International Insolvencies in the Financial Sector

A Study Group Report

Group of Thirty

Group of Thirty, Washington, DC

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Finally, recognition is due to several individual contributors to the project: to Charles Taylor, for preparing the original Discussion Draft; to Christopher Oprison, for legal analysis and management of the international consultative process; and to Sheila Campbell and Jeffrey Humin for their efforts in editing and producing this document.

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Introduction

For the last two years, the Group of Thirty, in cooperation with the International Insolvency Practitioners Association (INSOL International), has been examining the issues that could arise in the cross-border insolvency of a financial institution. While this project was originally triggered by the failure of Barings in 1995, the final report is being published amidst widespread insolvencies in the emerging markets of Asia, involving both financial institutions and large industrial conglomerates. Although the Asian crisis has affected a wide range of internationally active financial institutions and investors, it has not triggered the failure of any globally active financial institutions. Nonetheless, the insolvency issue has become a matter of greater importance now than when the project began.

This volume contains the full sequence of work the Group of Thirty has pursued on the issue of international insolvency. This effort began with the creation of a study group in 1996 to examine the issues surrounding the insolvency of a global financial institution. Given the complexity of the issues and substantial variations in insolvency law and practice across countries, the group's report and recommendations were presented in draft form to provide a basis for discussion. This text is included in original form in Appendix I.

The draft report was widely distributed, and comments were requested from private and official experts in twenty jurisdictions as well as international organizations and agencies. During the latter part of 1996 and early 1997, comments were received from 16 countries and three international organizations. This commentary follows the discussion draft in Appendix I.

Both the draft report and commentary served as background for a conference on international insolvency in the financial sector held in London in May 1997. Roughly 100 experts from 19 countries were assembled for a wide ranging discussion of insolvency issues. The agenda, speakers and proceedings of the conference are presented in Appendix II.

Out of this discussion has come an endorsement of the recommendations in the original report, modified to reflect mainly technical concerns, plus additional suggestions on how best to ensure that future insolvencies are pursued with speed and certainty. The overall conclusions of the study are provided in the overview section, "Reducing the Threat of International Insolvency," along with the expanded list of recommendations and the agency or organization best suited to take the lead on them, where appropriate.

Given the variety of national laws and the absence of an international framework for cooperation on insolvency, the proposals in this report must be considered only a first step in reducing the risks inherent in cross-border financial insolvencies. They place heavy reliance on voluntary action by supervisors, insolvency practitioners and the private sector, offering a way forward in the near term. The recommendations also propose changes in law and regulation, to ensure consistency of practice and legal authority for cross-border cooperation, which will clearly take longer to accomplish.

The report does not even broach the subject of conforming national insolvency laws for financial institutions to a single international standard, since eliminating differences in national preferences and approaches is unlikely in the near term and may simply be unworkable. However, the present level of international attention to the problem of insolvency is such that it may be possible to develop a set of broadly applicable required elements for an effective insolvency regime as a basis for evaluating and improving upon current national laws. Until such time as broad international agreement on insolvency is reached, the recommendations in this report make a start at ensuring that if a global financial institution gets into serious difficulty, its insolvency can be handled with greater speed and certainty.

Overview: Reducing The Threat of International Insolvency

After an extended review of the issue of international financial insolvency, it is clear that supervisors, legislators, the financial services industry and insolvency and legal professionals have a great deal of work to do. There is no international framework for dealing with the supervisory, legal and financial problems that would arise in a cross-border insolvency of any kind, and a major cross-border insolvency in the financial sector could therefore pose a substantial risk to the international financial system.

In considering the nature of this problem, it is important to recognize that globally active financial institutions are increasingly complex financial groups, a development with implications for both risk management and supervision. Experience has shown that counterparties may be distressingly unaware of the actual party within a group with which they are contracting, and therefore of their true financial and legal position in insolvency. Supervisors, even where they strive to take a global view of a firm, inevitably focus on that part of the group that is within their jurisdiction. Yet the triggering event of an insolvency is likely to originate within the firm's trading arm, where a collapse can happen literally overnight. Thus, both private and official observers must comprehend both the general and particular conditions of the firms with which they are dealing.

In considering how to address this problem, it is important to recognize that the first line of defense in dealing with a financial insolvency is the supervisor, whose approach to supervision will, in general, be consistent with the requirements of national bankruptcy laws. In the event of insolvency, and ideally in advance of balance-sheet insolvency, supervisors in the G-10 countries would undertake resolution procedures under the special legal authority available to supervisors and central banks, without recourse to general insolvency procedures in the courts. And certainly if supervisors had cause to believe that a financial insolvency could be a source of systemic risk, they would act quickly and directly to address the problem, avoiding the protective mechanisms built into insolvency laws that would be likely to slow emergency action.

Yet while this supervisory imperative may be the same across countries, the legal authorities available to deal with a financial insolvency vary greatly from country to country, often based on quite different social preferences, with different priority assigned to protection of creditors, borrowers, employees and shareholders. Some are well tested and provide a fair and effective basis for sorting out competing claims within the national context; others much less so. In addition, virtually none were written with attention to the cross-border dimensions of an insolvency, offering no mechanism for dealing with matters outside of home jurisdiction or reconciliation of national differences. There is therefore substantial scope for conflict and miscalculation. On the other hand, the tradition of cross-border and now cross-sectoral supervisory cooperation that has developed because of the globalization of finance ameliorates this problem to some extent.

Even more fundamental than good national insolvency procedures, however, a sensible international resolution of claims cross-border depends upon well-functioning systems of national law (as for netting and contract enforceability), supervision, lender of last resort, courts and other institutions in the countries involved. These are important in their own right, but also provide important collateral benefits. By providing the assurance to national authorities that cross-border cooperation will preserve value rather than assist looting abroad, they promote closer international cooperation and reliance on more universal approaches to settlement of claims. In addition, the assurance that institutions are in place to deal effectively with insolvency, both financial and non-financial, should improve market discipline and reduce moral hazard by reducing the chances that supervisors will be forced to step in to prevent messy failures. Unfortunately, however, there are serious questions about the effectiveness of supervision, the ability of supervisors to intervene in the affairs of failing financial institutions, the reliability of safety nets and the effectiveness and impartiality of courts in a number of countries, and particularly in emerging markets.

For all of these reasons, cross-border problems are more likely to be handled on an *ad hoc* basis, in the first instance by supervisors, rather than by formal procedures set down in law, regulation or memoranda of understanding, which leaves a good deal to chance. And they will be handled by supervisors and insolvency practitioners who are trained to be cautious, in situations where rapid judgements about values and outcomes are essential, especially if a firm is to be reorganized short of insolvency. This requires that those involved are sufficiently confident of their authority and the information at hand to offer their best professional judgements.

Recommendations

The 14 recommendations in the original study group report issued by the Group of Thirty focused on the uncertain conditions that currently surround cross-border insolvency, and were always intended as a first step in addressing those problems. Nonetheless, they have received consistent support during the review process, with objections focused on the details and only minor modifications required to address technical concerns. As the process of review and discussion has gone forward, additional proposals have emerged, expanding upon the original list.

Taken together, the overarching theme of the proposals is to *be prepared*. A sound legal framework for action, knowing whom to contact and what assistance will be provided in an emergency, and being able quickly to establish the exposure of individual firms to the insolvent and the total magnitude of its losses: all these require emergency preparedness. Once an insolvency occurs, action must be immediate and only advance preparation can ensure that the process will proceed smoothly.

The workload in implementing the proposals is widely distributed across financial supervisors and international supervisory bodies, national legislatures, financial institutions, and insolvency professionals and their professional associations. Some of the proposals can be implemented quickly if there is the will and the benefits are sufficiently clear. Others, such as changes in national law, will take much longer — but even new legislation is not a hopeless proposition.

In 1997, the United Nations Commission on International Trade Law (UNCITRAL) completed work on model legislative provisions on judicial cooperation and access and recognition in cases of cross-border insolvency. Because of the separate supervisory regime that exists in many countries for dealing with troubled financial institutions and the alternative legal structure and wider range of actors that may be involved, the model law's application is likely to be limited to commercial insolvency in most jurisdictions, though many of the principles embodied in the law would apply equally to financial insolvency. These model provisions have now been recommended to governments and experience suggests that they will be widely adopted among UN member states.

It should be possible to provide the same sort of guidance on addressing financial insolvency, drawing upon the resources of supervisors, insolvency practitioners and industry. The Group of Thirty and INSOL are exploring further cooperation in this area, aimed at providing a forum for studying the issues involved and mobilizing the best supervisory and legal thinking on this question. The objective of this exercise would be to offer further advice and guidance that would encourage the widest range of countries to enact legislation and adopt rules for access and recognition in their courts in the case of a financial insolvency.

In addition to these efforts, the financial crisis in Asia has focused attention on the weakness of many domestic insolvency regimes and the need for improvements both domestically and cross-border. As an example, Indonesia has announced that it is moving swiftly to enact a new bankruptcy law as part of procedures to deal with its huge private-sector foreign debt and Thailand has already enacted new legislation. In light of the Asian experience, the Economic Summit countries, the G-10 and the Interim Committee of the IMF have all placed promotion of stronger insolvency regimes on their agendas. Action will be needed across a broad front to reduce the potential for systemic risk arising from cross-border insolvency, especially the failure of a globally active financial institution.

Supervisors

Given the mandate of financial supervisors to protect the safety and soundness of national financial systems, it is inevitable that the first and greatest burden in addressing problems arising in cross-border financial insolvency would fall to them. Among the proposals that follow, there are steps that supervisors should take: in advance of a crisis to promote disaster preparedness; in the normal course of licensing approvals and supervision; and in the event of an actual insolvency.

In the interest of **disaster preparedness***:*

- **Supervisors should establish lines of communication for cross-border cooperation not only with fellow supervisors within a sector but across sectors, with insolvency practitioners and with appropriate officers of the courts.**
- **In their international supervisory bodies, supervisors should develop a protocol on the organization, timing and type of assistance they will extend to other supervisors and to foreign administrators so that all parties to an insolvency will know what type of assistance is available in an emergency.**

Critical to speeding up the insolvency process is simply getting the parties charged with resolving the insolvency down to work as quickly as possible. This requires prompt notification of the full range of official actors affected by an insolvency, as well as sharing of information on the scope of the problem, the actions being taken to address it, and the assistance that is available from official agencies. It will be necessary to build upon the relatively more frequent contact and cooperation that exists among supervisors of the same type, to extend that cooperation across functional lines and, when appropriate, outside the supervisory community to the courts and their agents.

Figuring out whom to call in an emergency, when the range of actors extends far beyond one's familiar network of fellow supervisors or the local courts, becomes a directory assistance or internet nightmare. Not only will it be difficult to identify the right agencies, but it will be all but impossible to locate the right people — certainly on Friday night when a crisis strikes. In the case of court systems and judges, they may be unfamiliar with the agencies and individuals likely to contact them from abroad and may even be prohibited from communicating with foreign parties or sharing information with them, either by law or their own agency's policies.

One possibility would be to create phone directories and calling lists, to be held in some central location like the Bank for International

Settlements, or distributed among national supervisory agencies and courts. But as anyone who maintains a database of this kind knows, chances are that such lists would be out of date when a crisis came. More realistic would be for a single agency in each country to accept the responsibility to serve as central clearing house and assign a "watch officer" who would be the point of contact in that country and responsible for contacting anyone else who needed contacting. This would be an alert system and information channel, at the ready any time that an institution got into trouble, not an exclusive communications channel that could become a bottleneck for officials who would normally speak in an emergency.

In addition, this wide range of actors would benefit from greater direct contact so that they would know better with whom they were dealing in an emergency and feel comfortable doing so. This should be pursued through contacts and meetings under the auspices of international supervisory bodies and professional associations, such as the Judicial Colloquium sponsored by INSOL International.

Together with knowing whom to contact, it is important to know in advance what sort of assistance is likely to be available. Development by supervisors of a protocol on the type of assistance they will provide to other supervisors and to foreign administrators would accomplish that goal. Some commentators suggested that differences in national law might make adoption of a protocol unworkable, and that a more formal convention or multilateral agreement would be necessary to give such an effort effect. Supervisors have made good use of bilateral memoranda of understanding in a number of areas, including cooperation in supervision and enforcement. Bilateral and multilateral agreements should both be pursued but, even if there are distinct limits to what can be accomplished through a protocol, the starting point should be a discussion among supervisors of what sorts of assistance can be made readily available. The very act of discussing possibilities and obstacles will increase awareness of the problems among supervisors.

- **Through the Joint Forum or individual supervisory fora, supervisors should pursue mechanisms or standards for the handover of proprietary models by insolvent firms to potential purchasers and for speedy assignment of portfolios of over-the-counter derivatives.**

The speedy resolution of a financial institution with a complex book of derivatives will require the rapid valuation of that portfolio by potential purchasers and its subsequent assignment to the successful bidder. Access to the proprietary models of the insolvent firm, even if they are considered suspect in light of the insolvency, is certain to assist the process of valuation by potential acquirers. This will all happen much more smoothly if guidance on the use of those models has been worked out in advance.

Similarly, assignment of a portfolio of OTC derivatives will raise complex financial, technical and legal issues. The process will proceed much more expeditiously if those issues have been thought out in advance, and rules and procedures agreed among supervisors and the industry. These matters, as well as the development of protocols for assistance to foreign supervisors and administrators discussed above, are sufficiently complicated matters that it would make sense to address them in a working group or groups. This might be pursued through the INSOL Regulators Group, or a working party formed by supervisors specifically for this purpose.

In the course of normal **licensing approvals and supervisory review***:*

- **Just as they evaluate the adequacy of home-country financial supervision, supervisors should consider the adequacy of the insolvency regime and legal basis for netting in the home country of a firm seeking entry or expansion into their markets, and establish appropriate conditions or limitations before licensing its operations.**

- **To promote the widest adoption of this approach and to maximize its effectiveness, this agreement should be reached on common minimum standards for national insolvency regimes.**

- **Supervisors should ensure that supervised firms appropriately weigh the enforceability of netting and collateral and effectiveness of insolvency procedures in the country where transactions are undertaken in their risk management procedures.**

As previously discussed, critical to reducing risk in the cross-border insolvency of a financial institution is improving the legal framework in the countries where that firm is active. If the country has an effective supervisory regime, netting is enforceable, collateral is deliverable and the insolvency regime is both sound and offers workable methods of restructuring, the chances of financial failure will be less, the parameters of any financial loss can be determined, and the course of a resolution reasonably predicted. If these conditions are not present in a financial failure, both the obligations of a failed institution in that jurisdiction, the way forward in bringing the institution's affairs to a conclusion, and the exposure of other firms may be indeterminate and open-ended.

These recommendations are intended to provide incentives for improvement of national netting, contract enforceability and insolvency regimes. If financial institutions from countries with weak regimes face barriers to entry in other markets, they will become agents for change at home. Even more important, if global institutions who are lenders and investors in countries with weak regimes give a higher risk-weighting to transactions in those countries, that will reduce the attractiveness of those markets, produce further impetus for change and lower market exposure to situations likely to trigger systemic disruption. These incentives are unlikely to be determinative, but should be part of a comprehensive effort to heighten attention to the importance of strong financial laws.

Of course, implementing these proposals requires at least some measure of agreement on what constitutes a sound insolvency regime and whether netting and contracts are enforceable. Enforceability of netting is a clearly understood concept, even if legal opinions can differ on its effectiveness in various countries. By contrast, there are no agreed standards for insolvency laws applicable to financial institutions. At a minimum, there should be clear and enforceable authority for appropriate official entities to intervene in the affairs of a financial institution in danger of, and certainly in, default. There should be clear supervisory and legal procedures for resolving claims in insolvency, with provision for judicial cooperation and recognition and access for foreign administrators in case of cross-border insolvency.

Minimum, common, agreed standards should be enunciated as part of the "preparedness" agenda discussed above. They are important not only to encourage adoption of sound insolvency laws but also to avoid unfair and discriminatory treatment of financial institutions from countries that have different, but not necessarily deficient, insolvency regimes. Transparent guidelines should make it more difficult for the home-country insolvency regime to be used as an excuse for protectionism.

In the **event of insolvency***:*

- **Supervisors, central bankers and deposit insurance agencies should make full use of available domestic resolution procedures, and do so in close cooperation with counterpart agencies in other affected countries.**
- **Supervisors should actively support access and recognition in local courts for foreign administrators, assist local administrators in their contacts with foreign supervisors and courts, and suggest to local courts the appropriate jurisdiction for main action in insolvency.**

Experience with financial insolvencies in a variety of countries has demonstrated that the surest way to minimize losses both within the firm and to the system as a whole is to take prompt and decisive action to end the insolvency, whether by closing the firm or transferring ownership of an entire firm or its assets. Thus, financial supervisors and central bankers should, first of all, be provided a mandate to take prompt action in an insolvency and they should use it. Likewise, they should act in as coordinated a fashion as possible with other national authorities.

Once the courts become involved in an insolvency, part of facilitating cross-border settlement of claims will involve access and recognition in local courts for foreign insolvency practitioners. Even where access and recognition is permitted by law, such recognition will be most effective where it enjoys the support of home country authorities. The draft report suggested a variety of ways in which supervisors could lend their support (e.g., through a “friend of the court” brief), some of which may be available in one country but not another. The point is simply that supervisors should provide their full support to efforts by receivers, liquidators and supervisors in other countries to obtain access and recognition in local courts and to adoption of laws permitting this. Of course, in countries that place a legal “ring fence” around financial institution assets, there will be distinct limits to what the home liquidator can accomplish by gaining access and recognition.

Supervisors can assist their own liquidators and receivers in their contacts with foreign supervisors, since they “speak the same language” and can vouch for their nationals. It is also clear that there will be times when multiple proceedings are being pursued and supervisors’ views on the appropriate locus of the main proceeding would be helpful. Again, not every supervisor will be authorized to offer, nor every court able to accept, such advice; but supervisors should help to sort out these matters wherever possible.

Legislatures

Even among the G-10 countries, with their long legal traditions and well developed financial systems, there are a variety of weaknesses in the legal framework for insolvency with important implications for the resolution of cross-border financial claims. Insolvency laws themselves, especially as they apply to cross-border access and recognition, need strengthening. Netting is not available in all countries in all circumstances. House and client funds are not always legally distinguished. As one moves outside the G-10 countries, the legal framework for financial transactions in general and for insolvency in particular, rather than occasionally deficient, may be wholly so.

As a starting point, it is important for a country to assign clear and independent authority for supervision to a financial supervisor, including legal authority to intervene in the affairs of financially weak institutions. The legal framework may also include safety nets such as deposit insurance schemes and a lender-of-last-resort function. National law must also provide a reliable legal basis for sorting out and settling claims in the event that an insolvency should occur.

- **National legislatures should provide a reliable legal basis for legal enforceability of financial contracts generally, for close-out netting and for clear distinction between house and client funds in trading activities.**

These issues can only be addressed effectively through legislation. Without a strong legal framework, it will be extremely difficult to sort out financial claims in insolvency or even to take authoritative action to bring an insolvency to a conclusion. The importance of netting has long been recognized yet its availability is far from assured, especially in emerging markets. Without it, settlement of small net positions in an insolvent firm could instead require sorting out large portfolios of claims on a gross basis. In the same vein, if house and client funds are not segregated in trading operations, the claims of parties for whom the insolvent was acting only as agent could become entangled in the insolvency, placing the rights of many more creditors at risk.

- **National legislatures should ensure that the national insolvency law provides authority to supervisors, the central bank or other appropriate agency to close promptly financial institutions that become insolvent; permits continued trading in insolvent firms to preserve asset value; and provides for access and recognition for foreign insolvency proceedings in the interest of effective cross-border cooperation and possible reorganization of the firm.**
- **Legislatures should ensure that necessary sharing of information among supervisors and with insolvency practitioners is permitted, including by amendment of blocking and secrecy statutes as necessary.**
- **To promote speedy access and recognition in national courts, a single port of call or lead insolvency court or judicial authority, should be designated where such designation is possible.**

As discussed above, a national insolvency law should provide clear authority to wrap up the affairs of a failed institution. For the reasons discussed previously, the particular issues that arise in cross-border insolvency require that national laws also provide a basis for access to, and recognition of, foreign administrators in local courts.

Among the powers provided in an insolvency statute should be the possibility of continued trading in the interest of preserving asset value and controlling the overall impact of an insolvency. Some commentators objected to continued trading out of concern that pre-insolvency creditors would be disadvantaged by continued trading. However, the value of a portfolio of derivatives may decline precipitously without careful management, rehedging, etc. and, in that case, the position of the pre-insolvency creditor could spiral out of control, leaving them with much less than would otherwise be available. It is this sort of activity that should be allowed, not new position taking or trading in the normal sense, in order to contain losses and permit creditors to mitigate their claims.

Some countries have secrecy laws and blocking statutes that make sharing of information, even with supervisors, difficult or illegal. More often, there are limits on the sharing of supervisory or proprietary information with private parties, including insolvency practitioners. It is important that information can be shared in a timely fashion with all parties involved in a workout. If this is made difficult or impossible by national law, the law should be changed.

There was considerable support for designation of a single port of call or lead insolvency court in each country in order to speed access and recognition in the courts. Such an approach is not possible in every country at present. To the extent that this approach makes sense, it should be pursued through administrative action or change in law.

Seeking detailed information in readily available form presents something of a dilemma. A recommendation to enact new laws related to insolvency, in and of itself, is unlikely to have much impact. Countries like the United States may well argue that they have all the legal authority they need and that matters are well in hand. Many emerging markets may not have a firm grasp of what steps they should take. And insolvency laws have never enjoyed the highest priority among the many policy issues facing the international financial system. What is required is to focus attention on these issues and problems and to demonstrate what can and should be done to improve the situation. The continuing work of the Group of Thirty, INSOL International, UNCITRAL and others should be directed toward that objective.

Financial Institutions

The primary prudential responsibility of the board of directors and management of a financial institution is to maintain the financial health of their own firm. Beyond preventing their own insolvency, they bear no broader systemic responsibility for preventing the insolvency of others. However, part of protecting their own financial position is ensuring that they can deal effectively with the insolvency of a counterparty firm, in particular by controlling their exposures to individual firms or financial groups and by being in a position quickly to assess their exposure to a firm that becomes insolvent.

- **Associations that develop master agreements should pursue reliable means for netting claims across instrument type, including creation of a single master agreement.**
- **Financial institutions should take legal enforceability of financial contracts and close-out netting and effectiveness of both the local and, if appropriate, "home jurisdiction"**

insolvency regimes into account in risk management within the firm.

In cross-border financial transactions, more netting is better than less. The more transactions that can be pulled under a single agreement and reduced to net terms, the less will be at stake financially and the fewer problems there are likely to be in an insolvency. Of course, there are limits to what can be done through netting owing to the complexity of firms and their portfolios, especially the number of separate legal entities. Some commentators have also expressed concern about putting too many eggs in one basket, relying too heavily on a single netting agreement. This argues for careful attention to perfecting and testing the validity of agreements, but is not an argument against netting wherever possible.

At the same time that the opportunity for netting is being maximized, global banks and investors should pay close attention to its actual availability. Even more important than supervisory attention to these issues, bankers and investors should assign a higher risk weighting to transactions in countries that do not: provide appropriate legal safeguards for financial contracts; ensure the availability of netting; or provide clear authority for resolution of insolvencies. If these factors become part of the industry's calculation of credit quality, individual firms will be safer and there will be a clear incentive for countries to strengthen their laws.

- **The financial services industry should develop information standards for recording transactions by legal entity of counterparty, form of documentation and law of jurisdiction, and for maintaining and storing that information in a central location in readily available, mutually intelligible and standard form.**
- **Industry should work with supervisors in developing rules for handover of propriety models and assignment of OTC derivatives.**

An important part of being prepared for the worst is having good information readily available within each firm, and rules in place for accessing information about the portfolio of any counterparty firm that becomes insolvent. This will work best if the information is available in sufficient detail, in standard form and in a common language, which in international finance normally translates to

English. While sound management of financial institutions requires consolidation of risks on a global basis, the situation is very different when a counterparty group gets into financial difficulty and begins to unravel into its component parts. At that point, the detail may be more important than the big picture.

Seeking detailed information in readily available form presents something of a dilemma. A well run firm may see the need to know its own exposures at the level of the individual counterparty, form of documentation and law of jurisdiction in order to evaluate its position in event of a counterparty insolvency. However, no single firm is going to devise a plan for advising others of the location and format of that information or how to access its models because that information will only have value to others in the event of its own insolvency. Nonetheless, the efficiency and safety of the financial system as a whole would be increased if everyone agreed on rules in these areas.

The need for rules, and the content and detail of the information needed, can only be decided by industry. Industry information standards should be formulated in this area. For example, they could be part of the broader industry framework for risk management proposed in the Group of Thirty report "Global Institutions, National Supervision and Systemic Risk."

Action by insolvency professionals and associations

While a heavy burden of responsibility for anticipating and dealing with insolvency falls upon the supervisors, it is incumbent upon the accountants, lawyers and other professionals who advise financial institutions, and are appointed to handle insolvencies, to bring their knowledge and expertise to bear on the problem as well. This will not only make their own work easier and more effective, but it will provide an important public service.

- **Insolvency professionals should cooperate with supervisors in their efforts to develop measures to improve cooperation, recognition and access to insolvency proceedings.**
- **Insolvency practitioners should advise governments on drafting and strengthening national laws on netting and insolvency and assist supervisors in rating insolvency regimes.**

Although a comprehensive effort to develop cooperative arrangements with supervisors and improve national laws would consume a great deal of time and resources, it would make the work of insolvency professionals much easier in the long run. And although it could be thought of as an effort to put themselves out of business, there are few cases where new and better laws did not beget more legal work rather than less.

The type of advice and assistance proposed here could be offered either on a global basis by some type of international advisory commission that would respond to government requests for advice, or on a national basis through a mechanism akin to the Financial Law Panel[1] in the United Kingdom. This is the sort of activity that could usefully be pursued under the aegis of organizations such as INSOL and UNCITRAL.

Conclusion

This list of recommendations is long and ambitious. It is also quite diffuse and requires cooperation among many actors. Even with the best of intentions, the changes in national laws, supervisory procedures and business practices necessary significantly to improve this state of affairs constitute a long-term project. And it is not as if the parties charged with their implementation do not have many other important issues on their agendas.

However, these issues are important, progress is certainly possible, and the level of attention to insolvency matters has never been higher. The Asian crisis offers an opportunity to direct the sort of attention to cross-border insolvency that has lately been devoted to standards of financial supervision. Even if progress can only be made piecemeal, that opportunity should not be missed.

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1 The Financial Law Panel is sponsored jointly by the Corporation of London and the Bank of England, and aims to identify and resolve areas of legal uncertainty affecting the wholesale financial markets.

Appendix I: Working Papers

Discussion Draft

Financial Sector Insolvency Study Group

List of Participants

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Official Observers

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Chairman‘s Foreword

In the wake of the Barings collapse in February 1995, the Group of Thirty, in cooperation with the International Insolvency Practitioners Association (INSOL International), convened a small group of experts to examine the issues raised by that episode. The potential for systemic risk in the failure of a global financial institution has long been recognized by supervisors, but the Barings case made manifest the complexity of sorting out claims in a globally active financial institution.

Rather than reviewing the Barings case itself, which had already been thoroughly analyzed elsewhere, the group looked more broadly at the issues surrounding the insolvency of a global financial institution. Given the complexity of the issues and substantial variations in insolvency law and practice, the group's report and recommendations are presented in draft form, providing a basis for discussion of the impediments to expeditious settlement of international financial insolvencies.

It is our intention to seek the views and comments of experts from a range of countries and disciplines on the draft recommendations. Through this process, we hope to refine the proposals to ensure their broad applicability and utility for major financial institutions, regulators, courts and legislatures. We look forward to the continuing dialog that will be required in order to ensure that, if a global financial institution gets into serious difficulty, its insolvency can be handled with speed and certainty.

PAUL VOLCKER

Summary of Recommendations

Through existing international regulatory forums, national regulators should:

- encourage co-operation among regulators of different types and between regulators and insolvency practitioners.
- develop a protocol on the organization, timing and type of assistance they should extend to foreign administrators.
- take steps to reduce risks in clearance and settlement.
- help establish standards on the hand-over of proprietary models by insolvent firms to potential purchasers.
- sponsor a forum to explore ways to speed up the process of assigning a portfolio of over- the-counter derivatives.

Regulators should:

- take the insolvency regime in the home country into account when licensing the operations of foreign financial firms.

Administrators should:

- endeavor to provide speed and certainty in the handling of international financial insolvencies as they develop broader measures to improve cooperation, recognition and access to insolvency proceedings.

Legislators should:

- enact laws to ensure judicial cooperation, access and recognition in international financial insolvencies, preferably supporting the norms of universality.

  — as soon as possible, eliminate any doubts about close-out netting.

  — in countries where no clear distinction is drawn between house and client assets, amend the law to clarify the position.

  — legislate to make it possible for administrators of financial firms to continue trading, in the interests of managing market risk.

Internationally active financial firms should:

- develop industry standards for monitoring, measurement and management of all sizable exposures by legal entity of counterparty, form of documentation and law of jurisdiction.
- develop industry standard for keeping up-to-date information on all significant exposures in a central location and in a readily available, standard form.

Associations whose master agreements are in wide use for various over-the-counter transactions should:

- pursue reliable means for settling claims across instrument type, including through development or endorsement of a single master agreement.

Discussion

Introduction

When any large financial firm becomes insolvent, it can cause widespread disruption in the financial system. This has always been a potential risk at the national level. It is becoming increasingly serious at the international level too, as links between financial systems grow. Whether or not the danger of a major financial failure has risen in recent years, the difficulties it would create have definitely multiplied. When Barings failed in February 1995, several problems arose during the week of the insolvency. If it had been a larger, more complex firm, if those involved had been less adroit, or if the insolvency had been more protracted, the danger could have become grave.

How international financial insolvencies should be managed is an important subject. It obviously matters to insolvency practitioners – the judges who oversee these cases and the lawyers and accountants they appoint to manage them. But the risk to the system makes it a central concern for financial policymakers, central bankers and regulators too. Many central banks have broad discretion to provide financial assistance to systemically significant commercial banks threatened by failure, but they face new challenges as non-bank institutions assume a bigger role. Furthermore, the potential for loss and the need for preventive measures in individual firms are reasons why senior management at every internationally active financial firm should consider this subject as well.

This report contains recommendations for all those groups. It has been prepared by a small study group set up jointly by the Group of Thirty and the International Insolvency Practitioners Association (INSOL International). The group's terms of reference were to examine the issues surrounding the Barings failure and to make recommendations for reducing the systemic risks associated with the insolvencies of internationally active financial firms.[1]

The scope of this report is limited in several respects.

