BRIEFING

European Parliament

Further harmonising EU insolvency law from a banking resolution perspective?

KEY FINDINGS

Further to recent resolution and liquidation cases experienced in the Banking Union, both the Single Resolution Mechanism (SRM) and the Single Supervision Mechanism (SSM) have called for further harmonisation of insolvency law. In April 2018, the SRB stressed that "the divergence of national insolvency laws is a major obstacle towards a fully-fledged Banking Union". As part of the SRM review due by 31 December 2018, the Commission shall "evaluate the necessity of taking steps order to harmonise insolvency proceedings for failed institution". This briefing explains why the completion of the Banking Union may need to be underpinned by further progress in harmonising Member States' insolvency law. This briefing takes a 'banking resolution' perspective, and does not specifically address initiatives that the Commission has taken to improve the efficiency of Member States' insolvency law framework for companies to underpin the Capital Markets Union.

1. Liquidation under national insolvency law as 'default' option to deal with failing banks

Delineation between resolution and liquidation

The BRRD and the SRM Regulation have gone a long way in harmonising EU insolvency law for banks by entrusting administrative authorities - as opposed to Courts - with harmonised resolution powers. Pre-BRRD, any liquidation in the context of a resolution was necessarily carried out in accordance with national insolvency procedures. The BBRD introduced in the EU the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, which is the internationally agreed insolvency standards for banks.

In the absence of an overriding 'public interest' (i.e. financial stability, protection of depositors, continuity of critical functions), failing banks will be liquidated under national insolvency law. In that respect, recital 45 of BRRD recalls that "*a failing institution should in principle be liquidated under normal insolvency proceedings*". Liquidation is hence the default-option to deal with failing bank, and its most likely outcome: as emphasised by Elke König, Chair of the Single Resolution Board (SRB) in

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a speech in January 2017: "*most banks are now in such a shape that we can say with confidence that their failure would not endanger financial stability and that they can be resolved if they fail - like any other business in the market economy – through regular insolvency procedures. The extra safety net of resolution is only for the few, not the many*". Only in case that there is public interest to keep a failing bank or parts thereof alive, it may be resolved in accordance with the BRRD and the SRM Regulation (see section 2 and box 4). In that context, the material aspects of national insolvency law for the purpose of liquidating banks may in itself be as relevant as a harmonised resolution framework to equip the competent authorities at the national and EU-level with relevant tools to deal with failing banks.

As evidenced by some recent liquidation cases, whether the resolution of a bank (that has been deemed failing or likely to fail) is in the public interest or whether a bank should be liquidated in the absence of a public interest has however been assessed differently at the EU and at national level based on the current legal framework.

The definition of "public interest": the orderly liquidation of Veneto Banca and Banca Popolare di Vicenza ('the Veneto banks')

The Veneto banks cases have evidenced the importance of national insolvency law in triggering resolution actions. Depending on national insolvency law, resolution actions may be undertaken at national level despite the absence of a 'public interest' determined at EU level by the SRB. The Veneto banks - which did not pass the SRB's 'public interest test' that is required for a bank to be 'resolved' at the EU-level - have been liquidated through a special insolvency procedure under Italian law (see for a detailed analysis, a separate EGOV briefing). That special insolvency procedure involved resolution tools[1] and state aid. Albeit the SRB concluded that the resolution was not warranted in the 'public interest', the Commission indicated that EU state aid rules foresee the possibility to grant State aid to mitigate economic disturbance at regional level.

Those liquidation cases have highlighted the existence of what Andrea Enria, Chair of the European Banking Authority (EBA) called "*two different definitions of "public interest" [...] one at the EU level and another one by national authorities*". In that respect, Silvia Merler (Bruegel) recommended in a paper commissioned by the European Parliament more clarity over the role that the concepts of critical functions and public interest play in Member states' decisions. The current diversity in national insolvency framework was seen as "a source of uncertainty about the outcomes of liquidation procedures".

