“The Legal Framework for Foreign Bank Entry”

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THE LEGAL FRAMEWORK FOR FOREIGN BANK ENTRY

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Abstract

This article seeks to contribute to the debate on how to devise an appropriate legal framework for foreign bank operations. It considers the implications of the corporate form of foreign bank operations and examines how countries can protect domestic financial systems effectively from the detrimental effects of cross-border failures. To this end, it critically reviews the various mechanisms and tools applied in a number of jurisdictions.

JEL classification: G21, G28.

Why should countries open their domestic financial sector to competition from foreign-owned financial institutions? It is now widely recognized that this is an effective way to make local financial systems more effective and efficient (CGFS, 2004). The entry of new institutions adds depth to the local financial system and gives domestic companies a wider choice of services and borrowing options. Also, they bring new techniques and expertise into the local market. Indeed, foreign entry through direct investment is widely recommended by researchers and analysts as a means of strengthening weak and inefficient banking structures, particularly in emerging economies (e.g., Claessens, 2006).

Under the General Agreement on Trade in Services (GATS) Member States are required to accord to services and service suppliers of other Member States treatment no less favourable than that accorded to like domestic services and service suppliers (national treatment)[1]. The GATS does not define market access. Instead, it lists six categories of measures that are prohibited unless specified in a country's schedule. These cover limitations on the number of service suppliers, on the value of service transactions or assets, on service operations or output, on the number of natural persons employed, on the type of legal entity, and on the permissible scale of the participation of foreign capital. However, the Annex on Financial Services contains an important carve-out. This so-called "prudential carve-out" permits measures taken for reasons of safety and soundness to ensure a financial system's integrity, subject to the proviso that such measures not in conformity with the GATS "*shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement*". A dispute settlement procedure is foreseen to resolve conflicting interpretations. The scope and character of prudential measures permitted under the "carve-out" of the Annex on Financial Services are not specified in the GATS, and there is clearly a need for clarification. The prudential exception must be assessed in light of the two purposes defined by the prudential carve-out: (1) the protection of depositors, and (2) ensuring the integrity and stability of the financial system.

The question is whether any national provisions relating to the corporate or organisational form of foreign banks that are different from those applying to their domestic counterparts, could be construed as constituting a violation of national-treatment.

Banks operating across borders can easily transfer losses from one country to another. In case of distress, a parent company could attempt to transfer good assets out of one country to itself or subsidiaries in other countries. The host country would in this case then bear the costs of a crisis that originated in another country (e.g., Hull, 2002). To reduce the potential burden on local taxpayers (and voters!) a country may choose to adopt special rules that provide for the protection of domestic

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The views expressed here are those of the author alone.

[1] Under Article XVII measures entailing deviations from national treatment are to be included in a country's schedule.

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stakeholders' interests by way of ring fencing of a foreign bank's domestic operations and other means, which will be further discussed in this article.

Foreign bank presence can take a variety of forms, ranging from the acquisition of domestic institutions with extensive branch networks to the establishment of isolated representative offices or operations across borders without a physical or legal presence (e-banking). However, only branches and subsidiaries book transactions and hold assets or liabilities. They are therefore most relevant from the perspective of safety and soundness.

Branches and subsidiaries – how different are they?

Branches are an extension of the parent bank, not a separate legal entity. Subsidiaries are separate legal entities. They have their own local capital base and their own local boards of directors.

Branches and subsidiaries typically involve different levels of parent bank responsibility and financial support. Subsidiaries are separate legal entities. By contrast, in the case of branches, parent banks are, in principle, responsible for their liabilities.

In practice, the distinction between branches and subsidiaries is much more subtle (Cerrutti et al., 2005). As markets and institutions become global, business decisions increasingly disregard legal and jurisdictional boundaries. Global financial institutions increasingby concentrate their managerial decision points in fewer places. In the case of risk management policies, financial institutions often measure their exposure to different risk factors on a global basis, consolidating all their positions, disregarding where these positions are booked. At the same time, global institutions increasingly book certain types of positions, like derivatives, in "hubs", to exert better control and to take advantage of economies of scale and friendlier regulatory environments. Some financial groups, as observed in Cardenas et al. (2003), are looking to consolidate all credit country risks in the country of origin. As a result, subsidiaries of such a bank may experience wider fluctuations in their profits and losses. The parent may, but in principle has no obligation to use gains in one entity to cover losses in another[1]. In good times, the distinction between branch and subsidiary may not matter because a banking group may be managed and treated by the market as a single economic entity. However, it appears that in times of stress, the differences between subsidiary and branch structures will matter.

Uncertain parent support

From the perspective of the host country concerned about the stability of the domestic financial system and the safety of domestic depositors' savings, the distinction between branches and subsidiaries and the legal framework under which they operate is of paramount importance.

