BANK RESOLUTION AND INSOLVENCY LAW: INTERACTIONS AND FRICTIONS

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Abstract

The aim of this article is to make a first pass at highlighting and summarising the main interactions between bank resolution and insolvency law, which sometimes result in frictions. The roots of these frictions lie in the different objectives of the two legal frameworks and the different interests that they aim to protect. Paradoxically, despite these frictions, resolution authorities in the European Union must apply the national insolvency law, which is still not harmonised at European level. And they must do so not only in the event of resolution, but also counterfactually, in ex post and ex ante situations, with respect to key issues (grounds for resolution, creditor protection and creditor hierarchy) that are either incompletely or too broadly regulated under the Bank Recovery and Resolution Directive. In the absence of specific rules, this article aims to shed light on the main interpretative tensions between the rules that are applicable in resolution and their insolvency counterparts.

Keywords: resolution, insolvency law, harmonisation of European insolvency law, bail-in, loss-absorption, creditor hierarchy, best-interest-of-creditors test, no creditor worse off, preventive non-financial restructuring.

1 Introduction

There is an area where bank resolution and insolvency law interact. From an institutional standpoint, one of the main questions that this framework raises is whether such interactions lead to frictions or to synergies between the two regimes.

As a starting point, the fundamentals seem clear at first glance. Namely, national insolvency law is the default legal option to be applied to a bank that is failing or likely to fail (FOLTF), except where the application of resolution powers is in the public interest because the national insolvency framework would not be as effective at meeting the resolution objectives.

However, if we take a closer look at the aforementioned legal model, things are not as clear as they first seem. Because it is a complex topic the in-depth assessment of which would exceed the limits of this article, this article serves as an initial analysis of the general relationship between insolvency and bank resolution frameworks, highlighting the main interactions and potential frictions between them.

In my view, the roots of such frictions can be traced back to the different objectives and interests protected by each regulatory framework, which, in turn, lead to different interpretative principles (Ramos Muñoz and Solana, 2020), as I will explain in this article.

Paradoxically, despite these material tensions, resolution authorities in the European Union (EU) must apply national insolvency laws in their counterfactual assessments. And they must do so not only in resolution, but also in ex ante situations (in the public interest assessment for resolution) and ex post situations (in the context of subsequent litigation, linked above all to creditor safeguards, when they need to compare the position and hierarchy of creditors in hypothetical winding-up proceedings and in the context of bank resolution) and with respect to key issues where these tensions arise and are regulated incompletely or broadly by 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[1] (the Bank Recovery and Resolution Directive or BRRD).

These key issues include:

— The triggers for taking resolution action and those for opening insolvency proceedings (public interest).

— Creditor safeguards (the no creditor worse off (NCWO) principle).

— Creditor hierarchy, determining the order in which creditors are repaid when tools such as bail-in are applied.

Moreover, insolvency law is not fully harmonised across the EU. To date, the only harmonisation achieved is provided for in (i) Regulation (EU) 2015/848[2] on insolvency proceedings, which addresses relevant issues of jurisdiction, recognition, enforcement, conflicts of laws and cooperation in cross-border insolvency proceedings, and (ii) from a substantive point of view, in the area of preventive corporate restructuring, Directive (EU) 2019/1023.[3]

However, it should be noted that the EU is also currently proposing to harmonise certain aspects of insolvency law across Member States (the draft "Second Insolvency Directive"). In any event, banks fall outside the scope of all these drafts and proposals.

Consequently, there are as many national insolvency laws as there are countries in the EU. This means that resolution authorities must apply and consider the national specificities of their insolvency law when making their resolution assessments, most notably in the above-mentioned areas.

At the same time, banks that are not subject to resolution (because they do not meet the public interest assessment) must be liquidated in accordance with the proceedings set out in their national insolvency law. The lack of harmonisation in this field results in an undesirable

1 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.

2 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

3 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

lack of legal certainty and in a different level of protection for creditors, shareholders and depositors across the EU.

With this in mind, I will now briefly outline the main interactions and interpretive frictions between the specific resolution rules and their insolvency counterparts. Considering the absence of specific rules to coordinate their interaction on key issues, I will also try to answer some of the relevant questions that could be posed, such as:

- Should national insolvency law simply default to a resolution regime where resolution tools or powers are unavailable?

- Or could it also be a supplementary regime for issues that the BRRD does not regulate or only partially regulates?

2 Bank resolution and the lack of insolvency law harmonisation

As mentioned above, except for the harmonisation introduced by Regulation (EU) 2015/848 and Directive (EU) 2019/1023, insolvency law is not harmonised across the EU. Such lack of harmonisation is one of the most important pending matters in the construction of the EU and of a single market for capital, and largely distorts the functioning of the bank resolution model, which is now ten years old.

The lack of harmonisation means that there are significant differences and varying degrees of efficiency across the Member States' insolvency regimes. This is particularly true with regard to the mechanisms that allow debtors to overcome, or at least minimise, the effects of their inability to meet their payment obligations.

In the context of an economic crisis, this may lead to forum shopping, i.e. cases where debtors, in particular legal persons, move to jurisdictions that are more favourable for their interests. Forum shopping increases regulatory competition between Member States, but also entails costs.

For instance, in pre-bankruptcy restructuring, there has been a tendency to adopt the UK model of "schemes of arrangement" or, subsequently, "restructuring plans", which involve, inter alia, high legal fees. As a result of Brexit, such schemes now face problems with the recognition of court decisions handed down in these proceedings (Galazoula, West and Harvey, 2023).

However, the lack of insolvency law harmonisation across the EU started to change following the transposition of Directive (EU) 2019/1023, which was preceded by the Commission Recommendation of 12 March 2014 on a new approach to insolvency and business failure[4]

4 Commission Recommendation (2014/135/EU) of 12 March 2014 on a new approach to business failure and insolvency.

and which represented a decisive step towards harmonisation across the EU of the pre-insolvency framework for the treatment of non-financial corporations in financial distress.

In this respect, Directive (EU) 2019/1023 harmonises substantive aspects of insolvency law and not just procedural ones, as was the case with Regulation (EU) 2015/848, establishing minimum harmonising principles but focused only on certain areas and aspects (i.e. targeted harmonisation). Specifically, Directive (EU) 2019/1023 focused on early warnings, preventive procedures and liability exemption mechanisms. In other words, it focused on second chance mechanisms that promote a fresh start for failed entrepreneurs.

I will now briefly analyse Directive (EU) 2019/1023, with the aim of highlighting its importance as a first milestone in the process of harmonising insolvency law across the EU. This harmonisation is extremely necessary, not only to avoid the adverse consequences of having as many insolvency laws as Member States, but also, as mentioned above, to avoid the subsequent negative impact on bank resolution.

It should be noted that this Directive does not apply to financial or credit institutions (Article 1(2)(b)) and, therefore, does not play any role in bank restructuring and resolution. Consequently, there is no friction in this area between insolvency law and bank resolution, which is the subject of this article. However, I will touch on this Directive because one of the new aspects it introduces is the idea of restructuring, also with respect to non-financial corporations experiencing financial distress. Moreover, the Directive provides for restructuring not only by consensual means, but also, where applicable, by forced restructuring within each class ("cram-down") and across classes of creditors ("cross-class cram-down"), in a way that resembles the forced restructuring of banks that occurs through mechanisms such as bail-in.

In this respect, Directive (EU) 2019/1023 urges Member States to regulate preventive pre-insolvency restructuring procedures. Article 2(1)(1) adopts a very broad definition of restructuring, which covers not only the debtor's liabilities, but also their assets. It also includes the possibility of adopting measures such as changing the terms and conditions of the debtor's liabilities: write-offs, debt-equity conversion, capitalisation of loans and other measures to modify existing liabilities or restructure their assets through the sale of certain assets or of the company (Garcimartín Alférez, 2021).

