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Thinking ahead for Europe

Harmonising Insolvency Laws in the Euro Area

Rationale, stocktaking and challenges

Diego Valiante

No. 153 / December 2016

Abstract

There are four distinct areas where harmonising national insolvency frameworks could improve the functioning of the single market and the stability of the euro area. Early restructuring of businesses, bank resolution, cross-border insolvency and management of non-performing loans rely on common features of local insolvency frameworks, which can affect their legal certainty and operation. To promote a more entrepreneurial spirit, a pan-European framework for the early restructuring of businesses could offer a true second chance for entrepreneurs. To benefit from a capital markets union, insolvency frameworks would also need to remove sources of cost unpredictability in cross-border insolvency procedures, which are often hidden in national insolvency laws or are not sufficiently dealt with in the current EU framework. Moreover, measures to harmonise insolvency laws could have positive impacts on the banking union, and particularly those harmonising the hierarchies of claims could strengthen the functioning of the resolution mechanism. The diffusion of best practices in credit recovery procedures could help to improve the management of non-performing loans by fostering liquidity in secondary markets. In addition, this report contributes to defining areas for further action, such as the opening and governance of proceedings and reliefs.

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List of Abbreviations

BRRD	Bank Recovery and Resolution Directive
CJEU	Court of Justice of the European Union
COMI	Centre of main interest
CSR	Country-specific recommendation
GDP	Gross domestic product
IMF	International Monetary Fund
NCWO	No creditor worse off
NPL	Non-performing loan
TFEU	Treaty on the Functioning of the European Union
TLAC	Total loss-absorbing capacity
UNCITRAL	United Nations Commission on International Trade Law

Harmonising Insolvency Laws in the Euro Area Rationale, stocktaking and challenges

Diego Valiante*

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Executive Summary

Insolvency laws are entrenched in local legal systems and play a key role in the proper functioning of the banking system and capital markets. At the same time, effective insolvency proceedings could have tangible effects on the functioning of the single market for capital and banking services. The quality of insolvency proceedings across the euro area is generally lower than that in regions like the US and Japan, and it has barely improved in recent years.

Lately, potential conflicts between EU legislation (or the lack thereof) and national insolvency regimes have emerged in the following areas:

- business restructuring and a 'second chance';
- cross-border insolvency;
- bank recovery and resolution; and
- the management of non-performing loans (NPLs), along with the quality of national insolvency regimes.

As a result, distinct EU actions in these areas could be considered. In the area of business restructuring and a second chance for bankrupt entrepreneurs, regimes across the euro area are very diverse and often punitive for entrepreneurs. The European Commission will soon propose a directive that will introduce an early restructuring (pre-insolvency) regime to be implemented across the EU, together with a list of other actions that are reviewed in section 4.2. In doing so, the proposal could expand on other aspects that are relevant for the

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predictability of cross-border insolvency procedures, which have direct effects on cross-border capital market transactions (and so the capital markets union).

As data indicate, the quality of insolvency frameworks across the euro area is low on average and highly diversified across member states. This situation raises barriers to the development of a single market for capital, which relies on a smooth and coordinated legal framework. This report, therefore, suggests additional actions in the following areas:

- the opening of proceedings (with the introduction of a minimum liquidation evaluation);
- relief actions (with the harmonisation of suspect periods and a list of 'suspicious' and 'benign' transactions); and
- the governance of proceedings (with the introduction of a common period for a 'duty to file', a cramdown procedure and two options for a set of specialised insolvency courts).

In the area of banking union, different insolvency regimes can obstruct the effective functioning of the Single Resolution Mechanism, with implications for the stability of the financial system. There are two sets of measures for domestic insolvency regimes to be considered: those addressed at the (effective) functioning of the bank resolution mechanism and those aimed at improving the management of NPLs. Measures to enhance the resolution mechanism include

- statutory subordination (along the lines of a new class of debt securities that are non-retroactive and contractually subordinated, in keeping with the Financial Stability Board guidelines on total loss-absorbing capacity. A potential full harmonisation of the hierarchy of creditors across the EU would be highly beneficial with limited evidence of disruption for local legal and economic systems);
- a moratorium for bank resolution (perhaps with the introduction of a pre-insolvency procedure for the early restructuring of banks that would trigger an automatic stay);
- statutory preference in liquidation for Single Resolution Fund contributions; and
- a European principle of no creditor worse off through the creation of a pan-European liquidation procedure for banks.

Actions to advance market and supervisory practices in the management of NPLs mainly involve accelerated procedures for the repossession and sale of collateral. These measures could be taken as a package of reforms that are included in the oversight and monitoring efforts directly carried out by the European Commission and informally by the Eurogroup, through its work over the European Semester and oversight of national economic policies. However, this action would be confined to coordination and to moral suasion in pursuing European reforms. A formal role for the Eurogroup in the legal procedures or the legislative process cannot and should not be envisaged, due to its consultative nature and limited accountability, unless there is a clear change in the Treaties.

Finally, work is underway to define indicators that would help to identify best practices across the euro area to provide benchmarks for all the countries in the monetary union and beyond. Indicators could be used to create a scoreboard to measure progress in the development of more effective and harmonised insolvency regimes.

1. Setting the scene

Insolvency regimes are important for two reasons: i) they provide the general legal framework for investments (and their liquidation) across Europe; and ii) they can address the inefficiencies that create unnecessary costs for the financial system and thus the economy through higher funding costs (e.g. as effective tools to manage non-performing loans, NPLs).

Defining insolvency is a difficult task, as it plays a key role beyond supporting companies in financial difficulties. Insolvency proceedings can have different structures and objectives, with an important divide between the resolution and insolvency tools for financial and non-financial firms. This section provides a definition of insolvency and outlines the general framework for insolvency proceedings. It also discusses the economic rationale for insolvency proceedings and the quality of the current frameworks across the euro area.

1.1 What is insolvency?

Insolvency is a financial state in which a natural or a legal person (a firm) is unable to meet its financial obligations. This financial situation may lead to the disorderly enforcement actions of all the creditors, who are afraid to lose their money should the company be unable to generate sufficient revenues. Consequently, legislation seeks to avoid a creditors' run and make the procedures more effective and predictable. There are different insolvency proceedings for companies and individuals, but no distinction usually exists between financial (credit institutions) and non-financial institutions once they are in liquidation. To avoid knock-on effects on the banking system and hence a bank run, there are ad hoc resolution procedures for banks, now partially harmonised under the Bank Recovery and Resolution Directive (BRRD),[1] which entered into force on 1 January 2016. These resolution procedures intervene well before the insolvency materialises, allowing the orderly reorganisation of financial claims with limited risks for depositors and senior creditors of the bank. The result is that it is rare for a bank to enter a formal insolvency proceeding, or at least only pieces of its business might.

1.1.1 Insolvency proceedings

Formal insolvency proceedings entail a judicial process, in which a judge assesses whether the company/individual is insolvent and considers which legal proceedings best fit the situation. Moreover, to avoid a disorderly run of creditors on the company, a *pari passu* treatment of creditors ensures trust and predictability of the procedures through equal and fair treatment for the same categories of creditors (UNCITRAL, 2013; World Bank, 2015; see also Box 1 in section 3.1).

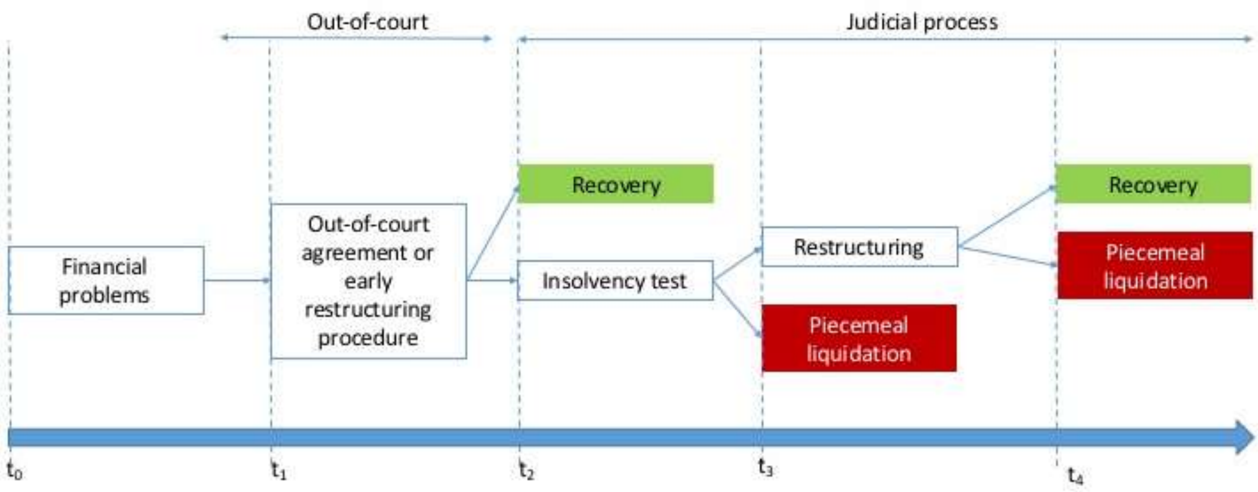
[1] See Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council Text with EEA relevance, OJ L 173, 12.6.2014.

While there are typically different proceedings for individuals and firms, the court has to declare both 'insolvent' before starting any formal procedure. Insolvency proceedings are available in two main forms:

1) restructuring, and
2) liquidation.

Restructuring proceedings require a majority of creditors to agree to a haircut or to sell part of the business if the liquidation scenario would be costlier. The liquidation, more specifically, is the piecemeal sale of all assets or of pieces of a 'going concern' business to cover creditors' claims (Figure 1).

Figure 1. Stylised insolvency timeline



Source: Author.

The financial states that could trigger an insolvency procedure are typically two:

1) cash flow insolvency (or financial distress), and
2) balance sheet insolvency (or economic distress).

Financial distress occurs when the debtor does not have enough liquidity to cover its obligations. Negotiation with creditors may resolve the insolvency (avoiding liquidation), through the (partial) sale of assets and the reorganisation of the payments of creditors' claims, especially if the value of the assets is still higher or close to the debtor's financial liabilities.

Economic distress occurs when the value of the liabilities is higher than the assets. This situation will soon lead to financial distress, so negotiation may lead creditors to accept a loss, if there is a prospect for the business to create value as a going concern. If the prospects as a going concern are negative, the company would not be economically viable and it would then enter into liquidation to satisfy creditors. For consumers, some member states adopt a trigger mechanism called 'over-indebtedness'. It is equivalent to a balance sheet test, whereby the level of liabilities (debt) and their growth prospects are overwhelmingly higher than the value of the consumer's assets. Across member states, the assessment can apply either to individuals or to households.

The ultimate objective of the insolvency proceeding may also differ across legal systems. In effect, an insolvency proceeding can aim at

- maximising value to satisfy creditors; or
- maximising value to satisfy all stakeholders and the economy as a whole, for instance, rehabilitating a business that would have been liquidated otherwise (IMF, 1999).

In practice, national laws attempt to balance both in the optimal division of bankruptcy value, while creditors have a more prominent role in the procedure. To achieve that, the formal insolvency proceedings provide powerful legal tools, like 'avoidance actions' to void fraudulent transactions or 'stays' to limit the number of enforcement actions that can be perpetrated by creditors.[2] The judicial process also offers legal certainty and reduces the risks of an inefficient and disorderly winding-up of cross-border groups (by granting legal recognition).

