



Faculty of Law, Economics and Finance

Legal Instruments for Restructuring Bank Debts in the European Union

Pierre-Henri Conac

University of Luxembourg

AEDBF – Luxembourg

December 12, 2013



Introduction

I. The draft bank recovery and resolution directive (RRD)

- A. Bail-in and the protection of property rights
- B. Bail-in and the depositor preference rule

II. The national legislations on bail-in of creditors

- A. Bail-in of junior creditors
- B. Bail-in of senior creditors and depositors

Conclusion



**Should the rule of law be damaged
because it is expedient to do so in a crisis?**



Faculty of Law, Economics and Finance

- **Trust in the rule of law has suffered during the financial crisis both in the US and in the EU**
- The rule of law means “that government in all its actions is bound by rules fixed and announced beforehand -- rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge” (Hayek, *The Road to Serfdom*)
- The rule of law implies: predictability, stability, fairness and judicial control
- A financial crisis implies losses on stakeholders (taxpayers, shareholders, creditors) but these losses should be applied in a predictable, stable and fair way, with rules known ex-ante, judicial review, and not through a political opaque, sudden and unpredictable process, with potentially unfair results
- **A legal regime should be in place before the restructuring process**



Faculty of Law, Economics and Finance

- **Bail out of creditors but not of shareholders: “Too big to fail” (TBTF) approach or “Geithner doctrine” (US) or the “Sanio doctrine” (EU)**
 - First period of the crisis: only shareholders are wiped-out or significantly diluted, sometimes through a State recapitalization
 - Germany: IKB (2007), Hypo Real Estate (2008)
 - UK: Northern Rock (2007), Royal Bank of Scotland (2008), etc.
 - Belgium: Fortis (2008), Dexia (2008)
 - Ireland: guarantee for all bank liabilities (2008) and recapitalization
 - Switzerland: UBS (2008)



Faculty of Law, Economics and Finance

- **Reason for the bail-outs:**
 - No banking resolution legislation in place and insolvency judicial proceeding is not workable (too long, loss of value, affects clients)
 - Sovereign having the resources and political will to do the bail-in
 - Underestimation of the size of the problem
 - ECB pressure for a bail out because of fear of a “Lehman moment”
- **Limits to the bail-outs and change of approach towards a bail-in:**
 - Costs to the taxpayer
 - Risk to the sovereign
 - Remove incentive to bondholders and management of banks to exercise discipline (moral hazard)



Faculty of Law, Economics and Finance

- **There is a need for legal instruments facilitating bank restructuring in the vicinity of insolvency, as an alternative to ordinary insolvency laws**
 - Lehman experience of 2008 of filing for Chapter 11 bankruptcy proved a turning point: inability to fund business, disorderly, costly, lengthy
 - Systematically Important Financial Institutions (SIFIs) are better handled through an administrative process which allows continuation of key operations, that will maximize the value of the firm and will avoid a disorderly collapse, **but need for a judicial control**
 - Dodd–Frank Act (2012): established Orderly Liquidation Authority for the FDIC to resolve SIFIs that parallels FDIC bank receivership
 - Need for legal instruments also in the EU allowing the bail-in (reduction) of amounts due to creditors of SIFIs in an orderly fashion



- **The EU framework on bank supervision and resolution**
 - October 2013 : two regulations establishing a Single supervisory mechanism (SSM)
 - ECB becomes the EU banking supervisor in November 2014
 - Asset quality review to be concluded in November 2014
 - June 2012: proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms (RRD)
 - Trilogue to be finalised (currently) in February 2014
 - Issues raised by Germany on SRM/SRBF has delayed the RRD



Faculty of Law, Economics and Finance

- **Proposal of a Single Resolution Mechanism (SRM)**
 - Commission is the Resolution Authority in the proposal
 - Germany would prefer that a network of national resolution authorities, or the Ecofin, that is Member States, takes the decision
 - Such approach is dangerous as it would facilitate bail-outs
- **Proposal of a Single Bank Resolution Fund (SBRF)**
 - Funded by banks but will take time to be fully funded (10 years)
 - Should reach 1 % of insured eurozone deposits (€60bn-€70bn)
 - MS deposit guarantee schemes will support losses in the meantime
 - Germany would prefer a network of national funds and doesn't want that the ESM can lend money to the SBRF



**I. The draft resolution and recovery directive
(RRD)**



Faculty of Law, Economics and Finance

A. Bail-in and the protection of property rights



- **Time frame of development and implementation of the RRD**
 - 6 June 2012: Publication of a proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms (RRD)
 - 31 December 2014: Member States to adopt the laws, regulations and administrative provisions necessary to comply with Directive
 - 1st January 2018: Member States to implement the **bail-in tool**
 - ECB requests bail-in tool to be in place in 2015 to remove uncertainty as soon as possible
 - Member States have started to introduce legislation allowing bail-ins, under pressure of ECB and Germany (Germany, France, UK...)