If losses occur in a bank's home country operation, this can lead to the bank's retrenchment from foreign operations and cause the parent to abandon its foreign establishments. Unfavourable conditions in the host country and dim prospects of continued profitable banking may cause a retrenchment of foreign banks in a host country. As such, during the Argentine crisis, some foreign banks abandoned their branches or subsidiaries in Argentina, and depositors were not able to make claims against the foreign parent (Del Negro and Kay, 2002). Where the foreign bank's operations are significant, this can have an important effect on the stability of the host country's financial system. Such a situation can be found in Eastern and Central Europe, Latin America and also New Zealand. Pursuant to Caviglia et al. (2002) foreign investors own more than two-thirds of the banking system in accession Countries. Foreign ownership implies an effective control of over more than one-half out of the roughly 300 commercial banks in the region and is heavily geared towards the larger institutions.

[1] See *infra* note 3 on the "source-of-strength" principle.

Thus, the question arises whether or not and under what circumstances a parent company can be held liable for the obligations of its subsidiaries and branches. In the case of branches and agencies, the head office is in principle fully liable. In the case of subsidiaries there is, in principle, no legal obligation. Yet, there seem to be exceptions to those general rules:

(1) Under some circumstances, a *foreign parent may be willing assure the solvency of the subsidiary in order to maintain its reputation.* In fact, Argentinean depositors filed a legal dispute in Spain against the Spanish bank BBVA in order to recover deposits booked in Argentina given that "*[s]ome of the success of global banks in attracting deposits derived precisely from the fact they marketed themselves as being 'safer' than local banks because they have the backing of the parent company*" (Del Negro and Kay, 2002, p. 10).

(2) Under US law, there is a requirement that a holding company assists its bank subsidiaries in case of a crisis. Under the so-called "source-of-strength" principle in US law, a holding company must act as a source-of-strength to its subsidiary banks. "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." 12 C.F.R. § 225.4. "*A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe and unsound banking practice*…"[1] It is noteworthy that this provision seems to apply only to domestic subsidiaries.

(3) Support from the parent bank to its foreign subsidiaries should, however, not be taken as granted. A decision to support a subsidiary will be made solely in light of expected future profits and losses and expected reputational cost. The existence of financial agreements between parent companies and their subsidiaries in the form of "comfort letters" should not be considered as an incontrovertible source of strength since their enforceability in times of stress is untested.

(4) In order to limit reputation costs of abandoning a subsidiary, some internationally active banks may consider using different brand names. But this needs to be balanced against the marketing gains associated with the use of a single name for different legal entities. Different banks reach different conclusions, but the use of a common name is widespread. For example, after the merger of UBS with Paine Webber and Warburg, the firm undertook a marketing campaign to create a unified global brand.

(5) While a bank should in principle be considered liable for all its branches' obligations, ring-fencing provisions in home country laws may limit such obligations. As a result, banks may not be required to honour the obligations of a foreign branch in conditions where the branch faces repayment problems resulting from extreme conditions or events (such as war or civil conflict) or owing to certain actions by the host government (e.g., exchange controls, expropriations, etc.). For instance, in the case of U.S. bank branches section 25C of the Federal Reserve Act establishes that "*a member bank shall not be required to repay any deposit made at a foreign branch of the bank if the branch cannot repay the deposit due to an act of war, insurrection, or civil strife or (2) an action by a foreign government or instrumentality (whether de jure or de facto) in the country in which the branch is located, unless the member bank has expressly agreed in writing to repay the deposit under those circumstances*".

(6) This provision was introduced following the Philippine payment moratorium of 1983 (McCauley et al., 2002). A Singapore subsidiary of one US bank had placed a dollar deposit with another US bank's branch in Manila. After the Philippine government

[1] Federal Deposit Insurance Corporation, 52 Fed. Reg. 15707, April 30, 1987. 31 32

imposed a moratorium on the repayment of such deposits, the depositor bank sued the other US bank in American courts for repayment in the United States. The Supreme Court ultimately found in favour of the plaintiff, arguing that the deposit contract did not explicitly prevent the repayment in New York. US law was subsequently amended so that, in the event of a moratorium, payment would be required in the United States only if the contract explicitly called for repayment in such circumstances[1].

(7) Another example of a provision limiting the liability of the head office is found in the International Swaps and Derivatives Association (ISDA) Master Agreement. It stipulates that the headquarters will bear no responsibility for transactions made at overseas branches in the case of exchange controls or expropriation (see ISDA (2003), Section 10 (a) Ring-Fencing Agreements).

