LEGAL ANALYSES

Three Paradigm Shifts in Recent Bank Insolvency Law

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Abstract

In this contribution, the authors identify three paradigm shifts underlying recent developments in bank insolvency law. The "new normal" of bank insolvency law, they argue, is characterised by public interest considerations taking precedence, non-judicial control of bank resolution, and a supranational approach to the same. This leads to a new area of law with its own characteristics: inter and infradisciplinary, as well as inter and supranational.

Introduction[1]

Financial law may not have been shaken, but it has certainly been seriously stirred over the last ten years. With some exaggeration, it might be contended that there has been no other area of law in which the developments have been so numerous or so fundamental. Moreover, financial law does not seem to have reached its final form or even steered into smoother waters yet. Recent developments in the rules relating to bank insolvency represent only one illustration of this position.

Traditionally, the legal regime governing a bank insolvency was generally aimed at the satisfaction of creditor interests, and courts were the main supervisors and referees of the bank's resolution, while their decisions were based on mainly national legislation. A bank in crisis then seemed a rather isolated and ad hoc event. But this has now become a rear window view. The last decade has seen paradigm shifts that seek to reach a balance between the various interests at stake, viz those of creditors, banks and society at large.

The main driver for these changes has been the global financial crisis that started in 2007 and the scale and magnitude of the havoc it caused, forcing the attention of policy makers, academics, practitioners, financial institutions and taxpayers alike to a subject until then relatively unknown: crisis management in the global banking sector. Until then the theme of crisis management in the banking sector was a *terra incognita*, or at best, very differently and minimally regulated. Then the spotlights turned to—in legal terms—bank restructuring and insolvency law as an area of coherent study, not only at a global level, but also at the regional level and at the level of national laws and regulations.

In this article, we will present what we consider to be three paradigm shifts underlying these recent developments in bank insolvency law. From the outset, it is of note that in some jurisdictions, most notably the US but also Australia, bank insolvency law has been an area of law with longstanding specific rules that have been reviewed (rather than drafted from scratch) in light of the global financial crisis. On the other side of the spectrum, jurisdictions such as China are drafting a brand new bank insolvency law and look at the developments in the EU for inspiration.[2] Thus, the role of European legislative developments extends beyond the borders of this continent.

More specifically, the EU has witnessed a dramatic integration in recent years as illustrated by the introduction of the Banking Union.[3] A common European deposit guarantee scheme, which initially was part of the Banking Union set-up, might still be a bridge too far for political reasons, although a latest initiative is aimed at the introduction of a "European Deposit Insurance Scheme".[4] However, this Banking Union has introduced harmonised bank insolvency rules for the entire EU and a unified application of those rules for the Eurozone. Our first conclusion, therefore, is that while the development of bank insolvency law has not followed an identical path across the globe, it has tremendously accelerated European integration in the area of, specifically, bank restructuring and insolvency law, but also and more

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[1] The following article is based, in part, on Matthias Haentjens and Bob Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector, Research Handbooks on Financial Law* (Cheltenham: Edward Elgar Publishing, 2015). See also Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution—A Conference Book* (The Hague: Eleven International Publishing, 2014).

[2] Since early 2014, the Leiden Law School's Hazelhoff Centre for Financial Law works together with the China University of Political Science and Law (CUPL, Beijing, China) in an innovative joint research project "New Bank Insolvency Law for China and Europe". Publication of interim results is foreseen later in 2016. The project is partly funded with a grant from the Royal Netherlands Academy of Arts and Sciences (KNAW).

[3] See, e.g. Danny Busch and Guido Ferrarini, *European Banking Union* (Oxford: Oxford University Press, 2015).

[4] Available generally at: *http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm* [Accessed 12 April 2016].

generally, of financial law.[5] Remarkable, in this respect, is that the driver of the development of bank insolvency law is not a national jurisdiction itself, rather a regional entity (EU) setting out the course for implementation on a national (Member States) level.

