

SOME ISSUES IN CROSS-BORDER *bank regulation*

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This paper examines three methods of cross-border banking and their treatment under Australian regulation. It also compares these different forms of cross-border banking in a situation in which the banking business is facing financial difficulty and resolution is required. Several reform proposals are also provided to address the challenges associated with banks contracting under foreign laws and through branches.

Cross-border banking

Banking is a commercial activity that often takes place across borders. Although we may think of this as a recent phenomenon arising from the deregulated financial system that arose from the late 1980s and reached its zenith in 2007, it is much older. Think of the old Anglo chartered banks, incorporated in England, with English capital, but with most of their business in Australia, New Zealand, South Africa and other colonies. The predecessors of ANZ (the Banking Australasia and the Union Bank) were examples of this,¹ and Standard Chartered Bank is another. Much earlier, there were great banking families, Medici, Fuggers and Rothschilds, handling payments, bullion and raising loans across the cities, principalities and states of Europe.

In modern times, banking is also a regulated activity since, if left entirely to a free market, it is prone to bouts of instability and loss.² So most jurisdictions now require a bank to obtain a licence to conduct business and impose upon it some measure of ongoing prudential requirements and supervision, such as requirements to hold a certain quality of capital or liquid assets and have sound management and supply the authorities with copious data about its financial position.

Regulation is essentially territorial. It is also not uniform and, despite the best effects of international cooperation through organisations such as the Financial Stability Board (FSB) and the Bank Committee on Banking Supervision (BCBS), it is unlikely that it ever will be. Regulators may agree among themselves to share information and to cooperate but this does not mean that they are free to depart from the direction of their local laws.³ To apply regulation to cross-border banking frequently involves a decision as to the point of nexus between the activity and the jurisdiction. The nexus may be formed by incorporation, by business presence or in some cases by the use of the law of the jurisdiction in contracts. Jurisdictions may see the points of nexus in different ways and have different substantive rules. Conflicts of laws are likely to arise.

Of course, these conflicts could be avoided if banks did not venture beyond the borders of their home jurisdictions. In the aftermath of the financial crisis that began in 2008 some might think that would be a good thing. The overseas forays of financial behemoths have ended in disappointment at best, and outright disaster at worst. Some say such institutions are unmanageable, others that they are dangerous conduits for the transmission of malpractice and risk to otherwise safer quarters of the globe. Let us put an end to this by law, they say. This equation of domestication and security is, in my view, an error.

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If we ask which is more secure, an international or a domestic banking system, the answer is that it depends upon the nature of the economic difficulties to which it is subject. It is true that an internationally active bank may transmit an overseas crisis to a healthy domestic economy. But, on the other hand, it may protect the domestic financial system from the worst effects of a domestic slump. This is one lesson of the Australian crisis of the 1890s. The slump was most acute in Australia. Australian financial institutions failed. The cross-border 'Anglo' banks with their foreign capital resources remained open, and their deposits secure. Further, a purely domesticated banking system relies on a balanced economy where domestic banks are financed from domestic savings and finance domestic loans. In an open economy with persistent current account deficits some element of cross-border banking activity is unavoidable. The question is rather: what is the best approach to conducting this activity and, in particular, what is the best structure for allowing an institution to be resolved, should it fall into difficulty?

The conduct of cross-border banking

I will discuss three methods of cross-border banking, and illustrate how they are treated in Australian regulation.

These are:

- > subsidiary banking
- > branch banking
- > cross-border banking by contract.

Subsidiary banking: This is straightforward: a separate legal entity is incorporated in the domestic (or 'host') jurisdiction. It is owned by a foreign banking parent, and may rely to a greater or lesser degree on the foreign parent's brand and know-how. It is unlikely to be guaranteed by the foreign parent, and it is separately capitalised.

Branch banking: A company may carry on business in more than one place.⁴ That physical place is a branch. The branch is not at law an entity separate from the parent, although particular laws may treat activities at a branch in one jurisdiction differently from activities at another branch.⁵ As it is the same legal entity, there is no legal obligation between branches⁶ and an obligation incurred through a dealing at the branch is a liability of the legal entity, not merely of the branch, unless the creditor agrees to limit its recourse to the assets of the branch. The capital of the banking business is the capital of the legal entity, not the branch.

