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Subject: Possible harmonisation of winding up procedures for banks
- Presidency non-paper



Possible harmonisation of winding up procedures for banks

PRESIDENCY NON-PAPER FOR THE 25 OCTOBER 2021 MEETING OF THE
WORKING PARTY ON FINANCIAL SERVICES AND THE BANKING UNION

I. INTRODUCTION

Winding up procedures that provide efficient exit of failed banks from the market are necessary for orderly functioning of the market and for the exercise of the fundamental freedoms for other market participants. Banking/investment activities and the nature of banks' assets and liabilities is specific and different from characteristics of non-financial firms. The BRRD framework is based on an acknowledgement that general corporate insolvency procedures are not always appropriate for banks as they do not always ensure sufficient speed of intervention, the continuation of the critical functions and the preservation of financial stability.

For efficient crisis management (CM) framework, it is necessary to recognise that also “normal insolvency” or winding up proceedings (that would generally apply to banks as alternative to resolution) bear important incentives for financial stability. The winding up proceedings should not, as a matter of principle, generate financial stability concerns where a bank is failing and needs to exit the market in an orderly manner (i.e. without generating financial instability). Given the importance of banks' financial and economic functions and their role in social environment, it is necessary that those winding up proceedings which normally apply to failing banks, provide adequate tools and powers to a designated authority to address these concerns in a way that enables an orderly exit from the market.

This non-paper discusses some topics of conceptual nature and seeks opinion of member states on some fundamental choices underlying the CMDI framework. In this regard, it revisits some issues that were already discussed in the past, concerning the normal insolvency procedures (NIP) and orderly liquidation tool (OLT). Further discussion on these issues at a wider, conceptual level, taking into consideration the practical experience with implementation of BRRD, could contribute to more substantiated discussions on future legislative proposals to enhance the CMDI framework. Issues discussed in this paper are not directly related to proposed alternative funding arrangements and conditions for SRF and DGS contribution in resolution, that are discussed in preparation of the CMDI review, although they may offer new insights on creditor hierarchy in normal winding up procedures and on conditions for DGS contributions in resolution/winding up.

In particular, it proposes to review whether the dichotomy of liquidation tools and powers in resolution and in normal winding up/insolvency procedures is still justified and efficient in addressing the “failing or likely to fail” (FOLTF) in banks. The practical experience in implementing BRRD has shown that existing approach allows diverging national winding up procedures, including special funding arrangements related to winding up procedures, thereby weakening the common resolution framework and its objectives. In some member states, national winding up regimes have been tailored to address the public interest concerns related to FOLTF banks, by replicating some resolution tools and powers. Such national approach is usually reasoned by the fact that piecemeal liquidation is usually not the most appropriate tool for winding up a bank in an orderly manner.

In order to address this the dichotomy of liquidation tools and powers and to harmonise the application of these tools for banks, a possible solution could be either to integrate all liquidation tools as part of resolution procedure or, as alternative, to define all liquidation tools and powers as part of normal winding up procedure (including transfer tools and powers that are defined under BRRD). A single liquidation/winding up procedure would provide a clear and level playing field approach to liquidation and winding up of banks. It would also ensure a harmonised conditions for application of specific tools in liquidation (sale of business, asset separation), including the use of SRF and DGS contributions, and minimising the reliance on extraordinary public financial support.

Discussions related to harmonisation of OLT should be expanded to the (wider) concept of all relevant winding up procedures that are applied with respect to a bank declared FOLTF. There should be further discussion on public interest concerns related to winding up of banks that are declared FOLTF. These discussions are important for defining the scope of tools and powers attributed to winding up procedures either as part of resolution in a closed bank scenario or as part of normal winding up procedure, both contributing to a broad CMDI framework. Future discussions should also tackle the resources and conditions for funding for winding up of banks, especially conditions for SRF and DGS contributions for winding up a bank.

Wider resolution concept, that would include also winding up procedures, could offer additional, more appropriate scenarios to orderly dissolve a FOLTF bank under the resolution framework (including e.g. contributions from DGS in a closed bank scenario, as a winding up procedure).

For the purpose of this document, winding up procedures do not refer to a single, specific procedure, but rather to a set of tools and powers available to designated authority after a bank is declared FOLTF, aimed at winding it up in an orderly manner, as part of resolution action or as part of normal winding up procedure (NWP) outside resolution.