The European bank insolvency law integration just mentioned has been the result of the global financial crisis and, in part, of subsequent recommendations from international bodies such as the Financial Stability Board (FSB) and the Bank for International Settlements (BIS). The crisis not only resulted in bank insolvency law *stricto sensu* having been introduced or significantly amended, but many countries and regions have also witnessed the amendment or introduction of new capital requirements, supervisory and resolution regimes. These new regimes have a strong emphasis on preventing and avoiding bank failure, while structurally changing and moving focus from the traditional insolvency law aim of general protection of creditors to protecting the central economic and societal functions of banks. In our opinion, this has led to a dramatic shift in the balancing of public interests against individual interests. Next to the radical steps in European integration just referred to, we consider this shift—which we think is global—a second important general conclusion. The general dogmatic corner stones of private law (protecting legal positions of individuals) are being subordinated in favour of an externally oriented focus: the protection of public interests at large, including taxpayers financial positions.

Relating to the shift from the primacy of individual interests, especially of creditors, to the public interest just mentioned, we conclude that whereas traditionally, insolvencies in many countries had been under court control and supervision, bank insolvencies under the new rules tend to be—often entirely—controlled by (whether or not independent) government authorities, either state owned or acting independently. This shift, in our view, is not less dramatic than the other two, and represents major new challenges, especially in a cross-border context. In the following, we will further discuss these three general paradigm shifts, viz the shift, in short, from individual to public interest, from judicial to government authorities control and from European convergence to European harmonisation and unification.

From individual to public interest

Starting with the shift from individual to public interest, in many countries under the new rules promulgated in the context of bank crisis management, individual interests have been subordinated to public interest considerations in several instances. Individual interests so subordinated are the interests of (financial) counterparties of the failing bank, and of the failing bank itself. A prominent example of the first category, that is of interests of (financial) counterparties of the failing bank that are subordinated to public interest considerations, is the power of government authorities to bail-in, that is the power to write down, possibly to zero, claims creditors may have on a failing bank or to convert those claims into shares. One of the most contentious issues currently debated is the amount of "bail-inable" debt banks must be required to have, and also at which level in a banking group such debt should be issued. As these requirements of so-called "gone-concern loss-absorbing capacity" (GLAC) and "minimum required eligible liabilities" (MREL) must be internationally harmonised, it is of importance that no discrepancies arise between the international instruments regulating the same requirement and this discussion is intensively held at the supranational level.

Collateralised lending arrangements such as repurchase agreements, and financial derivate contracts represent another example where individual interests of (financial) counterparties of a failing bank are subordinated to public interest considerations. As a general observation, the new regulatory framework has introduced requirements that most derivatives be cleared at a clearing house guaranteeing the performance of both parties, and also traded on exchanges rather than negotiated privately by the two parties involved. Secondly, and as a drastic infringement on party autonomy and the freedom of contract, the new resolution framework reduces the privileges of close-out netting provisions in collateralised lending arrangements in financial derivate contracts. However, neither of these groundbreaking reforms have removed the main safe harbours for derivatives and other financial instruments from domestic insolvency regulations.[6]

An example of the second category of rules, that is of rules under which the interests of a (failing) bank itself are subordinated to the public interest, or, at least, under which the autonomy of banks is restricted for public policy reasons, are the new (or renewed) requirements as to the legal and operational structure of the bank. More specifically, it has now been widely accepted that banks must separate or ring-fence their wholesale activities and proprietary trading from the deposit taking part of the bank (or vice versa) so as to protect the depositors from the risks of proprietary trading. The US (by means of the Volcker Rule), the UK (as a result of the Vickers Report), France and Germany have all introduced rules to that effect while the EU may still be in the process of considering similar ones. However, these approaches differ in important ways. Other than the UK approach, for instance, the Volcker Rule would only require separating a limited set of trading and would continue to permit underwriting, market-making and asset management to remain on the banks' balance sheets. In any event, a truly harmonised regime within the EU, let alone globally, has become unlikely so that cross-border