Nevertheless, Directive (EU) 2019/1023 is not only important for the harmonisation of European insolvency law in the aforementioned area, but also because it is based on a new paradigm of business insolvency linked to corporate governance. This new paradigm aims to promote business creation and business continuity, as well as job preservation. It is based on two core premises: (i) the prevalence of pre-bankruptcy restructuring solutions and (ii) the second chance mechanisms for sole proprietors, which are reminiscent of the US system. In fact, Directive (EU) 2019/1023 is closely linked to the US approach to restructuring and in particular to Chapter 11 of the US Bankruptcy Code, which since 1978 has promoted both the restructuring and reorganisation of companies in crisis and discharge mechanisms for individuals.

However, it should be noted that while Directive (EU) 2019/1023 promotes a US-style approach to restructuring distressed companies, it is adopted differently from the approach taken in Chapter 11 of the Bankruptcy Code. Directive (EU) 2019/1023 favours pre-bankruptcy restructuring with minimal judicial intervention, similarly to the UK schemes of arrangement model, given the economic, time and reputational costs of judicial insolvency restructuring proceedings. By contrast, the rationale behind the US model is to encourage judicial restructuring of distressed companies in accordance with a “second chance” philosophy. It achieves this not only through an agreement in a judicial insolvency proceeding, but also through settlements that provide for the transfer of productive units in operation. This solution is consistent with two features of the US bankruptcy system. First, in that system directors of distressed companies are not obliged to file for a bankruptcy proceeding if the company is insolvent. Second, the US bankruptcy system is not characterised by the “stigmatisation” of bankrupt debtors, something that is (still) observable in other legal systems.

As mentioned above, Directive (EU) 2019/1023 is important because it adopts a new corporate governance approach to regulate the insolvency or potential insolvency of a non-financial corporation. This approach is typical of Anglo-Saxon models, as opposed to some continental European models that only take into account the corporate governance of solvent companies. It is precisely this approach that has proved essential to addressing business recovery in the EU in a post-COVID-19 and post-Brexit economic environment.

The aforementioned resemblance to the Anglo-Saxon models is reflected in Directive (EU) 2019/1023 in at least three areas. First, in the necessary involvement of equity in the restructuring process, including possible changes of control and non-consensual restructurings, not only for creditors but also for the debtor and shareholders. Second, in the need for administrators to take into account the interests of not only the shareholders, but also other stakeholders, such as creditors, employees, etc. Lastly, in the possibility (provided for in the Directive itself) of introducing an early warning in cases of economic difficulties, at least with respect to small and medium-sized enterprises.

The objective pursued by Directive (EU) 2019/1023, as per recitals (2) and (3), is very ambitious, since in principle it aims to restructure viable companies close to insolvency (i.e. companies whose going concern value is higher than their liquidation value), without excluding, however, those firms that are already failing.

The goal is to maximise the value of corporate assets in a balanced manner to the benefit of creditors, shareholders (as owners of the company) and the economy as a whole, thereby preserving jobs. At the same time, it prevents the build-up of non-performing loans for banks, which may, through the pre-insolvency procedures regulated in the Directive, identify borrowers’ economic difficulties at an early stage to ensure that action is taken before companies default on their loans. They will thus be able to take measures to avoid the declaration of a judicial insolvency procedure and the liquidation of viable companies. Liquidation can have an indirect, punitive effect on financial institutions in terms of their income statements and recognition of provisions.

Directive (EU) 2019/1023 promotes the liquidation of companies that are not economically viable. Member States must introduce measures in their insolvency laws to improve efficiency and to prevent the proliferation of "zombie companies", as recommended by the Organization for Economic Co-operation and Development.

Directive (EU) 2019/1023 takes as its starting point the general rule of consensual restructurings. Yet it also provides for scenarios of non-consensual restructuring (cram-down and cross-class cram-down), not only for creditors, in an attempt to overcome hold-out and free-rider problems, but also for shareholders, who may sometimes be willing to block the adoption of the corporate resolutions needed to restructure the company on the basis of the traditional paradigms of corporate and contract law (the principle of relativity of contracts, the role of shareholders as owners of the company, etc.).

The possibility of forced restructurings entails the need for regulated safeguards for dissenting creditors and shareholders that are nonetheless going to be affected by the restructuring. In this context, Directive (EU) 2019/1023 introduces new paradigms with respect to the traditional restructuring approaches, in which the influence of the US model is felt once again.

One of these safeguards is the best-interest-of-creditors test (BIT) in the context of the cram-down within each creditor class (Article 10(2)(d)). This test compares the value under a restructuring scenario against the value attributable to creditors in the event of liquidation or, at the Member States' discretion, the best alternative scenario if the restructuring were unsuccessful. Furthermore, Directive (EU) 2019/1023 nuances the absolute priority rule, which protects creditors where other classes of creditors are crammed down. Member States may opt for a relative priority rule as a means of protecting entire classes of creditors (Article 11(1)(b)).

Non-consensual restructurings for non-financial corporations under Directive (EU) 2019/1023 have been tested through the restructuring of financial institutions under the BRRD. In this context, the NCWO principle, which would be the equivalent of the BIT for non-financial corporations, has served in practice to test the problems that the non-consensual restructuring of non-financial corporations may entail. Since financial restructuring preceded non-financial restructuring, this experience helps us to identify the problems and see that they are ultimately the same.

At the same time, inversely, the question arises as to whether this parallel between the BIT and the NCWO principle could be used to interpret some of the doubts raised in practice by the application of the NCWO principle given its scant regulation in the BRRD.

On 7 December 2022 the European Commission published[5] a proposal for a Second Insolvency Directive harmonising certain aspects of insolvency law, which in principle is consistent with and complementary to the targeted harmonisation introduced by Directive (EU) 2019/1023.

5 COM 22/0408 (COD).

At this juncture, I deem it necessary to touch on this proposal, specifically in relation to the choice of the areas harmonised in it.

The proposal focuses on avoidance actions (Title II); asset tracing (Title III); pre-pack proceedings (Title IV), which could be seen as analogous to the sale of business tool in bank resolution; directors' duty to request the opening of insolvency proceedings (Title V); the winding-up of insolvent microenterprises (Title VI); creditors' committee (Title VII); and measures enhancing transparency of national insolvency laws (Title VIII).

However, other issues with potentially important implications for bank liquidation or resolution (such as the grounds for the opening of insolvency or restructuring proceedings, the hierarchy of creditors, or the particular issue of financial distress within a group of companies) are outside of the scope of the harmonisation sought by the European Commission with its proposal.

Their exclusion, particularly in relation to creditor hierarchy, is questionable, among other reasons, because this absence, as mentioned above, has considerable consequences for putting bank resolution into practice. In this respect, even if it is true that the proposed Second Insolvency Directive does not apply to financial institutions, it is no less true that in the context of bank resolution, creditor safeguards (such as the NCWO principle) are built on the basis of a counterfactual analysis of the position that creditors would occupy in a potential judicial insolvency proceeding (insolvency hierarchy). Such position would in turn determine the order in which claims are written down when tools such as bail-in are applied. Consequently, the lack of harmonisation at European level of this insolvency creditor hierarchy, which should have been deemed a priority over the harmonisation of other areas (e.g. creditors' committees), may determine, and indeed is determining in practice, a different treatment and assessment of the burden-sharing among creditors in bank resolution across the different Member States.