II. SCOPE AND OBJECTIVES OF WINDING UP PROCEDURES

According to the Directive 2001/24/EC, resolution tools and powers are defined as reorganisation measures¹, which aim to preserve the bank or its (critical) activities. However, resolution tools under BRRD are also closely related to winding up proceedings, i.e. “normal insolvency proceedings”, since these proceeding are applied to a residual bank or entity (in connection with a transfer strategy). According to Article 37(6) BRRD: *Such winding up shall be done within a **reasonable timeframe**, having regard to **any need to provide services or support** (by this institution or entity pursuant to Article 65) in order to enable the recipient to carry out the activities or services acquired by virtue of that transfer, and **any other reason that the continuation of the residual institution or entity is necessary to achieve the resolution objectives** or comply with the principles referred to in Article 34.*

BRRD already provides certain incentives for legislators to enhance existing winding up proceedings in a way to accommodate the resolution objectives related to resolution action.

¹ Article 2 of Directive 2001/24/EC: ‘reorganisation measures’ shall mean measures which are intended to **preserve or restore the financial situation of a credit institution** or an investment firm as defined in Article 4(1), point (2) of Regulation (EU) No 575/2013 and which could affect third parties’ pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims; those measures **include the application of the resolution tools and the exercise of resolution powers** provided for in Directive 2014/59/EU.

An NWP should ensure an orderly exit of a failed bank from the market, and thus promote the freedom of establishment and the freedom to provide services. General “public interest concern” is to meet the resolution objectives as defined in Article 31 BRRD, which can be done either in resolution or in the NWP. Resolution action is permissible only if **these, i.e. resolution objectives** cannot be met in normal insolvency proceedings. **The resolution objectives should be regarded as the “winding up objectives”**.

Although both resolution and NWP in principle pursue the same objectives, subject to proportionality, different requirements may apply at national level for procedural safeguards, powers and governance, as well as for access to funding (such as DGS, other industry funded safety nets, or public funds).

Improving winding up tools and powers outside resolution, could better address the resolution/winding-up objectives, for more FOLTF banks to exit from the market under normal NWP (as opposed to under resolution action, which is an exceptional, reorganizational measure).

NWP is often subject to certain procedural and material guarantees as part of respective legal and constitutional framework in a Member state. However, considering the special status of banks as supervised entities, the nature of their assets and liabilities and their business activities, as well as the special role of competent authorities (CA)/resolution authorities (RA), in order to ensure the orderly exit from the market, it should be possible for legislator to apply the exemptions from these guarantees. Rules that apply in NWP for non-financial firms, are not necessarily best fitted for banks.

The principle of proportionality should be observed by CA/RA, with regard to measures and related exclusions and limitations of procedural guarantees for creditors and other participants being applied only if necessary and adequate to ensure the orderly exit of a failed bank from the market.

Specific resolution tools and powers to wind up a bank as part of a closed bank scenario (sale of business, bridge bank, asset separation) are already defined in BRRD. Unless winding up tools and powers are integrated as part of resolution framework, there is a merit to replicate these tools and powers in NWP, in order to better accommodate the requirements defined in 37(6) BRRD, to support the resolution measures and to ensure an orderly exit from the market. In both cases, the dichotomy of liquidation/winding-up tools and powers in resolution and in NWP should be eliminated which would ensure more clarity in defining the scope of resolution and NWP, common definitions of conditions for application of specific tools and powers, clear governance arrangements and responsibilities of CA/RA/designated authorities, including common definitions of funding arrangements. All these elements are essential for the assessment of NCWO, for the application of proportionality principle and legal certainty for banks and creditors and level playing field concerning the burden sharing requirements in case of winding up of banks due to FOLTF.

A possible scope of harmonisation of liquidation tools as part of resolution framework or as a separate NWP should comprise at least:

- common terminology and definitions for winding up procedures under BRRD;
- clearly defined (minimum) features and triggers of NWP;
- special (supervisory) powers and eventual withdrawal of authorisation.

Each of these elements is discussed below.

1. Terminology and definitions

When defining terms in BRRD, it is essential to take into account the broader meaning of these terms within the CM (as opposed to just individual provisions, institutes or even articles in BRRD). At the same time, efforts should be made to better align these concepts with those already laid down in Directive 2001/24/EC.

1.1. Definition of “winding up” should be better aligned with Directive 2001/24/EC

In BRRD ‘winding up’ is defined as *the realisation of assets of an institution or entity referred to in point (b), (c) or (d) of Article 1(1)*.