1.1.2 *Pre-insolvency and other 'out-of-court' procedures*

Growing recognition of the burden involved in official insolvency proceedings, in terms of time and costs, has led to much more focus on improving the tools available before a company becomes insolvent. Pre-insolvency proceedings are those actions that anticipate insolvency and overcome a debtor's financial difficulties as an alternative to costly judicial procedures. This framework is part of the measures that many countries are considering to complement national insolvency regimes and to make them more cost effective. These proceedings typically involve a restructuring plan to reorganise financial claims with the agreement of creditors, which courts only evaluate and approve at the end of the process (when creditors agree). In this way, the company avoids the stigma of being 'bankrupt' and the formal and costly judicial procedures.

Other credit recovery procedures that are not formally part of the insolvency also help to minimise the use of expensive insolvency proceedings. These procedures change according to the type of credit, and in particular whether it is a secured or an unsecured claim. Recent reforms in several countries, inspired by the 2014 Recommendation of the European Commission (European Commission, 2014a), have improved the framework for these preliminary procedures. In particular, Garrido (2012) gives the following classifications for the set of out-of-court procedures:

1) 'informal', when the debtor is able to come to an agreement with creditors on its own to overcome financial difficulties;
2) 'enhanced', when statutory law or other norms support the contractual arrangement; or
3) 'hybrid', when a judicial or administrative authority plays a partial role in the execution of the contract.

According to the individual case, these procedures can follow one after the other or they can become alternative options. For instance, a minority of creditors may aim at recovering their claims in full and begin enforcement actions that would jeopardise the business of the debtor, despite their agreement to share losses with the vast majority of the creditors. To solve the

[2] A stay (or so-called 'moratorium') suspends the rights of creditors to enforce their claims, so to allow the beginning of a structured procedure to repay all creditors (including them). It is a crucial tool when an insolvency proceeding begins, as it allows the orderly restructuring of the financial claims.

'hold-up' problems, a stay issued by the judge would suspend the enforcement actions and allow the debtor to run its business by allowing the financially distressed company to raise new financing without interference (World Bank, 2015). This judicial procedure complements out-of-court contractual solutions.

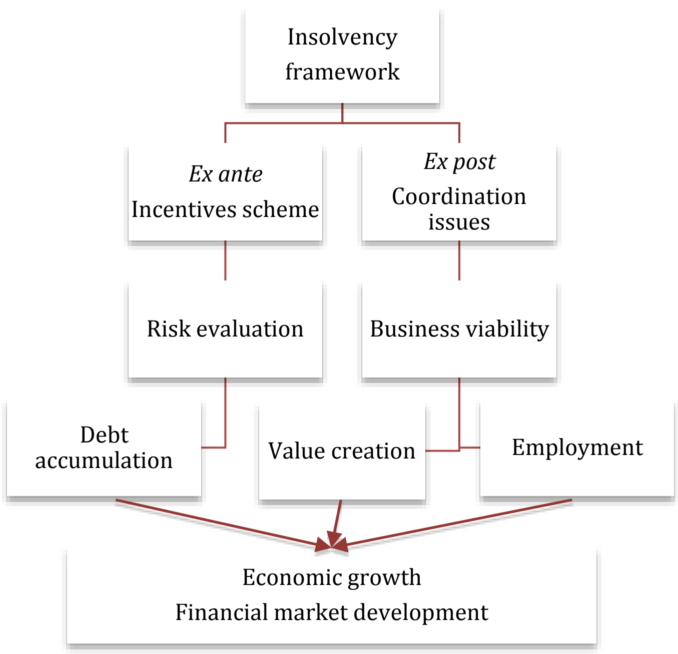
1.2 The economic impact of insolvency proceedings

There is a growing body of literature on the economic impact of insolvency frameworks, which can have both micro- and macroeconomic implications.

On the microeconomic side, as briefly discussed above, insolvency proceedings minimise coordination issues that may arise due to creditors' 'race to collect' (a run on the debtor's assets; Armour, 2001), favouring those who come first and triggering a potential 'fire-sale' liquidation (Shleifer & Vishny, 1992). Such actions may hamper the viability of a business that could potentially go back to 'business as usual', with spillover effects on employment and value creation. Notably, an insolvency framework can also shape *ex ante* incentives and, in particular, can align those of borrowers and lenders, who may be unable to exploit failures in the private enforcement mechanisms, such that they might be more willing to assess risk more thoroughly.

This incentive mechanism also produces implications at the macroeconomic level (as shown in Figure 2). By affecting the protection of creditors and (in general) investors' rights, insolvency proceedings can have an impact on financial market development (La Porta et al., 1996, 1997; La Porta et al., 2006; Djankov et al., 2008a). The private debt enforcement mechanism is strongly correlated with per capita income and predicts debt market development (Djankov et al., 2008b). Nonetheless, it is highly complex to measure the impact of (diverging) insolvency proceedings on investment decisions and credit flows (European Commission, 2014b).

Figure 2. Stylised view of the economic effects



Source: Author.

The insolvency framework can also produce effects on self-employment rates (as an indicator of entrepreneurship) and corporate deleveraging (Carpus Carcea et al., 2015). Moreover, an effective insolvency framework would limit 'gambling for resurrection' by banks, as NPLs rise to dangerous levels (IMF, 2015). Incentives for more entrepreneurial spirit and actions to reduce recovery time and increase recovery amounts in the management of NPLs can produce a distinct impact on the overall economy. In effect, high NPLs impair the ability to support economic activity, resulting in higher lending rates, lower lending volumes and more risk aversion (among others, IMF, 2015). AFME et al. (2016) estimate that a 10% increase in the expected recovery rate can reduce corporate bond spreads by up to 37 basis points and the lower risk premium can add up to 0.55% (€78 billion) of EU GDP.

Besides helping to improve the quality of banks' balance sheets, finally, the insolvency framework can help to increase deleveraging (Carpus Carcea et al., 2015) and so reduce the debt overhang, which tends to thrive in a low growth–low inflation environment (Brincogne et al., 2016). Overall, insolvency frameworks could strengthen the absorption capacity of the euro area, by pushing a more rapid (but orderly) adjustment of values if a permanent shock hit the region. This economic effect has (positive) implications for financial stability and could accelerate the economic recovery.

1.3 The quality of insolvency frameworks in the euro area

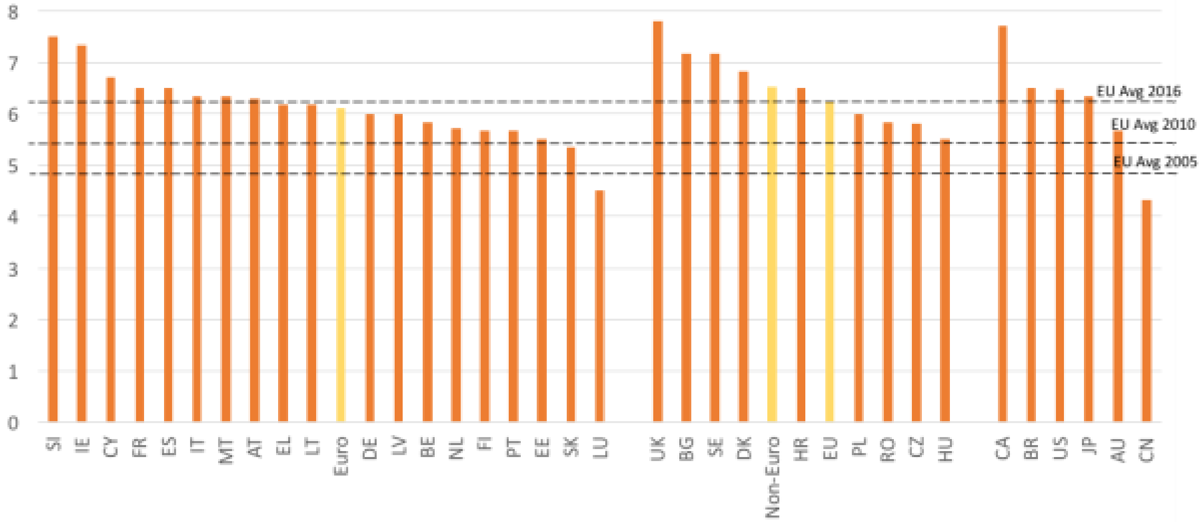
The quality of insolvency frameworks across the euro area, and the broader European Union, diverges rather dramatically. In this regard, there are three important dimensions to consider: protection of minority shareholders (and investors), the quality of contract enforcement mechanisms and the ability to resolve insolvency.

Protection of minority investors[3] primarily provides a balance in the governance of firms, which may ensure upfront protection of rights and potentially reduce disputes when things worsen and insolvency proceedings begin. More specifically, access to information about the underlying company (including information on conflicts of interest) is very important for a cost-effective and simpler insolvency procedure.

The protection of minority investors is fairly similar across Europe (Figure 3), except for a few countries, and it has been improving on average since 2005, as many regulatory actions have been implemented in this area.

[3] For a more detailed list of key components, see World Bank (2016), Data Notes (www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Data-Notes.pdf). It includes indicators, such as shareholders' rights in major corporate decisions, requirements for related-party transactions and the extent of conflict of interest disclosure.

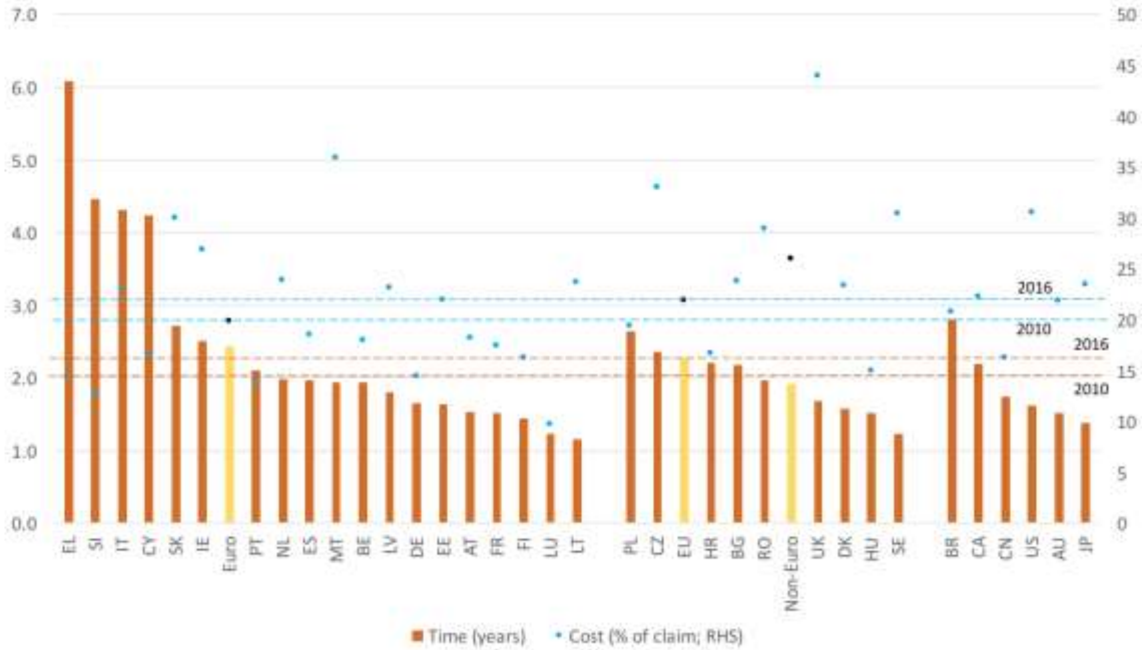
Figure 3. Protection of minority investors



Source: World Bank (2016).