- **Legal Instruments (Art. 29 et seq.) at the ‘point of non-viability’**
 - Sale of business (if resolution planning was possible)
 - Bridge bank (parts of the bank kept as a going- concern)
 - Asset separation
 - **Bail-in (debt write down)**
 - Minimum set: possibility for additional national tools
- “No Creditor Worse Off” than in normal insolvency principle



Faculty of Law, Economics and Finance

- **Legal issue : protection of property rights (shares, bonds, loans)**
- Art. 6 of ECHR (right to a fair trial) and Art. 1 of the First Additional Protocol to European Convention on Human Rights (ECHR)

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.”

- Article 17 of the Charter of Fundamental Rights of the EU
- Protection is not absolute and interference is possible if:
 - (i) duly justified by an overriding interest (“public interest”)
 - (ii) provided by law, which is sufficiently accessible and precise and its application is sufficiently foreseeable
 - (iii) respect the principle of “proportionality” to the intended aim



Faculty of Law, Economics and Finance

- **ECHR recognizes a wide margin of discretion to the State on what is public interest and whether an expropriation is necessary**

“The Court will respect the legislature’s judgment as to what is in general interest unless that judgment be manifestly without reasonable foundation” (Mellacher and Others v. Austria, 19 December 1989, Series A n° 169, § 45)

Contracting States enjoy a “wider margin of appreciation . . . in delicate areas such as the stability of the banking system” (Olczak v. Republic of Poland, 7 November 2002, n° 30417/96)

- **ECHR recognizes a wide margin of discretion of local laws on what is “fair” compensation (Lithgow v. UK, 8 July 1986, n° 9006/80)**



- **Art. 26 of the RRD refers to “resolution objectives” (public interest)**

Various objectives “of equal significance”: financial stability, stabilizing an institution and reducing moral hazard, saving public funds, protecting clients funds and assets, the minimization of the unnecessary destruction of value and the cost of resolution, etc.

But vague and broad concept : public interest will be defined *ex post* by the resolution authority itself which makes predictability difficult



B. Bail-in and the depositor preference rule



Faculty of Law, Economics and Finance

- **Bail-in (Art. 35 et seq.) : all debts unless expressly excluded**
 - Shareholders: dilution or cancellation
 - Hybrid capital, subordinated debt, bail-inable bonds (*Cocos, if not already converted before*), junior unsecured creditors (*junior creditors*) and senior unsecured creditors (*senior debt*), non-insured deposits
 - Excludes (Art. 38): **insured deposits**, secured liabilities, repos, trust monies; employee claims; tax and social security claims (*if preferred in insolvency*), short term liabilities with an original maturity of less than a month (*in order to maintain inter-bank funding*), etc.
 - Limited list of exclusions prevents a MS to protect other categories: public institutions, non-profit organisation such as local Church...



- **“Depositor preference rule” is limited to insured depositors**
 - Non-insured depositors (above € 100 000) are bail-inable
 - **Justifications:** increases the effectiveness of the bail-in as more assets are covered; non-insured depositors are large companies and individuals able to protect themselves; no guarantee has been made
 - **Arguments against :** creates risk to target the not well connected and to create deposit flights with the ECB or NCB being forced to provide the difference before the bail-in (*some risk of pro-cyclicality*)



Faculty of Law, Economics and Finance

- **Non-insured depositor need to rank above in “creditor hierarchy”**
 - Senior bank debt ranked *pari passu* with non-insured deposits in the proposal but senior bank debt needs to be subordinated to depositors
 - **Justifications** : reduces the risk of deposit flights, increases the monitoring of risk taking of banks by creditors (market discipline), bank would be easier to resolve, alignment with most G-20 (US, recommendation of the Vickers report (2011), Switzerland (2012))
 - **Arguments against** : could increase the cost of funding for banks
 - **Adopted** by the European Commission in amended proposal, and by ECON (if no systemic crisis), but not in the Council approach



