

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

held on 15 October 2010

AGENDA:

1. Discussion on a possible regime for Intra-group Asset Transferability in the banking sector.
2. Discussion on a possible regime for Write Down of Debt.
3. Information point: Organisation of ILEG future work on Bank Insolvency.

Before opening the discussion, the Commission updated the group on the progress in the preparation of the legislative framework on Crisis Management in the Banking Sector. It explained that the publication of a Commission communication was expected on 20 October, a public consultation on a possible legal framework would be launched at the end December and a legislative proposal was planned to be adopted in Spring 2011. The Commission explained that after this first step focusing on the introduction of a set of harmonised tools and powers for Early Intervention and Resolution of banks, further work was planned on a possible more extensive harmonisation of substantial and procedural insolvency law for banks. On this topic the Commission planned to issue a report in 2012.

1) Discussion on a possible regime for Intra-group Asset Transferability in the banking sector

The ILEG sub-group tasked with providing advice on an enabling framework for intra-group asset transfers presented its findings. The outline of a possible EU framework on asset transferability (ILEG/12/2010) prepared by the Commission services was discussed. This framework would determine the conditions under which assets may be transferred within entities of a cross-border banking group in a distressed situation. The objective would be to allow *ad hoc* asset transfers between entities of the same group in order to allow restoring the financial soundness of the transferee. This could apply in the phase of Early Intervention under the crisis management framework that the Commission plans to propose. A preliminary shareholders agreement should set out the pre-conditions for asset transferability and authorize the directors to carry out asset transfers when these conditions are met. The Rozenblum criteria, i.e. group interest, existence of a consideration, etc. should be fulfilled. The preliminary shareholders agreement should obtain supervisors' approval. As a safeguard for the financial stability in the home country, the supervisor of the transferor should have the power to prohibit or restrict a transfer of assets pursuant to the agreement when it threatens the liquidity or solvency of the transferor or financial stability.

The discussion first focused on the legal difficulties posed by national law to asset transferability. It was noted that these difficulties may consist, among other things, in supervisory action, tax barriers and obstacles under company law, especially for upstream asset transfers, since subsidiaries have to act consistently with their commercial activity. It was concluded that in order to overcome these legal obstacles, the regime on asset

transferability should be a *lex specialis*. It should therefore exclude the liability of managers if assets are transferred in accordance with the requirements set out by the framework.

The concept of **group interest** was discussed. The Commission proposed to identify the group interest on the basis of certain characteristics of the group structure and organisation, such as the centralization of functions, the existence of common commercial, financial and economic policies and objectives and the controlling role played by the parent company over the subsidiaries. The purpose of the financial support would be to ensure the financial stability of the whole group. One member observed that it is difficult to identify a group interest in diversified groups and suggested that the framework should simply provide that companies affiliated to a group should set up an agreement to provide each other with financial support, that they should be under the obligation to provide this support in accordance with the agreement and supervisors should have the duty to constantly monitor that the member companies have sufficient funds to provide the support. Another member noted that the agreement should not be seen by creditors as an explicit guarantee to finance another company. One of the members pointed out that the concept of group interest was nevertheless important in order to define the limits to asset transferability. Failing this limitation, assets may be transferred for any purpose with consequent liability risks for the management. One of the members raised the general question whether there was a need for an EU framework on asset transferability and if the national legal rules were not sufficient to allow transfers when needed.

There was general agreement on the following points: a framework was necessary in order to give confidence and legal certainty to managers and supervisors about the circumstances in which assets may be transferred in stress situations. In the absence of a framework that would put limits to the transferability of assets, the risk of uncertainty and of running into obstacles put by different national laws, will prevent any transfer. The framework should leave flexibility to companies as regards the inclusion or exclusion of certain companies affiliated to the group from the support agreement. As regards the requirements of the group, it was suggested to link the concept of group interest with consolidated supervision.

The group further discussed the problem of finding a **definition** for asset transfers. The sub-group on asset transfers proposed to use the definition of intra-group transactions elaborated by UNCITRAL. The Commission suggested limiting the concept of asset transfers to loans and guarantees. Members agreed that limiting the definition of asset transfers to loans and guarantees, instead of including any kind of commercial transaction within a group, would respond to the objective of making funds available in a crisis situation while making it easier for supervisors and management to check that the criteria for asset transferability are fulfilled. It was suggested that the definition of asset transfers as loans and guarantee should however be integrated in order to include the provision of collateral (liquid assets) for access to central bank liquidity. There was general agreement that it was not necessary to determine a certain maturity for the loans/guarantees as long as the set purpose of the support was to redress temporary financial difficulties of the transferee.

The issue of the **remuneration** of the loan/guarantee was discussed. One of the members suggested that the essential was that the framework set out the general rule that the transfer of assets should be made against consideration, while it would be more difficult to set precise quantitative/qualitative criteria for the remuneration of the support. It was suggested that the shareholders' agreement – to be concluded in going concern situations – should define the terms and conditions of the financial support and that the same terms would apply to any

transfer in stress situations. Some members noted that this mechanism would ensure that transfers would be conducted at a reasonable price having regard to commercial terms, and was in essence very similar to an 'insurance' contract whereby prices are agreed upon prior to 'events' triggering the 'insurance' contract.

