EU bank resolution framework: A comparative study on the relation with national private law

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2 European bank insolvency rules[1]

1 Introduction

This chapter discusses the questions of why most policymakers and scholars consider a special legal framework to deal with banks failures crucial and which rules for bank insolvencies exist at the EU level. To answer these questions, paragraph 2 examines the primary policy goals of general insolvency law, why a corporate insolvency procedure may not work for a failing bank, and which policy goals an ideal bank resolution framework pursues. Paragraph 3 then explores the main developments in the field of EU bank insolvency law before the entry into force of the BRRD. The paragraph also introduces the bank resolution procedure created by the BRRD. The cross-border convergence and coordination sought by the BRRD and the unified decision-making procedure under the SRM Regulation are discussed in the last sections of the chapter.

The chapter shows that the EU bank resolution framework does not reject the more traditional insolvency framework, but it heavily relies on insolvency law. The resolution framework aims to replicate the economic outcome of an insolvency procedure for the shareholders and creditors of the failing bank and adheres to some fundamental principles of insolvency law. The deviations of the resolution rules from general insolvency law reflect the unique characteristics of a bank failure when compared to a more traditional business failure.[2]

2 Special legal framework for bank insolvencies

2.1 General framework of insolvency law

Insolvency scholars have described insolvency law as a set of rules which core is to be found in 'the prevention, regulation, or supervision of discontinuity in the legal relations of a legal subject that is in financial difficulties'.[3]

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1 This chapter contains and builds on the following work previously published by the author: Janssen 2018a; Janssen 2018b; Janssen 2017.

2 *Cf.* Massman 2015, p. 644.

3 Wessels 2016, para. 1001, who notes in Dutch that '[i]n het insolventierecht staat centraal het vermijden, reguleren of begeleiden van discontinuiteit in rechtsbetrekkingen van een rechtssubject dat in financiële moeilijkheden verkeert'. Wessels, Markell & Kilborn 2009, p. 2 provide almost the same definition.

The term 'insolvency' derives from the Latin verb 'solver', to pay, and is often used interchangeably with the term 'bankruptcy'. The latter term derives from the Italian term 'banca rotta', broken table. It appears to refer to the fact that the table of an early Italian money-changer in the market place was broken if he was no longer able to pay his debts.[4] A modern-day, widely-used definition of the term 'insolvency' is 'when a debtor is generally unable to pay its debt as they mature, or when its liabilities exceed the value of its assets.'[5] The literature describes it as a state of affairs in which the debtor is overwhelmed by debts and the creditors, therefore, can no longer expect that their debtor will be able to meet its financial commitments fully and in time.[6] When a debtor is insolvent for the purpose of the law, the creditors and debtor can typically initiate a legal process that requires a court judgment.[7]

The justification for the existence of insolvency law and the purpose of this area of law have been much debated amongst scholars, especially US scholars.[8] We consider two important camps in this debate in turn.

The scholars in one camp argue that the main function of insolvency law is to organize a collective procedure.[9] Their theory is called the 'creditors' bargain theory', which is the most influential theory of insolvency law and has been mainly developed by Jackson and Baird.[10] It is based on the idea that if insolvency law does not provide for a collective procedure, creditors would agree on a collective debt collection method themselves. Without such a procedure, it would be free for all and a chaotic race to the assets of the insolvent debtor would take place in which some creditors may be better off but which does not result in the most efficient outcome for the creditors as a whole.[11] Thus, a so-called 'common pool problem' exists.[12] Insolvency law seeks to overcome the coordination problems amongst creditors by providing a collective, compulsory insolvency procedure and respecting the pre-insolvency entitlements.[13] It imposes a moratorium or automatic stay on the actions of individual creditors.[14] The only objective of the collective procedure is to allocate the common pool of assets in such a

4 Wessels, Markell & Kilborn 2009, p. 2; Rajak 2008, p. 3-4; Hüpkes 2000, p. 12.
5 UNCITRAL, Legislative guide on insolvency law, New York: United Nations 2005, p. 5 (para. 12, under B, 'Glossary').
6 McBryde & Flessner 2003, p. 15.
7 *See* Rajak 2008, p. 4-5. *See also* Finch & Milman 2017, p. 119; Goode 2011, para. 4.01.
8 *See* Goode 2011, para. 2.15.
9 *See* Goode 2011, para. 2.15.
10 E.g., Jackson 1986; Baird & Jackson 1984; Jackson 1982.
11 Jackson 1986, p. 9-13.
12 Jackson 1986, p. 11.
13 *See* Jackson 1986, p. 13 and 21.
14 *See* Jackson 1986, p. 151-192.

way as to maximize the returns to the creditors. According to the creditors' bargain theory, insolvency law should not concern itself with societal aims such as keeping the corporate debtor in operation and protect community interests.[15]

By contrast, according to the scholars of another camp, insolvency law should play a wider role and consider a larger range of interests than the interests of the creditors.[16] Warren, for instance, distinguishes four principal goals of insolvency law. In her view, this field of law creates a system to (1) enhance the value of the failing firm, (2) distribute value according to multiple normative principles, (3) internalize the costs of business failure to the parties dealing with the debtor and minimize the losses to the general public, and (4) create reliance on private monitoring.[17] Thus, enhancing the collective returns to the creditors is not the only goal of insolvency law.[18] Furthermore, according to Warren, insolvency law does not only aim to create a system to distrubute value amongst the persons with formal legal rights to the assets. She advocates a regime that also takes into account the distributional implications of business failure on other parties. Insolvency law may, for example, indirectly protect the interests of employees in the preservation of their jobs and the community interests by facilitating going concern sales and reorganizations so that the business of a failing company can remain in operation.[19]

In actuality, as we will see in chapter 6, the primary objective of Dutch, Germany and English insolvency law is considered maximizing the returns to the creditors.[20] The insolvency laws offer multiple procedures. These procedures do not all offer an automatic stay on creditor action.[21] For example, there is no automatic stay in the company voluntary arrangement[22] (CVA) under the English IA 1986.[23] Moreover, besides providing for the possibility of a sale of the debtor's assets to one or more parties, the insolvency laws offer a debtor the possibility to restructure as a business in the hands of the original legal entity on the basis of an arrangement with the creditors and

15 Jackson 1986, p. 210 and *see* Finch & Milman 2017, p. 28-29; De Weijs 2012, p. 68-70; Goode 2011, para. 2.15

16 *See* Goode 2011, para. 2.15. *See also* Finch & Milman 2017, p. 35-41.

17 Warren 1993, p. 344.

18 *See* Warren 1987, p. 777.

19 Warren 1993, p. 354-356 and *see* Finch & Milman 2017, p. 35-37; Kirshner 2015, p. 799-800, who refer to several other scholars.

20 Paragraph 4 of chapter 6.

21 On English law, *see* Paterson 2016, p. 700.

22 Part I IA 1986; Schedule A1 to the IA 1986.

23 In the CVA, a statutory moratorium is only available for small, eligible companies under Schedule A1 to the IA 1986, para 7. *See* Finch & Milman 2017, p. 420-424; Paterson 2016, p. 700.

shareholders.[24] Also, as chapter 5 will show, they provide for a distributional order of priority amongst creditors. Dutch and English insolvency law has become infused with some societal interests as they give a few types of creditor claims, including claims of employees, a preferential status.[25]

In addition to the ex-post objective to maximize the returns to creditors when the debtor is insolvent, insolvency law is said to have an important effect on ex-ante incentives and behavior.[26] If certain parties do not consider insolvency a sufficient threat, the problem of moral hazard may arise in that these parties have no constraints to limit risk-taking.[27] Moral hazard is the concern that someone who is protected against the consequences of a risk because another party will incur the costs, is less inclined to take precautions but has an incentive to take the risk.[28] Insolvency law determines the consequences of business failure. A failing company may need to leave the market if it is no longer economically viable.[29] The shareholders may have to incur losses if the company enters an insolvency procedure because they do not receive any payments until the other claims are paid. Insolvency law also aims to create appropriate ex-ante incentives for managers by, for instance, presenting the threat that the management of the debtor may not keep its jobs in the event of insolvency.[30] Under English insolvency law a director can be held liable for wrongful trading in the period before the commencement of an insolvency procedure.[31] Under German insolvency law the directors are also obliged to file for an insolvency procedure within three weeks after a company has become insolvent.[32] This ex-ante perspective on insolvency law plays an important role in the bank resolution framework, as the next paragraphs will discuss.

24 *Cf.* however Madaus 2018, who uses the term 'insolvency law' in a narrow sense. He argues that insolvency law only governs liquidation procedures to address a common pool problem, whereas restructuring law facilitates the conclusion of a restructuring agreement, including an insolvency plan in an insolvency plan procedure under the InsO. The present study uses the term 'insolvency law' in a broader sense.

25 Paragraph 5.3 of chapter 5.

26 E.g., Eidenmüller 2018, para. 3.3.1; Goode 2011, para. 2.01; Eidenmüller 1999, p. 27-30.

27 Krimminger 2011, para. 11.11.

28 *See* Ayotte & Skeel 2010, p. 485.

29 Eidenmüller 2017, p. 284-285. *See also* Goode 2011, para. 2.01.

30 Marinč & Vlahu 2011, p. 4-5; Davies 2006, p. 304; Hart 2000, p. 4-5. *See also* Acharya, Amihud & Litov 2011, whose empirical research suggests that providing strong rights to the creditors of a company which is in financial trouble leads the company to reduce risks. Such strong rights increase the likelihood of companies making diversifying acquisitions, in which case the managers may run the risk of being dismissed in the reorganization.