3 The root of the frictions: different goals and protected interests

The BRRD linked the bank resolution framework to the lessons learned from the 2008 financial crisis.[6] In this respect, the financial crisis showed that there was a significant lack of adequate tools at European level to deal with the situation triggered by failing or likely to fail credit institutions and investment firms.[7] In particular, as stated in the recitals of the BRRD, such tools were necessary to prevent insolvency or to minimise its adverse effects by preserving the systemically important functions of the institutions concerned.

At the time, the solution to financial crises was to use the Member States' taxpayers' money (bail-out), which carried the risk of moral hazard and the false notion that taxpayers should

6 See recital (1) of the BRRD and the report on the adoption of the aforementioned directive.

7 See recital (2) of the BRRD.

pay for banks' mistakes.[8] Thus, the goal of a credible recovery and resolution framework for banks and investment firms was to avoid, to the extent possible, the need for such actions, since the primary objective of resolution is to protect financial stability, in particular, to prevent contagion and to protect depositors.

Accordingly, the BRRD and Article 14(2) of the Single Resolution Mechanism Regulation (SRMR) set out five objectives for the bank resolution regime:

- To ensure the continuity of critical functions.
- To avoid significant adverse effects on financial stability, above all by preventing contagion, including to market infrastructures, and by maintaining market discipline.
- To protect public funds by minimising reliance on extraordinary public financial support.
- To protect depositors covered by Directive 2014/49/EU on deposit guarantee schemes (DGSs) and investors covered by Directive 97/9/EC on investor-compensation schemes.
- To protect customer funds and assets.

However, by contrast, the main goal of corporate insolvency law has to date been to maximise the value of the distressed companies in the interest of private creditors.

At this point, the key question should be: how can the resolution authority apply insolvency law rules, which focus on protecting private interests, in the context of bank resolution, which is primarily about protecting the public interest?

It is true that the concept of insolvency law has been broadened by virtue of Directive (EU) 2019/1023, since the tools for dealing with insolvency are now broader and their objectives have been extended beyond the satisfaction of creditors to the restructuring of viable companies that are experiencing financial difficulties, through procedures that avoid the declaration of a traditional insolvency proceeding. This could suggest an approximation, to some extent and with nuances, of the goals entrusted to the pre-insolvency restructuring procedures to the objectives pursued through the resolution of financial institutions.

In this respect, based on Directive (EU) 2019/1023, it should be possible to distinguish, via the preventive restructuring procedures, between viable companies – i.e. companies whose value as a going concern is higher than their liquidation value – and non-viable companies, which should be liquidated immediately.

8 Wojick (2016) pointed out that at that time (i.e. the financial crisis) there were no alternatives to ordinary insolvency proceedings or to bail-out, and in most cases neither at national nor at EU level did a special framework for the recovery and resolution of banks exist that would have avoided the disadvantages for banks of ordinary insolvency proceedings.

Preventive restructuring procedures ensure that appropriate measures are taken before companies default on their loans. The underlying idea is that as soon as the financial difficulties arise, the debtor, as long as it is a viable company, should be able to reach a consensual solution with its creditors in order to avoid the declaration of traditional insolvency proceedings.

One could therefore say that the new preventive restructuring proceedings share with the bank resolution regime the objective of avoiding a traditional judicial insolvency proceeding and liquidation, given that the latter would be the best way to destroy the economic value of the company.

Nevertheless, the main difference lies in the interests taken into account, since the interests protected in bank resolution are mainly public and general interests (financial stability, protection of covered depositors, etc.), whereas it is the creditors' interests that are taken into account in the restructuring of non-financial corporations. These creditors decide by majority vote and with an economic criterion whether they wish to reach an agreement with their debtor in order to avoid a judicial declaration of insolvency.

Moreover, Directive (EU) 2019/1023 not only provides for consensual restructurings, i.e. agreements with a large majority of creditors, but also for non-consensual restructurings for dissident creditors, debtors and shareholders. It thereby seeks to deal with traditional hold-out scenarios by attempting to overcome the well-known principle of the relative effects of contracts, on the basis of the premise that corporate law should not hinder the restructuring of viable companies. Accordingly, several measures may be imposed on shareholders to "encourage" them to cooperate in the restructuring of their company. Particularly relevant in this respect is the possibility of converting debt into equity, which would allow creditors to become shareholders, even with the potential risk of diluting the current shareholders' position.

As mentioned above, non-consensual restructurings have, for some time now, been tested through the restructuring of financial institutions under the BRRD. This experience has been useful to become aware of the main issues that may arise in practice after the introduction of non-consensual restructurings in the non-financial corporate realm.

However, the basis for a non-consensual restructuring is different for financial institutions and non-financial corporations. In the case of the former, it is a regulatory issue, where the public interest is at stake. In the case of the latter, it is a purely economic issue, where what is under analysis is who the actual owners of the company are when it is in financial distress and where the class in which "the value collapses" is able to drag in others.

In other words, under the framework for non-financial corporations, the economic approach to corporate distress is based on the idea that if the company has no residual value for its shareholders, then the company belongs to the creditors, and they cannot jeopardise the restructuring of viable companies. By contrast, under the resolution framework, the rationale for non-consensual restructuring is not only economic but is also based on the public interest and the protection of financial stability and depositors.

In light of all the above, I consider that the comparison for the purposes of the counterfactual analysis conducted under the bank resolution framework (public interest assessment, creditor safeguards, etc.) should continue by express legal provision in respect of a liquidation in a traditional judicial insolvency proceeding (Articles 34(1) and 73(b) of the BRRD and Article 15 of the SRMR) and not in respect of the new pre-insolvency restructuring procedures, whose guiding principles, as analysed above, are different, without Directive (EU) 2019/1023 also being applicable to financial institutions.

In any case, it will be useful to analyse how the aim of restructuring viable companies through the new procedures designed in Directive (EU) 2019/1023 is incorporated into the insolvency law of the Member States. This will allow us to better identify the differences between the restructuring of non-financial corporations and the resolution of financial institutions, which in some ways bank restructuring also pursues where possible.

4 The grounds for opening proceedings: failing or likely to fail versus insolvency

In terms of the grounds for opening the proceedings, there are major differences and, in my opinion, even greater frictions between bank resolution and both traditional judicial insolvency proceedings and the new preventive restructuring proceedings.

Under Articles 18(1) and 18(6) and recital (57) of the SRMR and Article 32 of the BRRD, a resolution scheme shall be adopted where three cumulative conditions are met:

- The institution is FOLTF.
- The absence of a reasonable prospect of effective alternative private sector solutions or supervisory measures to prevent the failure within a reasonable timeframe.
- The resolution action is in the public interest. A resolution action is deemed to be in the public interest if two conditions are cumulatively met (Articles 18(1)(c) and 18(5) of the SRMR).[9] First, that such action is necessary and proportionate to achieve at least one of the resolution objectives set out in Article 31 of the BRRD and Article 14(2) of the SRMR.[10] Second, the liquidation of the institution under normal insolvency proceedings, as defined in Article 2(1)(47) of the BRRD, would not achieve these resolution objectives "to the same extent".[11] Hence, the EU resolution authorities

9 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

10 Single Resolution Board (2019).

11 See the proposed new wording of Article 32(5) of the BRRD in the proposal for the Directive of the European Parliament and the Council of 18 April 2023, which includes the requirement that the winding-up under a national insolvency law enable the resolution objectives to be achieved not only "to the same extent" as under the resolution, as it is currently worded, but also "more effectively". See, in this respect, Colino Mediavilla (2023) and Gómez de Tojeiro and Piazza Dobarganes (2024).

