of power are not constructive. In the event of a crisis, the procedures to follow should be crystal clear *ex ante* for the institution affected, other market participants and the public at large. The only ‘ambiguity’ that can be constructive in lender of last resort is the discretionary component in the provision of such assistance, in the sense that there is no

obligation for the central bank to provide lender of last resort loans. It is this discretionary nature — this uncertainty — that reduces the moral hazard incentives inherent in any support operation. The mandate to achieve financial stability, a term of art in the new European financial architecture, is both national and European; both home and host country supervisors have a shared interest in the pursuit of financial stability. As the process of financial integration in Europe advances, the likelihood of a pan-European crisis increases, and with it the need for a European solution.

National or Community competence in prudential supervision in the EU?<sup>52</sup>

<i>Stage</i>	<i>Principle</i>
1. Licensing	Home country with regulatory harmonisation
2. Prudential supervision	Home and host country with regulatory harmonisation and consultation — ECB and Lamfalussy
3. Sanctioning	Home country
4. Lender of last resort	National and European competence
5. Deposit Insurance	Home country with regulatory harmonisation
6. Insolvency proceedings	Home country with regulatory harmonisation

*Both home country and host country are national competence*

The debate about the future of prudential supervision in the EU remains a matter of intense policy and academic debate, with proposals that range from a single regulator or a European System of Financial Supervisors to proposals that suggest a much more limited sectorial or functional approach. An analogy

with the football leagues in Europe, with national leagues governed by national football associations and a Champions League governed by UEFA, could be taken into account in the future design of supervision and regulation of banks in Europe.

### RECENT INTERNATIONAL INITIATIVES

A number of international initiatives have addressed the current credit crisis. The Financial Stability Forum published a report on 12th April 2008 on actions to enhance market and institutional resilience,<sup>53</sup> including the use of international colleges of supervisors for each of the largest global financial institutions. The Institute of International Finance (IIF) released on 9th April a report of its Special Committee on Market Best Practices, an effort in self-regulation.<sup>54</sup> The Basel Committee announced on 16th April a number of steps to strengthen the resilience of the banking system.<sup>55</sup> Other efforts stem from the US (the cradle of the sub-prime mortgage crisis), such as the [US] President's Working Group, a committee of US regulators and financial officials, that recently issued a policy statement with recommendations to improve future state of financial markets.<sup>56</sup>

All these initiatives are commendable. They should lead to an overhaul of the regulatory system. A final note of caution, though, against the temptation to over-regulate. It is important to establish a system of incentives that corrects the excesses of the last years (in a system in which gains were privatised while losses have become socialised).<sup>57</sup> It is, however, also important to preserve innovation and flexibility.

### ACKNOWLEDGMENTS

I am grateful for comments and suggestions received from members of MOCOMILA (Monetary Committee of the International Law Association) and from other colleagues participating in a workshop organised by Cass Business School on 7th April on the new UK regime for resolution of banking problems.

Errors and limitations of judgment are the author's alone. This paper was completed on 30th April, 2008.

### REFERENCES AND NOTES

- (1) Northern Rock was formally a building society. 'The Northern Rock Building Society had originally been set up in 1965 following the merger of the Northern Counties Permanent Building Society (established in 1850) and the Rock Building Society (established in 1865). The new society demutualised and converted to a bank in 1997 with a separate Northern Rock Foundation being set up in 1996 to continue its local community and charity work. Northern Rock enjoyed spectacular growth and expansion subsequently. It was quoted on the FTSE 100 Index from 2000 (and was only re-transferred to the FTSE 250 in December 2007 following the recent difficulties). Northern Rock was one of the five top mortgage lenders in the UK. By 2006 it had revenues of £5bn and around 6,400 employees with sub-divisions in Guernsey and separate branches in Ireland and Denmark (...) Before the crisis, the bank's funding had comprised approximately 50 per cent securitisation, 10 per cent covered bonds and 25 per cent wholesale. Retail deposits only represented 22.4 per cent of funding as against its total liabilities and capital'. See Walker, G. (2008), 'Northern Rock falls', *Bankers' Law*, Vol. 2, No. 2, pp. 4–12.
- (2) On 14th September, Northern Rock announced that 'extreme conditions' in financial markets had forced it to approach the Bank of England for assistance. The bank's website collapsed under the strain. See [http://www.bbc.co.uk/blogs/newsnight/2007/09/friday\\_14\\_september\\_2007.html](http://www.bbc.co.uk/blogs/newsnight/2007/09/friday_14_september_2007.html), Accessed 24th April, 2008.
- (3) See Memorandum of Understanding of 1996 revised in 2006 between HM Treasury, FSA and the Bank of England, [http://www.hm-treasury.gov.uk/documents/financial\\_services/regulating\\_financial\\_services/fin\\_rfs\\_mou.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm), Accessed 20th April, 2008.



