

Client Alert

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EU Commission Proposes Crisis Management Directive

Following some delay, on June 6, 2012 the European Commission finally published its Proposal for a Directive of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (so-called Crisis Management Directive¹ or CMD), which — once adopted — will apply to the 27 member states of the European Union (EU), but may also have relevance for those three contracting states of the Treaty on the European Economic Area (EEA), which are not member states of the EU. A primary goal of the CMD is to harmonize the recovery and resolution regime for troubled financial institutions and introduce harmonized tools (*i.e.*, the sale of business, bridge institution, asset separation and bail-in tools) across the EEA² covering financial regulatory, company and insolvency law areas, as well as underlying funding and state aid law aspects.

The CMD is only a draft and is expected to change prior to final adoption. Moreover, the CMD must (unlike an EU Regulation, which has direct effect) be transposed into national legislation in each Member State before becoming legally effective in that Member State.

The CMD provides that EU member states must transpose (*i.e.*, adopt) the CMD into national law no later than December 31, 2015³, save in respect of the bail-in tool which must be transposed by January 1, 2018. There is currently no indication whether the instruments existing before the application of the bail-in rules will benefit from any grandfathering protections. The European Banking Authority (EBA⁴) is expected to issue both technical standards and guidelines for the CMD within 12 months after the CMD's entry into force.

Key Features

Objectives

The CMD provides a harmonized EU policy structure and specific tools for dealing with failing EU credit and financial institutions. The core approach involves:

- *Early regulatory preparation and prevention*: through a "special management" regime to undertake a recovery plan including debt restructuring.
- *Early intervention*: to avoid insolvency.

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- *Intervention powers of resolution as an alternative to normal insolvency proceedings:* e.g., to reorganize or wind down the bank in an orderly fashion while preserving the critical functions as well as minimizing taxpayer losses in an insolvency of the bank.

The CMD is a giant step towards an EEA-wide harmonization of the national insolvency laws applicable to credit institutions and investment firms. The CMD will supplement, rather than replace, Directive 2001/24/EC on the reorganization and winding up of credit institutions. The CMD provides for the establishment of a resolution procedure similar to an insolvency plan for financial institutions prior to, and instead of, a moratorium order of the national regulator and the institution of insolvency proceedings. One unresolved commercial question is the need, in addition to the tool box available in the CMD, for additional governmental support (whether in the form of government guarantees of bank liabilities or otherwise). In other words, will the mere use of CMD tools cause a “bank run” absent other governmental support?

Scope

The CMD applies to (i) EU domiciled credit institutions and investment firms (institutions), (ii) financial holding companies, mixed financial holding companies, mixed activity holding companies (holding companies), (iii) and financial institutions that are subsidiaries of institutions or holding companies and (iv) EU branches of institutions with head offices outside the EU.

Contrary to the original recommendations of the Financial Stability Board, the application of the CMD is not proposed to be conditional upon the systemic relevance of the institution or holding company.

Resolution Tools

The CMD proposes four resolution tools that may be used by the relevant resolution authority (see below) after having taken control of an institution that has failed or is about to fail, augmented by the power to “stay” on a temporary basis creditor and counterparty rights of enforcement of claims/close-outs, acceleration or otherwise terminate contracts against a failing institution. The four tools are:

- *Sale of business:* Permitting the relevant resolution authority to market and sell the failing institution on commercial terms without shareholder consent requirement or procedural limitation.
- *Bridge institution:* Permitting the relevant resolution authority to transfer, on commercial terms, all or part of the business of an institution (*i.e.*, transfer of shares or other instruments of ownership, all or specified assets/liabilities) to a publically controlled entity subject to the Capital Requirements Directive, as amended (CRD).
- *Asset separation:* Permitting the relevant resolution authority to transfer at market or long term economic value (so that losses are recognized at the moment when the transfer takes place) impaired or problem assets to an asset management vehicle to allow them to be “*managed or worked out over time*” (this resolution tool may only be used in conjunction with another resolution tool).
- *Bail-in:* Permitting the relevant resolution authority to write down the claims of unsecured creditors of an institution and convert debt to equity, with the first losses being taken by shareholders and thereafter by subordinated and then senior creditors, with the objective of recapitalizing an institution.

Bail-in Details

The CMD provides that a regulatory-led bail-in may be used, *inter alios*, to convert to equity or to reduce the principal amount of claims or debt instruments that are transferred to a bridge institution with a view to providing capital to the bridge institution. Bail-in may be applied only if it will restore the financial soundness and long-term viability of the institution.