[5] See Matthias Haentjens and Pierre de Gioia-Carabellese, *European Banking and Financial Law* (Abingdon: Routledge, 2015).
[6] See Francisco Garcimartín and Maria Isabel Saez, "Set-off, netting and close-out netting" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.331–344.

banks will have to comply with varying rules, which might not contribute to a reduction of complexity and risk.[7]

A last example of new rules which will result in the interests of the bank being subordinated to the public interest are the powers of government authorities to intervene in a bank's corporate governance. The new EU resolution regime established by the Single Resolution Mechanism Regulation (SRM Regulation)[8] and the Bank Recovery and Resolution Directive (BRRD)[9]—under some circumstances: radically—interferes with shareholders' rights and the powers of banks' boards, and thus, derogates from earlier EU legislation protecting those shareholders' rights.

Concluding, in our opinion, that virtually all relevant stakeholders of a bank, that is both the bank itself, its management and its shareholders, but also its (financial) counterparties, have been or will be affected by the new bank insolvency regimes. In short, as a crucial feature has emerged that party autonomy has been and will be restricted as primacy is given to public policy considerations of systemic stability. This policy decision implies a weighing of individual justice against welfare, but we conclude that legislators and policy makers practically never make such weighing explicit. We would argue, however, that it should be made explicit and must be done carefully, not only in the context of new rules of bank insolvency law *stricto sensu*, but also, for instance, when new rules are being developed to regulate "shadow banking". Shadow banking has been put high on the policy agenda of, for example, the FSB and of the European legislator, while repurchase agreements and structured credit products have recently become the subject of new European legislation.[10]

From judicial to government authorities control

The first paradigm shift (from individual interest to public interest) has also led to a dramatic shift from judicial to government authorities' control of bank (pre-)insolvencies. The primacy of control by authorities (rather than by a court) underscores the urgent need for international co-operation by those authorities in the context of bank insolvencies. Experiences in 2007 and 2008 have painfully demonstrated that international co-operation between supervisory and regulatory authorities is critical. Campbell and Moffatt have stated that in any large-scale bank failure it is necessary that authorities in all of the countries involved are able to work together, to share information and to take appropriate action with sufficient speed to ensure the best possible outcome. They conclude that, at present, such co-operation is unlikely to become available unless specific agreements are in place. At the same time, they are doubtful that an agreement in the form of a treaty will be feasible—at least with the US willing to be a party—in the near future, as "… ring-fencing and territorial dominance still appear to be the norm for the US authorities".[11] Moreover, it is still more than doubtful whether a common, single bank resolution procedure as established by means of the SRM Regulation will be effective as it will be limited to the Eurozone countries, which most notably leaves out the UK. Indeed it may be doubted that mechanisms for the safe resolution of failing banks with no or reduced taxpayer support can be successfully applied to cross-border groups, that is whether national or regional authorities will co-operate in a crisis so as to maximise value and ensure fair treatment of creditors, especially when authorities have to co-operate on a global level.

While the crisis has demonstrated the dramatic consequences of a lack of international co-operation between supervisory and regulatory authorities, virtually all new bank insolvency regimes have conferred far reaching powers and a large margin of discretion to those authorities. Under the European BRRD and SRM Regulation, for instance, resolution authorities have been granted the power to transfer shares, assets, rights and liabilities of financially distressed institutions to a third party free and clear and without shareholders' consent so as to facilitate the resolution of those financially distressed institutions. Moreover, under the same instruments they have been empowered to write down and convert into equity capital instruments and eligible liabilities so as to significantly deleverage an institution's balance sheet. Yet, as Schillig notes, "… the efficacy of such resolution tools and powers depends on the willingness and capability of resolution authorities to rigorously apply them in any given case", and he believes the wide discretion afforded to resolution and competent authorities under the BRRD and SRM Regulation, in particular in the context of establishing the "regulatory threshold" and the public interest requirement as a precondition for resolution, increases the potential for counterproductive political interference, financial sector lobbying and regulatory capture.[12]

[7] See Alexandria Carr, "Bank structural reform: too big to fail, too big to save and too complex to manage, supervise and resolve?" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.283–307.