31 Section 214 IA 1986. *See* Finch & Milman 2017, p. 599-604; Eidenmüller 2006, p. 249; Davies 2006, p. 316-329.

32 Section 15a InsO. *See* Eidenmüller 2006, p. 250.

2.2 Banks subject to a special insolvency regime

2.2.1 *Why a traditional, formal insolvency procedure may not be an appropriate option for a bank*

Is a traditional, formal insolvency procedure also an appropriate option for a bank? It has been argued that

> '[a] priori there is no reason not to apply general insolvency rules to banks. In fact, many aspects of a bank liquidation, such as the calculation of the assets, the verification of claims, the adjudication of disputed claims, and the distribution of assets will need to be handled largely in the same manner as the liquidation of a commercial company.'[33]

Nevertheless, some scholars and standard setters advocated a specialist framework for bank failures several decades ago already.[34] Furthermore, as we will see in chapter 3, already before the start of the latest financial crisis specific rules for banks in financial distress existed in the Netherlands, Germany, and the UK. An example is the rule that the supervisory authority may file the petition addressed to the court for the initiation of an insolvency procedure for a bank.[35] Moreover, at that time, Dutch law provided for the emergency procedure (*noodregeling*) as a bank-specific suspension of payments procedure. Bank failures during the latest financial crisis underlined that there are strong arguments to give banks a more special treatment if they are in financial distress. These failures include the collapse of UK bank Northern Rock, which experienced a bank run and was subsequently taken into public ownership in 2008,[36] and the failure of the German bank HRE, which financial position significantly worsened following the insolvency of US investment bank Lehman Brothers in 2008.[37]

The reasons given by Hüpkes to view banks as 'special' when compared to most other companies are the following.[38]

First, traditionally banks have highly liquid liabilities in the form of demandable deposits and short-term funds. The deposits can be withdrawn at any time and much of the short-term debt is due in a few days or even

33 Hüpkes 2005, p. 475.
34 E.g., Asser 2001, p. 8-11; Hüpkes 2000, p. 12-30; Basel Committee on Banking Supervision, 'The insolvency liquidation of a multinational bank', December 1992.
35 Paragraphs 2.1.2, 3.1.2 and 4.1.2 of chapter 3.
36 *See* paragraph 4.1.3 of chapter 3 and *see* Lastra 2008.
37 *See* paragraph 3.1 below and *see* Admati & Hellwig 2013, p. 11.
38 Hüpkes 2005, p. 472-473; Hüpkes 2000, p. 8. *See also* Cranston et al. 2017, p. 6-8; Bliss & Kaufman 2007, p. 147-149; Kelly 1997, p. 264-268.

overnight. By contrast, banks typically invest a large part of the money in long-term loans and other investments for longer periods that are often difficult to be converted into cash on short notice. Thus, a maturity mismatch exists between their short-term liabilities and long-term assets.[39] This maturity mismatch may not create any problems under normal circumstances. However, a sudden loss of confidence in the bank may result in a large number of deposit withdrawals and run on funds that threaten its liquidity position and may require it to sell assets at a loss.[40] As we will see below, these problems can also quickly affect other parts of the financial system. Second, banks offer financial services that are critical to the functioning of the economy. For instance, they lend funds to other companies and households and participate in payment systems. The literature considers this special role in our economy 'a sort of public service.'[41] A third characteristic function of banks is that they perform a crucial function in the transmission of the monetary policy of central banks.[42]

It is true that modern-day banks in the EU are much more complex than these characteristics may suggest. They have significantly expanded their activities beyond the traditional activities of taking deposits and making loans. Examples include the involvement in securitization and derivatives markets.[43] Furthermore, many non-bank financial companies now also carry out traditional banking functions, such as the credit-providing functions,[44] and it is argued that financial innovation will soon fundamen-

39 Allen, Carletti & Gu 2014, para. 2.4; Admati & Hellwig 2013, p. 39 and 51; Ayotte & Skeel 2010, p. 474-475; George 1997, p. 252. *Cf.* the definition of 'credit institution' in article 4(1)(1) CRR: 'an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.' This business model is of all times. *Cf.* e.g., *Foley v Hill* [1848] 2 HLC 28, in which case the House of Lords noted that '[m]oney, when paid into a bank, ceases altogether to be the money of the principal [...] it is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into the banker's, is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker's money; he is known to deal with it as his own; he makes what profit of it he can, which profit he retains to himself, paying back only the principal, according to the custom of bankers in some places, or the principal and a small rate of interest, according to the custom of bankers in other places. The money placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases.' *See also* Campbell 2008, p. 212-213.

40 Allen, Carletti & Gu 2014, para. 2.4; Admati & Hellwig 2013, p. 39; Ayotte & Skeel 2010, p. 474-475. *See also* Diamond & Dybvig 1983.

41 Hüpkes 2005, p. 472.

42 Hüpkes 2005, p. 473; Hüpkes 2000, p. 8. For a discussion of the role in the transmission of monetary policy, *see* Peek & Rosengren 2014.

43 Cranston et al. 2017, p. 15-17; Final report of the High-level expert group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen (Liikanen Report), October 2012, p. 13-14. *See also* Fonteyne et al. 2010, p. 10.

44 Krimminger 2011, para. 11.12-11.18.

tally change the current financial intermediation structures.[45] However, in the EU, the banking sector still has a significant share in financial intermediation.[46] The present study focuses on banking in the traditional sense and considers other types of financial institutions and activities if relevant for the analysis of bank insolvency. Further research might consider how the analysis of the present study maps into the insolvency regimes that apply to other parts of the financial sector.

The above-mentioned characteristics of a banking business lead to great public interest in protecting the banking functions in case of failure.[47] A general corporate insolvency procedure may not always be appropriate to do so. That analysis mainly applies to banks which are considered too important, connected and/or big to fail because of their size, complexity or interconnectedness with other market participants, or the insubstitutionability of some of their operations. The limitations of a general corporate insolvency procedure include that (1) it does not have as its primary objective to minimize the impact of the failure on the financial system as a whole,[48] (2) it traditionally involves a stay, (3) the trigger for the initiation of the procedure may be inadequate, (4) the procedure may require negotiations with shareholders and creditors, and (5) it may not sufficiently facilitate international coordination.

The first limitation of insolvency law is that it does not focus on the protection of the broader public interest.[49] Dutch, German, and English insolvency law has traditionally been directed towards the maximization of the value for the creditors and their equal treatment.[50] The principal players in an insolvency procedure, such as the debtor, creditors, administrator or trustee and court, may not consider or may not be able to take full control over the broader implications of a bank failure.[51]

45 For an analysis of fintech and some issues policymakers might need to consider, *see* Demertzis, Merler & Wolff 2018.

46 *See* Final report of the High-level expert group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen (Liikanen Report), October 2012, p. 12; Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final, 6.6.2012), p. 7.

47 Attinger 2011, p. 7.

48 *See* Jackson & Skeel 2012, p. 448-449; Levitin 2011, p. 483-487.

49 Jackson & Skeel 2012, p. 448-449; Levitin 2011, p. 483-487.

50 *Cf.* Hüpkes 2005, p. 479-480.

51 Jackson & Skeel 2012, p. 449; Hüpkes 2005, p. 479-480.

What distinguishes the failure of a bank that is considered considered too important, connected and/or big to fail from, for example, the failure of a local bakery is often the systemic risk.[52] A single definition of the term 'systemic risk' does not exist. One definition provided in the literature on bank insolvency is that it is 'the risk that the failure of a market participant to meet its contractual obligations may, in turn, cause other participants to default, with a chain reaction to broader financial difficulties.'[53] Thus, it is about the risk to the entire financial system. One can argue that the fact that a bank failure may result in negative externalities beyond the private costs of the failure justifies a special legal framework for bank failures.[54]

The financial problems of a bank can quickly affect the rest of the financial system through three channels:[55] (1) through counterparty risk because the bank is a direct counterparty of many other market participants, such as through derivatives contracts and repurchase agreements (repos), so that its problems can easily be transmitted to the balance sheets of these other participants;[56] (2) through liquidity risks when the bank is forced to fire-sale its assets to obtain cash, which sales depress the value of the assets of other financial institutions;[57] and (3) through contagion risks because the problems of one bank cause a panic that spreads to other financial institutions.[58] The problems within the financial system can, in turn, affect the broader economy, for instance, because there is less funding available for companies to finance their activities.[59]

The third channel, i.e., contagion, entails run behavior.[60] Banks are especially vulnerable to such behavior because, as indicated above, a large part of their assets tends to be less liquid than their liabilities. Moreover, they are highly leveraged, that is, they rely heavily on debt to finance their

52 *See* Grünewald 2014, p. 11; Hüpkes 2005, p. 489.
53 Hüpkes 2005, p. 489 (footnote 118). For comparable definitions, *see* Schillig 2016, p. 46 ('the probability that the process of financial intermediation ceases, at least to a significant extent and in significant parts of the financial system.'); Schwarcz 2008, p. 204 ('the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.'). *Cf.* Coffee 2010, p. 1, who notes about systemic risk that '2008 essentially witnessed a localized economic shock in the U.S. subprime mortgage market that nearly caused the meltdown of worldwide capital markets because that shock was transmitted rapidly through counterparties and global markets with the speed of a tsunami.'
54 Beck 2011, p. 56.
55 Tröger 2018, p. 39; Zhou et al. 2012, p. 4. *See also* Armour 2015, p. 457-458.
56 *See* Scott 2016, p. 3-4.
57 *See* Admati & Hellwig 2013, p. 63.
58 *See* Scott 2016, p. 5-14.
59 Tröger 2018, p. 39.
60 Scott 2016, p. 6.

investments.[61] A loss of confidence in the financial position of a bank may lead to the sudden withdrawal of their money by the creditors. Such a run may be targeted to one bank, but the suggestion that one bank is in default may also spread a panic and trigger creditors of multiple financial institutions to withdraw preemptively.[62] If these institutions then cannot obtain new funding, they may have to fire sale their assets and may experience liquidity problems within a short period. Hence, banks are confronted with a more dramatic form of common pool problem than most non-financial companies. They have a large number of creditors who have an incentive to immediately run to the firm to withdraw their money and liquidate their claims.[63]

In the past, banking crises were often limited in scope, such as the crisis in Finland and Sweden in 1992, which had limited effects outside the borders of those jurisdictions.[64] Also, the literature on contagion has traditionally focused on bank runs by retail depositors.[65] The latest financial crisis provided new insights into the contagion risks and run behavior. The contagion risks have increased over the last few decades, especially because of the greater (international) interconnectedness of and new types of players and transactions in the financial system.[66] Following the insolvency of Lehman Brothers in 2008, for example, a run by investors on money market funds ensued, even on funds that were themselves not directly affected by the failure of Lehman Brothers.[67] Furthermore, banks now rely heavily on the wholesale markets for their funding. During the crisis, many banks experienced financial difficulties as a result of wholesale market (rather than retail deposit) runs, including on the repo and interbank lending markets.[68] In 2007, Northern Rock experienced a classic retail deposit run, with many queuing depositors wishing to withdraw their money. The main run, however, took place on the wholesale market.[69] While, at least in theory, a deposit guarantee scheme may prevent a run by retail and some other types of depositors because it guarantees them that they will have continuous access to their deposits if their bank defaults, such a scheme may not mitigate the effects of other types of runs.[70]

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61 Admati & Hellwig 2013, p. 30; Fonteyne et al. 2010, p. 10.
62 Scott 2016, p. 5-14. *See also* Diamond & Dybvig 1983.
63 Schillig 2018, para. 2.2; Schillig 2016, p. 63-64; Swire 1992, p. 494-495.
64 Admati & Hellwig 2013, p. 65.
65 Scott 2016, p. 10 and 68.
66 Admati & Hellwig 2013, p. 65-69. *See also* Coffee 2010, p. 22.
67 Admati & Hellwig 2013, p. 62.
68 Leckow, Laryea & Kerr 2011, para. 12.22. *See also* Scott 2016, p. 67-78.
69 Final report of the High-level expert group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen (Liikanen Report), October 2012, p. 59 and *see* paragraph 4.1.3 of chapter 3.
70 Leckow, Laryea & Kerr 2011, para. 12.22.