- (4) See <http://news.bbc.co.uk/1/hi/business/7007076.stm>, Accessed 3rd April, 2008. Lloyds had asked for a £30bn support facility, which was rejected by the Bank of England.
- (5) The Banking (Special Provisions) Act 2008, [http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/banking/banking\\_special\\_provision\\_bill.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/banking/banking_special_provision_bill.cfm), Accessed 20th April, 2008.
- (6) The Transfer Order came into force, and the transfers under it were made on 22nd February, 2008.
- (7) The coverage of the Northern Rock saga in *Financial Times* during this period was outstanding. Gillian Tett and Martin Wolf have provided excellent analysis of various issues associated with the credit crisis in general and Northern Rock in particular.
- (8) The words of Hal Scott and George Dallas, although written in another context ('End of American dominance in capital markets', *Financial Times*, 19th July, 2006) resonate in this comparative analysis: 'While the European approach to regulation may prove to be a more adaptable and sustainable model for global companies, we need to be alert to its vulnerabilities...'
- (9) See 'Actions by the New York Fed in response to liquidity pressures in financial markets', Testimony by Timothy F. Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York before the US Senate Committee on Banking, Housing and Urban Affairs, Washington, DC, 3rd April, 2008, <http://www.newyorkfed.org/newsevents/speeches/2008/gei080403.html> and Federal Reserve Announces Establishment of Primary Dealer Credit Facility, at <http://www.ny.frb.org/markets/pdcf.html>, Accessed 20th April, 2008.
- (10) For instance, Andrew Campbell, Peter Cartwright and Dalvinder Singh, in their response to the January 2008 consultation document explain that: 'In the Insolvency Act 1986 a new corporate rescue procedure, the administration order, was included for the first time as an alternative to liquidation in appropriate circumstances. Administration orders have been used with some degree of success in relation to banks in the past, the best-known example being the administration of Barings Bank in 1995. Under this procedure the FSA (FSA) has power to petition the court for the appointment of an administrator in relation to a bank that is either insolvent or is likely to become insolvent'.
- (11) See Banking Reform — Protecting Depositors: a discussion paper, 11th October, 2007 at [http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/bankingreform/consult\\_banking\\_reform.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/bankingreform/consult_banking_reform.cfm), Accessed 20th April, 2008. The consultation period for this paper ended on 5th December, 2008.
- (12) Consultation on the reorganisation and winding-up of credit institutions [http://ec.europa.eu/internal\\_market/bank/windingup/index\\_en.htm](http://ec.europa.eu/internal_market/bank/windingup/index_en.htm), Accessed 20th April, 2008.
- (13) The Treasury Committee published its fifth report of Session 2007–08, 'The run on the Rock' (HC 56-I) on 26th January, 2008. See <http://www.parliament.the-stationery-office.co.uk/pa/cm200708/cmselect/cmtreasy/56/5602.htm>, Accessed 20th April, 2008.
- (14) 'Financial Stability and Depositor Protection: Strengthening the Framework', Bank of England, HM Treasury and FSA, Cm 7309, 30th January, 2008, [http://www.hm-treasury.gov.uk/documents/financial\\_services/financial\\_stability\\_framework.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm), Accessed 20th April, 2008.
- (15) *ibid.*
- (16) *ibid.*, point 4.5.
- (17) In point 4.14, it is stated that among the new SRR tools, a new 'bank insolvency procedure' is to be introduced if the pre-insolvency resolution is not feasible or if the immediate closure of the bank is considered to be the best solution. In point 4.34, the document further states: 'A failed bank is currently subject to ordinary insolvency procedures. These range from corporate rescue mechanisms, such as administration and a company voluntary arrangement, to winding up a company's affairs through formal liquidation. Current insolvency procedures *appear to have significant weaknesses in relation to banks*' (emphasis added).
- (18) According to Hüpkes, E., Special Resolution and Shareholders Rights (paper presented at the workshop organised by Cass Business School on the new UK Regime for Resolution of Banking Problems on 7th April,