Faculty of Law, Economics and Finance

- **Deposit guarantee schemes (DGS) are bail-inable: not a good idea**
 - DGS would be subject to a bail-in in place of insured depositors and would rank *pari passu* with unsecured creditors (Art. 99 RRD)
 - Arguments : increases amount of bail-inable assets, reduces the write-down on other creditors (*DGS subject to same haircut*), **but**
 - National DGS are usually not pre-funded as banks are hostile to pre-funding as it ties up unproductive capital, so no money is there
 - DGS have not been designed for failure of a systemic bank
 - ECB against DGS ranking *pari passu* and several Member States providing preferential ranking to their DGS in resolution (Bulgaria, Latvia, Hungary, Romania and recently Greece and Portugal)



Faculty of Law, Economics and Finance

- **Deposit guarantee scheme (DGS) should not be bail-inable**
 - National taxpayer would be liable for the DGS (*bail-out by the back door as DGS are ultimately State-backed*) reinstating the link State-Bank
 - The cost for the Sovereign might be too high
 - Risk for the sovereign even if EFTA Court decision, 28 January 2013, Case E-16/11 — EFTA Surveillance Authority v. Iceland
 - DGS should not be bail-inable in case of resolution
 - ECON draft excludes the DGS from bail-in, but not the Council (provides super preference) and the Commission drafts



Faculty of Law, Economics and Finance

- Council and ECON amended proposal allow for flexibility from bail-in, which would allow MS to bail-out senior creditors
 - Council Approach provides for flexibility to replace loss absorption by some senior creditors and potentially all eligible depositors with a contribution from resolution funds, provided that **8% of liabilities** have already been bailed-in, and only **up to 5% of total liabilities**
 - The ECON report proposes to allow for state support immediately after loss absorption by capital instruments in case of a systemic crisis



Faculty of Law, Economics and Finance

- **State aids and bail-in of junior creditors**
 - Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis
 - ECB Asset Quality Review: Com. wants conversion of junior debt into equity (*bail-in*) when banks meet their capital requirements but are asked to strengthen their buffers following the stress test
 - ECB concerned that forcing losses on junior debt **before** allowing taxpayer support can create systemic risk by contagion
 - Commission stood his ground and highlighted that under its rules **exceptions** can be made “when the implementation of writing down or conversion of subordinated creditors would lead to disproportionate results or would endanger financial stability”
 - State aids regime to force bail-in of junior creditors until



II. The national legislation on bail-in of creditors



A. Bail-in of junior creditors



- **Bail-in of junior unsecured creditors**
 - Ireland: Anglo-Irish Bank (AIB), Allied Irish Bank's (AIB), Bank of Ireland, INBS
 - Spain (FROB, 2009 and 2012): Bankia (2013), and issue of mis-selling (MiFID) dealt separately (specific indemnisation fund)
 - Netherlands (2012 Intervention Act): SNS REAAL (2013)



- **Legal challenges to the method of the bail-in (Ireland)**
 - Legislation allowing the Finance Minister to bail-in subordinated creditors, considering the viability of the bank and subject to limited judicial review (procedure, reasonable opinion and no error of law)
 - “Exit consents” or “sweeper clauses” (Anglo-Irish Bank): exchange of bonds for new senior notes (80% voluntary haircut) provided that they voted in favour of a resolution which, if passed by more than 75% of voting noteholders, would allow AIB to redeem all of the subordinated notes for a nominal amount (threat of a 99,99% haircut)
 - *Anglo Irish* decision of the English High Court (2012) deems the exit consent illegal under English Law because it is unlawful for the majority to aid the **coercion of a minority** by voting for a resolution which expropriates the minority’s rights for nominal consideration



- **Legal challenge to the rapidity of the bail-in (Netherlands, SNS)**
 - Suit in the Council of State arguing a violation of the right to a fair hearing because of the **very short time for judicial review** (24 days), but justified by the legitimate aim to prevent “serious and immediate threat to the stability of the financial system” if legal uncertainty
 - Suit arguing that the expropriation was **not foreseeable** (Art. 1, Protocol 1 of ECHR), but enough to indicate the « manner »
 - Suit arguing that the amount of the **compensation was not specified** (Art. 1, Protocol 1 of ECHR), but enough to indicate the « manner »
 - Suit arguing that there was **no “serious and immediate threat** to the stability of the financial system”, but SNS Bank was a SIFI



Faculty of Law, Economics and Finance

- **Legal challenge to the valuation triggering the bail-in (Netherlands)**
 - Suit arguing that the additional losses estimated by Cushman & Wakefield (C&W) on the portfolio of real estate loans were too severe compared with a previous estimates by Ernst & Young (E&Y)
 - E&Y evaluation requested by SNS Bank and expected losses between 1,4 and 2,1 billion euros (mid-2012)
 - C&W evaluation requested Ministry of Finance and expected losses between 2,4 and 3,2 billion euros (Dec. 2012): 1,8 billion shortfall
 - Dutch Council of State held that the Ministry could act on the evaluation because C&W was an **expert** in this field, unlike E&Y, used more **recent information**, and SNS had the opportunity to **express its objections** to the Dutch Central Bank, which rejected them