Bail-in may be applied to all liabilities excluding:

- Protected deposits⁵
- Secured liabilities
- Liabilities connected to holding client assets/money
- Financial collateral arrangements provided these permit netting and set-off
- Structured finance arrangements (subject to certain criteria which may not cover all securitizations)
- Other arrangements which are subject to a fiduciary relationship
- Liabilities with an original maturity of less than one month
- Employee related or tax or social security related liabilities provided that these receive preferential treatment under applicable insolvency law⁶
- Commercial/trade creditor liabilities

These powers may also be exercised in relation to any part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured. However, the EU member states may exempt covered bonds from the bail-in tool.

Certain liabilities under derivatives may be reclassified if it would be in the interests of a resolution authority meeting the resolution objectives of protecting public funds, deposits, financial stability, etc.

When is Resolution Triggered?

The CMD provides that, in order to safeguard "*existing property rights*", a bank should enter into resolution at a point very close to insolvency — namely, when it is "*on the verge of failure*" subject to the assessment of market and idiosyncratic risks affecting the bank.

"No Creditor Worse Off" Principle

The CMD provides that resolution authorities, having regard to valuation processes for losses, are to allocate losses between shareholders and creditors of an institution in accordance with the hierarchy of claims established by each national insolvency regime. Referring to national insolvency regimes opens the door to varying approaches in different EU member states, which may be material, and raises significant complexities when considering competing national insolvency regimes and cross-border legal issues where creditors/shareholders (including ultimate beneficial owners) may be in different jurisdictions to that of the failing entity. Such an approach also raises significant complexities for intercreditor arrangements where creditors are located in different jurisdictions to that of the failing entity. The CMD clarifies that in applying these principles losses should be allocated in full:

- To shareholders and then to the creditors.
- That creditors of the same class to be treated differently if justified by reasons of "public interest" and in particular to underpin financial stability.

Where a creditor would receive less in economic terms than in a liquidation of the institution under normal insolvency proceedings, the authorities must ensure that those creditors receive the difference. Compensation, if any, would be paid by the resolution fund.

Resolution and Recovery Plans (RRPs)

Each institution must prepare and maintain a recovery plan that is to be updated at least annually and reviewed by the competent authorities. Recovery plans must cover a range of EBA mandated scenarios, which (presumably) will be in addition to any national regulatory requirements. Information required in the recovery plan is to be specified by the EBA when it issues the technical standards.

Each resolution authority must, other than for groups subject to consolidated supervision regulated in another Member State, draw up a resolution plan for each institution. Each resolution plan must take into consideration a range of market/ idiosyncratic risks and may not factor-in any public funded support other than the permitted support from a national or set of national resolution fund(s). Resolution plans must be reviewed and updated at least annually. The CMD requires the resolution authority to draft the resolution plan using information provided by the institution *inter alia*, in the recovery plan.

The requirements with regard to recovery and resolution plans (RRPs) will not only apply on single bank level, but also on group level. Thus, the CMD framework introduces a unique approach because EU rules and national insolvency laws in each of the 27 EU member states (as well as most non-EU countries) apply insolvency laws on single-bank level only and do not recognize a group insolvency concept.

Powers to Address/Remove Impediments to Resolution

Based on the recovery/resolution plans for each institution, the relevant resolution authority must assess the resolvability of an institution and/or group. If a resolution authority identifies significant impediments to an institution's resolution, it must require the institution/group to take measures to remove those impediments within 4 months of receipt of notice. We would expect the EBA, the Financial Stability Board and national resolution authorities to draft technical standards detailing key areas that are barriers to resolvability. Proposed (non-exhaustive) steps from the CMD's introduction include:

- Reducing an institution's complexity through legal or operational structures to ensure that critical functions can be legally and economically separated from other functions (also known as "ring-fencing" or "hive-off").
- Changing an institution's governance arrangements or strategy, including by requiring divestments.
- Requiring an institution to adopt service agreements for the provision of "critical functions" such as clearing and settlement systems, payment systems, market making/liquidity provision activity, asset management as well as retail banking and lending.
- Limiting an institution's maximum individual and aggregate exposures.
- Imposing additional reporting requirements.
- Imposing limits on or prohibiting an institution from engaging in existing or proposed activities (also known as "variation of permission").
- Restricting or preventing the development of new business lines or products (also known as "product intervention").
- Requiring an institution to issue additional convertible capital instruments or otherwise alter its funding strategy or recapitalization measures.

