European Parliament

IPOL | DIRECTORATE-GENERAL FOR INTERNAL POLICIES
EGOV | ECONOMIC GOVERNANCE SUPPORT UNIT

STUDY

Harmonising insolvency laws in the Euro Area: rationale, stock-taking and challenges. What role for the Eurogroup?

External author: Diego Valiante
Centre for European Policy Studies

Provided at the request of the
Economic and Monetary Affairs Committee

ECON

July 2016
EN

IPOL | DIRECTORATE-GENERAL FOR INTERNAL POLICIES
EGOV | ECONOMIC GOVERNANCE SUPPORT UNIT

STUDY

Harmonising insolvency laws in the Euro Area: rationale, stock-taking and challenges. What role for the Eurogroup?

External author: Diego Valiante, Ph.D.
Centre for European Policy Studies

Provided in advance of the Economic Dialogue with the President of the Eurogroup in autumn 2016

Abstract

There are four distinct areas where harmonising national insolvency frameworks can improve the functioning of the single market and the stability of the Euro area. Early restructuring of businesses, bank resolution, cross-border insolvency and NPL management rely on common features of local insolvency frameworks, which can affect their legal certainty and functioning. To promote a more entrepreneurial spirit, a pan-European framework for early restructuring of business could offer a true second chance for entrepreneurs. To benefit from a capital markets union, insolvency frameworks would also need to remove sources of cost unpredictability in cross-border insolvency procedures, which are often hidden in national insolvency laws or not sufficiently dealt with in the current EU framework. This report makes a contribution to define areas for further action. Measures, moreover, to harmonise insolvency laws can produce positive impacts on the banking union, with the harmonisation of hierarchies of claims in particular for the functioning of the resolution mechanism. Finally, the diffusion of best practices on credit recovery procedures can help to improve the management of NPLs via fostering liquidity in secondary markets.

ECON EN

PE 574.428

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

AUTHOR(S)

Diego Valiante, Centre for European Policy Studies

RESPONSIBLE ADMINISTRATOR(S)

Alienor Anne Claire Duvillet-Margerit and Cairen Power
Economic Governance Support Unit
Directorate for Economic and Scientific Policies
Directorate-General for the Internal Policies of the Union
European Parliament
B-1047 Brussels

LANGUAGE VERSION

Original: EN

ABOUT THE EDITOR

Economic Governance Support Unit provides in-house and external expertise to support EP committees and other parliamentary bodies in playing an effective role within the European Union framework for coordination and surveillance of economic and fiscal policies.
E-mail: egov@ep.europa.eu

This document is also available on Economic and Monetary Affairs Committee homepage at:
http://www.europarl.europa.eu/committees/en/ECON/home.html

Manuscript completed in July 2016

ACKNOWLDGEMENTS

The author is grateful to the Economic Governance and Support Unit, and in particular Cairen Power and Aliénor Anne Claire Duvillet-Margerit, for their extensive support during the drafting of this briefing paper. The report also relies on a wealth of discussions and interviews with international legal and economic experts. Those experts have provided input in their personal capacity and not on behalf of their respective institutions. I am thus grateful to Chris Bates (Clifford Chance), Blazej Blasikiewicz (EBF), Alexander Bornemann (German Ministry of Justice), Mihaela Carpus Carcea (European Commission), Adrian Cohen (Clifford Chance), Henri Colman (ING), Federico Cornelli (Italian Banking Association), Arnaud Demeocq (KPMG), Department of Finance, Ireland, Vittorio Di Bucci (European Commission), Nadege Jaussaud (Single Resolution Board), Marco Lamandini (Bologna University), Sebastian Mock (Hamburg University), Oliver Moullin (AFME), Rene Repasi (Erasmus University Rotterdam), Gabrielle Ruiz (Clifford Chance), Paolo Santella (Single Resolution Board), Silvia Scatizzi (European Commission), Michael Schillig (King's College London), Gary Simmons (AFME), Lorenzo Stanghellini (European University Institute), Ignacio Tirado (Universidad Autonoma de Madrid), Domenico Torini (KPMG), Emiliano Tornese (European Commission), Alessandro Turrini (European Commission), Eva Wimmer (German Ministry of Finance), Jo Windsor (Linklaters), Karl-Philipp Wojcik (European Commission) and Cosmina Amariei (CEPS) for her research support on data collection.

CONTENTS

List of abbreviations 4

List of figures 4

List of tables 4

Executive summary 5

Chapter 1. Setting the scene 7

1.1 What is insolvency? 7

1.1.1 Insolvency proceedings 7

1.1.2 Pre-insolvency and other ‘out-of-court’ procedures 9

1.2 The economic impact of insolvency proceedings 9

1.3 The quality of insolvency frameworks in the euro area 10

Chapter 2. Insolvency laws and capital markets union 15

2.1 Cross-border insolvency: relevant aspects 15

2.2 Opening of proceedings 16

2.2.1 Insolvency test 16

2.2.2 Asset evaluation 17

2.3 Relief actions 17

2.3.1 Stays 17

2.3.2 Avoidance actions 18

2.4 Governance of the proceedings 18

2.4.1 Directors’ liability 19

2.4.2 Voting mechanisms and cramdown 19

2.4.3 Priority of claims 20

2.4.4 Functioning of courts 20

Chapter 3. Insolvency laws and Banking Union 21

3.1 Ranking of creditors 21

Box 1. The ranking of claims in insolvency proceedings and the NCWO principle 25

3.2 Management of non-performing loans 25

Box 2. Pre-insolvency credit recovery mechanisms 27

3.3 Other relevant areas 27

Chapter 4. Current framework and potential options for convergence 29

4.1 The European Union framework 29

4.2 The European Commission consultation and potential actions 30

4.3 Options for convergence 31

4.3.1 Harmonisation options 31

4.3.2 Legal basis and tools 32

Box 3. The Euro group as a harmonisation tool 33

Conclusions 34

References 35

LIST OF ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive
CMU	Capital Markets Union
COMI	Centre of Main Interest
CSR	Country-Specific Recommendation
ECJ	European Court of Justice
EIB	European Investment Bank
FSB	Financial Stability Board
GDP	Gross Domestic Product
IMF	International Monetary Fund
MREL	Minimum Requirement for own funds and Eligible Liabilities
NCWO	No Creditor Worse-Off
NPL	Non-Performing Loan
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
TFEU	Treaty on the Functioning of the European Union
TLAC	Total Loss-Absorbing Capacity
UNCITRAL	United Nations Commission on International Trade Law

LIST OF FIGURES

Figure 1. Stylised insolvency timeline 8
Figure 2. Stylised view of the economic effects 10
Figure 3. Protection of minority 11
Figure 4. Enforcing contracts 12
Figure 5. Resolving insolvency 12
Figure 6. Key indicators in the Euro area and the EU 13
Figure 7. Dispersion of key indicators in the Euro area and the EU 13
Figure 8. 'Big Bank' vs 'HoldCo' model 22
Figure 9. German and French general priority of claims with post-BRRD modifications 23
Figure 10. NPL simulation: resolution timing 26

LIST OF TABLES

Table 1. Selected aspects of insolvency frameworks in selected euro area countries 16
Table 2. Comparing EU actions 34

EXECUTIVE SUMMARY

Insolvency laws are entrenched into local legal systems and play a key role for the proper functioning of the banking system and capital markets. Effective insolvency proceedings can have tangible effects on the functioning of the single market for capital and banking services. The quality of insolvency proceedings across the Euro area is generally lower than regions like the United States and Japan, and its quality has barely increased in recent years.

In recent years, potential conflicts between the EU legislation (or the lack thereof) and national insolvency regimes have emerged in the following areas:

- Business restructuring and 'second chance';
- Cross-border insolvency;
- Bank recovery and resolution;
- NPL management and quality of national insolvency regimes.

As a result, distinct EU actions in those areas could be considered. In the area of business restructuring and second chance for bankrupt entrepreneurs, regimes across the Euro area are very diverse and often punitive for entrepreneurs. The European Commission will soon propose a Directive that will introduce an early restructuring (pre-insolvency) regime to be implemented across the EU, together with a list of other actions that are reviewed in Section 4.2. In doing so, the proposal could expand on a series of other areas that are relevant for the predictability of cross-border insolvency procedures, which have direct effects on cross-border capital markets transactions (and so CMU). In effect, as data suggests, the quality of insolvency frameworks across the Euro area is low on average and very diversified across member states. This situation raises barriers to the development of a single market for capital, which relies on a smooth and coordinated legal framework. The report, therefore, suggests additional actions in the following areas:

- Opening of proceedings (with the introduction of a minimum liquidation evaluation);
- Relief actions (with the harmonisation of suspect periods and a list of 'suspicious' and 'benign' transactions);
- Governance of proceedings (with the introduction of a common time period for a 'duty to file', a cramdown procedure and two options for a set of specialised insolvency courts).

In the area of banking union, different insolvency regimes can obstruct the effectivefunctioning of the single resolution mechanism, with implications for the stability of the financial system. There are two sets of measures for domestic insolvency regimes to be considered: those addressed to the (effective) functioning of the bank resolution mechanism; and those to improve the management of NPLs. Actions to improve the resolution mechanism include:

- Statutory subordination (along the lines of a new class of debt securities that are non-retroactive and contractually subordinated, in line with TLAC FSB guidelines; a potential full harmonisation of hierarchy of creditors across the EU would be highly beneficial with limited evidence of disruption for local legal and economic systems);
- Moratorium for bank resolution (perhaps with the introduction of an early restructuring pre-insolvency procedure for banks that triggers automatic stays);
- Statutory preference in liquidation for SRF contributions;
- A European NCWO principle through the creation of a pan-European liquidation procedure for banks.

Actions to advance market and supervisory practices in the management of NPLs mainly include accelerated procedures for the repossession and sale of collateral. These measures could be taken as a package of reforms that are included in the surveillance and monitoring effort done directly by the Commission and informally by the Eurogroup, through its work around the European Semester and surveillance of national economic policies. However, this action would be confined to coordination and to moral suasion in pursuing European reforms. A formal role for the Eurogroup in the legal procedures or the legislative process cannot and should not be envisaged, due to its consultative nature and limited accountability, unless there is a clear change in the Treaties.

Finally, work is ongoing to define indicators that would help to identify best practices across the Euro area to provide as a benchmark for all the countries in the monetary union and beyond. Indicators could be used to create a scoreboard to measure progress in the development of more effective and harmonised insolvency regimes.

CHAPTER 1. SETTING THE SCENE

Insolvency regimes are important for two important reasons: they provide the general legal framework for investments (and their liquidation) across Europe and they can address the inefficiencies that create unnecessary costs to the financial system and so to the economy via higher funding costs (e.g. effective tools to manage NPLs).

Defining insolvency is a difficult task, as it plays a key role beyond being a tool to support companies in financial difficulties. Insolvency proceedings can have different structures and objectives, with an important divide between resolution and insolvency tools for financial and non-financial firms. This chapter provides a definition of insolvency and outlines the general framework for insolvency proceedings. Moreover, it discusses the economic rationale of insolvency proceedings and the quality of the current frameworks across the Euro area.

1.1 What is insolvency?

Insolvency is a financial state in which a natural or a legal person (a firm) is unable to meet its financial obligations. This financial situation may lead to the disorderly enforcement actions of all creditors, who are afraid to lose their money should the company be unable to generate sufficient revenues. Consequently, legislations exist to avoid a creditors' run and make the procedures more effective and predictable. Different insolvency proceedings exist for companies and individuals, but no distinction usually exists between financial (credit institutions) and non-financial institutions in liquidation. To avoid knock-on effects on the banking system and so a bank run, *ad hoc* resolution procedures for banks exist and are now partially harmonised by the Bank Recovery and Resolution Directive (BRRD),[1] entered into force on 1st January 2016. These resolution procedures intervene well before the insolvency materialises, so allowing the orderly reorganisation of financial claims with limited risk for depositors and senior creditors of the bank. The result is that it rarely happens that a bank enters a formal insolvency proceeding, or at least only pieces of its business might.

1.1.1 Insolvency proceedings

Formal insolvency proceedings entail a judicial process, in which a judge assesses whether the company/individual is insolvent and considers what legal proceedings best fit the situation. Moreover, in order to avoid a disorderly run of creditors on the company, a *pari passu* treatment of creditors ensures trust and predictability of the procedures via the equal and fair treatment for same categories of creditors (UNCITRAL 2013; World Bank 2015; see Box 1).