(including the Single Resolution Board (SRB)) need to make a comparison with a hypothetical national insolvency scenario, which requires a thorough knowledge of the bank insolvency and liquidation regime in the relevant Member State.[12]

Focusing on determining whether an institution is FOLTF, the starting point should be the first sentence of recital (57) of the SRMR, which states: "The decision to place an entity under resolution should be taken before a financial entity is balance sheet insolvent and before all equity has been fully wiped out".[13]

A credit institution shall be deemed in such a situation if it faces one or more of the following circumstances (Article 32(4) of the BRRD):

— Its assets are or there are objective elements to support that they will, in the near future, be less than its liabilities (Article 32(1)(a) of the BRRD and Article 18(1) of the SRMR).

— Extraordinary public financial support is required, unless that support takes any of the three forms mentioned in Article 18(4) of the SRMR to remedy a "serious disruption" to the national economy and preserve financial stability.

— It has infringed or there are objective elements to support a determination that it will, in the near future, infringe the requirements of its authorisation to operate, in a way that would justify its withdrawal by the competent authority.

While the last two conditions are not strictly related to the institution being balance sheet insolvent, they are related to possible situations of illiquidity, which would also be relevant to determining whether the institution is failing. Therefore, they would also include situations of insolvency, understood as a balance sheet insolvency test and situations of mere illiquidity.

These triggers for opening the resolution procedure are referred to as "objective elements" in the 2015 European Banking Authority (EBA) Guidelines, and even in the case of specific economic ones, are not defined in either the BRRD or in the SRMR.

Therefore, the term FOLTF is very specific to banking regulation and cannot be identified with the economic concept of insolvency provided for in insolvency law. In this vein, the concept of FOLTF is not always linked to the financial situation of the bank (i.e. whether the bank is over-

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12 The European Parliament (see *Annual Report 2021)* clearly expressed its support for a review and clarification of the PIA. Furthermore, the Eurogroup, in its 2022 Statement on the future of the Banking Union, expressed its agreement with the clarification and harmonisation of the PIA, as well the broadening of the application of resolution tools in crisis management at EU and national level, including for smaller and medium-sized banks where the funding required for effective use of resolution tools is provided by the MREL. See also the recent (April 2023) legislative proposals of the European Commission for the review of the existing EU bank crisis management and deposit insurance framework. See Gortos (2023), a study requested by the European Parliament Committee on Economic and Monetary Affairs.

13 See also the EBA Guidelines of 6 August 2015 (EBA/GL/2015/07), adopted based on Article 32(6) of the BRRD and in accordance with Article 16 of its founding regulation, on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail.

indebted, illiquid or insolvent). By contrast, it may sometimes be linked to the conditions for withdrawal of the authorisation to operate. For example, the supervisor may withdraw the authorisation in money laundering scenarios where the financial institution is not experiencing any economic difficulties. However, it should be noted that, according to the SRMR,[14] the fact that a credit institution does not meet the requirements for authorisation should not (per se) justify its entry into resolution, in particular if it is still viable.

Thus, the FOLTF determination by the European Central Bank (ECB) or the national competent authority[15] does not necessarily imply that the bank is insolvent. There are also possible scenarios in which the bank may be facing a liquidity crisis or no economic difficulties at all (money laundering).

At the same time, the FOLTF determination could occur in situations where the bank is insolvent, although recital (57) of the SRMR establishes that the decision to place an entity under resolution should be taken before it is balance sheet insolvent and before all equity has been fully wiped out.

In these cases, resolution encompasses all measures that need to be taken to avoid the opening of liquidation proceedings in respect of institutions whose failure may pose a systemic threat, thereby avoiding indirect spillover effects on the economy or the need to resort to bail-out measures through public financial support. Therefore, in practice, the BRRD appears to have extended the scope of resolution beyond insolvency to create what can be described as a specialised regime for bank failures.[16]

In my view, the real dividing line between liquidation and resolution is the public interest criterion.[17] In this assessment, the resolution authority must weigh up whether the resolution is necessary in the public interest or, on the contrary, whether the institution can be liquidated according to the national insolvency law. Thus, under the "umbrella" of the public interest criterion, an insolvent bank may be subject to resolution proceedings instead of insolvency liquidation.

There is still no harmonisation in the EU of the grounds for opening traditional judicial insolvency proceedings, or the new restructuring proceedings introduced by Directive (EU) 2019/1023. The core principle of this Directive is that debtors should be able to address their financial difficulties at an early stage, when it appears likely that insolvency can be avoided and the viability of the business can be ensured. This means that preventive restructuring frameworks should be available before the debtor fulfils the conditions for being considered insolvent under insolvency law.

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14 See recital (57) of the SRMR.

15 See Joosen, Pulgar Ezquerra and Tröger (2024) for more details on the design of the institutional framework around the resolution mechanism and on the ECB's powers, which must in any event conduct an initial FOLTF assessment (deciding independently whether the institution is failing in accordance with Article 32(1)(a) of the BRRD and on the judicial protection of this decision), and the powers of the SRB to assess the ECB's decision, conferring on the SRB the power to decide on the implementation of resolution tools.

16 Haentjens (2017), Ramos Muñoz (2017) and Hadjiemmanuil (2014).

17 Grünewald (2017) and Lastra, Russo and Bodellini (2019).

To this end, Article 2(2) of Directive (EU) 2019/1023 introduces the concepts of insolvency and likelihood of insolvency, but it does not define them, leaving their definitions to each national insolvency law. The grounds for opening insolvency proceedings are not, as mentioned above, a topic whose harmonisation has been addressed in the European Commission's proposal for a Second Insolvency Directive, which focuses on avoidance actions, the directors' duty to request the opening of judicial insolvency proceedings, the special proceeding to wind up microenterprises, asset tracing, creditors' committees and pre-pack proceedings.[18]

In any event, in corporate insolvency law, insolvency is always an economic concept and has traditionally been defined as either an inability to pay debts as they fall due or as an excess of liabilities over assets (balance sheet test), or both.

In contrast, in bank resolution the regulatory concept of FOLTF may, but does not always, derive from an actual insolvency, which means it resembles preventive restructuring proceedings more than the traditional concept of insolvency.

Further, from a procedural perspective, there is an important difference between bank resolution and traditional judicial insolvency proceedings in terms of the role and leeway of judges and resolution authorities. In a resolution scenario, the starting point is the broad discretionary powers of the resolution authority to adopt a resolution decision, as an alternative to submitting the bank to insolvency proceedings under national law. Conversely, the judge has no discretion in assessing the economic grounds for opening the insolvency proceedings, resulting in greater legal certainty.

All this means is that when the resolution authority must determine whether or not a resolution action is necessary in the public interest, it has to assess each national insolvency law against the resolution framework, even though the objectives and protected interests of such regimes are different. In addition, since national insolvency law is different in each Member State, some of the non-systemic banks (i.e. small banks) outside the scope of the resolution regime will have to be liquidated under different proceedings, which in turn leads to more differences among the Member States and, consequently, to a lack of legal certainty.

In this context, within the EU there are bank insolvency systems based on a judicial model (Spain) and others based on an administrative model (Italy), although in practice neither of these models is purely judicial or administrative.

In this respect, there are several complex legal issues that may arise in the context of the interplay between bank resolution and insolvency law with respect to the role of the courts in court-based models for bank insolvency. Indeed, administrative authorities may need court approval to initiate bank insolvency proceedings, or to adopt other key decisions during those proceedings. In most cases, such requests fall under the jurisdiction of commercial courts (Spanish model), general jurisdiction courts or, in a few cases, of specialised bankruptcy courts.

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18 Szirányi (2024), Garcimartín Alférez (2024) and Pulgar (2023).