Liquidation carried out under national insolvency law: the case of ABLV

More recently, the ABLV case gave rise to two conflicting decisions: the liquidation of ABLV in Latvia and the resolution of its subsidiary in Luxembourg in the following sequencing:

- On 23 February 2018, the ECB declared that ABLV Bank – as well as its subsidiary in Luxembourg ABLV Bank Luxembourg S.A – was failing or likely to fail due to the significant deterioration of its liquidity situation.

[1] On 25 June 2017 the two banks were wound down with the transfer of the performing business (performing loans, financial assets, deposits and senior debt) to Intesa San Paolo (ISP) subject to the injection of cash and the provision of guarantees by the Italian government (see below), the transfer of the non-performing portfolio to SGA, the vehicle formerly used for the liquidation of Banco di Napoli, and the bail-in of equity and subordinated shareholders, which remain in the entity into liquidation.

- On 24 February 2018, the Single Resolution Board (SRB) decided that it would not take resolution action at the EU level.
- On 9 March 2018, the Luxembourg Commercial Court, however, decided to refuse the request from Commission de Surveillance du Secteur Financier to place the subsidiary in Luxembourg – ABLV Bank Luxembourg, S.A. – in liquidation. That entity shall now be sold to new investors. Administrators have been appointed by this judgment in order to control the management of the bank's assets.

That Luxembourg court decision highlights that the liquidation process for a banking group with legal entities in more than one Member State leads to the application of different national insolvency law frameworks. This has a wider significance for the functioning of a 'single resolution approach' across banking groups active in different Member States (See Part 3).

Box 1 - ABLV statement regarding the decisions of the ECB and the Luxembourg Court

"*The decisions of the European Central Bank (ECB) seem to have been taken for all entities of the ABLV group regardless of their specific situation and quality. ABLV Bank Luxembourg, S.A. has an extremely strong excess capital (the capital adequacy ratio of more than 29% versus the legal requirement of 10.5%), a very high liquidity (the LCR of 383% versus the legal minimum requirement of 100%), no bad loans, and a very limited reliance on the group. The Luxembourg court considered the specific situation of the Luxembourg entity and overruled the decisions of the ECB based, amongst other, on the very strong financial standing of ABLV Bank Luxembourg, S.A., a result of its sound management*".

Both the SRB and SSM Chairs have therefore called for further harmonisation of national insolvency law as a consequence of the ABLV case:

- In a statement, Elke König, Chair of the SRB emphasised that the ABLV case highlighted "*the importance of harmonising banks' insolvency laws. The common SRM framework for resolution is faced with 19 or more different insolvency procedures. The failing or likely to fail (FOLTF) assessment does not automatically link to the criteria for insolvency/liquidation. Only by raising national bank insolvency procedures to a common standard we can clarify the line between resolution and insolvency and eliminate wrong incentives*";
- In the same vein, at the 26 March ECON hearing, Danièle Nouy, chair of the SSM, suggested amending Article 32 of BRRD to add as a criteria for liquidation under national law the declaration of "Failing or Likely to Fail". This amendment was meant to make "explicit" what is supposed to be "implicit" under BRRD so that national insolvency laws provide a full "*effet utile*" to SSM and SRB decision. This would make it clear that absent a 'public interest' underpinning resolution measures as determined by the SRB, banks would need to be liquidated under national insolvency law and not resolved.

The ABLV case also raises the issue as to whether insolvency proceedings need to be coordinated when it comes to the liquidation of a group active in different Member States. In that respect, the 2009 Commission communication on crisis management ('an EU Framework for Cross-Border Crisis Management in the Banking Sector') noted that '*as a minimum [...] an EU bank resolution framework should be supported, by a binding framework for cooperation and exchange of information between courts and insolvency practitioners responsible for proceedings relating to affiliated entities in a banking group*".