Foreign bank branches: asset maintenance, asset pledges, endowment (dotage) capital

Some jurisdictions impose asset pledge or asset maintenance requirements in order to assure that sufficient assets will be available in their jurisdiction in the event of failure of the parent bank. Also, a number of jurisdictions limit the types of activities that may be carried out through a branch structure. Branches subject to asset maintenance requirements have some of the characteristics of separately capitalized entities. The imposition of asset maintenance requirements enables the local regulator to continue to allow the institution to operate in its jurisdiction when there is concern regarding the safety and soundness of the bank's foreign head office. An alternative way to prevent any outflow of assets would be to close the branch early, but this would be feasible only if its soundness was in doubt. If it is solvent, the host country authorities would not have this option.

In *Canada,* foreign banks have the choice of two vehicles for establishing and operating bank branches in Canada: a "full-service branch" or a "lending branch". As a full-service branch, the foreign bank will generally not be permitted to accept "retail" deposits, i.e. amounts less than $150,000[2]. Also, the deposits are not eligible for insurance. Full-service branches are required to provide written notice to individuals opening an account and to post notices in their branches that deposits with the branch are not insured by Canada Deposit Insurance Corporation (CDIC). A full-service branch must also provide written notice that the Office of the Superintendent of Financial Institutions (OSFI) is responsible for supervising the foreign bank branch in Canada and is not the primary regulator of the foreign bank. Lending branches are prohibited from accepting deposits or otherwise borrowing money except from financial institutions. They are required to post notices in their branches that they do not accept deposits from the public and that they are not members of CDIC. In Canada, a full-service branch of a foreign bank is generally required to maintain assets on deposit equal to at least 5% of branch liabilities or $5 million, whichever is greater. These must be deposited with a Canadian financial institution approved by the Office of the Superintendent of Financial Institutions (OSFI). A lending branch will be required to maintain assets on deposit equal to $100,000. The deposits must consist of cash or acceptable securities, free of any encumbrances[3]. Subsequent to the commencement of operations, the Superintendent may impose more stringent asset maintenance requirements and order the foreign bank branch to maintain additional eligible assets specified as a percentage of the foreign bank branch's liabilities.

In the *United States*, some states give the state supervisor the authority to determine the asset maintenance ratio or to impose asset maintenance on a case by case basis. Others set the ratio by

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[1] Title 12, United States Code, section 633 (1994).
[2] Certain exceptions or "carve-outs" to this requirement are included in the *Prescribed Deposits (Authorized Foreign Banks) Regulations.*
[3] See OSFI's Guideline A-10 - Capital Equivalency Deposit for further details.

statute. Asset maintenance requirements may be imposed at levels in excess of total third-party liabilities. A foreign branch may be required to maintain a net "due to" parent position at all time[1]. In special circumstances, a state supervisor may require that the assets be placed in an account subject to special restrictions. These so-called asset pledge provisions, which are sometimes also referred to as capital equivalency deposits, require foreign bank branches and agencies to segregate a certain percentage of their assets in separate accounts pledged to the state supervisor. The branch or agency may make limited withdrawals and transfers, but not without the knowledge or consent of the state supervisor. The quality of the assets eligible for the asset pledge may be higher and the assets themselves more liquid than assets eligible for asset maintenance. The amount of the pledge is typically a percentage of the "total liabilities" of the branch or agency, which include all liabilities either "payable at or through" the branch or reflected on the books or records of the branch as liabilities of that office, excluding any liabilities to others offices, agencies, branches and affiliates of the bank ("intragroup liabilities"). In the event of liquidation of the foreign bank, the pledged assets are available for liquidation expenses and to satisfy depositors or other creditors of the branch.

In the *European Union (EU)*, the introduction of the single license and abolition of the authorisation requirement for EU branches of banks established in the EU led to the abolition of endowment capital. EU legislation does not deal with the establishment of branches by banks from third countries. The conditions for setting up branches are determined by national law. A number of EU Member States maintain the requirement for endowment capital for branches from banks in third-countries. Branches from third countries do not benefit from the single license regime. In other words, they cannot offer services across borders throughout the European Economic Area (EEA).

In *Germany*, a branch from a non-EU country needs an initial capital of at least Euro 5 million if it intends to accept deposits or other repayable funds from the public and to extend credit[2], otherwise a lesser amount will suffice, depending on the services offered[3].

In *Switzerland*, endowment capital is generally not required, though the Swiss Federal Banking Commission (SFBC) can require the branch to provide a guarantee if it determines that endowment capital is needed for the protection of creditors[4].