A second and related limitation of a formal insolvency procedure is that, as indicated above and notwithstanding certain exceptions under EU law,[71] a moratorium may come into effect to block individual creditors to enforce their claims against the debtor. A comprehensive moratorium has been considered problematic in case of a bank failure.[72] The bank may need to continue some of its operations and transactions to avoid disruptions in the financial system, give depositors access to their funds, and bring down the potential for systemic risk.[73] However, preventing some of the contractual counterparties of the bank, such as investors in repos and derivatives transactions, from the immediate liquidation of their positions may at least give the bank a breathing space in which can be determined which measures need to be taken. This 'paradox'[74] requires, according to Schillig, 'a finely balanced system under which a moratorium cannot be automatic and comprehensive; it may be discretionary, temporary and limited, as the individual situation requires.'[75]

Thirdly, the classic trigger of 'insolvency' for the initiation of a procedure may not be appropriate if a bank fails. The definition of 'insolvency' under insolvency law traditionally encompasses cash flow insolvency (inability to pay debts as they fall due) and balance sheet insolvency (the liabilities exceed the assets).[76] As already indicated, banks do not have the money available to immediately pay all debts that must be repaid upon first demand.[77] Moreover, it is generally acknowledged that in relation to a bank an additional, regulatory threshold should exist so that authorities can take action when they consider the bank no longer viable even though it has not

71 Under the Settlement Finality Directive exceptions to the automatic stay under insolvency law apply to netting of claims resulting from transfer orders and the transfer orders themselves entered into payment and securities settlement systems. Insolvency procedures do not have a retroactive effect on the rights and obligations of a system participant arising from or in connection with the participation. Also, an insolvency procedure against the provider of collateral does not affect the right of a participant to realize the security. Under the Financial Collateral Directive, a close-out netting provision in a qualifying financial collateral arrangement can take effect regardless of the commencement of an insolvency procedure and such a qualifying financial collateral arrangement and the provision of collateral under it are not affected by the retroactive effects of an insolvency declaration.

72 Schillig 2016, p. 64-65; Hüpkes 2005, p. 484.

73 Hüpkes 2005, p. 484; Asser 2001, p. 95-96.

74 Asser 2001, p. 95-96.

75 Schillig 2016, p. 64-65. *See also* Bliss & Kaufmann 2007, p. 157-159.

76 Campbell & Lastra 2011, para. 2.10; Goode 2011, para. 4.01-4.39 and *see* paragraph 2.1 of this chapter, which referred to the definition of 'insolvency' provided by the UNCITRAL, Legislative guide on insolvency law, New York: United Nations 2005, p. 5 (para. 12, under B, 'Glossary'). *Cf.* Section 1 Fw (referring to the condition of 'stop of payments' as the condition for the opening of a bankruptcy procedure); sections 123(1)(e) IA 1986 (cash flow test) and 123(2) IA 1986 (balance sheet test); sections 17 InsO (cash flow test), 18 InsO (imminent insolvency) and 19 InsO (balance sheet test).

77 Schelo 2015, p. 25 and 96; Hüpkes 2000, p. 13.

yet reached the formal state of balance sheet insolvency under insolvency law.[78] Such a regulatory threshold should ensure timely intervention to at least reduce the potential for systemic impact.[79] Several authors call the regulatory threshold 'regulatory insolvency' since the bank is considered no longer viable for the purpose of banking law rather than insolvency law.[80] It should be noted, however, that there is a strong tendency in EU Member States to allow also the opening of a restructuring procedure under corporate restructuring and insolvency law before the corporate debtor becomes insolvent for the purpose of the law. As chapter 5 will discuss in more detail, one can argue that the triggers preferred for the intervention in a bank are not far removed from more recent developments in corporate restructuring and insolvency law to enable timely restructuring.[81]

Fourthly, insolvency law typically provides for procedures that allow a negotiation about a solution for the financial problems and give a powerful and active role to the creditors. While the theory of the common pool problem used by insolvency scholars helps to understand the problems with run behavior, if the authorities want to negotiate a solution with the creditors and shareholders of a bank on the basis of an arrangement, they may face anticommons problems.[82] As chapter 5 discusses,[83] insolvency scholars use the anticommons dilemma to describe the situation that not all creditors vote in favor of a proposed arrangement. They holdout because they expect to have a chance to become in a better individual position without the arrangement. Accordingly, lengthy negotiations may be needed to reach an agreement and the deal may even fall apart.[84] The solution to anticommons problems which many insolvency laws offer, such as the German InsO in the insolvency plan procedure (*Insolvenzplanverfahren*),[85] is that a majority vote rather than unanimity and a court confirmation is required for an arrangement between the debtor and the creditors and shareholders to become effective. As a result, a dissenting minority can be overruled.[86] In case of a bank failure, the anticommons problems may be more severe than

78 Schillig 2016, p. 65; Grünewald 2014, p. 88; Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', October 2014, para. 3.1; Randell 2012, p. 116-117; Campbell & Lastra 2011, para. 2.12-2.13; International Monetary Fund & The World Bank, 'An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency', April 2009, p. 19; Hüpkes 2005, p. 477-478; Hüpkes 2000, p. 12-13.

79 Grünewald 2014, p. 88; Hüpkes 2000, p. 12-13.

80 Campbell & Lastra 2011, para. 2.14; Hüpkes 2000, p. 12.

81 Chapter 4.3 of chapter 5.

82 Schillig 2016, p. 65-66; De Weijs 2013. Anticommons problems in insolvency procedures were for the first time discussed by Baird & Rasmussen 2010, *see* especially p. 652-653. For the concept of anticommons in general, *see* Fennell 2011, p. 41-46; Heller 1998.

83 Paragraphs 2.2 and 4.3 of chapter 5.

84 Madaus 2018, para. 5.1; Schillig 2016, p. 65-66; De Weijs 2013; De Weijs 2012.

85 *See* paragraph 4.2.3 of chapter 5.

86 Madaus 2018, para. 5.1; De Weijs 2012, p. 74-78.

in corporate insolvency.[87] Time is usually of the essence to prevent further deterioration of the financial position of the bank and minimize the impact within the financial system, for instance, because of the dependence of the bank on short-term funding.[88] Thus, there may be no time for negotiations. Furthermore, the balance sheets of most banks are extremely complex with various types of financial counterparties, which may make the process at the negotiation table complicated.[89]

Finally, corporate insolvencies are typically resolved in court. A cross-border bank failure requires the coordination of an international procedure. An administrator or insolvency trustee and a judge may not be able to sufficiently coordinate with authorities and courts in the other countries in which the bank operates.[90] Moreover, because an insolvency court typically plays a reactive role, that is, a role at the outset of the case, it may have to take a decision in a short period, based on limited information. Accordingly, the court may find itself in a difficult position.[91]

2.2.2 Alternative: public financial support

The failures or near-failures of several banks in the EU during the latest financial crisis showed that governments are sensitive to such events and want to step in to prevent the default of banks which individual crisis threatens to have a substantial impact on the financial system. Because of the size, complexity, and/or interconnectedness of these banks or the insubstitutionability of some of their operations, they were considered of systemic importance and too important, connected and big to fail.[92] For example, as we will see in chapter 3,[93] when SNS Reaal and SNS Bank, which was the fourth largest bank in the Netherlands, experienced severe financial problems in 2013, the Dutch Minister of Finance did not consider the opening of an insolvency procedure an appropriate option. In his view, such a procedure would cause social unrest and pose risks to financial stability.[94]

87 Schillig 2018, para. 3.2; Schillig 2016, p. 65; De Weijs 2013, p. 215-221.
88 Schillig 2016, p. 65. *See also* Jackson & Skeel 2012, p. 447; Hüpkes 2005, p. 479.
89 Schillig 2016, p. 65.
90 Jackson & Skeel 2012, p. 445.
91 Jackson & Skeel 2012, p. 450.
92 Grünewald 2014, p. 13. *See also* Attinger 2011, p. 18-20. The term and doctrine of 'too-big-to-fail' is not new. For example, in 1984 it already attracted much public attention when the government of the United States intervened in Continental Illinois Bank to rescue it. *See* Gup 1998, p. 53-54 and 69-70.
93 Paragraph 2.2 of chapter 3.
94 Letter of the Dutch Minister of Finance to the Parliament of 1 February 2013 (*Kamerstukken II* 2012/13, 33532, no. 1), p. 6.

During the crisis, the alternative to the initiation of an insolvency procedure was in many cases a government intervention with public money to restore the balance sheets of the failing bank. According to a study by Stolz and Wedow, in the period 2008-2010 the public support measures of the EU governments for the financial sector took the form of guarantees for bank liabilities, recapitalization measures (such as the acquisition of preferred shares), and measures to provide relief from legacy assets.[95] An example forms the case of ING, which the Dutch government in 2008 and 2009 supported with a capital injection (the purchase of subordinated bonds), asset support measures, and guarantees for bonds issues.[96] A more dramatic example is the public intervention in Ireland, which government provided blanket guarantees for all liabilities of six large banks and took additional recapitalization and asset support measures.[97]

It is widely acknowledged that such government-funded rescues of banks can have several unintended consequences. The costly rescues can have a significant impact on public finances and sovereign debt.[98] Furthermore, they can be a source of moral hazard and distortion of competition in the banking sector.

The problem of moral hazard in the context of bank failures has been extensively discussed in the literature. The traditional corporate governance model encourages the management of a stock company to run the business in the interest of the shareholders. Such a focus on the shareholders' interests motivates the management to seek to maximize the overall value of the company and, thus, the share price.[99] As we saw in the previous sections, banks are different from most other types of companies in several regards, including because they are highly leveraged. Their ratio of debt funding to funding through equity is high.[100] As a result, the bank shareholders tend to favor an increase in leverage. The shareholders benefit from a potential upside of risky activities while the downside risk falls in an insolvency procedure on the unsecured creditors. The liability of the shareholders is limited to the value of their investments.[101] It is believed, however, that in an efficient market, investors monitor the financial condition of a company and set funding prices that reflect this condition.[102] Accordingly, if the bank pursues a risky business strategy, the risk-taking would normally increase the expected costs for its creditors because the probability of default grows.

95 Stolz & Wedow 2010.
96 Stolz & Wedow 2010, p. 10-11.
97 Allen et al. 2015, p. 33-35.
98 *See* Tröger 2018, p. 39; Avgouleas & Goodhart 2015, p. 4; Zhou et al. 2012, p. 4.
99 Armour et al. 2016, para. 17.2.1.
100 Armour et al. 2016, para. 14.1.1 and 17.2.2.
101 Armour et al. 2016, para. 17.2.2; Armour 2015, p. 458-459; Admati et al. 2013, p. 28-29. *Cf.* Davies 2006, p. 306-307.
102 Flannery 2010, p. 379.

The creditors are then likely to demand a higher risk premium, which makes an increase in leverage less attractive for the bank.[103]

If, however, this bank is a bank which the creditors expect to be rescued by the government in the case of failure because it is regarded 'too-big-to-fail', the market participants will underprice the bank capital. They have reduced incentives to monitor the bank and are willing to lend to the bank on more favorable conditions than without the implicit government guarantee. Thus, the bank capital prices do not reflect the true financial condition of the bank. The bank managers and shareholders, in turn, are expected to have less incentives to change their risk-taking behavior.[104] Hence, the expectation of public financial assistance could give them an incentive them to increase the risks and leverage to maximize shareholder returns.