[8] Regulation 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (1093/2010) [2014] OJ L225/1.

[9] Directive 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Directive 82/891, and Directives 2001/24, 2002/47, 2004/25, 2005/56, 2007/36, 2011/35, 2012/30 and 2013/36, and Regulations 1093/2010 and 648/2012 of the European Parliament and of the Council [2014] OJ L173/190.

[10] Regulation 2015/2365 on transparency of securities financing transactions and of reuse and amending Regulation 648/2012 [2015] OJ L337/1.

[11] See Andrew Campbell and Paula Moffatt, "Large scale bankruptcies and the challenges ahead" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.55–78. Similar concerns are expressed by Bob Wessels, "Giving Legal Effect to Foreign Resolution Measures in the Financial Sector" (2015) 28(3) *Insolvency Intelligence* 44–45, and Federico Lupo-Pasini and Ross P. Buckly, "International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects" (2015) 16 *European Business Organisation Law Review* 203.

[12] See Michael Schillig, "The EU resolution toolbox" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.81–102.

In the same vein, it has been argued that bank resolution managed by government authorities would become influenced by undue political considerations. These considerations are largely absent where bankruptcy courts oversee a resolution process that is driven by private parties,[13] and where the separation of powers (between administration and judiciary) has traditionally and fundamentally guaranteed the independence and impartiality of the judiciary. This argument is evidenced by several recent examples of bank resolutions across Europe that have proven to be highly politically charged, as was the case with the resolutions of Banca Etruria (Italy), Alpe Adria Bank (Austria), and Banco Espírito Santo (Portugal), which all happened in 2015.[14]

It goes without saying that the new powers of government authorities require further attention, not only to achieve the necessary level of cross-border co-operation, but also to remain critical of how their powers and discretion relate to the rule of law, that is whether these powers and large margin of discretion comply with, for example, the European Convention on Human Rights and Fundamental Freedoms of the Council of Europe and the Charter of Fundamental Rights of the European Union. Under the traditional insolvency regimes in which independent judicial oversight and control was the norm, the relationship with the rule of law seemed less problematic.

From national regulation to European harmonisation and unification

As referred to above, recommendations from international bodies such as the FSB and BIS have led, globally, to a light form of convergence of national bank insolvency regimes. Within the EU, such convergence has a longer history, as it has happened since Directive 2001/24 on the reorganisation and winding up of credit institutions.[15] Even more generally, European integration within the area of financial law has developed slowly yet steadily since the Directive 77/780 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.[16] Yet the European legislative responses to the Global Financial Crisis have led to a dramatic increase in integration if not to unification, most notably by the introduction of the Banking Union, so that the EU may be cited as a prominent example of the shift from (near) pure national solutions to a coordinated and even unified regional one.

Meanwhile, it should be clear that the solution created has not been really put to the test, as—fortunately!—no systemically important financial institution has failed or systemic crisis has materialised in Europe under the new regime. We believe an important problem in such instance would prove to be the current absence of a common fiscal backstop, and, perhaps even more pressingly, the absence of a common Deposit Guarantee Scheme (DGS).[19] More specifically, depositors may only be completely secure if some form of mutualisation is introduced and national sovereign risk is excluded.[17] Next to DGSs, depositor protection must be ensured through effective segregation of client assets and prompt access to segregated client funds when their bank finds itself in resolution. This segregation of cash, derivatives and securities must be accomplished by both operational and legal means, and EU legislation has already made significant progress through harmonisation in both fields.[18]