Local incorporation requirement

A number of jurisdictions have codified requirements regarding the corporate forms of foreign banks where operations involve significant risk or are undertaken on a significant scale. Incorporation as separate legal entity ensures that assets and liabilities are separable from those of the foreign parent or head office, which is not the case with a branch. A branch is only physically but not legally separate from the head office and does not have its own legal personality. With a branch it may be difficult to determine what assets are, or would be, available in a failure to satisfy creditors' claims and which liabilities can be attributed to the branch. Assets can easily be transferred from the branch to the foreign head office and the management of the branch does not have a fiduciary responsibility to the branch's local clients. By contrast, local incorporation ensures that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent. A locally incorporated bank has its own board of directors and those directors are required to act in the best interests of the company, to prevent the bank from carrying on business in a manner likely to create a substantial risk of serious loss to the bank's creditors. It is generally held that these directors' duties together with a legal entity structure provide much greater control in the

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[1] See, e.g., N.Y. Banking Law § 202-b(1) and (2) (2002) (setting forth the asset maintenance and pledge requirements for a New York state licensed branch).
[2] Sec. 33 (1) and section 53 (1) Gesetz über das Kreditwesen of July 10, 1961, 1961 BGBl. I 881, in the version of Sept. 9, 1998, 1998 BGBl I 2776 as amended (Kreditwesengesetz) KWG (Banking Act).
[3] Sec. 23 (3) KWG.
[4] Art. 7 Ordinance of the Swiss Federal Banking Commission on Foreign Banks in Switzerland of October 21, 1996 RS/SR 952.111 (Foreign Banks Ordinance).

event of a failure and increase the likelihood that value will be retained in the local bank in the lead up to a failure. Some countries, such as the United States and Australia, have local depositor preference schemes which favour domestic depositors over foreign branch depositors[1]. More generally, there may be a perception that host country creditors may not be treated equitably if the crisis is managed from the foreign home country. In particular in case of a large bank failure, the fate of foreign branches may be uncertain. Laws of the home country may be rewritten under political pressure in order to give a preferred treatment to home country stakeholders. In times of crisis, cooperation with foreign authorities may be difficult. A cooperate home/host relationship requires time to develop. Yet, ownership may change. If the foreign bank is acquired by a bank from a third country, the counterparty for home/host coordination changes. Local incorporation provides more effective control in a banking crisis and enables the host country authorities to act more independently as would be the case with respect to branch operations. Other reasons for requiring local incorporation along with the requirement to have some key operations in the host country may preserve jobs and protect the host country's tax base.

A number of jurisdictions impose a local incorporation requirement for foreign banks that want to operate deposit taking activities in their jurisdiction.

In *Australia*, a foreign bank is not permitted to accept retail deposits, that is deposits or other funds of less than AUD 250,000, from individuals and non-corporate institutions. While retail deposit taking activities are restricted, foreign bank branches are permitted to accept deposits and other funds in any amount from incorporated entities and from non-residents[2]. They are subject to strict disclosure requirements to ensure that depositors opening an account or making an initial lodgement of funds understand that the foreign bank branch is not subject to depositor protection[3]. Likewise in *Canada,* if a foreign bank intends to take retail deposits, it must set up a separately incorporated subsidiary. Foreign banks wishing to engage in retail deposit-taking in the *United States* may do so only through an insured, domestically-chartered subsidiary bank[4], Branches that had FDIC insurance prior to December 19, 1991 (the effective date of FBSEA) were grandfathered and may continue to accept retail deposits, but no new insured branches may be established. Foreign bank branches may accept deposits only in excess of $100,000 (wholesale deposits) from U.S. citizens and residents and other deposits as specified by the FDIC and OCC that do not require deposit insurance protection. Deposit insurance is offered only to U.S.-chartered depository institutions. Some states restrict deposit-taking by foreign banks to non citizen non-resident deposits[5].

In *New Zealand,* foreign banks intending to take retail deposits[6] may be required to incorporate locally if one of the following conditions is met[7]:

(1) The foreign bank is incorporated in a jurisdiction that has legislation which gives deposits made, or credit conferred, in that jurisdiction a preferential claim in a winding up. The rationale is that it is difficult for New Zealand depositors to assess their likely position in a bank failure if the legislation in a foreign bank's home jurisdic-

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[1] Under the Depositor Preference Act of 1993, deposits at foreign offices of U.S. banks are subordinated to deposits at domestic offices and are eligible for payment only after domestic deposits have been paid in full.
[2] 11E(1) Banking Act 1959.
[3] 11E(2)(b) Banking Act 1959.
[4] See Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA"). The FBSEA was passed as a direct reaction to the well-publicized improprieties of two foreign banks namely the Bank of Credit and Commerce International ("BCCI") and Banca Nazionale Del Lavoro ("BNL"), an Italian bank. The Act gave the Board of Governors of the Federal Reserve a more direct role in the supervision of foreign bank activity in the United States. It mandates, among other things, annual on-site examinations of all foreign branches and agencies and requires the approval for the establishment of any new branch, agency, subsidiary, or representative office.
[5] See, e.g., N.Y. Banking Law § 201-b (2002), N.J. State Ann. Tit. 9-B, § 1314(1); CAL. Fin. Code § 1755(b) (2002).
[6] A retail deposit-taker is defined as a financial institution that has more than $200 million retail deposits on its books in New Zealand. Retail deposits are defined as deposit liabilities held by natural persons, excluding liabilities with an outstanding balance of more than $250,000.
[7] See The Banking Supervision Handbook, Statement of principles: bank registration and supervision, BS1, March 2005, sec. 23 *et seq*.