- Its recommendations are aimed at internationally active firms whose failure could threaten the global financial system.
- It focuses on measures intended to limit disruption after an insolvency begins rather than on what might reduce the chances of an insolvency in the first place. It complements other recent studies and initiatives aimed at improving risk management generally (Other studies undertaken since Barings' failure appear on pages 52 and 53);
- It concentrates on the direct effect of a financial insolvency on other financial firms. The losses caused by the exposures of creditors and counterparties are an obvious mechanismthrough which systemic risks can develop. The recommendations made here may also reduce the chance of systemic risk arising through other channels, such as a loss of confidence in firms similar to the one that failed, but that is not their primary aim in the context of this report;
- It does not deal with sovereign default. Although this is also of interest to the Group of Thirty, it raises different issues and calls for a different approach.

However, this report is not limited to commercial banks. It deals with insolvencies of financial conglomerates, investment banks and insurance companies as well, whenever failure might pose a systemic threat. It is intended to be relevant to both developed and emerging economies.

The recommendations in this report are meant to be practical. So, for example, there is no recommendation for the international harmonization of insolvency law. That would indeed reduce systemic risks, but it is unlikely to happen in the foreseeable future.[2]

Finance and Regulation

The international financial system is changing rapidly. The changes have been driven by deregulation; by improvements in communications and technology that have increased the speed and volume of transactions enormously; and by widespread innovation in markets, organization structure, services and instruments. As a result, many financial institutions and activities that once were local are now international. Regulatory systems and insolvency law are not. Both regulation and law are diverse and inconsistent across countries. In some cases, neither regime is up to the task of coping with a major financial failure. Given these uncertainties, there is substantial risk that the insolvency of a major financial institution could cause significant difficulties to the world's financial system.

Similarly, the lender-of-last-resort role, intended to prevent damage to the banking system in the event of serious financial disruption, is limited by function and geography. The discretion conferred on many central banks to provide liquidity and capital to systemically significant banks generally does not extend to non-banking institutions of similar size. Nor is there a mechanism for coordinated assistance of this kind for a global institution with sizeable operations in a number of jurisdictions.

Nonetheless, progress has been made in recent years. There have been national and international efforts to strengthen financial risk management at the level of the individual firm. Initiatives are underway to strengthen market mechanisms, the payments system and the regulation of financial firms in several countries. Cooperation and coordination efforts by regulators have intensified, both across sectors and across national boundaries. These efforts were given added impetus last year by the call in the communiqué following the Halifax Summit for the G-7 finance ministers to review current arrangements and assess their adequacy.[3]

Insolvency

In most countries, a fiduciary (or trustee, or administrator) is appointed to manage an insolvency.[4] The appointee is often a lawyer or an accountant; sometimes a businessman, an authorized trust company or a government official. The fiduciary must complete three tasks: first, gain control of the firm and its assets and, if it is still a going concern, stabilize its management structure and operations; second, sift through creditor claims, and value and prioritize them; and third, reorganize or liquidate the firm and ensure that the claims of the creditors are met in accordance with law. This third task may also involve valuation, if the firm is to be sold, in whole or in part.

Some regimes stress settling claims. Others put weight on preserving economic value and employment. In most jurisdictions the administrator has considerable powers, but often needs a court review before making certain major decisions, and particularly before the final resolution of an insolvency.

Many jurisdictions have special insolvency procedures for dealing with financial institutions, especially banks, stockbrokers and insurance companies. They are sometimes similar to non-financial insolvency procedures, but financial regulators often get deeply involved as the administrator or as “a friend of the court” and there are often special provisions for dealing with the claims of depositors.

There have been two recent initiatives to improve the international insolvency process:

- Insolvency practitioners have been developing measures short of full-blown harmonization. This effort encourages informal cooperation among judges, fosters the recognition of foreign insolvency proceedings and promotes access of foreign practitioners to the courts. INSOL International and Committee J of the International Bar Association have been actively involved. So too has the United Nations Commission on International Trade Law (UNCITRAL) which, in conjunction with INSOL International, has organized a series of papers and international meetings. In addition, UNCITRAL has established a working group to study cross-border insolvency issues with the objective of proposing model legislation on cooperation, recognition and access.
- Financial firms and their lawyers have developed master agreements under which individual transactions can be regulated by identical contract terms. They have encouraged their use

and sought to establish that their insolvency provisions are widely enforceable. These agreements now exist for several types of transactions. Two important examples are the International Foreign Exchange Master Agreement (IFEMA) and the International Swaps and Derivatives Association Master Agreement (the ISDA Agreement).[5]

Five Principles

With this as background, the study group concluded that, to reduce the systemic risks of an international financial insolvency, five basic principles would have to be observed:

- **Speed**. *International financial insolvencies must be dealt with as quickly as possible.* Some financial assets, like options positions, waste rapidly; people, whose skills are a large part of the value of a financial firm, may leave; and protracted uncertainty about recoveries on creditor claims creates doubts about other financial firms and increases the risk of a contagious loss of confidence. Global markets now operate twenty-four hours a day, so that market reactions to a financial failure, whether it is rumored or real, unfold rapidly and continuously. Efforts to control the effects of financial insolvency must begin immediately, with regulators in a position to react around the clock and courts able to turn quickly to the legal issues involved.
- **Cooperation**. *More must be done to ensure cooperation.* Although cooperation among regulators and insolvency practitioners has improved in recent years, it cannot be taken for granted. This cooperation is sometimes facilitated by establishing contacts and agreeing procedures beforehand. Formal arrangements, such as bilateral or multilateral treaties and conventions, can play a useful part. But they are not the only route to cooperation and, in practice, they can be difficult to arrange. Furthermore, much can be done informally. The key is to create an environment in which common objectives can be agreed and cooperation can begin.
- **Information**. *Critical information must be available to regulators, courts, insolvency practitioners, markets and other financial firms.* As in any crisis, decisions will inevitably be taken without all

the facts, but the lacuna should be as small as possible. Disseminating information effectively depends partly on understandings and agreements already being put in place on how to share whatever is available. In addition, key information must exist in the first place and be easily accessible. This is especially true at the beginning of an international financial insolvency as regulators work out the extent of the crisis and insolvency practitioners seek to get control of the insolvent firm. Dissemination of information to the market at large, as soon as it is available, then becomes an essential ingredient in stabilizing the situation. It can also be important later on, when (for example) a firm or its assets are valued for sale.

- **Size of Potential Losses**. *Every effort must be made to ensure that losses at counterparty and creditor financial firms do not cause a wider crisis.* This depends mainly on the risk management practices in those firms. Once an insolvency has occurred, they are a major influence on whether its effects will spread. Regulators will need close contact with these firms, as well as the tools to offset the effect of excessive potential losses.

- **Standardization**. *Regulatory, insolvency and industry policy and practice should be standardized wherever possible.* Where policies and practices touch on the handling of an international insolvency, establishment of standards can be helpful. Generally, global uniformity of approaches is not a realistic goal. But there is scope for convergence in a number of areas and, in some, true standardization would be useful in a crisis. Cooperation would be easier if all parties involved in an insolvency took the same approach to the problem.

These principles underpin all the recommendations in this report. Securing them, and implementing the recommendations, will involve both private and public costs. Nevertheless, the study group believes that there is room to improve current public policy and private practice; that the stakes are high; and that the costs of implementation should be reasonable in comparison with the benefits.

Recommendations

Cooperation

Recommendation 1: *Insolvency practitioners and governments should ensure that measures taken to improve cooperation, recognition and access will also provide for speed and certainty in international financial insolvencies.*

The preliminary steps in an international insolvency procedure include winning recognition for the procedure in foreign jurisdictions where the firm was active, and access for the administrator to the foreign courts concerned. Direct cooperation between the different courts can help.

Insolvency practitioners are already at work developing methods to achieve greater cooperation and more assured recognition and access. Their efforts should take account of the special circumstances and features of international financial insolvencies. Among the measures that could encourage speed and certainty are the following:

- Local financial regulators helping to ensure that foreign insolvency practitioners are supported by a "friend of the court" brief, where possible and appropriate;
- Encouraging prompt action in the courts, appointing an administrator and initiating contact with courts in other jurisdictions;

- Seeking some standardization of the protocols governing the way in which courts and administrators cooperate, a device that is being used in a growing number of international insolvencies;[6]
- Assigning all international financial insolvencies to a single court, or in some other way establishing a recognized "port of call" and a pool of expertise in the court system; and
- Establishing authoritative legal opinion on what the effects of recognition are likely to be in particular countries for financial insolvencies, even where recognition is left to the discretion of the courts.

Perhaps, too, some understanding could be reached about local proceedings in international financial insolvencies. The primary proceeding is usually the one started in the main place of business of the insolvent firm. Thereafter, secondary local proceedings concerning the same assets or debts may be started at the instigation of creditors or other involved local parties. It would be particularly helpful if it became established practice for the administrators in the primary proceeding to obtain swift access and recognition on local actions. And, assuming there was enough cooperation among regulators internationally, it might also help if the courts would listen to local regulators about which jurisdiction should be the place of the primary proceeding.

There is one other issue that matters: the ring-fencing of assets—that is, keeping local assets available for settling local-creditor claims first. This principle is increasingly unsuited to modern conditions. As institutions move toward managing their risks on a global basis, it is likely that managing an insolvency on a global rather than a local basis will reduce the chances of a concentration of severe loss that could threaten other institutions by distributing the eventual losses widely. This is not to suggest, however, that local law on separate legal entities and legally enforceable relationships should be disregarded.

Ring-fencing is motivated by a concern that domestic interests will not be adequately protected if global firms are in trouble. Supporters fear a lack of effective supervision by foreign supervisors, and doubt that there will be an equitable settlement of claims in foreign insolvency proceedings. Eliminating ring-fencing will require national authorities to be more confident that the interests of their nationals will be adequately protected by official actions abroad.

Thus, a unified approach to international insolvency process may be possible only if it is combined with agreement on accepted standards of home-country consolidated supervision.

Recommendation 2: *Legislators should enact laws to provide for speed and certainty on the issues of judicial cooperation, access and recognition in international financial insolvencies, preferably supporting the norms of universality.*

One element of the work by INSOL and UNCITRAL explores the possibility of legislation to ensure judicial cooperation, access and recognition. Some countries already have such laws. Others are considering legislation, and more may do so in the future. The advantage of legislation is that it reduces uncertainty about the initial steps in an international insolvency. And it need not remove all national discretion on the conduct of an insolvency: generally speaking, legislation that provides for cooperation in cross-border insolvencies reserves the right to refuse recognition when that would conflict with legitimate public policy.

In the case of financial insolvencies, the first policy consideration should be systemic risk. This tends to strengthen the case in favor of international cooperation rather than against it. Laws that acknowledge this fact would be beneficial; and the norms of universality, which call for a global approach to insolvency, should wherever possible be incorporated into new law for financial insolvencies.

Otherwise, the issues for legislation are much the same as those for informal cooperation discussed under *Recommendation 1*. Even where the law does not produce certainty and speed for international commercial insolvencies in general, it should do so for financial insolvencies.

Recommendation 3: *Financial regulators should pursue international contact among regulators of different types and with insolvency practitioners.*

Regulators from different countries and sectors meet in several forums: the G-10 Central Bank Governors at the Bank for International Settlements (BIS); the Basle Committee of G-10 bank supervisors at the BIS; the International Organization of Securities Commissioners (IOSCO); and, newest among the groups, the International Association of Insurance Supervisors (IAIS). The Basle Committee and IOSCO have pursued joint discussions on a number of occasions, and the Basle Committee, IOSCO and IAIS have established the Joint Forum to pursue more effective supervision of international financial conglomerates. The various groups can exert considerable influence over national regulatory policy and international private practice, although they have no formal authority. (The counterpart European Union regulatory groups have a more direct role in shaping EU law.)

Regulators may know the leading insolvency practitioners in their own country today. Indeed national law sometimes stipulates that the administrators must be regulators themselves: in the United States, for example, federally insured banks are administered by the Federal Deposit Insurance Corporation when they fail, and stock brokerage firms by a trustee appointed by the Securities Investor Protection Corporation. Also, regulators are increasingly familiar with their direct counterparts in other countries, largely because of the work of the international financial regulatory groups. The fact that the Joint Forum was set up is testimony to the importance which regulators are beginning to attach to contacts across industry lines.

However, this falls far short of the international web of familiarity and trust that is needed. The Barings insolvency was marred by insufficient trust and cooperation among the various regulators and insolvency practitioners involved. Regulators from different industries too often have sharply different legal responsibilities and quite distinct ideas about systemic risk. Bridging these gaps will require more contact across borders and across sectors.

This recommendation reflects the experience of INSOL and UNCITRAL. Providing the opportunity for informal international contacts has been a highly valued achievement of their work to date. Until recently, many insolvency judges had little or no contact with their counterparts in other countries and little knowledge of insolvency practices abroad. The INSOL and UNCITRAL meetings and conferences have helped judges, as well as lawyers and accountants and other practitioners in different countries, to start tackling their common problems.

Recommendation 4: *National regulators should work through the international regulatory groups to develop a protocol on the organization, timing and type of assistance they should extend to foreign administrators.*

During an international financial insolvency, the regulators who have supervised the failed firm can provide vital help to the administrators concerned. A foreign administrator in a secondary proceeding may need basic information (which a national regulator should have) about the operations of the failed firm such as where its local establishments are, what its legal structure is, the extent of its operations, its governance arrangements, the applicable law and court and, perhaps, where qualified local counsel and other professionals might be found. In establishing their authority, the administrators might often be helped by the friendly intercession of local regulators with the local courts.

The best approach to providing this assistance will vary from country to country, but certain general principles should apply. For example, in the same way that this report calls upon countries to set up a "single port of call" in the legal system for international financial insolvencies, so it should be possible for regulatory agencies within a country to agree among themselves which of them should be the contact point for foreign administrators in the event of the insolvency of a financial institution. This facility must be operational twenty-four hours a day. Perhaps the desirable characteristics for information—scope, timing and conditionality—could be agreed. The nature of assistance for foreign administrators, not only with the courts but also on the practical problems of exercising local control, might be worked out. Since adoption of these principles across countries is desirable, the international financial regulatory groups could contribute greatly to their design.

Recommendation 5: *National regulators should take the insolvency regime in the home country into account when licensing the operations of foreign financial firms.*

Regulators have to consider many applications for licenses from foreign financial firms wanting to open a subsidiary or a branch in their countries. To suggest that they should take into account the insolvency regime in the home country may seem contentious. However, it has recently become common for regulators to consider the quality of home country regulation and to grant a license only when they are satisfied that it is adequate. Moreover, they can and do give consideration to other home country policy issues, such as the prevailing standards on accounting and disclosure.

This recommendation would extend that screening to include the home country insolvency regime as well. The factors that regulators might consider are, broadly speaking, the issues raised in this report, such as access to local courts and the ease of achieving recognition, and the rate of progress which is being made in addressing these issues.

Notwithstanding the importance of this issue, however, fair and adequate consideration of insolvency issues will take time: time for minimum standards to be developed and agreed, and for them to be reflected in national supervisory practice and adopted into national law. This recommendation does not provide a new pretext for excluding foreign competitors.

Information

Recommendation 6: *International financial firms should aim to have up-to-date information on all significant exposures by transaction, agreement, legal entity and jurisdiction, held centrally and in a readily available, standard form.*

When a financial firm becomes insolvent, its assets and liabilities have to be valued in order to establish the scale of competing claims. To do this, the administrator has to examine positions and exposures in some detail. Information may be scattered across different parts of the organization, documentation may vary (even for one type of transaction, even with a single counterparty), transactions records may not be easily related to legal records, and the records themselves may be out of date. The administrator must be prepared to examine the firm's position transaction by transaction—which can take a long time.

If a failed firm or its parts are to be put up for sale, portfolios have to be valued. This is relatively straightforward for instruments and contracts from a liquid market, such as exchange-traded instruments. But valuing over-the-counter portfolios is much harder because positions have to be run through the data management systems and models of other firms.

That was what happened when Drexel Burnham Lambert failed in 1990. Although its over-the-counter portfolio was uncomplicated by today's standards, it took a long time to assemble all the information, establish how it was organized and then run the tapes and produce a value in which an interested firm could place some trust. The process would be far more protracted and difficult today for any large internationally active financial firm.

Some over-the-counter transactions (such as long-dated interest-rate swaps) last a long time, and documentation practice may well change materially before they expire. Records must therefore distinguish between documentation of different vintages, whenever these differences have significant implications for value.

Ideally, an internationally active firm should keep exposure data centrally and in a standard up-to-date form. In the event of insolvency, this would help the administrator and other firms value its businesses quickly. Although it is not in the interest of any particular firm to do this itself, each would stand to benefit if all did it.

The goal of this recommendation is information standards for systemically significant financial institutions. Achieving this goal will require collective action by the firms to establish standards, after first studying the level and kind of exposures to be covered, the form and content of data collected, and the feasibility and cost of doing so. National regulators could encourage this process, and might ultimately play an active role in ensuring that the standards are properly applied.

Size of Potential Losses

Recommendation 7: *As part of sound credit-risk management, international financial firms should monitor, measure and manage all sizable exposures by legal entity, form of documentation and law of jurisdiction.*

Any internationally active firm is likely to be made up of several affiliated legal entities. When such a firm fails, the parent may or may not be insolvent and the insolvency may well affect only some of the subsidiaries. Then the potential loss of any counterparty depends not just on the size of its exposures, but also on the legal entities with which it has positions; the form and enforceability of the documentation underlying the exposure; the jurisdiction in which any disputes about losses have to be resolved; and the internal record-keeping to identify who the counterparties are.

Looking carefully at legal issues is, of course, only part of what is needed to prevent the spread of insolvency via counterparty exposures. For example, the accessibility and certainty of credit enhancements, such as collateral or guarantees, have to be understood and properly evaluated. Credit concentrations, not just to single firms or groups, but also to firms with a particular geographic, industry or business cycle exposure, have to be properly controlled. Sound credit risk management is the first defense against the spread of trouble. For internationally active firms, this requires systems and controls that monitor credit exposure in sufficient detail. As in the previous recommendation, this one seeks the establishment of new industry standards, developed by systemically significant firms and encouraged by regulators.

Recommendation 8: *National regulators, sometimes working through international regulatory groups, should encourage the speedy adoption of measures to reduce the risks in clearance and settlement.*

When a big firm fails, it is almost certain to leave many transactions still in train with other financial institutions. Depending on how the clearance and settlement process works and the nature of the transactions, counterparties can suffer significant losses. For example, in many stock markets, there is still a delay between delivery of a stock in one direction and payment for it in the other. Delay is also common in foreign exchange markets, and the amounts involved are much larger, so the solvency of the counterparties of an insolvent firm might become an issue. The responsibility to contain this risk is divided between the firms themselves (for whom it is a type of credit risk) and those who manage the clearance, settlement and payment systems.

For at least two decades, regulators, markets and several private sector groups have worked together to strengthen these systems. Despite their achievements, it is hard to be sure that the chances of a systemically significant disruption have fallen. For, as the volume of transactions grows and the financial system becomes more international, the importance of quick and reliable systems for settlement and payment increases.

One recent initiative comes from the G10 Governors Committee on Payments. It has been developing recommendations for deepening and strengthening the international payments system, specifically to reduce the "Herstatt risk" of an incomplete transaction in the foreign exchange market. A group of private foreign-exchange-market participants, the G20, has been working in parallel to tackle this problem through the establishment of a new foreign-exchange clearing bank. Other recent work has covered clearance and settlement systems in securities and options markets, bilaterally and multilaterally. These initiatives have been useful. The recommended improvements should be implemented.

Recommendation 9*: In jurisdictions where there is still doubt about the enforceability of close- out netting, legislators should clarify the position as quickly as possible.*

In over-the-counter markets, it is good risk management practice for firms to group individual transactions between them within bilateral master agreements. Each master agreement is intended to be a legally enforceable agreement that requires payment of the net value of all included transactions in the event of an insolvency. The importance of these agreements in controlling the effects of an insolvency is that, while the gross amounts can be very large indeed, the net amounts may be quite small.

Unless enforceability is clear, there is a danger that an administrator will ignore the net position, preferring to treat an insolvent firm’s liabilities as common credits (where the proceeds of liquidation would be apportioned in due course) and its assets as credits on which the full amount should be paid. In that case, the solvent party can be made to pay up, even if the insolvent side does not.

Much work has been done by different industry associations to prevent this “cherry picking” and some jurisdictions now prohibit it by law. But in others, the enforceability of close-out netting agreements is supported only by legal opinion; and in a few places, there is no supporting opinion, precedent or law, so doubt about enforceability is all the greater.

A limitation on the extent of netting is that the separate capital of each legal entity within a large financial group will be subject only to the claims of those creditors with whom that entity has legally binding agreements, not to all creditors of its parent and affiliates. While broader netting might be helpful in reducing systemic risk, this recommendation is only intended to encourage netting between parties in legally binding relationships. It does not advocate disregarding the separate legal status of distinct entities and their assets.

Consistent with this legal framework, in countries where there is doubt about enforceability, legislators should change the law.

Recommendation 10: *In countries that draw no clear distinction between house and client assets, the law should be amended.*

Some jurisdictions have a statute (or a legal tradition) that recognizes the distinction between house and client assets inside a financial institution. Others do not. So, for example, a US brokerage might execute a transaction on behalf of a client through a subsidiary abroad. If that brokerage then failed, US bankruptcy courts, or the Securities Investor Protection Corporation as trustee, might consider client funds or securities to be exempt from creditor claims. But under foreign law, creditors of the foreign subsidiary might have a claim against those same assets.

As a result, in insolvency proceedings there can be uncertainty about the potential loss to some clients. It is often difficult enough for those in charge of an insolvency to distinguish between own funds, co-mingled funds and client funds. The difficulty is compounded if an insolvency involves a jurisdiction without a tradition of making any distinction.

This has usually been viewed as a consumer protection issue. For example, consumer concerns were the main motive behind a similar recommendation by the Futures Industry Association in 1995 (See appendix II). But the issue is broader and more complex than that. The client could be another financial firm and the amounts involved so large that the law's failure to discriminate between client and own funds could put the counterparty itself in danger.

Recommendation 11: *Laws are needed to make it possible for administrators of financial firms to continue operating in the interests of managing market risk.*

In a number of countries, the law does not grant an administrator much (if any) authority to continue trading the portfolio of an insolvent institution. The suspension of authority to operate may be particular to certain instruments, discretionary and temporary; or it may be inclusive, automatic and lasting throughout the insolvency; or some mixture of these constraints.

In the insolvency of an internationally active financial firm, the administrator often needs to continue trading. The value of the firm has to be hedged against changes in financial markets to avoid potentially large further losses. Typically, the market risks of its portfolios will be managed continuously before the insolvency occurs, and this process should not be interrupted.

Even if the law does permit trade to continue in principle, that may not ensure that it does so in practice. Potential counterparties will shun an insolvent firm unless they are confident that they will be paid in full in any new transaction. They need assurance that such transactions will take precedence ahead of previous creditors. Finally, there may even be a case for limiting the power of exchanges to stop an insolvent member from trading.

Recommendation 12: *Just as widespread use of master agreements for over-the-counter transactions has standardized contract terms and enforceability of netting, netting should be extended across agreements, ultimately through development of a single master agreement covering many different products.*

Use of standard documents does much to ensure the clear understanding of contractual obligations in insolvency. At the moment, there are different master agreements in use for different types of over-the-counter business. These have developed in line with each activity, typically to suit its particularities. Traders like this diversity, because it is convenient and familiar.

However, in an insolvency, diversity can exacerbate the losses of counterparties. To take an example, suppose that a counterparty is a net debtor to the insolvent firm under one agreement and a net creditor under a second agreement. That counterparty is liable for the full settlement of its position with the administrator under the first agreement but, at the same time, it should only expect some fraction of its claims to be made good under the second agreement. Just as it is desirable to minimize the potential exposure of counterparties through formal netting arrangements within over-the-counter transaction types, so there is a case for extending netting across them.

The same limitation on the extent of netting discussed in *Recommendation 9* applies in this case as well. While worldwide, cross-affiliate master agreements may be the ultimate objective, for the moment cross-agreement netting should be encouraged between parties in legally binding relationships, taking account of the separate legal status of distinct entities and their assets.

The most straightforward route to cross-netting would be through the adoption of a single multi-product master agreement. This would require the various associations either to collaborate in developing a new agreement or to endorse an existing instrument, such as ISDA's agreement which is already widely used.

Facilitating Sales

Recommendation 13: *The international regulatory groups should help establish standards on the hand-over of proprietary pricing models by insolvent firms.*

Any financial firm that is interested in buying the over-the-counter portfolios of an insolvent firm will almost certainly be unable to value every transaction and position. In many internationally active firms, parts of their over-the-counter portfolios are priced using unique proprietary models. Potential purchasers may have to depend on those models to establish a sensible value.

This is an area that offers more questions than answers. Could the proprietary value of models be protected if the authorities used them on behalf of bidders? What if a firm bought the portfolio, after relying on official assistance in valuation, and then concluded that it had paid too much? Alternatively, should these models be made available to bidders? If so, when and how? Should there be standards for documenting models so that bidders could quickly assess them?

Even if firm answers to these questions are impossible, guidelines would be useful.

Recommendation 14: *Regulators should consider sponsoring a forum to explore ways to speed up the process of assigning a portfolio of over-the-counter instruments in case of insolvency.*

When a firm has agreed to buy a portfolio of over-the-counter instruments from an administrator, assignment of each component contract has to be negotiated with the third party firm involved. The latter may be reluctant to have one of its contracts assigned if (for example) it was out-of-the-money and might be used to offset some other obligation to the insolvent firm under a netting agreement. Negotiating the assignment of a portfolio can therefore take a long time.

In the future it might be possible to couch the documentation of over-the-counter transactions so as to facilitate subsequent assignment. However, if assignment is made automatic, a third-party firm almost inevitably loses control over its credit risk—whether or not the instrument in question is in or out of the money at the time. So it is unlikely that all over-the-counter activities could take place on fully-assignable terms. On the other hand, it is difficult to imagine how a third-party firm could be given an effective assurance against loss of value or increase in credit risk. That might require some new institutional arrangement for compensation and risk adjustment, which in turn might need some form of official sponsorship. The range of theoretical alternatives is wide, and choosing between them will be difficult. A forum, bringing together regulators, practitioners and lawyers, would be a good way to start tackling the issues.

Notes to Discussion Draft

[1] This report often refers to a single insolvent firm. In principle, much of the analysis and many of the recommendations would also apply to a group of firms that became insolvent for some common reason such as severe macro-economic problems in a particular country or region.

[2] The European Community has made a serious effort over the past three decades to negotiate insolvency harmonization. Even there, where countries are neighbors and share economic and political objectives, the historic differences in insolvency law have made progress extremely difficult, with a treaty on insolvency harmonization having only recently been reached after decades of work.

[3] The Halifax Communiqué said:

"Closer international cooperation in the regulation and supervision of financial institutions and markets is essential to safeguard the financial system and prevent the erosion of prudential standards. We urge:

_ "a deepening of cooperation among regulators and supervisory agencies to ensure an effective integrated approach, on a global basis, to developing and enhancing the safeguards, standards, transparency and systems necessary to monitor and contain risks; ... and

_ "finance ministers to commission studies and analysis from the international organizations responsible for banking and securities regulations and to report on the adequacy of current arrangements, together with proposals for improvement where necessary, at the next Summit."

Para 21 of the Communiqué. (June 15-17, 1995)

[4] In the US, shareholder-appointed management stays in place (subject to extensive court supervision) to operate the failed concern as ‘debtor in possession’ in the case of industrial, commercial, retail and certain financial-services houses (e.g., bank holding companies and consumer small-loan companies). However, there is no debtor-in-possession for most banks or securities firms. When a federally-insured bank fails, federal law requires that the Federal Deposit Insurance Corporation be appointed as receiver and liquidator. This replaces management. When a securities broker-dealer licensed by the Securities and Exchange Commission fails, management is taken over by a trustee appointed by a court at the request of the Securities Investor Protection Corporation.

[5] The use of master agreements in over-the-counter derivatives was supported as good risk management practice in the Group of Thirty report *“Derivatives: Practices and Principals”* July 1993.

[6] In the non-financial sector, the International Bar Association has promulgated a useful “Cross-Border Insolvency Concordat” for just such a purpose

Other Insolvency Studies and Initiatives:

- *Case study of the insolvency liquidation of a multinational bank* (Report by the study group on the BCCI liquidation to the Basle Committee on Banking Sueprvision, 1992)

  This study examines the insolvency of BCCI, including an analysis of key legal concepts in insolvency, the implications for bank supervisors arising out of the bankruptcy of a multinational bank, and observations on netting and payments systems.

- *Joint Project of UNCITRAL and INSOL International on Cross-Border Insolvencies: Expert Committee Report on Cross-Border Insolvency Access and Recognition* (Draft 1, March, 1995)

  This study, and the efforts of which it is a part, aim to establish rules of recognition and access for international insolvency proceedings that are predictable, quick and efficient. Its recommendations are primarily addressed to legislators and judges. It covers all types of commercial insolvency, not only those in the financial sector.

- *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (July 18, 1995; Bank of England, London)

  In contrast with the study group, which focusses on events after the collapse of Barings, this study deals exhaustively with events leading up to it. Its recommendations do touch on the issues of insolvency to the extent that they call for improvements in the management of banks, or in their regulation by the Bank of England, that would affect the task of an administrator. For example, the Bank of England is encouraged to look into the force and extent of comfort letters and guarantees issued by banks to non-bank affiliates and to pursue uniform international harmonization of their supervisory treatment (para 14.58).

- *The Windsor Declaration* (May 17, 1995; CFTC and SIB, Windsor)

  This declaration of intent was made by the sixteen national regulators who oversee the largest futures and options markets in the world. It was aimed at "strengthening regulatory supervision, minimizing systemic risk and enhancing customer protection," and concentrated on cooperation between market authorities and their regulators, protection of customer positions and default procedures. They undertook, "cognizant of national insolvency regimes, [to] promote national provisions and market procedures that facilitate the prompt liquidation and / or transfer of positions, funds and assets, from failing members of futures exchanges." A progress report was made to the technical committee of IOSCO in June, 1996.

- *Financial Integrity Recommendations for Futures and Options Markets and Market Participants* (June 1995, Futures Industry Association, Washington DC)

  This task force produced sixty recommendations for improvements in disclosure, risk control and risk-management practices for exchanges and clearing houses, for brokers and intermediaries, and for customers. It paid special attention to ways in which exchanges and clearing houses could protect customer property in the event of a broker default. It made four recommendations about bankruptcy proceedings: prompt close-out or transfer of positions should be provided for, with an exemption from "automatic stays where necessary;" the rights of customers and brokers should be clear in the event of a default; margin and settlement payments should be protected from reversal; bankruptcy laws should be harmonized to ensure, among other things, that rights to netting and set-off in the event of a bankruptcy are protected.