There are typically different proceedings for individual and firms, but the court has to declare both 'insolvent' before starting any formal procedure. Insolvency proceedings are available in two main forms:

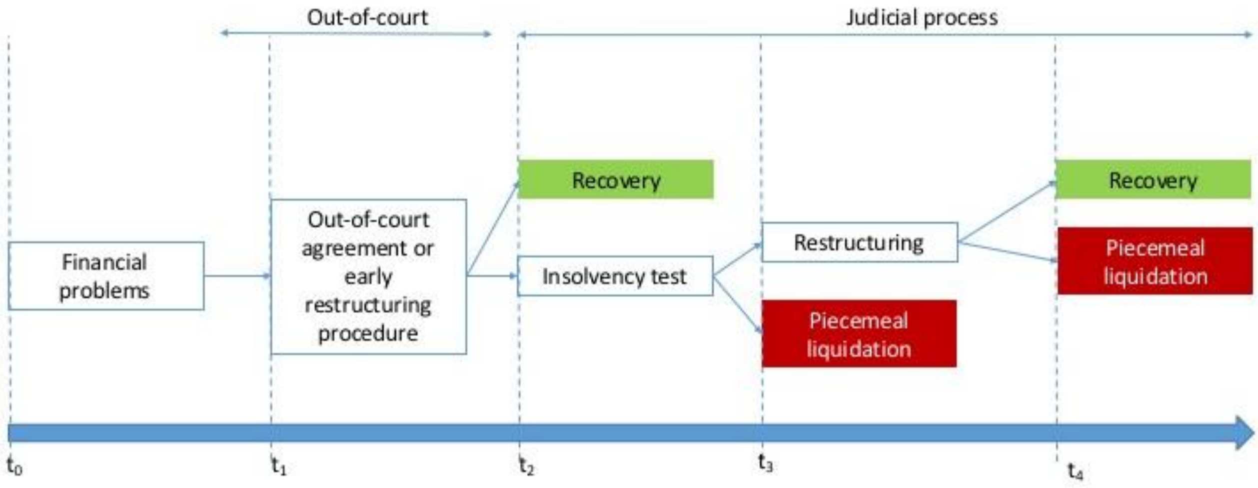
1. Restructuring; and
2. Liquidation.

Restructuring proceedings require a majority of creditors to agree to a haircut or to sell part of the business if the liquidation scenario would be costlier. The liquidation, instead, is the piecemeal sale of all assets or of pieces of 'going concern' business to cover creditors' claims.

---

[1] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance.

Figure 1. Stylised insolvency timeline



Source: Author.

The financial states that could trigger an insolvency procedure are typically two:

1. Cash flow insolvency (or financial distress); and
2. Balance sheet insolvency (or economic distress).

Financial distress occurs when the debtor does not have enough liquidity to cover its obligations. Negotiation with creditors may resolve the insolvency (avoiding liquidation), through the (partial) sale of assets and the reorganisation of the payments of creditors' claims, especially if the value of the assets is still higher or close to its financial liabilities.

Economic distress occurs when the value of the liabilities is higher than its assets. This situation will soon lead to financial distress, so negotiation may lead creditors to accept a loss, if there is a prospect of the business to create value as a 'going concern'. If the prospects as a 'going concern' are negative, the company would not be economically viable and it will then enter into liquidation to satisfy creditors. For consumers, some member states adopt a trigger mechanism called 'overindebtedness'. It is equivalent to a balance sheet test, whereby the level of liabilities (debt) and their growth prospects are overwhelmingly higher than the value of the consumer's assets. Across member states, the assessment can apply either to individuals or to households.

The ultimate objective of the insolvency proceeding may also differ across legal systems. In effect, an insolvency proceeding can aim at:

1. Maximising value to satisfy creditors; or
2. Maximising value to satisfy all stakeholders and the economy as a whole, for instance, rehabilitating a business that would have been liquidated otherwise (IMF 1999).

In practice, national laws attempt to balance both in the optimal division of bankruptcy value, while creditors have a more prominent role in the procedure. In order to achieve that, the formal insolvency proceedings provide powerful legal tools, like 'avoidance actions' to void fraudulent transactions or 'stays' to limit the number of enforcement actions that can be perpetrated by creditors.[2] The judicial process also offers legal certainty and reduces the risks of inefficient and disorderly winding up of cross-border groups (by granting legal recognition).

[2] A 'stay' (or so-called moratorium) suspends the rights of creditors to enforce their claims, so to allow the beginning of a structured procedure to repay all creditors (including them). It is a crucial tool when an insolvency proceeding begins, as it allows the orderly restructuring of the financial claims.

1.1.2 Pre-insolvency and other 'out-of-court' procedures

Growing recognition of the burden involved with the official insolvency proceedings, in terms of time and cost, has led to much more focus on improving tools available before the company becomes insolvent. Pre-insolvency proceedings are those actions that anticipate insolvency and overcome debtor's financial difficulties in alternative to costly judicial procedures. This framework is part of the measures that many countries are considering to complement and to make national insolvency regimes more cost-effective. These proceedings typically involve a restructuring plan to reorganise financial claims with the agreement of creditors, which courts only evaluate and approve at the end of the process (when creditors agree). In this way, the company avoids the stigma of being 'bankrupt' and the formal and costly judicial procedures.

Other credit recovery procedures that are not formally part of the insolvency also help to minimise the use of expensive insolvency proceedings. These procedures change according to the type of credit, and in particular whether it is a secured or an unsecured claim. Recent reforms in several countries, inspired by the 2014 Recommendation of the European Commission (European Commission 2014a), have improved the framework of those preliminary procedures. In particular, Garrido (2012) classifies the set of 'out-of-court' procedures as:

1. 'informal', when the debtor is able to come to an agreement with creditors on its own to overcome financial difficulties; or
2. 'enhanced', when statutory law or other norms support the contractual arrangement; or
3. 'hybrid', when a judicial or administrative authority plays a partial role in the execution of the contract.

According to the individual case, these procedures can follow one after the other or they can also become alternative options. For instance, a minority of creditors aims at recovering their claim in full and begins enforcement actions that would jeopardise the business of the debtor, despite its agreement to share losses with the vast majority of the creditors. To solve the 'hold up' problems, a so-called 'stay' issued by the judge would suspend the enforcement actions and allow the debtor to run its business by allowing the financially distressed company to raise new financing without interference (World Bank, 2015). This judicial procedure complements 'out-of-court' contractual solutions.

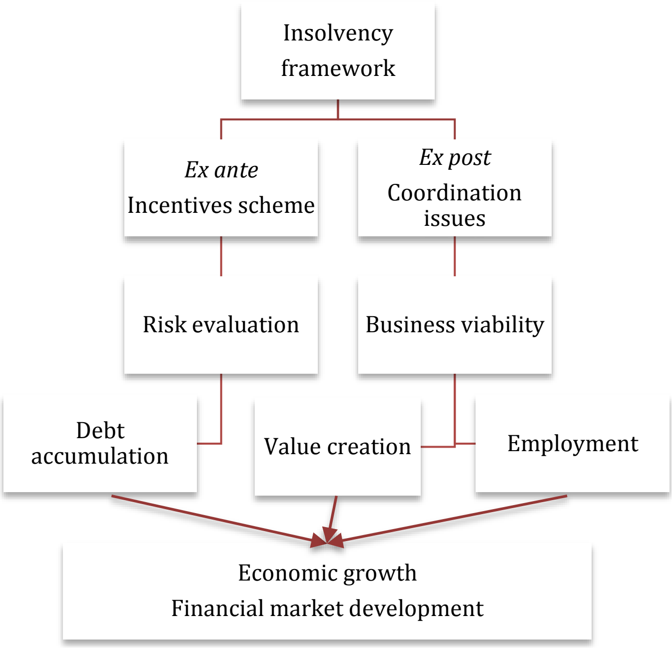
1.2 The economic impact of insolvency proceedings

There is a growing body of literature on the economic impact of insolvency frameworks, which can have both micro and macroeconomic implications.

On the microeconomic side, as briefly discussed above, insolvency proceedings minimise coordination issues that may arise due to creditors' 'race to collect' (a run on debtor's assets; Armour 2001), favouring those who come first and triggering potential 'fire-sale' liquidation (Shleifer & Vishny, 1992) and hampering the viability of a business that could potentially go back to 'business as usual', with spillover effects on employment and value creation. Notably, an insolvency framework can also shape *ex ante* incentives and, in particular, can align those of borrowers and lenders, who may be unable to exploit failures in the private enforcement mechanisms, so they might be more willing to assess risk more thoroughly.

This incentive mechanism also produces implications at macroeconomic level. By affecting protection of creditors and (in general) investors' rights, insolvency proceedings can have an impact on financial market development (La Porta et al., 1996, 1997, La Porta et al., 2006; Djankov et al., 2008a). The private debt enforcement mechanism is strongly correlated with per capita income and predicts debt market development (Djankov et al. 2008b). Nonetheless, it is highly complex to measure the impact of (diverging) insolvency proceedings on investment decisions and credit flows (European Commission 2014b).

Figure 2. Stylised view of the economic effects



Source: Author.

.
The insolvency framework can also produce effects on self-employment rates (as an indicator of entrepreneurship) and corporate deleveraging (Carpus Carcea et al., 2015). Moreover, an effective insolvency framework would also limit banks' 'gambling for resurrection', as NPLs raise to dangerous levels (IMF 2015). Incentives for more entrepreneurial spirit and actions to reduce recovery time and increase recovery amounts in the management of non-performing loans (NPLs) can produce a distinct impact on the overall economy. In effect, high NPLs impair the ability to support economic activity, resulting in higher lending rates, less lending volumes and more risk aversion (among others, IMF 2015). AFME et al. (2016) estimate that a 10% increase in expected recovery rate can reduce corporate bond spreads up to 37 basis points and, the lower risk premium, can add up to 0.55% (€78 billion) of EU GDP.

Besides helping to improve the quality of banks' balance sheets, finally, the insolvency framework can help to increase deleveraging (Carpus Carcea et al., 2015) and so reduce the debt overhang, which tends to thrive in a low growth-low inflation environment (Brincogne et al., 2016). Overall, insolvency frameworks can strengthen the absorption capacity of the Euro area, by pushing a more rapid (but orderly) adjustment of values when a permanent shock hit the region. This economic effect has (positive) implications for financial stability and can accelerate the economic recovery.

1.3 The quality of insolvency frameworks in the euro area

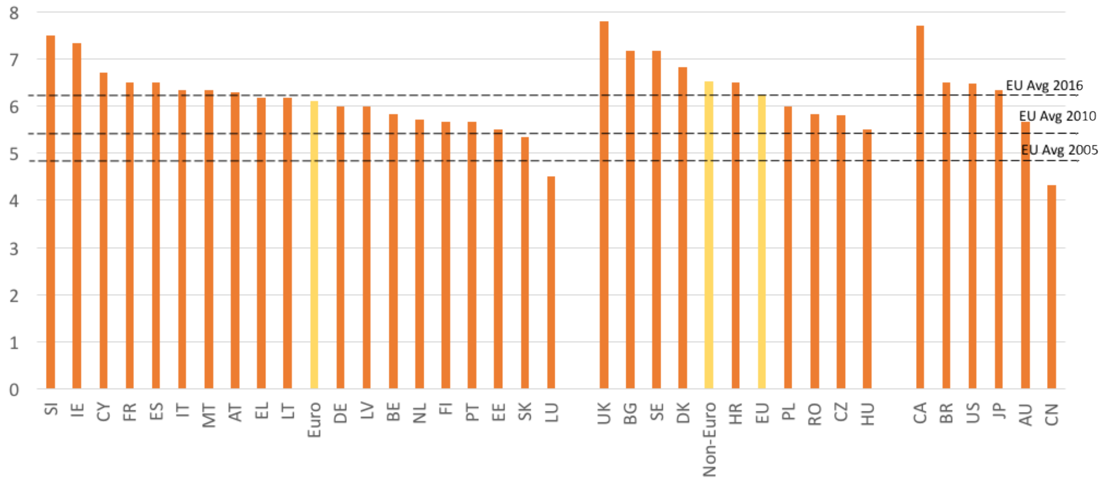
The quality of insolvency frameworks across the Euro area, and in the broader European Union, change rather dramatically. In order to understand the quality of the insolvency frameworks, there are three important dimensions to consider: protection of minority (shareholders and investors); quality of contract enforcement mechanisms; ability to resolve insolvency.

Protection of minority investors[3] primarily provide a balance in the governance of firms, which may ensure upfront protection of rights and potentially reduce disputes when things worsen and insolvency

[3] For a more detailed list of key components, please see World Bank, 2016 Doing Business Report, Data Notes, available

proceedings begin. In effect, access to information about underlying company (including conflicts of interest information) is very important for a cost effective and simpler insolvency procedure.