2) Discussion on a possible regime for Write Down of Debt

After a presentation of the paper prepared by the sub-group on debt write-down, members discussed the main themes.

The group agreed that there were strong arguments for a statutory regime, subject to appropriate conditions, on the grounds that this offered the necessary flexibility for authorities. One member suggested that those should include the conditions that creditors are no worse off than they would be in liquidation, with a right to compensation if that is not the case.

Members made a range of points on the subject of compensation:

- There was a question as to who should be liable to pay such compensation: one option was creditors who had received too much.
- Compensation should be awarded through the balance sheet, for example by means of warrants, forced buy-backs, rather than through cash.
- Statutory write-down necessarily has to be applied quickly, but compensation can be worked out later when the financial position of the institution can be assessed more thoroughly. This is more easily achieved if an authority is in control of the institution (e.g. through receivership).

One member explained that a number of options for applying the write down exist. These include simple write down and splitting the bank into a 'good' and 'bad' bank, with the result that those creditors left with the 'bad bank' would be haircut on liquidation. Living wills would be necessary contingency planning to ensure that write down or splitting the bank could be carried out in a short timeframe.

Another member compared the options of bail-in and partial transfer. Authorities need both options, but partial transfer, although useful, is a tool for small banks.

On the range of debt that might be covered by a statutory regime, one member argued that not all liabilities could feasibly be haircut, and although authorities would need flexibility clear parameters should be set for any statutory power. Others considered that the power would need to be broad. One member pointed out the difficulties of applying a write down power to derivatives: netting is necessary before it is known whether they are an asset or a liability, and in any event derivative liabilities are generally secured. Another noted that banks wanted to limit the regime to subordinated debt, but this might be too restrictive. Even if coupled with a requirement for banks to issue a specified amount of subordinated debt, it was not clear that this would be sufficient in all cases and the effectiveness of the tool would be limited. In order for the tool to be credible, banks would have to be required to issue significant amounts of subordinated debt, and might not be able to place it at a realistic price. Another concluded that although policy makers might wish to apply the power broadly, there were strong reasons for retaining the distinction between subordinated debt, which is risk capital, and senior debt.

The systemic impact of going beyond subordinated debt could be enormous. However, it was acknowledged that a restricted application implied a warranty for the senior debt holders that were not covered by the regime.

The group agreed that the definition of triggers would be a key element of any regime, but did not agree on what the trigger should be. A couple of members argued in favour of an insolvency trigger on the grounds that write down of creditors could only be justified if the entity is insolvent, and would not be justified while equity capital remains. Others considered an insolvency trigger would mean that intervention would be made too late to meet the financial stability objectives, and favoured a regulatory trigger. A regulatory trigger pitched at the point where supervisors could withdraw the bank's licence should justify interference with creditors' rights and would not require supervisors to demonstrate insolvency. One member noted that owing to the complexity of banking business, it is virtually impossible to work out whether a bank is actually insolvent. Whatever trigger is used, it should require the authority to assess that the bank cannot avoid insolvency, rather than prove it is insolvent. Moreover, the question of the trigger should be considered separately from questions of compensation. The settlement of rights as between various classes of creditors and questions of ranking were not a supervisory concern, but as matters relevant to insolvency law they could be dealt with at a later stage when considering compensation.

There was some discussion of whether the regime should restrict rights to close-out netting and the activation of cross-default clauses. While most considered this necessary for effective resolution action, dealing with cross-default clauses would not be easy. However, it should be feasible to provide that transfer to a bridge bank did not constitute a trigger event for the purposes of close-out netting rights.

Some members raised concerns about the impact of a debt write-down regime on bond market financing for banks, and the disadvantages that EU banks might suffer in relation to US competitors.

3) Information point: Organisation of ILEG future work on Bank Insolvency

The Commission reminded the objective and content of the next phase of the ILEG work.

The objective is to establish the desirability and feasibility of introducing harmonised administrative insolvency proceedings for banks and of a framework for better coordination of national insolvency proceedings (whether or not harmonised) of affiliated entities within a cross-border banking group. The sub-group tasked with providing advice on this issue should produce a draft paper by 10 December 2010 and a final paper by end January 2011. This advice would feed in the second step of the Commission's work-plan on Crisis Management in the Banking Sector concerning the possible harmonisation of bank insolvency on which the Commission is expected to issue a report in 2012.

4) Miscellaneous

Next steps - in order to progress the work, concerning asset transfers the Commission will circulate to the ILEG members a possible draft EU framework revised on the basis of today's discussion. The members will be requested to provide written comments and propose improvements. Concerning debt write down, the Commission will now prepare options for the

consultation on the crisis management framework that will be published in December. [Those options will be discussed at the next meeting.]

Next ILEG meeting will take place in February, the date will be communicated as soon as possible - a written invitation with a proposed agenda of the next meeting will be distributed in due course.