2. Role and importance of national insolvency law under the EU resolution framework

The EU acquis, including Directive 2001/24/EC on the Reorganisation and Winding-Up of Credit Institutions[2], does not currently provide for further harmonisation of material insolvency law for banks. The BRRD and the SRM Regulation have only partially harmonised insolvency law so far (i.e. ranking of claims for the purposes of applying the bail-in tool in Box 2 below) although implementation of resolution action remain rooted in national insolvency law for the purposes of protection creditors and applying resolution tools at legal entity level.

Facilitating a "No-Creditor-Worse-Off" assessment

The EU resolution framework aims at protecting creditors which must not be "worse off" than under liquidation ('No Creditor Worse Off" principle, see box 2). In that context, the SRB is tasked with assessing whether shareholders and creditors would have received a better treatment under insolvency proceedings than in resolution. For the purposes of carrying out that valuation, Member States are required to notify to the Commission and to the SRB the ranking of claims in national insolvency proceedings of every year or immediately, where there is a change of the ranking.

Box 2 - The No-Creditor-Worse-Off Principle ('NCWO')

The NCWO principle is a key principle of the BRRD that governs the protection of creditors whereby no creditor should incur greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings.

For this purpose, a valuation shall be carried out by an independent person as soon as possible after resolution actions have been effected. This valuation shall determine the difference between the treatment of shareholders and creditors should normal insolvency proceeding had taken place in lieu of resolution and the actual treatment that the shareholders and creditors have received under resolution.

The counterfactual of no-creditor-worse off (NCWO) might produce different results in different Member States depending on the national insolvency regime.

For the resolution of a legal entity, the insolvency law of the Member State where the resolution takes place will be used for the purpose of carrying out the NCWO assessment. The BRRD does not particularly specify this approach but resolution actions under the BRRD are governed by the "universality principle" of the Winding-Up Directive whereby the resolution authority relies on the law of its Member State (the '*lex fori*') that will be fully effective in other Member States. The ranking of creditors in the insolvency law of the Member State where a legal entity is resolved would apply. The Winding-Up Directive entails exceptions to the '*lex fori'* principle[3] in situation which may give rise to conflicts of law across Member States, but the ranking of claims on the basis of which the

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2 Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions prohibits the application of separate insolvency measures to branches under the law of the host State. It ensures the mutual recognition and coordination of procedures under home country control, imposes a single-entity approach by which all the assets and liabilities of the 'parent' bank and its foreign branches are reorganised or wound up as one legal entity under, subject only to exceptions specified in the Directive, the law of the home State. However, this directive does not provide for the consolidation of insolvency proceedings for separate legal entities within a banking group, and makes no attempt to harmonise national insolvency law.

3 For instance, rights in rem in respect to tangible and intangible assets situated in other Member States are governed by the 'lex situs' (i.e. the law of the Member states where those assets are situated). Proprietary rights registered abroad are subject to the lex rei sitae (i.e. the law where the law where the property is situated).

NCWO assessment is performed is governed by the law of the home Member State (see recital 17 and Article 10 (2) (h) of the Winding-Up Directive).

In the absence of a harmonised regime for banks' insolvency law, the NCWO principle would not result in similar outcomes across the Banking Union in case of the resolution of a cross-border group. As clarified by EBA in 2016, the NCWO assessment has to be performed at the level of each group entity subject to resolution measures. That NCWO assessment would compare the treatment received by creditors in the course of the resolution action with the treatment they would have received under normal insolvency proceedings. For that purpose the national insolvency law that would be applicable had those entities entered normal insolvency proceedings should be taken into account. Given Member States' discrepancies in insolvency law, the SRB *"strongly encourage[d] legislators to harmonise national insolvency laws, in order to create a level-playing field"*. The BRRD has harmonised the ranking of claims for the purposes of applying the bail-in tool (See Box 3), but national differences still exist. The issue of group treatment is further discussed in Part 3 below.