Figure 3. Protection of minority



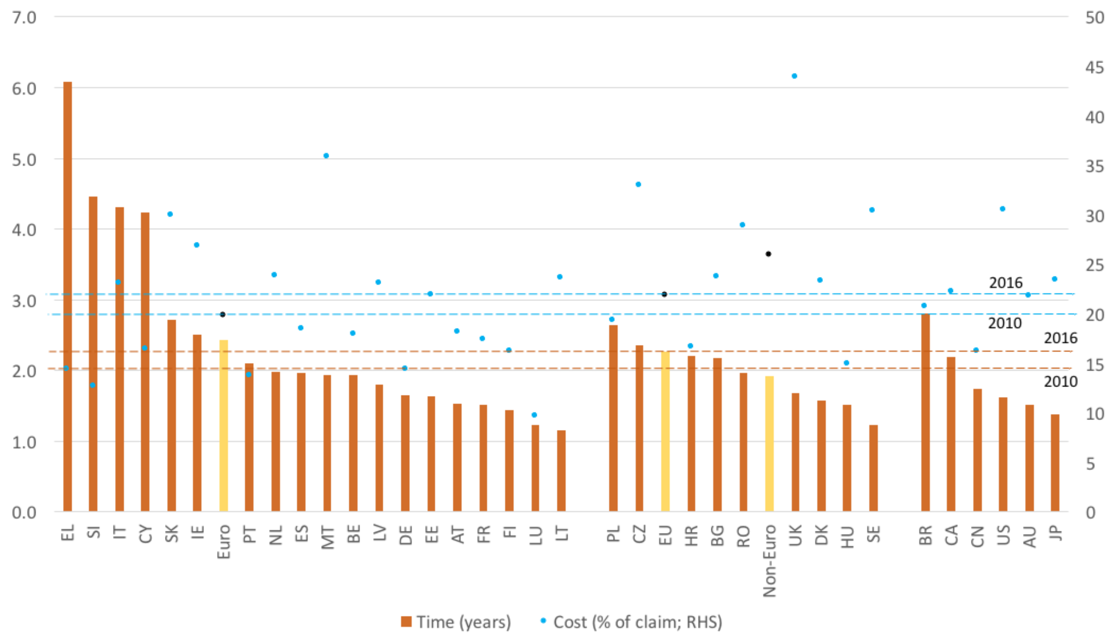
Source: World Bank 2016 Doing Business Report.

The protection of minority investors is fairly similar across Europe, except for a few countries, and it has been improving on average since 2005, as many regulatory actions were implemented in those areas.

A second important dimension, which makes the system more efficient and reduces the risk of insolvency and related litigations, is the ability to enforce contracts. The European Union, on average, is doing relatively well compared to other advanced economies. However, the differences across countries are huge. In countries like Italy, Slovenia, Greece and Cyprus, enforcing a contract may take on average more than 4 years (see Figure 4). Costs may be on average very high as well, but still lower than Japan and the United States. Nonetheless, the dispersion across countries is still remarkable. Improving the enforcement of contracts, via the introduction of complementary action to insolvency reforms, can improve quality and effectiveness of insolvency proceedings. In recent years, however, the time required to enforce a contract and the cost of doing it have been increasing on average across the European Union and the Euro area.

at http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Data-Notes.pdf. It includes indicators, such as shareholders' rights in major corporate decisions, requirements for related-party transactions, the extent of conflict of interest disclosure, etc.

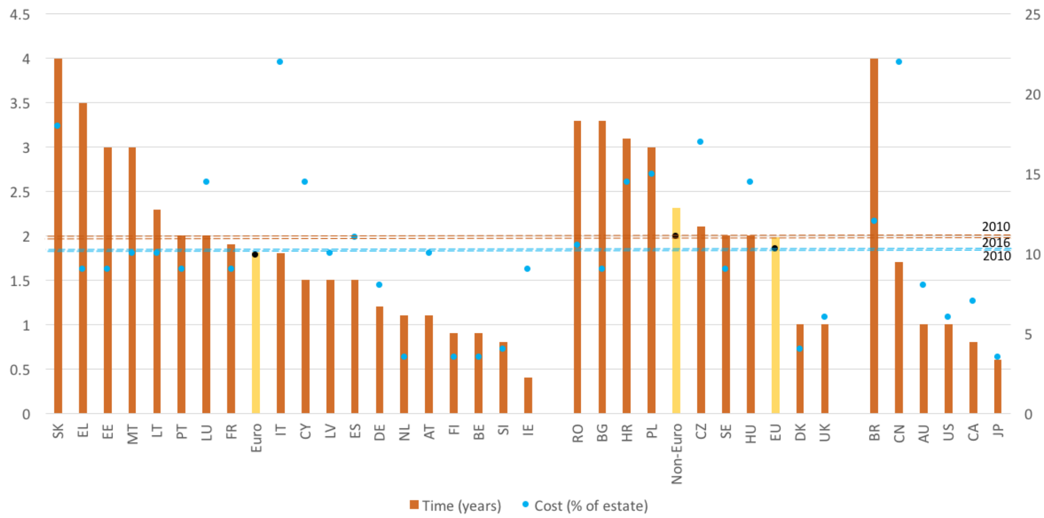
Figure 4. Enforcing contracts



Source: World Bank 2016 Doing Business Report.

The third dimension looks at the quality of insolvency proceedings.[4] The dispersion across country is remarkable, with 4 years required on average to finish insolvency proceedings in Slovakia, versus less than 6 months in Ireland. The average EU framework also scores lower than other advanced economies and emerging markets, like China. Moreover, in recent years, there are small signs of improvements in terms of times and costs of insolvency procedures. This is not surprising, as the area of insolvency proceedings has always been largely considered as a national prerogative and, domestically, an area of the legal system that is hardly reformed with time.

Figure 5. Resolving insolvency

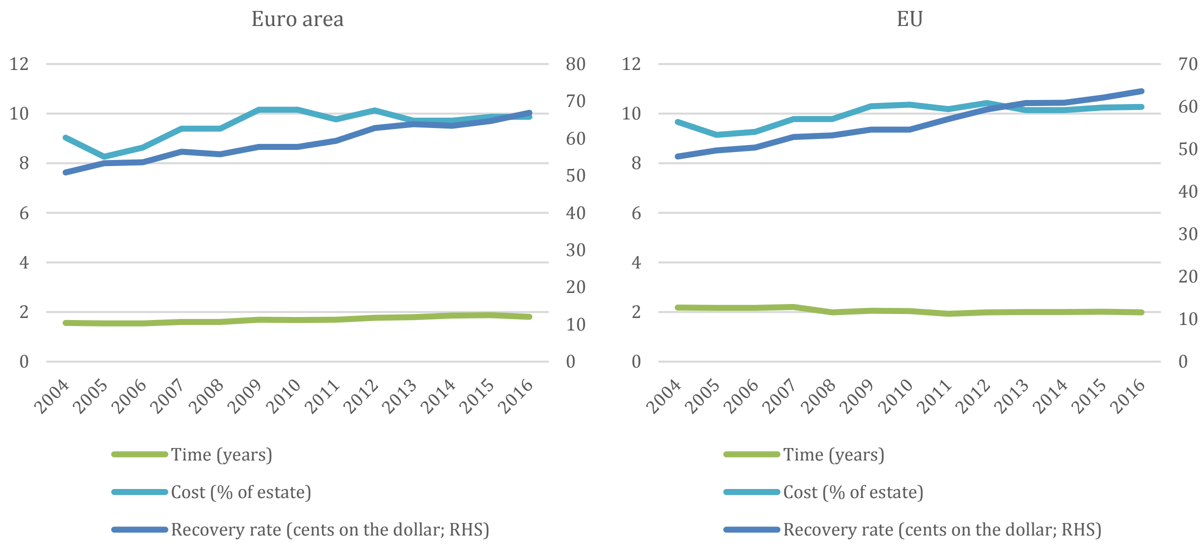


Source: World Bank 2016 Doing Business Report.

[4] For a more detailed list of key components, please see World Bank, 2016 Doing Business Report, Data Notes, available at http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Data-Notes.pdf. It includes indicators, such as time required to recover debt, costs required to recover debt (lawyers' fees, etc) and creditors' participation.

If we look more into detail, in particular, evidence about the evolution of the efficiency of insolvency proceedings over the years is rather mixed. Recovery rates have increased across both the Euro area and the European Union, but the costs of the proceedings have gone up as well and the time to complete an insolvency proceeding has even slightly increased in the Euro area on average.

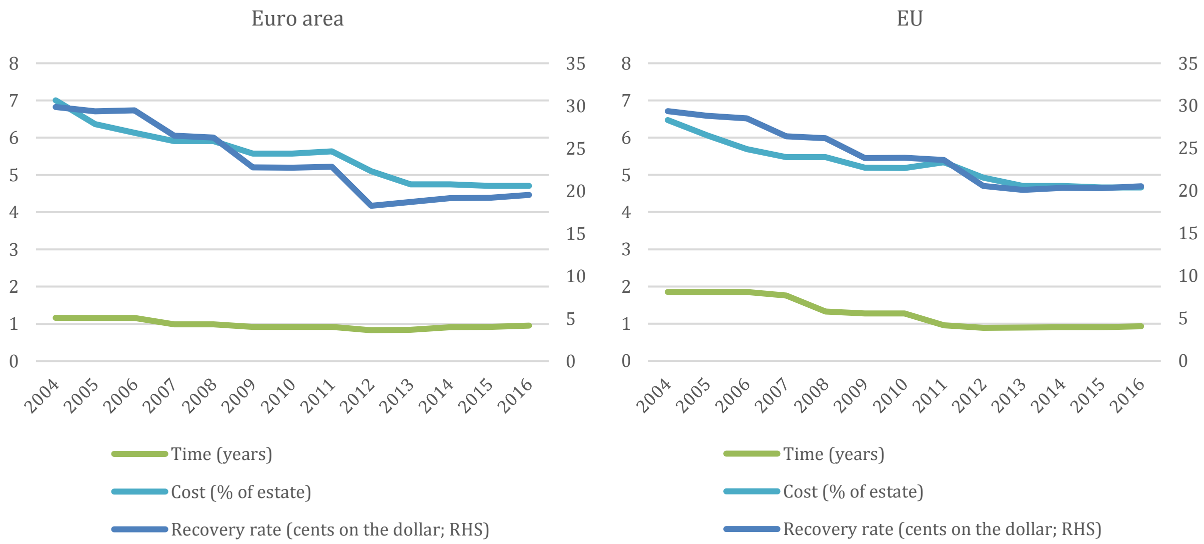
Figure 6. Key indicators in the Euro area and the EU



Source: World Bank 2016 Doing Business Report.

Despite being high absolute values, the dispersion among member states, however, has been steadily dropping in the past, for what concerns the time and the cost of the insolvency proceedings. This trend towards a more harmonised framework may be the result, on the one hand, of the international efforts in fora like the World Bank to push for common principles in insolvency proceedings. On the other hand, the growth of international commerce may have led to market pressures on local governments to upgrade their legal infrastructure, so to make cross-border trading less costly.

Figure 7. Dispersion of key indicators in the Euro area and the EU



Source: World Bank 2016 Doing Business Report. Note: Standard deviation.

This reduction in dispersion rates occurred up to 2012. After the euro area crisis, this process has mostly stopped or is even reverting, as far as recovery rates in the euro area are concerned. To conclude, evidence shows that insolvency regimes in the euro area are fairly diverse across countries, with a wide range of differences that have slowed down the long-term process of improvement of national insolvency frameworks.

CHAPTER 2. INSOLVENCY LAWS AND CAPITAL MARKETS UNION

Insolvency laws are the backbone of cross-border capital markets transaction, as they ensure the well-functioning of private enforcement mechanisms, should one of the counterparts experience financial difficulties or acts strategically to exploit differences in insolvency laws, especially in a cross-border setting (so called *forum shopping*). In effect, contrary to banks (institution-based funding), capital markets (market-based funding) are less able to overcome severe information asymmetries about the financial state of the counterparties of a transaction. Therefore, predictability in insolvency procedures play a key role to deter misconduct by one of the counterparties attempting to exploit those asymmetries and so to incentivise capital market transactions. As a result, in order to foster cross-border capital market transactions, legislative actions could and should reduce unpredictability of procedures in cross-border insolvency proceedings, which are an important deterrent of further capital market integration.

Approach to insolvency laws diverge across the EU, with insolvency proceedings that are more employee-friendly in countries like France or more punitive for natural persons like in Italy. For this assessment, insolvency frameworks across the Euro area, with particular attention to France, Germany, Italy and Spain, have been assessed.

This section builds on interviews, reports on national insolvency laws in selected Euro area countries (Italy, Spain, Germany, France, Netherlands, Belgium, Greece) from Freshfields (2015) and AFME (2016).

2.1 Cross-border insolvency: relevant aspects

Enforcement mechanisms, like insolvency frameworks, are built upon trust and reliability of the procedures that offer protection for creditors and debtors, especially in a cross-border setting. The interaction between national legal systems and principles is partially dealt with in Europe via a combination of minimum harmonisation in selected areas and mandatory recognition of foreign insolvency proceedings (the so-called ‘hybrid’ model to approach cross-border insolvency; Story 2015). This model, however, might be insufficient to keep the trust that a more interconnected financial system (with its banking and capital markets union) may require. As a result, accessibility (transparency and accountability), predictability and equitable treatment (supported by the NCWO principle) are the elements that create this trust and make the system more reliable (IMF 1999, UNCITRAL 2013, World Bank 2015). As long as they are uniformly applied within the domestic framework, accessibility and equitable treatment principles can actually differ from country to country, but with only limited affect to the level of cross-border activity. It will certainly be costlier to deal with different rules and treatments of creditors on a cross-border basis, but it would not be prohibitively so.