Summary of Comments on Discussion Draft

Recommendation 1: This recommendation, which seeks improvements in cooperation, recognition and access, attracted general support. However, a few countries expressed some concerns or reservations with specific points in this recommendation.

(A) The idea of providing assistance to foreign administrators through a "**friend of the court**" brief seems to embrace a predominantly American concept. As Germany* points out, this concept, taken literally, is unavailable in German Courts. Similarly, Canada points out that such a concept may "overstep" the role of the regulator or may run contrary to established procedures. However, construed metaphorically, the concept simply asks for the written support from local regulators to foreign administrators seeking recognition and access to local court. Many times, local courts lack the expertise in one area that regulators or local practitioners may possess due to years of specialized experience. Therefore, guidance by regulators may not only be necessary but warranted. Australia discusses the role a "friend of the court" brief could play in facilitating the processing of letters of request by which a foreign administrator seeks to gain access to an Australian court. Insofar as the EC is concerned, its *Winding Up Directive* and *Settlement Directive* would require cooperation, access, recognition and swift judicial action

* Although comments were solicited and received from various institutions, agencies or individuals within each country, the comments as they appear herein are attributed to countries for ease of reference. Detailed comments may be obtained by contacting The Group of Thirty.

rendering a "friend of the court" brief unnecessary, but they would do so only in cases involving Member States. It is unclear how the EC handles an insolvency situation involving non-Member States.

(B) Encouraging **prompt action** in courts received overwhelming support as a general principle. Only Canada (while a supporter of this recommendation) warns against the potential for courts to act in haste. Certainly, identifiable procedures and guidelines should be promulgated and adhered to in order to ensure speed while protecting the institution and its creditors during insolvency proceedings. The Czech Republic suggested that the first step to achieving cooperation and prompt judicial action is to create specialized courts with specialized administrators and regulators. These specialized entities would be better able and more likely to cooperate internationally.

(C) **Standardizing protocols** regarding cooperation received general support. Australia required a foreign administrator to file a letter of request for recognition in its courts, but recognized that aside from those seven countries with which it has "reciprocal assistance" agreements, there are significant limitations and drawbacks to this procedure. The Czech Republic reiterated its suggestion that one means by which cooperation protocols can be standardized is through the establishment of specialized insolvency courts. The EC proposed standardized protocols through its *Winding Up Directive*. Italy recommended that a treaty or other form of multilateral agreement would be necessary if cooperation is to be achieved on an international level due to the differences in national laws, the established procedures set out in those laws, and structural considerations. The Netherlands Antilles pointed to its Central Bank, which acts as sole administrator in financial insolvencies, as evidence that achieving the general principle of international cooperation is possible. Finally, Singapore pointed out that judicial cooperation can be achieved not through legislation but through actions by the Courts themselves. [Singapore seemed to be very concerned about preserving judicial autonomy.]

(D) Establishing a **single "port of call"** and "pool of expertise" received general support with some reservation expressed by Germany and Mexico. The EC in its *Winding Up Directive* touches on this issue to the extent that it identifies which single country would be responsible for commencing insolvency proceedings (i.e., home or host Member States) but it would not require the establishment of a single entity to handle the proceedings, leaving the logistics up to the individual Member States. The Netherlands, a Member State itself, suggested that there should be one regulator (or regulatory entity) in each country in charge of handling all insolvencies and prepared to communicate and cooperate with foreign administrators. On the other hand, Germany, another Member State, found requiring legislative enactment of a "single port of call" unrealistic and unavailable in its legal system. Similarly, Mexico expressed skepticism about requiring developing countries, with little to no experience or legal precedent in international insolvency issues, to establish a single entity or specialized court system to dispose of these cases.

(E) Establishing **authoritative legal opinion** on the effects of recognition in particular countries received general support, with the exception of Germany. Germany found this recommendation untenable under the German legal system primarily due to the cost involved in creating institutions and a regulatory framework to foster these changes.

(F) Ensuring the ability of an administrator in a primary proceeding to gain **swift access and recognition** in local actions was generally supported. The EC has specific provisions in its *Winding Up Directive* that would provide for automatic recognition between Member States. [Again, no mention is made of the degree of recognition afforded non-Member States.] Italy relied on its suggestion above of promulgating a treaty or other multinational agreement to ensure access and recognition. Finally, Canada's *Bankruptcy and Insolvency Act*, which has not yet been "proclaimed," includes "limited jurisdiction" provisions that would permit recognition to a foreign administrator for purposes of the insolvency proceedings but not subject that representative to general jurisdiction of the Canadian Courts. It pointed out, however, that the current applicable statute, its *Winding Up and Restructuring Act*, contains no such provisions. [Canada's "limited jurisdiction" provision parallels Article 8 of UNCITRAL's *Model Provisions*, discussed separately below.]

(G) Local **regulators suggesting to courts** the appropriate jurisdiction was generally supported, with Singapore expressing disagreement. Singapore stated that the Monetary Authority of Singapore has no authority or *locus standi* (unless it is a party to the proceedings) to suggest to Courts which jurisdiction would be proper. It once again seemed to be wary about any acts which may compromise the autonomy or discretion of its courts. For the Netherlands and the EC, the suggestions by a regulator would be unnecessary if *a fortiori* there was one jurisdiction deemed to have exclusive responsibility over an institution's insolvency proceedings.

The Netherlands suggested that the principal place of business for the institution be pre-determined to have exclusive responsibility over all aspects of that institution's insolvency proceedings, except where forum or arbitration are agreed upon between the parties. In this sense, the suggestions by regulators would be unnecessary and unwarranted because the issue would be settled.

(H) **Ring-fencing** found support in Australia, Hong Kong, and Indonesia only. Australia's *Banking Act* provides for ring-fencing to protect local creditors. Similarly, Hong Kong's banking industry, its insolvency practitioners, and its financial regulators all supported the principle of ring-fencing in the interest of protecting local creditors. Ring-fencing, at least insofar as Hong Kong is concerned, will continue to be viable until authorities are made confident that actions by foreign regulators and liquidators will provide this level of protection to its creditors. Moreover, Indonesia recently enacted Government Regulation No. 68/1996 which formally adopted the principle of ring fencing in bank liquidation. Finally, while Germany does not support ring-fencing in the sense of granting local creditors preference over foreign creditors, it does support the use and acknowledgement of local insolvency regulations during liquidation.

Recommendation 2: This recommendation is essentially an extension of Recommendation 1, but is directed at legislators enacting legislation to achieve the goals of speed and certainty in cooperation, access and recognition. This recommendation, while laudable because it seeks concrete, enforceable documented statutes to serve as guidelines for courts and liquidators, presents some problems, out of which the responding countries provide potential solutions. Again, general support was voiced for the underlying precepts of cooperation, access, recognition, speed and certainty, all potentially brought about through a global approach. But, Australia emphasized some practical problems to consider when contemplating enacting legislation supporting the "norms of universality." Canada expressed skepticism about the effectiveness of such legislation in practice. And Singapore expressed concern over the propriety of legislation compelling courts to "cooperate."

On the other hand, the EC, Germany, Luxembourg, the Netherlands, and the Netherlands Antilles described legislation or proposed legislation that serves these exact purposes. Hong Kong, as a matter of legal practice, offers speedy and broad recognition to international insolvency proceedings. Italy proposed foregoing action on the national level and pressing these issues on the international level in an effort to ensure greater uniformity. Australia suggested using as a frame of reference Articles 11-17 of UNCITRAL's *Working Group Report*, discussed separately below.

Indonesia emphasized that, the universality norm notwithstanding, each country should maintain discretion to deny recognition or access if doing so would violate a legitimate public policy, that is, anything which is determined by the government as involving the public interest. Similarly, Mexico was concerned about preserving this discretion and in fact, Article 14 of its *Law of Bankruptcies and Suspension of Payment* provides for such discretion. However, the issue that may need to be addressed here is what constitutes "public policy" and of what nature and how serious does the conflict need to be in order to allow "public policy" to preempt granting access or recognition to a foreign administrator.

Recommendation 3: There was near universal support for this recommendation. However, Singapore questioned what was meant by "universal norms" regulators would seek to adopt through such international contact. Several countries have specific legislative provisions or formal agreements requiring coordination of actions between foreign and local regulators: Australia has Memoranda of Understanding negotiated between its regulators and foreign regulators; the EC *Winding Up Directive* would require coordination and cooperation between Member States; and Italy has enacted *Legislative Decree 415/1996* modeled after the EU Directives on investment services. Germany suggested working to establish institutionalized cooperation and, in the interim, creating a Crisis Management Group which would be responsible for handling post-insolvency measures expeditiously.

Recommendation 4: There was near universal support for this recommendation to establish a protocol for assistance and the exchange of information. Singapore expressed reservations concerning the feasibility of setting up a "single port of call" to be operational 24-hours a day. Mexico as well as Hong Kong expressed concern about preserving the confidentiality of sensitive information relating to local firm activities.

Recommendation 5: Taking the insolvency regime of an institution's home state into consideration when deciding whether to license their operation locally raised some concerns. Italy expressed concern about the potential discriminatory use of such a standard. Germany commented that it is probably not practicable for either the EU, with its "country of origin" principle, or Germany, fearing an "unlawful restraint of competition" challenge, to refuse a charter to branches of foreign firms on the basis of the home country's insolvency regime. Mexico contended that such a licensing scheme could abrogate its concessions under NAFTA. On the other hand, the Netherlands Antilles offered strong support for this recommendation and notes that it currently takes into account the home country regulations and insolvency regime when licensing branches of foreign firms. While Hong Kong supported taking an insolvency regime of the home country into account, it opposed using this consideration as the sole or dispositive factor.

The Discussion Draft suggests establishing minimum standards as fenceposts. However, Singapore and Indonesia raised concerns about whether this recommendation, in practice, would serve as a mechanism for pretextually excluding developing countries or countries with whose insolvency regime the host country does not agree, respectively.

Recommendation 6: Overall support for encouraging up-to-date information systems containing information on all significant exposures was expressed, with Italy and Japan raising concerns about feasibility and Singapore raising concerns about cost. Hong Kong primarily took issue with the recommendation that this information be "held centrally", particularly in light of disclosure limitations, difficulties in ascertaining what "central" is for purposes of a complex-structured institution, and cost. Indonesia and Canada seemed to suggest that developing a single, standard form in which information is held may be unrealistic due to many differences in operational activities. However, they agreed with the underlying principle and encourage development of forms which may be reasonably adapted to the many different schemes. Australia and Germany opined that this recommendation could, in fact, serve a greater proactive purpose—maintaining up-to-date, easily accessible information systems on sizable exposures could reduce the potential for insolvency in the first place.

Recommendation 7: Overall support was expressed for sound credit risk management through more thorough monitoring and measuring of potentially harmful exposures. Sound credit risk management is a principle with which no country disagreed, although one Australian respondent found that complexities may make literal application of this recommendation impractical. Hong Kong expressed some concern about likely expense involved. Germany, Indonesia, Italy and Singapore all mentioned regulations or legislation which have recently been promulgated in one form or another which achieve the goals set forth in this recommendation.

Recommendation 8: Overall support was expressed for encouraging measures aimed at reducing clearance and settlement risks. The EC *Settlement Directive* would support cross-border participation in payment systems. Also, the Directive proposes, as does the Luxembourg *Law of May 9, 1996*, to abolish the retroactivity of insolvency proceedings ("zero-hour rule") which significantly reduce systemic risk for payments and securities settlement systems. Moreover, Australia and Singapore are each currently working to implement a "Real-time gross settlement system." Germany suggested reaching a consensus on "harmonized minimum standards" to apply to clearing systems in order to prevent disparate settlement systems from competing against each other. The Netherlands suggested establishing a single, foreign-exchange clearing bank for the settlement of all claims and debts of an insolvent institution.

Hong Kong expressed general support for the underlying principle of reducing clearance and settlement risks, but had reservations with respect to how best to carry this recommendation out. The Hong Kong banking industry expressed concern about expense and the problems associated with speedy settlement arrangements for market participants with relatively unsophisticated settlement systems. Hong Kong insolvency practitioners expressed concern over the narrow, "systemic collapse" perspective of international insolvency taken in the Discussion Draft which only takes into account large internationally active firms. They suggested that, instead of modifying a country's entire insolvency regime, special rules or focused legislation are preferable to deal with the particular issues raised in the Draft. Finally, Hong Kong's financial regulators suggested introducing legislation that not only recognizes close-out netting processes of clearing houses, but which enables a prompt close-out to take precedence over insolvency laws.

Recommendation 9: Overall support was expressed for not only clarifying positions on netting but on enforcing close-out netting agreements. Indonesia disagreed with the fundamental principle of netting, expressing concern that it is unfair to some creditors. Hong Kong expressed some reservation about the fairness of netting in certain circumstances. However, Hong Kong as well as the EC, Canada, Germany, Italy, Luxembourg and Mexico each have legislation or proposed legislation of some sort affirming the enforceability of netting. Australian regulators and practitioners have published a report recommending legislation to this effect. The Netherlands Antilles, lacking legislation, referred to its significant case law on netting enforceability. Finally, Singapore found legislation unnecessary because the private sector and their lawyers address this issue adequately.

Recommendation 10: Universal support was expressed for having some mechanism ensuring the segregation of house and client assets for client protection. While Australian common law requires this, other countries such as Germany, Indonesia, Italy, Mexico and Singapore currently have legislation ensuring the segregation of assets.

Recommendation 11: Widespread support was expressed for allowing continued operation of insolvent institutions, particularly directed toward winding up the company and hedging losses. However, Mexico prohibited administrators from carrying out new operations. Hong Kong found that in practice, this recommendation is controversial, especially among pre-insolvency creditors. The EC, Germany, Italy, the Netherlands Antilles and Singapore each currently have legislation or proposed legislation allowing an administrator to continue operations after insolvency. The major concern of the recommendation was finding ways to breed confidence in potential counter parties, thereby inducing them to continue transacting business with an institution on the brink of insolvency. One suggestion was to provide them with priority over previous creditors. A fairness issue arises, however. Where netting is allowed, counterparties with whom the insolvent institution has a history of business in both directions may not suffer substantial, or any, losses. However, those pre-insolvency creditors in arrangements where netting is not an option face substantial risk of losses.

Recommendation 12: General support was expressed for the use of uniform master agreements allowing for cross-agreement netting. However, Australia, Canada, Hong Kong and Indonesia expressed reservations with this recommendation. Australia, Hong Kong and Indonesia commented on the difficulties associated with cross-border standardization of agreements and cross-affiliate netting. Canada and Indonesia (as with its reservations with Recommendation

9) expressed concern about the fairness and propriety of allowing netting across agreements.

Recommendation 13: General support was expressed for having international regulatory groups help establish standards for valuation and disposal of insolvent institutions, with Germany expressing disagreement. Germany suggested that the market is the best mechanism for valuation and assignment of a company's portfolio. On the other hand, even Germany agreed that promulgation of "assessment guidelines" for valuation can be useful. Australia recommended a close examination of the internal pricing models to highlight the differences that exist between them. Italy suggested valuation should be conducted not by regulatory groups (which should remain neutral) but by the parties to the liquidation or a panel of mutually agreed upon arbitrators. Mexico suggested forming study groups to reach common ground on valuation procedures amid different regulatory frameworks and to do so by establishing relevant disclosure requirements.

Recommendation 14: General support was expressed for this recommendation, with Australia and Germany expressing reservations. Australia supported communication and contact between regulators and practitioners but voiced concerns with what it saw as an inherent incompatibility between netting and assignment. In Australia, a pre-requisite for netting is restricting assignability, not greater allowance of it. Germany stated that forums such as those referred to in this recommendation may constitute inadmissible interference with third-party rights. Mexico, while supporting forums, favored smaller, more specialized working groups over large forums of regulators, lawyers and practitioners.

Respondents

Copies of the Discussion Draft *International Insolvencies in the Financial Sector* were submitted primarily to bank supervisors or monetary authorities in each of the following countries: Australia, Brazil, Canada, the Czech Republic, the European Union, France, Germany, Hong Kong, Indonesia, Italy, Japan, Luxembourg, Mexico, the Netherlands, the Netherlands Antilles, Singapore, Switzerland, and the United Arab Emirates.

Comments were received from the following individuals and institutions:

Australia: Mr. Les J. Phelps, Head of Bank Supervision, Reserve Bank of Australia coordinated comments from the following:

1. The Reserve Bank of Australia;
2. The Australian Securities Commission;
3. Mr. John Stumbles, Partner of Mallesons Stephen Jaques;
4. Mr. Greg Hall, Australian Director, Corporate Recovery, Price Waterhouse;
5. ANZ Bank
6. Commonwealth Bank of Australia; and
7. Westpac Banking Corporation.

Canada: Mr. Nicholas Le Pan, Deputy Superintendent for Policy and Mr. Brian Corbett, Senior Counsel, Legal Services, Office of the Superintendent of Financial Institutions Canada. Mr. Corbett in turn solicited comments to the recommendations from the following people:

1. Mr. Gordon Marantz of Osler Hoskin & Harcourt;
2. Ms. Gale Rubenstein of Goodman Phillips & Vineberg;
3. Mr. Brad Crawford of McCarthy Tetrault;
4. Mr. Justice Farley of the Ontario Court (General Division);

5. Mr. Jim Baillie of Tory Tory DesLauriers & Binnington;

6. Mr. Don Milner of Fasken Campbell Godfrey; and

7. Mr. Bob Sanderson of KPMG.

Czech Republic: Vlastimil Tesar, Executive Director, Bank Supervision Policy Department, The Czech National Bank who, in addition to summarizing the general comments received, included specific responses submitted by Ladislav Zelinka, Partner, HZ Praha spol. s r.o.

EC: Mr. John F. Mogg, Directorate General XV, EC International Market and Financial Services.

Germany: Dr. Joachim Bauer, Mr. Hans-Joachim Dohr, and Dr. Rainer Wigelmann of the Federal Banking Supervisory Office, Mr. Gerd Hausler of Dresdner Bank AG and Dr. Wilfried Guth of the Deutsche Bank.

Hong Kong: Raymond Li, Executive Director (Banking Policy), Banking Policy Department, Hong Kong Monetary Authority coordinated comments from the following organizations:

1. Hong Kong Monetary Authority

2. The Law Reform Commission of Hong Kong - Sub-Committee on Insolvency

3. Securities and Futures Commission

4. Office of the Commissioner of Insurance

5. Hong Kong Society of Accountants

6. Hong Kong Law Society

7. Hong Kong Association of Banks

8. Deposit-Taking Companies Association

9. Official Receiver’s Office

Indonesia: Bambang Setijoprodjo, Head of Legal and Secretariat Department, Bank Indonesia.

Italy: Tommaso Padoa-Schioppa, Vice Direttore Generale della Banca d'Italia who in turn coordinated comments from the following individuals:

1. Professor Leonardo Felli, London School of Economics;
2. Professor Francesca Cornelli, London Business School;
3. Giorgio Cherubini, experienced bankruptcy lawyer in Rome;
4. Roberto Pistorelli, experienced bankruptcy lawyer in Milan;
5. Enrico Galanti, Bank of Italy Legal Department;
6. Giuseppe Boccuzzi, Bank of Italy Division of Supervision Department; and
7. Vittorio Tusini Cottafavi, Bank of Italy Division of Supervision Department.

Japan: Tomoyoshi Uranishi, Director of Research International Finance Bureau, Ministry of Finance.

Luxembourg: Jean Guill, Directeur and Pierre Jaans, Directeur General, Institut Monetaire Luxembourgeois.

Mexico: Patricia Armendariz, Vice President of Supervision, Comision Nacional Bancaria y de Valores who in turn coordinated responses from the following financial and legal experts:

1. Guillermo Guemez, Vice-Governor, Banco de Mexico
2. Ricardo Guajardo Touche, CEO, Bancomer S.A. de C.V.
3. Javier Arrigunaga, Head of Legal Affairs, Banco de Mexico
4. Thomas Heather, Senior Partner, Rich, Heather & Mueller
5. Oscar Medina Mora, CEO, Valuacion y Venta de Activos
6. Jeffrey Wernick, Financial Advisor, Corporate Financial Services

Netherlands: Tom de Swaan and Alison Macro, De Nederlansche Bank who in turn solicited and received comments from Sijmon H. de Ranitz, J.C. van Apeldoorn and R.J. Schimmelpenninck of De Brau Blackstone Westbroek.

Netherlands Antilles: C.M.C. Monte, Executive Director, Financial Economic Affairs, Bank van de Nederlandse Antillen

Singapore: Koh Beng Seng, Deputy Managing Director, Banking & Financial Institutions Group, Monetary Authority of Singapore

Additional Comments and Observations from several of the aforementioned countries are included in this project as well. Comments were also solicited from selected organizations or agencies in the United Kingdom and the United States. Comments were received from the following:

US:

1. Carolyn J. Johnson, CLU, Senior Counsel and Model Laws Coordinator, National Association of Insurance Commissioners. Comments were not received by date of publication;
2. John M. Abbott, Deputy Comptroller for International Banking and Finance, Office of the Comptroller of the Currency; and
3. Jennifer Cooperman, Director of Policy, New York State Banking Department

Finally, comments on the Discussion Draft were solicited from UNCITRAL and the IMF. Jernej Sekolec, Senior Legal Officer, International Trade Law Branch, Office of Legal Affairs, UNCITRAL responded by sending UNCITRAL's *Report of the Working Group on Insolvency Law*, A/CN.9/433, from October, 1996 and UNCITRAL's *Model Legislative Provisions on Cross-Border Insolvency*, A/CN.9/WG.V/WP.48, from November, 1996. The applicable provisions of the *Working Group Report* and the *Model Provisions* are included in this report.

Appendix II: Conference Proceedings

International Insolvency in the Financial Sector

A Conference Sponsored by the Group of Thirty
in Cooperation with INSOL International
Grocer's Hall, Princes Street, London
May 13-14, 1997

Welcome and Overview: Rupert Pennant-Rea, Study Group Chairman

Let me begin by thanking you all for coming. Many have come a long way to be here and that in itself imposes a great obligation on all of us to use our time effectively. I would also like to thank INSOL International for collaborating with the Group of Thirty on this project and especially Richard Gitlin, who served as vice-chairman of our small study group and who has been an invaluable source of advice. I would also like to thank the many organizations who responded to the discussion paper that we sent out. And finally, I would like to thank the sponsors of this conference: Ernst & Young who gave us a splendid opening dinner last night; Morgan Stanley who are our hosts today; and the Bank of England for our concluding reception this evening.

I feel that the spirit of Voltaire hangs over us today. It was Voltaire who said: "If you see a banker jump out of a window, jump after him. There is bound to be a profit in it." I wonder whether he would feel we really ought to be meeting in the Undertaker's Hall, not the Grocer's, since there is something macabre about studying insolvency, particularly when many of the people here make their living from handling insolvencies in one way or another. Well, I suppose I could construct an elaborate metaphor about grocers and the food chain, the occasional interruption of supplies and the role of health and hygiene and inspectors, and how all of this has parallels in banking. But I will refrain. I will simply say that insolvencies do happen to financial institutions, and how they are handled matters a lot.

Within the living memories of all of us in this room, we can recall names like Franklin National, Continental Illinois, Drexel and BCCI, and most recently Barings. All were prominent insolvencies that caused difficulties in various parts of the financial system. All were handled without lasting impact on the financial system, and the handling matters enormously. The Group of Thirty study group was established in the aftermath of Barings to see if there was something coherent to say about international financial insolvencies. This was done in recognition of the fact that the financial world is a world of blurring borders: geographically, as more and more financial institutions cross national borders; and functionally, as the old rigid division between banks, securities houses and insurance companies continue to disappear. Those changes have been underway for fifteen to twenty years with the result that the financial conglomerate, the financial supermarket, is very familiar in many developed financial systems.

You have all seen the discussion draft which our study group produced along with a summary of the reactions we received from various countries. Rather than review that material, I would like to draw out just a few points to begin our discussions today.

The first, and obvious, point worth emphasizing is that our study began with a simple premise: assume an insolvency. We did not spend any time considering the many preventive and prophylactic measures that are constantly used by managers of firms and by supervisors to ensure the health of financial institutions. By excluding them, we did not mean in any sense to underplay their importance. But our mission was to start where those measures had failed, and an institution was in, or close to, a state of insolvency.

Our first conclusion, and a theme that runs through the whole report, is that there is no science to the insolvency business. Every insolvency that involves a financial institution is different: in scale, in circumstance, in its knock-on effects and in its potential to threaten the financial system as a whole. Given that fact, the next phase cannot be scripted—everybody learning their lines and all the props perfectly positioned on the stage. Insolvencies are anarchic and dealing with them requires a lot of improvisation, quick thinking, long hours and, like most things in life, a little luck.

In the same vein, the legal framework for insolvency, which can scarcely be dignified by such a formal name, has been drawn up on a national basis with little or no regard for the international dimension. Insolvency laws vary from country to country and often in fundamental ways. These laws may have been designed originally with the insolvency of a small building firm, or a factory, or a sweet shop in mind. They were very rarely designed to address the circumstances of a major financial institution operating across national borders.

That having been said, our study group hankered after tidiness which is what we were asked to produce. You will see that hankering just below the surface of many of our recommendations. Unfortunately, we did not manage to develop a set of prescriptions that will solve all problems the next time an insolvency occurs. But just because tidiness on that scale was not possible, it does not mean there is nothing to be done. In fact, we became increasingly convinced that a lot can be done to improve the handling of international insolvencies amongst financial institutions, but some of the most useful things that can be done are informal.

Perhaps the simplest way to improve matters is to ensure that individuals confronted with the sudden challenge of an insolvency know each other and share common goals. Such familiarity will allow them to come together quickly and act more effectively, even in the absence of a manual of emergency procedures. Such interaction should, at a minimum, prevent more damage than if the parties had never met and never considered collaborating across borders and disciplines. Equally, it is important that the concerned parties come to an insolvency already sharing a common view that working together for the greater good is likely to produce the least bad results for all concerned. While each party may have very clear and valid objectives, their single-minded pursuit without regard to the goals of others may yield a smaller pie with greater disruption than if everyone recognized the need for some compromise at the outset.

With that in mind, the simple fact that you are all here today is a step in the right direction: a step towards greater understanding of the complexities of international insolvency and the virtue of collaboration. I hope that our discussions today, and the continuing contacts that flow from them, will improve our handling of international insolvencies so that the next time "the balloon goes up," the losses can be kept to a minimum and the damage kept from spilling over into the wider financial system.

I. What is Different about a Financial Sector Insolvency?

Moderator: Rupert Pennant-Rea
Panelists: Jonathan Rushworth, Partner, Slaughter and May
Maggie Mills, Partner, Ernst & Young
Ernest Patrikis, First Vice President, Federal Reserve Bank of New York

Jonathan Rushworth:
Maggie Mills and I will together attempt to consider what is different about a financial sector insolvency, and particularly why speed is needed in handling such an insolvency. For any company in financial difficulties, the aim is to avoid formal insolvency proceedings if at all possible. Liquidity is generally the limiting factor in corporate insolvency, as opposed to deficiency of assets. The accountants like to say that only three things are needed to run a business successfully: cash, cash and cash. And liquidity is particularly important in a financial institution which relies on a substantial flow of funds to manage the volume of transactions taking place on a daily basis.

A large financial institution will probably trade in most markets globally, and therefore will require a legal presence in numerous countries. They will not only be subject to various local regulatory regimes but to judicial systems based on both common and civil law. Their business could be further complicated by their operating as branches of overseas companies in some cases and as locally incorporated subsidiaries of an oversees company in others. Mercifully in the Barings case, the language problems and translation issues that can often arise were avoided. The Financial Times recently reported a discussion on accounting standards in which translation from Polish into English was proceeding smoothly until "stock-take" was translated as "warehouse theft."

The Barings situation unfolded over the weekend from Friday to Sunday as efforts were made to assemble a "lifeboat" of banks and to structure a package of temporary financing. The financing package was intended to restore balance-sheet losses which resulted from writing off all intra-group debts linked to the Far Eastern operations that failed. One aspect of Barings that had to be evaluated very quickly was its structure of branches and separate companies in numerous countries. It was necessary to determine which companies would go into administration if the efforts at a bank rescue failed, and which could stand alone in financing terms and carry on in business, albeit in the immediate short term. This meant assessing whether regulatory guarantees or assurances with respect to the parent company would be deemed worthless if the parent itself became insolvent.

The refinancing exercise with the banks failed because of the extent of the losses in the Far East—their extent was simply not known. Nonetheless, we had to decide how much of the business could be protected and permitted to continue in operation with a view to achieving its sale. There were guarantees and letters of comfort from companies in the group which were themselves untainted by the Far Eastern losses. Things would fall apart quickly.

We had a global financial services business whose good people could simply leave or be poached by other companies. Clients of the business, particularly in the asset management part of the business, were likely to cancel their investment-management agreements, particularly if administrators were appointed. Barings was involved in trading around the clock and across the world, from New York to London to Hong Kong, Singapore and Japan. Multiple teams of administrators would be needed, particularly in London and the Far East, to control the ongoing business, to avoid taking on unnecessary new liabilities, to protect assets, and to deal with regulators.

Concern also arose with regard to deposits that had been placed with Barings Bank from various parts of the group. In particular, all cash from asset-management investments was deposited there and the group would have been jeopardized by an old fashioned run on the bank. However, the administration order had the effect of trapping all the cash in the bank, which stopped a run but starved the asset-management function of its cash and therefore placed its health in jeopardy anyway. In addition, the administrators had to protect the group's cash and securities deposited in numerous countries around the globe, and had to manage sophisticated derivatives contracts with a variety of termination clauses and settlement dates.

When it became clear that the bank rescue under the auspices of the Bank of England was not going to rescue Barings, on Sunday night administrators were appointed by court order in respect of nine companies. Two of these companies, we discovered rather at the last minute, were incorporated in the Cayman Islands. These were the subject of provisional liquidation proceedings there and the appointment of administrators for the branches of those companies in the UK was effected through the cross-border cooperation regime, under the Section 426 of our Insolvency Act. Without this procedure, we could not have appointed administrators in relation to those branches because it is generally thought overseas companies cannot have administrators appointed under English law.

Meanwhile, independent action was taken in Singapore by the appointment of judicial managers of the subsidiary which was outside our control, and equivalent action was taken in respect to the Japanese company. We also had to address the Dutch subsidiary, which was the issuer of two of the three series of bonds which funded the group. Initially that was not put into any protective regime, but subsequently a provisional liquidator was appointed.

As previously mentioned, there were substantial deposits of cash and assets in numerous countries. Procedures had to be put in place immediately to protect these, in case banks and other creditors tried to withdraw or seize them. For instance, arrangements were set up for an application to be made to the New York court under Section 304 of the US Bankruptcy Code to empower the administrators to take control of those assets situated in the United States. These assets were of great concern because we realized that if steps were taken too early to repatriate those assets, that might well encourage creditors to take legal action that would have precipitated the collapse of the whole business. Some creditors did succeed in attacking bank accounts, but fortunately the sale to ING was achieved before material damage was done.