Box 3 - Hierarchy of claims under BRRD

According to Article 108 of BRRD, a priority ranking is established between certain classes of creditors:

(a) Own funds instruments as defined in CRR and subordinated liabilities that do not qualify as own funds instruments with the following ranking (i) CET1, Additional T1, Tier 2, Subordinated debts;

(b) Non preferred senior debt;

(c) Ordinary unsecured debts;

(d) Eligible deposits from natural persons and micro, small, and medium-sized enterprises which exceed the DGS coverage level of EUR 100,000; and

(e) Covered deposits.

Class (b) has been added by Directive (EU) 2017/2399 of 12 December 2017 amending BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy.

In keeping with the objective of ensuring a level playing field across creditors, further harmonisation of insolvency law may be justified on the following grounds:

- In *its* resolution of 10 March 2016 on the Banking Union (Annual report 2015), the European Parliament called on the Commission to present proposals to reduce further the legal risks of claims under the no creditor worse off principle. In that respect, Directive (EU) 2017/2399 of 12 December 2017 harmonised the ranking under normal insolvency proceedings of unsecured claims for banks to comply with the "subordination requirement"[4] in a more efficient manner. In that respect, in its opinion on the Commission's proposal as regards the ranking of unsecured debt instruments in insolvency hierarchy, the ECB stressed that the proposed directive only provides for partial harmonisation and that additional reforms would be useful to promote further harmonisation in the hierarchy of creditor claims in bank insolvency" (e.g. a general depositor preference rule);
- *"Harmonisation of national insolvency law [...] is necessary in order to minimise exposure of the resolution funds of Member States under the no creditor worse off principle"* (Recital 111 of BRRD). Indeed, differences in national insolvency law may lead to potential "no creditor

[4] The TLAC standard requires G-SIIs to meet the TLAC minimum requirement, with certain exceptions, with subordinated liabilities that rank in insolvency below liabilities excluded from TLAC ('subordination requirement'). Under the TLAC standard, subordination is to be achieved through the legal effects of a contract (known as contractual subordination), the laws of a given jurisdiction (known as statutory subordination) or a given corporate structure (known as structural subordination).

worse off" (NCWO) claims by bailed-in creditors. Such claims would be eligible for compensation by the Single Resolution Fund;
- Where creditors are differently treated across Member States, this may result in national authorities adopting 'ring-fencing' behaviours. This is analysed in Part 3 below.