BRRD refers to situations, where bank is “wound up” (in normal insolvency proceeding) in the context of:

- defining conditions for resolution (Article 31 BRRD) for the purpose of PIA, where hypothetical results of resolution action are compared to hypothetical results of winding up under normal insolvency proceedings;
- providing for the equal treatment of creditors and determining the NCWO benchmark in application of the resolution tools and powers; and
- dealing with residual entity when applying transfer tools in resolution, where BRRD refers to any national winding up procedure (Article 32b BRRD), or specifically to national “normal insolvency procedures” (e.g. Article 37(6) BRRD).

On the other hand, Directive 2001/24/EC defines ‘winding-up proceedings’ as a specific concept, to address all *collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure*.

According to Directive 2001/24/EC, opening of winding up proceedings also entails that the bank will cease to exist as a result of such procedure (withdrawal of authorisation, see Article 12).

Comparison shows that the legislator deviated from the concept of “winding-up proceedings” as defined in Directive 2001/24/EC when defining the term “winding up” in BRRD. The definition in BRRD, however, does not provide sufficient elements and features to determine the procedures or arrangements of winding up. It is not clear which specific national procedures the legislator had in mind. It is up to national legislator to define the respective national proceedings and arrangement for the purpose of BRRD considerations, irrespective of scope defined in directive 2001/24/EC. Therefore, it remains unclear what counterfactual the RA will have to take into account in its assessment for PIA and NCWO.

Such legal vagueness poses a major risk for legitimacy and legality of individual RA decisions, as the legislators’ discretionary powers are not clearly defined and may create significant differences between RA assessments in different Member States. These differences are an important obstacle to the effective exercise of the freedoms under the TFEU and should therefore be harmonised.

The definition of winding up in BRRD should be closer to the concept in Directive 2001/24/EC, while at the same time additional criteria need to be considered: winding up procedures under BRRD should include only those winding up procedures that are triggered by FOLTF declaration (and where no resolution action is taken), as indicated in Article 32b BRRD. These proceedings should also ensure that

the bank leaves the market in an orderly manner (including through sale of assets or sale of equity) and its authorisation is withdrawn².

Resolution proceedings are defined as reorganisation measures (according to Directive 2001/24/EC), therefore the tools and powers of RA in resolution should primarily aim to preserve or restore the financial situation of a bank (open bank scenario) or at least an important part of the bank that supports the critical functions (closed bank scenario). Closed bank scenario in resolution should in principle be regarded as a winding up procedure and not reorganisation (according to definitions in Directive 2001/24/EC).

The following revised definition of winding up might be considered in BRRD:

“Winding-up refers to any collective³ proceeding opened and monitored by the resolution authority or other administrative or judicial authorities of a Member State, against an institution or entity referred to in points (b), (c) or (d) of Article 1(1) in relation to which the designated authority considers that the conditions in points (a) and (b) of Article 32(1) are met, with the aim of ensuring institutions’ orderly exit from the market, by revoking credit institution’s authorisation and realising its assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure.”

1.2. Reference to ‘normal insolvency proceedings’ is insufficient

BRRD defines ‘normal insolvency proceedings’ or ‘NIP’, as *collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person.*

In addition to allowing broad national discretions in what counts as NIP, BRRD also does not define common triggers for initiating these proceedings.

Although the name itself implies that “normal insolvency” should be established, insolvency triggers are defined differently across member states MS (though usually referring to balance sheet insolvency and liquidity issues) and are not necessarily fully aligned with triggers that apply for declaring bank as FOLTF.

Therefore, banks declared FOLTF according to BRRD may not meet triggers for NIP as stipulated in national legislations (“limbo” situation). This situation opens a dilemma, which national procedure and what consequences should be taken into consideration as benchmark for PIA (as condition for resolution) and to be applied as NCWO assessment in resolution.

In addition, considering that there is a wider range of triggers for FOLTF compared to traditional (narrow) insolvency triggers, the latter are not sufficient as a single benchmark for the purpose of PIA or NCWO in resolution. Limiting the assessment only to expected results of designated national

² There is a further question, whether a transfer of a qualifying holding in a bank to an acquirer should be considered as a new banking authorisation, since the transfer should be conditional on reestablishing the full compliance with regulatory requirements and on eliminating the FOLTF circumstances, the transfer should be prior approved by the NCA and “revoking” the FOLTF declaration.

