

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

held on 11 April 2011

AGENDA:

1. Discussion on a possible harmonised framework of bank insolvency law
2. Discussion on the draft legal framework on bank recovery and resolution
3. Planning of the next work of ILEG .

Before opening the discussion the Commission updated the group on the results of the consultation launched in January 2011 on the technical details of a possible EU crisis management framework. The Commission explained that it had received 140 responses from a variety of stakeholders (national authorities, Member States, international organisations, industry stakeholders, academics and law firms); most respondents were favourable to the Commission's proposed framework; the analysis of the responses was ongoing and the outcome would be shortly published on the Commission's website.

1) Discussion on a possible harmonised framework of bank insolvency law

The ILEG sub-group on Bank Insolvency presented its preliminary findings on the desirability and feasibility of introducing a harmonised insolvency regime for banks and establish a framework for better coordination of national insolvency proceedings of entities affiliated to cross- border banking groups. The sub-group has indentified a list of issues that should be looked at when dealing with harmonisation of bank insolvency law. In the opinion of the sub-group, the full harmonisation of the whole insolvency law applicable to banks does not seem a workable option at least in the short term. An incremental process seems more feasible. In the view of the sub-group, the starting point for establishing the degree of harmonisation that would be desirable should be to identify which regulatory disparities represent obstacles to the achievement of a less costly resolution/liquidation of banks. This requires a distinction between i) procedural rules and ii) substantive rules, and a further distinction between iii) provisions that are fundamental for ensuring the continuity of essential functions, and iv) provisions which are necessary but not so much related to these essential functions.

The sub-group agreed that the first areas of harmonisation should coincide with the bank recovery and resolution framework that the Commission intends to propose. These areas are the identification of the authorities, the need for each Member State to have a restructuring process in place aimed at preserving the business of the bank as going concern, mechanisms to achieve an orderly wind down of banks, the statutory grounds for the activation of the proceedings, the notification and publicity of the opening of the proceedings, the powers granted to national resolution authorities, a special regime for banking groups aimed at achieving a coordinated resolution of the group companies under the same authority, a group wide approach to reorganisation and the administrative character of the proceedings in order to allow for the necessary speed and an effective process.

As a second step, the sub-group found that a harmonisation of some key substantive insolvency rules appears necessary for the purpose of building an orderly and predictable

bank insolvency framework. In the sub-group's view, the candidate rules for this second harmonisation could be the ranking of creditors, the effects of insolvency on collateral and set-off rights and the claw back rules. Another important question identified by the group is whether the banks in insolvency should be allowed to conduct certain activities such as to deal with existing customers and foreign exchange counterparties, and to perform securities transactions which are pending. The group had noted a disparity of the insolvency rules of different countries in this respect: only in certain countries the "no cash out" rule leaves enough flexibility to the insolvency administrator to make certain payments out of the cash of the bank that are beneficial for the purpose of ensuring financial stability.

The discussion first focused on the relations between resolution and reorganisation/liquidation, in particular if the ordinary bankruptcy proceedings remains an open option for the winding down of a bank. One member observed that there are advantages of looking into restructuring, resolution and liquidation at the same time. Other members underlined that resolution and insolvency are closely connected and there is a need to have special rules on liquidation of banks, in particular on whether the business should continue or not. Other members observed that the insolvency of banks should be clearly distinguished from resolution and that insolvency law should not be applied when resolving a bank because it interferes too much with resolution. Another member pointed out that the specificity of banks is addressed by the resolution tools and once the systemic nature of banks is addressed by the resolution tools, the bank may be liquidated as an ordinary company. However, authorities need to have control over a bank for a certain time when they determine a partial transfer, as services may be needed from the residual bank to the new bank.