tion gives depositors or creditors in that country a preferential claim on assets. New Zealand depositors, depositors in the home jurisdiction, New Zealand creditors and creditors in the home jurisdiction may each have different claims on the same legal entity. The situation is even more complex when the legal entity has branches in other jurisdictions as well. In contrast to retail depositors, wholesale depositors and creditors, while faced with the same information gap as retail customers, are generally considered to be able to understand the deficiencies in the information disclosed and can take them into account when making investment decisions. Thus, foreign banks that deal solely with wholesale clients are not required to incorporate locally purely on the basis of inadequate disclosure or depositor preference legislation[1].

(2) The foreign bank's home jurisdiction does not provide for adequate disclosure[2]. In that case, New Zealand depositors have no way to assess the financial strength of the foreign bank as a whole and the likelihood of the bank failing.

(3) The foreign bank operates both as a branch and a subsidiary in New Zealand. In this case, the foreign banks will not be permitted to take retail deposits through the branch operation[3]. If banks with a dual registration were able to take deposits through both entities it is likely that depositors would be confused about which entity they were dealing with. The operation of a foreign bank branch in New Zealand is subject to the requirement that the business of the bank in New Zealand does not constitute a predominant proportion of the business of the global bank[4].

(4) The foreign bank is systemically important as defined by the Reserve Bank. Systemically important banks are defined as those whose New Zealand liabilities, net of amounts due to related parties, exceed $10 billion. The incorporation requirement serves to ensure that the bank can function on a stand-alone basis if the foreign parent experiences difficulties. It also gives the Reserve Bank some assurance that it would have the ability to manage a failure affecting one of these banks[5].

Governance structures and listing requirements

Global financial groups manage their investments globally and allocate resources across their various subsidiaries on the basis of their assessment of the risk/return trade-offs. These actions are undertaken for the benefit of the stockholders of the controlling institution. Concerns may arise when the actions affect domestic stakeholders, such as local depositors and authorities. For this reason, the governance structures of the subsidiaries should be designed to reflect the interests of both the parent company and the stakeholders of the subsidiary. The importance of the board and management looking after the interests of all the stakeholders of the financial institutions is recognized under *New Zealand* law. Banks in New Zealand must have charters that explicitly prevent directors from damaging the subsidiary and its creditors in the course of pursuing the interests of the holding company. The Reserve Bank of New Zealand sets out this requirement explicitly when authorizing the purchase of Lloyd's National Bank of New Zealand by the Australian ANZ banking group. The operation was approved subject to conditions "*aimed at ensuring that local boards have effective operational reach over core assets and people, and the lines of responsibility and accountability are clear*" (Bollard, 2003). Moreover, a requirement to have independent directors

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[1] *Ibid*., sec 35.
[2] *Ibid.*, sec. 32. When assessing the adequacy of disclosure, the Reserve Bank will consider namely the quality of accounting standards used to prepare the applicant's accounts, the frequency and timeliness of publication of the accounts, the quality of auditing standards used by the auditors of the applicant's accounts, the adequate disclosure of accounting policies, the availability of both legal entity and consolidated accounts and disclosure of key indicators of financial soundness such as capital adequacy ratios and impaired asset data.
[3] *Ibid*., sec. 39.
[4] *Ibid*., sec. 38.
[5] *Ibid*, sec. 26.

seeks to ensure that the management of the subsidiary acts in the best interest of the local institution.

Another approach that is used to ensure that domestic stakeholder interests are addressed is to require the domestic subsidiary to be listed on the local stock exchange. Market discipline is generally stronger when institutions are listed on a stock-exchange and subject to its disclosure requirements. If banks are de-listed as a result of being acquired by a foreign stockholder, this could result in loss of market discipline. Information disclosure will not by itself lead to more stringent market discipline in conditions where the lack of market-traded instruments preclude market signals and the scrutiny of independent financial analysts (Cardenas et al., 2003). Even if the acquiring foreign bank is listed in its home market or even in the host country market, the information that it releases as a result may not be sufficient to assess the soundness of its subsidiary unless the latter represents a significant share of the total assets, which is rarely the case. The problems associated with de-listings have led authorities in some countries to persuade foreign banks to keep the shares of acquired institutions listed. This policy is applied in *Poland* (Bednarski et al., 2002) and also considered in *Mexico* (Majnoni et al., 2005).