A second important dimension, which makes the system more efficient and reduces the risk of insolvency and related litigation, is the ability to enforce contracts. The EU, on average, is doing relatively well compared with other advanced economies. Yet, the differences across countries are huge. In countries like Italy, Slovenia, Greece and Cyprus, enforcing a contract may take on average more than four years (see Figure 4). Costs on average may be very high as well, but are still lower than in Japan and the US. In recent years, however, the time required to enforce a contract and the expense of doing it have been increasing on average across the EU and the euro area. Improving the enforcement of contracts, through actions that are complementary to insolvency reforms, could improve the quality and effectiveness of insolvency proceedings.

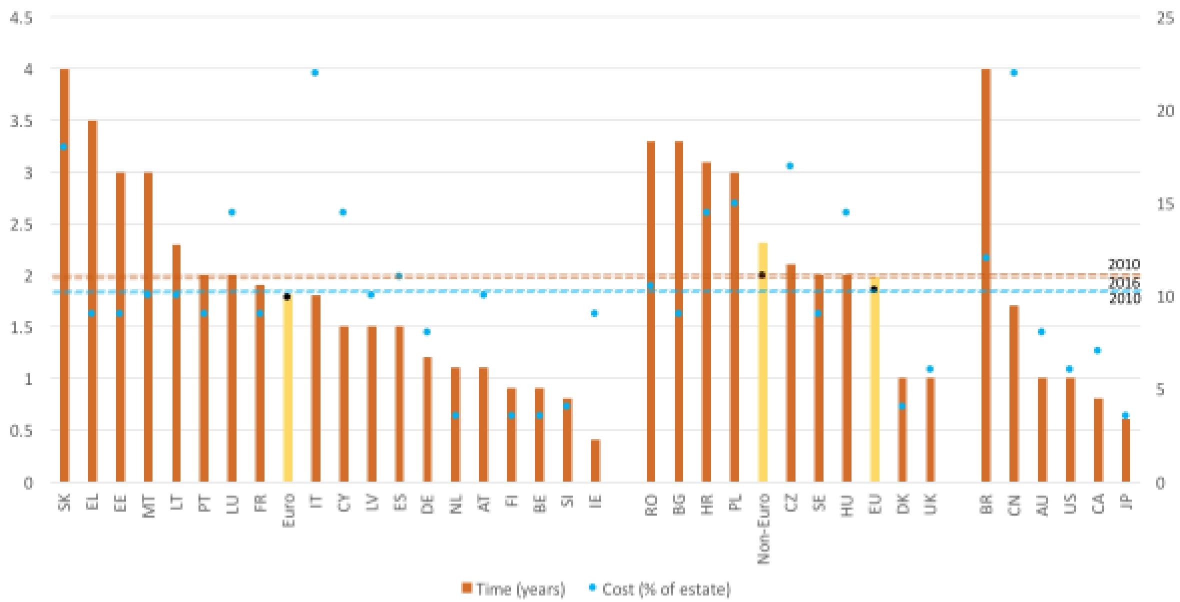
Figure 4. Enforcing contracts



Source: World Bank (2016).

The third dimension looks at the quality of insolvency proceedings.[4] Here too, the dispersion across countries is remarkable, with four years required on average to finish insolvency proceedings in Slovakia, versus less than six months in Ireland. The average EU framework also scores lower than other advanced economies and emerging markets, like China (Figure 5), with only very small signs of improvement in terms of the time and costs of insolvency procedures between 2010 and 2016. This is not surprising, as insolvency proceedings have always been largely considered a national prerogative and an area of the legal system that has hardly reformed over time.

Figure 5. Resolving insolvency

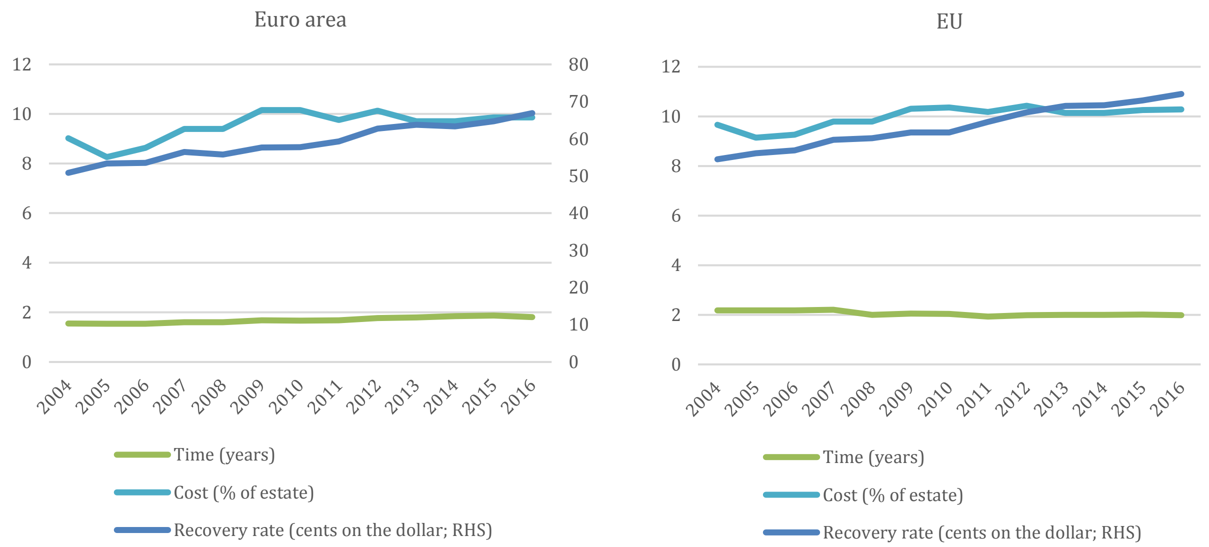


Source: World Bank (2016).

While the resolution of insolvencies has hardly improved, evidence is mixed on the overall efficiency of the insolvency proceedings over recent years, if we compare the euro area with the European Union (Figure 6). Recovery rates have increased across both the euro area and the EU, but the costs of the proceedings have gone up and the time to complete an insolvency proceeding has also slightly increased in the euro area.

[4] A more detailed list of key components is given in World Bank (2016), Data Notes (www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Chapters/DB16-Data-Notes.pdf). It includes such indicators as the time required to recover debt, costs required to recover debt (e.g. lawyers' fees) and creditors' participation.

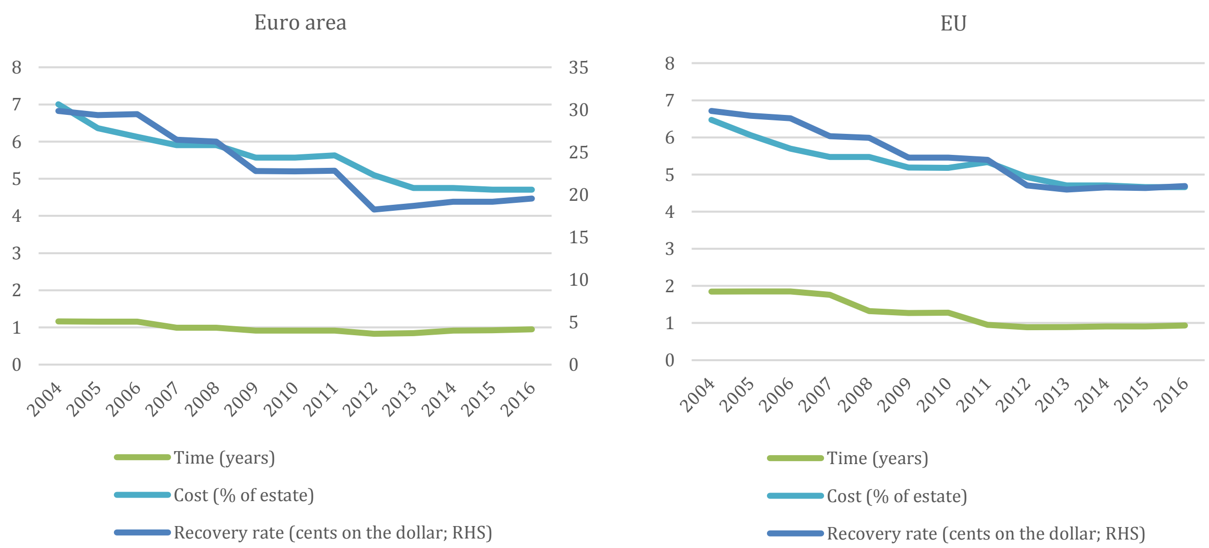
Figure 6. Key indicators in the euro area and the EU



Source: World Bank (2016).

Despite being high in absolute values, the dispersion of the time and costs of insolvency proceedings among member states did steadily reduce over the last decade. The trend towards a more harmonised framework may have been the result, on the one hand, of international efforts in fora like the World Bank to push for common principles in insolvency proceedings. On the other hand, the growth of international commerce may have led to market pressures on local governments to upgrade their legal infrastructure, in order to make cross-border trading less costly. However, the reduction in dispersion rates stopped in 2012 (Figure 7).

Figure 7. Dispersion of key indicators in the euro area and the EU



Note: Standard deviation.

Source: World Bank (2016).

After the euro area crisis, this process mostly stopped or even reverted, as far as recovery rates in the euro area are concerned.

To conclude, evidence shows that insolvency regimes in the euro area are diverse across countries, with a wide range of differences that have slowed down the long-term process of improving the national insolvency frameworks.

2. Insolvency laws and capital markets union

Insolvency laws are the backbone of cross-border capital market transactions, as they ensure that private enforcement mechanisms are well functioning, should one of the counterparties experience financial difficulties or act strategically to exploit differences in insolvency laws, especially in a cross-border setting (so-called 'forum shopping'). In effect, contrary to banks (institution-based funding), capital markets (market-based funding) are less able to overcome severe information asymmetries about the financial state of the counterparties of a transaction. Therefore, predictability in insolvency procedures plays a key role in deterring misconduct by one of the counterparties attempting to exploit those asymmetries and thus incentivise capital market transactions. As a result, in order to foster cross-border capital market transactions, legislative actions could and should reduce the unpredictability of procedures in cross-border insolvency proceedings, which are an important obstacle to further capital market integration.

Approaches to insolvency laws vary across the EU, with insolvency proceedings that are more employee-friendly in countries like France, or more punitive for natural persons, like in Italy. As a result, this assessment covers insolvency frameworks across the euro area, with particular attention to France, Germany, Italy and Spain. This section builds on interviews and reports on national insolvency laws in selected euro area countries (including Italy, Spain, Germany, France, Netherlands, Belgium and Greece) from Freshfields (2016) and AFME (2016).

2.1 Cross-border insolvency: Relevant aspects

Enforcement mechanisms, like insolvency frameworks, are built upon trust and the reliability of procedures that offer protection for creditors and debtors, especially in a cross-border setting. The interaction between national legal systems and principles is partially dealt with in Europe through a combination of minimum harmonisation in selected areas and mandatory recognition of foreign insolvency proceedings (the so-called 'hybrid' model as an approach to cross-border insolvency; Story, 2015). This model, however, might be insufficient to retain the trust that a more interconnected financial system (with its banking and capital markets union) may require. Accessibility (transparency and accountability), predictability and equitable treatment (supported by the principle of no creditor worse off, NCWO) are the elements that underpin this trust and make the system more reliable (IMF, 1999; UNCITRAL, 2013; World Bank, 2015). As long as they are uniformly applied within the domestic framework, accessibility and equitable treatment principles can actually differ from country to country, with only limited effect on the level of cross-border activity. It will certainly be costlier to deal with different rules and treatments of creditors on a cross-border basis, but not prohibitively so.