In this context, scholars often use the term 'market discipline'. In the literature on financial regulation, effective market discipline is understood to involve a monitoring component (i.e., the ability of investors to timely and accurately assess the financial condition of a financial institution).[105] Moreover, it is considered to involve an influence component (i.e., the ability of the subsequent reactions by the investors to the institution's liability choices to influence the behavior of the institution, for instance, because the investors charges more for funding if the bank increases its risks).[106] The implicit public guarantees are argued to undermine the market discipline.[107]

Empirical research confirms that the relation between bond spreads and risks has been weaker for the largest financial institutions that investors most likely expect to be rescued by the government should they ultimately fail than for the other financial institutions. Thus, such a large financial institution could attract funding at lower prices.[108] The public guarantees create competitive distortions between banks that are regarded candidates

103 Armour 2015, p. 458-459; Flannery 2010, p. 379.

104 Armour 2015, p. 458-459; Admati & Hellwig 2013, p. 129-130 and 142. *See also* Ayotte & Skeel 2010, p. 486, who discuss that a government may try to addresses the moral hazard problem in relation to the shareholders of banks by, for instance, purchasing shares in the capital of a distressed bank in such a way that existing shareholders are diluted. However, such a measure may not solve the moral hazard problem in relation to creditors. The creditors may have no reason to stop lending money to banks at more favorable terms than they would otherwise require. And *see* Coffee 2010, p. 18, who claims that 'even if shareholders were not protected in these cases, creditors were, and as a result the implicit subsidy in interest rates may remain. If so, this should continue to motivate shareholders to pursue "cheap" sources of financing at the price of excessive leverage.'

105 Flannery 2010, p. 378-379; Bliss & Flannery 2002.

106 Flannery 2010, p. 378-379; Bliss & Flannery 2002.

107 E.g., Tröger 2018, p. 40-41; Acharya, Anginer & Warburton 2016.

108 Tröger 2018, p. 40, who refers to the studies by Acharya, Anginer & Warburton 2016; Morgan & Stiroh 2005. *See also* Avgouleas & Goodhart 2015, p. 19; Hüpkes 2011, para. 5.02.

for government rescues and those that are not. Moreover, empirical studies conclude that expected government support to banks has influenced the willingness of the banks to take on more risks.[109] Such studies also indicate that the banks that had a governance structure that made them accountable to their shareholders took large risks to pursue policies favored by these shareholders and ultimately performed poorly during the financial crisis because the risks led to significant losses.[110]

In sum, the 'too-big-to-fail' consideration has created a moral hazard problem. Moreover, the prospect of government support to a bank may encourage a potential purchaser of the failing bank or a part of its business to wait until the financial situation is so bad that it can claim public financial assistance as part of the deal.[111] Also, if insolvency is not a sufficient threat, the management of the bank may fail to take steps to prepare for and initiate an insolvency procedure.[112]

2.2.3 Compromise: a bank resolution framework

It follows from the analysis in the previous sections that for a failing bank for which the initiation of an insolvency procedure is not appropriate, an ideal bank resolution framework strives for some of the policy goals pursued by insolvency law. In particular, it should aim to address the moral hazard problem, for instance, by ensuring that in the event of a failure the shareholders and creditors bear the losses, as they would do in an insolvency procedure. Furthermore, we should add some of the objectives pursued if public financial support is provided to a bank, including ensuring financial stability and access to critical functions.[113]

According to Hüpkes, the objectives of a bank resolution framework should be six-fold.[114] Chapter 6 will show that the EU bank resolution framework includes these objectives.[115] First, the framework should create adequate ex-ante incentives to comply with contractual obligations and promote market discipline. Thus, it is not the function of the resolution framework

109 Tröger 2018, p. 40, who refers to the study by Brandao Marques, Correa & Sapriza 2013. *See also* Krimminger 2011, para. 11.11.

110 Armour 2015, p. 459, who refers to the study by Beltratti & Stulz 2012 and *see* Coffee 2010, p. 15-18.

111 Ayotte & Skeel 2010, p. 485.

112 Ayotte & Skeel 2010, p. 485-486.

113 *See* Schillig 2016, p. 54-55; Beck 2011, p. 58-64, who claim that a bank resolution framework provides a trade-off between objectives that have often been presented as being at different ends of the spectrum. These objectives are, on the one hand, minimizing external costs and, on the other hand, strengthening market discipline.

114 Hüpkes 2010, p. 219-220. *See also* Claessens, Herring & Schoenmaker 2010, p. 58-59.

115 Paragraph 4 of chapter 6.

to eliminate the risk of business failure.[116] Second, the regime should aim to maximize the value of the failing business that can be distributed to debtors, creditors, and possibly other parties. Third, it should allocate the assets amongst creditors by respecting the insolvency hierarchy of claims so that the pre-failure entitlements are respected in the resolution procedure.[117] These objectives derive from general insolvency law.

Three additional objectives come into play in a bank resolution procedure.[118] First, the resolution framework should enable the competent resolution authorities to intervene rapidly to attempt to limit contagion effects. Second, it should ensure the continuity of the critical functions of the bank for the financial system, such as payment services. Finally, the bank resolution framework should enable the continuity of access of depositors to their funds or prompt repayment of these funds.[119]

An example of a possible bank resolution measure is the isolation and transfer of a part of the business of the failing bank to a temporary bridge bank or a 'healthy' bank so that some functions are continued, such as the deposit-taking activities. When other parts of the business, including the claims of the shareholders and subordinated creditors, are left behind with the residual bank that is placed into an insolvency procedure, this measure may have a positive effect on market discipline and contain moral hazard.[120] Creditors and shareholders of banks become more certain that they have to bear losses should the bank they invested in fail and, therefore, they are likely to have more risk-monitoring incentives and set funding prices that reflect the true financial condition of the bank.[121]

Although most scholars and policymakers agree that a special legal framework for bank failures that pursues the above-mentioned objectives should exist, worldwide less agreement exists about the form such a framework should take. For example, in the US, the question whether a large financial institution, including a bank holding company, should be resolved in an administrative procedure or a judicial procedure under the US bankruptcy

116 *See* Goode 2011, para. 1.57. In his famous book *Lombard street: a description of the money market* of 1873, Bagehot noted at p. 104 already that '[t]he cardinal maxim is that any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank.' As also quoted by Hüpkes 2000, p. 1. *See also* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee of the Regions and the European Central Bank, An EU framework for crisis management in the financial sector (COM(2010) 579 final, 20.10.2010), p. 2: 'Banks must be allowed to fail, like any other business.'

117 Hart 2000, p. 5.

118 Hüpkes 2010, p. 219-220. *See also* Claessens, Herring & Schoenmaker 2010, p. 58-59.

119 Hüpkes 2010, p. 219-220. *See also* Claessens, Herring & Schoenmaker 2010, p. 58-59.

120 *See* Beck 2011, p. 60-61.

121 *See* Massman 2015, p. 661; Jackson & Skeel 2012, p. 448.

Act has been fiercely debated.[122] In the EU, most commentators claim that an administrative, non-judicial resolution procedure should exist for a failing bank, including its a holding company.[123]

The next paragraph identifies the steps that have been taken at the EU level over the last decades towards the EU bank resolution framework and provides some introductory remarks about the BRRD and SRM Regulation.

3 EU BANK INSOLVENCY FRAMEWORK

3.1 Towards a European bank insolvency framework

In 1957, six European countries, i.e., France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg, signed the Treaty of Rome with the aim to create a European Economic Community (EEC). The Treaty did not consider a financial market part of the envisaged common market. At that time, the founding Member States regarded finance and its regulation part of the national sovereignty.[124]

The first European legislative instruments to build a single financial market were only adopted in the 1970s.[125] A directive on 'the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions'[126] aimed to create the equal regulatory and supervisory treatment of financial institutions operating in one jurisdiction.[127] In 1977, the First Banking Directive introduced the principle of home country control, according to which the country in which the bank obtains authorization

122 Schillig 2016, p. 56-59. *See also* e.g., US Treasury, 'Orderly Liquidation Authority and Bankruptcy Reform', Report to the President of the United States, 21 February 2018; Gordon & Roe 2017; Kirshner 2015, p. 830-834; Jackson & Skeel 2012; Jackson 2010; Morrison 2009. The US Financial CHOICE Act to replace the Orderly Liquidation Authority under the Dodd-Frank Act with a new, judicial bankruptcy procedure for systemically important financial institutions was proposed in 2017.

123 *See* Schillig 2016, p. 56. *Contra* Amend 2009, p. 597, who claims that '[d]ie Ausführungen zum Insolvenzrecht zeigen, dass ein modifiziertes Insolvenzplanverfahren geeignet wäre, auch zur Sanierung eines systemrelevanten Kreditinstituts beizutragen. Insofern bestehen erhebliche Zweifel, ob überhaupt die Notwendigkeit besteht, völlig neue Wege zu beschreiten, um ein eigenständiges Sanierungsverfahren für diese Kreditinstitute zu kreieren.'

124 Teixeira 2017, p. 536.

125 Teixeira 2017, p. 538.

126 Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions (OJ L 194, 16.7.1973, p. 1)

127 Dermine 2002, p. 3.

is responsible for the regulation and supervision of the bank, including its foreign branches across the common market.[128] The Second Banking Directive of 1989 took the next step in financial integration.[129] It incorporated the principles of a single banking license, home country control, and mutual recognition of national laws. Once a bank was authorized in a Member State, it was permitted to establish branches and supply financial services throughout the EEC, without further authorization of the authorities in the jurisdiction into which this bank expands.[130] A subsidiary, rather than a branch, remained subject to the supervision and regulation of the country in which it is established. Moreover, although the adoption of the legislative instruments constituted important steps in the development of a single financial market,[131] a European framework on mutual recognition of bank insolvency measures did not exist.[132]

In 1992, a report of the Basel Committee on the liquidation of a multinational bank identified many potential issues in a cross-border bank failure.[133] The study was published following the collapse of the Bank of Credit and Commerce International (BCCI), which operated in nearly 70 countries.[134] It concluded that because there was no supranational bank insolvency framework, a multinational bank failure was likely to involve separate insolvency procedures in different jurisdictions, with multiple insolvency trustees (or liquidators), and the interaction of different insolvency and other relevant national laws. Complexities and uncertainty could result from difficulties in determining the location of the assets of the bank, diverging national insolvency set-off laws, differences in deposit protection schemes, and the fact that authorities may attempt to protect certain assets of a bank or branch (supervisory ring-fencing).[135]

128 First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (OJ L 322, 17.12.1977, p. 30) and *see* Teixeira 2017, p. 538.

129 Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (OJ L 386, 30.12.1989 p. 1).

130 Teixeira 2017, p. 540; Dermine 2002, p. 4-5.

131 *See* Teixeira 2017, p. 536-541.

132 *See* Galanti 2002, p. 50.

133 Basel Committee on Banking Supervision, 'The insolvency liquidation of a multinational bank', December 1992.

134 Basel Committee on Banking Supervision, 'The insolvency liquidation of a multinational bank', December 1992, p. 1 and 17.

135 Basel Committee on Banking Supervision, 'The insolvency liquidation of a multinational bank', December 1992 and *see* Hüpkes 2010, p. 217.