Restrictions on centralization and outsourcing arrangements

A recent development is the trend in large banking groups to concentrate different functions, such as funding and liquidity management, risk management and credit decision-making to specific centres of competence in order to reap the benefits of specialisation and economies of scale. As a consequence, subsidiaries are becoming less self-contained, and it can no longer be taken for granted that even a large subsidiary will be able to continue its operations if the parent bank defaults – at least not in the short run.

The outsourcing of operations or "offshoring" of operations beyond national borders also increases risk. Arrangements are sometimes entered into with unrelated parties, while in other cases the outsourcing firm establishes its own offshore base (i.e., through an affiliate) to provide services. Risks to the continued performance of the function can arise when the contractual terms and conditions of the outsourcing arrangement are not sufficiently clear and complete to ensure continued service provision under circumstances of stress of either the service provider or of the bank itself. If the service provider is in another jurisdiction, a risk exists that proceedings to enforce performance may have to be brought in that other jurisdiction's court and under that jurisdiction's laws. If so, the bank may be less able to ensure continued performance than if the provider were domestic, and if proceedings were handled by domestic courts and under domestic law. If the provider (or the provider's ultimate parent) is regulated by a foreign regulator, there is a risk that the duties and powers of that regulator will cause it to intervene in such a way as to interfere with the provider's performance. If the provider is also performing functions for other entities in a way in which the functions are operationally mingled, there is a risk of competition for the provider's resources that could impede the performance of functions for the bank.

Financial regulators in many jurisdictions have established policies on outsourcing that seek to ensure that the arrangements are adequately managed, and that the viability of the firm is not compromised[1]. Under the new European Market in Financial Instruments Directive, firms must not undertake the outsourcing of important operational functions in such a way as to impair materially

[1] Various international bodies have issued guidance on outsourcing. These include the Joint Forum ("Outsourcing in Financial Services", 15 February 2005), the International Organization of Securities Commissions (IOSCO) published its Principles on Outsourcing of Financial Services for Market Intermediaries ("Outsourcing Principles" of 15 February 2005), the Committee of European Banking Supervisors (CEBS) (CP 02 30th April 2004 "The High Level Principles on Outsourcing") and the Committee of European Securities Regulators (CESR) which published advice on the implementation of EU legislation on outsourcing within the Markets in Financial Instruments Directive (MIFID).

the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations[1].

Some jurisdictions have gone a step further and imposed restrictions on the centralisation of functions or the outsourcing of activities in foreign jurisdiction in order to ensure that the continued operation of core functions that are crucial for the a financial system and the wider economy as a whole are not compromised.

In *New Zealand*, for instance, the Reserve Bank places specific obligations on bank boards to ensure that they retain sufficient control of outsourced functions, while providing flexibility in the means by which a bank may meet the policy's requirements (Bollard, 2004). The policy is framed in terms of the continuity of bank functions and the provision of core services. In the event of a failure of a bank or a service provider to a bank, these functions must be continued without material interruption in order to avoid significant damage to the financial system.

The banks are required to have a legal and practical ability to control and execute any business, and any functions relating to any business, of the bank that are carried on by a person other than the bank. Whereas the ability to control and execute a function refers to the ability to invoke statutory, contractual or other rights to ensure that the function continues to be provided, the practical ability to control and execute a function refers to the ability to secure continued provision of the function, taking into account any delays associated with the enforcement of legal rights, the availability and responsiveness of personnel with the necessary technical and business knowledge and physical access to and control of the required systems and data. More specifically, banks are required to ensure that under normal business conditions and in the event of stress or failure of the bank or of a service provider to the bank

(1) the bank's clearing and settlement obligations due on a day can be met on that day; financial risk positions on a day can be identified on that day;
(2) financial risk positions can be monitored and managed on the day following any failure and on subsequent days; and
(3) existing customers can be given access to payments facilities on the day following any failure and on subsequent days.

In addition, banks whose New Zealand liabilities, net of amounts due to related parties, exceed $10 billion (Large Banks) are subject to a condition of registration relating to outsourcing arrangements[2]. They also must ensure that

(1) the management of the bank by its chief executive officer or person in an equivalent position (together "CEO") be carried out solely under the direction and supervision of the board of directors of the bank;
(2) the employment contract of the CEO of the bank is with the bank. The terms and conditions of the CEO's employment agreement must be determined by, and any decision relating to the employment or termination of employment of the CEO must be made by the board of directors of the bank; and
(3) all staff employed by the bank shall have their remuneration determined by (or under the delegated authority of) the board of directors or the CEO of the bank and are accountable (directly or indirectly) solely to the CEO of the bank.