Still, if rules and procedures are unpredictable, there is a higher chance that the transaction may not take place, as it is not possible to place a cost on the transaction *ex ante*. Issues surrounding predictability arise with discretionary procedures or rules that leave room for interpretation by the judges involved in the proceeding. There will never be a completely objective and non-discretionary insolvency proceeding, but there are areas where the unpredictability can be contained, as these may impact the 'union' of banking and capital market services, more specifically,

- the opening of proceedings (e.g. applicable law and solvency test);
- relief actions (e.g. moratoria and avoidance actions); and
- the governance of the proceedings (e.g. directors' liability, cramdown and the discretionary actions of judges).

Aspects of the opening of proceedings for cross-border services concern the applicable law, including the possibility to open a secondary proceeding, and use of insolvency tests (including the procedures), which can differ significantly across the euro area and the EU more broadly (see Table 1).

Relief actions mainly include moratoria and avoidance actions, which support the smooth functioning of the insolvency proceedings and protect the business from management's wrongdoing.

The governance of the proceedings, finally, include voting mechanisms and tools to deal with 'hold-up' by classes of creditors that have nothing else to lose, as well as the priority to discipline claims and the training of judges to limit arbitrary decisions.

Table 1. Selected aspects of insolvency frameworks in some euro area countries

		France	**Germany**	**Italy**	**Spain**
Opening of proceedings	Pre-insolvency proceeding	Yes (up to 12 months)	Yes (3 months)	Yes	Yes (credit institutions)
	Insolvency test	Illiquidity	Imminent illiquidity, illiquidity & over-indebtedness	Illiquidity	Illiquidity
Relief actions	Automatic stays	Yes	Yes	Yes	Yes
	Avoidance actions (clawback period)	18 months	Between 3 & 12 months (10 years if knowledge of illiquidity)	Between 6 & 24 months	24 months
Governance of proceedings	Cramdown	No	Yes	Yes	No
	Directors' liability (time to file)	45 days	21 days	No time limit	2 months (suspension in pre-insolvency)
	Priority of claims (tax claims)	Priority	No priority	Priority	Priority
	Specialised insolvency courts	No	Yes (lower courts)	No (but spin-offs in large regions)	No

Source: Author.

The comparative analysis in the following sections highlights areas of unpredictability that emerge in these three areas. To advance the capital markets union with respect to insolvency laws, improvements in national frameworks are discussed.

2.2 Opening of proceedings

The procedures that lead to the opening of insolvency proceedings vary by country, according to the national legislation and case law. In a cross-border insolvency framework, the beginning of the judicial procedure comes after the assessment of the applicable law, which relies on the given location of the centre of main interest (COMI; see also section 4). In some countries (e.g. Italy), a different insolvency framework may apply to financial institutions. In most of the countries, however, there is a single insolvency procedure that applies to both financial and non-financial corporations.

2.2.1 Insolvency test

There are typically two insolvency tests to kick off an insolvency proceeding: balance sheet or cash flow-based. The application of these tests can significantly differ across countries. For instance, the balance sheet test does not apply in Spain and France, but it does in Germany (if chances for the continuation of the company as a going concern are less than 50%) and Italy (if the debtor asks for it in both creditors' composition and liquidation), and it can lead to bankruptcy if there is a likelihood that the company business cannot continue. There are no detailed criteria on how this likelihood should be estimated and it is usually left to the judge, after consulting an expert. Discretionary processes apply in other countries when assessing the cash flow, which is the only test available in countries like France, Greece and Spain. For the liquidity test, by contrast, the German Federal Supreme Court introduced some objective criteria, such as the presumption of illiquidity if the liquidity shortfall is at least equal to 10% of the payment obligations within three weeks. Moreover, in the German insolvency regime, there is a temporary preliminary proceeding of up to three months before insolvency. In this proceeding, the insolvency practitioners (by request of the judge) assess the solvency of an entity and outline preparatory measures to be finalised and taken upon the formal opening of proceedings (including drawing up an insolvency plan, negotiating with potential acquirers and investors), while preserving the workforce inter alia by ensuring the payment of employees' wages by way of a fund financed by the industry.

2.2.2 Asset evaluation

The valuation of assets is an important aspect of insolvency and pre-insolvency proceedings and it is probably the main source of litigation for debtors. The judge, having heard the experts, has much discretion in applying the valuation of the different assets of a going or gone concern and in determining whether the case is suitable for restructuring or liquidation. For instance, the different sensibilities of judges to the protection of local employment (as in the case of court decisions in France) may lead to different approaches, with the risk of damaging creditors beyond what is reasonable. This damage can come from keeping alive parts of a business that could have been split and sold separately, as well as from the risk of piecemeal sales when the sale of a going concern (by business) would have maximised returns for investors for a longer time and protected jobs for employees.

The presumption of a going concern's asset value, unless the creditor or the insolvency expert hired by the judge can prove otherwise by comparing a 'gone concern' with a 'going concern' over a reasonable period (e.g. three to five years), could be introduced at the European level to make the procedure more consistent across the EU. However, this presumption could increase overreliance on experts' assessments. In this respect, the judge could wave this presumption when the hiring of experts would involve a cost for the proceeding that is manifestly higher than any benefits that a presumption of a going concern valuation would produce. Even this intervention may nonetheless entail a loss of neutrality in the assessment of the judge, which actually may not necessarily result in a reduction of legal disputes, as it implicitly modifies creditors' rights. It would also increase the transaction costs of finding an agreement on a restructuring plan, as it would reduce the room for action, while creditors are only asking for similar or better treatment than normal insolvency procedures. Alternatively, for instance, the UK is evaluating the possibility of introducing a minimum liquidation valuation to be used as a benchmark to make the going concern evaluation more accurate. This minimum evaluation, together with a uniform training of judges and a harmonised set of minimum qualifications for insolvency practitioners[5] could lead to a more harmonised assessment of value (with more consistent methodologies) and so fewer disputes and more predictability at last.

2.3 Relief actions

Once the procedure starts, there are actions for relief that can help protect the practitioner responsible for the procedure and the debtor's assets against uncoordinated enforcement actions of creditors and wrongdoing by the debtor or the management of the company.

2.3.1 Stays

A moratorium (or stay) suspends the possibility for creditors to begin enforcement actions on their claims, so as to allow the beginning of the procedure that will also repay creditors. An automatic stay applies to all creditors' claims at the beginning of the insolvency procedure in all the main euro area countries. Divergences exist on the duration of these stays, which in Spain can last a year for secured creditors and for the duration of the procedure for unsecured ones. The Spanish moratorium applies only to assets related to the business (to be assessed by the court) and will not apply to 'financial collateral'. A stay also applies during the three months that the Spanish debtor has to set off a temporary procedure to reach an agreement with creditors before the declaration of insolvency. This time limit applies as well to the composition of creditors in Italy. The temporary procedure is available in most of the euro area countries, but in France it can go up to eighteen months. In Germany, this temporary procedure is available for three months prior to the opening of insolvency proceedings and after the declaration of insolvency for the duration of the proceeding. Contrary to what happens in Spain, a stay in France also applies to secured creditors with no time limit during the liquidation procedure.

While EU intervention may be needed for the use of stays in pre-insolvency (early restructuring) procedures, the use of automatic stays in insolvency proceedings is now widespread and may not require further intervention.

2.3.2 Avoidance actions

More complex is the situation with avoidance actions, i.e. actions to challenge past transactions that have been taken to deprive creditors of a debtor's assets. There are no countries with a pre-defined list of transactions that can be voided. However, in Spain there is a presumption

[5] For example, there are no minimum requirements or licenses for insolvency practitioners in Germany yet there are in Ireland.

that the court should void the transaction, unless proved otherwise, in the case of donations and payments of debt that were not due at the time of the transfer. Other transactions could be voidable too, if taken within nine months before the insolvency, such as the transformation of an unsecured credit to a secured one (unless there is no damage) or those with related parties. In Germany, the mandate is very broad and the insolvency administrator can challenge transactions up to ten years before the insolvency, if the counterparty had knowledge of the illiquidity and the negative effect on other creditors (unless there is proof that the debtor did not intend to harm creditors), while the regular clawback period is three months. A current reform bill pending in the German parliament provides for a maximum period of four years in cases in which the transfer served the purpose of discharging a valid claim. The suspect period goes down to one year in the Netherlands, up to eighteen months before the beginning of the procedure in France, up to two years in Greece and Italy (depending on the type of transaction) and so on. As a result, greater predictability could be achieved in the procedures to define potentially voidable transactions and a common clawback period during which transactions could be voidable after the beginning of the proceeding (unless transactions are fraudulent, for which no time limit would apply). Considering a broad time range, to suit the current disparities across the EU, a period of eighteen months from the application to the opening of the proceeding (for transactions that are not fraudulent) may be a good compromise, which may not be too invasive in the regular business of a company. Furthermore, a list of transactions that cannot be voided ('benign' transactions) and another list of 'suspicious' transactions may help to alleviate concerns about the continuation of the business in an insolvency procedure.

2.4 Governance of the proceedings

The governance of insolvency proceedings is another important aspect for cross-border dimensions of the banking and capital markets union. In particular, there are four main areas where uncertainty can affect the implementation of these two projects:

1) directors' liability,
2) the voting mechanism ('cramdown' in particular),
3) the priority of claims and
4) the functioning of courts.

2.4.1 Directors' liability

There is a general duty for directors to disclose the state of insolvency as soon as it becomes manifest. Still, its application across the euro area is fairly different, producing some level of unpredictability when the director of a cross-border entity has to assess when to file for insolvency. To reduce this uncertainty, the Court of Justice of the European Union (CJEU) has recently clarified that the question is a matter of national insolvency law, rather than company law.[6] The application in countries like Germany is pretty strict and requires the director to file for insolvency within three weeks, otherwise the entity will be prosecuted. This period goes up to forty-five days in France. In Spain, by comparison, this period goes up to two months, but notably the debtor can communicate the 'imminent' risk of insolvency to the judge, who may give three months for negotiation with creditors, plus an additional month to file for insolvency. In Italy and the Netherlands, there is no time limit, but only a risk that directors

[6] See the CJEU Case C-594/14, *Kornhaas* v *Dithmar*, 10 December 2015.

are held accountable for late filing. This fragmented landscape creates unnecessary clouds for directors of cross-border companies on when to file for insolvency, with the additional burden of determining what is the applicable law for defining the requirement to file in the country where the insolvency proceeding will take place. Despite the existence of an EU framework to define the applicable law (see section 4), this determination cannot be easily made *ex ante* and requires the discretionary evaluation of the judge.

Since the given 'time to file' changes across countries, as well as its enforcement, this fragmented approach can generate undue unpredictability, while the benefits of a piecemeal approach are far from clear. As a result, it may be appropriate to introduce a common period to file for insolvency, which would be subject to local insolvency opening procedures. Alternatively, a less strict duty to file could be less burdensome, but it would expose creditors to more possibilities of debtors' wrongdoing.