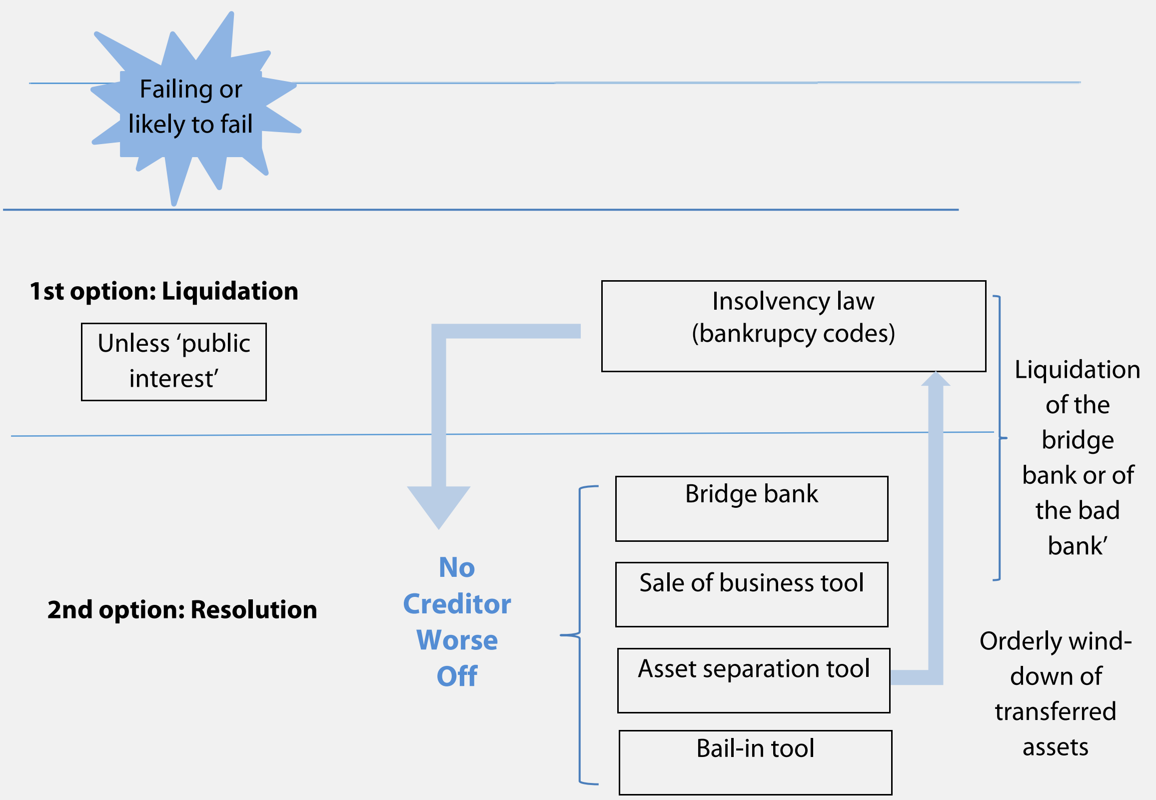
Application of resolution tools

The BRRD and the SRB Regulation provides for four resolution tools: (i) the bridge bank tool; (ii) the sale of business tool; (iii) the asset separation tool and (iv) the bail-in tool. Implementation of those resolution tools is closely linked to national insolvency law. First, when applying those resolution tools, resolution authorities should endeavour to comply with the No Creditor Worse Off principle (see above) that may give rise to creditor's claim and compensation by the Single Resolution Fund. Second, the following resolution tools may partially or fully rely on national insolvency law in terms of implementation and enforcement:

- Where the operations of a bridge institution are terminated, the bridge institution shall be wound up under national insolvency law;
- Part of the assets, rights or liabilities of the original bank that have not been transferred to a bridge bank may be transferred to an asset management vehicle;
- Asset management vehicle receiving assets, rights or liabilities under the asset separation tools shall maximise their value through eventual sale or orderly wind down under national insolvency law.

Interactions between resolution and national insolvency law are summarised in Box 4 below.

Box 4 - Resolution and insolvencv



Source: EGOV based on BRRD and 2010 Commission Communication on crisis management

The case of the Portuguese Banco Espírito Santo, S.A. (BES) illustrates the legal challenges raised by the application of the NCWO principle in case of asset transfer[5].

Resolution at entity level

As this is the case under BRRD, the SRB plans for the resolution of groups, adopts a group resolution strategy and implements a group resolution scheme that is more likely to deliver the best result for all entities of a group. Nevertheless, the resolution tools only apply at legal entity level (parent or subsidiaries) under national insolvency law (see above) and not at "group level" unless the insolvency law of a Member State provides that groups may be treated as a whole. This is without prejudice to the determination of whether a group needs to be resolved as a whole which is possible under specific conditions[6].

In the absence of a group treatment in insolvency law, group resolution amounts to the application of resolution powers and resolution tools at the level of the parent entity with a view to resolving two or more credit institutions of the group that meet the conditions for resolution and stabilising the group as a whole, and the coordination of the application of resolution tools and the exercise of resolution powers by resolution authorities in relation to the legal entities of the group that meet the conditions for resolution.