It is worth noting that without the Section 304 procedures in the United States and the UK's cross-border cooperation regime under Section 426, which only operates with a limited number of countries, we would have had to rely on the goodwill of the courts in various countries to protect the assets. This would have been very unwieldy and potentially unworkable in addressing aspects of insolvency that are common features of a financial services business. The administration orders protected the assets from creditors, at least in this country, but this did not eliminate the urgency of the matter. As Maggie Mills will now explain, speed was also essential in dealing with the trading position of the group.

Maggie Mills

The aim of an administrator or a liquidator in any insolvency procedure is to maintain or maximize value and to minimize losses—or liabilities, for that matter. This generally requires making rapid decisions and acting on them quickly. To explain why speed is so essential to the financial services sector, there are four main considerations that must be examined.

Firstly, financial services is made up of a myriad of interconnected legal contracts which default on the insolvency of one of the parties. That default will cause losses and penalties to the defaulting party, and it is essential to react quickly to minimize losses or maintain value as best you can. It is quite right to argue that any business relies on business contracts but the difference is that not every type of business is based mainly upon those legal contracts; nor are they as plentiful in other businesses; nor are those contracts traded daily. A manufacturer may have a contract to supply the infamous "widget," but that contract changes on an infrequent basis. It is not altered and repriced on a daily basis. If you are going to reprice a contract and hedge to maintain its value, you have to be able to do so quickly. That is even more critical for a financial services business that is in insolvency, never mind daily operations.

The second consideration is confidence. Confidence is paramount in the financial services environment. If you cannot address clients' or counterparties' problems and resolve them in the short term, you will have no clients or counterparties; there will be no business; and value will just be destroyed. So quick action is needed to maintain confidence.

The third consideration, already touched upon, is that one of the main assets of a financial services business is the people who run it. Those assets have legs and can walk, taking the information and the skills unique to the firm with them. If the employees see business evaporating, and clients who they view very proprietarily going with it, they too will consider moving. And you can be sure that the competition will be only too willing to point out that those mobile assets are being lost—not only to the world at large, but to the troubled firm's clients in particular. This can become a self-perpetuating cycle: clients who do not move their business in the first wave, either through loyalty or indecisiveness, will move when they see their financial advisor is moving. The result is destruction of the business' value.

The fourth consideration, although perhaps more an extension of the first than a separate factor, is globalized, twenty-four-hour trading. Although clear enough in theory, I did not realize its impact in practice until we confronted it in the Barings debacle. Many financial services firms do very little trading within their own geographic borders, but are likely to be doing a lot of trading somewhere in the world through subsidiaries or branches on a twenty-four-hour basis. This precludes pause for thought in an emergency because you have continuous action and reaction going on. If you do not bed down one side of the simultaneous equation at a point in time and get stability, events will overtake you and you really will be unable to act. As an aside, I have always been impressed by the financial services businesses with which I have dealt, in that troubled firms have the habit of struggling on through the week until Friday evening. When the collapse comes on Friday evening, it can ruin your weekend. On the other hand, you do have two days to think before the markets begin asking you what are probably unanswerable questions.

All of that may seem a glimpse of the blindingly obvious, which it may well be since all of these factors appear in some fashion in all sectors of the economy. What is different about financial services is that you find these factors all in the same place, at the same time, adding urgency to the problem and reinforcing the need for speed. Even if not all these factors came into play in a particular financial firm, it would not matter because the market would still be demanding an answer within the next twenty-four hours, if not the next four hours.

The very fact that an insolvency proceeding is underway will destroy any risk-neutral trading strategy that an entity might pursue. Your positions are thrown out of control, and you enter something of a free fall the minute that the court appoints an administrator. There are determination clauses in financial contracts that could be automatic or at the option of the non-defaulting party. The exchanges will close out your positions to protect their own markets, as required under their own regulations and laws. If you indulge in stock borrowing and lending, you could find that the other party will keep the cash and leave you with a stock position. After that, it is likely that most of your *nostras* will be frozen, so that you will not have the liquidity to do things that you could or would like to do. The nostra-holder will probably look at it as a security buffer and will want to be at least 110% sure that his exposure to the insolvent entity is covered before he will release any cash. That is not a criticism; if called in as adviser, I would probably recommend just that course of action. But it does mean that you will not have the liquidity to take the actions you would like. Your market counterparties probably will not understand your inaction, and if they do understand, they will not appreciate it.

Most of the problems mentioned are capable of resolution if you could rehedge to minimize losses. Of course, there is always the possibility that an inadvertent position in which you find yourself could actually produce a profit but I am discounting that on grounds that the non-defaulting party would take the profitable option themselves. The report argues that administrators or liquidators, whatever their title may be in any jurisdiction, should be able to trade. It would be a brave administrator indeed who would actually trade in the normal sense. I hope that is not what the report means because my professional insurance policy would not cover it. But the ability to limit damage, minimize losses and minimize the impact of the insolvency overall is clearly needed. In the country comments, there was concern expressed that pre-insolvency creditors would be prejudiced by continued trading. I would merely point out that if you do not minimize losses, the position of pre-insolvency creditors will spiral out of control, and whatever you could have paid them at the end of the day will be greatly diluted. While the mechanism used for damage limitation may be trading, it is really a risk-management mechanism intended to protect the unsecured creditors.

My final point is that hand in hand with speed goes certainty. One of the major problems of any insolvency is that counterparties may not know their situation with respect to the insolvent firm. They may not have any documentation or, to be rude, they may not know where it is or they may not understand its effect. The counterparty cannot take action because he does not know his position or is uncertain of the outcome of his actions. Although I know that industry documentation will be discussed later in the program, I would like to stress the importance of clear, standard documentation. In a case we dealt with in 1990, we came across the ISDA/87 contract with one-way settlement provisions. For the insolvent company, it is a sort of "heads-I-win-tails-you-lose" proposition. The market reacted quite badly, and correctly, to that and the 1992 contract came into being which gave limited two-way settlement.

Given that change, this was one problem we did not think that we would face with Barings. But I can assure you there are counterparties in the marketplace that still use the 1987 contract, and we still faced that problem as a result. Because it would have interfered with party rights to try to impose certain types of contracts, we had to look at each contract one by one. Given the number and types of trades, that could best be described as a time-consuming exercise. Similarly, for foreign exchange and the IFEMA contracts: there was uncertainty, disagreement over interpretation, and delay while discussion proceeded, particularly sorting out what it all meant in the civil code and common law countries. The result was uncertainty and inability to act.

Jonathan Rushworth

It should be clear by this point that insolvencies are not tidy and they present a lot of scrappy issues. A particular problem with financial services businesses is that there are numerous aspects to them. In Barings, we had to deal not only with the bank, but with the asset-management and securities sides of the business, each presenting their own challenges.

I suppose one of the most important challenges we faced was the differentiation and segregation of house, as opposed to client, positions. Inevitably Barings was trading on its own account as well as engaging in a large measure of trading for clients. The handling of cash is a good example of the segregation problem, and presented its own problems in a number of ways.

A key concern was loss of margin. The securities part of the business had acted as principal, first entering into futures contracts with customers and then booking matching transactions with the Tokyo and Singapore Barings' affiliates, which were members of the respective exchanges there. Margin was, of course, taken from the customers and was thought to be segregated. These transactions, furthermore, were considered comparatively safe because they were exchange-traded instruments.

Now, to the extent that margin was not required by the relevant exchange, it was deposited in the group bank and was, therefore, frozen, as I mentioned earlier. To the extent that it was held by the Japanese exchanges, there was no requirement to segregate the client from the so-called house positions, and therefore the client margin moneys could be used to cover losses of Barings on its own house trades. This led to problems with US hedge funds. Any broker taking over the positions would require new margin, which was not available because it was used to absorb the losses of Barings house funds or it was frozen. Even in some countries where funds were thought to be properly segregated, the fact that they were deposited with the bank meant that they were frozen and the other parties were left with only an unsecured claim.

A further example of this problem arose for clients of the asset-management part of the businesses who believed that their funds were held in special segregated accounts. They were, in fact, in special segregated accounts but the cash portion was deposited with Barings bank, and that left the third-party clients with only an unsecured claim. We found the rather strange anomaly that the clients' securities held by the asset-management part of the business were entirely safe while their cash, which would ordinarily be considered safer, was stuck in the bank following the administration procedure.

Our goal was to preserve and protect the businesses of the group, so that it could be sold as a going concern, which was eventually what we managed to achieve. To that end, we established principles on which settlements could be effected. As a starting point, it was important not simply to convert contracts into cash as there would be no portfolio to sell. In those parts of the business which were to be preserved, transactions were to be settled if consistent with normal prudent banking practice, and hedging positions were to be properly maintained to control risk. However, there had to be a limit on carrying on new trading because, while administrators have powers to operate businesses, they have to be cautious about taking on new liabilities and particularly taking on new risks.

A number of restrictions were imposed. Transactions had to be for simultaneous delivery so that intra-day counterparty risk was not taken. In agency buying or selling, there had to be simultaneous delivery of the relevant securities, because otherwise there would be too great a risk. An alternative approach was for the insolvent company to drop out of the trade, and for the counterparties to settle directly with each other.

Other issues we looked at included custody services provided by the bank, whereby the bank held securities under a custody agreement but the customers' assets were managed by a third party. These could be tripartite agreements between the asset-management part of the financial services group, the bank which held the securities and the client. The customer could also have a management agreement with the asset-management subsidiary, but a separate custody agreement with the bank. In each of these cases, it was necessary to quickly review the agreements to establish that the securities belonged to the customer, and that neither the bank nor the asset-management subsidiary had an interest in them. For example, there could be charges over the securities in respect of unpaid fees, and it was necessary to establish how to deal with the settlement accounts held in custodian and sub-custodian accounts. Further, the sub-custodians could be situated overseas, for instance, with Euroclear.

One way to handle custody arrangements would be to release the securities to enable the customers themselves to deal with the securities and settle their trades. In that situation, cash would be received and come into the hands of the administrators. We had to be very careful that the cash was not deposited into the normal account at Barings Bank because that would become frozen. Separate accounts had to be set up that were available to meet liabilities on those sales. Special trust accounts were set up at the Bank of England to hold the proceeds of the sale of securities and to fund further purchases, as long as such arrangements were not prohibited by the custody agreements. Again, we had to review all these documents very carefully.

Finally, it goes without saying that if securities were to be released, the records would have to be checked carefully to be certain that there were sufficient securities available to meet all relevant obligations.

Maggie Mills

I will now attempt to pull together all that Jonathan and I have presented. If you overcame all the problems we discussed, and you managed to hold it together pending a sale of all or part of a financial entity, your problems would not actually stop there.

In a manufacturing insolvency, for example, it is not unusual that the assets are sold, most liabilities are left behind and the liquidator distributes the proceeds in whatever legal ranking is appropriate. The purchaser gets on with life while the administrator or liquidator tidies up after the event. There are always assets that cannot be sold free of liabilities—a plant with leasing liabilities attached to it. In most businesses, that is the exception rather than the rule.

In the banking and securities businesses, you have so many back-to-back contracts that to divorce the asset from the liability is very difficult. When selling the asset, the liability may have to go with it—the burden and the benefit of the contract together. So rather than dealing with sale of a single entity, you have to trace the flow of transactions through the business and check the assignment of every contract. If you are going to hand over the business properly, there is quite a job to do and you need the cooperation of every one of the counterparties. Any one counterparty can potentially blow out of the water a sale that the majority of the others want.

In the case of Barings, we worked closely with ING, their attorneys and the counterparties—and we got there. But it was not made any easier by the fact that there were differences in interpretation of the contracts and that there were so many of them. Looking to future insolvencies, the difficulty is that just when you think you understand all the problems, the market will invent some new, rinky-dink contract that you will not understand. You may have a better start, but there will always be new challenges.

Above all other considerations, we wished to cooperate with the regulators. There were many regulators involved, both our own and the regulators of Barings' counterparties. Self-evidently, regulators' duties and interests are different from those of the insolvent business that we were representing. For example, they had to be concerned about investment protection and orderly markets. That having been said, there were times when we did actually have the same aims. We cooperated closely with our home regulators, and we relied upon our home regulators, led by the Bank of England, to liaise with their counterpart regulators overseas.

We relied upon them, I have to say, partly as a matter of resource: you cannot be in communication with everyone. As importantly and more seriously, it was because regulators are better able to understand their counterparts and to address their requirements. Our home regulators could vouch for who we were, what our duties were and what we were trying to achieve, which meant that this avoided another learning curve for the regulators overseas. I think it worked very well. We discovered major uncertainties and many problems but a lot was learned. Since then, there has been the Windsor Declaration, the IOSCO meeting in Paris in early 1996, the Halifax communiqué, and initiatives like this, all of which allow people to better understand the problems, to come up with solutions, and to find an easier way forward.

The Financial Times noted of the Barings collapse "that it will enhance the health of the financial system by reinforcing prudence in proprietary trading and encouraging total control over derivatives operations." Whether that is the case or not, I believe that you need the odd crisis here or there to expose problems and force the search for solutions.

Ernest Patrikis

My presentation will attempt to do three things. One is to try to set out some of the facts of life of bank supervision. The second and main point of my remarks, which is an easy task is to rehash war stories. My third objective is to point out some goals for the future - and I mean the *future*, not tomorrow.

First, the facts of life. When faced with the prospect of bankruptcy at a multinational bank, it is the solemn duty of each bank supervisor to do all that can possibly be done to ensure that the adverse financial effects fall on no customer or counterparty of the bank. But failing that, they should fall in another jurisdiction.

Cooperation between bank supervisors is an important goal. That cooperation is best when institutions are financially healthy, and it continues for a period during an institution's decline. Financial information should flow continuously from the downstream host-country supervision to the upstream home-country financial supervisor. I have no doubts about that. But when a multinational institution becomes severely financially distressed, the home-country supervisor will then become less willing to be completely forthright about the financial condition of the bank. Home-country supervisors may be unwilling to target the closing date for one of their banks. Host-country supervisors will be motivated to take prudential steps that may not be in the best interests of the financially troubled bank. The reason for this is that bank supervisors, whether they realize it or not, supervise foreign banks in their countries with an eye on bankruptcy. There's a link: not an after-the-fact link, but a before-the-fact link. That is, the supervisory approach generally will be consistent with the bankruptcy regime in that country.

Given the facts of life and the reality of a financially troubled bank, it must be recognized that, in many cases, there will simply not be enough assets to pay all creditors. In that case, host country bank supervisors will feel that their primary responsibility is to protect the creditors of the branches they are supervising. As to the question of whether there will be sufficient assets to accomplish that, in the United States we have a statutory regime referred to as progressive discipline, which should lead to the closing of a bank with severe liquidity problems with some positive capital. I like to think that, when banks close in the United States, there will be enough assets to pay off all creditors and perhaps even some for shareholders.

I would like to offer three or four war stories to illustrate how the cross-border dimensions of insolvency have been handled in the past. The first is American Bank and Trust Company; the second, Franklin National Bank; the third, BCCI, and fourth, Drexel. You may not be aware of American Bank and Trust because it was part of a chain of banks, as opposed to a multinational bank. The banks were owned, or were taken over, by the Graver family, Argentines who found themselves facing a hostile government and equally hostile urban guerrillas. In 1976, they contracted to purchase American Bank and Trust Company, a New York bank, obtaining control of the bank before they obtained supervisory approval to acquire it. They asserted that this urgency was needed to help certain Argentines who were being persecuted by the government, an argument that one did not dismiss easily.

Besides owning a bank in Argentina, the Gravers owned a bank in Belgium and one in Israel. There was no cross-border supervisory coordination at that point as the Basle Committee was not as it is today. Nonetheless, it became clear that the Gravers were kiting—they did not have sufficient funds for their acquisitions. They established a *de facto*, but not ***de jure*** American Bank and Trust branch in Mexico City to take deposits, a court later determined to be covered by FDIC insurance. It seemed clear as events unfolded that, when the plug was pulled, the kite would explode in one or more countries. While there was some supervisory cooperation with the Swiss bank authorities because American Bank and Trust was still owned by a Swiss bank, there was better communication with the supervisors.

There were two fascinating side events to the story. One was that the oldest son David Graver left the United States in a jet he had hired for that purpose which crashed into a mountain near Mexico City. Nonetheless, a New York grand jury indicted the presumed-dead David Graver—his body was never found. Dr. Rubenstein, who was the family's financial advisor for their bank holdings, returned to Argentina. There he was incarcerated, and his dead body was later found in the streets of Buenos Aires—that is tough supervision.

My second example is Franklin National Bank, which had a branch in London that accepted Eurodollars placements from other banks and made loans. The declining financial position of the bank was no secret, its reliance on the New York Fed's discount window was a matter of common knowledge. As I recall, our discount-window officials were in contact with the Bank of England, largely as a matter of ongoing relationships rather than as part of a formal system. I traveled to London to obtain a security interest in the assets held at the branch. Bank of England officials were less than enthusiastic about Franklin's situation and took the view that this problem was clearly American in origin, and it was the responsibility of the United States to clean it up.

Notwithstanding an initially chilly reception in London, supervisory cooperation eventually proved to be first rate. We received assistance from the staff of the Bank of England, including in the bankruptcy proceeding. The bank was eventually closed by the Comptroller of the Currency when the Reserve Bank refused to roll over the daily loan it had been making to the bank. In the absence of that liquidity support, the Comptroller determined that the bank was insolvent. In London, the bank's branch was sold with the assistance of the Bank of England. To me, that was one of the first cases of international supervisory cooperation in the case of a failing multinational bank and also helped lay the groundwork for cooperation in the Basle Supervisors Committee.

In the case of BCCI, I would like to begin by giving credit to two individuals who have never been adequately recognized for uncovering the BCCI fraud and bringing the institution down: my New York Fed colleague Tom Baxter and Assistant District Attorney John Moskow. This was a case in which good communications between bank supervisors and law enforcement officials, in the United States, helped to uncover the largest bank fraud ever.

BCCI was truly a multinational bank, with banking offices and subsidiaries and affiliates in a large number of countries. A number of bank supervisors participated in a "college" of bank supervisors to supervise BCCI. Although the Fed was not a member of the group, we did seek and receive information from members of the college as we progressed in our investigation. The members of the college received advance notice of the imminent demise of the bank and its subsidiaries. We also had sources within BCCI.

BCCI presented a complex cross-border bankruptcy. What would you do if you were a host-country supervisor facing such an event? I would wager that you would do your best to ensure that the branch had sufficient assets to cover its liabilities to unaffiliated persons. You would do this by requiring the office subject to your jurisdiction to maintain assets exceeding liabilities in your jurisdiction—a net-due position vis-a-vis all other offices of the bank. When the bank closed, you would hope to have sufficient assets to pay all creditors of the office. You might respond that is "job number one". Any assets left could be transferred to the home-country liquidator. Is that fair? In a bank bankruptcy, not all liquidators will be in a position to pay creditors of local offices. Is it not fairer to combine all assets and have a single, home-country liquidation? Perhaps, but the problem was that BCCI had branches in some countries where bank supervisory practices were lax and there would be a substantial shortfall of assets.

For the United States, BCCI was a typical case. In recent years, no failure of a foreign bank with a banking office in the United States has resulted in losses to creditors of the United States offices of the bank. Is that good supervision, good luck, both, or something else? It may be some of both, but there is an "else". Owing to the role of the United States dollar as a leading medium of exchange in financial markets, a foreign bank is likely to maintain assets in New York. Those assets are not attributable to the branch, but may be assets of other non-United States offices—such as correspondent balances and securities, held for safe-keeping. If these assets are in New York, and the closed bank has a New York branch, these assets are available to the liquidator of the New York office.

In the case of BCCI, I would note that it was not a case of good luck but of good supervision. In January 1991, the New York Fed recommended to the New York State Banking Department that it ratchet up the asset-maintenance requirement for BCCI to 120% of liabilities to unaffiliated persons. As a result, there were no creditor losses. The liquidator of BCCI tried to capture all of BCCI's assets in the United States for a single liquidation proceeding in Luxembourg. This was resisted by state and federal banking supervisors, and I must say that I was not pleased to receive only a few hours notice of this bankruptcy action by that liquidator.

The BCCI liquidator had set the tone for the negotiations to follow, which did not make his life easier. The question of whether there can be a bankruptcy code Section 304 ancillary proceeding, in which all United States assets are gathered and shipped to the home country, was not definitively answered in the BCCI case because there was an overriding RICO proceeding involving racketeering charges. The RICO proceeding gathered all the assets, certain of which were used to pay penalties, and the remainder was transferred to the home-country liquidation. In general, I believe that the liquidator of the United States branch of a foreign bank would resist an ancillary proceeding for the assets on the book of the branch, or other assets of the bank in the United States. In effect, each branch is treated as if it were a separate bank.

Finally, I would like to discuss the Drexel case briefly. It involved a holding company, broker-dealer, government-securities dealer, a commodities trading company, and a swap dealer subsidiary. There was no consolidated oversight of the entity, and once any one of those entities got into trouble, confidence was lost and sooner or later they would all experience liquidity and transactional problems. I note that bankers and their attorneys should consider the effect of cross-default and affiliate-default clauses in documentation. These clauses can make it much harder to contain the effects of an insolvency in a financial conglomerate.

Good cross-border supervisory coordination in the Drexel case was at a high level. Based on the earlier discussion by this panel, the question arises whether cases like this one argue for temporarily suspending the Thirteenth Amendment to the United States Constitution on involuntary servitude. That is, how do you keep traders chained to their desks? We found that, in the Drexel case, the traders remained with the firm. They enhanced their reputations in the market by skillfully working down the firm’s trading book.

In a case like Drexel, a goal is to work down the size of the trading book. However, if all of the firm’s traders move off to other firms, this will be a difficult task because it may be unreasonable to expect another firm to take over a trading book in such circumstances. It should be clear that it is desirable to have a bankruptcy law that will give firms the confidence to continue to deal with a firm that is encountering financial difficulty in order to assist that firm to reducing its trading book and reduce the potential for systemic risk.

I would like to conclude by laying out some principles for the future. In an ideal world, all bank supervisors would be exceptionally and equally competent. Information would be freely shared up and downstream by home and host-country supervisors. There would be a simple, low-cost, expeditious liquidation proceeding in the home country. All creditors would be paid in full and there would even be a bit left over for shareholders. That day is not about to come soon.

How defective is the current system? If a potential creditor of a bank is rational, it will make a cost-benefit judgement about where to place a deposit. On one hand, the rate paid on the deposit will be considered. But will that potential creditor's judgement include the quality of supervision over the institution? Will the creditor be aware of the bankruptcy regime in each country? Will the creditor consider whether cross-border netting arrangements are in place and will be enforceable?

In the long term, in my personal opinion, the goal should be for a single bankruptcy proceeding. In order to attain that goal, home and host country supervisors should meet some minimum standards. The single home-country bankruptcy regime will have to be fair. The Basle Committee on Banking Supervision has gone a long way toward getting us to this goal and the work of the Joint Forum on Financial Conglomerates is a step in the right direction, but we still have a way to go.

Questions and Comments

Question: Mr. Patrikis, your comments suggest that we should look at the individual agreements signed between financial institutions, because they are differentiated by the strength of supervisory regime under which they are signed and the netting and collateral agreements individually negotiated between counterparties. In contrast, the point of the discussion today is that a focus on individual agreements can make for a very messy, very difficult rescue operation and may increase systemic risk. Should regulators give more guidance on how best to achieve a middle course?

Ernest Patrikis: I think the market is reacting to these pressures in a very rational way. One bank of which I am aware is planning to consolidate its global foreign-exchange book in London. A single book with all confirmations out of London, as an example, would be easier to manage, cheaper in terms of computer and processing power, and simpler legally since it would eliminate a lot of work defining legal rights. As regards the terms of the agreements, the capital-adequacy regime is a driving force for market participants. The critical issue in insolvency is how fine the "default trigger" is for an agreement. That is a matter that should be left to market participants.

The supervisor should not set the terms of a default clause. If market participants feel that they have to get out, they should do so without interference from a supervisor or regulator. On the other hand, there are limited automatic triggers. In the foreign exchange area, a mere technical default, an erroneous payment gone astray, could not serve as a default trigger.

Question: Has the licensing process—in terms of who qualifies to go into the banking business or to start a new operation—now reached a stage of maturity that we are satisfied that it works? I am thinking particularly of emerging-market countries where, quite obviously, those doing the licensing are somewhat less experienced and are dealing with many people they do not know.

Ernest Patrikis: There are two sides to that question: whether supervision is adequate and whether everyone should be supervised. In the United States, we have had a strict requirement with respect to comprehensive, consolidated, home-country supervision. While that may be an overly strict standard, the focus on strong supervision is the proper approach. However, a second question arises whether everyone engaged in financial activity should have to be supervised or regulated.

Why not let market participants decide for themselves whether they want to deal with an FCM that is regulated by the Commodities Futures Trading Commission, a bank supervised by a bank supervisor, a securities firm regulated by the Securities and Exchange Commission, or an unregulated firm? People understand the risk of dealing with a AAA-rated unregulated swap dealer. Companies in the United States issue commercial paper and make loans; they are not banks but compete with banks. There is nothing wrong with that as long as the counterparties buying that commercial paper know what they are doing and can make judgments about it. Of course, I do see a need for consumer protection because of inequality of bargaining power. But we do not need a “let’s regulate everyone” approach.

Comment by Andrew Crockett: The last question underlines a longstanding concern over the wide variation in national licensing procedures for banks, less in the G-10 countries but particularly in the emerging market countries. As a result of that concern, the Basle Committee released a set of core principles for banking supervision a few weeks ago that is much more comprehensive than previous guidelines issued by the Committee. There are several recommendations that relate specifically to the licensing process. If they are implemented effectively across countries, we will have moved a long way toward addressing the concern raised here. But the Core Principles are only a first step; their implementation lies in the future. Because of the damage that weak banking systems and poor supervision can do to economies, the International Monetary Fund is expected to look at banking systems and their supervision as part of its annual country surveillance of countries. So we have made a first step but there is a lot further to go.

Comment: There is not only a need for effective licensing but for more transparency in the marketplace regarding the management of firms and the legal and supervisory regime under which they are operating. If you are going to select among a menu of possible financial counterparties, you should have good information on them. There has been a fair amount of international work to make disclosures more uniform and information on off-balance-sheet exposures more accessible. This must continue.

Question: To be cynical, one could argue that what really is distinctive about a financial sector insolvency is that most financial institutions have multiple regulators—within their own country, not to mention the problems in the host countries where they operate. Does that aspect of financial insolvency so complicate matters that it should be a priority for reform, if reform is possible, or is a "lead regulator" the best that we can ever hope to achieve in all of this?

Maggie Mills: It complicates matters self-evidently if you have three or four home regulators with different criteria. However, in the Barings case, matters did not become overly complicated, whether through luck or otherwise. A working group met every day to surface the problems we found, and we were able to resolve them reasonably. The Bank of England served us quite well as lead regulator. Whether this would work as well in other circumstances, I may not be qualified to say.

Jonathan Rushworth: It is a truism to say if you had one regulator globally then we would not have faced some of the problems we had with Barings. But while we may be examining global insolvency issues here, the insolvency regime still operates on a domestic basis and that is where you have to start. Since cross-border insolvencies will go on arising, they will have to be approached very much on an *ad hoc* basis.

You have to start off looking at the local regime where the branch or company is located, and there are very different philosophical approaches. For instance, the US regime is very much a debtor regime, whereas in the UK and Commonwealth countries, it is more of a creditor regime. Then of course you get into the difficult conflicts of law areas of universality and territoriality. Every country agrees, in concept, to recognize overseas trustees, liquidators and bankruptcy trustees but when it comes to the crunch, they focus on local creditors. There have been a number of positive legal developments: section 426 of the UK insolvency act; co-operation provisions in some Northern European countries; and the EC bankruptcy convention, which unfortunately the United Kingdom did not sign because of the dispute over beef a while ago. However, the EC convention was only going to have limited effect in that it would provide a center of administration and then allow parallel insolvency proceedings in other countries.

There have been very successful *ad hoc* arrangements, such as the protocol between UK administrators and the US examiner in Maxwell Communications Corporation. Until the elusive global insolvency regime comes into being, we will have to make it up as we go along. Cooperation among judges is very useful because when you face a crisis, you have to look at local legislation and the local regulatory regime and then try to put it all together.

Maggie Mills: What is also clear, considering conferences like this one, is that people are now asking questions. They are looking for transparency. They are trying to understand risk management better. Next time around, perhaps we will not be faced by parties who believe they can offset globally anything with Barings in the name against any transaction with their company's name on it. People operating under that misconception are now asking how they can make it happen if they face a similar problem in the future. They are now aware of what happens with onward transmission of margin moneys. Perhaps in the future we will not face the "horror factor" because people will have asked the right questions beforehand.

Ernest Patrikis: I would also like to note the groundbreaking work that was done under Alexandre Lamfalussy to set standards for clearing and payments systems which the Basle supervisors then applied to netting agreements. Early in the life of ISDA, I was asked whether supervisors would recognize netting if counsel took the usual bankruptcy exception in its opinion. In the work that was subsequently done, the requirement for recognizing netting required that it be valid under all relevant jurisdictions. That was the "Lawyer's Relief Act" but we knew what we were doing. The financial world should not operate without some certainty as to the enforceability of agreements in bankruptcy.

People were put to work on the bankruptcy laws and the result is that netting is now much more widely available. We know the countries where the situation is not clear, or where there are still problems, where netting is weak. ISDA members can obtain a multi-volume series of legal opinions on netting. I am sure that there are many firms who think that just because there is a legal opinion on a country in the book that netting must be effective there. This is not the case. Each firm's counsel should review each of these opinions. As an example, let us look at Italy. Netting is not valid in Italy, although there is proposed legislation to make it so. Does any counterparty doing a swap with an Italian bank charge more because of higher risk or the inability to net? Maybe the market will start reacting as the bank supervisors begin to examine matters more closely. If examiners begin asking the bank to evaluate legal opinions on a very-strong to very weak-scale and to establish a point at which netting is not effective, then we will make headway on improving bankruptcy laws.