In Poland, subsidiaries of a foreign financial group play a significant role although they present only a fraction of the parent's balance sheet (Bednarski et al., 2002). The National Bank attempts to address the problem arising from the asymmetric relations between the parent bank and Polish subsidiary by applying the "stand alone principle" that is requiring that systemic foreign subsidiaries be able to operate on a stand-alone basis (Bielicki, 2005). This principle translates into the re-

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[1] Art. 13 of the Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (Markets in Financial Instruments Directive).
[2] See Reserve Bank of New Zealand, Financial Stability Department Document BS1, Outsourcing Policy, October 2005.

quirement that management in all areas should be in the hands of the local management board. Besides group-wide risk management, local risk management must be in place with the necessary resources and expertise available at the local level.

When imposing restrictions on centralization and outsourcing it is necessary to carefully weigh the gain in efficiency against greater dependency on foreign operations and the risk of failure. Requiring major financial institutions to operate on a stand-alone basis may significantly reduce banking efficiency to the extent that it forces them to rely on more costly and less expert in-house resources. On the positive side, outsourcing can reduce the probability of failure through diversification and access to greater expertise and capital.

Ex post remedies – the separate entity approach

In some jurisdictions, a carving out of domestic operations and assets from a distressed foreign bank may only take place in an insolvency scenario. Under this so-called separate entity approach, branch operations that normally form an inseparable part of the foreign head office are treated as if they were separately incorporated (Baxter, 2004). If the host country is able to detach the local branch from the larger bank in a crisis situation, it will be able to assume control of all domestic operations as in the case of local incorporation discussed earlier. Such an approach may give rise to conflict and a regulatory run on the assets to be assigned to the branch. The host country may seek to take a larger share of the global bank's capital whereas the home country may seek to transfer assets from the branch to the parent balance sheet.

In *Canada*, the Office of the Superintendent of Financial Institutions (OSFI) is authorized to seize all of the assets of the foreign bank in Canada. These assets can be used to satisfy the claims of depositors and creditors of the foreign bank branch in Canada. If these assets are not sufficient to reimburse depositors and creditors of the Canadian branch, they could seek recourse from the liquidator of the foreign bank in the home jurisdiction.

In the *United States*, some state laws provide for the taking of possession of the branch located in that state[1]. An amendment to the Bankruptcy Code that became effective on October 17, 2005 explicitly preserves the ability to conduct a separate liquidation[2]. Others allow the state supervisor to

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[1] See, e.g., Mich. Stat. Ann. § 487.15103 (2002).

[2] Pursuant to Section 1501(c)(1) and 109(b)(3)(B) of the Bankruptcy Act foreign banks may file under chapter 15 only if they do not have a branch or agency in the United States. Foreign insurance companies, by contrast, are permitted to commence chapter 15 proceedings apparently without limitation. These provisions were introduced with the Bankruptcy Abuse Prevention Consumer Protection Act of 2005 following the "Yugo case" which had giving rise to concerns over the legality of ring fencing and the conduct of a "local liquidation". The foreign liquidating agency in of Jugobanka sought to use Section 304 of the Bankruptcy Code that permits the U.S. Bankruptcy Courts to grant assistance to worldwide proceedings. The case stems from a 1992 order by the first President Bush freezing assets of Yugoslav-owned banks in connection with the Balkans crisis. Jugobanka, which rented 30,000 square feet at 437 Madison Avenue in Manhattan owned by Sage Realty eventually stopped paying rent. While Sage won a ruling in seeking about US$4 million in rent and interest in American federal courts, Jugobanka sought bankruptcy relief in Serbia. Judge Blackshear ruled that Jugobanka did not have standing to repatriate the assets to Serbia and that no jurisdiction here permitted that. Judge Rakoff -- who as a district judge hears appeals from Bankruptcy Court -- reversed Judge Blackshear, and said Jugobanka had the right to make that argument before Judge Blackshear. See In re Agency for Deposit Ins. Rehabilitation, Bankruptcy and Liquidation of Banks v. Superintendent of Banks of New York, 313 B.R. 561, 564 n.1 (S.D. N.Y. 2004) ("*without section 304 relief, the foreign bank's U.S. assets are subject to control of state banking regulators who likely will "funnel the assets of failed U.S. branches of foreign banks to domestic creditors in preference to foreign creditors*"). The regulators asked Judge Rakoff to reconsider his decision, arguing that it threatens to legitimize Jugobanka's attempt to take those assets offshore to Yugoslavia, beyond the reach of state banking laws and regulators. Conference of State Bank Supervisors president Neil Milner wrote, "*…the states' banking regulators have the sole authority to liquidate the assets of an insolvent state-licensed foreign bank for distribution to creditors of the bank's branch or agency. We write to point out that the Court's interpretation of Section 304, as applied in this context, is unprecedented and brings the Bankruptcy Code -- which ordinarily would not apply to these institutions -- into irreconcilable conflict with state bank insolvency laws. The Court's application of Section 304 would alter fundamentally how state-licensed foreign banks are regulated. The purpose of state licensing and supervision is to protect the creditors who do business with state-licensed foreign entities. Expatriating the assets to a foreign proceeding would defeat this*." The amendment to the Bankruptcy Code resolves the issue in favour of the interpretation of the bank supervisors.