Under this framework, the main question that could be posed is: what is the criterion for judicial review? There are some models that introduce the judicial review rules from administrative law in the civil procedure relevant to bank insolvency, and some other models that limit the court's ability to rely on certain matters in its assessment of the petition.[19]

At the same time, it is important to note that the role given to administrative authorities in bank resolution should not be without safeguards and checks and balances.

That is why national insolvency law is, in my opinion, an alternative to resolution where the grounds for resolution do not exist. However, it cannot be a supplementary regime to plug gaps such as the economic grounds for opening resolution, which are only broadly regulated in the BRRD.

Simultaneously, this legal framework raises a number of questions, including: what if the resolution authorities, such as the SRB, decide not to resolve a national bank, even though the bank is very important for the local economy? What should national governments do? These questions could be resolved with the inclusion of the PIA at the regional level in the EU's proposal for the reform of the crisis management and deposit insurance (CMDI) framework.

5 Non-consensual bank resolution versus non-financial restructuring: bail-in and non-financial cram-down

Regarding cram-down, the BRRD introduced a statutory cram-down through bail-in, which was a first in EU law.

Following the 2008 crisis, the financial system in most Member States underwent far-reaching restructuring, conducted in accordance with the BRRD, via bail-in measures as opposed to bail-out programmes. The latter are considered a form of State aid, which not only affects taxpayers, but also increases the risk of moral hazard and creates a dangerous link between sovereign debt and potential economic crises.

The term bail-in, in contrast to the term bail-out, is regulated in the BRRD and the SRMR with a double meaning.[20] First, bail-in is mentioned as one of the possible resolution tools for credit institutions applicable by the administrative authority when the conditions laid down in Article 33 of the BRRD and Article 27 of the SRMR are met. As a resolution tool, it entails the

19 See the Unidroit project on small and medium-sized bank insolvency, led by Professor Ignacio Tirado, currently Secretary General of Unidroit, which aims to fill the current gap in the international legal architecture, by developing an international soft law instrument covering the main features of bank liquidation proceedings. Guidelines on bank insolvency were expected to be prepared over five sessions of the Unidroit Working Group on Bank Insolvency in 2021-2023, to be adopted in 2024. The work is conducted in cooperation with, and with the support of, the Bank for International Settlements' Financial Stability Institute and the participation in the working group as observers of several central banks, supervisory authorities, resolution authorities, deposit insurance schemes and academics (inter alia, the SRB, the European Banking Institute and the International Insolvency Institute). The current status of the project is available on the Unidroit website.

20 Wojcik (2016) refers to bail-in as an "umbrella term".

bank's losses being borne first by the shareholders and then by the creditors through write-down or conversion, the latter according to the order of priority of their claims established in ordinary insolvency proceedings. According to the BRRD, ordinary insolvency proceedings are collective proceedings involving the partial or total liquidation of a debtor and the appointment of a liquidator or an administrator under national law (Article 2(1)(47) of the BRRD).

As academics have rightly pointed out, bail-in is the authentic resolution tool introduced by the BRRD, as opposed to the negotiated or contractual nature of other instruments, such as the sale of assets.[21] As a resolution tool, bail-in can be used alone, as an internal measure to recapitalise credit institutions, or in combination with other tools, as a means to provide capital to a "bridge" bank and to complement the sale of its assets. Bail-in is not merely a loss-absorption mechanism, but also a mechanism to recapitalise the institution, and can therefore serve to restore its viability, at least as far as solvency is concerned. This is the essential purpose of the harmonised resolution regulated in the BRRD.

Second, the term bail-in is related to the concept of reductions or write-offs and cases of debt-to-equity conversion. In practice, write-offs and conversions can be applied independently or in combination with a resolution tool, in accordance with Article 37(3) of the BRRD and Articles 21 and 27 of the SRMR.[22]

In this context it is important to note that bail-in is in any event a resolution tool, unlike write-offs and debt-to-equity conversion, which can take place either independently of resolution action or in combination with a resolution action where the conditions for resolution specified in Articles 32 and 33 of the BRRD are met (Article 59(1) of the BRRD), and not only with a bail-in, but also, for example, with a sale or a bridge bank. They are therefore a "resolution measure" rather than a tool. Indeed, the latter, in combination with write-off and conversions, and not the bail-in as such, have so far been the means whereby resolution has occurred in practice. Accordingly, strictly speaking, bail-in has not yet been applied in practice.

The original intention was to apply bail-in measures only to certain creditors (in particular, to providers of regulatory capital).[23] However, it was ultimately extended to ordinary and subordinated claims, except for those specifically protected and excluded from bail-in under the BRRD and in the SRMR.[24]

Once again, in this context of burden-sharing, a comparison can be made between the resolution and restructuring framework for credit institutions and investment firms and insolvency proceedings, as collective procedures involving the partial or total divestment of a

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21 Ringe (2016) refers to a compromise between two traditionally opposing tools in banking crisis, in particular the provision of liquidity by the ECB to illiquid banks and the liquidation of insolvent banks.

22 For more details on the functions of bail-in, see Wojcik (2016).

23 The bail-in measures were not initially intended to affect all creditors of a bank, but only shareholders and creditors participating in the "core equity instruments", "hybrid instruments" and "tier 2 instruments". In short, this means creditors who would be subordinated if an insolvency proceeding was initiated (Brescia Morra, 2020).

24 Gortos (2021). Troeger (2018) pointed out that the initial option to extend the bail-in only to specific creditors was more consistent with the system.

debtor and the appointment of a liquidator or an administrator under national law (Article 2(1)(47) of the BRRD).

The bail-in tool is exercised by public authorities through a special administrative procedure that differs from traditional judicial insolvency procedures. This is justified on the grounds of the public interest served by banks, which makes it possible to reconcile concurrent public and private law rules in the banking sector. Just as the incorporation of a credit institution and the beginning of its operations are subject to administrative authorisation, so too is the treatment of any economic difficulties it may encounter and the disappearance of the conditions necessary for the granting of the initial authorisation, even if corporate law techniques are used (Gleeson, 2012).

The bail-in tool is thus established, not as a contractual solution to a bank's economic difficulties reached by the bank, its shareholders and its creditors, but rather as a statutory cram-down, imposed by law and exercised by administrative authorities with broad discretionary powers under this framework. However, it should be noted that this is a regulated discretionality, as bail-in and its exclusions are subject to mandatory rules.

To such end, the resolution authority can determine the existing classes of shares or instruments that may be cancelled or transferred to creditors subject to bail-in. Moreover, the resolution authority may decide to convert the creditors' loans into shares or other instruments. Such a decision entails an accounting mechanism that modifies the structure of the bank's balance sheet and may sometimes dilute the position of existing shareholders (see Articles 47(1)(b) and 63(1)(f) of the BRRD).

This new approach to financial restructuring entails replacing a State aid regime with an effective bail-in mechanism that requires investing creditors to consider a bail-in scenario and to conduct an analysis of the credit institution's liability structure, including the debt ratio that would be outside the bail-in, in order to "predict" their position in such a context. Consequently, if creditors conclude that there is a significant possibility of a bail-in, they are likely to demand a higher rate of return to invest in debt instruments issued by a bank.

The bail-in tool represents the use of restructuring techniques that originated in corporate law and are justified by the corporate nature of financial institutions. They take the form of an administrative cram-down of shareholders, who are forced to bear the losses of the investee bank outside of a negotiated or contractual framework (Janssen, 2017). In this regard, the new aspect of the BRRD does not lie in the compulsory nature of the restructuring that the bail-in entails and that, as a compulsory corporate restructuring technique, was already provided for in Chapter 11 of the US Bankruptcy Code (Pulgar, 2020), but rather in two features. First, the administrative nature of the cram-down, subject to an ex post judicial review where the decision is challenged by affected creditors. Second, the particularity of bail-in as a tool, compared with a potential cram-down in the event of a non-financial corporation restructuring, is that it is forced on the creditors, or rather on those who are not legally excluded from the bail-in, i.e. investors in banks' subordinated debt instruments, determining the priority and

order among them based on the insolvency hierarchy (insolvency ranking). Therefore, the legal basis for bail-in is neither contractual, in the sense of being supported by a qualified majority of creditors, as is the case under the framework for restructuring non-financial corporations. Instead, it is regulatory in nature, based on a decision taken by the competent administrative authority under the legal framework governing bail-in.