A member pointed out that it would be important to define which transactions could be made void in the insolvency proceedings. In particular the resolution regime should be protected from the spill-over from the insolvency proceedings; the power to make transactions void should be limited in order to isolate and protect the resolution process. Another member observed that liquidation for banks should follow a special regime different from ordinary corporate companies because the liquidation of a bank inevitably has consequences on financial stability, even if it is just a small bank (reputation effect). In addition, the principle of no worse off than in insolvency may be dangerous because it's often impossible to predict what creditors will get in liquidation. Other members pointed out that the official evaluation of the value of the bank, although challenging for the authorities, is not impossible. It can be carried out by thirds parties at liquidation value; in addition the ultimate compensation should not be a problem as it may be challenged later by the parties concerned. The main priority is that the resolution, i.e. the possibility to effect a partial transfer of the assets and liabilities of the bank may not be stopped. This addresses the sistemicity of banks. Other members pointed out that financial stability should not be the only criterion; also the principle of the least cost is important and should be taken into account; decisions of purchase and assumption should be based also on the cost because the value of assets decreases very quickly. In relation to a plain liquidation, the purchase and assumption by a private acquirer is usually less costly. Plain liquidation applies only to a very small part of the assets. Another member pointed out that the asset and liabilities that have to be transferred should be paid by the bridge bank to the old bank.

The group concluded that if the insolvency law avenue is left open, there should be a) a rule requiring supervisory consent for the opening of insolvency proceedings against a

bank, and b) if a bank subject to insolvency proceedings is a member of a cross-border group, there should be a statutory requirement for the authorities to exchange information and cooperate with other authorities.

The group further discussed the issue of the ranking of creditors. The Commission asked if in the view of the group the authorities could be empowered to decide to change the ranking of creditors. The group noted that the ranking of creditors is a given rule established by law. The authorities should be empowered to decide which creditors is to be transferred to the new bank and which creditors should stay with the old bank and the decision should be taken on the basis of financial stability.

As far as the cross-border aspects are concerned, the members underlined the need for a clear indication of which authority should decide in a cross-border banking group and the need to include the principle of cross-border recognition of the powers/tools.

The issue of claw back actions was discussed. Some members argued that there's no need to harmonise claw back actions or that it would be very complicated. Other members stressed the importance of harmonising this area: they argued that it is important to have clarity and to protect the new bank from the effects of claw back actions from the residual bank in insolvency. A suggestion was made that the framework should include a provision that prevents any action that would nullify a transaction transferred to the new bank. The claw back action that the administrator of the insolvent bank intends to initiate should be agreed with the resolution authority. If an action has an indirect effect on the good bank/bridge bank, it should not be commenced by the administrator without the consent of the resolution authority. A special treatment should be designed for intra-group claw backs.

There was some discussion on whether the regime should give a preferred ranking to depositors. While one member thought that there was a clear case for preferring depositors (consumer protection, protecting public confidence in banks). Other members expressed the opposite view in light of the following arguments: a) depositors are already protected by the Deposit Guarantee Scheme and by the transfer in the bank resolution of all the deposits to the new bank/bridge bank; b) giving preference to depositors would mean to favour banks who participate in the Deposit Guarantee Schemes; c) protecting depositors would be an incentive for choosing insolvency rather than resolution (principle of least cost); d) preference to depositors would damage the funding market, as bond markets would turn into deposit markets and would run first, even earlier than depositors and e) the preference to depositors makes sense only if a State subsidy is granted, because the State recovers more money, if there is a depositor preference.

2) Discussion on the draft legal framework on bank recovery and resolution

A brief discussion of the draft legal framework took place on the basis of the Commission's consultation document on the technical details of a possible EU crisis management framework.

The Commission presented the safeguards proposed in the consultation documents:

- the temporary suspension (48 hrs) of the activation of close out and netting agreements;
- the simple act of resolution should not be invoked as an event of default;

- the transfer of all contracts subject to the same clause of netting or close out, in order to avoid cherry picking and ensure legal certainty;
- the treatment of structured finance: the transfer of all contracts subject to the same securitization operation.

The ILEG members broadly supported the proposed safeguards. A number of issues were however raised: a) what would be consequences in case of transfer against the law? Should the transfer be considered void in the eyes of the resolution authority, or of the Court or of a third party? When would be the starting point for the suspension?

The resolution thresholds were also briefly discussed. Most members favoured option 2. The following points were made:

- the threshold conditions should also have the purpose of reducing the costs of resolution;
- it's important to find the right balance in designing the thresholds because if they are too wide and open, they can engender a risk of liability for the authorities, while if they are too specific they can delay resolution and not be effective.

3) Planning of the next work of ILEG

The Commission thanked the participants for their work and announced that as a next step, it will circulate the draft legal text to the members and ask them for their input. Afterwards, the Commission will organize and assign further work of the ILEG in preparation of 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.

Next ILEG meeting will take place in October, 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.