2.4.2 *Voting mechanisms and cramdown*

The voting mechanisms for involving creditors in the insolvency proceedings, and in particular for the restructuring of the financial claims, can be a source of cross-border unpredictability if there are no requirements for cramdown[7] over small classes of creditors that can hold up the majority, as they no longer have anything to lose (e.g. shareholders). The cramdown and the 'best interest' test, i.e. whether the creditor is better off with the restructuring rather than the liquidation, is available in Germany and Italy, but not in the Spanish insolvency framework, which gives limited voice to creditors. A similar approach, for instance, is used in France. In addition, voting mechanisms typically consider classes of creditors and a majority of the classes has to approve the restructuring procedures. For example, in Germany and the Netherlands there is a split between secured and unsecured classes that vote for the insolvency plan. Yet, they are not always classified according to legal status and their economic interest. In Spain, creditors are classified according to the nature of the entity (public, financial, non-financial, etc.). This classification is highly dysfunctional in relation to the economic incentive that the legal structure of the instrument and its economic function may create.

As voting mechanisms are important for insolvency proceedings to function well, a limit to the ability of minorities to hold up and slow down the procedure may be beneficial. EU action could improve voting mechanisms in national insolvency laws by introducing a cramdown power over minority creditors like shareholders, who may hold up every restructuring procedure. The introduction of a cramdown procedure across the EU would thus increase the stability and predictability of insolvency proceedings.

2.4.3 *Priority of claims*

The priority of claims in the distribution of the proceeds in liquidation or restructuring also differs across countries. In Italy, Spain and France, for instance, tax authorities can enforce their liens on a debtor's assets before secured creditors (together with the expenses of the proceedings). In countries like Germany, there is no priority for tax claims. In some cases, like Spain, the salaries of the employees for a limited time during the insolvency proceedings

[7] 'Cramdown' is the legal authority for courts to impose a restructuring of debt in an insolvency proceeding despite objections from some classes of creditors, typically shareholders that have nothing to lose.

receive special priority vis-à-vis secured creditors. This aspect is most relevant for the functioning of the banking union, which the following section extensively discusses.

2.4.4 *Functioning of courts*

Finally, the functioning of the courts and the training of judges is very important to reduce the likelihood of arbitrary decisions in the necessary discretion that judges have when interpreting local insolvency laws for individual cases. Creditors and debtors have the right to be heard and this right to a fair judicial review of the proceedings should be preserved. According to the IMF's principles (1999), "all insolvency laws should provide adequate guidance as to how a court should exercise its discretion when making a determination on matters that involve economic or commercial issues. This is essential if the law is to be predictable." In this respect, the quality of the regulatory framework and the training of judges is key. Most of the countries do not have specialised courts, but spin-offs of commercial courts and/or regular civil courts. In Spain, trials are concentrated in commercial courts located in the main urban areas with highly qualified judges. Elsewhere, such as Germany, proceedings are concentrated in a few courts located only in some regions, while in other countries proceedings take place in courts that are spread across the country and thus are de facto less specialised. As a consequence, the quality of the procedures may significantly differ across regions. In France, the civil court is the competent court for civil debtors and the commercial court for commercial entities. Most recently, the French government has introduced a law to move gradually towards specialised courts for insolvency proceedings.

EU intervention can actually support this process potentially in two ways. A first-best solution could be the creation of a European system of courts with branches in every country, which only deals with cross-border transactions and provides a separate judicial review for the insolvency cases that are related to those transactions. This could quickly align the quality of judges and procedures with the same standard. A second-best yet perhaps more politically feasible solution, would involve the following measures:

- the creation of an EU-wide training programme for local judges, as is foreseen for judges in competition law;
- the recommendation for member states to create separate courts (even spin-offs of local commercial courts) dedicated to insolvency proceedings, limiting the number (of courts) to the main regions, compatible with their size and the number of proceedings;
- the introduction of minimum requirements for insolvency practitioners, which are aligned as much as possible with international standard-setters (as for financial analysts), together with a common compensation scheme with a minimum fixed payment and a variable one based on the complexity of the insolvency; and
- the creation of an EU-wide programme of investment under the Juncker Plan to improve the physical infrastructure (including the digitalisation) of courts and supporting services.

3. Insolvency laws and banking union

Banking union theoretically relies on three pillars: the single supervisory mechanism (coupled with the single rulebook), the single resolution fund and the single deposit insurance scheme (still missing). It is the most important institutional project in recent European history. The relationship between banking union and insolvency laws puts less emphasis on the predictability of procedures, as banks have a cost structure that is able to deal (to a good extent) with information asymmetries. It calls instead for insolvency laws to be effective enough in reducing asset/liability mismatches through more efficient (and rapid) enforcement of claims and less legal complexity in supervisory and resolution actions. This section reviews aspects of insolvency laws that may have an impact on the functioning of the two banking union pillars in operation so far. In addition, it reviews the areas in which improvements to pre-insolvency and insolvency proceedings could enhance supervisory actions and the management of NPLs, irrespective of their cross-border impact. This part mainly relies on benchmarking national regimes.

3.1 Ranking of creditors

A first area where insolvency laws may interact with banking union is the ranking of creditors in bank resolution procedures, which may involve the write-down of shares and the bail-in of subordinated creditors. The legal subordination of claims on the assets of the debtor can take place through three approaches:

1) contractual,
2) structural and
3) statutory subordination.

Contractual subordination is achieved through contractual terms. It offers flexibility and decentralisation, but it involves high transaction costs (complexity, lack of transparency, legal uncertainty and negotiation) to ensure that subordination is offered in the same way to all the creditors in the same class, according to the NCWO principle.

Structural subordination is achieved through the legal structure of a commercial group, whether a bank or another legal entity. The division of the group between a holding company (issuing the capital and other subordinated liabilities) and subsidiaries (running the operations and exposed to secured and unsecured operational credit) offers a structural subordination of liabilities sitting in the holding company. This model of legal entity is widely used in common law legal systems.

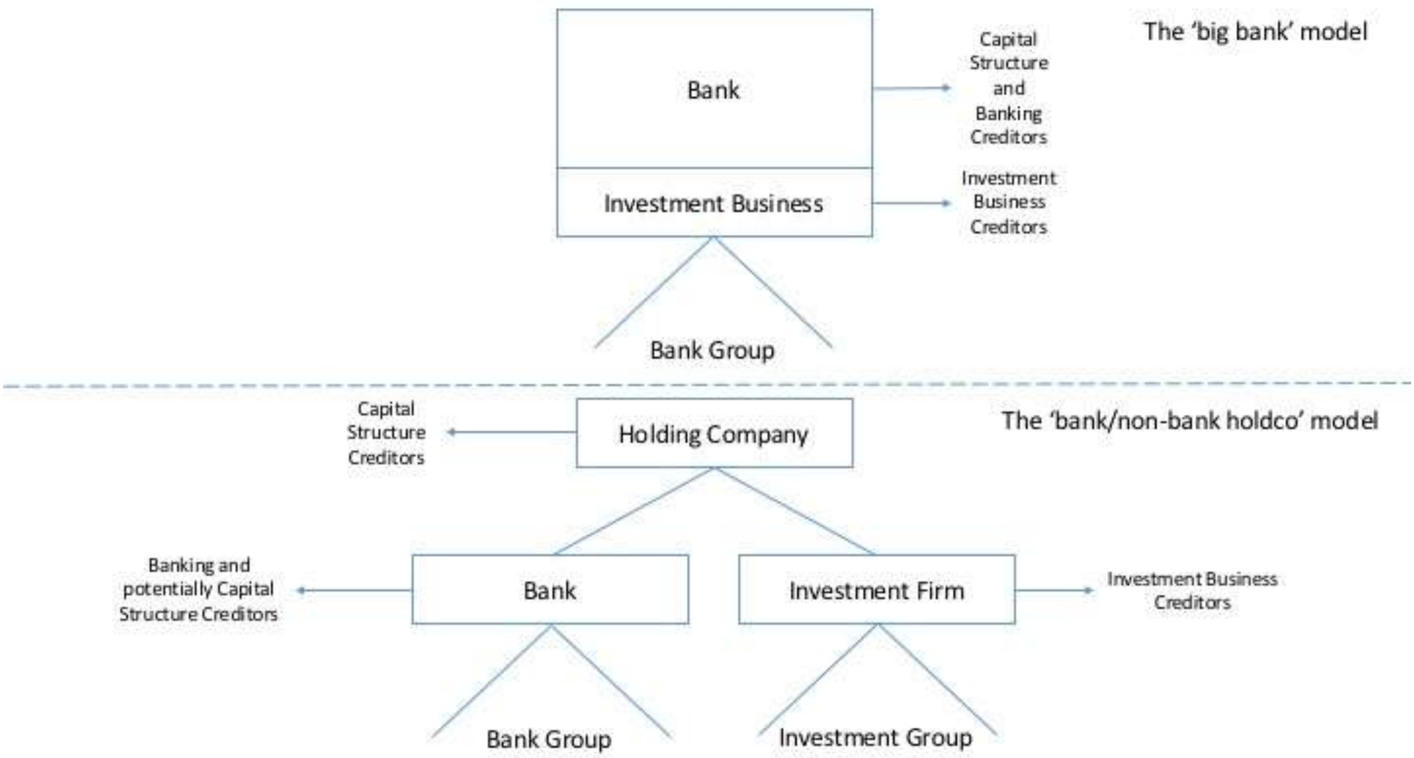
Statutory subordination is delivered by statutory law, which provides a legal framework for recognising the subordination of creditors within the same class. This tool provides legal certainty, transparency and centralisation, but may lack flexibility and it may require legal adjustments over time.

As a result of the different types of subordination co-existing in the euro area, there are some issues with the implementation of the newly introduced BRRD (Directive 2014/59/EU), with its bail-in mechanism and with the priority of claims (and creditor classes) that is a constituting element of national insolvency laws. According to the NCWO principle (under the 'best interest' test), the pre-insolvency resolution of a bank, which occurs in the "public interest" (Recital 13, BRRD), in effect has to produce an impact on creditors that does not make them worse off vis-à-vis the national insolvency regime.

In this assessment, two issues emerge. First, there is a need to assess the impact of a standard insolvency procedure on creditors' claims, whether under debt restructuring or liquidation. The BRRD (under Art. 108) has explicitly harmonised the subordination of uncovered deposits (above €100,000) to covered deposits, with a preference for natural persons and small and medium-sized enterprises (Wojcik, 2016). However, it does not specify what 'preferred creditor' means or how depositor preference relates to other classes of preferred creditors

(Schillig, 2016). In particular, the BRRD does not introduce subordination for unsecured debt securities versus other forms of unsecured debt claims. Notably, when the parent company is an operational entity (in the 'big bank' model, see Figure 8), it is not possible to achieve structural subordination, as operational preferential credit is mixed with other unsecured credit (e.g. unsecured debt instruments). These two forms of credit usually have the same priority under the national insolvency law. As is the case in Germany and Slovenia (ECB, 2015, 2016a),[8] statutory intervention may thus be necessary to create subordination in the local insolvency framework for unsecured debt instruments (e.g. tier 3 capital), which is in the same class as other senior unsecured credit. While contractual subordination is legally accepted in all the insolvency frameworks, a change of law could deal with past issuance, generate bail-inable capital immediately available (as in Germany) and address NCWO issues. Overall, it may create a more legally certain environment for the issuance of total loss-absorbing capital (TLAC), under the Financial Stability Board (FSB) guidelines, vis-à-vis the NCWO principle test. Moreover, contractual subordination may stumble into legal issues in local insolvency laws and is generally a less transparent solution from an *ex ante* market perspective.