³ The definition of collective redress should be modeled on the definition deriving from Regulation 2015/848: ‘collective proceedings’ means proceedings which include all or a significant part of a debtor’s creditors, provided that, in the latter case, the proceedings do not affect the claims of creditors which are not involved in them. (Regulation (EU) 2015/848 on insolvency proceedings does not apply to credit institutions.)

insolvency proceeding (i.e. proceeding, where balance sheet insolvency or payment default is established), not considering the actual circumstances of FOLTF declaration (to a possibly still solvent and liquid bank), might be considered as infringing the right to property and triggering constitutional concerns and raising doubts over the legitimacy of resolution decisions.

For PIA and NCWO evaluation, any national winding up procedure that is reasonably expected to apply for a bank, as a result of particular FOLTF circumstances should be considered. Such interpretation is also supported by Article 32b BRRD, which refers to (any) national winding up procedure that is applied after bank is declared FOLTF.

2. Minimum features and triggers for winding up procedures

Minimum features of winding up procedures should apply with respect to a bank where:

- a closed bank scenario is approved with the application of transfer tools for winding up under resolution (including winding up of the residual entity in a way that supports the objectives of resolution scenario); or when
- RA has not approved resolution action to be taken with respect to a bank declared FOLTF and winding up procedures are applied outside resolution.

Harmonised features of winding up procedures should apply to all proceedings established for banks under common CMDI framework under national winding up regimes (and not limited only to insolvency procedures).

These features should support the resolution objectives both in resolution as well as in national winding up procedures. Defining common features does not prevent the designated authority to apply specific powers and tools differently, considering the principle of proportionality to the extent necessary for meeting the “orderly exit” objectives. Powers granted to resolution authority with respect to resolution action in principle support a speedy intervention, thereby limiting certain procedural and material rights of creditors and investors, to ensure the continuation of the critical functions of a bank and the preservation of financial stability and other public interest objectives. Although BRRD does not explicitly define “orderly exit from the market” as one of the resolution objectives, this concept is already indirectly integrated in Article 31 BRRD.

The same powers should also be provided as part of a winding up procedure **to ensure the orderly exit from the market**, and to prevent the financial, economic or social instability through contagion and deterioration of value for creditors. This conclusion can be substantiated by the fact that the winding up procedure (i.e. tools and powers applied outside resolution) should, according to Article 37(6) BRRD, also be able **to support the effectiveness of resolution tools** applied by RA.

It is the responsibility of designated authority to consider the proportionality of individual measures and their encroachment upon creditors’ rights and compare it against the public interest objectives, taking account of specific circumstances in which the measures are taken. Nevertheless, since public interest concerns are also integrated in broader CMDI framework for banks, principle of proportionality related to application of winding up tools and powers (such as transfer tools and powers defined in BRRD) is not the exclusive attribute of resolution action under BRRD.

By taking into consideration the public interest related to winding up procedures (orderly exit from the market), replicating the same tools and powers for winding up procedures that apply in resolution (BRRD transfer tools), could be considered legitimate and appropriate. Their application, however,

should be proportionate, considering the circumstances of each individual case. DGS contributions could also be used to support tools and powers under winding up procedures, when a bank is deemed to exit the market (in addition to pay-out), along with SRF contribution. Specific conditions for funding arrangements and contributions from DGS and SRF could be established to support the liquidation tools and transfer strategies (differently from conditions and arrangements that apply for reorganisation under resolution), taking into consideration the creditor hierarchy in NWP.

Governance of NWP should be considered with respect to a wider CMDI framework. For the effective application of the winding up tools and powers, in order to establish level playing field for banks, depositors, creditors and investors, NWP as well as winding up scenarios applied in resolution, should be controlled by the same authority (RA). This may require a combination of responsibilities and powers of RA (for application of winding up tools and powers) and those of a designated authority (administrative or judicial, for procedural and other material matters).

Triggers for opening winding up proceedings are already established in Article 32b BRRD: when bank is declared FOLTF, but resolution action (as reorganization measure) would not be in public interest in accordance with point c) of Article 32(1) BRRD.

The following common features should be considered:

- Declaring FOLTF should trigger appropriate supervisory action that eventually results in withdrawal of authorisation (Article 32.b BRRD, Article 12 of the Directive 2001/24/EC), considering specific national implementation of Article 18 CRD;
- In order to support transfer strategies and equal treatment of creditors ranking *pari passu*, further differentiation of rankings could be considered for non-covered deposits and other senior liabilities, to allow for wider possibilities to apply the transfer tools for all creditors of a single class of liabilities. There would be no need to establish NCWO-like safeguard requirements as hierarchy ranking is observed as a condition for application of transfer/liquidation tools. Regular judicial remedies should be sufficient;
- Winding up procedures and even the withdrawal of authorisation should not prevent banking activities insofar as they are necessary and appropriate for the purposes of winding up;
- When bank is declared FOLTF any voluntary liquidation or other similar arrangements initiated by the management or shareholders (such as mergers or similar corporate actions) should be excluded.