As regards supervision, problems and situations do arise even with supervisory structure in place. We sometimes find as foreign banks in the United States that no one approved. We have sometimes done our enforcement through the telephone book, finding a bank that we did not know was there. These things do happen. We do react to them promptly

II. Can Speedy International Cooperation Be Achieved?

Moderator: Richard Gitlin
Panelists: Neil Cooper, Vice President, INSOL
Andrea Corcoran, Director, Division of Trading and Markets,CFTC
Gordon Marantz, Partner, Osler, Hoskin, & Harcourt

Richard Gitlin

In considering the question before this panel, we must begin with a recognition that the foundation upon which we must resolve an international insolvency is an inadequate system of international laws. Yet after an insolvency filing, we are supposed to achieve speedy cooperation among any number of parties in several countries to stabilize the situation. That is complicated enough in a commercial context where cooperation is needed among administrators, trustees, insolvency practitioners and judges in three or four countries. It is even more complicated for a financial institution, where it is necessary to integrate financial regulators and market-makers as well, and to do it all within a few days of an initial crisis. In addition, the first week following an insolvency is the time when accidents happen. It is therefore critical to eliminate, or at least reduce, the risk of accident: the risk that a key person may be absent, or that two judges might not choose to cooperate when such cooperation is key to preserving financial assets. These are the issues underlying the question posed to our panel.

Andrea Corcoran

The Commodities Future Trading Commission has been very active both nationally and internationally in promoting cooperation among regulators, and we believe that the Group of Thirty report makes some important recommendations in this regard. Today I will discuss the tools available to regulators for cooperation, how we are working to make those tools more effective, and what some of the obstacles are to using those tools. First, however, I would like to step back and reflect upon what is different about financial sector insolvency.

There is a basic tension between standard insolvency law, which applies a stay that is intended to protect the status quo, and the needs of the financial market for aggressive, dynamic management of a financial emergency to preserve asset value—and thereby attempt to contain the impact of an insolvency to maintain the status quo. As you have heard today, one of the big problems encountered by market participants in the Barings case was their inability to liquidate, transfer or rehedge their positions. This was true even though these participants were not the defaulting parties, raising the spectre that one default could precipitate others.

During the period that the outcome of Barings was in doubt, non-defaulting participants experienced losses on several counts. The currency exchange rate between the dollar and the yen, for example, changed dramatically during the several days that the positions were frozen and could not be altered. The Nikkei-225, one of the contracts at issue, lost substantial value during that period. Following the Barings episode, UK supervisors and the CFTC convened a conference in Windsor to discuss what steps regulators could take, consistent with national insolvency regimes, to permit the transfer of positions, funds, and assets from failing members who were transacting business on futures exchanges. The goal of this exercise was to isolate the insolvent and to reduce its potential to transmit risk to the market.

At that meeting we talked about the common objectives of regulators in a financial emergency. First among these is to protect the market itself so that the failure of a single firm does not become the failure of multiple firms. Second, we discussed how to transfer the funds and positions of non-defaulting customers, who would generally be unwilling to pay margin into a failing firm, out of the defaulting firm so that their capacity to continue to meet their obligations can be preserved. We examined how to clarify the regulatory status of the local component of a firm so that people in other countries can be informed whether a regulated entity, located, for example, in the United States is still solvent or needs to be liquidated. Finally, we examined the potential to enable the failing entity to meet its obligations until liquidated, and other participants in the markets to meet theirs.

The CFTC played a very visible role in the Barings case because Barings was active on the Singapore International Monetary Exchange and a counterparty of the Chicago Mercantile Exchange, and it was very clear that Barings was going to require a substantial financial rescue package. While Singapore was in the process of organizing that rescue package, there was a risk that clearing members would withdraw from the market because members of most futures exchanges have common-bond arrangements that require them to support, or make up for losses of, any other member in order to keep the market afloat. The clearing members in Singapore would not want to pay additional margin into SIMEX if that margin was going to be used to protect the market or to cover Barings losses rather than to finance their own obligations. The CFTC and the Monetary Authority of Singapore issued a joint press statement indicating that any payments made during the market emergency would be used only to support the firms making the payments, and would not become part of a mutual assistance package to rescue Barings. This was an important step and the kind of concerted action that regulators can take to calm markets.

In the United States, we have a very robust law to support the movement of customer funds, to collect collateral and to protect customer positions. Pre-insolvency transfers of margin cannot be reversed under most circumstances. Liquidation and transfer of positions is permitted even after a bankruptcy filing. And there is a substantial incentive to resolve problems before there is a bankruptcy filing because a firm that has safely placed all of its customers' positions can reorganize and one that has not must liquidate. The US law therefore provides significant incentives and significant legal support for resolution of insolvencies in the United States.

As one moves outside the United States the treatment of market positions and funds margining becomes less clear. Therefore, a premium is placed on cooperation among regulators to attempt to resolve the emergency and to reduce its impact. There are two types of cooperation. One is contingency planning and the other is information-sharing. Contingency planning largely consists of developing contact lists of those available to be contacted in an emergency, both regulators and regulated firms. The goal of information sharing among regulators is pretty much the same as that for liquidators. We have attempted over the years to develop information-sharing arrangements that enable us to comprehend the overall exposure of a firm as transactions move across borders. We want to know where the primary risks are located; whether or not exposures in a US market are offset in another market; whether we are facing a customer default or a proprietary default; and what the size of the potential default is. We will want to know whether the firm that is having the problem is a small part of a large entity or the primary entity itself. We will want to know more about the liquidity, cash flow, and solvency of that firm. What is its staying power?

Barings had no exposures to speak of in US markets. It was doing proprietary trading in the United States but it was not authorized to do customer business. The US interest in the Barings situation was entirely the product of US customers doing business through US intermediaries who had omnibus accounts with London financial subsidiaries of Barings who were trading futures and options in the Far East. Notwithstanding this indirect relationship, there was a fair amount of concern when people realized that customer funds that had been passed along to the Far East were not protected. They were neither segregated from Barings' funds and from being used to pay that firms' expenses, nor were they apparently otherwise protected. Early information on the nature and scope of US market exposure to Barings helped us to decide how best to react.

There are several mechanisms available internationally for sharing information. The primary type of mechanism is a Memorandum of Understanding negotiated on a bilateral basis. These memoranda have largely been used to address cases of misconduct and developing information relative to the prosecution of that misconduct. Recently, however, there has been attention to use of MOUs to get better information in a market emergency on the exposures and risks within a troubled firm subject to a particular regulator's supervision, but with activities in many markets. This is a new use of such memoranda. Only recently fourteen regulators and more than fifty market participants have signed a multilateral expression of intent formally to share information on large exposures when there is a market emergency, subject to certain trigger mechanisms or threshold requirements. This mechanism-companion arrangements of regulators and market authorities were executed in Boca Raton in march, 1996 and are known as the "Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations."

As Ernie Patrikis has noted, one of the challenges in sharing information is that your goal is to make matters better, not worse. A number of obstacles stand in the way of doing this effectively. First of all, there may be the lack of means. You may not be able to share information between markets, or between regulators of a certain type, or with a particular market participant. For example, in the United States, the CFTC is expressly permitted by statute to share information with a domestic receiver but we cannot share information with a foreign receiver. Or there may not be the kind of information available that would be useful to share. In the United States the CFTC has on-line access to information on all beneficial owners who have positions above a specified size in the marketplace. There are very few other markets that have that kind of information, and in the case of some over-the-counter transactions, the firms themselves may not even know their whole position.

It is also important to measure the risk accurately, and sometimes firms are not measuring their risks appropriately. In the case of Metallgesellschaft, ten-year performance contracts were carried on the books at par. It was apparent that those ten-year contracts were valued inappropriately if they had to be liquidated once trouble started. In some cases, even where information-sharing mechanisms are in place, competition among markets may prevent the free flow of market information. When the Sumitomo emergency arose, the London Metal Exchange and the New York Mercantile Exchange were competing for the copper-futures markets. When their regulators attempted to share information, the markets reacted as if the regulators were on a fishing expedition to develop information for competitive purposes rather than to meet supervisory objectives.

The save-yourself-first syndrome was mentioned here earlier. If you see real problems developing in your market, it is very difficult not to focus on your own area of accountability, notwithstanding the cooperative arrangements that are in place. Sumitomo is a good example of the breakdown of the lead regulator idea. Sumitomo, although active in the London copper market, was clearly a Japanese institution but the Japanese financial authorities, initially denied any responsibility on grounds that it was a trading firm, not subject to financial regulation. Nonetheless, it could certainly be argued that the Japanese were the lead regulators of the Sumitomo group. Although Sumitomo had copper-market exposure in New York and London, both the US and British authorities could have argued that they were not accountable and relied on the Japanese authorities, but that would have left U.S. and U.K. markets at risk. Instead, it became clear that if a problem develops on your territory, it is ***your*** problem.

Finally, it is clear that however speedy you would like information exchanges to be, it will take time to decide what kinds of information are relevant and to develop that information. For that reason, the bigger the firm that is experiencing difficulty and the more resources it has available, the greater the likelihood that you will be able to work your way out of the emergency, although the more complex the evaluation of the relevant information will be. The larger the cushion, the softer the crash. And the more independent segments of the firm remain healthy, the easier it will be to manage the emergency.

Regulators are working to make existing cooperative mechanisms more robust. They are surveying the availability and accessibility of information that can be shared. Second, they are reviewing existing information-sharing agreements that are very broad to make them much more specific about the kinds of information regulators might request of each other. The goal is for every regulator to be able to obtain a corporate map and the most recent financial information on a firm, including stress tests. Regulators are also exploring emergency techniques. In February of this year, US and UK authorities scripted the default of a firm that was a member of the Chicago Mercantile Exchange, the New York Mercantile Exchange, and the London

International Financial Futures Exchange to examine what would happen and what kinds of information would and should flow between the markets. Even in this fictitious case, politics came into play and we had to devise a politically correct default. It was critical to the British participants that the default not originate in their jurisdiction; it had to emanate from the United States and travel to the UK, so that is how the script was written. We also have worked out case-by-case protocols for sharing information through conference calls and other mechanisms. Often what is shared is based more on personal than formal relationships among regulators and other affected parties.

My final point is that regulators are working to strengthen the legal basis for obtaining information on market exposures and positions and for sharing that information directly with receivers and those in the markets who need the information promptly in order to resolve emergencies. The more specific the consensus on what the needed information is, the greater the likelihood that it will be shared timely and hence useful to resolve an emergency. I would note that, although the regulators were in constant communication during the Drexel Burnham and Barings cases, there was very little information-sharing or discussion with the administrators. One of the advantages of meetings such as this is to make clear to administrators and liquidators the kinds of information that regulators have available that could make their jobs easier.

Richard Gitlin

I will address briefly the subject of judicial cooperation. Back in 1974, INSOL approached the United Nations organization UNCITRAL with a proposition for achieving better laws for international insolvency. After thirty years of fruitless effort to improve laws in this area, we proposed getting all the government officials from around the world who have been trying to do this into a room for a discussion. Our goal would be to figure out what practical steps could be taken to improve the handling of international insolvencies because, while the search for perfect laws went on, value was being lost.

We assembled that group, and Lord Hoffman summarized our mission as “the search for something practical.” Out of that discussion emerged two projects: a meeting of judges, which became the judicial colloquium; and development of a model law dealing with access and recognition which Neil will discuss.

Why is the judicial colloquium so important? The reality is that, when a problem erupts, there is only one place to go for relief that is not spelled out in statutes and treaties, and that is to the judges. To revisit the Maxwell case, we started with one very large company that filed for bankruptcy protection in two jurisdictions: a *Chapter 11* filing in the United States, which claimed worldwide jurisdiction, and an *administration proceeding* in the United Kingdom, which also claimed worldwide jurisdiction. Both courts issued injunctions preventing actions by other parties. The British and American legal systems were inadequate to the task of dealing with this situation, but something had to be done with a billion dollars of assets. What happened is that the judges took matters in hand.

In the United States, Judge Broman ordered me, as examiner, to find a way to harmonize the two proceedings. She was unwilling to tolerate a situation in which the lawyers made money litigating over who had jurisdiction while the assets lost value. In the UK, Mark Holman of Price Waterhouse was appointed and given a similar mandate by then-Justice Hoffman. With the direction and support of the two judges, we developed a protocol that was nothing more than common sense. It set the ground rules for dealing with two proceedings: who could do what, and when you had to go to each court. But without two judges who treated this as a priority, it never would have happened. In the absence of good laws, judicial cooperation is absolutely essential, and even more essential in financial failures than in commercial failures.

That is the logic behind the judicial colloquium, which was sponsored by UNCITRAL and INSOL in 1995 and again in 1997. We had judges from over forty countries attend and they engaged in very serious debate on difficult issues. There were two noteworthy features of that debate. First, there was discussion of a thorny issue: can judges talk to each other over the telephone? Some judges felt that was clearly inappropriate and they would never consider it. Others said that if an emergency required it, they would consider it proper—with counsel involved and so forth. But it was a really serious debate. The second feature of note was that the meeting was attended by the Chief Justice of the Cayman Islands, Justice Harry.

As Jonathan mentioned, when Barings failed, speedy coordination was needed between the UK and Cayman Island courts. Unless you could get Justice Knox in the UK and Justice Harry in the Cayman Islands on the phone together, the Barings failure could have been a whole lot messier. Well, Justice Harry did get on the phone and the two judges provided the relief that was needed. In fact, he came to the second judicial colloquium specifically to share that experience with judges from other countries.

One clear lesson that the judicial colloquium has taught us is that judges develop greater comfort about cross-border cooperation if they hear about it directly from other judges, and if they have the chance to develop personal relationships with judges on the other side of the border or ocean. This is a very simple, practical step but it could make a critical difference in a major failure.

Of course, this type of personal interaction will never occur, and judges will not be sensitized to the importance of prompt action in cross-border insolvencies, unless they participate in international discussion of these issues. And the simple fact is that most countries do not send their judges to international meetings. They send their regulators and other government officials but the only way to get most of the judges to our colloquia is to have INSOL raise the money to pay their expenses. The government of Canada is a notable—and laudable—exception, sending seven judges to our last colloquium. But for the most part, we find that if we want a judge from India—or even from the United States—to attend, the burden of raising the money is ours. So we encourage you to promote judicial participation in these meetings both with judges from your countries and with your governments.

Having participated in the colloquium, the judges at the last meeting did not want to wait two years until the next gathering to hear about progress being made in judicial cooperation. Therefore, they decided to establish the "INSOL Judges Group," chaired by Judge Broman, to gather information on interactions between judges around the world. She will distribute that information to the membership so that judges will have continuous updates on circumstances where cooperation is being pursued. This is an important initiative because judges simply do not receive this type of information in the normal course of their work; it requires an extraordinary effort.

Moving beyond meetings and exchanges of information, what else can be done to enhance judicial cooperation in the future? The study group report calls for regulatory support. This is important because a judge is frequently asked for extraordinary relief before having the opportunity to hear proper legal argument. Unless the government indicates that relief is important and offers its support, the chances of getting quick and extraordinary relief are reduced.

The report suggested a "friend of the court" brief, which is not available in some countries, but the thrust of the recommendation is clear—for regulatory support, in whatever form, when a crisis requires judicial action.

A second proposal in the report is to develop a standardized protocol for judicial cooperation. Cooperation comes easiest if the parties involved know ahead of time what is expected of them. What this requires is deciding what type of protocol for judicial cooperation would work best in the failure of a financial institution. It would probably make sense to form a working group to give further thought to this issue.

Finally, and most importantly, national law must allow judicial cooperation. A number of judges, particularly in civil law jurisdictions, made clear that without statutory authorization, they could do nothing—no matter how clear and convincing the case for cooperation. They argued that if progress is to be made, it would be helpful to have a model law upon which to rely. That was a major impetus to the UNCITRAL effort, and a perfect segue to Neil Cooper's presentation on the UNCITRAL effort to produce model legislation.

Neil Cooper

My mission is to explain our work with UNCITRAL and the preparation of a model law. I will refer to it, in shorthand, as the "model law" although it is, in fact, model legislative provisions that need not be a stand-alone law. In drafting this model, we have not sought to build anything that would harmonize national laws because that would take longer than our collective lifetimes. What we have sought to do, very simply, is to provide for access to foreign courts and for recognition of foreign proceedings, a level of relief and to provide for judicial cooperation, for all in the interest of cost and administrative efficiency.

One reason that the project has moved slowly is that it took a long time to define the essential difference between common-law and civil-law systems. The staff of UNCITRAL deserves credit for making this clear. At the end of the day, it proved desperately simple. It has nothing to do with legal codes, and nothing to do with binding case law. It was a matter of understanding the mechanics: recognizing that the civil law system works like this, while the common law system works like that. Once you understand the essential difference in the operation of the two systems, everything else becomes manageable.

What has been accomplished since starting the project? We have prepared a survey which has now been bound into a book. We have held the judicial colloquia that Richard referred to, including one in New Orleans earlier this year. The working group on the model law met four times and has now completed its work. Each meeting lasted a fortnight and each was, by and large, jolly hard work. The Commission itself is meeting on the model law now. There are some inefficiencies in the process because not all countries have sent the same people to the Commission meetings that have been on the working party, but we are making progress. The meeting started on Monday, and is due to go through to the 30th of May. Not all of that time will be devoted to the insolvency law as there are other issues on the agenda.

Before going on, I would like to take a moment to speak up for UNCITRAL, the United Nations Commission on International Trade Law. Bearing in mind the number of jobs at risk and the amount of money lost every year by inefficient insolvencies, it is desperately sad that an organization like this is short of funds. At the moment, three of ten professional positions in the secretariat cannot be filled for lack of funds, which means that important work is not being done. I really would encourage those of you with clout at home to support UNCITRAL.

How have we done in drafting the model law? The objectives set out at the beginning of my presentation all have been achieved. We have only had to make limited use of a "menu approach;" that is, options for those countries that are unable to accept what we all believe to be the ideal. Problem areas have been clearly identified and we are now working on them.

At the moment, the model law does not cover financial institutions, largely because many of the countries involved have been through the heritage of the EU bankruptcy convention, which excluded financial institutions and insurance companies. Going forward, it would be helpful to know from you the experts which parts of this model law would need modification if it were to be applied to the financial sector. Is this model a useful starting point?

For example, in the access provisions, the foreign representative can apply directly to the nominated courts. There is no exequatur required and no surrender to the foreign jurisdiction. Those of you who are familiar with *British Israel Bank vs. Herstatt* would know the problems that were thought to arise when an application to a court means that you have surrendered to jurisdiction. The model law is precisely in line with section 304 of the US Bankruptcy Code, but this approach is not necessarily understood worldwide. The civil law countries, incidentally, do not tend to have a problem with this approach.

As regards recognition, we unfortunately have the baggage from the EU Bankruptcy Convention which divides proceedings between main proceedings and non-main proceedings. Countries such as Germany simply will not recognize proceedings that start anywhere other than in the center of main interest, which is the registered office almost invariably. This is a rebuttable presumption, and one that is quite important when you consider financial institutions. There is a debate at the minute as to whether "establishment" means business activity, as in the EU bankruptcy convention, or whether it merely means reserve of assets. Some countries are not happy to recognize proceedings originating in a country where the court's jurisdiction is premised solely on assets. On the other hand, the English courts do not have a problem finding jurisdiction on the basis of assets, if the proper case can be made.

Relief is in two types: discretionary and automatic depending on the type of proceeding and status of the application. Discretionary relief is essential because of the speed that is necessary to deal with insolvency cases. This would be even more important in a financial insolvency. Because we assume that recognition may take some time, there is need for pre-recognition discretionary relief. While it will not be the case in all jurisdictions, there may be a delay between the application and a hearing. Under article 19 of the model law, from the time that an application for recognition is filed, relief is available—and it is very far reaching. This relief can be refused if the proceedings for which recognition is sought are not from the main center of business. Notice may be required to be given to affected parties by the Court granting relief.

Post-recognition, the courts may order continuing interim relief, staying actions and suspending disposals. Of those powers, I would draw your attention to two particular reliefs: compelling testimony and the distribution of assets. Up to that point in the model, all reliefs made available are those that you would expect. But these two are not powers that you will find in some parts of the world, particularly as regards expatriation of funds. Nonetheless, they have been quite well received. There is the problem of what is termed in some countries "fishing expeditions" with respect to compelling testimony in pre-discovery actions. That is one of the outstanding issues that we have to debate over the next week.

What is terribly significant in the model law is the extent of automatic relief—the relief available as soon as the local court recognizes you. But we have to think about what protection is needed when a stay takes effect. When transfers and disposals are suspended, protections must be provided for ordinary operations so that a business that must continue trading is not inadvertently brought to an end. Avoidance remedies may be used by the foreign representative available under the local law. The representative will also have the ability to intervene in local proceedings, both to request the opening of local proceedings and to participate in other relevant local proceedings. The word "relevant" is important as there is a fear that this will permit the insolvency proceeding to become entangled with a man's divorce proceeding or other like matters. Despite assurances that no one has such a thing in mind, narrowing down the problem by finding other words is really very difficult.

Local and foreign creditors enjoy the same rights. In the financial sector, there are enormous problems in determining what a foreign creditor is, so we have solved the problem by granting everyone the same rights. In the UK, there is the possible exclusion of foreign tax authorities.

Judicial cooperation is not included in permissive form, but in the form of a directive: courts shall cooperate. This addresses the problems not only of civil law countries, but of countries like India as well. Under Indian law at the minute, once a judge is appointed to a case, he may not discuss it with anyone else, not even another Indian judge. So a directive that appointees shall cooperate with foreign representatives is essential. Some lawyers will argue that this is absolutely useless, too vague to be enforced. But as these model legislative provisions are interpreted into local law, I rather suspect that directions like this will find their way into practice.

There are rules for collaboration on concurrent proceedings. States may open local bankruptcies with local effects, only providing the debtor has assets in the jurisdiction. These proceedings will have local effects only, unless they are the main proceedings. Unlike the EU convention, there is no effort to determine applicable law.

Once all problems are resolved, UNCITRAL will adopt the model law at which point, the General Assembly will issue a Recommendation to Nations. Although the model is just in draft, without being enacted in any jurisdiction, courts are already citing the UNCITRAL discussions and there is evidence of improved cooperation.

Of course, nothing is perfect and there may be some watering down as the law is enacted in various countries. However, we are quite close to a model law and it may be the best example yet of practical international legal cooperation. For the moment, the model is inappropriate for the financial services market, but it contains nothing contrary to what practitioners need in that sector. It is a step in the right direction and, with some tailoring, it can help.

Adapting the model to financial services will require recognition of the special rights and special issues in this sector. Restricting the rights of regulating jurisdictions is an important issue. The information problem is critical. Keeping trading losses to a minimum while making sure that the fox is not allowed to finish emptying the hen house is difficult. As some of us have seen, many individual transactions may be lawful but only when you get an overview of an entire pattern of transactions is it possible to form a view of whether the intent was lawful. INSOL can help in identifying, defining, and agreeing the model provisions that will address the particular needs of the financial sector. This should be possible by refining the UNCITRAL model and building in the additional provisions that are needed.

Gordon Marantz

Having spent the last seven years with the Canadian government, putting two sets of bankruptcy law amendments through Parliament, you get to see what a bitter, frustrating and, in the end, rewarding experience it can be. These are real-world problems and it is gratifying to see so many policymakers in the audience—senior regulators and people with influence in the banking community who have a direct influence on the policies that government enacts. The Canadian Department of Finance meets with the banking industry on a continuing basis, and this is certainly the case in other jurisdictions as well.

In pursuing bankruptcy reform, you are dealing with complex problems involving regulatory, administrative, legislative and judicial frameworks and industry pressures. You are also dealing with a variety of government departments, not all of whom work together the way they should. In Canada, we have three different statutes that deal with insolvency, but not all administered by the same government department. We have had legislative initiatives, for example addressing netting and set-off on derivative contracts, which have been enacted by two different ministries, on differing timetables and with inconsistent results. While they are all now in one place, there are still issues moving on separate timetables, such as looking at reviewable or preferential transactions.

The ministries involved live in some degree of isolation from one another: Finance, Revenue and the Industry and Trade departments. People in one department believe that those in another do not really want to discuss the issues, but nothing could be further from the truth. So part of what is required is to open up a dialogue among government ministries to try and bring the legislative framework under one roof. Knowing that I have the ear of people in government, friends approach me to ask why the government cannot simply enact a law to fix the problem?

Those of you who have been involved in the legislative process know it is extremely cumbersome. A departmental initiative requires someone to sit down and sort out the problem, draft the legislation, go to a deputy minister and a minister to get approval and then on to the Cabinet. Then the House dissolves because an election is called and the process must start all over again. It may be easier in parliamentary systems than in the congressional system of the United States, but it is never easy. Legislatures are not proactive; they only respond to problems. Getting them moving is a major undertaking.

Given these problems, it is remarkable that we have had two major pieces of legislation dealing with financial institutions go through Parliament in the space of a year: each over 100 pages long, each an omnibus bill amending eight or nine statutes at a time. They sailed through with virtually no debate and no opposition. At the same time, we had bankruptcy legislation which took four years to complete.

In looking for reasons, part of the difference is a matter of responsibility. Financial institution legislation affects consumers, policyholders and depositors who are supposed to be protected by government. When the issue is a matter of the responsibility of regulators and standing in the world financial community, Parliament will act quickly. There is limited incentive to play politics. Although they could make a bit of political “hay” beating up on the banks for poor performance, they also know that actions that could roil global financial markets, induce currency speculation and force interest rates upward could cause tremendous domestic problems. Since no politician wants to take heat in those areas, it is possible to have legislative reform.

When it comes to bankruptcy legislation—especially commercial bankruptcy not affecting financial institutions—the politics can become very difficult. This is a matter affecting the local flower shop or the consumer debtor that runs into trouble. The stakes are limited and the debate becomes political and bogs down.

A particular concern is that financial regulation is fragmented. Three or four ministries are involved at the federal level in Canada, but there is also provincial level regulation. There is no national securities commission that regulates securities firms, but a patchwork of provincial securities commissions. You have different industries—securities, commodities trading, banking, the savings and loan industry, insurance—whose regulatory jurisdiction is an accident of constitutional history. Just as nations do not want to give up jurisdiction, in a federal state, the individual states and provinces are loath to give up jurisdiction until regulation becomes too expensive or burdensome.

All the major Canadian banks, which are federally regulated, own securities dealers that are provincially regulated. Some of them maintain separate corporate structures for their securities operations but others are attempting to integrate the securities business into the banking structure. Who exercises regulatory jurisdiction and how do you deal with this patchwork? The question of a national securities commission has been debated for the last thirty years, but nobody is prepared to give up jurisdiction.

The UNCITRAL initiative has been foreshadowed in Canadian law because Canada recently amended its bankruptcy law to provide recognition of foreign insolvency proceedings, access to courts and judicial cooperation. This came about because INSOL people are working with the Canadian government. Canada has taken a minimalist approach: basic, bare relief but a foreign representative can have easy access to Canadian courts. You can choose your judge in many of the jurisdictions in Canada, which is a concept that I believe is unknown in most of the world. A foreign representative does not surrender to the jurisdiction by coming into the Canadian courts, and stays of proceedings are available. Canada is very much aware of its international obligations and Canadian courts are very open and welcoming to representatives of other countries. This is true of both judges and policymakers. It is therefore a little disappointing that there are not Canadian government representatives at the conference, although the private sector is well represented. However, there are Canadian government representatives in Vienna working on the UNCITRAL initiative.

International cooperation among judges is complicated both by cultural differences and language differences. Japan is one of the major financial powers in the world, but their judges have a great deal of difficulty dealing with international concepts. Japanese businessmen and bankers all know English and several other languages because they deal in an international marketplace. The judges operate domestically and may be completely unaware of what is going on, in the outside commercial world. At the two judicial colloquia, the Japanese judge who attended asked if there were audio tapes of the discussion because he had to listen repeatedly to understand the discussion. It is difficult for Japanese judges to read up on international issues because most of the materials are in English. There is a serious communication problem with judges in non-English speaking jurisdictions but it is a real issue in a financial powerhouse like Japan.

That is why conferences like this are important. People begin by getting together to discuss ideas, problems and cultural differences. Having learned about the issues, they return home with a deeper understanding of the problems and work to strengthen the domestic legislative framework piece by piece. A common understanding can promote speedy action even if it does not produce harmonization of law. Thank you.

Questions and Comments

Question: The practical difference between financial firms and other firms is the fact that financial firms are regulated. In the European Union, the home-country-control principle governs. That is why the directive for banking insolvency provides for a different set of rules, because this principle is not consistent with ancillary proceedings.

As far as the UNCITRAL model law is concerned, the model may be very useful but the difficulty is getting it enacted. What will be the incentive to convince sovereign states to adopt such a model law? In the case of big trading companies, they take into account the commercial law in countries where they do business because sound laws contribute to a safe business climate. This is an incentive to adopt reasonable trade laws. Is there a similar mechanism whereby big international investment banks could encourage states to adopt a model financial insolvency law? If not, UNCITRAL's work may have little real effect.

Richard Gitlin: This is an interesting point because there are certain things that UNCITRAL has done—arbitration rules, model commercial laws—that have been widely adopted and widely effective, while others have not. The key to success is having government and business support, and willingness to push for change. A number of countries are anxious to have UNCITRAL model legislation because it gives them a basis upon which to proceed; without it they cannot even get started on the process of modifying their laws.

Question: Some countries only recognize foreign proceedings that have been opened in the country where a company is incorporated, not a proceeding opened in the center of main interest. As an example, Switzerland was asked by a judge in Dusseldorf, Germany to recognize a proceeding that involved an institution incorporated in the United States. After three years of proceedings, the Swiss Supreme Court ruled that while the company had its main activity in Dusseldorf, the German proceeding could not be recognized because the company was not incorporated in Germany. How does the UNCITRAL model law deal with this?

Neil Cooper: This is quite a problem: the registered office or legal seat raises a rebuttable presumption that it is the center of main interest. But it is rebuttable. The model law states that only the center of main interest is entitled to automatic relief. Discretionary relief of a similar sort may be given in other cases, but this is permissive. Both the German and the Swiss representatives to UNCITRAL, from their respective Ministries of Justice, have indicated that this is acceptable in their law.

Question: An important issue arises in extending the UNCITRAL work to financial institutions. In Europe, it is the winding-up directive, not the bankruptcy convention, that applies to credit institutions, emphasizing home control and disallowing secondary proceeding. In fact, a text was agreed but its adoption was blocked for political reasons. The result is that if a German bank goes down, German law applies throughout the European Union. Is it possible that we may miss something by trying to extend the UNCITRAL model to financial institutions, rather than applying the home law?

Neil Cooper: Whether the "unity approach" holds sway may depend on who is in the chair in Brussels at the time. The text that you have characterized as agreed was under the Belgian presidency, and the Belgians are very keen on unity. In fact, we are a long way short of being able to claim that the text in question is agreed. Unfortunately, you only have to come to the UK to see the problem of bureaucratic inefficiency of which Gordon was speaking. We had the discussion regarding the bankruptcy convention being led by the Department of Trade and the winding-up directive being led by the Treasury, and just getting the terminology of the two in line was a challenge.

Richard Gitlin: If each country would adopt a winding-up bill comparable to the UNCITRAL model law, that would make a great deal of sense. The problem with the winding-up directive is that it only applies to European countries, and it is likely that when we have a problem it will involve countries outside Europe. So unless all countries address access and cooperation with other courts, we will have half a loaf. That is the advantage of the UNCITRAL effort. Of course, it is quite different from what has been accomplished in Europe and some significant things have been accomplished there. But if we just stop with the winding-up directive, too much will be missed. We should see how we can extend it.