Following the BCCI failure, European rules on deposit guarantee schemes were incorporated in the Directive on Deposit Guarantee Schemes of 1994.[136] The Settlement Finality Directive of 1998, the Winding-up Directive of 2001, and the Financial Collateral Directive of 2002 then also brought some harmonization in the field of bank insolvency law.[137]

With the Winding-Up Directive, the principles of home country control and mutual recognition of the First and Second Banking Directive were implemented into a bank insolvency framework. The framework is aimed at 'the elimination of any obstacles to the freedom of establishment and the freedom to provide services within the Community'.[138] The directive covers 'reorganisation measures'[139] and 'winding-up proceedings'[140] in relation to banks and their branches in other EU Member States. It provides that these measures and procedures are decided on by the administrative or judicial authorities of the Member State in which the authorization of the bank has been granted, and are, in principle, governed by the law of this so-called 'home Member State'. Furthermore, these measures and procedures are automatically recognized and effective in the Member States in which the bank and its branches operate.[141]

However, the Winding-up Directive did not introduce similar coordination and recognition in relation to separate legal entities (subsidiaries) within a banking group. These legal entities are subject to separate reorganization

136 Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5). The directive was amended by Directive 2009/14/EC of the European Parliament and the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay (OJ L 68, 13.3.2009, p. 3) and Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) (OJ L 173, 12.6.2014, p. 149).

137 *See* Galanti 2002, p. 50-51.

138 Recital 1 Winding-Up Directive. *See* Hüpkes 2000, p. 164-165.

139 Article 2 Winding-Up Directive, as amended by article 117 BRRD, now defines the term 'reorganisation measures' as 'measures which are intended to preserve or restore the financial situation of a credit institution or an investment firm as defined in Article 4(1), point (2) of Regulation (EU) No 575/2013 and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims; those measures include the application of the resolution tools and the exercise of resolution powers provided for in Directive 2014/59/EU.' *See* Wessels 2017, para. 3.26-3.60.

140 Article 2 Winding-Up Directive, as amended by article 117 BRRD, now defines the term 'winding-up proceedings' as 'collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure.' *See* Wessels 2017, para. 3.61-3.106.

141 The Winding-Up Directive creates some exceptions to the principle that the law of the home Member State determines all the effects of the reorganisation measures or winding-up proceedings, including for netting agreements and employment contracts. *See* Recitals 23 and 24 and articles 20-33 Winding-Up Directive. *See* Wessels 2017, para. 3.107-3.172.

measures and liquidation procedures in their jurisdictions, even though in practice the activities of banking groups are often heavily intertwined.[142] Also, the Winding-up Directive harmonized procedural aspects of bank insolvency law, but substantive insolvency law remained in the hands of the legislatures of the Member States. The literature indicates that in the years following the entry into force of the Winding-up Directive, considerable differences existed between the national bank insolvency frameworks in the EU. Diversity existed, for example, in the powers of competent supervisory authorities to impose a moratorium, the threshold conditions for the initiation of insolvency procedures, and the involvement of the court.[143]

The financial crisis that started in 2007 and intensified in 2008 put bank insolvency law back on the agenda of the EU legislature. The case of Fortis and case of HRE, for example, showed which challenges governments and authorities may face if a bank resolution framework is absent. The cases demonstrated that requirements to seek approval of the shareholders may slow down or block a rescue plan for a distressed or failing bank.[144] The former case also showed that governments or authorities may tend to pursue national objectives and adopt domestic solutions rather than a solution for a cross-border group as a whole.[145] It has been argued that the outcome of the Fortis case 'was an obvious setback to financial integration in the Benelux and was likely significantly more costly than a first-best join solution for the group as a whole would have been.'[146] According to Beck, the lack of a more comprehensive legal framework for cross-border bank resolution was 'one of the major weaknesses' of the bank resolution frameworks in the EU in those days.[147] We will consider both cases in turn.

142 *See* Fonteyne et al. 2010, p. 50; Hüpkes 2005, p. 494. *See also* Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final, 6.6.2012), p. 89; Garcia, Lastra & Nieto 2009.

143 Garcia, Lastra & Nieto 2009. *See also* Čihák & Nier 2012, p. 417-418; Hüpkes 2005.

144 Čihák & Nier 2012, p. 401.

145 Lupo-Pasini 2017, p. 108-109; Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final, 6.6.2012), p. 111; Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 11.

146 Fonteyne et al. 2010, p. 13.

147 Beck 2011, p. 53.

Fortis was a Dutch-Belgian financial conglomerate with significant subsidiaries in Belgium, the Netherlands, and Luxembourg. It was regarded as systemically important in these countries.[148] When it experienced liquidity problems in September 2008, the governments of these jurisdictions stepped in and injected funding to stabilize the financial position. Unfortunately, this measure failed to calm the markets and depositors, and continuing deposit withdrawals caused new liquidity problems.[149] The authorities did not consider the opening of an insolvency procedure a suitable option because that was thought to have a significant impact on financial stability.[150] The three governments subsequently decided to proceed individually and to split Fortis into national parts.[151] The Dutch government nationalized the Dutch banking and insurance subsidiaries. The Belgian and Luxembourg government sought to sell a large stake of the Belgian-Luxembourg parts to the French bank BNP Paribas.[152] However, in December 2008 a Belgium court suspended the sale to BNP and ruled that the sales to the Dutch government and Belgium government, and the subsequent sale to BNP, needed the approval of the shareholders of Fortis.[153] The authorities did not have the legal powers to intervene quickly by overriding the rights of the shareholders.[154] After the shareholders initially opposed the plans and certain transactions were renegotiated, the shareholders approved the plans at a second meeting.[155]

The HRE case shows that even if the procedure remains within the borders of one country, it may be difficult to resolve a failing bank.[156] When HRE experienced financial problems in 2008, it was one of the largest commercial property lenders in Germany and a major issuer of covered bonds.[157] Because of its size and stake in the covered bond market, a failure was considered unacceptable.[158] When the liquidity support and government guarantees proved insufficient, the German decided to nationalize it.[159] This idea

148 Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 10.
149 Herring 2011, p. 43.
150 Marinč & Vlahu 2011, p. 43.
151 Lupo-Pasini 2017, p. 108-109; Čihák & Nier 2012, p. 430.
152 Wiggings, Tente & Metrick 2015, p. 9.
153 Claessens, Herring & Schoenmaker 2010, p. 50; Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 11.
154 Čihák & Nier 2012, p. 401.
155 Claessens, Herring & Schoenmaker 2010, p. 50; Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 11.
156 Fonteyne et al. 2010, p. 13.
157 Mitchell 2017, p. 81; Hopt, Kumpan & Steffek 2009, p. 541.
158 Mitchell 2017, p. 82; Hopt, Kumpan & Steffek 2009, p. 541-542.
159 Hopt, Kumpan & Steffek 2009, p. 542.

led to resistance of a large group of shareholders, who lobbied for generous state rescue terms.[160] The Bundestag enacted emergency legislation, i.e., the Financial Market Stabilization Act (*Finanzmarktstabilisierungsgesetz*) and the Financial Market Stabilization Supplementary Act (*Finanzmarktstabilisierungsergänzungsgesetz*), to amend company and takeover law. The government agency Special Fund for Financial Market Stabilization (*Sonderfonds Finanzmarktstabilisierung*, SoFFin) initially bought a small percentage of the shares in HRE's capital and then raised its share to almost 50 percent.[161] It offered high prices for the shares to induce shareholders to voluntary sell their entitlements and did not expropriate their entitlements.[162] After the endorsement of a further capital increase by the general meeting of shareholders, the SoFFin brought its stake up to 90 percent and then squeezed out the remaining shareholders under the recently amended rules.[163] The literature claims that without these new rules of company and takeover law, the German government would have been unable to nationalize HRE by October 2009.[164]

3.2 EU bank resolution framework

The (proposals for) reforms of the EU bank insolvency framework in the aftermath of the latest financial crisis have been extensively discussed in policy documents,[165] books,[166] and articles.[167] A significant development was the introduction of the BRRD and SRM Regulation. The EU bank resolution framework created by these EU legislative instruments broadly has two goals: (1) to strengthen the existing national bank resolution frameworks, and (2) to establish cross-border coordination and cooperation and bring the Member States closer towards the same standards for the resolution of failing banks in the EU. Paragraph 3.2.1 examines the bank resolution procedure introduced by the BRRD. Paragraph 3.2.2 then makes some remarks about the cross-border convergence sought by the BRRD and the unified decision-making procedure under the SRM Regulation.

160 Mitchell 2017, p. 85.
161 Hopt, Kumpan & Steffek 2009, p. 542.
162 Mitchell 2017, p. 86; Hopt, Kumpan & Steffek 2009, p. 526 and, critically, Hellwig 2012, p. 39-41.
163 Hopt, Kumpan & Steffek 2009, p. 542. *See also* Bornemann 2015, p. 456-459; Mitchell 2017, p. 86.
164 Čihák & Nier 2012, p. 401-402; Hopt, Kumpan & Steffek 2009, p. 535. *See also* Schuster 2010.
165 E.g., Merler 2018; Van der Zwet 2011.
166 E.g., Schillig 2016; Grünewald 2014.
167 E.g., Tröger 2018; Wojcik 2016.

3.2.1 Bank resolution procedure under the BRRD

The BRRD promises to establish a mechanism 'to prevent insolvency or, when insolvency occurs, to minimize negative repercussions by preserving the systemically important functions of the institution concerned.'[168] It requires Member States to designate a public administrative authority that performs all resolution functions and tasks and closely cooperates with, inter alia, the relevant supervisory authorities.[169] Each resolution authority 'has the expertise, resources and operational capacity to apply resolution actions, and is able to exercise their powers with the speed and flexibility that are necessary to achieve the resolution objectives.'[170] In many EU Member States, such as the Netherlands and Germany, the competent supervisory authority is the designated resolution authority.[171]

The legal framework created by the BRRD rests on three pillars: (1) preparation, (2) early intervention, and (3) resolution. First, Title II BRRD, which has the heading 'Preparation', requires banks and the competent supervisory and resolution authorities to draw up and maintain recovery and resolution plans. These plans set out the measures to be taken, respectively, to restore the financial position of the bank or to resolve it. The provisions under this Title also require the resolution authorities to ensure the non-disruptive resolvability of banks under insolvency law or the bank resolution framework. Second, Title III BRRD provides for specific measures the competent supervisory authority can take when the bank no longer meets or is likely to infringe the prudential requirements. These early intervention measures include the requirement to make changes in the business strategy and to remove or replace members of the bank management. Finally, Title IV BRRD, which is entitled 'Resolution', creates a regulatory alternative to an insolvency procedure for a bank under national insolvency law to resolve a failing or near-failing bank with the goal to, amongst other things, preserve systemic stability and minimize moral hazard.