Cross-border banking by contract: Banks may deal with people in a jurisdiction from a place of business outside the jurisdiction and without having a place of business inside it. Examples of this practice are where a bank raises funds in the international bond markets⁷ or where it participates in wholesale lending activities, e.g. syndicated loans, without having a place of business in the jurisdictions where the borrower is a resident. Activities of this nature are likely to increase with the growth in electronic commerce.

Which forms of cross-border business a bank chooses to engage in is a product of many factors, including its business model and what is permitted by local regulation.⁸ In a jurisdiction which permits foreign banks to operate either as a branch or through a subsidiary, if the model is for a purely domestic operation, borrowing from domestic deposits and lending to a domestic business, a subsidiary may be more likely to be the chosen legal vehicle. Where, on the other hand, the model contemplates cross-border business in wholesale markets, a branch may be preferred on the basis that counterparties will want to have the credit of the foreign institution securing their claims. Branch banking is likely to require marginally less capital and hence is less costly, since it is easier to allocate capital within a legal entity than when there are separate capital requirements for separate subsidiaries. The contractual structure may be convenient if the nature of the business can be prosecuted without a physical presence.

For an example of how the different forms are tolerated by a regulatory system, we may turn to Australian law. The starting point is territorial and is applied on the basis of physical presence. Under the *Banking Act 1959* (Cth) ('Banking Act'), a person carrying on banking business in Australia, whether incorporated in Australia or not, must have an authorisation from the Australian Prudential Regulation Authority (APRA).⁹ Licences may be granted to Australian or to foreign incorporated companies, but there are restrictions on the latter. First, they must be licensed deposit-taking institutions in their jurisdiction of incorporation. In practice, this needs to be a jurisdiction with a supervising regime that APRA regards as adequate.¹⁰ Second, their activities are limited to dealing with customers who are broadly 'wholesale'.¹¹

Australian law also regulates contracting from abroad with Australians. Such activity may require the consent of APRA. This is because, without APRA's consent, the Banking Act prohibits the use of the term 'bank' and cognate expressions in Australia by a person carrying on a financial business, whether or not that business is carried on in Australia.¹² Unless the entity has, with APRA's approval, established a branch or a representative office in Australia,¹³ this may confine the entity's activities to those permitted by other class orders, for instance, wholesale fundraising by certain foreign financial institutions, subject to conditions,¹⁴ or require specific consent.

The *Corporations Act 2001* (Cth) ('Corporations Act') overlays additional restrictions. Offers of 'financial products' aimed at Australian investors may require the issuer to have an Australian financial services licence.¹⁵ The issue of debentures to retail investors is deemed to constitute carrying on business in Australia.¹⁶ Any bank doing this would be forced to register as a foreign corporation with ASIC and would require a specific consent from APRA.

Legislation in many other jurisdictions follows a broadly similar pattern.

Resolving cross-border banks

Suppose then that a cross-border banking business is in financial difficulty and needs to be resolved. How do the different forms of cross-border banking compare?

As a first step it is necessary to appreciate some of the techniques of a modern system of resolution. By resolution I mean a formal procedure, short of winding up, for keeping the banking business 'viable', so that it's a going concern. These include the following actions by direction of the prudential regulator:

- > a merger or transfer of business to a sound institution or to a 'bridge bank';
- > a recapitalisation, in particular by cancelling debt or converting certain existing liabilities to equity;
- > a transfer of ownership, where the existing share capital is temporarily seized by regulator, and redistributed among creditors in exchange for the cancellation of their debts.

It is envisaged that these methods are implemented at great speed, e.g. over a weekend.¹⁷

Now let us consider the application of these resolution measures to the different forms of business, starting with subsidiaries.

Subsidiaries

Since the subsidiary is a separate legal entity incorporated in the domestic or host jurisdiction, it should be most susceptible to the powers of the host regulator. Its corporate existence, its shareholdings, and likely most of its assets are shaped by the law of the host jurisdiction. There should be little conflict with the rules of the foreign regulator, at least so long as the foreign regulator agrees to let the resolution of the subsidiary be a matter for the host regulator. Yet there may be practical problems. Both subsidiary and foreign parent may be in difficulty. One may be dependent on the other for services or access to capital. Foreign and host regulator may have different judgments, different plans or inconsistent duties under their national laws.