Cross-border Groups

The CMD establishes special rules for cross-border groups, including rules concerning the transfer of assets between entities affiliated to a cross-border group in times of financial distress and group RRPs, the latter being a first step towards a group liquidation/insolvency concept which — so far — is not currently available under the individual EU Member States' national insolvency laws. The RRP rules aim to preserve the group as a whole and protection of financial stability in each of the EU member states in which the group operates. It is anticipated that groups already subject to group consolidation will have their RRPs reviewed by the consolidating supervisor. The CMD also proposes that the current legal restrictions on financial assistance and EU competition rules be changed to permit group institutions to enter into contingent plans of intra-group financial support. All such measures must be submitted for approval to the consolidating supervisor of the group who will coordinate with the competent supervisory authorities of the subsidiaries in advance of shareholders' meetings. Any intra-group support agreement must be publically disclosed and such disclosure must include the names of entities parties to it. Disclosures regarding group support arrangements must be updated at least annually.

Competent Authorities

European Banking Authority

The EBA will issue guidelines and technical standards to ensure consistent application of the CMD, participate in resolution planning in relation to all cross-border institutions, and carry out binding mediation between national authorities in the event of disagreement on the application of the CMD.

Resolution Authorities

The CMD does not specify the resolution authorities in each Member State. However, it is anticipated that the resolution authorities will be the competent financial regulatory authorities (as defined under the Markets in Financial Instruments Directive, as amended (MiFID⁷)) who are also the lead regulators for the purposes of the CRD. A group of institutions located in different EU member states will be subject to multiple resolution authorities, and if the group has a consolidated regulator under the CRD that authority may be the consolidated lead regulator for group recovery/resolution purposes under the CMD.

Relationship Between CMD and non-EU jurisdictions

The CMD recognises the need for cooperation with third-country authorities and resolution efforts by giving effect to transfers of assets/liabilities located in, or governed by the law of, a non-EU (*i.e.*, foreign) jurisdiction. Such assistance shall only be given where resolution and recovery in the foreign jurisdiction ensures "*fair and equal treatment for local depositors and creditors and did not jeopardize financial stability in the Member State.*" The CMD further provides that resolution authorities may apply resolution tools to national branches of foreign institutions where separate resolution within the EU is necessary for reasons of financial stability or the protection of local depositors.

The CMD proposes that national resolution authorities and perhaps the EBA will enter into cooperation agreements in respect of international groups.

Other Considerations

Firms may wish to consider specific events of default or termination events in their contracts to cater for termination/close-out arrangements ahead of any trigger of any CMD resolution tool.

The CMD's recitals provide that, where deposits are transferred to another institution by way of a resolution, depositors should not be insured beyond the level of coverage in Directive 94/19/EC, as amended, on deposit guarantee schemes (DGD), currently €100,000. However, certain EU member states establish considerably higher coverage than the DGD's coverage. Thus, any application of the CMD could disenfranchise a considerable amount of a depositor's otherwise protected deposits.

Costs

Resolution funds are to be funded through *ex ante* and *ex post* contributions to achieve a minimum target fund level of a minimum of 1 percent of all DGD protected deposits in the respective Member State. The CMD establishes a system of national financing arrangements who have borrowing powers and mutualisation powers. A resolution fund may guarantee the assets/liabilities of an institution under resolution, its subsidiaries, a bridge or asset management vehicle. It may also purchase the assets of an institution under resolution, make loans to such institutions and/or make contributions to a bridge institution.

The CMD acknowledges that it will also increase funding costs for institutions because it removes the implicit certainty of state support. The CMD recognises that institutions may, subject to competitive market forces, transmit those costs to customers or shareholders thereby depressing deposit rates, increasing lending rates and banking fees or reducing returns on equity.

In conclusion, the CMD will bring great change to the mechanisms by which the financial difficulties of EU financial institutions are resolved and to the powers that regulators will have to restore such institutions to financial viability. The CMD raises many issues that will need to be resolved prior to final adoption, and once adopted the final rules will challenge EU financial institutions to adopt RRP and funding and governance strategies that are robust across the jurisdictions in which they operate. However, the CMD, if adopted and implemented correctly, may result in greater financial stability of institutions and financial markets, and, thus, the positive results could well outweigh the costs of implementation.

Endnotes

- ¹ http://ec.europa.eu/internal_market/bank/docs/crisis-anagement/2012_eu_framework/COM_2012_280_en.pdf
- ² Harmonization of course being an aim to reduce substantial differences in existing national legislation, in particular the protection of shareholder and creditor rights which would otherwise permit market distortion, forum shopping and a fragmented situation in the EU and thus uncertainty in financial markets.
- ³ Per Art. 115(1) of the CMD proposal.
- ⁴ <http://www.eba.europa.eu/Home.aspx>
- ⁵ Of up to €100,000 per person under deposit guarantee schemes. By imposing a limit on protected deposits, the CMD would undermine protections in those EU Member States with higher levels of depositor protection in place.
- ⁶ For example, certain EU Member States may grant tax authorities super preferential creditor status.
- ⁷ Directive 2004/39/EC, as amended and subject to a number of reform initiatives.

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