However, if rules and procedures are unpredictable, there is a higher chance that the transaction may not take place, as it is not possible to place a cost on the transaction *ex ante*. Issues around predictability arise with discretionary procedures or rules that leave space for interpretation by the judges involved in the proceeding. There will never be a completely objective and non-discretionary insolvency proceeding, but there are areas where the unpredictability can be contained, as it may impact the ‘union’ of banking and capital markets services. Those areas are:

- Opening of proceedings (e.g. applicable law, solvency test);
- Relief actions (e.g. moratoria, avoidance actions);
- Governance of the proceeding (e.g. directors’ liability, cramdown, discretionary actions of judges).

Aspects of the opening of proceedings for cross-border services concern the applicable law, including the possibility to open a secondary proceeding, and the application of the insolvency tests (including the procedures), which can differ significantly across the Euro area and the EU more broadly. Relief actions mainly include moratoria and avoidance actions, which support the smooth functioning of the insolvency proceedings and protect the business from management's wrongdoing.

The governance of the proceedings, finally, include voting mechanisms and tools to deal with 'hold-up' by classes of creditors that have nothing else to lose, as well as the priority to discipline claims and the training of judges to limit arbitrary decisions.

Table 1. Selected aspects of insolvency frameworks in selected euro area countries

		FRANCE	GERMANY	ITALY	SPAIN
OPENING OF PROCEEDINGS	Pre-insolvency proceeding	Yes (up to 12 months)	Yes (3 months)	Yes	Yes (credit institutions)
	Insolvency test	Illiquidity	Imminent illiquidity, illiquidity & overindebtedness	Illiquidity	Illiquidity
RELIEF ACTIONS	Automatic stays	Yes	Yes	Yes	Yes
	Avoidance actions (clawback period)	18 months	Between 3 months and 12 months (10 years if knowledge of illiquidity)	Between 6 & 24 months	24 months
GOVERNANCE OF PROCEEDINGS	Cramdown	No	Yes	Yes	No
	Directors' liability (time to file)	45 days	21 days	No time limit	2 months (suspension in pre-insolvency)
	Priority of claims (tax claims)	Priority	No priority	Priority	Priority
	Specialised insolvency courts	No	Yes (lower courts)	No (but spin-offs in large regions)	No

The comparative analysis in the following sections highlights areas of unpredictability that emerge in the opening of proceedings, relief actions and the governance of the proceeding. As a result, in order to advance the CMU in the area of insolvency laws, improvements in national frameworks are discussed.

2.2 Opening of proceedings

The procedure that lead to the opening of insolvency proceedings changes across country, according to the national legislation and case law. In a cross-border insolvency framework, the beginning of the judicial procedure comes after the assessment of the applicable law, which relies on the given location of the Centre of Main Interests (COMI; see Chapter 4). In some countries (e.g. Italy), a different insolvency framework may apply to financial institutions. In most of the countries, however, there is one single insolvency procedure that applies for both financial and non-financial corporations.

2.2.1 Insolvency test

There are typically two insolvency tests to kick off an insolvency proceeding: balance sheet or cash flow-based. The application of these tests can significantly differ across countries. For instance, the balance sheet test does not apply in Spain and France, but it does in Germany (if chances for continuation of the company as a going concern are less than 50%) or Italy (if debtor asks for it in both creditors' composition and liquidation) and can lead to bankruptcy if there is a likelihood that the company business cannot continue. There are no detailed criteria on how this likelihood should be estimated and it is usually left to the judge, after consulting an expert. Discretionary processes apply in other countries when assessing the cash flow test, which is the only test available in countries like France, Greece and Spain. For the liquidity test, instead, the German Federal Supreme Court

introduced some objective criteria, such as the presumption of illiquidity if the liquidity shortfall is at least equal to 10% of the payment obligations within 3 weeks. Moreover, in the German insolvency regime, there is a temporary preliminary proceeding of up to 3 months before insolvency where the insolvency practitioners (on request of the judge) assesses the solvency of an entity and takes preparatory measures to be finalized and taken upon the formal opening of proceedings (including the preparation of an insolvency plan, negotiations with potential acquirers and investors), while preserving the workforce inter alia by ensuring the payment of employees' wages by way of a fund financed by the industry.

2.2.2 Asset evaluation

The valuation of assets is an important aspect of insolvency and pre-insolvency proceedings and it is probably the main source of litigation for debtors. The judge, having heard the experts, has much discretion in applying a going or gone concern to the valuation of the different assets, whether the case is suitable for restructuring or liquidation. For instance, the different sensibilities of judges to the protection of local employment (such as the case of court decisions in France) may lead to different approaches, with the risk of damaging creditors beyond what is reasonable. This damage can come from keeping alive pieces of business that could have been split and sold separately, as well as from the risk of piecemeal sales when a going concern sale (by business) would have maximised returns for investors in a longer time period and protected jobs for employees.

The presumption of a 'going concern' asset value, unless the creditor or the insolvency expert hired by the judge can prove otherwise comparing 'gone concern' with 'going concern' over a reasonable period of time (e.g. 3 to 5 years), could be introduced at European level to make the procedure more consistent across the EU. However, this presumption could increase overreliance on experts' assessment. In this respect, the judge could wave this presumption when the hiring of experts would determine a cost for the proceeding that is manifestly higher than any benefits from a 'going concern' valuation presumption would produce. Even this intervention, nonetheless, may produce a loss of neutrality in the assessment of the judge, which can actually not necessarily determine a reduction of legal disputes, as it implicitly modifies creditors' rights. It also increases the transaction costs of finding an agreement over a restructuring plan, as it reduces the space of action, while creditors are only asking for a similar or better treatment than normal insolvency procedures. Alternatively, for instance, the UK is evaluating the possibility to introduce a minimum liquidation valuation to be used as a benchmark to make the 'going concern' evaluation more accurate. This minimum evaluation, together with a uniform training of judges and a harmonised set of minimum qualifications for insolvency practitioners[5] could produce a more harmonised assessment of value (with more uniform methodologies) and so less disputes and more predictability at last.

2.3 Relief actions

Once the procedure starts, there are actions of relief that can help the practitioner responsible for the procedure and the debtor's assets against uncoordinated enforcements actions of creditors and wrongdoing of the debtor or of the management of the company.

2.3.1 Stays

A moratorium (or so-called 'stay') suspends the possibility for creditors to begin enforcement actions on their claims, so as to allow the beginning of the procedure that will also repay creditors. An automatic stay applies for all creditors' claims at the beginning of the insolvency procedure in all the main euro areas countries. Divergences exist on the duration of those stays, which in Spain can last 1 year for secured creditors and for the duration of the procedure for unsecured ones. The Spanish

[5] For instance, there are no minimum requirements or licenses for insolvency practitioners in Germany yet there are in Ireland.

moratorium applies only to assets related to the business (to be assessed by the Court) and will not apply to 'financial collateral'. A stay also applies during the three months that the Spanish debtor has to set off a temporary procedure to reach an agreement with creditors before the declaration of insolvency. This time limit applies as well for the Italian's composition of creditors. This temporary procedure is also available in most of the euro area countries, but in France it can go up to 18 months. In Germany, this temporary procedure is available for a period of three months prior to the opening of insolvency proceedings and after the declaration of insolvency for the duration of the proceeding. Contrary to what happens in Spain, a stay in France also applies to secured creditors with no time limit during the liquidation procedure.

While an EU intervention may be needed for the use of stays in pre-insolvency (early restructuring) procedures, the use of automatic stays in insolvency proceedings is now widespread and may not require further intervention.

2.3.2 Avoidance actions

More complex is the situation with avoidance actions, i.e. actions to challenge past transactions that have been taken to deprive creditors of debtor's assets. There are no countries with a pre-defined list of transactions that can be voided. However, in Spain there is a presumption that the court should void the transaction, unless proved otherwise, in the case of donations and payments of debt that were not due at the time of the transfer. Other transactions could be voidable too, if taken within 9 months before the insolvency, such as the transformation of an unsecured credit toa secured one (unless there is no damage) or those with related parties. In Germany, the mandate is very broad and the insolvency administrator can challenge transactions up to 10 years before the insolvency, if the counterparty had knowledge of the illiquidity and the negative effect on other creditors (unless there is proof that the debtor did not intend to harm creditors), while the regular claw-back period is 3 months. A current reform bill pending in the German parliament provides for a maximum period of 4 years in cases in which the transfer served the purpose of discharging a valid claim. The suspect period goes down to 1 year in the Netherlands, up to 18 months before the beginning of the procedure in France, up to 2 years in Greece and Italy (depending on the type of transaction) and so on. As a result, greater predictability can be achieved in the procedures to define potentially voidable transactions and a common clawback time period in which transactions can be voidable after the beginning of the proceeding (unless transactions are fraudulent, for which no time limit would apply). Considering a broad time range, to suit the current disparities across the EU, a time period of 18 months from the application to open of the proceeding (for transactions that are not fraudulent) may be a good compromise, which may not be the end too invasive in the regular business of a company. Moreover, a list of transactions that cannot be voided ('benign' transactions) and another list of 'suspicious' transactions may help to curb concerns about the continuation of the business in an insolvency procedure.

2.4 Governance of the proceedings

The governance of insolvency proceedings is another important aspect for cross-border dimensions of banking and capital markets union. In particular, there are four main areas where uncertainty can affect the implementation of these two projects:

1. Directors' liability;
2. Voting mechanism ('cramdown', in particular);
3. Priority of claims;
4. Functioning of courts.

2.4.1 Directors' liability

There is a general duty for directors to disclose the state of insolvency as soon as it becomes manifest. However, its application across the Euro area is somehow fairly different, producing some level of unpredictability when the director of a cross-border entity has to assess when to file for insolvency. To reduce this uncertainty, the European Court of Justice (ECJ) has recently clarified that the question is a matter of national insolvency law, rather than company law.[6] The application in countries like Germany is pretty strict and requires the director to file for insolvency within three weeks, otherwise it will be prosecuted. This period goes up to 45 days in France. In Spain, instead, this period goes up to two months, but notably the debtor can communicate the 'imminent' risk of insolvency to the judge, who may give three months for negotiation with creditors, plus an additional month to file for insolvency. In Italy and the Netherlands, there is no time limit, but only a risk that directors be held accountable for late filing. This fragmented landscape creates unnecessary clouds for directors of cross-border companies on when to file for insolvency, with the additional burden to determine what is the applicable law to define what is the requirement to file in the country where the insolvency proceeding will take place. Despite the existence of an EU framework to define the applicable law (see Chapter 4), this determination cannot be easily determined *ex ante* and requires the discretionary evaluation of the judge.

Since the given 'time to file' changes across countries, as well as its enforcement, this fragmented approach can generate undue unpredictability, while the benefits of a piecemeal approach are far from clear. As a result, it may be appropriate to introduce a common time period to file for insolvency, which would be subject to local insolvency opening procedures. Alternatively, a less strict duty to file could be less burdensome, but it would expose creditors to more possibilities of debtors' wrongdoing.

2.4.2 Voting mechanisms and cramdown

The voting mechanisms to involve creditors in the insolvency proceedings, and in particular the restructuring of the financial claims, can be a source of cross-border unpredictability if there are no requirements of cramdown[7] over small classes of creditors that can hold up the majority, as they have nothing to lose anymore (e.g. shareholders). The cramdown and the 'best interest' test, i.e. whether the creditor is better off with the restructuring rather than the liquidation, is available in Germany and Italy, but not in the Spanish insolvency framework, which gives limited voice to creditors. A similar approach, for instance, is used in France. In addition, voting mechanisms typically consider classes of creditors and the majority of the classes has to approve the restructuring procedures. For instance, in Germany and the Netherlands there is a split between secured and unsecured classes that vote for the insolvency plan. However, they are not always classified according to the legal status and their economic interest. In Spain, creditors are classified according to nature of the entity (e.g. public, financial, non-financial, etc). This classification is highly dysfunctional in relation to the economic incentive that the legal structure of the instrument and its economic function may create.

As voting mechanisms are important for the well-functioning of insolvency proceedings, a limit to the ability of minorities to hold-up and slow down the procedure may be beneficial. EU action could could improve voting mechanisms in national insolvency laws by introducing a cram down power of minority creditors like shareholders, who may end holding up every restructuring procedure. The introduction of a cram down procedure across the EU would thus increase stability and predictability of insolvency proceedings.

[6] ECJ, Kornhaas vs Dithmar, C-594/14, 10 December 2015.

[7] 'Cramdown' is the legal authority for courts to impose a restructuring of debt in an insolvency proceeding despite objections from some classes of creditors, typically shareholders that have nothing to lose.