Insolvency procedure or resolution procedure for a bank
Under the BRRD an insolvency procedure remains the preferred procedure for a distressed bank. In other words, the harmonized bank resolution procedure does not aim to replace an insolvency procedure. A resolution procedure under Title IV BRRD is triggered if a bank meets the conditions for resolution set out in article 32 BRRD. The conditions are that (1) it is con-

168 Recital 1 BRRD.
169 Article 3 BRRD.
170 Article 3(8) BRRD.
171 *See* paragraphs 2.3 and 3.3 of chapter 3. For an overview of all designated resolution authorities in the EU Member States, *see* the list of designated resolution authorities of the European Banking Authority, available at http://www.eba.europa.eu/about-us/organisation/resolution-committee/resolution-authorities.

sidered failing or likely to fail,[172] (2) any alternative private sector measure cannot prevent the failure, and (3) a resolution action is necessary in the public interest (i.e., it is necessary to fulfill the resolution objectives listed in the BRRD).[173] The resolution objectives include ensuring the continuity of 'critical functions'[174] of the bank and avoiding serious adverse effects on the financial system.[175] According to a Commission Delegated Regulation, a function is 'critical' if 'the function is provided by an institution to third parties not affiliated to the institution or group'. Furthermore, 'the sudden disruption of that function would likely have a material negative impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to the systemic relevance of the function for the third parties and the systemic relevance of the institution or group in providing the function.' Examples of such critical functions are deposit-taking, lending and loan services, payment, clearing, custody and settlement services, wholesale funding markets activities, and capital markets and investments activities.[176]

The BRRD leaves the resolution authorities discretion in their assessment of whether a bank meets the resolution conditions. The functions of the Italian banks Veneto Banca and Popolare di Vicenza, for instance, were mainly deposit-taking, lending activities, and payment services. In June 2017, the competent resolution authority, i.e., the Single Resolution Board (SRB), did not regard these functions 'critical' because they were provided to a limited number of third parties and they could be replaced. It decided not to take

172 The competent supervisory authority makes the 'failing or likely to fail' assessment, although the BRRD explicitly provides that the competent resolution authority may also make this assessment if that is provided for by national law. Article 32(1), (2) and (4) BRRD.

173 The competent resolution authority makes the assessment of whether alternative measures or actions could prevent the failure and whether the resolution action is in the public interest. Articles 31(2) and 32(1) and (5) BRRD.

174 According to article 2(1)(35) BRRD 'critical functions' are 'activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross- border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations'.

175 The other resolution objectives provided in article 31(2) BRRD are protecting (1) public funds by minimising reliance on extraordinary public financial support, (2) covered depositors, and (3) client funds and client assets.

176 Recital 4 and articles 6-7 Commission Delegated Regulation (EU) 2016/778 of 2 February 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to the circumstances and conditions under which the payment of extraordinary ex post contributions may be partially or entirely deferred, and on the criteria for the determination of the activities, services and operations with regard to critical functions, and for the determination of the business lines and associated services with regard to core business lines (OJ L 131, 20.5.2016, p. 41). *See also* Single Resolution Board, 'Critical functions: SRB approach in 2017 and next steps', 2018.

resolution action but to initiate an insolvency procedure.[177] As already indicated, although the bank resolution framework has now been significantly reformed and harmonized at the EU level, insolvency procedures for banks under insolvency law have remained largely in the hands of the national legislatures and regulators. Thus, the two failing Italian banks were placed into an insolvency procedure under Italian insolvency law because the 'public interest' resolution condition was not met.

If the resolution authority decides to initiate a resolution rather than an insolvency procedure, it has a toolbox at its disposal to resolve the bank in an administrative, non-judicial procedure. The resolution rules mandate that the management of the bank is dismissed in the procedure.[178] The toolbox consists of four 'resolution tools' and of 'resolution powers' to assist the implementation of the resolution tools. Examples of the resolution powers are the powers to replace or remove the management of the bank and to temporarily suspend termination rights of contractual counterparties.[179] The resolution tools are the sale of business tool, bridge institution tool, asset separation tool, and bail-in mechanism. The first three tools empower the resolution authority to reorganize the failing bank by transferring shares, or assets, rights, and liabilities to a bridge institution, private sector purchaser or an asset management vehicle.[180] Chapter 6 of the present study analyzes these three transfer tools in further detail.

Private sector contributions through bail-in

The bail-in mechanism enables the resolution authorities to change contractual rights of the shareholders and creditors by ordering a write-down of capital instruments and liabilities and subsequently swap liabilities for new equity.[181] The BRRD and the literature on bank resolution put much emphasis on this mechanism, which chapter 5 examines in more detail. Bail-in should enable the failing bank to recapitalize swiftly. It is also designed to remove the implicit guarantees of government support by requiring the participation of the shareholders and creditors in bearing the costs of restoring the balance sheet of the bank as an alternative to the injection of public money. As a result, the price of bank capital and debt instruments should be more sensitive to the risks the bank faces.[182] Only if the resolution authorities have imposed losses representing 8 percent of the liabilities on the shareholders and creditors, they can use the resolution fund that is filled

177 Single Resolution Board, 'The SRB will not take resolution action in relation to Banco Popolare di Vicenza and Veneto Banca', press release, 23 June 2017. *See also* Merler 2017.

178 Article 34(1)(c) BRRD; Article 15(1)(c) SRM Regulation. The management body and senior management is not replaced if retention of the management is considered to be necessary for the achievement of the resolution objectives.

179 Articles 63(1) and 71 BRRD.

180 Articles 38-42 BRRD.

181 Articles 43-55 BRRD.

182 Tröger 2018, p. 41.

with contributions from the banking sector, for example, to guarantee the assets or liabilities of or make loans to the bank under resolution or a bridge institution.[183]

When the BRRD was adopted in May 2014, the idea to require financial contributions from the creditors and shareholders to restore the financial position of a bank was not new at the EU level.[184] The EU rules on state aid to banks already contained the requirement of burden sharing. Articles 107 and 108 TFEU exceptionally allow the granting state aid to a bank to 'remedy a serious disturbance in the economy of a Member State',[185] provided that the European Commission approves the measure. The overarching goal is that state aid to the banking sector should be limited to prevent competition distortions and counter moral hazard.[186] According to the Commission in its Banking Communication of July 2013, the burden sharing requirement means that '[t]he bank and its capital holders should contribute to the restructuring as much as possible with their own resources. State support should be granted on terms which represent an adequate burden sharing by those who invest in the bank.'[187] It continues that the requirement normally entails, 'after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent.'[188] Similar to the bail-in mechanism under the BRRD,[189] the contributions can take the form of a write-down or a conversion into equity, provided that financial stability concerns do not require a different approach.[190] In contrast to the mechanism under the bank resolution framework, however, the Commission does not require contributions from

183 Articles 44(5) and 101 BRRD. *See also* articles 27(7) and 67 SRM Regulation (on the use of the Single Resolution Fund).

184 For an extensive analysis of the EU state aid policy, the recent case law of the CJEU on state aid to the banking sector, and the relation of the EU state aid policy to the bank resolution framework, *see* Lo Schiavo 2018. *See also* Grünewald, p. 121-134.

185 Article 107(3)(b) TFEU.

186 European Commission, 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 ('Banking Communication') (2013/C 216/01), para. 15.

187 European Commission, 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 ('Banking Communication') (2013/C 216/01), para. 15.

188 European Commission, 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 ('Banking Communication') (2013/C 216/01), para. 41.

189 *Cf.* Wojcik 2016, p. 105, who considers the burden sharing requirement in the 2013 Banking Communication of the Commission 'functionally equivalent' to bail-in under the BRRD. *See also* Lo Schiavo 2018, para. 4.3.

190 European Commission, 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 ('Banking Communication') (2013/C 216/01), para. 45.

senior creditors such as senior bondholders.[191] Thus, if resolution procedure under the BRRD is not triggered, private sector contributions in line with the Communication are, in principle, required before any public support may be granted, including in the form of precautionary recapitalization of a solvent bank.[192]

Departure from more general insolvency law

Although the bank resolution frameworks may first appear to be a fundamental shift from insolvency law, they also contain resolution rules that replicate or refer to provisions of insolvency law or consider corporate restructuring and insolvency law practices.[193] Chapters 5 and 6 of the present study will show that the bank resolution frameworks incorporate some fundamental rules and principles of insolvency law. For example, they adhere to a 'best interest of creditors' or 'no creditor worse off'-principle and the starting point is that they follow the insolvency law's distributional order of priority. Also, the overall economic result of the bank restructuring achieved in a resolution procedure may not be very different than the result of the restructuring of another type of business, whether it is a restructuring within the same legal entity or through the establishment of a new one.[194] A resolution procedure may involve reorganization and liquidation and requires the shareholders and specified creditors to bear the losses. Thus, the resolution rules do not set aside insolvency law.[195]

Most of the deviations of the resolution rules from general insolvency law reflect the perticularities of a bank failure when compared to a more traditional business failure,[196] which special characteristics were considered in paragraph 2.2.1 above. As we saw already, insolvency law is traditionally mainly directed towards the interests of the creditors of the insolvent debtor. The bank resolution rules, by contrast, grant all powers over the resolution process to an administrative authority with the aim to facilitate immediate and firm action so that the resolution objectives such as the protection of financial stability can be pursued.[197] To secure the prompt action, the decisions of the resolution authority are, in principle, not subject to judicial review throughout the resolution procedure.[198] Appeal against a

191 Lo Schiavo 2018, para. 2.1.
192 *Cf.* Article 32(4)(d) BRRD. *See* Lo Schiavo 2018, para. 6.1.
193 *Cf.* Massman 2015, p. 631 and 644; Baird & Morrison 2011, p. 287, who make a similar claim as regards the US Dodd-Frank Act.
194 Schillig 2018, para. 3.2.
195 *Cf.* Massman 2015, p. 631 and 644; Baird & Morrison 2011, p. 287.
196 *Cf.* Massman 2015, p. 644.
197 *Cf.* Massman 2015, p. 645-646. *See* paragraphs 2.2 and 4.3 of chapter 5.
198 Article 85(1) BRRD provides that Member States may require that resolution decisions are subject to ex-ante judicial approval. The Netherlands, Germany and the UK have not opted-in to this possibility.

resolution decision may be made ex-post,[199] which illustrates the transition that has taken place in most Member States from the court-based regimes for bank insolvencies to an administrative system.[200]

The no creditor worse off-principle also illustrates the transition to an administrative system for bank failures.[201] Before a resolution authority implements any resolution measures, an independent expert has to provide an estimate of the treatment that the creditors and shareholders would have received, if the bank was wound up under 'normal insolvency proceedings' instead of put into resolution.[202] As chapter 6 will examine in further detail, a normal insolvency procedure is a collective insolvency procedure that is considered 'normal' for a bank under national insolvency law when compared to a resolution procedure, whether it is under general insolvency law or a bank-specific insolvency framework.[203] The preliminary valuation is meant to inform the resolution authority on the resolution actions that can be taken without breaching the no creditor worse off-principle.[204] If the shareholders and creditors incur greater losses in resolution, they are entitled to payment of the difference. For example, if the shareholders of the bank do not receive anything in a hypothetical insolvency procedure, cancellation of their shares by a resolution authority does not place them in a worse position.[205] The emphasis of the no creditor worse off-principle, however, lays on the final valuation which the expert makes as soon as possible after the resolution action. This valuation determines if compensation is to be awarded.[206] Thus, he compares the actual treatment of the creditors and shareholders in resolution with the hypothetical outcome of an insolvency procedure for these stakeholders.