- 2008), 'Shareholders have legitimate rights that need to be respected in a special resolution regime. (...) [I]t is necessary to provide a clear legal framework with adequate intervention powers that make the restriction or elimination of shareholders rights predictable as does the corporate insolvency regime'.
- (19) Section 13.3 of the Federal Reserve Act, which was invoked in the rescue of Bear Stearns, was a useful provision to provide a legal basis for the rescue of an investment bank, Bear Stearns (March 2008) marks the first time since the 1960s that the Fed authorised the provision of emergency funds to any financial institution other than a regulated bank. See *Financial Times*, 15th March, 2008. Fed officials said that Bear Stearns (the fifth largest US investment bank) was not too big to fail, but 'too interconnected to be allowed to fail at a moment when markets were extremely fragile. 'The Fed acted under section 13.3 of the Federal Reserve Act, which gives it authority to lend to any individual, partnership or corporation in unusual and exigent circumstances'. That authority was last invoked in the 1960s and Fed officials said loans were last disbursed in the 1930s. As an investments bank, Bear Stearns did not have access to the Fed's discount window lending. So the Fed arranged back-to-back transactions with JP Morgan to give Bear indirect access to the window. JP Morgan bought Bear Stearns paying \$2 per share (later revised to \$10 per share).
- (20) For instance, the Resolution and Trust Corporation was created by the 1989 Financial Institutions, Reform, Recovery and Enforcement Act (FIRREA) to manage the assets of failed saving and loan associations. Debt-to-debt conversions (securitisation) and debt-to-equity conversions can also be useful debt restructuring techniques in some circumstances.
- (21) Banks (whether publicly or privately owned) are subject to EC competition rules (articles 81–89 EC Treaty), including state aid rules (Articles 87–89) as confirmed by the European Court of Justice in *Zuchner v Bayerische Vereinsbank* (Case 172/80 [1981] ECR 2021). With regard to Northern Rock, the Commission had already approved rescue aid in December 2007 (the emergency liquidity assistance provided by the Bank of England did not constitute illegal state aid), on condition that the support lasted no longer than six months and that it was aimed at keeping the bank afloat (state aid beyond six months must be targeted at restoring the long-term viability of a company and not distort competition). Following the nationalisation of Northern Rock in February 2008, and the formal Treasury notification on 17th March, 2008, the Commission has launched (on 2nd April) a new in-depth state-aid investigation into the government's bail-out. See <http://www.guardian.co.uk/business/2008/apr/02/northernrock>, Accessed 20th April, 2008. At the heart of the EU investigation is whether the long-term restructuring plan distorts competition. Danish banks have already made formal complaints to the European Commission alleging unfair competition in the European banking sector after the state aid given to Northern Rock. As regards Northern Rock, see for example <http://www.euractiv.com/en/financial-services/eu-scrutinise-uk-aid-northern-rock/article-171333>, Accessed 20th April, 2008. The issue of monetary financing is also at stake.
- (22) See point 4.39.
- (23) See Walker, above note 1.
- (24) See Campbell, A. The run on the rock and its consequences', *Journal of Banking Regulation*, Vol. 9, No. 2, p. 63. The case of Barings was in his judgment adequately handled via the use of the judicial process. Will an administrative process make it more likely that the authorities would act more quickly and more decisively than with a judicial procedure? What evidence is there to demonstrate that such an approach would be more efficient than making an application to a judge in the Commercial Court? The introduction of an administrative process also requires adequate appeal mechanisms. See also above note 10. 'It is unclear why an administrative rather than a judicial process would more appropriate in the UK...'.  
 (25) FDICIA Section 131 on PCA says, 'The purpose of this section is to resolve the problems of insured depository institutions at



