Bank Insolvency: A special case without a special regime

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The problem identified

- Lack a fully harmonised bank-specific insolvency framework within the EU was in conflict with the increased interconnectedness of the European banking sector.
- During the financial crisis authorities decided to bail-out several failing banks with taxpayers' money because the opening of a formal insolvency procedure in respect of these banks could have undesirable effects
- In general, the failure of a company, including a bank, needs to be dealt with by insolvency law
- The EU bank resolution rules aim to reproduce the economic effects of a traditional insolvency procedure for a failing bank's shareholders and creditors and recognise several principles of insolvency law, while the effects of a bank failure on the financial system and the wider economy are taken into account.
  - The rules can be found in the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRM Regulation).

Why should banks be accorded special treatment in insolvency?

- Bank institutions are ‘perhaps the most depiction-difficult corporations’.
- Banks typically hold highly liquid liabilities in the form of deposits that are repayable at par on demand.
- Banks perform financial services that are fundamental to the functioning of an economy, such as the extension of credit, the taking of deposits, and the processing of payments.
- Banks constitute the transmission belt for monetary policy, that is, the linkage between the monetary policy process and the economy.

Does general insolvency law actually work for banks?

- Many aspects of a bank liquidation need to be handled largely in the same manner as the liquidation of a commercial company.
- In most European countries the insolvency law applies to banks as *lex generalis*, while special rules or exemptions from the general regime apply where called for by the specifics of bank insolvency
  - For example: Italy, Norway, UK
- Contrary to the majority of European countries, which choose to apply ordinary insolvency rules to banks, the United States Congress opted very early for a special bank insolvency regime.

Bank resolution – priority of claims

- An order of priority of claims establishes who are paid first out of the available pool of assets in a liquidation procedure under insolvency law.
- In most EU Member States, shareholders would first be subject to bail-in, secondly subordinated creditors and thirdly unsecured, non-preferred creditors.
- Also, creditors who are granted priority in insolvency, which may include tax authorities, would be part of the group of creditors standing at the end of the line of creditors potentially subject to bail-in.
  - This approach corresponds perfectly with the idea that creditors should not become worse off as a result of bail-in than in liquidation
- BUT: public interests may need to be prioritised over the interests of the creditors

BRRD and SRM Regulation

- **Article 34 BRRD and Article 15 SRM Regulation:**
  1) the shareholders of the bank under resolution bear first losses;
  2) the creditors of the bank bear losses after the shareholders, in accordance with the hierarchy of claims under insolvency law, unless otherwise provided;
  3) the creditors in the same class are treated in an equitable manner, unless otherwise provided; and
  4) covered deposits are fully protected
- No creditor worse off (NCWO) principle: a creditor should not incur a higher loss than the one incurred in a hypothetical scenario of a wind-up under normal insolvency rules.

The interplay between the BRRD and the SRM Regulation and national insolvency law

- While the Ranking Directive harmonises the ranking of certain types of claims in insolvency proceedings, many other claims are not captured by it.
  - Their ranking is still subject to national insolvency law, which may vary substantially from Member State to Member State.
- Examples:
  - Claims arising from large corporate deposits, or tax, social security and similar claims of public authorities
  - Claims arising from the operational activities of a financial institution are not captured, however sizeable or critical these activities may be for the survival of the institution
  - Whether or not Tier 2 instruments are to be treated differently and rank below subordinated liabilities in case of insolvency, or the ranking of intra-group liabilities in the hierarchy of creditor claims

The interplay between the BRRD and the SRM Regulation and national insolvency law

- Differences that currently exist between Member States' insolvency laws can negatively affect the predictability of and trust in the application of bank resolution tools, for instance, of creditors who wish to assess the likelihood that their claims are written down or converted by authorities.
- These uncertainties about the possible applications of those tools can also cause a higher risk of legal challenges.
- However, it is argued that a fully-fledged harmonisation of insolvency law at EU level may not be possible, particularly because it is closely connected to and intertwined with many other areas of national law, including property, contract and company law, and reflects national regulatory traditions.

The example of Cyprus

- Article 4 of the Business of Credit Institutions Law of 2013, clearly states that Article 300 of the Companies Law applies in case of liquidation of an institution under resolution.
- The Resolution Law of 2014 provides for a separated priority of claims arising after the liquidation.
  - Priority should be given to claims regarding any ‘necessary and reasonable expenses incurred by the liquidator and the Resolution Authority’, then to claims on credits extended to the bank after the appointment of the liquidator or by the Central Bank of Cyprus before the appointment of the liquidator, and, finally, insured deposits and amounts due to the Deposit Protection Fund.