Branches

This method throws up greater challenges. Two regulators and national laws are seeking to deal with the one legal entity. Outside legal systems which have adopted a common law,¹⁸ there is no general principle for the courts of one country to recognise comprehensively the resolution measures of another. In particular, the Model Law on Cross-Border Insolvency¹⁹ does not apply to banks.²⁰ The effective transfer of shares or other property pursuant to a resolution measure may be frustrated by rules of private international law that do not recognise a foreign regulator's action where it purports to affect title to property in the jurisdiction.²¹ The common law is a patchwork of remedies and jurisdictions, always liable to be trumped by mandatory laws of the jurisdictions where the case is being heard.²²

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Moreover, in the winding up of banks and their branches there are widespread departures from the usual insolvency principle that available assets be distributed among creditors equally and rateably. Examples of these departures are:

- *Local depositor preferences:* where depositors in the supervised jurisdiction are liable to be paid out of assets, or assets within the jurisdiction, in preference to other creditors. In some jurisdictions the preference is limited to the extent that the deposits are covered by a guarantee or insurance scheme,²³ in others, such as Australia, where it applies to Australian incorporated banks, they are unlimited in amount.²⁴
- *Local creditor preference:* where local creditors (depositors or not) of a branch of a foreign bank are given a prior claim on assets of the bank in the jurisdiction over other creditors or the assets are otherwise 'ring-fenced' for the benefit of local creditors.²⁵
- *Set-off:* in some jurisdictions, a creditor of an insolvent bank may set-off claims they owe to the bank against the claims it has against the bank. In others, the creditor must pay what it owes to the bank and prove for its claims in the insolvency of the bank. Where the bank operates as a branch, and is being wound up in its home jurisdiction and in the place of the branch, and the home jurisdiction does not allow set-off, will the branch winding up proceed on the same basis? No, said the court in *Re Bank of Credit and Commerce International SA (No.10)*,²⁶ the English rules for set-off are mandatory.

There are further complications. Suppose a creditor of a branch is given a priority claim by local law. Notwithstanding that preference, he does not recover in full. He goes to prove the balance of his claim in proceedings in the foreign jurisdiction. The foreign court may not allow his claim, to the extent the creditor has received a preference under local laws over what it would have recovered had he been treated *pari passu* with creditors in the jurisdiction of the foreign court. To be allowed to claim in the foreign proceedings, the creditor must first give up its preference.²⁷ As well as this common law rule, there are signs of jurisdictions proposing to legislate against jurisdictions which provide a preference to home depositors.²⁸

Contracts

This is legally less complex but no less convenient. The outcome will turn on the law chosen by the parties to govern the contract and the rules of private international laws that govern the effect of statutes and regulatory action on contracts.

Suppose a German bank issues bonds governed by New South Wales law in the Australian wholesale capital market. Under German law resolution measures purport to discharge or vary the bank's liabilities. Are those measures effective if the matter is before a New South Wales court? No, because under New South Wales law discharge and variation of contracts is determined by the governing law of the contract and that is New South Wales law, not German law.²⁹

Suppose, on the other hand, an Australian bank borrows in the US markets under New York law. As part of a process of resolution APRA directs the bank not to repay the borrowing.³⁰ The Banking Act purports expressly to present the consequences, notwithstanding the choice of foreign law,³¹ but it is doubtful that this would be effective in New York proceedings.³²

Proposals for reform

How could the difficulties with banks contracting under foreign laws and through branches best be addressed?

A blunt rule requiring a bank to contract only by instruments governed by the law of its home jurisdiction would resolve the problems of the recognition of home state resolution measures. Already we are seeing some moves to require this by certain regulators in relation to borrowings by their banks.³³ The implications of adopting rules of this kind merit careful consideration. In bond markets, choice of the investors' law, or an internationally accepted law (e.g. English law or New York law) is customary to protect the investor from the risk of foreign state action to relieve the debtor from its obligations.³⁴ Requiring the use of the bank borrower's law moves that risk to investors. It is likely that a price will be charged for that risk. It may at least be more prudent to create a framework where parties are free to allocate that risk. Where it lies with investors, the bank may receive recognition in the issuer's capital structure as a bond susceptible to bail in, or counting towards 'total loss absorbing capital' but bonds could still be issued on traditional terms to investors who do not wish to take that risk.³⁵