This may certainly affect the property rights of shareholders, as recognised in Directive (EU) 2017/1132.[25] However, the underlying assumption is that corporate law should not be an obstacle to the resolution or specific restructuring of credit institutions, nor to the restructuring of non-financial corporations. This is reflected in recital (121) of the BRRD and finds its parallel in Directive (EU) 2019/1023, even if the mechanisms to overcome corporate law are different in each Directive. Indeed, Directive (EU) 2019/1023 provides for two different ways to achieve this objective. First, it empowers judges, instead of the general meeting, to take decisions on the restructuring of the company (e.g. the decision to increase capital via a debt write-off). Second, it treats shareholders as a class of creditors and, as such, subjects them to a cross-class cram-down procedure, under the framework for which Member States may choose between an absolute or relative priority rule, as a protection mechanism for dissenting classes.

In contrast, under the BRRD these options are regulatory in nature. Corporate law is overridden by an administrative decision on public interest grounds. In these scenarios, there are no absolute or relative priority rules typical of pre-bankruptcy corporate restructurings.

Academics have rightly highlighted the special status of bank creditors. In effect, they become creditors *sub iudice,* subject to a resolution condition if the entity is failing, in the broad sense analysed in this article, and its resolution is in the public interest. Despite being stakeholders, these creditors therefore run the risk of bearing, alongside the shareholders, any losses incurred by the institution.

The following reasons justify this shift from consensual restructuring to mandatory and regulatory administrative restructuring.

First, in bank resolution, the possibility of implementing a rapid solution is crucial, unlike what happens in the non-financial sector, and this speed could be jeopardised if the restructuring is consensual.

Second, as mentioned above, there is the concurrence of public and private interests when financial institutions fail, with the former taking precedence over the latter. In this area, taxpayers' interests come into play, since they must not bear the consequences of mismanagement of credit institutions or the issues of conventional restructuring.

Capital plays an important preventive role here, as financial institutions are required to have an adequate level of regulatory capital, consisting of a balanced combination of subordinated

25 Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law.

debt and hybrid capital.[26] It should be noted that in the event of ordinary insolvency proceedings, a high level of regulatory capital could, in theory, ensure that a bank's losses would be borne, first, by shareholders and subordinated creditors and then, and only to a limited extent, by senior creditors and the economy as a whole.

However, in the event of unexpected losses, this may be insufficient to satisfy investors' claims, especially where short-term solutions are needed. The traditional debt-to-equity conversion by non-financial corporations is also problematic, especially when shareholders are unable to provide supplementary capital.

Banks can admittedly issue contingent capital instruments, including contingent convertible bonds (CoCos) and write-down bonds (Gleeson, 2012). These typically contain a clause that allows them to be redeemed or converted into ordinary or preferred shares when a trigger event occurs. However, the advantage of bail-in, as provided for in the BRRD, is that it applies not only upon contractually agreed trigger events, but also when the resolution authority exercises its "resolution power" to take the appropriate resolution action. In these cases, the write-down and conversion of capital instruments must in any event precede the use of contingent capital instruments issued by credit institutions to supplement them.[27]

Third, non-consensual bail-ins of an administrative nature may, as mentioned above, have a relevant impact on the property rights of shareholders and creditors with regard to their instruments and claims respectively. This is also true from a contract law perspective, as a bail-in decision by the administrative authority affects the object and purpose of their contractual relationship with the financial institution. This raises the question of whether the administrative authority's decision constitutes a mandatory novation or rather a supervening impossibility of performance of the contract.

In this contractual area, the aim is to prevent a judicial decision in one Member State regarding the liabilities of a bank under resolution established in another Member State from undermining the effectiveness of the administrative cram-down initiated in the latter. For this reason, Article 55 of the BRRD regulates the "contractual recognition of bail-in" as a means of ensuring the resolvability of the institution. However, it should be noted that such clause only applies to liabilities governed by the laws of third countries, and not between Member States.

The rationale is to make bail-in more effective and conclusive and to ensure that the powers of the administrative authority – to convert, write down or cancel – under such framework are not affected by the decision of a judicial authority in another Member State. In this context, each Member State must require credit institutions to include, when issuing their securities or debt instruments in third countries, a contractual clause whereby creditors formally express that their debt may be converted into capital. Article 55(1) of the BRRD lays down the conditions under which this contractual clause must be included, which increases the effectiveness of

26 On the functions and structure of banks' capital, see Diamond and Rajan (2000).

27 Kenadjian (2013).

the contractual recognition of bail-in and, therefore, the effectiveness of a cram-down in the context of bank resolution.

In short, it is a regulatory/statutory cram-down, unlike the contractual/negotiated cram-down regulated by Directive (EU) 2019/1023 in the context of preventive restructuring proceedings of non-financial corporations, which is based on an economic approach to the economic difficulties and the underlying idea that corporate law should not jeopardise the restructuring of viable companies.

In addition, there are other key differences between the cram-down in financial resolution and in non-financial restructuring. In financial resolution, a cram-down is the only solution to protect the public interest. In non-financial restructurings, on the other hand, while this option is a possibility, it is an exception. Indeed, in the latter case, the general rule is to follow a contractual and negotiated approach between the debtor and its creditors to deal with corporations' economic difficulties, in order to protect creditors' interests. The restructuring of a non-financial corporation is ultimately subject to the approval of at least a majority of the affected classes of creditors, while bank resolution is enforced regardless of any creditor's approval.

Further, the delimitation of the scope of the non-consensual resolution or restructuring (cram-down) is different for financial institutions and non-financial corporations. The scope of bail-in is defined by law by distinguishing between bail-inable and non-bail-inable liabilities (Article 47 of the BRRD).

By contrast, the scope of cram-down in the context of the non-consensual restructuring of non-financial corporations (i.e. the scope of restructuring) is defined on a case-by-case basis by debtors/creditors based on consensual agreements, including inter-creditor agreements, according to recital (46) of Directive (EU) 2019/1023, as no restructuring is the same.

In any case, the fundamental justification for bail-in and cram-down measures for non-financial corporations and financial institutions is that they must be considered proportionate, meaning that they achieve their objectives while minimising the potential harm to the creditors and shareholders affected against their will.

Therefore, any bail-in or cram-down measure linked to non-financial corporations must ensure that it is proportionate in order to protect such creditors and shareholders. This is ensured under the resolution framework by the NCWO principle (whose counterpart in insolvency and pre-insolvency law governing non-financial corporations is the BIT).

6 Creditor and shareholder safeguards: no creditor worse off versus the best-interest-of-creditors test

The NCWO principle regulated in Articles 34(1) and 73(b) of the BRRD and Article 15 of the SRMR entails that "no creditor shall incur greater losses than would have been incurred if the bank had been wound up under normal insolvency proceedings".

The calculation of the outcomes of liquidation should be based on the information reasonably available to the authorities at the time of resolution[28] (not on the basis of the information available when the ex post evaluation is finalised), which needs to be compared with the actual outcomes of the resolution.[29]

In turn, the BIT is the safeguard that applies within each class of creditors in the context of intra-class cram-downs in non-financial restructurings pursuant to Article 10(2)(d) of Directive (EU) 2019/1023. In this case, the actual outcome is compared to the value attributable to creditors in the event of liquidation or, at the Member States' discretion, in the best alternative scenario, if the restructuring was not successful (Hicks, 2005; Bris, Welch and Zhu, 2006).