A prismatic field of law

Generally, global and regional law producing engines work slowly, but in the field of bank insolvency law fundamental changes have been accomplished at an extraordinary pace. Yet the proof of the effectiveness of the new rules on crisis management in the banking sector will be in the eating. Only real life experiences will learn whether the new bank insolvency regimes actually work. We believe that the optimal banking system for a given nation depends on its stage of development, its particular social values, its political system, and various idiosyncratic factors. Moreover, as in the area of general corporate restructuring and insolvency law, we acknowledge that the quality of the applicable rules is greatly dependent on the key players applying it.[19]

In any event, we may conclude that the current status of bank insolvency law is an enhanced coordinated employment and a common contemplation of crisis management, which has proven to be inter and infradisciplinary, as well as inter and supranational. Standard setters, policy makers and legislators all over the globe struggle with the same questions, albeit sometimes in a different legal tradition and context. Moreover, the financial crisis has shown the international

[13] P. Wallison, "The meaning of the Lehman Bankruptcy", before The American Bankruptcy Institute (American Enterprise Institute for Public Policy Research, 5 November 2009), as quoted by T.H. Jackson, "Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve (Restructure, Sell or Liquidate) Financial Institutions". Available at: *http://www.southbaylawfirm.com/blog/upload/bankingbailoutschapter11f.pdf* [Accessed 12 April 2016], fn.8.

[14] See, e.g. "Renzi faces political backlash over Italian banks' rescued", *Financial Times*, 10 December 2015; "Austrian court rejects Hypo bondholders case", *Financial Times*, 29 July 2015; and "'Sócrates effect' looms large in Portugal poll; Corruption claims: General election", *Financial Times*, 29 September 2015, respectively.

[15] Directive 2001/24 on the reorganisation and winding up of credit institutions [2001] OJ L12/15.

[16] Directive 77/780 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [1977] OJ L332/30. See Gabriel Moss and Bob Wessels, "General Introduction to the EU Insolvency Law Framework and Principles with regard to Financial Institutions" in Gabriel Moss and Bob Wessels (eds), *EU Banking and Insurance Insolvency* (Oxford: Oxford University Press, 2006), pp.3 onwards.

[17] George Zavvos and Stella Kaltsouni, "The Single Resolution Mechanism in the European Banking Union: Legal Foundation, governance, structure and financing" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.117 onwards, and Blanaid Clarke, "Deposit guarantee schemes" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.345–365.

[18] Matthias Haentjens and Pim Rank, "Legal and operational segregation of securities, derivatives and cash" in Haentjens and Wessels, *Research Handbook on Crisis Management in the Banking Sector* (2015), pp.366–378.

[19] See E. Dirix, "Het insolventierecht anno 2014" in H. Braekmans, E. Dirix, M.E. Storme, B. Tilleman and M. Vanmeenen (eds), *Curatoren en vereffenaars: actuele ontwikkelingen III* (Antwerpen—Cambridge: Intersentia, 2014), pp.3 onwards, and Ian F. Fletcher and Bob Wessels, *Harmonization of Insolvency Law in Europe, Preadvies 2012 uitgebracht voor de Vereniging voor Burgerlijk Recht* (Deventer: Kluwer, 2012), pp.78–84.

and supranational dimension of crisis management in the banking sector, so that new rules in this field should be enacted, analysed and interpreted on the same international and supranational basis.

Today's pertinent questions on bank insolvency law must be answered using an infradisciplinary approach, as this field is not restricted to one specific legal area, but relates to a wide area of legal matters which traditionally have been understood to belong to the realm of company law, (financial) regulatory law, private law, as well as insolvency law. Moreover, economic analyses play an important role and are remarkably characteristic of this new field of law, so that it is not only infra but also interdisciplinary. Moreover, it also includes—next to hard law—several forms of soft law, such as recommendations of international organisations and cross-border information exchange gentlemen's agreements between supervisors, which play such an important role in daily practice.

Bank insolvency law in the last ten years has developed itself to a fully-fledged branch of law that overlaps other branches of law, while it rubs and scours with fundamental values in these latter branches. The unfinished state of bank insolvency law will undoubtedly remain both challenging and inspirational for banking practice and academia alike for some time to come.