2.4.3 Priority of claims

The priority of the claims in the distribution of the proceeds in liquidation or restructuring also differ across countries. In Italy, Spain and France, for instance, tax authorities can enforce their liens on debtor's assets before secured creditors (together with the expenses of the proceedings). In countries, like Germany, there is no priority for tax claims. In some cases, like Spain, the salaries of the employees for a limited time during the insolvency proceeding receive a special priority vis-à-vis secured creditors. This part is most relevant for the functioning of the banking union, which the following chapter will extensively discuss.

2.4.4 Functioning of courts

Finally, the functioning of the courts and the training of judges is a very important to reduce the likelihood of arbitrary decisions in the necessary discretion that judges have when interpreting local insolvency laws for individual cases. Creditors and debtors have the right to be heard and this right to a fair judicial review of the proceedings should be preserve. According to the IMF principles (1999),

"all insolvency laws should provide adequate guidance as to how a court should exercise its discretion when making a determination on matters that involve economic or commercial issues. This is essential if the law is to be predictable."

In this respect, the quality of the regulatory framework and the training of judges is key. Most of the countries do not have specialised courts, but spin-offs of commercial courts and/or regular civil courts. In Spain, trials are concentrated in commercial courts located in main urban areas with highly qualified judges. In others, like Germany, proceedings are concentrated in few courts only in some local regions, while in others proceedings take place in courts that are spread across the country in others and thus are de facto less specialised. As a consequence, the quality of the procedures may significantly differ across regions. In France, the civil court is the competent court for civil debtors and the commercial court for commercial entities. Most recently, the French government has introduced a law to move gradually towards specialised courts for insolvency proceedings.

An EU intervention can actually support this process potentially in two ways. A first best solution could be the creation of a European system of courts with branches in every country, which deals with only cross-border transactions and provide a separate judicial review for the insolvency cases that are related to these transactions. This could quickly align quality of judges and procedures to the same standard. A second best solution, and perhaps more politically feasible, would be the following:

- The creation of a EU-wide training programme for local judges, like it is foreseen for judges in competition law;
- The recommendation to member states to create separate courts (even spin-offs of local commercial courts) dedicated to insolvency proceedings, limiting their number (of courts) to main regions, compatible with their size and number of proceedings;
- The introduction of minimum requirements for insolvency practitioners, which are aligned as much as possible with international standard setters (as for financial analysts), together with a common compensation scheme with a minimum fixed payment and a variable one based on the complexity of the insolvency;
- The creation of a EU-wide programme of investment in the Juncker Plan to improve the physical infrastructure (including the digitalisation) of courts and supporting functions.

CHAPTER 3. INSOLVENCY LAWS AND BANKING UNION

Banking union theoretically relies on three pillars: the single supervisory mechanism (coupled with the single rulebook), the single resolution fund and the single deposit insurance scheme (still missing). It is the most important institutional project in recent European history. The relationship between banking union and insolvency laws puts less emphasis on predictability of procedures, as banks have a cost structure that is able to deal (to a good extent) with information asymmetries. It calls instead on insolvency laws to be effective enough in reducing assets/liabilities mismatches via more effective (and rapid) enforcement of claims and less legal complexity in supervisory and resolution actions. This section reviews aspects of insolvency laws that may produce an impact on the functioning of the two banking union pillars in operation so far. In addition, this chapter reviews the areas in which improvements to pre-insolvency and insolvency proceedings can improve supervisory actions and management of non-performing loans (NPLs), irrespective of their cross-border impact. This part mainly relies on benchmarking national regimes.

3.1 Ranking of creditors

A first area where insolvency laws may interact with banking union is the ranking of creditors in bank resolution procedures, which may involve the write-down of shares and bail-in of subordinated creditors. Legal subordination of claims on the assets of the debtor can take place in three ways:

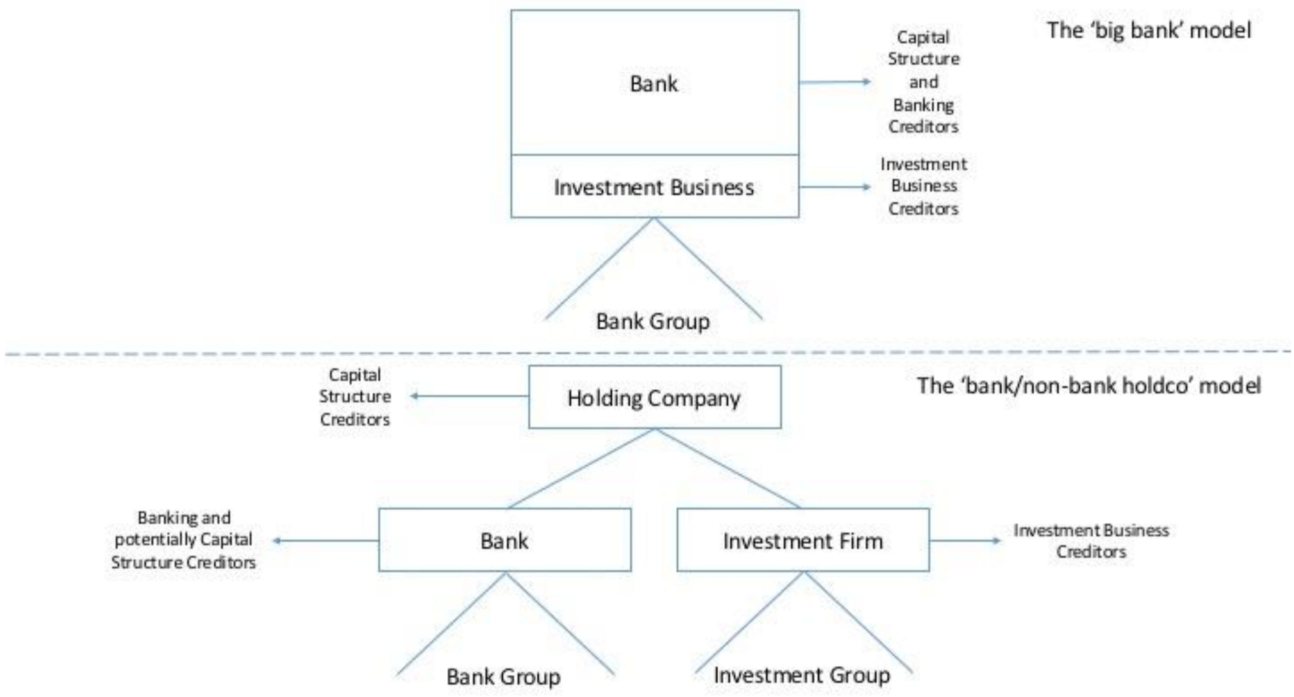
1. Contractual;
2. Structural; and
3. Statutory.

Contractual subordination is achieved through contractual terms. It offers flexibility and decentralisation, but it involves high transaction costs (complexity, lack of transparency, legal uncertainty and negotiation) to ensure that subordination is offered in the same way to all the creditors in the same class, according to the NCWO principle.

Structural subordination is achieved through the legal structure of a commercial group, whether a bank or another legal entity. The division of the group between a holding company, issuing the capital and other subordinated liabilities, and subsidiaries, running the operations and exposed to secured and unsecured operational credit, offers a structural subordination of liabilities sitting in the holding company. This model of legal entity is widely used in Common Law legal systems.

Statutory subordination is delivered by statutory law, which provides a legal framework for the recognition of subordination of creditors within the same class. This tool provides legal certainty, transparency and centralisation, but may lacks flexibility and it may require legal adjustments over time.

Figure 8. 'Big Bank' vs 'HoldCo' model



Source: Author from Gleeson & Guynn (2016).

As a result of the different types of subordination co-existing in the euro area, there are some issues with the implementation of the newly introduced Bank Recovery and Resolution Directive (BRRD, EU Directive 2015/59), with its 'bail-in' mechanism, and the priority of claims (and creditor classes) that is a constituting element of national insolvency laws. According to the NCWO principle (under the 'best interest' test), in effect, the pre-insolvency resolution of a bank, which occurs in the "public interest" (recital 13, BRRD), has to produce an impact on creditors that does not make them worse off vis-à-vis the national insolvency regime.

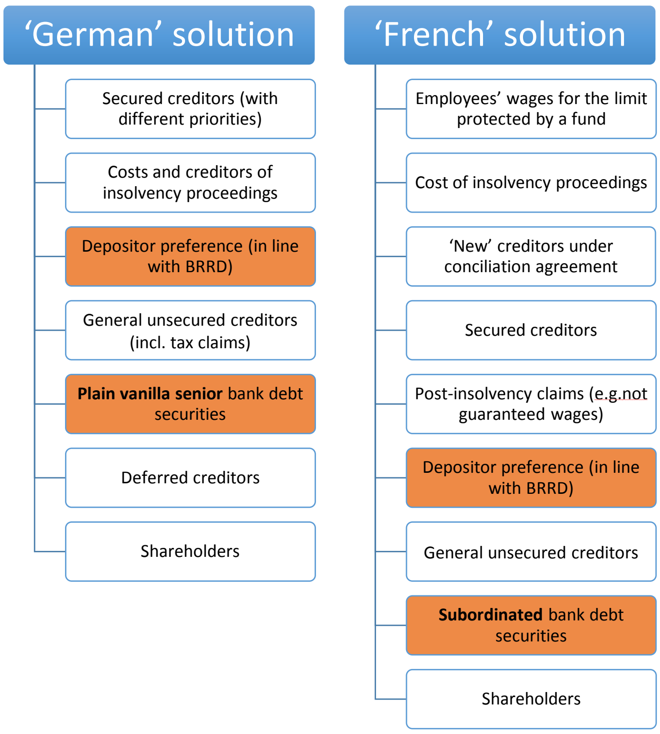
In this assessment, two issues emerge. Firstly, there is a need to assess the impact of a standard insolvency procedure on creditors' claims, whether debt restructuring or liquidation. The BRRD (under art. 108) did directly harmonise subordination of uncovered deposits (above €100,000) to covered deposits, with the preference for natural persons and small and medium enterprises (Wojcik, 2016). However, it did not specify what 'preferred creditor' mean and how depositor preference relates to other classes of preferred creditors (Schillig, 2016). In particular, the BRRD does not introduce subordination for unsecured debt securities versus other forms of unsecured debt claims. Notably, when the parent company is an operational entity ('big bank' model, see figure above), it is not possible to achieve structural subordination, as operational preferential credit is mixed with other unsecured credit (e.g. unsecured debt instruments). These two forms of credit usually have same priority under the national insolvency law. As done in Germany and Slovenia (ECB 2015, 2016),[8] a statutory intervention may be thus necessary to create subordination in the local insolvency framework for unsecured debt instruments (e.g. Tier 3 capital), which is in the same class of other senior unsecured credit. While contractual subordination is legally accepted in all the insolvency frameworks, a change of law can deal with past issuance, generate bailinable capital immediately available (as in the case of Germany) and addresses NCWO issues. Overall, it may create a more legally certain environment for issuance of Total Loss Absorbing Capital (TLAC), under the Financial Stability Board (FSB) guidelines, vis-à-vis the NCWO principle test. Moreover, contractual

[8] The Slovenian draft law also includes a preferred status for natural persons, microenterprises and SMEs, facilitating bail-in procedures in line with the domestic insolvency framework.

subordination may stumble into legal issues in local insolvency laws and is generally a less transparent solution for an *ex ante* market perspective.

As a result, until the preferred status for some unsecured debt securities is not enshrined into local laws, the transposition of TLAC rules for banking groups that do not adopt the holding company model may not take place. The implementation of this statutory change can take two forms: the German one, which is retroactive, since it also applies to unsecured debt securities that were not contractually subordinated; and the French one, which is a not retroactive solution. The 'German solution' is able to free more resources for banks from past issuance immediately and addresses potential NCWO issues upfront. However, this solution changes the loss given default by providing statutory subordination (vis-à-vis general unsecured creditors) for all senior debt securities issued by credit institutions (Schillig 2016).[9] Even though, this does not foreclose the possibility for banks to issue debt securities that are even more subordinated (with contractual subordination), this intervention may result in a structural increase in funding costs for banks, which will not be able to issue anymore plain vanilla senior debt that is treated *pari passu* with other unsecured debt. Moreover, due to the subordination to general unsecured creditors, those plain vanilla senior debt securities would also lose their eligibility for ECB operations. It must be noted that new French class of subordinated debt will not be eligible for ECB operations, while senior non-subordinated debt will still be eligible (ECB 2016).

Figure 9. German and French general priority of claims with post-BRRD modifications



The 'French solution' (not formally adopted yet) also introduces a new category in the insolvency hierarchy, subordinated to secured creditors and general (unsecured) creditors (including senior debt securities). This category of claims would be statutorily subordinated, with a maturity longer than 1 year and immediately eligible for TLAC. This solution is more flexible, as it provides the bank with the choice to issue either subordinated debt or senior unsecured debt on markets that can price the *pari passu* of senior debt with other unsecured debt. Nonetheless, it does not provide immediate bailinable capital from past issuance and does not address upfront NCWO issues.