take possession of all of the assets of the foreign bank located in that state[1]. Under the New York Banking Law, for example, the Superintendent of Banks can take title not only to the assets of the branch wherever located, but also to all assets of the foreign bank located in New York[2]. Given New York's position as an international financial centre, the foreign bank may indeed have substantial assets in New York, such as correspondent bank accounts established by other branches of the foreign bank, title to which vests in the Superintendent when the Superintendent takes possession of the branch[3]. The payment of claims against the branch is usually limited to third party claimants having a transaction with the branch or agency and excludes subsidiaries, affiliates or other offices of the foreign bank[4]. With court approval, the state supervisor may compromise debts and sell property. Some state statutes specifically provide for the adoption or the rejection of contracts, such as leases and other executory contracts. Some incorporate explicit statutory protection for multi-branch close-out netting. As such, New York banking law provides that, following termination of a multi-branch master agreement, the single net termination amount is calculated on both a global and New York-branch only basis[5]. The Superintendent of Banks, as receiver of the branch, is only liable to pay to a non-defaulting party the lesser of the two amounts. Some states permit the state regulator to recover any transfers made by the branch in contemplation of insolvency[6] or void such transfers[7]. Some states also provide for an automatic stay of all actions brought against the foreign bank branch[8]. When the liquidation of the branch is complete, the residue is transferred to the foreign bank. If the bank has another office or offices in the United States and if the assets of those offices appear to be insufficient to pay creditors in full, the court may order the state regulator to transfer funds to cover the insufficiency[9].

In *New Zealand,* a foreign bank branch can be converted into a subsidiary in order to ring fence its operation from distress at its head office. Under Section 117 of the Reserve Bank of New Zealand Act, the Reserve Bank can recommend to the Minister that a bank be placed under statutory management where there is a threat of insolvency. A statutory manager has wide powers, including the power to suspend payment of money owing and the power to convert a branch of a foreign bank into a locally incorporated entity[10].

Resolution of foreign-owned bank insolvencies

Difficulties with the efficient resolution of foreign-owned bank insolvencies arise from inherent incentives of regulators to favour the welfare of their domestic jurisdiction at the expense of the foreign home or host country. Bank failures are managed on a national level and in the national interest. Coordination and cooperation among home and host countries are a necessary but not a sufficient condition to solve the problem (Hüpkes, 2005). What appears to be required is greater harmonization and homogeneity, particularly of closure policies and claims resolution. Indeed, multinational regimes that are standardized in terms of both provisions and enforcement, can be seen as a desirable way to ensure that bank failures are resolved efficiently and in an equitable manner (Ingves, 2006). But there are many challenges in putting such a system in place so that it is unlikely that a single, multinational structure, even if it was limited to only the world's largest banks, will be adopted in the near future. In the meantime, how should cross border banking be operated? Until a satisfactory solution to the problem can be developed, it appears to be in the best

[1] See., e.g., Cal. Fin. Code § 1785 (2002).
[2] N.Y. Banking Law, § 606(4)(a) (2002).
[3] N.Y. Banking Law, § 606(4)(a) (2002).
[4] See, e.g., N.Y. Banking Law § 606(4)(a) (2002).
[5] The "global net amount is the amount owed by or to the non-U.S. bank as a whole if all transactions across all branches subject to the multi-branch netting agreement are considered. The "New York or local branch net amount" is the amount owed by or to the non-U.S. bank after netting only the transactions entered into by the New York branch.
[6] See, e.g., Ga. Code Ann. § 7-1-157(b) (2002).
[7] See, e.g., Con.. Gen. Stat. § 36a-235 (2002).
[8] See., e.g., N.Y. Banking Law § 619 (2002).
[9] See, e.g., N.Y. Banking Law § 606(4)(b) (2002).
[10] Sec. 140 Reserve Bank of New Zealand Act.

interest of countries to devise a regulatory framework governing physical cross border banking presence that reduces the problems arising from financial failures in a cross-border context.

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