Therefore, the level of protection of creditors and shareholders both in a bail-in scenario and in a restructuring of non-financial corporations is compared to the hypothetical level of protection under a potential scenario of an insolvency proceeding ending in the liquidation of the company.

In any event, the position of the affected creditors or shareholders should not be worse than in an ordinary insolvency proceeding and, in conclusion, the limit of the sacrifices to be made by creditors and shareholders seems to be determined by their order of priority in an ordinary insolvency proceeding (Wojcik, 2015).

Were this objective to be effectively achieved, the cancellation of a share or the write-down or conversion of a liability would not actually alter the economic situation of the affected creditor or shareholder in comparison to a potential insolvency proceeding. In this respect, and applying an economic approach, if shareholders received nothing from the liquidation of the bank's assets under normal insolvency proceedings, the cancellation of their shares would not leave them worse off.

Similarly, if the claims of the bank's creditors were only partially redeemed under normal insolvency proceedings, a write-down to the extent of their economic loss in insolvency proceedings is justified in any event (Wojcik, 2016).

Creditors may admittedly try to argue that the introduction of bail-in as such changed their legal and economic situation, because, due to implicit State guarantees materialising in full bail-outs of failing banks, it was – prior to the adoption of the recovery and resolution framework – very unlikely that a systemically important bank would fail. Nevertheless, as the most qualified academics have pointed out, this argument must be qualified, because, under Articles 107 and 108 of the Treaty on the Functioning of the European Union, as a general rule State aid is prohibited in the EU.

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28 World Bank (2017).

29 Ventoruzzo and Sandrelli (2019) consider that this option is questionable, because it does not ensure that creditors will not be treated worse than how they would have been treated in liquidation, but rather than how they would have been treated based on an ex ante hypothetical assessment of the consequences of liquidation. It may be the case that during resolution information becomes available or events occur that suggest that the outcome of liquidation may have been significantly better than what was originally imagined.

Accordingly, investors in a bank cannot rely on legitimate expectations for the granting of public financial support or claim the right to benefit from a State aid measure.

Therefore, and taking into account the experience with the non-financial restructuring framework, bail-in in and of itself is not a form of expropriation, especially if the requirements analysed are met.[30]

Nonetheless, it is true that the NCWO principle, which acts as a safeguard for shareholders and creditors, needs to be applied such that the intended result is effectively achieved, and this is difficult in practice mainly for one reason: it involves a difficult “prognosis”, from both a financial and an accounting perspective, that the resolution authorities must make in advance – if it wishes to avoid subsequent legal challenges – as to how the position of shareholders and creditors would have evolved without the bail-in having taken place as part of a resolution, i.e. in a hypothetical normal insolvency proceeding ending with the institution being wound up.

Indeed, as noted above, according to the NCWO principle, the limit on the sacrifices to be made by shareholders and creditors seems to be determined by their order of priority in a normal insolvency proceeding.

The problem is that, to date, the hierarchy of creditors in normal insolvency proceedings has not yet been harmonised across Europe, meaning that creditors in the same position in relation to their claims can be classified differently in a normal insolvency proceeding depending on each national insolvency law.

Similarly, if we apply to the NCWO assessment the parameters applied to the BIT for non-financial corporations, we must consider the time it would take for a creditor to see their claims satisfied in a liquidation proceeding, compared to the bank resolution tool. And once again, the lack of harmonisation of insolvency law across Europe means that the efficiency of those proceedings and how long they take vary depending on the national insolvency law.

That is why the harmonisation of insolvency law, in particular with regard to the hierarchy of creditors, must be a priority task for the European Commission if the goal is to achieve the capital markets union within the framework of a more predictable and effective bank resolution regime. However, the harmonisation of the hierarchy of claims was for some reason excluded from the scope of Directive (EU) 2019/1023 and from the Commission’s proposal for a Second Insolvency Directive, published on 7 December 2022.

Notwithstanding these difficulties in the practical application of the NCWO principle as a safeguard for creditors and shareholders, where this principle is breached and they are bearing greater losses than they would have had to under normal insolvency proceedings, according to the ex ante assessment, Articles 73-75 of the BRRD provide for an important

30 See, in Spain, the Celsa group restructuring plan case (leading case), which was the first judicial approval *(homologación)* of a restructuring plan that was not agreed with the debtor and entailed a shareholder cram-down. (Ruling of Commercial Court No 2 of Barcelona of 4 September 2023).

additional safeguard to make the NCWO principle truly effective. To this end, the BRRD introduces a payment claim for bailed-in shareholders and creditors – including DGSs – against the resolution fund to compensate them if the resolution imposes a greater loss on them than they would have had to bear under normal insolvency proceedings (Article 74 of the BRRD). The compensation will be determined via a valuation carried out by an independent party as soon as possible (timing problem) after the bail-in tool is applied (Wojcik, 2016). This ensures that application of the bail-in rules does not lead to an "expropriation without compensation" of creditors or shareholders.

With regard to the cram-down in non-financial restructuring proceedings, Directive (EU) 2019/1023 does not contain express stipulations on compensation. However, Member States may provide for compensation in cases where shareholders or creditors suffer a greater loss in the preventive restructuring than they would have to bear in normal insolvency proceedings on the basis of the Directive. Therefore, unlike in the case of bank resolution, under the non-financial corporation framework this compensation is not obligatory in any case, but merely an option for the Member State.

In any event, the truth is that if a bank's shares are worth nothing in normal insolvency proceedings, no compensation is justified if the bank's losses are absorbed by its equity. Similarly, if all the losses cannot be absorbed by the equity and a bank continues to fall below the minimum regulatory capital requirements, no compensation is due to the creditors of that bank as long as the economic value of their claims is not reduced below the level at which those claims would have stood in the absence of State aid to the bank.[31]

7 Creditor hierarchy: resolution versus insolvency proceedings

Lastly, with respect to the creditor hierarchy, at first glance the fundamentals of the resolution system seem clear, and it respects the order of priority under normal insolvency proceedings. But things are not as clear as they first appear.

First, as mentioned above, the lack of harmonisation of the creditor hierarchy under normal insolvency proceedings poses a problem, as the comparison between a creditor's position in bank resolution and in a normal insolvency proceeding depends on each national insolvency law.

Second, if we were to compare the insolvency creditor hierarchy with the resolution creditor hierarchy, we could say that we are dealing with two different systems.[32]

Indeed, we can distinguish the creditor hierarchy under insolvency law, which is based on a vertical hierarchy of preferences, and the creditor hierarchy in bank resolution, which is based

31 Ibidem.

32 The EU has tried to minimise the impact of this potential clash between bank resolution and insolvency law through the minimum requirement for own funds and eligible liabilities that all banks, not just systematically important ones, must fulfill (Lamandini and Ramos (2019).

on an "in/out" system if we consider the liabilities legally exempt from bail-in and the legal distinction between bail-inable and non-bail-inable liabilities, which is not consensual but established by law (Ramos Muñoz and Solana, 2020).