[9] Kreditwesengesetz (KWG; German Banking Act), §46f(5).

Secondly, there is an additional cross-border dimension in keeping different priority of claims under local national insolvency laws, which relates to the absence of a uniform NCWO principle across the banking union area. Under current application of the principle, when facing a liquidation or resolution of a bank operating in different countries, some creditors may be treated differently. Even though this may not be a problem for the predictability of the procedures, since this information is known *ex ante*, it complicates nonetheless the resolution/liquidation by forcing supranational European institutions to apply and interpret local legislation. In particular, decisions, like those of the Single Resolution Fund (SRF) Board or the Commission, would have to apply (and interpret) domestic laws. The legality of those decisions will be subject to judicial review by the European Court of Justice (ECJ), mainly via actions for annulment (art. 263 TFEU) or preliminary references (art. 267 TFEU). This implies that the ECJ could end up interpreting national law.[10] In particular, there is very limited experience of cases in which a court interprets and applies foreign laws (e.g. family laws). Notably, under art. 263-264 TFEU, the decisions of EU authorities (including the Single Resolution Board) are subject to the judicial review of the ECJ. It could be plausible that the ECJ may follow *Master Card,*[11] which states that, when deciding on a decision taken in application of EU law, the court should also assess the facts, i.e. going into the merit of that decision to check if conditions are met (including that it took into account the national legislation). By extension, this could mean that the ECJ could end up interpreting national law, as long as it is functional (and linked) to the application of EU law. Nonetheless, due to the institutional issues and practical legal issues, it may not be ideal that EU bodies apply national laws.

Finally, there are two additional issues with the application of the NCWO principle. First, the lack of a harmonised list of priorities in insolvency may also require the upfront definition of the applicable law that would be the loss given default, even if the resolution of a cross-border entity will in the end avoid the formal insolvency proceedings. Second, the set-off right for opposing claims[12] from the same debtor may be restricted or applied differently across countries, which may ultimately determine a violation of the NCWO in some countries when a resolution produces a haircut on a creditor's claim, which would have been set off (100%) with the normal insolvency proceedings. Overall, set-off rights (with different applications) are available all across the Euro area, so it would be preferable to have a broad application of the right in the bank resolution procedure as well. This would minimise the risk of litigation.

[10] See also art. 4.3, SSM Regulation n. 1024/2013.
[11] ECJ, C-382/12 P, §155-156.
[12] The set-off right is the right for someone exposed to the insolvent entity with both credit and debit claims to set off these claims before entering in the insolvency proceedings.

Box 1. The ranking of claims in insolvency proceedings and the NCWO principle

Pari passu (equal) treatment of same categories of creditors is a fundamental principle to avoid disorderly liquidations in insolvency proceedings (see Chapter 1). However, it only works in combination with a ranking of the different classes of creditors. In particular, this ranking of priorities is crucial for the loss-absorbing capacity of a failing institution (Schillig, 2016). It particularly matters in the assessment of the NCWO principle, as the ranking determines the impact of the liquidation under the local insolvency regime.

The 'no creditor worse-off' (NCWO) principle guides the bail-in procedures under the Bank Recovery and Resolution Directive (BRRD; art. 34.1 2014/59/EU). The principle protects the fundamental human rights of creditors, according to article of the Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, through a compensation scheme, when a resolution action changes the legal status of these claims under the protection of a 'public interest'. It entails that no creditor should receive a treatment, in their enjoyment of their possession, that is less than what they would have received in economic terms from a normal insolvency proceeding and, more specifically, a piecemeal liquidation, which is the 'worst case' insolvency scenario. As a result, it provides all classes of creditors (including shareholders) with an assessment of fair treatment of their property rights.

Ranking of priorities is currently not fully harmonised across the EU, as it typically reflects well-established rights in local jurisdictions. For instance, both French and German laws provide special protection to employees. But different levels of priority apply to secured creditors. Tax claims receive priority in Italy and Spain (according to the type of tax), but not so in Ireland, treated as other unsecured creditors, and only in very specific cases in Germany. Secured financial collateral required a separate EU law (Directives 98/26/EC, 2002/47/EC and 2009/44/EC) to ensure that all European insolvency regimes are able to provide the same priority to financial arrangements (like derivatives contracts or repos) for the smooth functioning of the financial system. In order to create a NCWO for the banking union, the harmonisation of rankings could be a similarly important step.

3.2 Management of non-performing loans

Effective management of NPLs relies on a well-functioning secondary market. The creation of a pan-European secondary market can facilitate bank restructuring and harmonisation of supervisory practices for the management of NPLs across the banking union. An efficient secondary market, however, requires a small price difference between the valuation of the bank and the evaluation of the investor. This pricing gap is currently fairly high in countries where NPLs have a big weight on banks' balance sheets, like Italy, Portugal or Greece. Evaluation varies whether loans are secured or unsecured. Unsecured loans would rely more on benchmark or standard haircuts, which would include the time to start a procedure and its effectiveness to attack debtor's assets, within or outside an insolvency proceeding.

Most of the NPLs are secured loans in countries like Italy. Based on the type of collateral, the NPL classification can be residential or commercial. The pricing gap is the difference between book and market value, which is usually partially covered by loan provisioning. The smaller is the pricing gap, the higher is the chance to create a secondary market. Loan provisioning and the market valuation of banks and investors in NPLs are the two key aspects that can make the secondary market liquid. The evaluation of the discounted market value by the bank and the investor may significantly differ. For the bank, NPL valuation relies on the discounting factor (usually the original interest rate of the deal), the value given by the expert and the time to repossess and sell the asset (via auctions), which is used to define the time for the actual discounting. On the investor side, the investor also includes the expenses for the recovery (usually included in a higher discounting interest rate).

Therefore, all procedures inside or outside the insolvency that speed up the repossession and sale of the collateral can make NPL management more effective by creating secondary market activity. Both banks and investors always look for out-of-court solutions, as they are less expensive. Nonetheless, reducing the time and increasing recovery rates in insolvency procedures (see section 1.3) can help

to offload NPL from banks rather quickly, and so support the unified supervision over the bank restructuring across the banking union area.

Assuming no pricing gap between book, market values with a natural reduction of NPLs at historical value (3-4 % of gross loans book), a target capital adequacy ratio of 16%, and 10% return on investment, the IMF (2015) argues that a two years' reduction of the expected foreclosure time would create a capital relief of €19 billion and an amount of lending equal to €261 billion. Estimates for Italy suggest that a reduction of 2 years in the recovery time would increase the market price of NPLs by 10% and reduce the stock of NPLs. If recovery time goes down from 7 to 1 year, market value could go from 22% (market price of book value for the 4 banks that were resolved at the end of 2015 in Italy) to 36.3% (Ciavoliello et al., 2016). Assuming a book value of NPL of €300 billion, this would amount to creating value for roughly €43 billion, which could make the NPLs crisis in Europe much milder if these additional resources are summed up to the current loan provisioning (between 45% and 50% in Italy) and the collateral value attached to most of those loans.

Figure 10. NPL simulation: resolution timing

Hypothesis:

Collateral value = 59% of outstanding gross NPLs
Current average time to guarantees recovery = 7 years
Fees for recovery procedures: servicies fees = 6% + legal fees = 5%

Current scenario

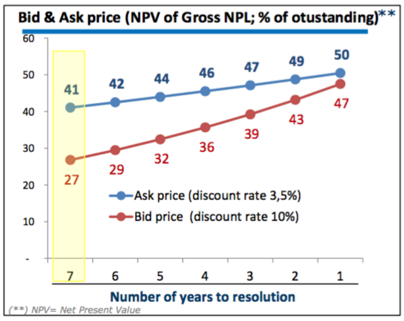
Ask price* (as a % of outstanding gross NPLs)

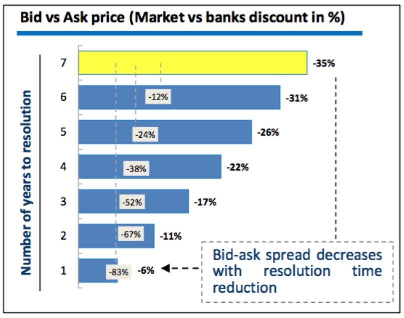
Discount rate: banks	Resolution timing: years 7	6	5	4	3	2	1
2.0%	45	46	47	48	49	50	51
2.5%	44	45	46	47	49	50	51
3.0%	42	44	45	46	48	49	51
3.5%	41	42	44	46	47	49	50
4.0%	40	41	43	45	46	48	50
4.5%	38	40	42	44	46	48	50
5.0%	37	39	41	43	45	47	50
5.5%	36	38	40	42	44	47	50
6.0%	35	37	39	41	44	46	49

(*) = NPLs carrying value = NPLs /Gross Npls

Bid price (as a % of outstanding gross NPLs)

Discount rate: market	Resolution timing: years 7	6	5	4	3	2	1
8.0%	30	33	36	38	41	45	48
8.5%	30	32	35	38	41	44	48
9.0%	29	31	34	37	40	44	48
9.5%	28	30	33	36	40	44	48
10.0%	27	29	32	36	39	43	47
10.5%	26	29	32	35	39	43	47
11.0%	25	28	31	34	38	42	47
11.5%	24	27	30	34	38	42	47
12.0%	24	26	30	33	37	42	47





Source: Associazione Bancaria Italiana (ABI)

For Italy, with a loan provisioning of around 45%, the reduction of the resolution time from the current 7 years to 1 year can almost double market valuation by investors and tighten the spread with the valuation of the bank, accelerating the off-loading process (see figure above).

Box 2. Pre-insolvency credit recovery mechanisms

Credit recovery procedures, outside the formal insolvency proceedings are important for a more effective functioning of the insolvency framework run by courts. In effect, courts are often overloaded with cases that could have been solved either with full-fledged out-of-court solutions or through the use of more standardised credit recovery procedures, such as the order of the judge to repossess the collateral and sell it in the market through auctions. The quality of credit recovery mechanisms relies on:

- The ability to repossess the collateral; and
- The accessibility and management of sale auctions.

In countries like Italy, the procedure to repossess and to sell via an auction may take up to 5 or 6 years on average. The time of the procedures also depends on the type of credit claim and the underlying collateral. As a result, in 2015 and 2016, the Italian government introduced procedures to reduce this time, such as the use of insolvency practitioners, rather than through slow court procedures, to run the auctions or the possibility for the creditor to repossess the collateral without a judicial procedure (but the approval of the debtor, who also gets part of the proceeds that are in excess of the due amount). Anecdotal evidence suggests that latest reforms may have already reduced the average time to enforce a credit claim by 6 months. These procedures are important to develop secondary markets for non-performing loans (NPLs), as the average time of recovery is used to estimate the residual value of the collateral, which is ultimately factor for the market price of NPLs. A minimum harmonisation at EU level can help to create a European secondary market to support the ongoing bank restructuring process. Ultimately, this is what the Obama Relief Programme did, increasing debt restructuring versus additional expensive foreclosures and court procedures. In Germany, in case of threat of illiquidity, it is possible to bring together creditors for a restructuring outside the insolvency proceeding, requesting the judge to issue a stay to support this procedure and avoid the illiquidity that is “imminent”. A similar procedure applies in Spain and France as well.

3.3 Other relevant areas

The beginning of a resolution procedure for a bank does not exclude the possibility for creditors of the bank to act via judicial means, in case the bank has failed to repay any claim meanwhile. In particular, it is beneficial to align as much as possible the tests adopted to assess the ‘likelihood to fail’ in a resolution procedure with the tests used in a normal insolvency proceeding. In effect, the alignment of the tests may minimise the disputes over the valuation of assets that the resolution authority (together with the supervisor) would make, as it is close to the one that a judge could reasonably make using the same approach. Nonetheless, there is no way to eliminate risk of litigation, as the resolution mechanisms relies on creditors’ compensation in exchange for the modification of their property right (including write downs; see art. 75, BRRD). Moreover, a moratorium (stay) to stop enforcement actions, when the bank is judged ‘likely to fail’, could help the setting up of the resolution procedures with legal certainty. This may require an amendment to national insolvency frameworks, ideally with the introduction of an early restructuring (resolution) procedure for banks (outside courts) as one of the available pre-insolvency proceedings to fit better the BRRD regime into national law.