The problems that may arise between parent and its subsidiaries might be mitigated by agreements between regulators to act in a coordinated fashion, coupled with laws empowering them to act in that way. An example is the Memorandum of Understanding between the Federal Deposit Insurance Corporation in the United States and the Bank of England, under which the regulators propose that in many cases it would be appropriate for a cross-border globally significant group to be resolved by the resolution of the ultimate holding company under the direction of the regulator in that country's jurisdiction. Such a regime requires a high level of trust between the regulators and how appropriate it is may vary according to the structure of the group, the nature of its business and the size and location of its losses and, in some cases, these may favour resolution action by both regulators.³⁶ Australia is yet to adopt this approach.

The problems of branches could be dealt with by a blunt requirement that business be carried on through a subsidiary. That too would come at a price, as having separate capital in each subsidiary is likely to be more costly than operating on a branch basis.³⁷ A more efficient alternative may be to reform the law relating to banks that engage in significant cross-border business on a branch basis.

While it would seem an insurmountable task to harmonise bank insolvency laws, or produce accepted principles of recognition resolution measures affecting all banks, a more limited goal would be to establish a framework that permitted certain types of banks to operate on a cross-border branch basis with greater certainty than currently applies. The banks in question could be identified by their systemic importance and the percentage of their business conducted on a branch basis. It is likely that the banks would be institutions dealing with wholesale customers (as regards both their assets and liabilities). The framework would proceed on internationally agreed principles that treated creditors as far as possible on a pari passu basis i.e. there would be no depositor preference, no branch ring-fencing or priority.

Wholesale investors should not need these protections. The single legal entity lends itself to the principles governing the winding up in the jurisdiction of incorporation being applied. For instance, principles of set-off should be decided by that law. Different capital requirements could be used to encourage banks to organise their affairs so that relevant operations become subject to this framework.

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Notes

1. The Bank of Australasia and Union Bank were merged into the Australia and New Zealand Bank in 1951. It was not until 1977 that the merged entity was re-domiciled to become an Australian company: *Australia and New Zealand Banking Group Act 1977* (Vic).
2. For examples of banking crises in liberal market conditions, see the Australian crisis of 1893: SJ Butlin 1961, *Australia and New Zealand Bank: The Bank of Australasia and the Union Bank of Australia Limited 1828–1951*, London. See also the New York panic of 1907: Robert F Bruner and Sean D Carr 2007, *The Panic of 1907 Lessons Learned from the Market's Perfect Storm*, John Wiley & Sons.
3. For a survey of the arrangements for cooperation see Calvin Doan, Veronica Glanville, Adrian Russell and Damien White 2006, [Greater international links in banking – challenges for banking regulation](#). For more recent proposals for global systemically important institutions, see note 36 below.
4. *De Beers Consolidated Mines v Howe* [1906] AC 455; *Koitaki Para Rubber Estates Ltd v FCT* (1940) 64 CLR 15.
5. For instance, the company may be considered resident for tax purposes where it has its place of central management and control, but have a 'permanent establishment' in other countries where it carries on business and income derived at the foreign permanent establishment treated differently. Or for certain purposes, e.g. dealings under letter of credit branches in different countries are treated as if they were separate banks: *Uniform Customs and Practice for Documentary Credits*, Article 3.
6. *Max Factor v FCT* (1984) 15 ATR 231.
7. In Australia, much of the major banks' wholesale funding is raised offshore. For medium-term notes this is approximately 73%. See Australian Bureau of Statistics 2014, *Financial Accounts*, March Quarter, p. 35, where the amount of Australian issued bonds and offshore issued bonds is \$110.7 billion and \$303.4 billion, respectively.
8. For a useful survey, see Jonathan Fiechter, Inci Otker-Robe, Anna Ilyina, Michael Hsu, Andre Santos and Jay Surti 2011, *Subsidiaries or branches: Does one size fit all?*, International Monetary Fund, 7 March.
9. Section 9 *Banking Act 1959*.
10. Australian Prudential Regulation Authority 2008, [ADI Authorisation Guidelines](#).
11. The APRA test is that they not take deposits for less than A\$250,000. It does not align with the test of a wholesale client in section 761G of the Corporations Act.
12. Section 66 *Banking Act*.
13. See the *ADI Authorisation Guidelines*.