Figure 8.'Big bank' vs 'holding company' model



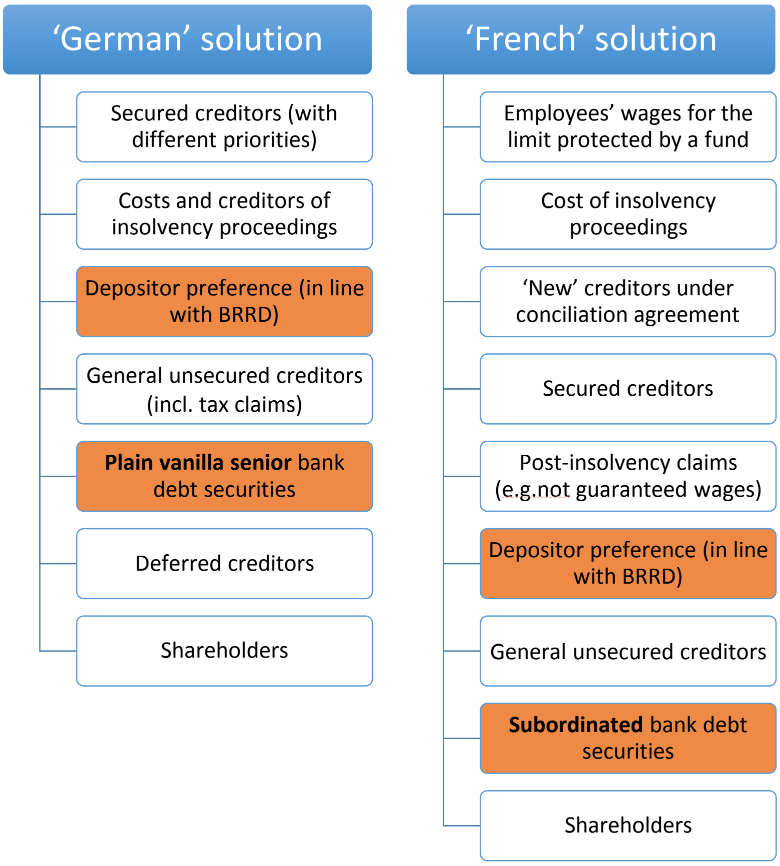
Source: Author, from Gleeson & Guynn (2016).

Consequently, until the preferred status for some unsecured debt securities is no longer enshrined in local laws, the transposition of TLAC rules for banking groups that do not adopt the holding company model may not take place. The implementation of this statutory change could take two forms: the German one, which is retroactive, since it also applies to unsecured

[8] The Slovenian draft law also includes a preferred status for natural persons, microenterprises and SMEs, facilitating bail-in procedures in line with the domestic insolvency framework.

debt securities that were not contractually subordinated; and the French one, which is not a retroactive solution (Figure 9). The 'German solution' is able to free more resources for banks from past issuance immediately and addresses potential NCWO issues upfront. Yet this solution changes the loss given default by providing statutory subordination (vis-à-vis general unsecured creditors) for all senior debt securities issued by credit institutions (Schillig, 2016).[9] Although this does not foreclose the possibility for banks to issue debt securities that are even more subordinated (with contractual subordination), this intervention may result in a structural increase in funding costs for banks, which will no longer be able to issue plain vanilla senior debt that is treated *pari passu* with other unsecured debt. Furthermore, due to the subordination to general unsecured creditors, these plain vanilla senior debt securities would also lose their eligibility for ECB operations. It must be noted that a new French class of subordinated debt will not be eligible for ECB operations, while senior non-subordinated debt will still be eligible (ECB, 2016b).

Figure 9. German and French general priority of claims with post-BRRD modifications



The 'French solution' (not formally adopted yet) also introduces a new category in the insolvency hierarchy, subordinated to secured creditors and general (unsecured) creditors (including senior debt securities). This category of claims would be statutorily subordinated, with a maturity of longer than a year and immediately eligible for TLAC. This solution is more flexible, as it provides the bank with the choice to issue either subordinated debt or senior

[9] See Kreditwesengesetz (KWG, German Banking Act), §46f(5).

unsecured debt on markets that can price the *pari passu* of senior debt with other unsecured debt. Nonetheless, it does not provide immediate bail-inable capital from past issuance, nor does it address upfront NCWO issues.

Second, there is an additional cross-border dimension in keeping different priorities of claims under national insolvency laws, which relates to the absence of a uniform NCWO principle across the banking union area (see Box 1). Under the current application of the principle, when facing a liquidation or resolution of a bank operating in different countries, some creditors may be treated differently. Even though this may not be a problem for the predictability of the procedures, since this information is known *ex ante,* it still complicates the resolution/liquidation by forcing supranational European institutions to apply and interpret local legislation. In particular, decisions – like those of the Single Resolution Fund (SRF) Board or the Commission – would have to apply (and interpret) domestic laws. The legality of those decisions would be subject to judicial review by the CJEU, mainly through actions for annulment (Art. 263 of the Treaty on the Functioning of the European Union, TFEU) or preliminary references (Art. 267 TFEU). This implies that the CJEU could end up interpreting national law.[10] There is very limited experience of cases in which a court interprets and applies foreign laws (e.g. family laws). Notably, under Arts 263-264 TFEU, the decisions of EU authorities (including the Single Resolution Board) are subject to the judicial review of the CJEU. It is plausible that the CJEU may follow *MasterCard,*[11] which states that, when reviewing a decision taken in application of EU law, the court should also assess the facts, i.e. go into the merit of that decision to check if conditions were met (including that it took into account the national legislation). By extension, this could mean that the CJEU could end up interpreting national law, as long as it is functional (and linked) to the application of EU law. Nevertheless, due to the institutional issues and practical legal ones, it may not be ideal for EU bodies to apply national laws.

Finally, there are two additional issues with the application of the NCWO principle. One is that the lack of a harmonised list of priorities in insolvency may also require the upfront specification of the applicable law, which would define the loss given default scenario, even if the resolution of a cross-border entity will in the end avoid the formal insolvency proceedings. Another is that the set-off right for opposing claims[12] from the same debtor may be restricted or applied differently across countries, which may ultimately determine a violation of the NCWO in some countries when a resolution produces a haircut on a creditor's claim that would have been set off (100%) in the normal insolvency proceedings. Overall, set-off rights (with different applications) are available all across the euro area, so it would be preferable to have a broad application of the right in the bank resolution procedure as well. This would minimise the risk of litigation.

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[10] See also Art. 4.3, Council Regulation No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies related to prudential supervision of credit institutions, OJ L 287/63, 29.10.2013.

[11] See CJEU, Case C-382/12 P, *MasterCard and Others* v *Commission*, §155-156, 11 September 2014.

[12] The set-off right is the right for someone exposed to the insolvent entity with both credit and debit claims to set off these claims before entering into the insolvency proceedings.

Box 1. The ranking of claims in insolvency proceedings and the NCWO principle

Pari passu (equal) treatment of the same categories of creditors is a fundamental principle to avoid disorderly liquidations in insolvency proceedings (see section 1). Yet it only works in combination with a ranking of the different classes of creditors. In particular, this ranking of priorities is crucial for the loss-absorbing capacity of a failing institution (Schillig, 2016). It especially matters in the assessment of the NCWO principle, as the ranking determines the impact of the liquidation under the local insolvency regime.

The NCWO principle guides the bail-in procedures under the BRRD (2014/59/EU, Art. 34(1)). The principle protects the fundamental human rights of creditors, according to the Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, through a compensation scheme, when a resolution action changes the legal status of these claims under the protection of a 'public interest'. It entails that no creditor should receive treatment, in their enjoyment of their possession, that is less than what they would have received in economic terms from a normal insolvency proceeding and, more specifically, a piecemeal liquidation, which is the 'worst case' insolvency scenario. As a result, it provides all classes of creditors (including shareholders) with an assessment of fair treatment of their property rights.

The ranking of priorities is currently not fully harmonised across the EU, as it typically reflects well-established rights in local jurisdictions. For instance, both French and German laws provide special protection to employees. But different levels of priority apply to secured creditors. Tax claims receive priority in Italy and Spain (according to the type of tax), but not in Ireland, where these are treated as other unsecured creditors, and only in very specific cases in Germany. Secured financial collateral has required separate EU legislation (Directives 98/26/EC, 2002/47/EC and 2009/44/EC) to ensure that all European insolvency regimes are able to provide the same priority to financial arrangements (like derivatives contracts or repos) for the smooth functioning of the financial system. To create an NCWO for the banking union, the harmonisation of rankings could be a similarly important step.

3.2 Management of non-performing loans

Effective management of NPLs relies on a well-functioning secondary market. The creation of a pan-European secondary market could facilitate bank restructuring and harmonisation of supervisory practices for the management of NPLs across the banking union. An efficient secondary market, however, requires a small price difference between the valuation of the bank and the evaluation of the investor. This pricing gap is currently fairly large in countries where NPLs have a big weight on banks' balance sheets, like Italy, Portugal or Greece. Evaluation varies, depending on whether loans are secured or unsecured. Unsecured loans would rely more on benchmark or standard haircuts, which would include the time to start a procedure and its effectiveness in attacking a debtor's assets, within or outside an insolvency proceeding.

Most of the NPLs are secured loans in countries like Italy. Based on the type of collateral, the NPL classification can be residential or commercial. The pricing gap is the difference between the book and market values, which is usually partially covered by loan provisioning. The smaller is the pricing gap, the higher is the chance of creating a secondary market. Loan provisioning and the market valuation of banks and investors in NPLs are the two key aspects that can make the secondary market liquid. The evaluation of the discounted market value by the bank and the investor may significantly differ. For the bank, NPL valuation relies on the discounting factor (usually the original interest rate of the deal), the value given by the expert and the time to repossess and sell the asset (through auctions), which is used to define the time for the actual discounting. On the investor side, the investor also includes the expenses for the recovery (usually included in a higher discounting interest rate).

Therefore, all procedures within or outside the insolvency that speed up the repossession and sale of the collateral can make NPL management more effective by creating secondary market activity. Both banks and investors always look for out-of-court solutions, as they are less expensive (see Box 2).

Box 2. Pre-insolvency credit recovery mechanisms

Credit recovery procedures outside the formal insolvency proceedings are important for a more effective functioning of the insolvency framework run by courts. In effect, courts are often overloaded with cases that could have been solved either with full-fledged out-of-court solutions or through the use of more standardised credit recovery procedures, such as the order of the judge to repossess the collateral and sell it in the market through auctions. The quality of credit recovery mechanisms relies on two factors:

- the ability to repossess the collateral, and
- the accessibility and management of sale auctions.

In countries like Italy, the procedures to repossess and sell through an auction may take up to five or six years on average. The duration of the procedures also depends on the type of credit claim and the underlying collateral. Consequently, in 2015 and 2016, the Italian government introduced procedures to reduce the duration, such as the use of insolvency practitioners, rather than slow court procedures, to run the auctions or the possibility for the creditor to repossess the collateral without a judicial procedure (but with the approval of the debtor, who would also get a share of the proceeds that are in excess of the due amount). Anecdotal evidence suggests that the latest reforms may have already reduced the average time to enforce a credit claim by six months. These procedures are important to develop secondary markets for NPLs, as the average time of recovery is used to estimate the residual value of the collateral, which is a factor in the market price of NPLs. A minimum harmonisation at the EU level could help to create a European secondary market to support the ongoing bank restructuring process. Ultimately, this is what the Obama Relief Programme did, increasing debt restructuring versus additional expensive foreclosures and court procedures. In Germany, in case of a threat of illiquidity, it is possible to bring together creditors for a restructuring outside the insolvency proceeding, requesting the judge to issue a stay to support this procedure and avoid an illiquidity that is 'imminent'. A similar procedure applies in Spain and France as well.