The resolution mechanism also foresees the use of specific resolution tools, such as a bridge bank or sale of business, which are alternative to normal insolvency procedures. In addition, it also allows for write downs and conversion of liabilities into equity (so called ‘bail-in’) to allow a smooth restructuring of banks’ financial claims. Wojcik (2016) suggests that the resulting change of property rights is legally sound from a fundamental rights perspective if, the interference is necessary in the public interest (which is tested at the beginning of the resolution procedure and in line with the BRRD

objectives in art. 31.2 BRRD),[13] and proportionate to achieve this goal, which may include the payment of compensation on the other hand (as established by art. 75, BRRD), at least equivalent to the difference between what received in resolution and what would be received in insolvency where the NCWO principle was violated. The resolution decision can be challenged in court, if creditors believe in violation of the NCWO principle. In particular, the cancellation of shares is equivalent to the cramdown of shareholders in a normal insolvency proceeding, which would most likely occur in the liquidation of a bank. The harmonisation of the ranking may bring benefits also for this other issue.

Moreover, there is currently no preference in the ranking of priorities for the contributions of the Single Resolution Fund (SRF) in the insolvency proceedings. In theory, this funding contribution could receive a high priority over other claims, as it comes to support the continuation of the business after the insolvency petition. This is a priority that seems to be available everywhere, but not necessarily with the same preferential treatment across countries. In effect, there is no certainty that the priority will hold in the same way across the Euro area national insolvency regimes, corroborating a harmonisation of priority of claims across the Euro area.

Finally, when the baseline scenario (of local insolvency laws) is so different, there is a lot of legal uncertainty surrounding the application of the NCWO principle at European level. The introduction of a harmonised liquidation regime for banks at European level could further simplify the functioning of the resolution mechanism, by making uniform the liquidation scenario that will apply to the NCWO assessment. This harmonisation would also facilitate the transfer of assets/liabilities in liquidation (e.g. the ability to move deposits of a failed bank to a new bank), which is currently not possible everywhere across the Euro area. For instance, in Spain, there are only judicial proceedings available and the intermediation of the judge may limit the transferability of assets and/or liabilities by often only allowing payout or compensation.

[13] See European Court of Human Rights (ECtHR), *Graingerandothers* v. *UnitedKingdom*, Appl. No. 34940/10, decision of 10 July 2012, para 35 in Wojcik, 2016.

CHAPTER 4. CURRENT FRAMEWORK AND POTENTIAL OPTIONS FOR CONVERGENCE

Insolvency laws go deep into the legal systems of individual member states, involving corporate and contractual laws, among others. These differences can be a significant impediment to cross-border trading activity. At the end of the 17th century, the US Constitution already had a clause (Art. I, §8, cl. 4) that allowed the creation of a federal bankruptcy law, should the treatment of creditors residing in different member states affect interstate commerce.

It took, nonetheless, almost a century to exercise this option, i.e. when interstate commerce indeed became so dominant that it suffered from a lack of harmonised treatment of creditors by local insolvency laws. Also in the European Union, despite the simplification to cross-border trade that the introduction of a pan-European 29th regime would bring, it may take still years before a regime that harmonises existing national legal systems would be implemented. In this respect, an approach that aims at removing sources of unpredictability to a common treatment of creditors and stakeholders across the EU might be a good start.

This section provides an overview of the current European framework for insolvency laws and looks at the current proposals that the Commission is working on, assessing the different options of convergence.

4.1 The European Union framework

A European framework for insolvency proceedings is already partially in place. Nonetheless, its scope is limited to cross-border insolvency and, in particular, to the definition of the applicable law, the recognition of legal decisions and other procedural aspects. For non-banks, there is the Insolvency Regulation 2015/848, which is a recast of Regulation 1346/2000.[14] This 'Recast Regulation' will apply as of 26 June 2017. For banks, there is a Bank Winding Up Directive 2001/24/EC and an Insurance Winding Up Directive 2001/17/EC, which sets in a nutshell:

- The competent jurisdiction to implement reorganisations or winding up (the home member state);
- The recognition of the legal decisions throughout the EU;
- The obligations to inform the host member state and publicise to third parties;
- Some specific requirements on specific transactions (e.g. netting and repurchase agreements).[15]

The key areas of the European insolvency framework for non-financial institutions instead are:

- The court authorised to open the main proceeding;
- Secondary proceedings (e.g. synthetic);
- The recognition of the legal decisions;
- Other areas.

The conflict-of-law regime requires that proceedings should be opened in the Centre of Main Interest (COMI) of the debtor (*lex concursus,* Article 3). The proceeding will also cover related actions (mainly under civil and commercial laws). For companies, this is presumed to be the registered office, unless there is proof of the contrary (Art. 3.1). For individuals, the regulation refers to the 'habitual residence' of the individual without further specifying how 'habitual residence' shall be defined. The uncertainty about the COMI presumption for individuals can still be a source of cross-border litigation in insolvency proceedings (in line with Wessels, 2003), after the new rules enter into force in 2017. With the recast of 2015, to limit forum shopping, the European Commission has improved the COMI's presumption by requesting (for the presumption to apply) to corporates that the relocation

[14] Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings, O.J. 2000, L 160/1.
[15] Directive 2001/24/EC of 4 April 2001 on the reorganization and winding up of credit institutions.

of the registered office or the place of business took place at least 3 months before the request for opening. For an individual, this time period goes up to at least 6 months for the relocation of his/her 'habitual residency' post opening request.

Opening a secondary proceeding in other countries is an important aspect for predictability of insolvency proceedings. To protect their interest, local creditors can open a secondary proceeding in any European country where the debtor has an establishment. If the procedure is open to too much discretion by the court of establishment, which can also hear the main liquidator and refuse to open the secondary proceeding, this can be a source of cost unpredictability in cross-border insolvency. With the recast, creditors can request secondary proceedings not just for merely winding-up proceedings, but for any proceeding (including restructuring) in any place of operation where "the debtor carries out an economic activity with human means and assets" (Recital 24; Article 2 n. 10). While the main liquidator can offer to treat local creditors as they would be treated in the jurisdiction of establishment, the procedure is still burdensome and leaves great discretion to the local court. The court of the country of establishment may tend to be excessively conservative in its attempt to protect local creditors under local laws and a local NCWO principle (Valiante, 2016).

4.2 The European Commission consultation and potential actions

The work of the European Commission is currently divided in two thematic areas:

1. Boosting jobs and growth; and
2. Surveillance and monitoring of financial systems.

Under the 'jobs and growth' discussion, the revision of the insolvency law focuses on early restructuring (pre-insolvency) proceedings. This action follows the implementation of a 2014 Recommendation (European Commission 2014) on giving a second chance to debtors (including a harmonised discharge period, which are very different across the EU), so moving towards a more 'debtor-friendly' insolvency framework, which is currently very punitive in some countries. This work stream, supported by an expert group, is producing a legislative proposal (most likely a Directive) that will implement the principles of the recommendation on 'second chance'. This initiative might involve actions that are not directly linked to banking union and CMU, but will be focusing on early restructuring procedures, which are not available in the majority of EU countries, as also requested by the Eurogroup (European Commission 2016; Eurogroup 2016b; European Council, 2015). The areas of actions may include:

- The introduction of an early restructuring or conciliation procedure, perhaps based on some elements of the French model;[16]
- The introduction of a list of non-voidable transactions without harmonisation of clawback time periods;
- The use of selective stays in early restructuring, which are confidential and only for specific claims;
- A common test to assess the risk to the 'viability' of the business to enter the pre-insolvency proceeding;
- The harmonisation of discharge periods from debts for natural persons, most likely after 3 years;
- The minimum liquidation valuation to be considered as the point of reference in NCWO assessments; and
- The disqualification of directors, if they are liable of wrongdoing once they knew about the insolvency.

[16] The main aspects of this model for conciliation and accelerated (financial) safeguard proceedings are, among others, the following: proceedings are confidential; limited in time (between 3 and 6 months); supervised by the court; possibility to cram down on minority of creditors.

The Commission, with this initial policy action, may not be able to address issues related to the creation of specialised courts (as suggested in Chapter 2), the removal of priority for tax claims, a harmonised suspect period for avoidance actions or the introduction of a harmonised insolvency test. The thematic area of surveillance and monitoring of national financial systems aims at identifying optimal insolvency regimes, starting from the ideal theoretical framework. In this respect, the Euro group has identified six principles that should guide the EU policy action (Eurogroup 2016a):

1. Early identification of debt distress, as early action helps to preserve value;
2. Availability of early restructuring procedures, to avoid piecemeal liquidation as much as possible;
3. Availability, accessibility and affordability of insolvency proceedings to offer tools that are easy to use and based on clear criteria;
4. Effective enforcement of creditor claims in secured lending, via more efficient foreclosure procedures;
5. Allowing distressed debtors a genuine fresh start, while incentivising responsible lending; and
6. Clear rules on cross-border insolvency.

Under the risk reduction measures and to increase ownership of economic surveillance in the euro area, insolvency reforms were in the country-specific recommendation for the Euro area. As a part of the European Semester, the European Commission and Council have invited a number of Member States to reform their national insolvency frameworks, in view of reducing the high level of NPLs. More specifically, on top of a Country Specific Recommendation (CSR) for the Euro area as a whole, CSRs relating to national insolvency frameworks and the high level of NPLs have been addressed to Ireland, Spain, Croatia, Italy, Hungary, Malta, Portugal and Slovenia (European Parliament, 2016). The Euro group also requested the creation of benchmarks, namely indicators of outcome to compare insolvency frameworks beyond the World Bank data. These indicators can be used like the tax wedges indicators to compare regimes across the euro area and to push for more reforms by learning from successful experiences. Indicators would need to be carefully designed to be meaningful. In particular, number of proceedings or length may not be always a quality indicator.

Finally, the harmonisation of creditors' hierarchy in insolvency laws is also considered as an important step for the strengthening of the banking union framework on bank resolution and will be part of a separate legislative proposal (European Council 2016).

4.3 Options for convergence

Harmonising insolvency laws is a difficult process, as the framework interacts with a myriad of local laws, including those that are typically not a core competence of European institutions, such as corporate and labour laws (including employees and creditors' rights). The following sections review harmonisation options and legal basis for action at EU level in insolvency laws.

4.3.1 Harmonisation options

Beyond the *status quo*, there are at least three options for the harmonisation of insolvency laws:

- Full harmonisation;
- Minimum harmonisation (e.g. a Directive or a Regulation for selected specific areas);
- A 29^{th} regime.

The full harmonisation approach of insolvency regimes would foster rapid convergence across Euro area countries, but would not necessarily address clashes with local laws that also reflect the existence of those differences in insolvency laws in the first place. The diverse environment, which is the current baseline scenario, may not advocate for an invasive legal tool on a large scale. Nonetheless, the full harmonisation approach is a concrete solution in very specific areas, like the ranking of creditors, due to the benefits that such harmonisation would create for the single market and for the

stability of the financial system (in resolution actions). This is currently the preferable tool for the proposal on the harmonisation of ranking of creditors under the BRRD.
A minimum harmonisation approach offers the flexibility to devise legal tools that take care of the balance between insolvency laws and connected legal areas that are historically domestic competences, such as company and labour laws. This appears to be the case for the initiative on early restructuring and second chance, which may be enshrined into a Directive that sets the principle of a more debtor-friendly framework without entering into the details of insolvency frameworks related to local legal traditions. However, this solution has often led to poor implementation practices.

Another possibility for harmonisation is the creation of a 29th insolvency regime that could apply to an insolvency in specific cases, such as when the majority of the unsecured creditors are from another country or when the insolvent entity is a counterpart of a given level of cross-border financial transactions. There are currently other examples of 29th regimes, such the lending contracts of the European Investment Bank (EIB). When the 29th regime applies, dedicated courts would supervise and manage the proceedings. They can be either full-fledged branches of European courts of first instance or spin-off of national courts dedicated to the application of this regime. Both options are possible, as long as the right of being heard is being protected.

4.3.2 Legal basis and tools

There are at least six legal basis and tools that can be used to harmonise insolvency laws in the European Union and, more specifically, in the Euro area:

- Art. 81 TFEU;
- Art. 114 TFEU;
- Art. 352 TFEU;
- The enhanced cooperation procedure; and
- An international Treaty.

Article 81 TFEU offers the legal basis for judicial cooperation. It has not been used for harmonisation of substantial laws, unless these laws are set to improve judicial cooperation and solve conflicts of laws. The use of this legal basis requires unanimity. There are few cases in which laws have been approved under article 81 TFEU. For instance, the credit institutions winding-up directive (2001/24/EC) because of its conflict of laws legislation. The directive has been then more recently amended by the BRRD under article 114 TFEU.

In effect, article 114 TFEU is the main legal basis for harmonisation of laws for the functioning of the single market, when member states are unable to provide a better framework for the single market. However, the Commission has to make the case for the intervention and its action needs to be proportional to the objectives to be achieved. This article is perhaps the most plausible legal basis to harmonise insolvency laws under two main arguments: the inability of member states to align their insolvency frameworks to avoid creating significant obstacles to the single market (as for the case of different ranking of creditors for the functioning of the single resolution mechanism and BRRD); the need to use tools that are proportionate to the objective, like measures to increase predictability in a cross-border transaction are pre-condition for the creation of a true single market for capital.