The example of Cyprus

- Article 33O of the Business of Credit Institutions Law 2016: ‘during the normal insolvency proceedings of a credit institution, Article 300 (1) and (2) of the Companies Law, is applicable based on priority’
- Article 33O (2) contains a specific order for claims and debts which must be followed in an event that a bank becomes insolvent.
    1) Any claim that is secured using the bank assets.
    2) Expenses incurred by the liquidator. Such expenses include the business expenses that are incurred during the process of liquidating the business.
    3) Credits that are granted to the bank by the resolution fund or by the Central Bank prior to the appointment of a liquidator.
    4) Covered depositors, individual depositors including medium and small sized deposits, deposits, claims or debts that are charged over the assets of the bank that have been used as security, government guarantees, tier II capital

The example of Cyprus

- Article 300 of the Companies Law Cap 113:

  1) Rates and taxes, particularly all local rates due from the company at the relevant date, and having become due and payable within 12 months next before that date, all Government taxes and duties due from the company at the relevant date.
  2) The salaries and other benefits that the company has withheld from the employee. These benefits include the monies that have been accrued as a result of working relationships or as a result of agreements between the employee and employer.
  3) The amount the company owes to its employees in terms of compensation that the employee may have suffered in the course of discharging his duties.
  4) The amount the company owes to its employees in form of unpaid leave allowance for a period that does not exceed one year. The amount that the company owes its employees in the form of holiday earnings that have not been paid and etc.

The example of France

1) employee wage claims guaranteed by the super priority accorded to employees;
2) legal costs properly incurred after the commencement order where required for the conduct of the proceedings, which includes remuneration due to the court appointees (creditors' representative, liquidator, etc);
3) priority for "new money";
4) claims which, although arising before the commencement order, are guaranteed by security over real property or over particular personal property accompanied by a right to retain possession, as well as claims guaranteed by general security over the business and security over professional tooling and equipment;
5) wage claims of employees arising after the commencement order, which have not been advanced by the wages guarantee fund;
6) claims arising from current contracts, where the party that has contracted with the company in difficulty has agreed to defer receipt of payment for its services;
7) amounts advanced by the wages guarantee fund;
8) claims arising after the commencement order, according to their ranking in the Civil Code;
9) claims arising prior to the commencement order and secured by general liens;
10) claims arising before the commencement order, according to their ranking in the Civil Code; and
11) unsecured creditors.

The interplay between the BRRD and the SRM Regulation and national insolvency law

- If covered deposits would only be excluded from the scope of bail-in, in a liquidation of the bank's assets under a Member State's insolvency law, they are likely to rank equally with ordinary unsecured, non-preferred claims.
- The probability that creditors are entitled to compensation under the NCWO principle would then increase if the latter claims are bailed in because the class of liabilities that can be touched in bail-in has become smaller.

The interplay between the BRRD and the SRM Regulation and national insolvency law

- Unsecured liabilities to trade creditors would in a liquidation procedure traditionally be on equal footing with the claims of general unsecured creditors that are not protected in bail-in.
- Thus, in a bail-in of the claims of the such group of creditors, the risk exists that this group has a claim under the NCWO principle and that compensation may have to be paid as the group of creditors that bears the losses has become smaller, unless the losses that would otherwise be imposed on these excluded creditors are imposed on an external party.

The interplay between the BRRD and the SRM Regulation and national insolvency law

- The BRRD creates a ranking within the layer of a bank's subordinated liabilities. Insolvency law traditionally does not make a distinction between debt instruments that meet the regulatory capital requirements (CET1, AT1 and T2 capital) on the one hand and other shares and subordinated liabilities on the other hand.
- If national insolvency law does not follow the same ranking of creditor claims in liquidation, the risk exists that the exercise of the write-down and conversion powers results in certain subordinated creditors being disadvantaged compared to their position in a hypothetical liquidation procedure.

The interplay between the BRRD and the SRM Regulation and national insolvency law

- Full harmonisation of national legislation governing the insolvency ranking of claims against a bank at the EU level might be politically difficult at the moment.
- Priorities recognised by national insolvency law can generally be justified on specific historical, cultural or policy grounds and are strongly intertwined with entitlements and priorities granted in other areas of law, such as security rights or privileges attached to tax claims under tax law.
- Even if the distributional rules in liquidation are fully harmonised, differences may remain to exist since Member States may still protect certain types of creditors outside insolvency law, for instance, via social security mechanisms.