14. *Banking (Exemption) Order No. 82*. The securities must have a face value of A\$500,000.
15. Section 911D Corporations Act.
16. Section 601CD Corporations Act.
17. Australian regulation contains examples of the first two measures described but in neither a comprehensive nor coherent code, see Part 4 of the *Financial Sector (Business Transfer and Group Restructure Act 1999)* (Cth) and APRA *Prudential Standard APS111 Attachment J* for the forced conversion or write-off of regulatory capital instruments and also section 14AA Banking Act. A more comprehensive approach is found in EU countries e.g. *Banking Act 2009* UK and *Banking Recovery and Resolution Directive (2014/54/EU)*. For the need for speed see Prudential Regulation Authority 2014, *Implementing the Bank Recovery and Resolution Directive*, Consultation Paper 13/14, July.
18. As with the European Union pursuant to the *Banking Recovery and Resolution Directive*.
19. Published by the United Nations Commission on International Trade Law and adopted into Australian law by the *Cross-Border Insolvency Act 2008* (Cth).
20. *Model Law on Cross Border Insolvency* art 1–2; see *Cross-Border Insolvency Regulations 2008* (Cth) reg 3.
21. *Williams & Humbert Ltd v W & H Trade Marks (Jersey) Ltd* [1986] AC 368.
22. A bank acting in Australia by means of a branch could be subject to at least five different forms of insolvency proceedings: a letter of request under section 581(3) of the Corporations Act; an ancillary liquidation under section 601CL(14); a winding up under Part 5.7 of the Corporations Act; an order recognising a foreign liquidation order; or a scheme of arrangement under Part 5.1 of the Corporations Act.
23. See Grant Turner 2011, 'Depositor protection in Australia', *RBA Bulletin*, December quarter, pp. 45–55, p. 54.
24. Section 13A(3) Banking Act.
25. In Australia, see section 11F of the Banking Act. In the US, see section 4(j)(2) of the *International Banking Act of 1978* (codified to 12 USC 3102(j)(2)).
26. [1997] 2 WLR 172. Subsequently considered in *In re HIH Casualty and General Insurance Ltd* [2008] 1 WLR 852.
27. This is the so-called 'hotchpot' principle: see *Re HIH Casualty and General Insurance Ltd* (2005) 215 ALR 562; *In re HIH Casualty and General Insurance Ltd* [2008] 1 WLR 852.
28. See for the UK, Financial Services Authority 2012, 'Addressing the implications of non-EEA national preference regimes', *FSA Consultation Papers*, vol. 12, no. 23, September.
29. *Gibbs v Societe Industrielle de Metaux* (1890) 25 QBD 399; *New Zealand Loan & Mercantile Agency Co v Morrison* [1898] A.C. 349 (P.C.); *Adams v National Bank of Greece* [1961] AC 255.
30. Section 11CA Banking Act.
31. Section 11CD Banking Act, contrast *Barcelo v Electrolytic Zinc* (1932) 48 CLR 391.
32. *NML Capital Ltd v Republic of Argentina* 699 F 3d 246, 250 (2d Cir. 2012).
33. For example, the Dutch regulator. Other regulators require this only in relation to particular provisions agreeing to the application of resolution measures, or in particular classes of instruments, e.g. regulatory capital as in APS III. See APRA 2013, *Prudential Standard APS 111*, Attachments E (para 14) and H (para 13).
34. *Adams v National Bank of Greece* [1961] AC 255.
35. Commonwealth of Australia 2014, *Financial System Inquiry Final Report*, p 70. See also FSB 2014, *Adequacy of Loss-absorbing Capacity of Global Systematically Important Banks in Resolution, Consultative Document*, 10 November; Andrew Gracie 2014, '[Total Loss-Absorbing Capacity – The thinking behind the FSB Term Sheet](#)', Bank of England speech, 4 December.
36. Federal Deposit Insurance Corporation and Bank of England 2012, *Resolving Globally Active, Systemically Important, Financial Institutions*, joint paper, 10 December. See also Financial Stability Board 2012, *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational*, November, p 15.
37. Jonathan Fiechter et al., op. cit.

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