- **Legal challenge to the extent of the bail-in (Netherlands)**
 - Ministry of Finance applied the ranking of creditors in bankruptcy
 - Suit in the Dutch Council of State arguing that expropriation of the subordinated debt of SNS REAAL and SNS Bank was unnecessary and therefore a **violation of the “proportionality principle”**
 - Dutch Council of State **upheld** the expropriation of the shares, subordinated securities, and subordinated loans of SNS Bank and SNS REAAL, but quashed the Minister’s order with respect to any future claims that former shareholders and bondholders might make on the ground that they were misled when purchasing the securities (**Mifid**)
 - Case continues as to the reasonableness of the compensation paid to expropriated parties with the Enterprise Chamber Amsterdam



B. Bail-in of senior creditors and depositors



- **Bail-in of senior creditors: from exception to the rule ?**
 - Iceland (2008): three largest Icelandic banks
 - Denmark: Amagerbanken (2011), Fjordbank Mors (2011)
 - Ireland: AIB for a small residual amount (2012)
 - ECB against bail-in of senior creditors because of fear of contagion, except (since July 2012) in the case of Spain and if a bank is liquidated



Faculty of Law, Economics and Finance

- **Bail-in of non-insured depositors (Denmark): market takes revenge**
 - Non-insured depositors in Amagerbanken (2011) subject to a 41% haircut (but not a systemic bank)
 - Denmark was sanctioned (funding market closed or higher funding costs) and had to change its law (facilitation of strong banks taking over weaker banks) which is evidence of the need for an EU rule
 - Compare with France (26 July 2013 Banking Bill) : no bail-in of senior creditors, because of a fear of increase in the financing costs of French banks compared to other MS if it is the first to move



Faculty of Law, Economics and Finance

- **Bail-in of non-insured depositors (Cyprus)**
 - First plan: attempt to bail-in secured depositors as well as to apply a haircut (*in reality a tax*) in all banks in Cyprus (even the solvent ones)
 - Second plan: non-insured deposits of only the two failed banks were subject to an haircut and exchanged for equity in a “bad bank”
 - Second plan: inversion in the hierarchy of creditors, as senior creditors were not bailed-in contrary to non-insured depositors



- **Validity of bail-in to be tested in the Cyprus and European Courts**
 - Depositors sued lenders, central bank, government, and ECB
 - Claims rejected by the *Cyprus Supreme Court* because « political act » and sent to district courts because « private acts » involving the contractual obligations of the bank to the depositor (7 June 2013)
 - Several suits filed in May and June 2013 with the General court of EU (ECJ) against the Eurogroup, the Commission and the ECB (because the decision was taken by the Cyprus Central Bank)



Faculty of Law, Economics and Finance

- **Arguments against the validity of the bail-in**
 - Decision by the Commission and the ECB was *ultra-vires*
 - No pre-existing EU legislation on deprivation of bank deposit
 - Expropriation not justified by a proportionate public interest
 - Principle that no-one may rely on his own failures to obtain an advantage and/or to justify wrongful and/or unlawful conduct
- **Arguments in favour of the validity of the bail-in**
 - Legitimate public interest is to protect « financial stability »
 - The two banking institutions were no longer viable
 - Creditors are protected by the ‘no creditor worse off’ principle



- **Legal challenges to the introduction of capital controls (Cyprus)**
 - Principle of prohibition on « all restrictions on the movement of capital between Member States and between Member States and third countries » (Article 63 TFEU)
 - Exception: capital controls are possible vis-à-vis third country, by decision of the Council, « in exceptional circumstances (Article 66)
 - Right of « Member States ... (b) ... to lay down procedures for the declaration of capital movements ..., or to take measures which are justified on grounds of public policy or public security (Article 65(b))
 - Legal action filed with the Supreme Court of Cyprus (rejected)



Faculty of Law, Economics and Finance

Conclusion



Faculty of Law, Economics and Finance

- Sanctity of insured deposits is assumed by population (see Cyprus in 2013 and Italy in 1992) and depositor preference rule is also in the RRD
- The sooner losses are recognized on the balance sheets of banks, and the bail-in of creditors is applied, the better for the European economy
- Therefore, adoption and implementation of the RRD as well as national laws is urgent, and the bail-in should be available in 2015, not 2018
- Bail-in should start in November 2014 after the Asset quality review by the ECB and EU State aid rules will force the bail-in of junior creditors