3. Winding up powers and withdrawal of authorisation

When a bank is declared FOLTF, but resolution action is not approved (e.g. due to conditionality related to funding or no appropriate acquirer), such circumstances require appropriate further response from CA/RA to address the regulatory infringement or solvency risks.

Harmonization of triggers for withdrawal of banking authorisation would require significant interventions in national material and procedural frameworks and might go beyond the needs arising from BRRD and an effective CMDI framework. Decision to withdraw the banking authorisation may be linked to a number of procedural guarantees, which are set out in national law for the withdrawal the banking authorisation according to Article 18 CRD. In any case, the banking authorisation is withdrawn at the latest when the legal entity has ceased to exist (as a result of NWP) or when the acquirer obtains a new authorisation to provide the banking activities. However, the CA may decide or national law may instruct that the authorization is revoked or terminated by an earlier trigger. In view of the above,

further harmonization of triggers for withdrawal of banking authorisation is not an indispensable element for future harmonization.

As a matter of principle, declaring bank FOLTF should lead to enhanced supervision by CA, which may eventually result in withdrawal of banking authorization at the point identified by CA. The activities of NCA should focus on preserving the supervisory objectives and the public interest to protect depositors, creditors and the financial stability in general. In this respect, **the existing supervisory powers and instruments as defined in CRD, and early intervention measures under BRRD, may not be sufficient to allow the CA to mitigate the risks associated with a bank which is considered as FOLTF** (especially when no resolution action is approved). CA should be able to impose limitations to prevent further risk taking and deterioration of solvency, considering the specific risks associated with a bank and the respective circumstances that resulted in FOLTF.

Where the CA/RA has already identified bank as FOLTF, the CA/RA should apply appropriate powers and measures, that would allow the CA/RA to independently and autonomously design an effective supervisory scenario, on a case by case basis, considering the specific circumstances of each individual bank, which would allow the CA/RA to better meet the public interest concerns in due process.

Special winding up powers for dealing with banks declared FOLTF should be granted to CA/RA, to apply specific measures for preparation and execution of winding up tools and powers either as part of resolution or outside resolution. These powers should also include powers to appoint special management, apply sale of business and asset separation tools, piecemeal liquidation, as well as other powers related to transfer tools (Article 63-71 BRRD), including:

- the transfer of assets without creditors consent (while taking into account also Article 39 BRRD with respect to the valuation of assets and the transfer price);
- the application of the sale of business tool should ensure that the hierarchy of claims is respected and creditors ranking pari passu receive equal economic treatment. The valuation of bank's assets and liabilities in NWP should be fair, prudent and realistic.

The withdrawal of authorization should not be regarded as an automatic result of FOLTF declaration when no resolution action is approved (due to conditionality requirements for resolution tools and funding).

ISSUES FOR DISCUSSION

1. *Do you consider that CMDI framework should include also normal winding up procedures that enable the orderly exit from the market for FOLTF banks, thereby changing the dichotomy of winding-up tools in resolution and normal winding up procedures? Should references in BRRD to winding up under NIP be replaced with reference to national winding up procedures as suggested in point 1.1. above?*
2. *Do you consider "orderly exit from the market" should be explicitly defined as one of the resolution objectives?*
3. *Should the same tools and powers that are defined in BRRD, be applied for all winding up procedures – including NWP in order to allow for orderly exit from the market (also with respect to consideration related to Article 37(6) BRRD)?*

4. *Do you consider that with respect to transfer tools and powers defined within BRRD and NWP, different application of tools and powers may be necessary? What are in your opinion the necessary criteria for the application of proportionality principle in such a case?*
5. *Do you consider that powers on CA/RA (supervisory powers, early intervention powers) are sufficient to address risks of FOLTF bank in case, when no resolution action is approved?*
6. *Do you consider that harmonised winding up procedures, as described in this non-paper, can be integrated into your national winding up proceedings for banks as part of enhanced winding up framework (with replicated tools and powers as in resolution)? What could be the main stumbling blocks of such harmonisation/integration?*