The aim of the no creditor worse off-principle is generally understood as to give shareholders and creditors a potential right to compensation as required by human rights legislation on interferences with property rights.[207] Human rights legislation, however, does not require that the safe-

199 Article 85(2)-(4) BRRD.
200 Haentjens 2016; Grünewald 2014, p. 86. *See also* Massman 2015, p. 646.
201 Article 34(1)(g) BRRD and *see* paragraph 1 of chapter 1.
202 Article 36(8) BRRD.
203 Paragraph 5.3 of chapter 6 and *see* article 2(1)(47) BRRD.
204 For an analysis of the resolution valuations, *see* Gardella 2015, para. 11.46-11.57.
205 *See* Wojcik 2016, p. 120.
206 Articles 74-75 BRRD.
207 Tröger 2018, p. 63; Wojcik 2016, p. 121; Attinger 2011, p. 10-11. Van der Velden & De Serière 2018, p. 54 claim that the no creditor worse off-principle also has another aim: if the resolution authority expects the shareholders and creditors to be worse off in resolution than in an insolvency procedure, the opening of an insolvency procedure should be the preferred course of action. According to the present author, however, the resolution conditions in article 32 BRRD rather than the no creditor worse off-principle determine whether the authority should take resolution action or initiate an insolvency procedure.

guards for creditors and shareholders are based on precisely this principle on the comparison with a hypothetical insolvency procedure.[208]

The principle that is currently in place is based on existing concepts of national insolvency law. For example, under sections 153(2) and 272(2) of the Dutch Fw, a court denies confirmation (*homologatie*) of a proposed composition within a bankruptcy procedure (*faillissementsakkoord*) or within a suspension of payments procedure (*surseance-akkoord*) if the value of the assets of the insolvent estate considerably exceed the sum proposed in the composition. According to the literature and case law, the requirement entails that the court assesses whether the consideration for the creditors is significantly less than that given in a hypothetical liquidation of the debtor's assets.[209] Moreover, in an insolvency plan procedure under the German InsO, a German court can overrule a class of creditors which has not accepted the proposed insolvency plan. One of the requirements for such a court decision is that the members of the dissenting class are not placed in a worse position than without the plan.[210] Hence, these provisions of the Fw and the InsO require the court to determine ex-ante whether the creditors receive at least as much as they would receive in a liquidation procedure.

Under the Fw and the InsO the ex-ante application of the no creditor worse off-principle by the court determines whether the measures under the composition or plan can be taken. Under the BRRD, by contrast, the resolution measures can be implemented but ex-post compensation may be awarded under the no creditor worse off-principle.[211] This example illustrates that the resolution rules allocate wide-ranging powers over the resolution process to an administrative authority rather than a court. The ex-post payment claims for shareholders and creditors under the BRRD do not interfere with the legal result of the resolution action.[212] Any difference between the ex-ante and the ex-post resolution valuation does not reverse the validity of the decision taken by the resolution authorities but may alter the economic result for the creditors and shareholders if they are compensated.[213]

This institutional architecture does not entail, however, that a resolution authority may not be cautious in the implementation of specific resolution measures. Its decision is likely to be based on preliminary valuations and assumptions and the going concern perspective of the bank resolution rules may require a large number of liabilities to be bailed-in to ensure that a

208 *Cf.* Kastelein 2014, p. 146.
209 Wessels 2014, para. 8397a; Wessels 2013a, para. 6116. Section 153(2) Fw uses the terms 'considerably exceed' ('*aanmerkelijk te boven gaan*') whereas section 272(2) Fw only uses the term 'exceed' ('*te boven gaan*').
210 Section 245 InsO. *See* paragraph 4.2.3 of chapter 5.
211 *Cf.* Articles 74-75 BRRD.
212 Tröger 2018, p. 61; Wojcik 2016, p. 132.
213 Tröger 2018, p. 61; Wojcik 2016, p. 132.

bank is sufficiently recapitalized.[214] This going concern perspective may not always correspond with the gone concern approach (the liquidation value of the assets) that forms the basis for the valuation under the no creditor worse-off principle.[215] The resolution authorities have flexibility in the exercise of their resolution powers if the valuation shows that if the bank was placed into liquidation, the value of the assets of the bank would have impaired significantly and the creditors, therefore, would not have been paid back in full.[216] In December 2015, the bankruptcy trustees of the Dutch DSB Bank, which failed in 2009, announced that they offer almost all senior and subordinated creditors of this bank to pay in full their claims, minus the interest claims against the bank. This announcement shows that it is not self-evident that creditors of a bank suffer significant losses in a liquidation procedure.[217]

Bank resolution framework as part of bank insolvency law

Generally agreed definitions of the terms 'insolvency procedure' and 'resolution procedure', when referring to a bank, do not exist in the literature and policy documents.[218] Some studies use the term 'insolvency procedure' as an umbrella term for a resolution procedure and a traditional insolvency procedure for a bank under insolvency law, while some other documents prefer 'resolution' as the overarching term. For example, the term 'bank insolvency proceedings' in an IMF and World Bank policy paper on bank insolvency law, published in 2009, covers both 'bank restructuring', which aims 'to secure the continuation of the bank's business, in whole or in part, as an economic unit', and the placement of the bank into liquidation.[219] By contrast, in 2010, the Basel Committee recommended countries to have in place 'special resolution regimes' that include a 'liquidation option' for banks.[220] The previous sections showed that the BRRD makes a clear distinction between a bank resolution procedure on the one hand, and a 'normal' insolvency procedure for a bank on the other hand.[221] The proposal

214 Tröger 2018, p. 61-64. *Cf.* Article 46(2) BRRD. *See also* Gleeson & Guynn 2016, para. 9.71.

215 Tröger 2018, p. 63-64; Wojcik 2016, p. 123-125; Gleeson & Guynn 2016, para. 9.46 and 9.74-9.75; Adolff & Eschwey 2013, p. 969-971.

216 Gleeson & Guynn 2016, para. 9.46 and 9.74-9.75.

217 Bankruptcy report no 36 of the bankruptcy trustees of DSB Bank N.V. 30 April 2018 (Faillissementsverslag no. 36 van de curatoren van DSB Bank N.V. 30 april 2018), para. 8.6. *See also* Gleeson & Guynn 2016, para. 9.75.

218 *See* Schillig 2016, p. 9-11.

219 International Monetary Fund & The World Bank, 'An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency', April 2009, p. 15, 35 and 44.

220 Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 23-24. Similarly, according to the Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', October 2014, p. 7-8, one of the resolution powers of a resolution authority should be the power to 'effect the closure and orderly wind-down (liquidation) of the whole or part of a failing firm'.

221 *Cf.* Articles 2(1)(47) and 32(1) and (5) BRRD.

for the BRRD which the European Commission published in 2012 called the bank resolution regime 'a special insolvency regime for institutions'.[222]

The present study uses the term 'bank insolvency law' as an umbrella term for both bank resolution law and the more traditional bank insolvency law.[223] It characterizes bank resolution law as a part of bank insolvency law in the Netherlands, Germany and England. It should be noted, however, that this use of the term 'bank insolvency law' may not correspond with the views of some insolvency scholars that the term 'insolvency law' is to be used in a strict sense as only encompassing liquidation procedures responding to common pool problems.[224] It is in line, however, with the view of other scholars that insolvency law seeks to address both common pool problems and anticommons problems.[225]

The use of 'bank insolvency law' as an umbrella term seems to be justified by the fact that a bank resolution procedure often involves both reorganization and liquidation, for instance, if the resolution authority transfers a part of the banking business to a bridge institution and initiates a liquidation procedure for the residual entity.[226] Thus, the boundary between the two types of measures may be difficult to detect.[227] The Winding-up Directive, which is an important pillar of the EU bank insolvency framework,[228] distinguishes between reorganization measures and winding-up procedures for banks. It includes the application of resolution tools and powers in its

222 Explanatory Memorandum Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM(2012) 280 final, 6.6.2012, 2012/0150 (COD), p. 5.

223 *Contra* Schillig 2016, p. 9-11, who prefers to use the term 'resolution' as umbrella term for both the application of the resolution tools and powers and an insolvency procedure under insolvency law. Even though this book uses the term 'bank insolvency law' in a broad sense, a bank resolution procedure may not qualify as 'insolvency proceedings' in EU legislative instruments. Article 68(1) BRRD explictly provides that resolution measures under the BRRD may not be considered 'insolvency proceedings' under the Settlement Finality Directive. Article 2(j) Settlement Finality Directive defines 'insolvency proceedings' as any collective measure provided for in the law intended to wind up or reorganize the bank. *See* Haentjens 2017, para. 7.88-7.89. On the Settlement Finality Directive, *see* footnote 107.

224 E.g., Madaus 2018.

225 E.g., De Weijs 2012.

226 *Cf.* Article 37(6) BRRD and article 22(5) SRM Regulation, which provide that if the resolution authority transfers only a part of the bank under resolution's assets, rights and liabilities to a private sector purchaser or a bridge institution, the residual entity is to be 'wound up under normal insolvency proceedings' within a reasonable timeframe.

227 *Cf.* Moss, Wessels & Haentjens 2017, para. 2.54.

228 *Cf.* e.g., Moss, Wessels & Haentjens 2017.

definition of the term 'reorganisation measures'.[229] As a result, similar to other types of reorganization measures and liquidation procedures, bank resolution procedures are governed by the procedural, cross-border bank insolvency principles that the Winding-up Directive created.[230]

The boundaries between the conditions for the opening of a resolution procedure and for the initiation of an insolvency procedure have also become blurred. As already indicated, under the BRRD the threshold conditions for the commencement of an action by the resolution authority include the condition that the bank is 'failing or likely to fail'.[231] When a bank crosses the 'failing or likely to fail' threshold, the resolution authority determines if it initiates an insolvency procedure or a resolution procedure for the bank.[232] Chapter 6 will show that the Dutch Fw also explicitly refers to the 'failing or likely to fail' resolution threshold condition as one of the thresholds for the commencement of a bank insolvency procedure. Under the UK Banking Act 2009 (BA 2009), the 'failing or likely to fail' condition is one of the conditions for the BoE and the PRA to apply to the court for a bank insolvency order to start a bank insolvency procedure.[233] Besides reaching the traditional thresholds of cash flow insolvency and balance sheet insolvency, a bank is considered 'failing' if its violation of prudential banking requirements justifies the withdrawal of the authorization of the bank and if extraordinary public support is needed.[234] The 'likely to fail' condition is satisfied if the bank is expected to reach the 'failing' threshold 'in the near furture'.[235] Thus, an infringement or expected infringement in the near future of the requirements for the continuing authorization in a way that would justify the withdrawal of the authorization, including the own funds and liquidity

229 Article 2 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15); Article 117(2) BRRD, which define 'reorganisation measures' as 'measures which are intended to preserve or restore the financial situation of a credit institution or an investment firm as defined in Article 4(1), point (2) of Regulation (EU) No 575/2013 [CRR, LJ] and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims; those measures include the application of the resolution tools and the exercise of resolution powers provided for in Directive 2014/59/EU'. For a discussion of which procedures which within the scope of the Winding-Up Directive, *see* Moss, Wessels & Haentjens 2017, para. 2.54-2.55.