Nonetheless, reducing the time and increasing recovery rates in insolvency procedures (see section 1.3) can help to offload NPLs from banks rather quickly, and so support the unified supervision over the bank restructuring across the banking union area. Assuming no pricing gap between the book and market values, with a natural reduction of NPLs at historical value (3-4% of the gross loans book), a target capital adequacy ratio of 16% and 10% return on investment, the IMF (2015) argues that a two-year reduction of the expected foreclosure time would create a capital relief of €19 billion and an amount of lending equal to €261 billion. Estimates for Italy suggest that a reduction of two years in the recovery time would increase the market price of NPLs by 10% and reduce the stock of NPLs. If recovery time goes down from seven years to one year, market value could go from 22% (the market price of the book value for the four banks that were resolved at the end of 2015 in Italy) to 36.3% (Ciavoliello et al., 2016). Assuming a book value of NPLs of €300 billion, this would amount to creating value for roughly €43 billion, which could make the NPL crisis in Europe much milder if these additional resources are summed up to the current loan provisioning (between 45% and 50% in Italy) and the collateral value attached to most of those loans.

Figure 10. NPL simulation: Resolution timing

Ask price* (as a % of outstanding gross NPLs)

Discount rate: banks	Resolution timing: years 7	6	5	4	3	2	1
2.0%	45	46	47	48	49	50	51
2.5%	44	45	46	47	49	50	51
3.0%	42	44	45	46	48	49	51
3.5%	41	42	44	46	47	49	50
4.0%	40	41	43	45	46	48	50
4.5%	38	40	42	44	46	48	50
5.0%	37	39	41	43	45	47	50
5.5%	36	38	40	42	44	47	50
6.0%	35	37	39	41	44	46	49

(*) = NPLs carrying value = NPLs /Gross NPLs

Bid price (as a % of outstanding gross NPLs)

Discount rate: market	Resolution timing: years 7	6	5	4	3	2	1
8.0%	30	33	36	38	41	45	48
8.5%	30	32	35	38	41	44	48
9.0%	29	31	34	37	40	44	48
9.5%	28	30	33	36	40	44	48
10.0%	27	29	32	36	39	43	47
10.5%	26	29	32	35	39	43	47
11.0%	25	28	31	34	38	42	47
11.5%	24	27	30	34	38	42	47
12.0%	24	26	30	33	37	42	47

(**) NPV= Net Present Value

Source: Associazione Bancaria Italiana (ABI).

For Italy, with a loan provisioning of around 45%, the reduction of the resolution time from the current seven years to one year could almost double market valuation by investors and tighten the spread with the valuation of the bank, accelerating the off-loading process (see Figure 10 above).

3.3 Other relevant areas

The beginning of a resolution procedure for a bank does not exclude the possibility for creditors of the bank to act through judicial means, in case the bank has failed to repay any claim meanwhile. In particular, it is beneficial to align as much as possible the tests adopted to assess the 'likelihood of failure' in a resolution procedure with the tests used in a normal insolvency proceeding. In effect, the alignment of the tests may minimise the disputes over the valuation of assets that the resolution authority (together with the supervisor) makes, as it would be close to the one that a judge could reasonably make using the same approach. Nonetheless, there is no way to eliminate the risk of litigation, as the resolution mechanisms rely on creditors' compensation in exchange for the modification of their property right (including write-downs; see Art. 75, BRRD). Moreover, a moratorium (stay) to stop enforcement actions, when the bank is judged 'likely to fail', could help to set up the resolution procedures with legal certainty. This may require an amendment to national insolvency frameworks, ideally with the introduction of an early restructuring (resolution) procedure for banks (outside courts) as one of the available pre-insolvency proceedings to enable a better fit of the BRRD regime with national law.

The resolution mechanism also foresees the use of specific resolution tools, such as a bridge bank or sale of business, which are alternatives to normal insolvency procedures. In addition, it allows for write-downs and the conversion of liabilities into equity (bail-in) to allow a smooth restructuring of banks' financial claims. Wojcik (2016) suggests that the resulting change of property rights is legally sound from a fundamental rights perspective, if the interference is necessary in the public interest (which is tested at the beginning of the resolution procedure and in line with the BRRD objectives in Art. 31(2))[13] and proportionate to achieve this goal, which may include the payment of compensation (as established by Art. 75, BRRD) at least equivalent to the difference between what was received in resolution and what would have been received in insolvency where the NCWO principle was violated. The resolution decision can be challenged in court, if creditors believe the NCWO principle has been violated. In particular, the cancellation of shares is equivalent to the cramdown of shareholders in a normal insolvency proceeding, which would most likely occur in the liquidation of a bank. The harmonisation of the ranking may also have beneficial effects on this other issue.

There is currently no preference in the ranking of priorities for the contributions of the Single Resolution Fund in the insolvency proceedings. In theory, this funding contribution could receive a high priority over other claims, as it comes to support the continuation of the business after the insolvency petition. This is a priority that seems to be available everywhere, but not necessarily with the same preferential treatment across countries. There is actually no certainty that the priority will hold in the same way across the national insolvency regimes of the euro area, corroborating the need to harmonise the priority of claims across the euro area.

Finally, when the baseline scenario (of local insolvency laws) is so different, there is a lot of legal uncertainty surrounding the application of the NCWO principle at the European level. The introduction of a harmonised liquidation regime for banks at the European level could further simplify the functioning of the resolution mechanism, by bringing uniformity to the liquidation scenario that would apply to the NCWO assessment. This harmonisation would also facilitate the transfer of assets/liabilities in liquidation (e.g. the ability to move deposits of a failed bank to a new bank), which is currently not possible everywhere across the euro area. For instance, in Spain, only judicial proceedings are available and the intermediation of the judge may limit the transferability of assets and/or liabilities often by only allowing payout or compensation.

4. Current framework and potential options for convergence

Insolvency laws are deeply embedded in the legal systems of individual member states, involving corporate and contractual laws, among others. These differences can be a significant impediment to cross-border trading activity. At the end of the 18th century, the US Constitution already had a clause (Art. I, §8, cl. 4) that allowed the creation of a federal bankruptcy law, should the treatment of creditors residing in different states affect interstate commerce.

It nonetheless took almost a century to exercise this option, i.e. when interstate commerce indeed became so dominant that it suffered from a lack of harmonised treatment of creditors

[13] See European Court of Human Rights, *Grainger and others* v *United Kingdom*, Appl. No. 34940/10, decision of 10 July 2012, para. 35 in Wojcik (2016).

by local insolvency laws. Also in the EU, despite the simplification of cross-border trade that the introduction of a pan-European 29th regime would bring, it may still take years before a regime that harmonises existing national legal systems is implemented. In this respect, an approach that aims at removing sources of unpredictability on the way to a common treatment of creditors and stakeholders across the EU might be a good start.

This section provides an overview of the present European framework for insolvency laws and looks at the current proposals that the Commission is working on, assessing the different options for convergence.

4.1 The EU framework

A European framework for insolvency proceedings is already partially in place. Nevertheless, its scope is limited to cross-border insolvency and, in particular, to the definition of the applicable law, the recognition of legal decisions and other procedural aspects. For non-banks, there is the Insolvency Regulation (EU) No. 2015/848, which is a recast of Regulation (EC) No. 1346/2000.[14] This 'Recast Regulation' will apply as of 26 June 2017. For banks, there is a Credit Institutions Winding-up Directive (2001/24/EC) and an Insurance Winding-up Directive (2001/17/EC), which sets in a nutshell:

- the competent jurisdiction to implement reorganisations or winding-up (the home member state);
- recognition of the legal decisions throughout the EU;
- the obligations to inform the host member state and publicise to third parties; and
- some specific requirements for certain transactions (e.g. netting and repurchase agreements).[15]

The key areas of the European insolvency framework for non-financial institutions are, among others:

- the court authorised to open the main proceeding;
- secondary proceedings (e.g. synthetic); and
- recognition of the legal decisions.

The conflict-of-law regime requires that proceedings should be opened in the centre of main interest of the debtor (*lex concursus,* Art. 3). The proceedings will also cover related actions (mainly under civil and commercial laws). For companies, this is presumed to be the registered office, unless there is proof of the contrary (Art. 3.1). For individuals, the regulation refers to the "habitual residence" of the individual without further specifying how that should be defined. The uncertainty about the COMI presumption for individuals could still be a source of cross-border litigation in insolvency proceedings (in line with Wessels, 2003), after the new rules enter into force in 2017. With the recast of 2015, to limit forum shopping, the European Commission has improved the COMI's presumption by stipulating (for the presumption to apply), in relation to corporates, that a relocation of the registered office or the place of business must have taken place at least three months before the request for opening

[14] Regulation (EU) No. 2015/848 of 20 May 2015 (OJ L 141, 5.6.2015) and Council Regulation (EC) No. 1346/2000 of 29 May 2000 (OJ L 160/1, 30.6.2000).

[15] See Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding-up of credit institutions, OJ L 125, 5.5.2001.

proceedings. For an individual, this period goes up to at least six months for the relocation of his/her "habitual residence" prior to the opening request.

Opening a secondary proceeding in other countries is an important aspect for the predictability of insolvency proceedings. To protect their interest, local creditors can open a secondary proceeding in any European country where the debtor has an establishment. If the procedure is open to too much discretion by the court of establishment, which can also hear the main liquidator and refuse to open the secondary proceeding, this can be a source of cost unpredictability in cross-border insolvency. With the recast, creditors can request secondary proceedings not just for merely winding-up proceedings, but for any proceeding (including restructuring) in any place of operation where "the debtor carries out an economic activity with human means and assets" (Recital 24; Art. 2(10)). While the main liquidator can offer to treat local creditors as they would be treated in the jurisdiction of establishment, the procedure is still burdensome and leaves great discretion to the local court. The court of the country of establishment may tend to be excessively conservative in its attempt to protect local creditors under local laws and a local NCWO principle (Valiante, 2016).

4.2 The European Commission's consultation and potential actions

The work of the European Commission is currently divided into two thematic areas:

- boosting jobs and growth, and
- overseeing and monitoring financial systems.

Under the 'jobs and growth' discussion, the revision of the insolvency law focuses on early restructuring (pre-insolvency) proceedings. This action follows the implementation of a 2014 Commission Recommendation (European Commission, 2014a) on giving a second chance to debtors (including a harmonised discharge period, which differs markedly across the EU), and so moving towards a more 'debtor-friendly' insolvency framework, which is currently very punitive in some countries. This work stream, supported by an expert group, is producing a legislative proposal (most likely a directive) that will implement the principles of the recommendation on a 'second chance'. This initiative might involve actions that are not directly linked to the banking union and the capital markets union, but will concentrate on early restructuring procedures, which are not available in the majority of EU countries, as also requested by the Eurogroup (European Commission, 2016; Eurogroup, 2016b; European Council, 2016). These may include multiple actions:

- the launch of an early restructuring or conciliation procedure, perhaps based on some elements of the French model;[16]
- the introduction of a list of non-voidable transactions without the harmonisation of clawback periods;
- the use of selective stays in early restructuring, which are confidential and only for specific claims;
- a common test to assess the risk to the 'viability' of the business of entering into the pre-insolvency proceedings;

[16] The main aspects of this model for conciliation and accelerated (financial) safeguard proceedings are, among others, that proceedings are confidential, limited in time (between three and six months), supervised by the court and have the possibility to cram down on a minority of creditors.