In this context, Article 44 of the BRRD establishes a long list of liabilities that are excluded from bail-in. On the one hand, some liabilities (such as covered deposits or secured liabilities to other banks) are automatically excluded from the application of "write-down" or "conversion powers" (Article 44(2) of the BRRD) by the resolution authority. On the other hand, other liabilities are not automatically excluded but require a specific decision by the resolution authority (Article 44(3) of the BRRD). In this regard, one could speak of "discretionary exclusions" within the general discretionary powers of the resolution authority.[33]

Under this framework, creditors clearly prefer to be excluded from the bail-in. However, it is important to note that creditors do not have the standing to include themselves in a statutory bail-in exclusion category if their claim is not included by its nature among the liabilities that are legally excluded from the bail-in, nor do they have the standing to include themselves in the discretionary exclusion category that is determined by a mandatory administrative declaration. Therefore, only once their liabilities have been included in the bail-in may they challenge it through an appeal.

Further, Article 108(1) of the BRRD, which regulates the ranking of deposits in the insolvency hierarchy, as amended by Directive (EU) 2017/2399, contains a minimum set of rules for the harmonisation of national provisions on bank insolvency/liquidation in relation to the ranking of creditors in the insolvency hierarchy.

It establishes a three-tier depositor preference in the hierarchy of claims in insolvency by providing that covered deposits and DGS claims (in the case of subrogation in the rights of covered depositors in insolvency) have (pari passu) the highest ranking (super-preference) in the hierarchy of Member State insolvency laws relative to non-covered preferred deposits, which in turn rank above the claims of ordinary unsecured and non-preferred creditors.[34]

However, the BRRD does not regulate the ranking of the remaining categories of deposits (non-covered, non-preferred and deposits excluded from repayment, in accordance with Article 5(1) of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes). As a result, national discretion applies, which creates an uneven playing field and raises obstacles to the resolution of cross-border groups.

In its 2021 consultation document, the European Commission raised the issue of amending the ranking of claims in insolvency and introducing a general depositor preference with a

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33 In its contribution to the Commission's consultation (2021), the SRB supported the objective of reducing the mismatch between the resolution and insolvency hierarchy, while noting that the risk of breaches of the NCWO principle can be minimised, but not eliminated, given the possibility of discretionary exclusions.

34 DGSs are critical players in some jurisdictions by funding transfer strategies and ensuring their success, particularly in the United States (Federal Deposits Insurance Corporation, FDIC) and Japan (Deposit Insurance Corporation of Japan (DICJ), as well as (in the EU) in Italy (Ramos, Lamandini and Thijssen, 2023).

single ranking for all deposits (in particular, for ordinary unsecured claims) to allow for the use of DGS funds for measures other than the payout of covered deposits.

This framework would facilitate the use of the DGSs both in resolution and in insolvency and avoid breaches of the NCWO principle, taking into account the lack of harmonisation of the ordinary unsecured and preferred layer of liabilities in insolvency.[35]

The Commission proposed amendments to Article 108 of the BRRD in its April 2023 legislative package, which includes a comprehensive review of the CMDI framework:

— First, it proposes an amendment to Article 108(1) to replace the three-tier depositor ranking preference with a fully harmonised single-tier general depositor ranking in two senses:

  - The statutory priority over ordinary unsecured claims provided for in the Member States' national insolvency laws is extended to all deposits, including those made through non-EU institutions, which shall rank above the claims of ordinary unsecured creditors.

  - The super-priority of DGS claims and of covered deposits will be eliminated, and they will now rank pari passu with other deposits (general privilege), which nevertheless are ranked higher than ordinary unsecured claims. This will, inter alia, "contribute to reinforcing depositors' confidence and to further preventing the risk of banks runs".[36]

— Second, the legislative proposal introduces new provisions to the effect that, where only part of the assets, claims or liabilities of the credit institution under resolution are transferred through the use of transfer tools (in particular, through the sale of business or the bridge bank), the resolution financing arrangement shall have a claim against the residual institution for any expenses and losses incurred as a result of any contributions made to resolution in connection with losses which creditors would have otherwise borne. Such claims, together with those regulated in Article 37(7) of the BRRD, shall have preferential ranking in national insolvency laws which shall be higher than the ranking provided for the claims of depositors and of DGSs under the (amended) Article 108(1).

35 Gortos (2023), pp. 46-47. The issues raised by the Commission in its consultation document were in line with the Eurogroup's 2022 Statement.

36 See recital (39) of the proposal for a Directive of the European Parliament and of the Council of 18 April 2023 amending the BRRD, with regard to the scope of depositor protection, the use of DGS funds, cross-border cooperation and transparency (Colino Mediavilla, 2023). At this stage, it would appear that this idea has essentially been abandoned, as most Member States are in favour of maintaining the super-priority and the discussion has instead moved towards relaxing the proposals on the least-cost test, in order to allow the mobilisation of DGS funds in resolution. How this will be achieved, however, was not clarified in the latest Council working group meeting held at the end of March 2024.

8 Conclusion

The banking union, established in 2014 against the backdrop of a banking sector marked by recent economic crises, made the Single Resolution Mechanism a cornerstone of bank resolution, which sought to avoid the winding-up of significant credit institutions subject to prudential supervision under a normal insolvency proceeding. By doing so, the potential adverse effects on financial stability and possible contagion effects were avoided, fostering the continuity of their essential functions, protecting investors and depositors, without affecting taxpayers, who should not have to foot the bill for the banking sector's errors.

As analysed in this article, it is a resolution model designed largely by reference to insolvency law, requiring resolution authorities to apply insolvency legislation not only as part of the resolution itself, but also counterfactually, in ex ante and ex post situations with respect to key matters that are either not regulated in Directive 2014/59/EU on the recovery and resolution of credit institutions, or are but very broadly (grounds for resolution and creditor safeguards and hierarchy).

Here, it should be highlighted and stressed that one of the key problems, a decade after banking resolution was launched, is that, in addition to the very tensions stemming from equating two legal frameworks that pursue different objectives and protect different interests, there is the particular issue arising from the lack of harmonisation of insolvency law across the EU. In this respect, the harmonisation introduced at procedural level by the Regulation on insolvency proceedings and the harmonisation of preventive restructuring procedures of viable firms under Directive (EU) 2019/1023 are insufficient.

Negotiations are admittedly under way at present over the proposal for a Second Insolvency Directive of 7 December 2022, which, opting for a targeted harmonisation, includes areas of insolvency law that are not harmonised in Directive (EU) 2019/1023 (avoidance actions, pre-pack proceedings, directors' duty to request the opening of insolvency proceedings, winding-up of insolvent microenterprises). However, several aspects that are key to bank resolution are excluded from this harmonisation, in particular the concept of insolvency and the related classification of claims that entail numerous problems and dysfunctionalities in the practical application of principles such as NCWO.

This lack of harmonisation means that there are as many national insolvency laws as Member States, with substantial differences among them and different degrees of efficiency. It also means that the resolution authorities must apply and take into account the national particularities vis-à-vis insolvency in order to conduct the above-mentioned assessments as a part of a bank resolution. All this may lead to different results in resolution, with the legislation on the forced restructuring of non-financial corporations not serving to interpret the gaps in bank resolution, despite the use of parallel techniques (cram-down) and the equivalence in terms of creditor safeguards in non-financial restructuring and in bank resolution (BIT/NCWO principle).

In addition, the lack of insolvency law harmonisation also has adverse consequences for those banks that are not subject to resolution because they do not comply with the public interest assessment but are subject to different winding-up procedures at national level. Here the importance of the Unidroit project on the insolvency and liquidation of small and medium-sized banks should be underscored. This project will foreseeably be adopted at the end of 2024 and aims to overcome to some extent this important handicap by developing an international soft law instrument covering the main features that bank liquidation proceedings should have.

The harmonisation of insolvency law, which is so important from various perspectives (e.g. the construction of a capital markets union), is therefore a pressing matter, especially in the areas that most affect the design of bank resolution, in order to achieve truly harmonised outcomes and avoid the current differences across Member States and the lack of legal certainty stemming from the lack of harmonisation.

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