

Summary of the first meeting of the Insolvency Law Group of Experts (ILEG)

held on 14 July 2010

AGENDA:

1. Introduction and process - discussion on the preparation of the Crisis Management Directive and possible harmonisation of substantive insolvency law.
2. General presentation of the possible contours of the Crisis Management Directive.
3. Discussion of the targeted issues of the Crisis Management Directive - assets transfer within group entities in stressed situation and write down of debts.

1) Introduction and process – general discussion

The Commission services introduced the objectives of the ILEG function in the area of the crisis management and the reasons for forming the ILEG and its future tasks. It was explained that the Commission intends to proceed in two phases – a first phase would be concerned with providing the national authorities with appropriate supervisory and preventative measures and bank resolution tools; the second phase would consist of improving coordination of insolvency proceedings within a group and, if appropriate, further harmonisation of substantive insolvency law. As regards timing, the ILEG members were also informed that the Commission would adopt a legislative proposal for the first set of measures in spring 2011, while the second phase of legislation was not expected before 2012 at the earliest. The Commission also indicated that it intends to publish a Communication on Crisis management in the banking sector in October 2010, accompanied by a staff working document that would outline the contents of the first legislative proposal.

2) General presentation of the possible contours of the Crisis Management Directive

The Commission services presented to the ILEG members the general framework. The Commission explained that the framework would comprise the phases of early intervention and crisis management and described the respective tools that would be available in these phases in order to restructure a bank as a going concern or to resolve it as a gone concern.

ILEG members discussed the scope of the framework, the distinction between early intervention and crisis management and the repercussions of bank resolution tools on insolvency law. There was general agreement that although resolution and insolvency were connected, they were also conceptually distinct and there was merit in treating them separately in the two stages proposed. A number of members observed that, because the financial situation of banks tends to deteriorate rapidly on a loss of confidence, ordinary liquidation is generally not suitable. Members agreed that the framework should apply to both banks and investment firms

Members agreed on the importance of the tools and noted that it is crucial that the tools are available when the bank still has a net value, in order to encourage private solutions. A

proposed distinction between tools to be used in relation to going and to gone concerns was not supported, and would in practice be unworkable: a crucial part of crisis management was the decision about what should be saved and what should be allowed to fail, and the choice of tool reflected that decision and determined the outcome for the institution or part of its business. All tools should be available to authorities in a particular case.

One member observed that it is important to strike the right balance between the need for authorities for sufficient flexibility and discretion and the market need for legal certainty. Some members observed that solutions are often a mixture between private funding and public incentives and that no tool should exclude the possibility of using the resolution fund for bank restructuring. Two members observed that every tool (e.g. asset transfer, haircuts) would have repercussions on insolvency, if the restructuring goes wrong, and that these repercussions should be analysed and dealt with within the framework.

Members agreed that tools should be the same for all banks and financial institutions regardless of their size. However, it was acknowledged that standard procedures such as the transfer of deposits was really only feasible for smaller banks. Large, systemic institutions would be difficult to resolve even with the tools proposed and additional solutions are likely to be needed that may imply public funding, as well as sources of private funds (including write down of creditors). The tools provided should allow for prompt and flexible actions enabling resolution of larger banks without turning such a situation into systemic crisis. In this respect a need for definition and evaluation of systemic crisis criteria was discussed. It was recognised that the use of those tools that interfered with property rights needs to be justified by the existence of systemic risk.

One member noted the importance of recovery and resolution plans, since these ensure that the authorities have access to all the information that is needed for rapid action. The requirement on banks should not be unduly onerous since institutions ought to have that information available in any event when a going concern.

Members expressed doubt about the suitability and usefulness of receivership in the context of resolution. A receiver is normally appointed to represent the interests of creditors, rather than to promote a financial stability objective; national authorities are unlikely to have the resources to perform this function; and questions of liability would need to be thought through. One member pointed out that receivership (and administration) are usually used when the bank is closed. However, losses are usually magnified significantly as soon as a bank is closed and sale will be more difficult: open-bank resolution – where resolution tools are applied over a weekend – is generally preferable. Another member doubted that FDIC model could be imported into the European context, and suggested that special administration (which allows an appointed administrator to take over the management without direct control of the institution by authorities) offered a better alternative. However, another expressed concerns about the effectiveness of special administration and the risk of the withdrawal of credit that would simply accelerate failure. Regulators already have the power to remove and replace management, and the ultimate threat of the withdrawal of authorisation to focus management efforts on restoration.

3) Discussion of specific issues - assets transfer with in group entities in stressed situation and write down or conversion of unsecured debt

Asset transfers

The Commission services presented the objectives of a possible framework for intra-group asset transfers on non-commercial terms: a reduction of the barriers to cross-border asset transferability to reinforce the private sector solutions and to avoid ring-fencing of assets, while ensuring protection of creditors to enhance the crisis management solutions. This tool should be used in the early intervention phase as a liquidity management tool by the directors of the affected institution.