Comment: One of the problems with the UNCITRAL model law, as currently drafted, is that it does not tackle the problem of consistency between regulatory approach and judicial approach. This is one of the most important areas for improvement if the UNCITRAL law is to work for financial institutions, where regulatory influence is very important. This does not necessarily imply adopting the single entity approach, because there are also a variety of regulatory approaches on this point. In the European Union we have home-country control but this is not the case for most of the countries which will apply the UNCITRAL law. If consistency can be provided, this will be a big step towards application of the model law in the financial sector.

Richard Gitlin: Banks and insurance companies were left out of the current model law by design, in the interest of getting something adopted. Even so, it has been two and a half years since the effort began and it has been the fastest proposed law that has ever gone through UNCITRAL. The plan was then to come to a group like this and seek your advice on how to reconcile the regulatory issues with the bill that was agreed. So now we can take that next step.

Comment: Returning to Andrea’s opening presentation, no one in this room would doubt that the collection and diffusion of good information is crucial to achieving a sensible rescue or workout for a financial institution. The thought that resolving the next Barings or BCCI, and it will certainly come, will depend on personal relationships is frankly horrifying. Now personal relationships are wonderful, but the thought that saving or selling a major global financial institution would depend on a regulator getting on with the wife or husband of his or her counterpart in another jurisdiction is just not good enough. What we have not heard from UNCITRAL, or indeed from any of the regulators, is what they plan to do about formalizing a permitted flow of information, not just among regulators but between regulators and administrators, liquidators, trustees—whatever the right word is in each jurisdiction. That is the sort of thing that the UNCITRAL model law and the regulators should be addressing: a formalized method of getting the right information to the right parties quickly.

Neil Cooper: The model law does provide for that, but only after there has been an appointment. One of the things that we need to discuss is how you can have that discussion and that exchange of information pre-appointment.

Gordon Marantz: It is a very slow process, because we first organized a meeting of the solvency regulators in Vancouver in 1989. They have now established an institutional relationship; they formed their own group; they have a newsletter; they meet regularly; and they deal with insolvency generally. The same thing happens with some regulatory bodies but it should be happening on a broader basis.

Andrea Corcoran: It should also be noted that the International Organization of Securities Commissions has an ongoing project to specify the types of information that each regulator should make available for particular types of market events. That having been said, there is still the problem that many jurisdictions have to amend their privacy and other blocking and secrecy laws in order to permit the flow of that information to the appropriate recipients. It is not too hard, generally speaking, to pass information between regulators, but it is much more difficult to give information to someone other than a regulator, prior to the commencement of a proceeding or in a proceeding to which the regulator is not a party. IOSCO is also conducting an assessment of every country that signed an information-sharing arrangement to make sure that they can actually provide the information that they have committed to share. So there is movement in this area but the problem is always the same: national law, international problems.

Richard Gitlin: One final comment: within this room are two groups of people, insolvency practitioners and financial regulators, who are probably the best in the world at solving crises. That is what we do, and I suspect that there are not many groups that are better at it. But I hope this discussion makes clear that we need better tools. It is not enough to rely on our experience or our inherent talent because things are a little more complicated than that and the risks are great. I hope that following this conference, everyone will take a careful look at the recommendations in the report, and see what more can be accomplished. Thank you very much.

III. Role of Industry in Dealing with Insolvency

Moderator: John Walsh
Panelists: Jeffrey Golden, Partner, Allen & Overy
Richard Rosenthal, Executive Director, Morgan Stanley
Stephen Case, Partner, Davis Polk & Wardwell

John Walsh

In deciding how to approach this panel, our goal was clearly to focus on the role of financial institutions themselves in dealing with insolvency. The earlier title for the program in the draft program, "The Role of Industry: Making the System Safe for Failure," was a bit flippant but may have made the point more clearly. And the point is that there is a critical role for the financial industry first in preventing insolvency and then in dealing with its effects because the reward they will reap by being prepared for the worst is self-preservation.

In pursuit of survival, the study group report proposes that financial institutions assume a substantial burden of paperwork and information-keeping, in particular form, detail and location so that it is readily available. This implies a potentially high cost to prepare and store information that may be of limited relevance to the manager of a going concern. A manager's concern is to gather and store information necessary to the pursuit of their business, not information that will permit others to deal easily with their portfolio in the event of their own failure—which is perhaps the darkest view of what is being requested. So this panel has to address issues of cost and utility: are the recommendations sensible, likely to be cost-effective, and of sufficient benefit to the system to justify the costs involved.

Before our panelists begin, I am informed by Stephen Case that the U.S. National Bankruptcy Review Commission, of which he is a member, is having its conference this week in Washington. He had to take leave of that meeting to come here, just as Neil Cooper has taken leave from the UNCITRAL session to attend our conference. So this is clearly the week of insolvency discussions around the world.

Jeffrey Golden

You have come here this afternoon to hear from experts on insolvency. My favorite definition of an expert is someone from out of town with slides. So although I do not really qualify as an expert, I am going to show a few slides and hope that those and, London being my adopted home, my New Jersey accent will get me through. My topic is the role of master agreements and their relevance in an insolvency proceeding, beginning with the general, moving to the specific, then taking a detour (some may think to outer space), and finishing firmly grounded in the reality of the Barings experience.

In general terms, are master agreements a good thing? Is having two of them twice as good, or half as good, as having one? We offer an introductory course for the new members of our derivatives group called: "How to succeed at a derivatives cocktail party without really trying." As a quick start to their practice, I give the newcomers a few one-liners that they can drop at a cocktail party to sound very knowledgeable about derivatives. Some of the one-liners are very topical and change from year to year, but the last one always stays the same. That last one is just one word: netting. If all else fails and you can remember nothing else intelligent to say, whatever the question, mention netting. You will either be making a profound statement, or you will leave your audience thinking you made one as they struggle to see how the concept of netting fits the situation.

The effectiveness and economy of master agreements boils down to that one concept, netting. And much of the statutory support for netting that has been introduced in recent years requires a master agreement. So are two twice as good, or should I put all of my eggs in one basket, so to speak? A couple of years ago, this subject was reviewed very intelligently in an article by Stephen Greene, General Counsel of the Credit Suisse Group. He argued that proliferating master agreements waste time and money; create a backlog of paperwork; and divert attention from other important tasks. They may even increase risk and increase capital costs. He characterized the problem as Multiple Agreement Disorder, or “MAD”. As you know, in its July 1993 report on derivatives, the G-30 study group came out in the same place, encouraging the maximum use of one standard contract for the broadest range of transactions. Since that report, others, like the International Chamber of Commerce, have reiterated that advice.

Moving to the specific, we have the ISDA contract. It looks complicated but it is really quite simple. It has what we would describe as a modular architecture. The core agreement has a number of terms and provisions that apply across the broader relationship between the parties, including a number of credit-sensitive terms and the netting provisions. Beyond the core agreement, there are product-specific modules which are added as needed.

To illustrate with a relatively straightforward example, if a bank wants to enter into a commodity-derivatives trade with a small oil company, it would send the customer a booklet of terms and provisions on commodity derivatives in which the customer would see familiar price sources and other common terms. In addition, the bank would send the core master agreement. The first time a trade is done, the short-form confirmation for that trade would literally be stapled to the back of the master agreement. And, at that moment, the agreement would represent a stand-alone agreement for that trade. As more trades take place, more confirmations would be stapled to the agreement. As long as the trades were restricted to the commodity-derivative universe, this would be in effect a single-product master agreement.

Suppose along the way that same customer gets involved in an international transaction that creates foreign-exchange exposure, and the customer wants to hedge that risk. Again, the bank would head to the shelf of product-specific documentation, pull out FX and currency-option definitions and send those to the customer along with the trade confirmation. That confirmation could again be stapled to the back of the master agreement, creating a multi-product master agreement. Thus the document can evolve and expand as the parties’ relationship evolves and expands. That is the first point I would like to make about the ISDA contract.

The second point is that the ISDA contract is a sophisticated document to which literally hundreds of lawyers around the globe have added value over a relatively long period of time. And therein lies a dilemma, because when I get a report card like Recommendation 12, I feel rather like the fellow who entered his poodle in the dog show and won the blue ribbon for the Alsatians. (Recommendation 12 states: "Just as widespread use of master agreements for over-the-counter transactions has standardized contract terms and enforceability of netting, netting should be extended across agreements, ultimately through development of a single master agreement covering many different products.") While reluctant to give back a blue ribbon, I feel that I should give it back and say: "I don't know that I deserve this blue ribbon but there's another one I might be eligible for." But that is my reaction.

The problem arises from the fact that invariably when a question is asked in its broadest, most general, sense, there is often an easier question that could be asked. The questions should not be: Are master agreements helpful in all cases? Are all master agreements fungible? Do they all work for the purposes we are trying to achieve? Instead, the real question is whether my ISDA master agreement is helpful for the particular purpose which we are attempting to achieve in this case? That is the basis on which we collect counsel opinions in support of the netting provisions. And that is my jumping off point as I head off into outer space. So either buckle your seat belts or take a nap, whichever suits you.

There are two linchpins of the ISDA contract: "single agreement" theory on the one hand, "flawed asset" theory on the other. The language of Section 1(c) of the ISDA contract is literally one sentence long and, to my mind, may well be the single most important sentence in the contract. This sentence states that the relationship of the parties to the contract is one seamless web, one ball of wax, and that they would not have entered into the trades that are covered but for their being treated in that way. There is a metaphor for this type of contract that is well known to residents of Manhattan, which I was while practicing law on Wall Street. When you live in Manhattan, you come to know an awful lot about cockroaches and a device designed to rid yourself of a cockroach problem known as a Roach Motel. The advertisement for it says: "The roaches check in, but they don't check out." Well, we call this contract a "Swaps Motel." The swaps check in, but don't check out. When they go into that contract, in a sense they dissolve a bit. However the trades were marketed or were thought about until then, when they go into that contract they dissolve, or at least they absorb and take on an awful lot of baggage.

There are, for example, fourteen provisions that apply to all trades under the ISDA master agreement, everything from non-transferability to netting, many of which would not apply if those trades stood on their own or were done outside the umbrella of the contract. One piece of baggage that those trades carry is conditionality: the obligations in respect of those trades are conditional. Make a loan, and the debt arises when that loan is made. Enter into these trades, and no debt arises until the relevant conditions are satisfied.

Where does that leave us? Well, we know that netting works as a matter of English law. It should soon be possible to open the Guinness Book of World Records and find the Financial Law Panel there because the Financial Law Panel got 23 law firms in the City of London to agree about something: that netting works as a matter of English law. They not only agreed about it, but put their names to a piece of paper. And indeed some of the opinions expressed have gone a bit further than the opinions that ISDA has submitted to the regulators on this matter.

The opinions say that prior to insolvency, the close-out arrangements in the contract would be enforceable. They would be enforceable in accordance with the principle that sophisticated parties have the freedom to agree to such terms. According to those opinions, following an insolvency, the receiver or the creditor's representative would not be able to cherry-pick the contract because there would be nothing to cherry-pick. The contract is just one lump sum. In fact, it is the insolvency that crystallizes that lump sum in the first place. The lump sum may be measured hypothetically by reference to trades like the trades entered into as part of that relationship, and the ISDA contract also contemplated that, that lump sum could be a quotation obtained from the marketplace in respect of the portfolio taken as a whole, or the relationship taken as a whole. In any event, the lump sum provides nothing to set off. Arguably, set off has little to do with the ISDA master agreement unless the parties choose as an optional feature to provide for set off and formally reach out beyond their agreement to other trading relationships that they may have.

The opinions acknowledge that, even if a court were to quarrel with this "flawed asset" theory of the contract, it does not matter so much because the underlying law in England would favor set off anyway. If for some reason these trades had been entered into outside the contract, in an insolvency the "mandatorily applicable" rules would achieve a similar result. But the opinions see all of that as a fall-back position. You will have seen from my handout that a leading Queen's Counsel, Jonathan Sumption, has viewed the contract in just that light.

Finally, I would like to comment on Barings. There are a number of lessons from Barings, and in my handout I have highlighted five. Since some of the speakers that follow me will certainly touch on some of these points, I would really just like to mention two that are particularly relevant to my theme. The first falls under the heading: "Thank goodness for standardization." As history has shown, writing a better contract does not prevent a Barings—or a Drexel or a BCCI, for that matter. However, standardization may make it easier to find a white knight. It may make it easier to evaluate and come to grips with a derivatives portfolio of a troubled market participant.

The challenge that confronted the marketplace on the weekend of February 25-26, 1995 might have been overwhelming, but I was impressed that, before the weekend was over, a number of my clients had already assessed their worldwide over-the-counter derivatives exposure to Barings. On Monday morning, action in accordance with the contract was being taken in a reasonably orderly way. There was no financial meltdown, no excessive panic, although a lot of hard work was required to be sure. That was lesson number one.

Lesson number two was the value of the ISDA contract, in particular. Following Barings, we saw a renewed interest in the potential of the so-called multi-product master agreement. At the time of the failure, there was a debate raging over the relative merits of product-specific documentation on the one hand and multi-product masters on the other. Certain regulators had expressed concern, perhaps understandable concern, about the notion of putting all your eggs in one basket—the approach that the multi-product master seemed to contemplate. There was internal politics associated with different desks at the financial institutions—the foreign exchange desk, the fixed-income desk—each having its own master agreement. That certainly fanned the flames of the debate. But it was clear that the debate would become far different when what Mr. Greene characterized as Multiple Agreement Disorder actually cost somebody money. We probably got there with Barings.

We got there, first, as a result of the inability as a matter of law to set off as between master agreements. Remember, Barings was not an insolvency but an administration. Therefore, the mandatory rules on set off did not kick in. In addition, you had the direct costs and simple practicalities associated with administering more than one contract. In any event, it is fair to say that, as they evaluated their portfolios, parties benefitted from the certainty of their position under the ISDA contract, certainty that flowed in no small part from the detail in it. While I heard many complaints about the ISDA contract in the run up to Barings, no one complained during that week that the ISDA contract was too long or too complicated. At that point, we could not have had too long or too detailed a contract. People took tremendous comfort from the guidance provided about what steps were required, the order in which they were to be taken, and the like.

With some of the other, non-ISDA contracts, we frankly had difficulty because we were in a more ambiguous position. In some cases, it was uncertain whether we had had the necessary triggering event of default. This was unclear because in some cases the distinction between administration and insolvency had been missed. In other cases, the waiting periods contemplated left players agonizing over whether they faced a thirty-day cooling-off period before they could proceed. In some cases it was difficult to say whether things happened automatically, whether you should sit back and let things run their course or not, whether notices were required and, if so, what the content of those notices should be. Certainly the attempt by some sponsors to effectively legislate the terms of the agreement, to dictate the terms in a domestic market, were quite simply a disaster.

If a trade is negotiated by telephone from Frankfurt with a counterparty in London, is the contract *in* London for those purposes? If I have negotiated that trade in London with my counterparty but I booked that trade in the head office in Frankfurt or where have you, am I *in* London for those purposes? That book-of-the-month club or literary guild approach to contracts, in which if you fail to shout "no" you have bought the book, just does not work for a sophisticated global financial marketplace.

In summary, it would be easy to underestimate the importance of master agreements in addressing the tricky issues that can arise in a cross-border insolvency.

Richard Rosenthal

My mission in today's discussion is to focus on Recommendation 7: "As part of sound credit-risk management, international financial firms should monitor, measure and manage all sizable exposures by legal entity, form of documentation, and law of jurisdiction." This would appear to be a *sine qua non* for any credit-risk management system. As the discussion draft states, when a financial institution fails, the parent may or may not be insolvent, and the insolvency may well affect only some of the subsidiaries. Firms may have the most sophisticated, state-of-the-art risk management systems, which can simulate hundreds of potential risk and loss scenarios, but when the music stops, meaning an insolvency has occurred, the probability of an insolvency for the affected entities is now 100%. Firms must then be able to establish what the extent of their exposures are.

It should therefore, come as no great surprise to anyone here today that there was uniform support for this recommendation from commentators around the world. One might go so far as to suggest that this recommendation is so sensible that nothing more needs to be said about it today, and we really should move on to discuss other topics. Well, I hope that by the end of my presentation you will agree that this is not so simple and straightforward, and the more you think about this recommendation, the more you realize how complicated the underlying issues are.

Let us set the scene by focusing on four questions. The first question is: do firms have this information in a usable format and, if not, what will it take to get there? The second is: while it is clear that the information is needed when an insolvency occurs in order to determine legal and financial exposure, does a firm need this information in this format to operate its credit risk management system? The third question is really the flip-side of the second: are there other categories of information that are required for an effective and robust credit management system? And the fourth question goes to the question of industry standards. The recommendation suggests that industry standards are required for the detailed monitoring of credit exposures. Do we agree with this proposition? How would we establish these standards? What are the costs? There are many competing demands on technology resources today: the millennium project, EMU, etc. So it is critical to consider the costs and benefits.

This first question - do firms have this information in a usable format, and what does it take to get there - recognizes that the financial services industry has not had a stellar track record in terms of properly identifying risks and exposures and documenting them in an organized fashion. The disasters that have arisen in the financial services industry, coupled with the mass scrambling by firms to respond to these crises, underscores the importance of this recommendation. If you speak to people in the industry, you will find that in some areas of business, there has been a total lack of documentation save for contract notes or confirmations. In other areas there is documentation but it has not been maintained in an organized fashion. Separately, with respect to establishing counterparty exposures, firms have exhibited varying degrees of accuracy and sloppiness. A record that indicates that your counterparty was Barings was clearly not precise enough. It could obviously make a big difference if your counterparty was Barings Bank or Barings Securities or Barings Asset Management. So, one of the challenges for the industry is to ensure that transactions are properly documented, that counterparties are accurately identified, and that this information is properly organized into a database.

I am happy to report that the industry has made great progress, in my view, over the last couple of years in understanding the seriousness of this problem and becoming more attentive to it. I would echo Jeff's tribute to the financial industry that by Sunday night, most firms had established what the order of magnitude of their exposures to Barings was. On the other hand, it is also clear when speaking to people in the industry and their advisors that there is still a lot of ground to make up.

Moving to the next level of analysis, it is also important to be aware that just having this information by legal entity and type of documentation is not the end of the story. The information is not self-executing into a risk management system. A mechanism is required that can take this information and analyze what your underlying exposures are. For example, if you have executed an ISDA master agreement with an insurance company governed by Italian law, you obviously need to determine whether netting is enforceable in Italy today and reflect that analysis in your system. If the answer is maybe, how should that be reflected in your system? Moreover, if the analysis changes based on a new law or a new court decision, the system has to be capable of reflecting that new analysis. This is not a straightforward process.

Ideally, risk management systems must have the ability to 'translate' document terms and assess enforceability issues within the context of their databases. But this is obviously a difficult endeavor, and achieving nirvana is clearly a complex and expensive proposition. To quote one of the respondents to the study: "the literal application of this recommendation, while novel in theory, is an impractical objective due to the complexities involved."

Moving to the second question, let me reiterate that few would dispute that this information would be useful to have and, in the event of an insolvency, absolutely critical to establishing your actual exposures. But to spark some debate, let me ask whether, from a credit-risk- management point of view, this information is needed to the degree that is suggested. For example, if you had exposure information on an aggregate basis, and ignored legal entities and documentation on an individual basis, you could still take a cut, and perhaps a more conservative cut, at what your potential exposures are.

So, for example, to be overly simplistic, if you could determine that you had a $3 million exposure to Barings entities in the aggregate, how important would it be to establish your precise exposures to the individual Barings entities? You have determined your worst-case exposure to Barings at $3 million for credit risk management purposes. Obviously this analysis would not be as precise as the approach suggested by the recommendation, but given the cost of compiling information to the level of detail suggested, is this perhaps an acceptable alternative - once again recognizing that there are obviously distinct advantages to achieving a finer risk assessment of your positions by legal entity and by form of documentation.

As another alternative, again being mindful of the complexities and costs, should firms make distinctions in their record-keeping based on the significance of their potential exposures?

The recommendation itself suggests that firms should embrace this detailed monitoring for all sizable exposures. Well, what is a sizable exposure and how do you build a system that captures trade data and information relating to the underlying documentation for only significant exposures? These are difficult questions in and of themselves, but I also raise them for consideration in the context of the fourth question, when we ask whether industry standards are really feasible at the end of the day.

Moving to my third question, the flip-side of question two, does Recommendation 7 really go far enough? Many in the room could probably think of other types of information that they would like to include in their ideal database. For example, you would certainly want to incorporate information about credit enhancements, such as collateral or guarantees, to fully evaluate your exposure. Moreover, you would want to be able to test the ripple effects of an insolvency, that is to say, the broader ramifications of an insolvency on other counterparties or the financial system itself? This would obviously require the data to be sensitive to geographic or industry-specific concentrations. If one bank in a country becomes insolvent, would that trigger other insolvencies in that sector? Also, in an ideal world, a firm would want to have the capability to use the information compiled by entity to assess exposures to various groupings across and within a holding company and not just on a single entity-by-entity basis.

Finally, moving on to question four, it would not be difficult to agree that internationally active firms must have systems and controls that monitor credit exposure in sufficient detail. But are new industry standards, as the recommendation proposes, feasible, or even appropriate? Moreover, who would have the responsibility for developing these standards and monitoring compliance with them? What role should the regulators play? This aspect of the recommendation raises the greatest number of questions and concerns in my mind. We could probably spend the rest of today discussing this particular area and still not develop a consensus.

In conclusion, let me state that I heartily support Recommendation 7. Financial institutions should establish, or rapidly move toward the establishment of, robust credit-risk management systems that can measure, monitor and manage exposures by legal entity, form of documentation and law of jurisdiction. These systems should also be able to assess the impact of credit enhancements, as well as enable a firm to manipulate the data in order to run various scenarios within a counterparty group, as well as across an industry or geographic region. International financial firms must achieve this result, and I believe regulators must foster and insist upon this outcome. However, I am not sure that it is feasible or even appropriate to insist on industry standards. I do believe that it is helpful to have guiding principles, and that industry-wide discussions, like the ones today, are extremely helpful to achieving that objective.

Stephen Case

Before beginning my presentation, I would like to underscore one of the points Rich made and redirect his question to all those who participated in the Barings case. If there had been perfect information, with exposures recorded by legal entity of all Barings entities and all counterparties, would it have been possible for supervisors to establish over the weekend that there were problems only at the

Barings operation in Singapore and at the London entity that provided the financing? Would it have been possible to declare those two insolvent, localize the declaration of failure, and let the other operations go on trading in the normal way? It seems to me that if making that level of detailed information readily accessible would not have limited the number of insolvencies in the Barings group, then it may not be cost effective to bother to do it.

As I stood back and thought about what the industry should do about insolvency, four major questions came to mind. One, how does one minimize the risk of insolvency at one's own firm? Two, how does one minimize the risk faced as the result of a counterparty failure? Three, what do you do when your own firm goes belly up? And four, what do you do when you learn that someone else has failed?

I will answer question three first. When you find that your firm has gone belly up, I guess you utter a curse, say a prayer, and restrain yourself from jumping out the window—unless you are the perpetrator of a fraud, in which case, you look for the nearest jurisdiction that will not extradite you for criminal prosecution. As for question one, minimizing one's own risk of failure is the artful science of successful management of financial intermediation. All that I can offer are lessons learned through my service as outside lawyer in some unhappy situations.

For instance, I have two observations about adequacy of documentation. Years ago, there was an article in *The American Banker* about an internal study of bad loans in its portfolio by the First National Bank of Chicago. Their goal was to try to find the magic litmus test to identify a bad loan before it was made. While they found none, the most significant correlation they found was between bad loans and inadequate documentation.

My experience, both in preparing loan documents and dealing with them after a loan went bad, is that loan documents themselves are almost always irrelevant after a default occurs. The existence of default is indisputable; the representations and warranties are irrelevant; the covenants do not matter any more. Sometimes the wording of the granting clauses for the security are important, but not often. So why have loan documentation?

The real value is in the loan documentation process itself, in the way deals are changed or ended, because the process is a memorialization of a careful analysis of the transaction by the lending bank. The parties sit at the table working out the details of a deal, having invested a lot of time in it already, and they come to some representation or warranty that the borrower cannot make. The banker decides that he cannot make the loan unless the representation is true, and disaster is averted at that stage. So while loan documentation is expensive, difficult and time consuming, I would argue that it should not be viewed as mere paperwork. It is the outward and visible sign of a thoroughly analyzed transaction. I think the lesson of the First of Chicago study is that there is a lower failure rate with thoroughly analyzed transactions, which is to say, with well documented transactions.

The other important issue with documentation is whether it is really a binding document. In the United States in the 1930's , there were a lot of smaller banks in the West that made loans to mining companies with a guarantee by the company's stockholders. When the mining company failed and the bank failed, the receiver of the bank would sue the principals for liability under their guarantee. In some cases, the guarantors contended that the guarantee could not be enforced against them because they had an oral agreement with the bank officer that the guarantee would not be enforced. In 1942, this issue reached the United States Supreme Court in a famous case with the ominous title D'Oench, Duhme—that is a name, not d-o-o-m. The Court declared that unless an agreement was in writing and properly authorized, it was not binding. In this case, that meant that the Federal receiver of the bank could collect on the guarantee. This has now been codified in 12 US Code, Section 1823E, and it is very clear and precise. It says that no agreement is binding against a bank unless it is in writing and authorized by the board of directors, and that the particular officer who signed it had power to bind the bank.

This means that we can have a wonderful ISDA agreement, but if the counterparty to the agreement is a bank which has failed, and the proper diligence was not done to determine that the officer who signed for the bank was authorized to do so, it is distinctly possible that the Federal Deposit Insurance Corporation as receiver of the failed bank will argue that the agreement was not binding on the bank. That is another feature of the nitty gritty of analyzing and documenting a transaction.

Another lesson of Barings for avoiding failure, that has not been mentioned by the other panelists, is the importance of separating trading functions and traders from the personnel who handle the back office functions. In the various reports on the Barings failure, the single, most obvious management failure was allowing Mr.

Leeson to do the trades, supervise the back office, post his own trades and hide his losses. The related lesson from Barings is how banks should purchase office furniture. Perhaps it should be a worldwide rule that traders cannot have desks with drawers, so they have no place to hide their tickets or losses. In the Franklin National Bank failure in the 1970s, losses were traced in large part to foreign exchange traders who simply put bad tickets in the desk to avoid having their supervisors see them.

Then there is the issue which Rich Rosenthal has addressed about careful credit analysis and careful measurement of the size of exposure. It is desirable and beneficial to know the size of one's exposure, but it is also important to know to whom you are lending. Twenty-five years ago there were significant losses on offshore commercial paper taken by investors in New York. After the failure had been recognized and the losses taken, the press reported that the US Steel and Carnegie Pension Fund, a highly respected investor, had been the initial purchaser of this paper in the United States. Fifty other equally good names had bought it without doing any credit analysis of their own, concluding simply that since a leading, prestigious investor had bought it, it must be okay. There is no substitute for rolling up one's sleeves and doing good credit analysis.

Now switching to the second question, what can be done to minimize one's own risk from counterparty failure? Some steps I have already mentioned: good credit analysis, careful documentation, due diligence to be assured that agreements are binding. Another area is credit enhancement, particularly collateralization. There is a clear danger that what is purported to be collateralized is not collateralized. In the United States, a security interest is not binding against the trustee in bankruptcy of a failed institution unless it has been perfected. Most judges are quite literal: "perfected" means perfect. If the collateral is misdescribed, or if certificated securities are not in the possession of the secure party, what has been booked as a safe, secure, collateralized exposure may turn out to be an unsecured exposure. The time and expense in dotting i's and crossing t's to achieve accuracy in collateralization is tiresome. But it really matters and can save millions of dollars in losses if its properly done.

Turning to the third question, what do you do in your institution when somebody else goes belly-up? I will offer one war story to illustrate a problem that I have seen several times with daylight exposure. An industrial complex files Chapter 11 at 8:30 in the morning. It announces the filing and informs its bank: "Shut down the commercial paper." Its bank had been in the habit of remitting payments on commercial paper at the opening of business and charging the customer's account at the end of the day. Word of the filing did not reach the back office soon enough and tens of million of dollars were paid on the commercial paper, which the bank would have great difficulty and long delay getting back from its customer. Based on discussion with the audience this morning, the management of a large financial services corporation faces an extremely difficult challenge to make the shut-down decision and get word to all the right places before funds are remitted. But one way to minimize risk might be to run a fire drill in the institution to establish a way to turn off the payments before a loss is incurred.

In the study group, we had an interesting discussion about cross-legal-entity settlers. As an example, suppose a respected name like Lloyd's Bank owed Barings Germany 90 units of currency and was owed 100 by Barings Singapore. Barings Singapore fails. Under conventional law of set-off Lloyd's Bank would not be permitted to set off the 90 due to Barings Germany against the 100 due from Barings Singapore. If the laws were changed, or hypothetical contracts were devised, to permit set-off, that would be nice for Lloyd's Bank but think about the problems it would cause for people who had relied on a separate credit of Barings Germany. Failure to receive the 90 units of currency would have to be recorded as a surprise loss to capital on their balance sheet. In consideration of the problems this would cause and the adverse effect on local collateralizations, the study group backed away from recommending mass-netting across a whole group of affiliated entities.

Recommendation 10 in the discussion draft talks about the separation of house and client funds. My observation is that while that seems like a good idea, it is not actually practiced very much today. It would be expensive and undesirable if it were really enforced. Banks keep reserve accounts at central banks but I do not think securities firms are required to segregate free credit balances in customer's accounts. To massively require segregation of cash because a customer has a claim on it raises the question of what will be done to invest it. Does it have to be put in low yielding funds, low yielding instruments and deprive the customer of good yield or deprive the house of the float and the use of the working capital? Those are the sorts of issues in my mind with pre-insolvency segregation of funds.

Post-insolvency segregation is a slightly different issue. The American Securities Investor Protection Act provides this scenario: After a securities firm or registered broker-dealer fails, a trustee is sent in to collects all the assets. The trustee finds 100,000 shares of IBM in-house and claims totalling 150,000 shares of IBM. He uses what he finds to satisfy the retail customer first and then, if there is a shortfall, the insurance fund will be tapped to cover every account up to $500,000 of value. But that kind of customer priority is quite different from very difficult and rigorous pre-insolvency segregation of customer assets.