- the least possible long-term loss to the deposit insurance fund.'
- (26) See Hüpkes, E. (2003) 'Insolvency — Why a special regime for banks', in 'Current Developments in Monetary and Financial Law', Vol. 3, chapter 25, pp. 471–513, International Monetary Fund Publications, Washington, DC.
- (27) See Goodhart, C. (2004) 'Multiple regulators and resolutions', paper presented at the Federal Reserve Bank of Chicago Conference on Systemic Financial Crises: Resolving Large Bank Insolvencies, 30th September–1st October, 2004.
- (28) Basel Committee on Banking Supervision. Core Principles for Effective Banking Supervision (Basel Core Principles), <http://www.bis.org/publ/bcbsc102.pdf>, Accessed 20th April, 2008.
- (29) This is the title of a paper I am writing with Geoffrey Wood: 'The Folly of Bankers and the Impotence of Regulators'.
- (30) See *The Times*, 21st September, 2007, pp. 6–7. The claim that the assistance could not be covert is questionable in my opinion. A different interpretation of the Market Abuse Directive (in particular Article 6) and a dispensation of its more stringent implementation in the UK would have rendered the covert assistance possible in my opinion and in the opinion of other commentators, such as Charles Proctor. As Proctor (mimeo, 2008) points out: 'The core provisions of the Directive have been transposed into UK law by the Disclosure Rules and Transparency Rules ("DTR") of the FSA's Handbook. (...) It should be emphasised that the disclosure requirements do not directly apply to the Bank of England; they only apply to publicly listed entities — such as Northern Rock — and those responsible for arranging the issue of such securities. They do not therefore directly inhibit the Bank of England in the conduct of its "lender of last resort" function. Nevertheless, the point would clearly have been a concern to the Board of Northern Rock. The difficulty here is that, whilst the FSA's guidance allows an issuer to delay release of information about negotiations to restructure its debt, it does not allow it to defer disclosure of the fact that it is in financial difficulties. If this distinction appears curious, it must be recalled that the spirit of the rules is to promote early disclosure. The FSA has power to modify the disclosure rules in particular cases, and it may well be that a short-term dispensation could have been granted on the basis that a run on Northern Rock might have wider consequences for the financial system. It is not clear whether this option was considered or could have been used in this particular situation'. Walker, above note 1, points out, 'The Northern Rock board and the FSA had both received legal advice that any assistance would have to be overt. Once a company had received emergency liquidity support, an announcement would have to be made to the market despite the concessions permitted under Article 6(2) of the Market Abuse Directive. The UK implemented requirements set out in Rule 2.5.1, 2.5.2 and 2.5.3 of the FSA's Disclosure and Transparency Rules which provided that disclosure could only be withheld where this would not mislead the markets and the confidentiality of the information could be ensured'.
- (31) See Lastra, R. (1999) 'Lender of last resort, an international perspective', *International and Comparative Law Quarterly*, Vol. 48, pp. 340–361 and Lastra, R. (2006) 'Legal Foundations of International Monetary Stability', Oxford University Press, Oxford, pp. 304–307 and 117–120.
- (32) See Bank of England, News Release, Special Liquidity Scheme, 21st April, 2008, <http://www.bankofengland.co.uk/publications/news/2008/029.htm>, Accessed 20th April, 2008.
- (33) See *Financial Times*, 22nd April, 2008. It is, however, worth pondering the following warning 'Public liquidity is an imperfect substitute for private liquidity', from Federal Reserve Governor Kevin Warsh. See *Financial Times* of 15th April, 2008, 'Fed warns of slow healing for fragile markets'.
- (34) See FSA Internal Audit Review, 26th March, 2008, <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml>, Accessed 20th April, 2008.
- (35) *ibid.*
- (36) See *The Run on the Rock*, above note 13, paragraph 31, pp. 19–20.
- (37) This point is also made by Walker, above note 1.