The SRB coordinates the resolution of a group, but does not resolve a group as a whole: as Elke Köning, Chair of the SRB put it in April 2019 in her Eurofi statement, "*in the current framework insolvency is clearly entity-specific as is NCWO" [...]*. In that respect, the SRB called for further harmonisation of insolvency law to facilitate resolution planning for cross-border banking groups within the Banking Union. Absent such framework, the SRB warned against the risk that "*the focus during the resolution of banking groups will have to remain at entity leve*l". This statement echoes the concerns voiced by Commission already in its 2009 Communication on crisis management: "*the* fundamental *obstacle to cooperative resolution of a cross-border group is, inter alia, rooted in the territorial nature of insolvency law. If insolvency law is national, domestic authorities have a legitimate – as well as a strong political – interest to ring-fence the national assets of an ailing bank in order to protect national deposits and maximise the assets available to the creditors of the national entity*".

It must be noted that wider "group resolution" actions (e.g. EU asset management companies) are not ruled out by the SRM Regulation, but would require further arrangements. For the purpose of applying the bridge bank tool at group level, recital 27 of the SSM Regulation refer to the establishment, where appropriate, of "burden-sharing arrangements".

[5] On 3 August 2014, the Portuguese Central Bank decided that it had to apply resolution measures to BES, separating problem assets from unproblematic assets and liabilities, which were transferred to a new bank (Novo Banco). On 29 December 2015, following the comprehensive assessment carried out in 2015 by the ECB, the resolution approach was modified, and some of the bonds (5 out of 52) that had initially been transferred out of BES to Novo Banco were transferred back (Art. 40 (7) of the BRRD provides for such transfers under specific circumstances). Investors impacted by the retroactive transfer of those bonds, however, complained that the pari-passu principle of equality among senior bondholders has been breached by the selection of those 5 bonds (rather than a pro rata haircut of all senior bonds), and filed suit. According to the press, the other bonds were excluded because they were issued under foreign law, or because they were held by retail investors (Art. 44 (3) of the BRRD provides for a number of exceptions on various grounds ranging from the feasibility to the risk of widespread contagion or the destruction of value). For more details, see a previous EGOV briefing.

[6] In accordance with Article 16(3) of the SRM Regulation, the Board may decide on resolution action with regard to a parent undertaking when i) one or more of its subsidiaries which are institutions are failing or likely to fail and meet the public interest test and ii) their assets and liabilities are such that their failure threatens an institution or the group as a whole and resolution action with regard to that parent undertaking is necessary for the resolution of such subsidiaries which are institutions or for the resolution of the group as a whole.

3. Insolvency regimes for banking groups

In accordance with the SRM Regulation, as part of its review due by end 2018, the Commission shall consider the "*necessity of taking steps in order to harmonise insolvency proceedings for failed institutions*" in accordance with Article 94 of the SRM Regulation. In that respect, the Commission "[...] *should [inter alia] determine whether any modifications or further* developments *are needed in order to improve the efficiency and the effectiveness of the SRM, in particular whether the banking Union needs to be completed with the harmonisation at Union level of insolvency proceedings for failed institutions"*.

The issue as to whether further harmonisation of insolvency law is needed to underpin a fully-fledged Banking Union has been addressed in two Commission's communications on crisis management ahead of the adoption of the BRRD and the Banking Union project (SSM and SRM). In its 2009 and 2010 communications, the Commission already outlined a roadmap to bring about an integrated insolvency framework for groups. The EU Resolution framework (i.e. BRRD) was seen as a first step down the road of a more integrated approach. The Commission suggested at that time to complement this first step by an insolvency framework[7] (medium term or second step) and an integrated framework (longer term or third step) that involved an EU authority and an EU resolution fund. For the Commission, the second and third steps were closely intertwined: "*the operational capacity of an EU resolution authority would depend on the establishment of an insolvency regime for banks*". The SRM Regulation delivered this roadmap and brought about an EU authority and an EU resolution fund as contemplated in 2010, but without harmonising insolvency law which was seen at that time as a necessary intermediary step.

In terms of going forward, the Commission suggested an integrated treatment of banking groups in the context of a harmonised EU insolvency regime for banks (See box 5 overleaf). Such integrated treatment was seen as a necessary step to "*fully address the problems associated with the separate entity approach under national insolvency law*". For the Commission, this project could take the form of a separate insolvency regime that would replace the otherwise applicable national regimes, for the winding up of cross-border banking groups. Harmonisation of substantial insolvency law would be in any case challenging.