- the harmonisation of discharge periods from debts for natural persons, most likely after three years;
- the minimum liquidation valuation to be considered the point of reference in NCWO assessments; and
- the disqualification of directors, if they are liable for wrongdoing after they knew about the insolvency.

The Commission, with this initial policy action, may not be able to address issues related to the creation of specialised courts (as suggested in section 2), the removal of priority for tax claims, a harmonised suspect period for avoidance actions or the introduction of a harmonised insolvency test.

The thematic area of oversight and monitoring of national financial systems aims at identifying optimal insolvency regimes, starting from the ideal theoretical framework. In this respect, the Eurogroup has identified six principles that should guide EU policy action (Eurogroup, 2016a):

- early identification of debt distress, as early action helps to preserve value;
- the availability of early restructuring procedures, to avoid piecemeal liquidation as much as possible;
- the availability, accessibility and affordability of insolvency proceedings to offer tools that are easy to use and based on clear criteria;
- effective enforcement of creditor claims in secured lending, through more efficient foreclosure procedures;
- mechanisms allowing distressed debtors a genuine fresh start, while incentivising responsible lending; and
- clear rules on cross-border insolvency.

Under the risk reduction measures and to increase participation in economic oversight in the euro area, insolvency reforms were in the country-specific recommendation (CSR) for the euro area. As part of the European Semester, the European Commission and Council have invited a number of member states to reform their national insolvency frameworks, in view of reducing the high level of NPLs. More specifically, on top of a CSR for the euro area as a whole, CSRs relating to national insolvency frameworks and the high level of NPLs have been addressed to Ireland, Spain, Croatia, Italy, Hungary, Malta, Portugal and Slovenia (European Parliament, 2016). The Eurogroup also requested the creation of benchmarks, namely indicators of outcomes to compare insolvency frameworks beyond the World Bank data. These indicators can be used like the tax wedge indicators to compare regimes across the euro area and to push for more reforms by learning from successful experiences. Indicators would need to be carefully designed to be meaningful. In particular, the number of proceedings or length may not always be a quality indicator.

Finally, the harmonisation of the creditors' hierarchy in insolvency laws is also considered an important step in strengthening the banking union framework on bank resolution and will be part of a separate legislative proposal (European Council, 2016).

4.3 Options for convergence

Harmonising insolvency laws is a difficult process, as the framework interacts with a myriad of local laws, including those that are typically not a core competence of European institutions, such as corporate and labour laws (involving employees and creditors' rights). The following sections review harmonisation options and the legal bases for action at the EU level on insolvency laws.

4.3.1 *Harmonisation options*

Beyond the status quo, there are at least three options for the harmonisation of insolvency laws:

- full harmonisation,
- minimum harmonisation (e.g. a directive or a regulation for selected specific areas), and
- a 29th regime.

The full harmonisation approach of insolvency regimes would foster rapid convergence across euro area countries, but would not necessarily address clashes with local laws that also reflect the differences in insolvency laws in the first place. The diverse environment, which is the current baseline scenario, may not suggest an invasive legal tool on a large scale. Nonetheless, the full harmonisation approach is a concrete solution in very specific areas, like the ranking of creditors, due to the benefits that such harmonisation would create for the single market and for the stability of the financial system (in resolution actions). This is currently the preferable option for the proposal on the harmonisation of ranking of creditors under the BRRD.

A minimum harmonisation approach offers the flexibility to devise legal tools that take care of the balance between insolvency laws and connected legal areas that are historically domestic competences, such as company and labour laws. This appears to be the case for the initiative on early restructuring and second chance, which may be enshrined in a directive that sets out the principle of a more debtor-friendly framework without entering into the details of insolvency frameworks related to local legal traditions. However, such solutions have often been affected by poor implementation practices.

Another possibility for harmonisation is the creation of a 29th insolvency regime that could apply to insolvency in specific cases, such as when the majority of the unsecured creditors are from another country or when the insolvent entity is a counterpart of a given level of cross-border financial transactions. There are currently other examples of 29th regimes, such the lending contracts of the European Investment Bank. When the 29th regime applies, dedicated courts supervise and manage the proceedings. They can be either full-fledged branches of European courts of first instance or spin-offs of national courts dedicated to the application of this regime. Both options are possible, as long as the right of being heard is protected.

4.3.2 *Legal bases and instruments*

There are a number of formal legal bases and informal instruments (such as the Eurogroup; see Box 3) that can help to harmonise insolvency laws in the EU and, more specifically, in the euro area:

- Art. 81 TFEU,
- Art. 114 TFEU,
- Art. 352 TFEU,
- the enhanced cooperation procedure, and
- an international treaty.

Art. 81 TFEU offers the legal basis for judicial cooperation. It has not been used for harmonisation of substantial laws, unless these laws are set to improve judicial cooperation and solve conflicts of laws. The use of this legal basis requires unanimity. There are only a few cases in which laws have been approved under Art. 81 TFEU, among which, for instance, is the Credit Institutions Winding-up Directive (2001/24/EC), because of its conflict-of-laws legislation. The directive has more recently been amended by the BRRD under Art. 114 TFEU.

In effect, Art. 114 TFEU is the main legal basis for harmonisation of laws for the functioning of the single market, when member states are unable to provide a better framework for the single market. However, the Commission has to make the case for the intervention and its action needs to be proportional to the objectives to be achieved. This article is perhaps the most plausible legal basis for harmonising insolvency laws through two main arguments: i) the inability of member states to align their insolvency frameworks to avoid creating significant obstacles to the single market (as in the different ranking of creditors for the functioning of the Single Resolution Mechanism and BRRD); and ii) relative to the need to use tools that are proportionate to the objective, measures to increase predictability in a cross-border transaction are a pre-condition for the creation of a true single market for capital.

Another option is Art. 352 TFEU (the flexibility clause), which is used under the implied powers clause and for objectives that are aligned with the Treaty, but for which the Treaty has not provided the necessary power. It is the article that sets the framework for modernising the Treaty. It also often requires unanimity in the Council (after consent of the European Parliament and the check of compliance with the subsidiarity principle by the European Commission) and ratification by most of the European national parliaments. It was used in the past for environmental issues.

Moreover, if Art. 352 TFEU fails, there is the enhanced cooperation[17] procedure, but it might not be suitable for legislative interventions on insolvency laws, which would not benefit from different speeds among subgroups of member states of the EU. The procedure requires a qualified majority in the Council and before getting into enhanced cooperation, a legislative text and a legal basis need to be proposed and cannot be linked to membership of euro area.

Finally, as a last resort, an international treaty for all 28 member states with the use of opt-outs could be signed. Still, this intervention might be suitable for the introduction of new institutions or laws, but less so for the (partial) harmonisation of long-established national insolvency regimes.

[17] According to the EUR-Lex website,

> Enhanced cooperation is a procedure where a minimum of 9 EU countries are allowed to establish advanced integration or cooperation in an area within EU structures but without the other EU countries being involved. This allows them to move at different speeds and towards different goals than those outside the enhanced cooperation areas. The procedure is designed to overcome paralysis, where a proposal is blocked by an individual country or a small group of countries who do not wish to be part of the initiative. It does not, however, allow for an extension of powers outside those permitted by the EU Treaties. Authorisation to proceed with the enhanced cooperation is granted by the Council, on a proposal from the Commission and after obtaining the consent of the European Parliament. As of February 2013, this procedure was being used in the fields of divorce law, and patents, and is approved for the field of a financial transaction tax.

Box 3. The Eurogroup as an instrument for harmonisation

As established by Protocol 14 of the European Treaties,* the Eurogroup is an 'informal body' that brings together the ministers of the member states whose currency is the euro. The work of the Eurogroup is prepared through the Economic Policy Meeting and the Eurogroup Working Group. Through the joint interpretation of Arts 121 and 126 TFEU (as the legal basis), over the years the Eurogroup has gained a considerable role in the setting-up of economic policies that affect the euro area, and in particular, its budgetary position.

Its current role in EU action on insolvency proceedings is limited to oversight of national economic policies. This topic is especially relevant for the thematic discussion of the Eurogroup on jobs and growth. In this regard, the group is working on two facets:

- benchmarking the different insolvency and foreclosure regimes (including fast access to collateral) to highlight best practices that could actually be adopted by all member states, with attention on those with less effective insolvency and foreclosure regimes; and
- ensuring a sound oversight of euro area countries' financial systems (chiefly the relationship between insolvency laws, credit recovery procedures and management of NPLs).

Therefore, the main role for the Eurogroup would be of coordination, through the definition of principles for action by member states (listed in section 4.2) and moral suasion (by 'naming and shaming' countries that are not compliant) for the adoption of these important reforms in the euro area. This coordination could take place in fora where the Eurogroup plays a greater role, such as the monitoring of national economic policies.

* See Protocol 14, Consolidated Version of the Treaty on the European Union and Consolidated Version of the TFEU.

5. Conclusions

Insolvency laws are entrenched in local legal systems, but they play a key role in the proper functioning of the euro area banking system and capital markets. Effective insolvency proceedings could have tangible effects on the functioning of the single market for capital and banking services. The quality of insolvency proceedings across the euro area is generally lower than that in advanced countries like the US and Japan, and it has barely improved in recent years. Policy actions are necessary to advance this legal framework. The European policy response is currently split into three areas:

- boosting jobs and growth;
- assessing the quality of insolvency frameworks and best practices (benchmarking); and
- strengthening the institutional architecture of the banking union (especially the functioning of the Single Resolution Mechanism).

Actions on jobs and growth include a directive to implement the 2014 Commission Recommendation on early restructuring and a second chance (more debtor-friendly procedures), and potentially selected changes to local insolvency regimes to reduce the unpredictability of procedures in cross-border transactions, such as standardised relief actions or harmonised rules on directors' liability (see Table 2). This set of actions would apply to the whole EU.

Table 2. Comparing EU actions

Jobs and Growth (CMU)	Bank Recovery & Resolution (banking union)	Benchmarking
• **What:** Early restructuring and second chance • **Legal tool & approach:** Directive under minimum harmonisation, plus separate action to reduce unpredictability	• **What:** Creditors' hierarchy in liquidation & other issues • **Legal tool & approach:** Amendments to BRRD under maximum harmonisation	• **What:** Indicators of quality of insolvency regimes • **Legal tool & approach:** New indicators to benchmark policy actions

Note: CMU refers to the 'Capital Markets Union'.

Actions are also being considered in the area of the institutional architecture of the banking union, and in particular the functioning of the Single Resolution Mechanism. These actions would be specifically for the euro area and include mainly include the harmonisation of the hierarchies in liquidation.

Further actions should be considered for the management of NPLs. These would require, notably, more effective procedures for collateral repossession and sale by auction by insolvency practitioners. Improvement in insolvency regimes could produce sizeable effects on narrowing the pricing gap between buyers (investors) and sellers (banks), thus supporting the creation of a liquid secondary market.

Finally, the establishment of indicators to measure the effectiveness of local insolvency regimes could help to identify best practices and to assess the impact of EU intervention. In this context, the Eurogroup has shown great ability to steer discussions, with the introduction of key principles and the ongoing monitoring of their implementation across the euro area.

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