- (38) It can be argued that the relaxation of the clear boundaries between commercial banking and investment banking that the 1999 repeal of Glass-Steagall (via the Gramm-Leach-Bliley Act) in the US, paved the way for banks to engage in a broader range of activities in the capital markets. See Randall, W. L. (2008) 'Lessons from the Subprime Meltdown', at [www.levy.org/pubs.wp\\_522.pdf](http://www.levy.org/pubs.wp_522.pdf). Securitisation allowed banks to earn income on the mortgage loans they originated, by moving these (some times risky) mortgages off their balance sheets to their affiliated investment banks (not subject to reserve and capital requirements) or to special purpose vehicles.
- (39) This part of the paper draws in part upon Lastra, R. (2007) 'Cross border resolution of banking crises' in Evanoff, D., LaBrosse, R. and Kaufman, G. (eds) 'International Financial Instability: Global Banking and National Regulation', Vol. 2, World Scientific Publishing Company Pte Ltd, Singapore, pp. 311–330.
- (40) For instance, the issue of foreign ownership of banks makes some host jurisdictions (where foreign ownership is high) reluctant to rely upon home country control. This has relevant implications in many eastern European countries (such as Poland).
- (41) See Krimminger, M. (2005) 'Deposit insurance and bank insolvency in a changing world: Synergies and challenges', in 'Current Developments in Monetary and Financial Law', Vol. 4, chapter 22, pp. 727–757, International Monetary Fund Publications, Washington, DC.
- (42) Article 13.1 of UNCITRAL's model law on cross-border insolvency does not permit 'ring-fencing'.
- (43) In 1992, the Basel Committee published a document on The Insolvency Liquidation of a Multinational Bank. See generally Lastra, above note 39.
- (44) Article 1(2) of the UNCITRAL Model Law.
- (45) The text of UNCITRAL Legislative Guide on Insolvency Law is available at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2004Guide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html).
- (46) The other 11 areas are: accounting, auditing, anti-money laundering and countering the financing of terrorism (AML/CFT), banking supervision, corporate governance, data dissemination, fiscal transparency, insurance supervision, monetary and financial policy transparency, payment systems, and securities regulation. See Lastra, R. (2006), above note 31, chapter 14.
- (47) Above note 12, Accessed 20th April, 2008.
- (48) Above note 39.
- (49) Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on cross-border financial stability, 4th April, 2008 at [http://www.eu2008.si/en/News\\_and\\_Documents/Press\\_Releases/April/0404ECOFIN\\_Memorandum.html](http://www.eu2008.si/en/News_and_Documents/Press_Releases/April/0404ECOFIN_Memorandum.html), See also Press Release, Slovenian Presidency on Supervision and Crisis Management, 4th April, 2008 [http://www.eu2008.si/en/News\\_and\\_Documents/Press\\_Releases/April/0404ECOFIN\\_SZJpredsedstva.html](http://www.eu2008.si/en/News_and_Documents/Press_Releases/April/0404ECOFIN_SZJpredsedstva.html), Accessed 24th April, 2008.
- (50) See Zuberbuhler, D., 'The financial industry in the 21st century', Speech at the Bank for International Settlements, Basel, 21st September, 2000, cited in Lastra, above note 39, at p. 324, note 28.
- (51) See above note 31. There are three types of crises where the provision of emergency liquidity assistance could be critical: (1) crisis in the payment system; (2) generalised liquidity dry up (credit squeeze); and (3) the classic liquidity crisis (collateralised emergency credit lines to support individual institutions). NCBs are responsible for deciding (with MoF) whether to provide emergency liquidity assistance to individual institutions based on good collateral. Regarding Eurosystem monetary policy operations, only institutions subject to the Eurosystem's minimum reserve requirements (Article 19 ESCB Statute) are eligible to be counterparties to Eurosystem facilities and open market operations.
- (52) See Lastra (2006), above note 31, at 300.
- (53) Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 7th April, 2008, [http://www.fsforum.org/publications/FSF\\_Report\\_to\\_G7\\_11\\_April.pdf](http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf), Accessed 28th April, 2008.



- (54) IIF Committee on Market Best Practices Interim Report, 9th April, 2008 <http://www.iif.com/>, Accessed 28th April, 2008.
- (55) Basel Committee on Banking Supervision BCBS press release on steps to strengthen the resilience of the banking system, BIS Press Releases, 16th April, 2008, <http://www.bis.org/press/p080416.htm>, Accessed 28th April, 2008.
- (56) President's Working Group Issues Policy Statement To Improve Future State of Financial Markets, 13th March, 2008 <http://www.ustreas.gov/press/releases/hp871.htm>, Accessed 28th April, 2008.
- (57) See Wolf, M. 'Bankers' pay is deeply flawed', *Financial Times*, 16th January, 2008.