Since this tool is aimed to enable a framework for financial support for a group entity prior to insolvency and formal resolution measure the issue of the **limited concept of group interest** was discussed. The ILEG members were asked to give their opinion on whether allowing banks to transfer assets intra-group on non-arms-length basis is regarded as a useful tool to assist a group member with liquidity problems, provided statutory conditions are met and what such conditions should be. With respect to guidance on the conditions of such transfer it was referred to conditions laid down by the Rozenblum judgement (see ILEG/04/2010) and ILEG members discussed what such conditions should be.

One member opposed entirely the concept of transfers on non-commercial terms: all intra-group transactions must be at arms length, and the Rozenblum case law – which had been developed in relation to ordinary corporates rather than the banking sector – did not represent a suitable basis for this framework. Another predicted that supervisors would object if transfers risked causing future liquidity problems for the transferor.

One member suggested that asset transfer would only be useful certain kinds of integrated group, and would not be suitable to those that used separate entities as firewalls.

Members acknowledged that if a framework were based on the Rozenblum case law, the conditions might need more specification in order to provide the necessary legal certainty for directors, who might otherwise be liable for authorising transactions.

One member cautioned that a framework of the kind contemplated could represent a barrier to business, since potential counterparties would have to do due diligence on the group as a whole rather than the specific legal entity.

Further the ILEG members discussed the introduction of suitable safeguards for shareholders and creditors in situations of intra-group assets transfers on non-arms-length basis to prevent uncontrolled shifting of assets amongst the group members. One possibility might be a clawback right on the bankruptcy of either the transferor or the transferee, although one member questioned whether preferential treatment for intra-group transactions was desirable.

Write down of unsecured debt

The Commission services outlined the issues that would need to be addressed if the write down of unsecured debt were to be developed as a crisis management tool.

There was broad interest in the idea although some members raised concerns about the impact on refinancing, on credit risk, and on the risk that it would be difficult to stabilise an institution that was subject to the power. A couple of members suggested that valuation may be difficult in stressed circumstances, but this could be addressed through a conservative

estimate coupled with a restitutionary mechanism. Some members regarded a mechanism to restructure debt (other than through usual, time consuming process of negotiation) as essential for crisis management. One considered that the effect of a power of the kind under consideration on the cost of funding should be neutral, provided that it is only applied when other funding options have been exhausted, since at this point the alternative would be insolvency where the loss suffered by creditors would be the same.

There was broad support among ILEG members for applying the write down of debt to the uninsured depositors as well as other debt instruments. One member noted that the exclusion of insured deposits would imply a windfall to the DGS at the expense of other creditors. The usefulness of this tool would depend on how individual banks are funded: in some markets, most funding came from intra-bank subordinated debt.

The ILEG members discussed whether or not this tool should be a statutory power to write down debt irrespective of the contractual terms, or applied only to debt instruments that contained a contractual term for write down or conversion. Views on this question were split. Several members suggested that a statutory power was necessary: a contractual approach could take decades to implement, although the market would progressively produce debt with a write down term if a statutory power existed. Another member did not favour a general statutory power for supervisory authorities since it would have an adverse impact on refinancing markets, so any power should be restricted to a mechanism to ensure that creditors did not benefit from public intervention. Another warned that a statutory power could be a source of litigation since authorities would not be in a position to assess the effect of insolvency on creditors' claims, and that the policy objectives should be pursued through more contingent capital.

The ILEG members also discussed the treatment of shareholders in such situations and whether or not the creditors need to be compensated. One suggested that the interference of property rights would not be a problem in relation to debt issued after the adoption of a statutory power, since the creditors would have given implied consent to the exercise of that power, while for debt that pre-dated the power, one could proceed on the assumption that the institution was insolvent. Another noted that issue involved weighing private property rights against public policy: this was possible, but tricky, and very wide discretionary powers should be avoided to provide certainty to the markets and reduce legal risk to regulators.

Further the issue of the possible different priority ranking under applicable national insolvency laws of subordinated debt susceptible to write down was discussed with a view to establish whether there is a need for harmonisation of this issue. It was suggested that there was already a significant degree of harmonisation as regards comparable instruments. Generally, it was agreed that losses through write down should be shared through a 'waterfall', with creditors that have accepted greater risk being 'haircut' first. Subordinated debt should be written down by 100% before senior debt is affected.

4) Miscellaneous

Next steps - in order to progress the work, ILEG members will be divided into three **working sub-groups** that will focus in more detail on the issues discussed in general during the first meeting. A list of topics and a proposed distribution of ILEG members into sub-groups will be distributed shortly for comment.

Next ILEG meeting will take place on 21st September - a written invitation with a proposed agenda of the next meeting will be distributed in due course.