230 *See* Grünewald 2014, p. 101.

231 For an in-depth analysis of the circumstances under which a bank is deemed 'failing or likely to fail' under the BRRD, *see* Schelo 2015, p. 92-100.

232 Article 32(1) and (5) BRRD.

233 Paragraph 5.3 of Chapter 6.

234 Article 32(1) and (4) BRRD.

235 Article 32(4) BRRD.

requirements, is an important indicator that the authorities may need to consider the bank 'regulatory insolvent' and have to take action.[236]

Moreover, the literature recognizes that a resolution procedure attempts to address both common pool problems and anticommons problems, which insolvency scholars describe as a justification for liquidation and reorganization procedures.[237] As chapter 6 will discuss in more detail, the transfer tools offer an alternative means to distribute the value of the common pool of assets in a coordinated procedure.[238] Chapter 5 will ascertain that the resolution framework also seeks to overcome anticommons problems by granting an administrative authority the power to bind all shareholders and creditors to the necessary restructuring measures.[239]

3.2.2 *Harmonized procedures and coordinated and unified decision-making process*

The BRRD did not only aim to strengthen the existing national bank resolution frameworks but also to establish a harmonized legal framework for bank resolution. Furthermore, it requires cross-border cooperation and coordination between the national competent supervisory and resolution authorities. Such an integrated EU resolution regime has been widely recognized to be essential to resolve the mismatch between, on the one hand, the intertwined, cross-border group structures of many banks in the EU and, on the other hand, the largely national focus of the bank insolvency laws of the Member States.[240] The European Parliament, for instance, underlined in 2010 that

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236 *See* Gleeson & Guynn 2016, para. 9.44-9.45; European Banking Authority, Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU, Final Report, EBA/GL/2015/07, 26 May 2015. *See also* article 59 BRRD, which provides for some 'early' threshold conditions when the resolution authorities can exercise the write down or conversion of capital instruments and eligible liabilities tool. For a discussion of this tool, *see* paragraph 3 of chapter 5.

237 Madaus 2018; De Weijs 2012.

238 Paragraph 4.3 of chapter 6 and *see* Schillig 2018, para. 2.2; De Weijs 2013, p. 216.

239 Paragraphs 2.2 and 4.3 of chapter 5 and *see* Schillig 2018, para. 3.2; Schillig 2016, p. 65-66; De Weijs 2013, p. 217-221.

240 Fonteyne et al. 2010, p. 55 and *see* Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final, 6.6.2012), p. 11, which notes that '[w]hile the operation of cross border banks has become highly integrated, (with the result that business lines and internal services have become interconnected and cannot be easily separated along geographical borders of Member States), crisis management as well as related legislative frameworks of banks has remained national.' *See also* Grünewald 2014, p. 106-108.

> 'it is evident that the time has arrived for Europe to make choices between further steps towards a common future or a nationalistic path. The latter is definitely not a solution. But the implementation of the former requires a lengthy process of convergence and mutual trust building, while immediate solutions are needed to tackle the risks posed by Systemic Banks. [...] In fact, less than 50 banks (out of 12,000 in the EU) represent 70% of banking assets. The high risk they embody results from their size, complexity and interconnectedness with the rest of the system. Their problems send shock waves across sectors and countries.'[241]

Moreover, one of the recitals of the BRRD underlines that

> '[t]he absence of common conditions, powers and processes for the resolution of institutions is likely to constitute a barrier to the smooth operation of the internal market and hinder cooperation between national authorities when dealing with failing cross-border groups of institutions. This is particularly true where different approaches mean that national authorities do not have the same level of control or the same ability to resolve institutions. Those differences in resolution regimes may affect the funding costs of institutions differently across Member States and potentially create competitive distortions between institutions. Effective resolution regimes in all Member States are necessary to ensure that institutions cannot be restricted in the exercise of the internal market rights of establishment by the financial capacity of their home Member State to manage their failure.'[242]

Thus, the BRRD is an instrument of the EU legislature to avoid obstacles to the exercise of the freedom of establishment and the free provision of services within the EU internal market.[243] Ensuring that the Member States have similar approaches to and procedures for bank resolution should avoid competition distortions in the banking sector in the EU. It should create a level playing field.[244] Also, the greater convergence of the national resolution rules, including their objectives, the conditions for intervention, and the available tools, is regarded one of the crucial elements to promote

241 European Parliament, Committee on Economic and Monetary Affairs, 'Report with recommendations to the Commission on Cross-Border Crisis Management in the Banking Sector' (2010/2006(INI), 28 June 2010), Explanatory Statement, para. 13-14.

242 Recital 9 BRRD.

243 Recital 3 SRM Regulation. The BRRD was adopted on the basis of article 114 TFEU. For an extensive analysis of article 114 TFEU as the legal basis for most EU legislative instruments that established the Banking Union, including the BRRD, *see* Tuominen 2017.

244 *See* Tuominen 2017, p. 1369.

the coordinated resolution of banks that have operations in multiple countries.[245]

To this end, the BRRD aims to bring all EU Member States closer towards the same resolution standards as part of the EU Single Rulebook, which is the common regulatory framework for the banks in the EU internal market.[246] As chapter 7 will discuss in more detail,[247] the European Banking Authority (EBA), which is an EU agency, plays an essential role in achieving consistency in the interpretation and application of this regulatory framework by developing binding and non-binding regulatory documents.[248] Examples include its technical standards, guidelines, and opinions. Furthermore, Title V BRRD contains rules on the resolution of internationally operating banking groups and the preparation of the resolution decisions by authorities in resolution colleges.[249] As indicated above, the resolution of a cross-border operating bank is also governed by the procedural, cross-border bank insolvency principles that were created by the Winding-up Directive.

In addition to contributing to the convergence of the bank resolution framework in the EU, the EU bank resolution framework has sought to entrust the decision-making on the resolution of some banks to a central authority. Under the SRM Regulation, the SRB applies many of the resolution rules of the BRRD in a unified and centralized resolution procedure for the 'signifi-

245 *See* Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (COM(2012) 280 final, 6.6.2012), p. 18; Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group', March 2010, p. 26-27; Fonteyne et al. 2010, p. 50. *See also* Herring 2003, p. 38.

246 *Cf*. The report of the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, 25 February 2009 (De Larosière Report), p. 27-29, which stressed that the EU financial sector should be equipped with 'a set of consistent core rules.'

247 Paragraph 3.2 of chapter 7.

248 Regulation 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12) (EBA Regulation), as amended by Regulation 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013 (OJ L 287, 29.10.2013, p. 5).

249 *See* Haentjens 2017, para. 8.01-8.13.

cant'[250] and cross-border operating banks in the nineteen EU Member States that form the Euro Area, including the Netherlands and Germany.[251] In relation to the other banks within the SRM, the national resolution authorities are directly responsible to adopt the resolution decisions. These other banks are the banks that are considered less-significant and do not have a parent and subsidiaries established in more than one SRM participating Member State.[252]

The SRM is the second pillar of the Euro Area's Banking Union, in which the European Central Bank (ECB)'s centralized banking supervision within the Single Supervisory Mechanism (SSM) constitutes the first pillar.[253] It builds on the substantive, common foundation created by the BRRD. Under the SRM Regulation, the SRB draws up the resolution plans and adopts all decisions relating to the resolution of the significant and cross-border operating banks.[254] Thus, for these banks the Board sidesteps the national resolution authorities in the assessment of whether a resolution or insolvency procedure needs to be initiated.[255] It can then adopt a resolution scheme that specifies which resolution tools need to be applied and resolution powers need to be exercised.[256] If the European Commission and the Council have not expressed any objections to this decision,[257] the scheme enters into force and the relevant resolution authorities at national level implement it based on national law transposing the BRRD.[258] The national resolution

250 Article 6 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63) (SSM Regulation) stipulates that a bank is considered 'significant' if (1) the total value of its assets exceeds EUR 30 billion; (2) the ratio of its total assets over the GDP of the Member State of establishment exceeds 20 percent (unless the total value of its assets is below EUR 5 billion); (3) following a notification by the relevant national supervisory authority that it considers the bank of significant relevance with regard to the domestic economy, the ECB considers the bank of significant relevance; (4) the ECB considers, on its own initiative, the bank of significant relevance; (5) it is one of the three most significant banks established in a Member State; or (6) it is a beneficiary of direct assistance from the European Financial Stability Facility or the European Stability Mechanism.

251 Article 7(2) SRM Regulation; Article 6(4)-(5) SSM Regulation. According to the European Court of Auditors, in January 2017 the SRB was competent to take the resolution decisions for 141 banks: 8 global systemically important banks, 118 other significant banks and 15 cross-border less significant banks. *See* European Court of Auditors, 'Single Resolution Board: Work on a challenging Banking Union task started, but still a long way to go', Special Report December 2017, no. 23.

252 Articles 2, 3(1)(24) and 7(2)-(3) SRM Regulation.

253 *See* Wojcik 2016, p. 93-95 and 100-104; Zavvos & Kaltsouni 2015.

254 Articles 7(2)-(5) SRM Regulation.

255 Article 18(1) SRM Regulation.

256 Article 18(6) SRM Regulation.

257 Article 18(7)-(8) SRM Regulation.

258 Articles 18(9) and 29 SRM Regulation.

authorities have to cooperate closely with the Board when carrying out their responsibilities under the SRM Regulation and inform the Board of the resolution measures they may take.[259]

4 Conclusions

This chapter discussed the desirability of a special legal framework for bank failures and analyzed which bank insolvency rules exist at the EU level.

Paragraph 2 examined the main policy goals of general insolvency law and why a corporate insolvency procedure may not work for a failing bank. It is generally recognized that banks have to be considered different from many other types of companies because their failure can cause severe damage to the rest of the financial system and the broader economy. Nevertheless, the paragraph showed that a bank resolution framework does not reject the traditional framework of insolvency law, but it heavily relies on insolvency law. A bank resolution framework aims to both (1) replicate the economic outcome of an insolvency procedure for the shareholders and some of the creditors so that market distortions known as moral hazard are minimized, and (2) protect financial stability and the critical functions of banks, such as deposit-taking.

Paragraph 3 then explored the main developments in the field of EU bank insolvency law before the entry into force of the BRRD. It ascertained that before the latest financial crisis, only a few rules in the field of bank insolvency law were harmonized at the EU level. The Winding-up Directive provides for procedural, cross-border bank insolvency rules but does not harmonize substantive bank insolvency law. The paragraph also introduced the bank resolution procedure established by the BRRD. The cross-border convergence and coordination sought by the BRRD and the unified decision-making procedure under the SRM Regulation were discussed in the last sections of the chapter.

259 Article 7(3) SRM Regulation.