The Recommendation 14 of the study group report talks about record-keeping to permit quick sale of a portfolio. I also think that this would probably be difficult to implement. Certainly if I were to decide to put my house on the market tomorrow, it might take a week or two for my wife and me to get it cleaned up so we would feel comfortable showing it to people. Similarly, it is quite idealistic and not terribly practical to think that a busy securities house or commercial bank with a trading operation should always have the "bread in the oven" and the papers cleaned off the desk so that somebody could walk in an buy the property without having to clean it up. Finally, although it is not addressed in the report, I think that it needs to be said that whatever can be done in world markets to decrease the lapse of time between trade dates and settlement dates is certainly desirable as a means to reduce risk. Thank you.

Comments and Questions

Comment by Ernest Patrikis: On the matter of using a single agreement, I have noted that people may have an ISDA agreement and other agreements with the same terms. They go to their law firm for an opinion on the agreements and are told that one is enforceable for netting while the other is not. In that case, perhaps it is good to have multiple agreements to be able to flesh out what the differences in them are—other than attorney incompetence!

On the same point, why is it good to put everything in a single agreement? What if that agreement is truly defective? Isn't that really concentration risk? What if the wrong person signed the agreement? What if it lacks a separability clause and you are doing equity derivatives and they are determined to be illegal, or doing a transaction in a country where it is illegal? Do you have a problem with the whole contract? Or does this mean that regulators and supervisors should scrutinize these deals even more closely than they do today, because of concentration risk which is not a good thing?

Cross-default in affiliates: if a bank is in the money and its affiliate is out of the money, and there is an agreement that would have the bank offset its in-the-money with the out-of-the-money positions, we as bank supervisors would say that was an extension of credit to the affiliate. That would fall within our regimes relating to extensions of credit. There are reasons why someone might say it is either unsafe, unsound, or needs to be subjected to the regime that separates banks from other affiliates.

Finally, while we spend a great deal of time and effort on master agreements, or master- master agreements, we have not addressed the issue of a jurisdiction where the trader doing a trade over the telephone has the right, notwithstanding the agreement, to amend the terms of the agreement. That is the law in some jurisdictions, maybe even the one in which we are located. What effect does that have? Do we have to listen to the phone tapes in order to decide whether all the work done on this wonderful master agreement is really any good?

Jeffrey Golden: Lawyers, like masters agreements, are not fungible in all cases, so it is pretty hard to pass judgement on whether all the lawyers who are asked to opine on these issues have got it right. But in defense of some who may appear to be splitting hairs, there is no escaping the fact that we can reach a different opinion on the same agreement because of local law. Moving from jurisdiction to jurisdiction globally, you may find more or less support for US or English law governed master agreements. Because the details of local law are so important, it has been an excellent exercise to do a sort of world bankruptcy tour collecting opinions. All that I am advocating is that those opinions should be read carefully, because a lot of intelligence has gone into them and a lot of guidance has come out of them as to what works and what does not.

As to concentration of risk, Ernie has raised some important issues that highlight the importance of diligence in the process, working to get it right. But it does not logically follow, even if some legal practice has been slipshod, that the fact that there are two contracts halves the problem so much as that it means there may simply be problems in two places rather than one. I am saying that, as a matter of legal theory, it muddies the waters to view these contracts in one sense as “multi-product” masters because what is emerging from the ISDA-agreement framework is something more homogeneous than that. That theory needs to be tested in a whole host of jurisdictions. While the risks that Ernie has identified are risks worth keeping in mind, I am not convinced that there is an obvious choice between electing one agreement or two. I guess I would vote that if one agreement is better than another, risk should be concentrated in the better agreement.

Question: In this day and age when traders' conversations are always recorded, what is the thinking at ISDA about the danger that oral modifications to the master agreement may occur in connection with a trade?

Jeffrey Golden: This is another issue on which you may get a different reading of what works and what does not in different jurisdictions. At least from an evidentiary point of view, there may be no escaping that the outcome will depend on who the parties are and the backup that they maintain for these trading activities, since the ability to prove the terms of a trade may vary from one party to another.

Richard Rosenthal: As the documentation standards in the industry improve, fewer of these issues or problems arise. It is not only a matter of oral amendment of contracts, but historically you had salesmen who could not resist following up a complicated derivatives trade with a letter to a client that inaccurately replicated a formula, getting a parentheses or bracket wrong, thereby producing a much different financial and economic impact than the original transaction. As firms have tightened sales standards and established documentation groups to act as gatekeepers on negotiation of these agreements, that has helped to reduce these types of issues.

I would add one other point that I believe Ernie referred to this morning. Assembling this binder of netting opinions was a significant exercise and a Herculean undertaking. But I think a number of firms just took the binder in hand and assumed that netting is therefore enforceable in 23 jurisdictions, without reading the opinions or realizing that there are netting issues in various jurisdictions. This goes back to the whole issue of information in risk management systems. Firms have assembled these netting opinions but you have to do more than write down that we have netting opinions in 23 jurisdictions. You have to reflect on them and their implications.

John Walsh: In a recent survey of large institutions, the Group of Thirty asked about the reliability of netting and there were literally three countries that were routinely cited as offering fully enforceable netting. Since the goal of netting is to limit net credit and reduce risk, reliability of netting is obviously a key consideration. Getting to Ernie's point, if confidence in netting is this limited, it does create the potential for some geographic concentration—although I do not think that any of our commentators viewed netting per se as an extension of credit or source of concentration, much to the contrary.

Stephen Case: One other point I would add is that, while documentation obviously provides an important discipline within an organization, once there is an insolvency, actually establishing that the transactions with the insolvent party have been documented is a low priority. Often there is not going to be an actual adjudication to determine whether those documents were enforceable or not. Much more important is to have a document that purports to be enforceable, that enables me to understand what my exposure is to the insolvent firm, rather than leaving it to serendipity to determine my actual financial and legal position.

Richard Rosenthal: I would like to add a point on process. The opinion-collecting exercise that I mentioned earlier has been invaluable, both in educating us to issues that arise in other jurisdictions, and in educating counsel in those jurisdictions to the collective wisdom that has been accumulated over time. This is particularly true in jurisdictions that until now have been largely out of the informational loop. This has been helpful in a variety of ways. Frequently, differences that people perceived at the outset of a discussion have become clearer as they share information. It has also enabled those lawyers to encourage adoption of new legislation and to comment usefully when legislation is adopted.

Question: One of the recommendations mentioned the hand-over of pricing models, but to what extent do you believe that potential buyers would want to use the insolvent company's pricing models instead of their own?

Richard Rosenthal: I think using the insolvent's models is certainly a helpful starting point. The more information you can gather on a firm's positions and how that firm valued those positions the further ahead you are at the outset. But at the end of the day, a firm that is seeking to purchase those positions would inevitably want to use its own models and evaluation techniques to be comfortable with the pricing.

Stephen Case: This seems rather simple. Presumably the pricing model will be on a Lotus or Excel spreadsheet. It is simply a lot easier to turn it over to the buyer and let him start playing with it on a computer than to ask the buyer to construct that spreadsheet from scratch. Using the seller's proprietary model might save two or three days of calculations, and this could make a big difference in the recovery of the seller's estate in a rapidly declining market.

IV. The Way Forward: Will We Be Ready Next Time?

Moderator: Alastair Clark
Panelists: Ricki Helfer, Chairman, Federal Deposit Insurance Corporation
Brian Quinn, Chairman, Nomura Bank International
Miguel Mancera, Governor, Banco de Mexico

Alastair Clark

This last session of the afternoon has the rather provocative title: "The Way Forward: Will We Be Ready Next Time?" This gives us a fair amount of scope to range over the issues that have been raised earlier in the day, but it also is a chance for a sort of stock-taking. In light of the experiences that we have had and the various initiatives that have been taken over the last year or two, how well placed are we to handle a future insolvency or a disruption in a major financial firm.

I have a number of points that I would like to add to the discussion but I will reserve my comments until after we hear from the members of the panel. The point I would like to mention now is that a good deal of the discussion today has revolved around the roles of three different groups: practitioners in the financial industry, lawyers in the insolvency profession, and regulators. But there is another dimension that, as you might imagine, I feel to be quite important, and that is the interest of central banks in these questions. There are two particular angles that I would mention. One is that central banks have conventionally been the lender of last resort to banks in difficulties. As central banks consider whether to provide that support, some of the questions they face are quite similar to those that we have been talking about today; in particular, deciding just exactly what the financial position of a firm is at the time it gets into difficulties.

Beyond that, my second point is that following the appointment of an administrator or an insolvency practitioner, it has sometimes been useful to have the central bank carry out certain financial transactions, to act as an intermediary, between the failed firm and the rest of the market. For example, in the Drexel case, the Bank of England helped to implement an orderly run-down of their foreign exchange exposures; and in the case of Barings, the Bank provided facilities for settlement of their securities transactions.

So both as lender of last resort and ex-post in helping with financial transactions involving a failed firm, central banks have an interest. This is in addition to the obvious regulatory interest where the central bank is the banking regulator. With those thoughts, let me turn the discussion over to our panel.

Ricki Helfer

I am delighted to have the opportunity to provide some of the history of the FDIC's involvement in these issues. When I glimpsed the Bank of England on my way here today, I was reminded just how great the contribution of that institution has been in inventing many of the financial practices that are used all around the world. We were of course a bit later in the United States in forming a central bank, about 160 years later. The one area where I believe we have led the world is that we have the oldest government-sponsored deposit-insurance system in the world.

Because I believe strong national systems for resolving failed financial institutions can make international coordination of insolvencies more effective, today I will talk about the FDIC's experience in resolving banking crises in the United States. Using these as case studies, I hope to highlight the issues associated with resolution of failed financial institutions. I will contrast our success in the banking area with another, considerably less successful, effort to deal with the Savings and Loan crisis in the same period. It is my hope that these two case studies will inform our work in developing coordinated international efforts to deal with insolvencies.

The FDIC is, of course, just one part of the safety net in the United States. We perform a function much like that of a central bank in other contexts. The Federal Reserve provides daylight overdraft protection to facilitate the payment system and discount-window lending for purposes of liquidity. We operate the deposit insurance fund.

The FDIC was created in 1933 to halt a banking crisis. In the four years before the FDIC was established, 9,000 banks or a third of the industry failed. Needless to say, the failure of one bank could create a chain reaction, and sound banks frequently failed when large numbers of depositors panicked and withdrew their deposits, creating a run on the bank. As depositors started to withdraw their accounts in amounts larger than the banks could sustain, banks suspended operations across the country and declared moratoria on bank transactions. The banking system in the US was on the verge of collapse.

It actually was not so irrational at that time for depositors to take this approach. They had learned from hard experience that if they kept their money in a bank, it might not be available when they needed it, and they might lose a portion of it when they were finally paid. As a general practice, between 1865 and 1933, before the creation of the FDIC, depositors at national and state banks were treated the same way as other creditors. They received funds from the liquidation of the bank's assets after those assets were liquidated. The time taken at the federal level to liquidate a failed bank's assets to pay depositors and close the books averaged about six years—in one case it took at least 20 years.

From 1921 to 1930, more than 1,200 banks failed and were liquidated. From those liquidations depositors at banks chartered by states received 62% of their deposits back, on average. Depositors at banks chartered at the federal level received about 58% back. Given the long delays in receiving any money and the significant reductions in deposits when banks failed, it was understandable why anxious depositors would withdraw their savings at any hint of a problem. With the wave of banking failures that began in 1929, it became widely recognized that the lack of liquidity that resulted from the process for resolving bank failures contributed significantly to the economic depression in the United States. To deal with the crisis, the US government focused on returning the financial system to stability by restoring and maintaining the confidence of depositors in the banking system. When it created the FDIC, the US Congress addressed this problem in three ways. It created an agency to insure deposits; it gave the agency bank supervision responsibilities; and it gave that agency authority to resolve failed banks. I will briefly discuss each of these.

First, the FDIC was established to insure bank deposits, initially up to $2,500. If a bank failed, its depositors were guaranteed much of their money from the government, in many instances within days. In 1934, coverage was raised to $5,000, and with that increase 45% of deposits within the banking system were covered by insurance. By providing the public with an assured source of liquidity, Federal

Deposit Insurance restored confidence in the banking system, insulated banks from runs and panics, and stabilized the financial system. The year after the FDIC was created, only nine banks failed and total deposits in the system increased by 22%.

Today we insure deposits of up to $100,000 at 11,500 institutions. With $27 billion in reserves in our Bank Insurance Fund, we cover about two-thirds of the deposits of the member banks. With just under $9 billion in reserves, our Savings Association Insurance Fund insures about 95% of the deposits of thrift institutions. Our insured institutions pay premiums based on the total amount of their insured deposits and the level of risk they represent. Their risk is measured by their capital level and the supervisory ratings they receive from bank examinations.

Second, when it was created, the FDIC was required to supervise state-chartered banks that were not members of the Federal Reserve system. Today, that is just over 6,300 banks. Without a strong supervisory system, which in the United States includes three federal bank regulators and a fourth for thrift institutions, granting insurance on deposits would be an even riskier business for the guarantor of the deposit insurance system, which is the US government.

Third, the FDIC acts as a receiver responsible for resolving the potential failure of all 11,500 insured institutions. It has extraordinary powers as receiver, which enable it to act quickly when a bank fails. These powers were enhanced during 1989 in the midst of our recent banking crisis. Aside from the D'Oench-Duhme doctrine we talked about earlier, which allows us to disavow an obligation of a bank if it is not entered into appropriately with written documentation in the records of the banks, in many instances we can also disavow legal contracts. We have to pay damages if we choose to do that, but we can choose to disavow legal contracts.

We do not have to return to the 1930's for evidence that the FDIC's ability to act quickly stabilizes the banking system during times of crisis. In 1991, just six years ago, *The New York Times* described events when the Bank of New England, a large regional bank, was failing. I quote: "Frantic depositors pulled nearly one billion dollars out of the bank in two days. Small savers trooped through the lobbies with their money in wallets, bulging envelopes and briefcases, and money managers yanked out multi-million dollar deposits by remote control with computer and telex orders." Yet *The Times* concluded that the panic ended as soon as Washington stepped in and the Federal Deposit Insurance Corporation took over the bank.

The Bank of New England case underscores how rapidly public confidence in a financial institution can evaporate. It also underscores the importance of having a bank regulatory authority that can move quickly to address a bank failure. Bank of New England customers had doubts about their bank, but the doubts were not contagious. A run on the Bank of New England did not become a general banking panic. Depositors at other banks did not demand their funds despite the fact that nearly 1,200 banks had already failed in the United States in the ten years leading up to the Bank of New England's failure.

It is useful to look more closely at the nature of the FDIC's role as receiver to see how important it is in promoting liquidity after bank failures; to examine some of the lessons learned from our recent crisis; and to see why a special approach to resolving bank failures is better than handling them through bankruptcy proceedings. In the FDIC's role as receiver, we generally use one of three techniques in resolving a bank failure.

The first technique permits the FDIC to pay depositors their insured deposits using money from insurance reserves; liquidate the failed institution's assets; and replenish the insurance funds with the proceeds. Typically when using this technique, the FDIC issues checks to depositors for the amount of their insured deposits within three days of a bank's failure. Notice I said days, and not weeks, months or years. The FDIC plays the roles of insurer and receiver in one process. As insurer the FDIC pays depositors of failed institutions from its insurance reserves, which also provides the working capital for the resolution of failed bank assets. As receiver, the FDIC liquidates the assets of the failed institution to replenish the insurance reserves.

The second technique allows the FDIC to sell an institution that has failed, or part of the institution, to another institution, which assumes the liability of the deposits of the failed institution. Generally, such a sale is carried out by the FDIC during a weekend, so depositors and customers have no interruption of banking service. Once again, we are talking about days to act.

Using the third technique, the FDIC can provide financial assistance to keep an institution open and serving its community. That is what the FDIC did when Continental Illinois National Bank, then the seventh largest bank in the United States, failed in 1984.

From 1980 through 1994, during our banking crisis, the FDIC used the first technique for 297 bank failures. We sold 1,184 failed banks to other institutions, sometimes with loss-sharing arrangements. And we provided financial assistance to keep 136 failed banks open. We have not used the third technique for several years, however, and we are much less likely to use it in the future because of a change in the law in 1991 that requires the FDIC to use the least-costly method for resolving a bank failure. This requirement is intended to introduce greater incentives for shareholders and large creditors of insured banks to impose more discipline on the management of insured banks to operate safely and soundly.

When appointed receiver, the FDIC assumes an obligation to all creditors of the receivership to cover them to the maximum amount possible and as quickly as possible. When the FDIC pays off insured deposits, it becomes a creditor of the receivership for the amount of the advances paid to insured depositors. As assets of the receivership are liquidated, the FDIC gets paid first and proceeds are periodically distributed as dividends to creditors on a pro-rata basis. To promote the rapid return to liquidity of creditors including depositors, the FDIC can declare advance or accelerated dividends based on an estimate of recoveries using its substantial insurance reserves.

Thus the FDIC seeks to insure stability in the financial system by guaranteeing the liquidity of insured deposits and the consequent liquidity of the banking system in times of stress. The FDIC also returns the assets of failed banks as quickly as possible to the private sector, which encourages greater market discipline in the economy and more rapid economic recovery. The 1,617 banks that failed or received financial assistance from the FDIC between 1980 and 1994 held nearly $320 billion in assets. That level of financial system exposure to insolvencies did not result in catastrophe, in part, because the FDIC was able immediately to return roughly $240 billion of the bank assets, or about 75% of the total, to the private sector. Over time, the FDIC has sold the bulk of the remaining assets so that at year-end 1996, only $4.2 billion remained to be liquidated. Because the FDIC was able to resolve bank failures quickly, providing liquidity to local and regional economies and promoting their recovery from recession, it helped the US economy return to the robust health it enjoys today.

In contrast, the United States also has experienced what happens when the widespread failures of financial institutions are not handled quickly or effectively. This occurred during the collapse of our savings and loan industry in the 1980s. The problems of the savings and loan associations, of course, began with rising interest rates. Until the 1980s, those institutions were by law generally limited to the business of accepting short-term deposits from the public and lending the funds for long-term mortgages with the maximum interest rates for deposits also limited by law. When interest rates began to climb in the late 1970s and early 1980s, the ceilings on interest rates for deposits were phased out, and savings and loan institutions found themselves earning low interest on their loans long after they had to start paying high interest rates for their deposits.

Over time, many institutions became insolvent, far more than the old savings and loan insurance fund—and here I quickly add, not managed by the FDIC—had the resources to liquidate. By one estimate, it would have cost that fund approximately $25 billion to close insolvent financial institutions in early 1983, four times the reserves that were available in the fund. The problem was exacerbated by the fact that savings and loan institutions in the United States were regulated unevenly and ineffectively up through the 1980s by an agency that has subsequently been replaced. In 1986 the reserves for the old savings and loan insurance fund were estimated at negative $6.3 billion. By 1989, there were 517 insolvent savings and loan associations being kept open because no insurance reserves were available to resolve the failures.

To clean up the problem, Congress ultimately had little choice than to establish a special government corporation to resolve the insolvent thrift institutions. Over all, Congress voted more than $132 billion dollars to pay the direct costs of resolving failures of savings and loans in the 1980s and 1990's. The FDIC was given responsibility for managing a new Savings Association Insurance Fund, which the Congress passed legislation last year to fully capitalize.

From the savings and loan crisis, the regulators in the United States learned that strong and effective supervision of depository institutions is essential to the soundness of government-sponsored deposit insurance and the safety net overall. Without such supervision, the insurer is faced with writing a blank check for losses. Without strong supervision, deposit insurance and the broader safety net become a public resource that risk-takers can exploit. We also learned the importance of closing or transferring the obligations of insolvent insured financial institutions promptly to keep the losses in the banking system to a minimum. Finally, we learned that a strongly capitalized insurance fund is essential to effective bank supervision; to assuring liquidity in times of financial stress; and to facilitating economic recovery by returning the assets of failed institutions to the private sector as soon as possible.

For more than two years, analysts at the FDIC have been systematically analyzing the bank and savings and loan failures that occurred in the United States between 1980 and 1994 in order to draw specific lessons from the experience. Part one of our study focuses on lessons for future supervision of financial institutions, while part two examines how our role as receiver evolved during the banking crisis and lessons learned for the future. Part one was discussed with outside experts in January and will be published within a few months. Part two will be the subject of a symposium later this year, and the conclusions will be published next year. Our goal is to learn as much as possible from these historical experiences.

Despite the FDIC's success during the banking crisis, a small number of observers have recently proposed eliminating the FDIC as receiver and shifting that function to the bankruptcy system, or privatizing the FDIC and letting the market do it. Could the bankruptcy process have acted as quickly as the FDIC in our recent banking crisis? The answer is clearly "no" and that answer is substantiated by our bankruptcy statistics. From 1982 through 1985, only 491 companies in the United States successfully emerged from bankruptcy proceedings under Chapter 11, which gives companies protection from creditors while they reorganize. The average length of time for a company to emerge from this process was 17.2 months, although it took one company 82 months, or almost seven years. Moreover, for Chapter 7 proceedings, which apply to liquidation of companies, the process ranged from two to four years. Given a wave of regional bank failures, or one large institution failure, such a delay in providing liquidity could have devastating effects on individual communities, regions, or even the financial system of the entire country. In addition, the delay in returning failed bank assets to the private sector could have a significant impact on the speed at which the economy recovers from a recession and returns to economic growth.

Governments of course have long recognized their responsibility to maintain stability and liquidity in the financial markets. It is instructive to note that the Bank of England, at the tender age of six, played an essential role in the rescue of the collapsed South Sea

Company. It bought £4.2 million of the company's stock when speculative mania involving that government- sponsored enterprise collapsed in 1720. The Bank of England, our host today, certainly has provided us a model for many things.

In conclusion, as we consider how to plan for the insolvency of an international financial institution, our experience in the United States has taught us that we will be more effective at assuring stability and liquidity in the banking system if we have a structure in place for dealing with financial crises. Now it is true that addressing an insolvency that crosses national boundaries and legal regimes means that a normal structure cannot soon be put into place. However, such a conclusion should not deter us from formalizing the kinds of international cooperation that is necessary to act quickly and effectively. Moreover, having clear mechanisms in place for resolving domestic financial institution insolvencies will, I believe, enhance our ability to set up a more effective, albeit informal, international structure. Finally, we need to study domestic approaches for addressing insolvency issues, like ours in the United States, as a guide for developing international standards.

To return to the original question, "Will we be ready the next time," the answer can be yes. Yes, if we learn from our individual past experiences and if we engage in a coordinated effort to implement international standards and mechanisms for addressing financial institution insolvencies.

Brian Quinn

When Rupert rang me up two or three months ago to ask whether I would take part in this session, I asked him what the context of the discussion would be. He said it would be a kind of a post-Barings review and I thought: "Do I really need this?" A slight sense of panic began to rise in me, as having just been released after an eight-year stretch, I thought it must feel like being asked to return to Alcatraz to inspect the plumbing.

As I have listened to the proceedings of what I think has been a very interesting day, one question I ask myself is: why has there not been more discussion of systemic risk as a basis for tackling the problem of international insolvencies? I want to come to that point; but first let me comment on one or two other remarks made.

First, I do not see it necessarily follows that because financial institutions are mostly regulated, any exceptional official or collective action is needed on insolvency for banks. There may be good reasons why there should be such action, and systemic threats may be one of them, but regulation of the relevant institution seems to me not to be a necessary condition. Unlike the situation in the United States, the banking supervisor in the UK does not act as administrator or as liquidator. He applies to the court for appointment of these officers of the court by a judge or magistrate, and does so on behalf of a class of creditors - the depositors. This seems to work fairly well, in a purely domestic context.

Let me expand on this thought a little by looking at some examples:

In essence, Drexel was potentially a problem of failing to settle on international securities transactions, and possibly creating a widespread problem. BCCI, I think largely unnoticed or unknown, was potentially a problem of payments breakdown because BCCI was a dollar-based bank and cleared its dollar transactions through CHIPS in the United States. There was a real risk that had BCCI collapsed in the middle of the business day, which was the day after the Independence Day holiday in the United States with two days of payments having to be settled, there could have been at least a spasm in both the US domestic and the international payments systems. Barings was more like Drexel in the sense of being primarily a potential settlements problem, affecting both foreign exchange and securities transactions. In all these cases there had to be ad hoc crisis management to avoid the risk of a serious systemic problem.

Compare this with recent experience in the UK, where there has been a consolidation of the UK banking system in a quiet and unnoticed way. When I began supervising banks in 1982, there were over 620 banks in the UK. When I left in 1996—and I would stress that one does not follow from the other—there were less than 500. This was done without stepping outside the accepted legal procedures applying to companies in general. A mix of administrations, liquidations, voluntary and legally enforced, did the job; greatly assisted by the fact that they were almost entirely purely domestic affairs.

The point I am making here is that there was no systemic problem in the UK arising out of those closures. There could very easily have been a systemic problem arising out of the closures of Drexel and BCCI. But, they were managed, and managed effectively, sometimes by prophylactic action on the part of the central banks, or by ex post intervention and intermediation. Alastair has referred to the joint activities of the Bank of England and the Federal Reserve

Bank of New York in both the Drexel affair and the BCCI affair. Barings was cross-border in its scope and was dealt with through the normal legal procedures - but with some behind the scenes co-operation between the Bank of England and the administrators. Had the bank actually gone into liquidation, that co-operation would have to have been enhanced by central banks acting collectively.

Which brings me back to my question: Shouldn't we therefore be giving an especially high priority to procedures that will reduce the risk of cross-border insolvencies which could give rise to international systemic problems? Or do we have to rely on central bankers getting it right, under sometimes very severe pressure?

Before I answer that question, let me make some related observations. Problems will not bring about a threat to wholesale payment systems. It is now effectively a requirement in EU countries to have RTGS. It has long been adopted in the CHIPS system in the United States. The Japanese are making progress with the introduction of RTGS. It has just been installed in Hong Kong. So it is becoming a global practice, especially in large centers.

Settlement systems are also being enhanced, partly through the efforts of the G-30, which first focused attention on the question of settlement of equities transactions. In the main international centers considerable attention has been given to these issues. As regards the safe operation of exchanges, we heard Andre Corcoran talk about the Windsor Declaration. The G-30 has also been offering suggestions and making proposals for the safe functioning of official and unofficial exchanges. On the forex front the G-10 Committee on Payments and Settlements has analyzed the problem, produced the report on netting systems which I think is the model, not just for netting, but for payments systems more generally, and which led the way to the adoption of RTGS. In brief, a great deal has been done and is being done to reduce the chance of systemic problems by strengthening the international financial framework.

But is that enough? Could you still have a geographical widespread problem arise from the collapse of a globally active financial services firm? I think we all feel it could, and would be wrong to assume that it could not, notwithstanding all that I have said. Furthermore, no system should operate on the assumption that the authorities will always come to the rescue in time. That, I think, would be imprudent behavior.

Thirdly, neither Drexel nor BCCI was actually a complete surprise; but that will not always be the case.

The authorities in the United States had actually taken public action against Drexel in the period before it was closed. And as everyone will quickly tell you, the whole world knew there was something not quite right about BCCI (although getting usable evidence was another matter). In both cases, counterparties in the financial system were aware of problems, and protective actions were taken by those parties. So again, the chances of knock-on problems were reduced. But surprises which threaten the financial system will continue to happen and the case for looking at the machinery for dealing with cross-border insolvencies is therefore, I think, especially strong if one accepts this.

But even if we are not facing systemic problems, it must surely be right to try to improve things so that collateral damage to third parties is reduced. This surely applied in the BCCI case, if you leave aside the threat to the payments system. It is important to remember that losing money is a powerful disciplinary force. But there are limits to it and I would certainly not advocate that damage be deliberately or consciously allowed to occur, and innocent parties get hurt, in order to teach people to stay on their toes. Contractual arrangements, properly entered into in good faith, do get disrupted and serious problems can arise.

In searching for answers to both kinds of problems - systemic and non-systemic - some of the analysis I have heard today has been pretty persuasive. The proposition that insolvency laws are national in their scope and reach, while the problem we are dealing with is international, echoes what supervisors and regulators have been telling themselves for years. There is certainly a group of internationally active financial services firms that no longer run themselves on a legal entity basis but on an international group-wide basis; yet the firms in the group are licensed as a number of legal entities by different national authorities. Thus, there is a mismatch between the corporate and operational reality, on the one side, and the legal and regulatory regimes, on the other. The parallel with insolvency arrangements seems to me to be close; both call for a new approach.

Going beyond analysis to possible solutions for the regulatory problem, a number of speakers have mentioned that efforts are being made by the regulatory authorities—the Basle Committee, IOSCO, participants in the Windsor Declaration—to move towards internationally accepted standards, but no one, to my recollection, has suggested that we should have a supranational regulator. I do not think any of us believes that it is remotely feasible and some, myself included, also doubt its desirability. Having listened to today's proceedings, that is how I see the current joint exercise between the G-30 and INSOL. It is not a treaty, not a protocol to be signed, but a process going forward. There is no indication that we will get an overarching insolvency law which governs the activities of institutions which are active across the world.

I was much impressed by the exposition about UNCITRAL, which I thought was really very cheering. It is certainly a step forward and although a number of questioners pointed out that it is less than absolutely perfect that does not trouble me unduly. In an earlier remark Richard Gitlin categorized the recommendations in the G-30 report as "the application of common sense." I think that sums it up rather neatly, and it reflects what has also been happening in regulatory regime around the world for many years.

What are the prospects for further progress, and how can things be moved forward? It is a mixed picture if you look through the comments made by the countries who were surveyed for the G-30 report. There are a number of countries who say that their laws are completely inconsistent with the proposed regime and nothing can be done. But let me suggest that this is not cause for despair. I well remember the struggle involved in reaching the Capital Accord among the G10 banking supervisors. We started in 1982 and it took until 1988 to reach the Accord. It was hard work, and a number of countries said along the way that the proposal was unacceptable; they could not join the initiative; they wanted a quite different regime. But we worked at it, struggled, cajoled, and finally got it done. So do not lose heart because some countries say they cannot do it.

A second problem arises from the quite serious differences that exist among legal regimes governing insolvency. At a number of points in the discussion, reference has been made to the difficulty of getting a bankruptcy convention or winding-up directive in the European Union. The reason for that, in part, is because countries have different social priorities. This is not simply a matter of being stubborn. It is that the "correct" order of claims on assets goes beyond strict matters of law to the cultural and social preferences of the countries. That is a real problem but one which can, I think, be made better and is being made better in rather an unglamorous but effective way. I think it was Richard Gitlin today who referred to the Maxwell Communications Corporations case, where the judges in question put their heads together and found a way through what looked as though it could have been, if not intractable, at least a very expensive exercise. The very fact that judges from different jurisdictions did that is a welcome and remarkable development. When I joined the supervision side of the Bank of England in 1982, the dialogue between the supervisor and auditors was confined to one meeting a year with the professional associations, usually dealing with matters of general policy. Trust had to be built up over a number of years and nowadays the relationship between auditors and supervisors is much closer, without infringing upon the independence of either party. Having the judiciary in the act is something that might be built upon as we try to find the way forward.