Another option is article 352 TFEU (the flexibility clause), which is used under the implied powers clause and for objectives that are aligned with the Treaty, but for which the Treaty has not provided the necessary power. It is the article that sets the framework for modernising the Treaty. It also often requires unanimity in the Council (after consent of the European Parliament and the check of the respect of the subsidiarity principle by the European Commission) and ratification by most of the European national parliaments. It was used in the past for environmental issues.

Moreover, if art. 352 TFEU fails, there is the enhanced cooperation[17] procedure, which might not be suitable for legislative interventions on insolvency laws that would not benefit from different speeds among sub-groups of member states of the European Union. The procedure requires a qualified majority in the Council and before getting into the enhanced cooperation, a legislative text and a legal basis need to be proposed and cannot be linked to membership of Euro area.

Finally, as a last resort, an international Treaty for all 28 member states with the use of opt-outs could be signed. However, this intervention might be suitable for the introduction of new institutions or laws, but less so for the (partial) harmonisation of long established national insolvency regimes.

Box 3. The Euro group as a harmonisation tool

As established by the Protocol 14 of the European Treaties,[18] the Euro Group is an 'informal body', which brings together the Ministers of the Member States whose currency is the euro. The work of the Euro Group is prepared through the Economic Policy Meeting and the Eurogroup Working Group. Through the joint interpretation of articles 121 and 126 TFEU (as the legal basis), the Euro Group has gained over the years a considerable role in the setting up of economic policies that would affect the Euro area, and in particular, its budgetary position.

Its current role for an EU action on insolvency proceedings is limited to the surveillance function over national economic policies. This topic is especially relevant for the thematic discussion of the Euro Group on jobs and growth. In particular, the group is working in two directions:

- Benchmarking the different insolvency and foreclosure regimes (including fast access to collateral) to highlight best practices that could actually be adopted by all Member States, with attention for those with less effective insolvency and foreclosure regimes; and
- Ensuring a sound surveillance of Euro area countries' financial systems (in particular, the relationship between insolvency laws, credit recovery procedures and management of NPLs).

Therefore, the main role for the Eurogroup would be of coordination, through the definition of principles for the action of member states (listed in section 4.2) and moral suasion (by 'naming and shaming' countries that are not compliant) for the adoption of these important reforms in the Euro area. This coordination can take place in the fora where the Eurogroup plays a greater role, such as the monitoring of national economic policies.

[17] See EUR-Lex website: "Enhanced cooperation is a procedure where a minimum of 9 EU countries are allowed to establish advanced integration or cooperation in an area within EU structures but without the other EU countries being involved. This allows them to move at different speeds and towards different goals than those outside the enhanced cooperation areas. The procedure is designed to overcome paralysis, where a proposal is blocked by an individual country or a small group of countries who do not wish to be part of the initiative. It does not, however, allow for an extension of powers outside those permitted by the EU Treaties. Authorisation to proceed with the enhanced cooperation is granted by the Council, on a proposal from the Commission and after obtaining the consent of the European Parliament. As of February 2013, this procedure was being used in the fields of divorce law, and patents, and is approved for the field of a financial transaction tax."

[18] Protocol 14, Consolidated Version of the Treaty on the European Union (TEU) and Consolidated Version of the Treaty on the Functioning of the European Union (TFEU).

CONCLUSIONS

Insolvency laws are entrenched in local legal systems, but they play a key role for the proper functioning of the Euro area banking system and capital markets. Effective insolvency proceedings can have tangible effects on the functioning of the single market for capital and banking services. The quality of insolvency proceedings across the Euro area is generally lower than advanced countries like the United States and Japan, and its quality has barely increased in recent years. Policy actions are necessary to improve this legal framework. The European policy response is currently split in three areas:

- Jobs and growth actions;
- Actions to assess quality of insolvency frameworks and best practices (benchmarking); and
- Actions to strengthen the institutional architecture of the banking union (in particular, the functioning of the Single Resolution Mechanism, SRM).

Actions on jobs and growth include a directive to implement the 2014 recommendation on early restructuring and second chance (more debtor friendly procedures), and potentially selected changes to local insolvency regimes to reduce unpredictability of procedures in cross-border transactions, such as standardised relief actions or harmonised rules on directors' liability (see Chapter 2). This set of actions would apply to the whole European Union.

Moreover, actions are being considered in the area of the institutional architecture of the banking union, and in particular the functioning of the single resolution mechanism. Those actions would be specifically for the euro area and include mainly the harmonisation of the hierarchies in liquidation.
Finally, actions shall be further considered for the management of NPLs. This would require, notably, more effective procedures of collateral repossession and sale by auction by insolvency practitioners. Improvement in insolvency regimes can produce sizeable effects in filling the pricing gap between buyers (investors) and sellers (banks), so supporting the creation of a liquid secondary market.

Table 2. Comparing EU actions

Jobs and Growth (CMU)	Bank Recovery & Resolution (banking union)	Benchmarking
• **What:** Early restructuring and second chance • **Legal tool & approach:** Directive under minimum harmonisation, plus separate action to reduce unpredictability	• **What:** Creditors' hierarchy in liquidation & other issues • **Legal tool & approach:** Amendments to BRRD under maximum harmonisation	• **What:** Indicators of quality of insolvency regimes • **Legal tool & approach:** New indicators to benchmark policy actions

Finally, the creation of indicators to measure the effectiveness of local insolvency regimes can help to identify best practices and to assess the impact of EU intervention. In this context, the Euro group has shown great ability to steer discussions, with the introduction of key principles and the ongoing monitor of their implementation across the Euro area.

REFERENCES

- AFME, Frontier Economics & Weil (2016), "Potential economic gains from reforming insolvency law in Europe", Joint Report, February.
- Armour, J. (2001), "A Law and Economics of Corporate Insolvency: A Review", ESRC Centre for Business Research, Working Paper n. 197, University of Cambridge, March.
- Brincogne, J.-C., M. Demertzis, P. Pontuch & A. Turrini (2016), "Macroeconomic Relevance of Insolvency Frameworks in a High-debt Context: An EU Perspective", Discussion Paper, N. 03X, European Commission, June.
- Carpinelli, L., G. Cascarino, S. Giacomelli & V. Vacca (2016), "La gestione dei crediti deteriorati: un'indagine presso le maggiori banche italiane", Questioni di Economia e Finanza, N. 311, February.
- Carpus Carcea, M., D. Ciriaci, C. Cuerpo Caballero, D. Lorenzani & P. Pontuch (2015), "The Economic Impact of Rescue and Recovery Frameworks in the EU", Discussion Paper, No. 004, European Commission, September.
- Ciavoliello, L. G., F. Ciocchetta, F. M. Conti, I. Guida, A. Rendina & G. Santini (2016), "Quanto valgono i crediti deteriorati?", Note di stabilità finanziaria e vigilanza, n. 3, Bank of Italy, April.
- Clifford Chance (2015), "A Guide to European Restructuring and Insolvency Procedures", Cross-country report.
- Djankov, S., La Porta, R., Lopez-de-Silanes, F., and Shleifer, A. (2008a), "The law and economics of self-dealing", *Journal of Financial Economics*, Vol. *88*, No. 3, pp. 430-465.
- Djankov, S., O. Hart, C. McLiesh & A. Shleifer (2008b), "Debt Enforcement around the World", Journal of Political Economy, University of Chicago Press, Vol. 116, No. 6, pp. 1105-1149, December
- Eurogroup (2016a), "Insolvency Frameworks in the Euro Area: Efficiency Principles and Benchmarking", Note to the Economic Policy Committee in euro area formation, March 31st, available at http://www.consilium.europa.eu/en/meetings/eurogroup/2016/04/22-eurogroup-insolvency-EGAres-note_pdf/
- Eurogroup (2016b), "Thematic discussions on growth and jobs: National insolvency frameworks", Eurogroup statement, April 22nd available at http://www.consilium.europa.eu/en/press/press-releases/2016/04/22-eg-statement-nationaln-insolvency-frameworks/
  European Central Bank (2015), "Opinion of the European Central Bank of 2 September 2015 on bank resolution", CON/2015/31, available at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_31_f_sign.pdf
- European Central Bank (2016a), "Opinion on the regime applicable to negotiable debt securities", CON/2016/20, available at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_20_f_sign.pdf
  European Central Bank (2016b), "Opinion on the resolution and winding-up of banks", CON/2016/28, available at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_28_f_sign.pdf
- European Commission (2014a), "On a new approach to business failure and insolvency", Commission Recommendation, C(2014) 1500 final, March 12th.
- European Commission (2014b), "Impact assessment accompanying the Commission Recommendation on a New Approach to Business Failure and Insolvency", Commission Staff Working Document, SWD(2014) 61 final, March 12th.
- European Commission (2016), "Initiative on Insolvency", Inception Impact Assessment, DG Justice 2016/JUST/025 – INSOLVENCY II, March 2nd.
- European Council (2016), "Council Conclusions on a roadmap to complete the Banking Union", Press Release, n. 353/16, June 17th, available at http://www.consilium.europa.eu/en/press/press-releases/2016/06/17-conclusions-on-banking-union/.

- European Parliament (2016), "Thematic analyses: Country-specific recommendations on banking issues", Briefing, Economic Governance Support Unit, available at http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574409/IPOL_BRI(2016)574409_EN.pdf.
- Freshfields (2016), "Restructuring & Insolvency In 46 Jurisdictions Worldwide", available at freshfields.com
- Garrido, J. M. (2012), "Out-of-Court Debt Restructuring", A World Bank Study, Washington D. C., available at https://openknowledge.worldbank.org/bitstream/handle/10986/2230/662320PUB0EPI00turing09780821389836.pdf?sequence=1
- Gleeson, S. and R. Guynn (2016), *Bank Resolution and Crisis Management. Law and Practice*, Oxford University Press.
- IMF (1999), "Orderly and Effective Insolvency Procedures: Key Issues", Legal Department, available at http://www.imf.org/external/pubs/ft/orderly/.
- IMF (2015), "A Strategy for Resolving Europe's Problem Loans", Technical Background Notes, September.
- INSOL (2014), "Study on a new approach to business failure and insolvency. Comparative legal analysis of the Member States' relevant provisions and practices", Tender n. JUST/2012/JCIV/CT/0194/A4, May 12th.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer, R. Vishny (1996), "Law and Finance", NBER Working Paper, 5661, July.
- La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1997), "Legal Determinants of External Finance", *Journal of Finance*, Vol. 52, No. 3, July, pp. 1131-1150
- La Porta, R., F. Lopez-de-Silanes and A. Shleifer (2006), "What works in securities law?", *Journal of Finance*, Vol. 61, No. 1, February.
- Schillig, M. (2016), Resolution and Insolvency of Banks and Financial Institutions, Oxford University Press.
- Shleifer, A., and R. W. Vishny (1992), "Liquidation Values and Debt Capacity: A Market Equilibrium Approach," *Journal of Finance*, Vol. 47, No.4, pp. 1343–66.
- Story, S. E. (2015), "Cross-border insolvency: A comparative analysis", Arizona Journal of International & Comparative Law, Vol. 32, N. 2.
- UNCITRAL (2013), "UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation", United Nations, available at http://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf.
- Valiante, D. (2016), Europe's Untapped Capital Market: Rethinking integration after the great financial crisis, CEPS Paperback, London: Rowman & Littlefield International.
- Wessels, B. (2003), "International Jurisdiction To Open Insolvency Proceedings in Europe, in Particular Against Groups of Companies", Institute for Law and Finance, Working Paper No.17, Goethe University, Frankfurt.
- Wojcik, K.-P. (2016), "Bail-in in the Banking Union", Common Market Law Review, Vol. 53, No. 1, pp. 91-138.
- World Bank (2015), "Principles for Effective Insolvency and Creditor/Debtor Rights Systems", Report, available at https://openknowledge.worldbank.org/handle/10986/23356.

Европейски парламент Parlamento Europeo Evropský parlament Europa-Parlamentet Europäisches Parlament Euroopa Parlament Ευρωπαϊκό Κοινοβούλιο European Parliament Parlement européen Parlaimint na hEorpa Europski parlament Parlamento europeo Eiropas Parlaments Europos Parlamentas Európai Parlament Parlament Ewropew Europees Parlement Parlament Europejski Parlamento Europeu Parlamentul European Európsky parlament Evropski parlament Euroopan parlamentti Europaparlamentet

QA-02-16-549-EN-C (paper)
QA-02-16-549-EN-N (pdf)

IPOL | DIRECTORATE-GENERAL FOR INTERNAL POLICIES
EGOV | ECONOMIC GOVERNANCE SUPPORT UNIT

Contact: egov@ep.europa.eu
For more information: http://www.europarl.europa.eu/committees/en/ECON/home.html

PE 574.428

ISBN 978-92-823-9333-8 (paper)
ISBN 978-92-823-9334-5 (pdf)

doi:10.2861/66998 (paper)
doi:10.2861/344343 (pdf)