As Commission put it in its 2009 Communication, "*the difficulty and sensitivity of such work should not be underestimated. Insolvency law is closely related to other areas of national law such as the law of property, contract and commercial law, and rules on priority may reflect social policy [...]"*.

The far-reaching changes to commercial, civil and company law that a harmonised EU framework would entail, may also explain why the recent Commission proposals on insolvency law only provide for a partial harmonisation. Those proposals are not bank specific and aim at improving the efficiency of the insolvency framework for companies to underpin the Capital Market Union[8] and

[7] With the possible aim of resolving and liquidating banks under of the same procedural and substantive insolvency rules, this review included "the desirability of administrative liquidation proceedings for banks to facilitate a faster and more orderly liquidation than the standard court-based procedure. Harmonisation of core principles of bank insolvency law, including priority rankings and rules on claw back actions. The Commission intended to publish a report on the further harmonisation of insolvency law by the end of 2012.

[8] **Legislative proposal of 22/11/2016** on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures. Commission proposed a set of European rules on business insolvency. The proposed directive focuses on three key elements: i) common principles on the use of early restructuring frameworks; ii) rules to allow entrepreneurs to benefit from a second chance as they will be fully discharged of their debt after a maximum period of 3 years; iii) Targeted measures for Member States to increase the efficiency of insolvency procedures; This should reduce the excessive lengths and cost of procedures in many Member States which result in legal uncertainty for creditors and investors and low recovery rates of unpaid debts.

help address NPL[9]. In that respect, in its opinion on Commission's proposal on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, the ECB reiterated its support for a "holistic" approach to further harmonising insolvency law while recognising the considerable legal and practical challenges of a 'holistic' approach. The ECB would have welcome an "*attempt to harmonise core aspects of insolvency law such as: (a) the conditions for opening insolvency proceedings; (b) a common definition of insolvency; (c) the ranking of insolvency claims; and (d) avoidance actions*".

Box 5: Harmonisation of insolvency regimes for banks

"Integrated treatment of corporate groups

It may [...] be desirable to go further in facilitating a more integrated treatment of corporate groups in insolvency. This might involve – in clearly specified circumstances - treating the group as a single enterprise in order to overcome the perceived inefficiency and unfairness of the traditional single entity approach. While techniques to achieve this are available under some national law, their application is necessarily restricted to entities within the same jurisdiction, and subject to the same insolvency regime. If similar measures were to be developed for use in insolvency proceedings for cross-border banking groups, the fact of different insolvency regimes - with different substantive rules on, for example, priority and avoidance powers – would need to be addressed.

A harmonised EU insolvency regime for banks

Techniques for a more integrated treatment of groups in insolvency might assist in addressing some of the inequities that might arise from winding up highly integrated banking groups on a separate entity basis. There is a growing body of academic and professional opinion that suggests that separate entity insolvency cannot adequately deal with complex corporate structures where form does not follow function, and that international work on the harmonisation of insolvency rules is now needed. Without such harmonisation, it will remain very difficult to re-structure a cross-border banking group.

Source: 2009 Commission communication on crisis management ('an EU Framework for Cross-Border Crisis Management in the Banking Sector')

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[9] **Legislative proposal** of 14/03/2018 on credit services, credit purchasers and the recovery of collateral. The proposed directive, which is part of Commission's 'NPL' package, aims at preventing the excessive future build-up of NPL by increasing the efficiency of debt recovery procedures. The proposal establishes an "accelerated extrajudicial collateral enforcement procedure" ('AECE'), which are out-of-court mechanisms which enable secured creditors (i.e. banks) to recover the value from collateral swiftly and at lower cost in case a borrower does not pay back a loan. This procedure would be accessible when agreed upon in advance by both lender and borrower in the loan agreement.