Exchanges of information have also been mentioned as absolutely vital in dealing with insolvencies, but sometimes very difficult to manage without creating other problems. Andrea mentioned the question of access to confidential information. Even in the most unpromising circumstances, progress is possible. Eddie George and I went to Washington in 1992, in the aftermath of the BCCI affair, because the House Banking Committee of the US Congress had issued a subpoena to the US Federal Reserve for access to documents on the affair, including documents that had gone to the Fed from the Bank of England under the protection of the Banking Act. We faced the prospect that information that had not been disclosed to the UK Parliament as a matter of law would be disclosed to the US Congress—not exactly a comfortable feeling as we climbed on the plane.

Upon arrival in Washington, we went to the Rayburn building where we were told that the Committee Chairman, Mr. Gonzales, was not in Washington (although we suspected he might not be a million miles away). Through dialogue and quiet explanation, we convinced the legal counsel to the Housing Banking Committee that the uncontrolled use of sensitive information could impede the effort to improve international banking supervision. In a surprisingly short time the deal was done. No laws were passed and no protocols signed. The application of common sense worked.

The need to keep things confidential or secret can create other problems, of course. In the days before the closure of BCCI, the Bank of England and other regulatory authorities immediately involved were not sure exactly what they were dealing with, but they knew there was criminality in the organization, perhaps going right through it. It was vital that the preparation to close BCCI were kept as quiet as possible. Otherwise the people could walk, and so might the money. We kept the lid so tight that when it came time to apply for an order to close the bank at its headquarters in Luxembourg, we discovered that it was the day of the annual Luxembourg Judges' Picnic, and there was no judge on hand to sign the necessary order. The clock was ticking towards the opening of the business day in New York and the process of closure was stalled. I had Jerry Corrigan on one phone and Eddie George on the other phone asking: "What is keeping you, Brian? Why can't we send in the inspectors and inform the markets?" You will appreciate I am giving a rough translation here and that the actual words used were a little bit more industrial. We did find a judge in the end, but not before my composure was tested to the limit.

Another serious issue is the question of doctrines of single and separate entities, which has been referred to a number of times today. This is a problem that could seriously complicate, if not impede, international banking supervision as well as obstructing a fair and equitable solution to an international insolvency. The UK authorities have tried on a number of occasions to resolve this issue, in dialogue with countries who favor the separate entity regime and who therefore resist the pooling of assets. This is a case of national interests overriding the interests of the international community - which might seem politically realistic but can be very unfair. The natural supervisory response in a single entity regime to this is that you "subsidiarize." Instead of being content to have a branch of a foreign-domiciled bank operating in your jurisdiction, you require it to become a nationally incorporated bank. That is an inefficient use of capital and goes directly against the spirit and letter of the Basle Concordat. I do hope at some stage that it may be possible to persuade the relevant countries to change their mind on this; but I am not holding my breath.

A step forward would be the appointment of a lead regulator. I have to take issue with my erstwhile colleague Andrea here, who is not in favor of the concept. It just seems to me odd to think that it would not be better if someone was given the responsibility, by common consent, for arranging the collection and analysis of data about financial services and co-ordinating access to it by people who need it, either before or after a failure. As we try to find a way through this, there must be more than institutional prerogatives allowed to drive the debate. You can work out for yourselves what that means.

Lastly, in finding a way forward, it is very important to have a good institutional framework in place. The Basle Committee, of which I was a member for eight years, has been at work for 20 years. The fact that that institutional framework is in place is one of the reasons that supervisory co-operation can work. That is why the efforts of INSOL to mobilize and organize the key participants is so important. I would strongly encourage them to strengthen their links with regulators and to contact international financial institutions like the World Bank and the IMF which are assuming a greater support role in financial supervision, and are accustomed to promoting things in an international way.

What of next time? Despite all the public and private efforts at prevention, I have no doubt that there will be a next time. Will we be able to cope? Things are improving. I have tried to indicate areas where more improvement is needed. The fact that Andrea knows Nigel Hamilton and Maggie Mills, and that they both know Jeremy Orme is a good beginning. I have to say that personal contacts are a very real strength when decisions are needed quickly. They give you a freedom of movement that you may not always have if you feel tightly bound by law. Such contacts should not be underrated, and the fact that the insolvency practitioners are coming into the broader network is very encouraging.

In this connection, it is important to remember how Barings found a buyer. This came about because the Bank of England, and the other regulatory authorities in the UK, provided the potential buyer with data when things were chaotic. The typical failed institution is a mess. Nobody knows were things are or where things should be; to put it mildly, there is a certain degree of dislocation. The supervisors can help the insolvency practitioner in a very direct way by helping him with the data. They can also make introductions and ensure that telephone calls are answered at crucial times on crucial issues. Central bankers can inform one another that the insolvency practitioners in a particular case are good people - as of course they always are - and a network can matter enormously and I would urge you to work at developing it, alongside more formal efforts.

So will we be ready next time? We will do a little better than the last time - and the time after that, a little better still. The collateral damage that I referred to earlier can be progressively reduced.

I would like to end by picking up on something that Alastair referred to, namely that a fixer-of-last-resort is probably always going to be needed. I therefore send a little message to my former boss in Threadneedle Street; do all you can to persuade our political masters that you can keep the weekend job.

Miguel Mancera

When the organizers of this conference very kindly invited me to make some comments on this occasion, I was quite reluctant to accept. This is because I am no expert in these matters as they have been defined. The conference is concerned not only with financial insolvencies, but international financial insolvencies. I planned to come to this seminar to learn, not to teach, but I am pleased to say a few words.

The Bank of Mexico itself does not have much experience in handling these affairs because, in Mexico, they are handled mostly by the National Banking and Securities Commission. However, it is true that sometimes the Commission's efforts to manage these problems is supported of the Bank of Mexico as lender of last resort. We can provide support under very specific conditions. One is that the debt of the banks is guaranteed by the government through an insurance agency like that run by Mrs. Helfer. When we provide funding to that agency, we fully sterilize the funds so that our monetary policy is not affected.

Another reason that my experience with these international problems is limited is that only in the last few years have foreign banks been allowed to establish themselves in Mexico, either in the form of new wholly-owned subsidiaries or by taking control of formerly Mexican-controlled banks. Fortunately the foreign banks established in Mexico are leading banks, very well respected, and we have therefore had no problems up to this point. It is very unlikely that we will have a problem in the future. But of course, one never knows and banks which seem to be strong now may get into trouble in the future. That is why it is very interesting to come to this seminar and to learn as much as possible from the experience of my colleagues on this panel.

Several subjects are of particular interest. For instance, in Mexico the foreign banks that have been allowed entry have to do so in the form of subsidiaries. They are Mexican banks controlled by foreign banks. It may be that this scheme avoids some of the problems that have been discussed today, but of course not all of them. For instance, it is conceivable that a subsidiary of a foreign bank that gets into trouble might be used to tap depositors' funds in Mexico, pass the money on to the parent bank, and when the problem explodes, we get their liabilities but not the assets. We are not entirely comfortable with the idea that because they are subsidiaries and not branches, we are at no risk. This is not the case.

The resolution of a firm in financial distress presents many problems when the objective is to maximize its value. The main reason for these problems is that the interests of the principal claimants may vary, and they may not be cooperative. For the owners or the shareholders of the bank, it may be in their interest to maintain a firm that has no economic value as an ongoing concern, in the hope that it may regain value in the future. The practice by managers and shareholders of "gambling for resurrection," as it is called, involves strategies aimed at regaining what has been lost. This may not be in the best interest of senior creditors, who may prefer to liquidate the firm, while junior creditors may prefer to wait and see if the firm can survive and regain value.

In addition to the other problems associated with firms in distress, in the case of banks, there is well known problem of contagion, leading to potential bank runs and threatening to disrupt the payment system, with further loss in value at the systemic level. When deposit insurance works, it prevents this type of complication. Still, deposit insurance does not prevent bank insolvency, a problem that concerns every country in the world. Experience seems to indicate that early intervention, or some form of government receivership, may encourage value preservation. However, even where such action is taken, the Mexican experience shows that the longer it takes to finalize the resolution of a bank, the greater the loss of value of the firm. For example, bank loans become delinquent more often as debtors become aware that they have become a contingency. Employee and manager morale also erodes over time.

Since the problem of firm valuation becomes more complicated in the case of troubled banks, it is difficult to determine unambiguously the extent to which former shareholders have capital at risk. That makes it difficult for the government to take control of an institution in trouble. This is why in many countries, like Mexico, we have had to legislate rules dictating when and how the government is allowed to intervene. In the case of international insolvency of financial firms, these complications become even greater, as we have heard discussed today.

In any case, information sharing, to the extent that it is legally permissible, is a key element. Efforts should be undertaken to ensure better disclosure of the financial condition of international conglomerates, according to minimum standards. An early warning system should be developed, and each host country should have the right to enter into consultation with home countries when available information suggests a potential problem. In addition, rules should be established allowing each country to impose domestic controls when international insolvency is detected, in order to minimize systemic risk. Mexican experience indicates that information-sharing among regulators in an informal and cooperative fashion is the key to effective consultation.

Certainly given the complexities involved in international insolvencies, the topic deserves special attention. In my view, most of the recommendations in the discussion draft are very desirable. However, it is important to pay attention to the feasibility of their implementation in each country. In particular we have learned that the diversity of laws in different countries and the differences in implementation make cooperation and harmonization extremely difficult. Mexican authorities welcome the Group of Thirty initiative because we would prefer to learn about the problems *ex ante*, rather than *ex post*.

Comments and Questions

Alastair Clark: To begin the question period, I would like to raise one issue, addressed to Brian as much as anyone. I wonder to what extent incompatibilities in national insolvency laws have been factored into regulators' thinking about financial requirements, and how those financial requirements would work in a crisis. Because consideration of this issue may have been less thorough than it should have been, one of the report's recommendations suggests the need to take account of the home-country insolvency regime in considering whether to license a firm's operations in a host country. Is this a concern that is well founded?

Brian Quinn: If you had asked this question five years ago, the answer would have been pretty short; that is to say, there was little attention paid to an applicant's home insolvency regime in judging whether they would be able to maintain their obligations. More attention was paid to the strength of the institution itself and to the regulatory regime. But since you ask the question today, this issue is more in the minds of banking supervisors, and my remarks about subsidiarization are a direct reflection of that.

When you are licensing institutions from a single-entity regime, there is a legitimate question whether your depositors will be effectively protected against discrimination in favor of local national depositors in an international insolvency. That issue now features among the considerations that supervisors ask themselves when they face such an application. It becomes part of a general set of questions, not about the characteristics of the particular firm but about the country from which it comes.

Ricki Helfer: The kind of evaluation you asked about is a natural part of the evolution of coordinated international supervision. Until risk-based capital standards were put in place ten years ago, we did not have a meaningful approach to coordinated international supervision. Since that time bank supervisors have insisted that each country assume responsibility for consolidated supervision of their financial institutions. Thus, the important evaluation of whether the home country provides consolidated supervision of a financial institution is made when assessing the effectiveness of a country's supervisory standards. In the same way, it is part of the natural evolution to expand this evaluation to the insolvency practices in countries. In my view, there ought to be incentives in the way insolvencies are handled to reward stronger banking supervision.

The fact that BCCI's US offices were in a positive net position when the institution was closed was partly the result of the close scrutiny being directed at that entity in the United States. It was also partly luck because the bank had been found guilty of money laundering several years earlier and had been ordered to phase out its operations and fund adequately the US entities in the United States. In the end, it is important to recognize that a critical part of maintaining stability in the financial system is being able to deal effectively with financial institution failures, and not just through normal bankruptcy procedures. One of the reasons I wanted to talk to you about the FDIC's broad powers as receiver is to point out that extraordinary powers are both suitable and appropriate for dealing with the failures of financial institutions because of the critical role they play in providing liquidity to an economy.

Alastair Clark: My point is a bit broader than the question of subsidiarization. The trend in global cooperation among banking supervisors has been towards consolidation. But in the event of insolvency, there must be some doubt as to whether those consolidated positions within the firm tell you anything terribly useful. Global consolidation may not be the circumstance that applies.

Stephen Case asked whether it might have been possible or a great deal neater to identify particular failed entities in an insolvency like that of Barings. Apart from the question of mutual guarantees among entities, the other big issue there is the extent of reputational damage to the firm. What credibility would the residual parts of the group, some subsidiaries of which have failed, have in financial markets? Even if their explicit financial exposure were limited, a question would remain about their ability to continue in business. This is an important dimension of the fire-wall and ring-fencing argument.

Question: For Mrs. Helfer, what portion of the cost of FDIC insurance comes from the banks and what portion is on the taxpayers' shoulders? Is the cost of the system shared?

Ricki Helfer: The costs for the deposit insurance system are paid solely by the banks and thrifts, and the premiums are risk-based. As a result of banking problems in the early 1990's, the Bank Insurance Fund was depleted and we actually had to borrow money from the US Treasury. The banks' premiums were drastically increased to 23 to 31 basis points on every 100 dollars of assessable deposits for several years until the Treasury was repaid with interest and the fund was fully recapitalized. Now the fund stands at $27 billion and premiums for our best-rated banks have been reduced to zero—currently 95% of the banking industry in the United States, which are both well capitalized and in the top two supervisory rating categories. The savings and loan crisis, in contrast, had to be resolved with taxpayer funds because that insurance fund was fully depleted and the losses were too great.

Question: Picking up a point that Brian Quinn made in his remarks, should we pursue personal networks for cooperation or more structured, formal arrangements? As good and desirable as networking may be, it has a built in obsolescence about it. People retire; people are promoted; they move on; gamekeepers turn back into coaches, and so forth. Justice Hoffman has ascended to the House of Lords and will not be presiding when the next Maxwell case comes on. So while it is fine to encourage and facilitate gatherings where personal links can be made, it is also absolutely vital that we address very seriously the need to have formal structures in place for enhanced communications, access to the appropriate parties and speedy and effective collaboration.

Brian Quinn: I do not disagree with that and I hope that what my words were not construed as disagreeing with it. I was only saying that you must not undervalue the contribution that good personal relationships can bring to these situations. The law tends to be drawn up for a given point in time, and does not necessarily take account of changes in circumstances as markets move, just as individuals move. You can find yourself in a straight jacket because of the law. That is why there is continuing value in relationships—and the risk of turnover can be exaggerated.

As a banking supervisor, you inherit institutionalized cooperation. This is something that does not die out with the individual. The possible exception here is our colleagues from Japan, where there is a culture of changing the individuals charged with supervisory responsibilities every two years. The shortcoming of that, of course, is that you have to begin all over again every two years with new individuals. I am not suggesting this accounts for the current financial problems in Japan, which is a much more complicated issue, but it does offer some support for your contention that you have to maintain continuity. But I would not exaggerate the point.

When framing laws, you have to frame them with a view that things do change very fast these days. Therefore, the law should have a certain degree of flexibility within it. You do not want to have to wait your turn in the legislative timetable for the next Parliament or the next legislative session, because you might not get the changes you need.

Ricki Helfer: Let me just add two points. First, having spent seven years of my life on the sovereign debt crisis, we were lucky that it involved mainly loans that had longer tenures and there was time to restructure the debt to deal with the problem. Given the nature of exposures today, however, it is not clear that we will have that much time in the future. Therefore, while relationships are important, I would also argue for some kind of standards for addressing these problems. In 1984, the FDIC dealt with its first big bank failure in the United States with Continental Illinois. Just before the failure, the Corporation had done a contingency study of what we would do if a large bank failed. That study formed the basis for the approach used in that resolution. We international supervisors could usefully come up with a clearer set of contingency guidelines for certain types of failures, and we could learn from the past in doing that.

My second point is that US law has, in one sense, become too restrictive. We have set statutory, prompt-corrective-action standards for regulatory intervention. This will probably result in failed institutions always having a positive asset position, which is a plus in some sense, but it will probably also lead to the closing of institutions that could otherwise be kept open and restored to full financial health. In this area, regulators should have more discretion.

Question: There seems to be a loose end in the set of proposals in the report. This morning, we heard a very compelling argument that it is important to continue to trade the dynamically hedged book of a failed institution. This afternoon Brian has reminded us that this has been possible on occasion, but only with the intermediation of the central bank. I believe the proposals themselves contemplate the possibility of subordinating old creditors in favor of new creditors who will continue to trade. Is that really a plausible approach, or is more careful attention needed to the very vulnerable position of a dynamically hedged institution?

Ricki Helfer: The FDIC has some experience with this. The Bank of New England had a book of derivative instruments that had to be worked down. We often hire employees from the failed bank—hopefully not the ones that caused the failure—to help us do that. We use netting in evaluating the position of individual institutions. Having a set standard for priority of claims is certainly something that one should consider in that context, bearing in mind that you need an incentive for those who are counterparties in the old obligations to continue to work them through.

Ernest Patrikis: This question does not make sense in this context because banks do not use Chapter 11. Ricki's job is to get rid of the problem institution on the weekend. There is no need to make loans to the bank or engage in transactions after bankruptcy. In our regime, it is too late for that.

Brian Quinn: In the UK regime, the administrator can continue trading, and indeed it is his duty to do so if he thinks that is best. Your question is whether it is plausible, and that is a very real issue. Are the people who have previously done business going to stand aside and let value be moved out of the institution for the benefit of newcomers? This is not different, in principle, from what we call in the UK "the London approach." You gather institutions around the table to decide what course is in their best interest—winding-up the institution or keeping it going in some way. Some will decide to stand aside and others will not. You do it case by case. I am not sure that there is a different matter of principle here that cannot be tackled: you will succeed in some cases but not in others.

Alastair Clark: I would just add that the so-called "London approach" has been used mainly in an industrial context. What Brian describes has indeed been the pattern, but I think it is fair to say that it has become increasingly difficult to apply that approach. In a capital market setting, rather than in a bank lending relationship, the number of counterparties who are involved is very numerous. It is much harder to get them together to agree on some sort of plan than it was in the past when an industrial company had a limited number of lenders who were relatively easy to corral.

With that, I am happy to leave it now to Rupert to synthesize all that we have discussed into a coherent message.

Concluding Remarks: Rupert Pennant-Rea

We have had a long day, and there have been a lot of complicated issues discussed. The idea that I can summarize it all in some coherent way is preposterous. As I ponder how I allowed myself to get into this position, I feel a bit like Mark Twain, who said: "It always takes me three weeks to prepare a good impromptu speech." So while I will not even pretend that I can do justice to all that we have heard today, I will try to highlight a few of the themes that seem to me to be most important and most interesting.

My first thought is that I am very pleased that nobody tried to be too tidy about all of this. Again quoting another great quotable American H. L. Mencken, he said that "for every intractable and difficult problem, someone always has a solution that is neat, plausible, and wrong." I think that we have avoided that trap today, a trap that applies particularly to the whole subject area we have been discussing.

The second thing that strikes me is the different weight that has been assigned at different times to the roles of the supervisors and of the managers of the institutions themselves. If you think about where public attention focuses when there is a high profile insolvency or failure, the attention of the media and the politicians focuses very heavily on the supervisors. The question about events before a failure is always: "How could they possibly have missed it?" In the days after a failure has happened, all attention remains focused on the supervisors and on the central bank: "How will they rescue this bank? Are they going to provide systemic support?" The focus is always on they, the supervisors, and it is deeply unfair. I say that with some feeling having been through it once myself.

My concern here is not just the issue of unfairness, but that it is actually quite misconceived to assume that the challenge of avoiding insolvency and minimizing disruption afterwards lies wholly on the shoulders of official institutions and official authority. In fact, and we have heard this clearly in one of our sessions today, the contribution of managers matters at least as much and arguably more than that of supervisors, both in prevention before an insolvency and afterwards in clearing up the mess and minimizing collateral damage. The firms which have good risk-control procedures and a strong, disciplined culture are the firms that are doing most to prevent the threat of insolvency ever arising. After an insolvency occurs, the way that creditors, counterparties and competitors manage themselves can make an enormous difference in minimizing systemic pressures.

I do not believe that even the most brilliant regulatory system, manned by the most diligent and omniscient supervisors, could possibly compensate for failures within firms, either before or after a failure. That is not to say that the supervisors are unimportant, but there is clearly a limit to what they can and should do. If they go beyond appropriate limits and take over all responsibility for putting things right, they actually increase moral hazard in the system which everyone, by and large, agrees is ultimately poison for the system. In today's discussions, we got the balance on that issue about right. But beyond a relatively small group of people who are genuinely interested and professionally involved in this issue, there will always be unrealistic expectations placed on the shoulders of the regulators—the nannies who really should have been sure that sort of behavior was not going on in the nursery. That is a very unattractive feature of the public debate.

The third broad theme that struck me is that the countries involved in the international financial system as a group face a problem of legal or legislative imbalance. By that I mean that there are very stark contrasts between the best functioning insolvency regimes and the worst ones. Even if we look at just the top twenty countries that have international firms operating in their markets and growing financial activity, the gap, I suspect, is very wide. As financial institutions become increasingly global, that gap becomes more and more troublesome. There are, no doubt, other general themes that have emerged but let me try and be a little more specific by listing specific points made in our discussions or specific proposals that have been brought forward.

First, with regard to netting, two concrete proposals have been suggested following our very useful discussion of that topic this morning. One idea is to set up a private-sector advisory commission which would, at the request of individual governments, review national laws to ensure that netting is fully enforceable or to advise on the drafting of new laws where none yet exist. The second, rather similar idea is to set up in each country a mechanism analogous to the Financial Law Panel that operates here in London, which would offer its best judgment on conventions and laws to do with netting.

The second subject where specific suggestions were made was on the question of increased international cooperation. Among supervisors, I think there was general agreement that it would be desirable to have a list of who to call in an emergency along with measures for coordinating the list and making sure that it was being kept up to date. A second area of agreement would probably be the desirability of a supervisory protocol for cooperation, covering what information can be shared, in what form, and with whom. Amongst insolvency practitioners similarly, there is scope for increased cooperation along the same lines: sharing of information, networking, calling lists so you know who you can contact and where they will be on the weekend and that sort of thing. These are practical housekeeping measures, in a way, but enormously helpful when "the balloon goes up."

The third area of specific agreement, I think, had to do with the financial institutions themselves. It would be desirable to agree on at least a general approach to the maintenance and availability of information, and the terms on which that information should be shared among financial institutions that find themselves pulled into an insolvency by virtue of being a counterparty.

A final area of agreement is the whole question of access and recognition in insolvency proceedings. This is a matter that is both practical and highly relevant because it can save a lot of time if we get it right. Again, there seemed to be general agreement that it would be desirable to offer advice to UNCITRAL on a model statute that would apply in the case of a financial failure.

Those are some concrete and specific ideas that have come out of our discussion today. I toyed with the idea of calling this list the "Grocer's Declaration" but I decided it did not have quite the same ring as the Windsor Declaration. On balance, I think that we would do better just to regard this as a meeting of minds rather than a message to the world. I hope that, in small ways and big, not immediately but gradually over time, the ideas that we have discussed here today will influence the wider constituency who establish the legal framework for insolvency, including those in the judicial system and the parliamentarians who make and amend our laws. Inside that framework, I hope that all the people here today will, at a minimum, have come to know each other better, strengthening a network that, I think, we have all agreed is valuable but not a solution to our problems. I hope that you take home names, faces, and contacts, but ideas as well.

Following our conference, the Group of Thirty will be circulating a full list of names and numbers of everyone who was here today to all participants so that the concept of a "Grocer's Convention" will at least be lodged in everyone's telephone list. The G-30 will also be deciding what it intends to do next about this issue. I hope that our eventual publication will do justice, not just to the original draft report, but to all the comments that came in response to our survey, and to the contribution that all of you have made here today. I want to thank everyone very much, for your time, for the effort you made to come here and for the high quality and thoughtfulness of the presentations and comments.

Let me conclude by reminding you that we are now invited to a reception at the Bank of England. After the historic moves of last week (to give the Bank independent authority to set monetary policy), I am sure that the canapés at the Bank will be even finer, the drinks colder and even the air will smell sweeter than ever before. Thank you very much.

Conference Panelists

Stephen Adamson is National Partner in charge of the Restructuring & Reorganization Services Department of Ernst & Young in the UK. He qualified as a Chartered Accountant in 1966 and has since then dealt with many varied assignments, having particular expertise in carrying out viability assessments of troubled companies, developing restructuring plans and managing their implementation. He led the administration teams in British & Commonwealth Holdings and Olympia and York's Canary Wharf, and advised the administrators of Barings Bank. He sits on the Steering Board of the Insolvency Service Executive Agency, was the President of the Insolvency Practitioners Association from 1989 to 1990 and of INSOL International from 1993 to 1995, and is a member of the Executive Committee and Conference Chairman for INSOL 2001.

Stephen H. Case is a partner in the law firm of Davis, Polk & Wardwell. He received bachelor's and law degrees from Columbia University, of whose board of trustees he has been a member since 1996. Since 1980, his law practice has focused on complex Chapter 11 cases and financial distress workouts. He has represented creditors in major cases from Columbia Gas back to PennCentral. He also has represented debtors, such as Manville Corporation and affiliates. Previously, he worked on SEC-registered public offerings, bank loans, and mergers. He acted as Senior Advisor to the National Bankruptcy Review Commission during 1996 and 1997, is a member of the American Law Institute, and the National Bankruptcy Conference for which he served as Vice-Chair of the Committee on Legislation from 1992-1996. As an adjunct professor for Georgetown University Law Center, he annually teaches introductory bankruptcy courses, and has published numerous short papers for lawyer-education programs.

Thomas Alastair Clark has been the Executive Director of Financial Structure at the Bank of England since March 1997. He was educated at Emmanuel College in Cambridge, the London School of Economics & Political Science, and Stanford University. He has served at the Bank of England since 1971, holding a variety of positions in the

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Neil Cooper is a partner in the London office of Buchler Phillips. He joined the firm in 1997, after serving as the National Head of Corporate Recovery at Robson Rhodes. He has handled a large number of assignments, many of them “behind the scenes” rescues, as well as a number of high-profile cases, acting as liquidator of Bishopgate Investments Management Limited, the Maxwell Pensions Company, and trustee in bankruptcy of Asil Nadir. He is Chairman of Polly Peck, the Vice President of INSOL International, President of the European Insolvency Practioners Association, and is involved in the INSOL project with the United Nations Commission for International Trade Law.

Andrea M. Corcoran currently is the Director of the Office of International Affairs of the Commodity Futures Trading Commission, after previously heading the Division of Trading and Markets for 15 years. She received a BA from Stanford University and an LLB from Harvard Law School, and is a member of the New York, California, and District of Columbia bars. She was principal staff person on CFTC efforts to develop the Windsor Declaration following the Barings collapse, and the London Communique that responded to Sumitomo’s losses in the copper market. She has also participated in IOSCO committees related to guidance on risk management and oversight of electronic trading systems, heading the committee that produced the first set of international principles for regulation of electronic trading.

Andrew Crockett has been General Manager of the Bank for International Settlements since 1994. He was educated at Cambridge and Yale Universities, began his career at the Bank of England, and then served as a staff member at the International Monetary Fund from 1972 to 1989. As Director of the Bank of England, he was responsible for International Affairs from 1989 to 1993. In that capacity, he was a member of the Monetary Committee of the European Union, Alternate Governor of the International Monetary Fund for the United Kingdom, and a member of the Working Party

3 of the OECD, being elected its Chairman in September 1993. He is a member of The Group of Thirty

Richard A. Gitlin is a founding member of the law firm Hebb & Gitlin of Hartford, Connecticut. He currently serves as the U.S. Examiner for Maxwell Communication Corporation Plc. He is Past President of INSOL International, and was Chairman of INSOL International's 1997 World Congress. He is Past President of the American College of Bankruptcy, and a member of the Creditors' Rights Advisory Committee of the Practicing Law Institute. He was Vice Chairman of The Group of Thirty study group on International Insolvencies in the Financial Sector.

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Miguel Mancera recently retired as Governor of the Banco de Mexico after a 40-year career with the Central Bank. He has also been a professor of Political Economy at the Autonomous School of Law, of International Trade and Economic Theory at the Instituto Tecnologico Autonomo de Mexico, and of Economic Theory at the Center for Monetary Studies of Latin America. He earned degrees in economics from the Instituto Tecnologico Autonomo de Mexico and Yale University. Before joining the Banco de Mexico, he worked for the Banco de Comercio, S.A. and the Presidential Commission on Public Investment.

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Ernest T. Patrikis is the First Vice President of the Federal Reserve Bank of New York, an alternate member of the Federal Open Market Committee, and is responsible for the Wholesale Payments Product Office. He received a JD degree from Cornell Law School in 1968 and a BA degree in economics from the University of Massachusetts in 1965. He was a U.S. Delegate to the Working Group on International Payments of the United Nations Commission on International Trade Law, and served as an advisor to the National Conference of Commissioners on Uniform State Laws. He is a member of the Committee on Payment and Settlement Systems of the G-10 central bank governors, a member of the staff of the President's Working Group on Financial Markets, and chairs the Financial Markets Lawyers Group.

Rupert Pennant-Rea chaired the Group of Thirty study group on International Insolvency in the Financial Sector and the London Insolvency Conference. He has degrees in Economics from Trinity College, Dublin and the University of Manchester. He is Chairman of The Stationery Office (a private company, formerly Her Majesty's Stationery Office) and of Caspian Securities, and a director of several other companies. He is a member of the Trinity Foundation, and is a consultant for the World Bank. He served as Editor of *The Economist* from 1986 to 1993, Deputy Governor of the Bank of England from 1993 to 1995, and was a member of The Group of Thirty from 1994 to 1997.

Brian Quinn C.B.E. became Chairman of Nomura Bank International Plc in 1996 after a 26-year career at the Bank of England. From 1988 onward, he was Executive Director in charge of banking supervision. He acted as Deputy Governor of the Bank of England during 1995, was Chairman of the Supervisory Committee of the European Monetary Institute until his retirement, and served as a member of the Basle Supervisors Committee. He is a Fellow of the Chartered Institute of Bankers in Scotland, a Companion of the Institute of Management, and a consultant to the IMF and World Bank. He holds Master's Degrees from Glasgow and Manchester Universities and a PhD in Economics from Cornell University.

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Jonathan E.F. Rushworth qualified as a solicitor in 1974 and has been a partner in the firm of Slaughter and May since 1981. He has a wide-ranging company and corporate finance practice, advising listed and other companies, and is involved in capital markets work. He also has a particular interest and specialization in corporate recovery and insolvency law, and his practice in this area involves advising companies and their directors, creditors (in particular banks) and insolvency practitioners. He has been closely involved in many of the recent major insolvencies, in particular advising the administrators of the Barings group. He is a member of the Company Law Committee of the Law Society and Chairman of sub-committee J of the International Bar Association. Committee J's interests focus on creditor's rights and insolvency.

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International Insolvencies
in the Financial Sector

Study Group
Report

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