Claims of depositors, subordinated creditors, senior creditors and central banks in bank resolutions

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1. Introduction.

I would like to thank Dr. Tsibanoulis for the invitation to speak here today to the Association Européenne pour le Droit Bancaire et Financière.

Any statements made here today are made in a personal capacity, and may not be attributed to the European Central Bank.

My main responsibility at the ECB is to coordinate the contributions of the ECB Legal Services to the EU/IMF mission teams in Athens, Dublin, Lisbon, Madrid and Nicosia. One of the main topics which has occupied lawyers in these mission teams has been the introduction of bank resolution regimes in all the EU/IMF programme countries. Of course, bank resolution is a vast topic, so what I thought would be useful would be to briefly discuss some of the more interesting issues which are currently arising. In particular, I will focus my remarks on a number of discrete issues, beginning with the introduction of a depositor preference rule in insolvency, which has been introduced here in Greece and also in Portugal, and the impact such a rule has on bank resolutions. I will then discuss the limited bail-in legislation which has been introduced in Ireland and Spain with respect to subordinated debt and hybrid capital instruments, and some of the litigation that this has generated. Finally, I will briefly discuss the special position of central bank claims in resolution.

2. Depositor preference rule.

So, the first topic I would like to address is the debate surrounding the introduction of a depositor preference rule in insolvency. As you know, a depositor preference rule requires that in the insolvency of a bank the claims of depositors enjoy a privileged status. This is a powerful form of depositor protection, as it effectively pledges the assets of the bank for the benefit of depositors, so it is to be hoped that the existence of a depositor preference rule reduces the risk of bank runs.

A majority of G-20 countries have some form of depositor preference rule, including Australia, Switzerland and the United States. The depositor preference rule has traditionally been less common in EU Member States. However, an increasing number of European countries which have undergone, or are undergoing, EU/IMF programmes, including Greece, Portugal, Hungary, Latvia and Romania, have introduced depositor preference regimes. Beyond the EU/IMF programme countries, the Vickers report advocates the introduction of a depositor preference rule in the UK, which would prefer retail depositors up to the limit of the deposit guarantee scheme.

The precise ranking of the deposit claim varies in those countries which have adopted a depositor preference rule. In most jurisdictions, including most relevant EU Member States, the deposit claims rank behind secured claims and other preferred claims, such as tax and employee compensation claims, and ahead of the claims of general unsecured creditors. However, in the U.S., among unsecured creditors, the claims of the insolvency administrator rank first, and the depositors rank ahead of tax and employee compensation claims. Greece has also created a super-priority claim for depositors, which rank ahead of tax and other state claims, and only behind the Bank of Greece or any other financial collateral holder. Bank employees have priority over depositors for part of their claims to be determined ad hoc by a ministerial decision. As I understand it, secured creditors seem to retain their preferential rank on the specific asset charged, limited however to 2/3 of the asset's net value upon liquidation.

Most countries impose some limitations on their depositor preferences, such as a limit linked to the guarantee limit under the deposit guarantee scheme, as in the case of most European regimes, including the Greek and Portuguese legislation.

The interaction of a depositor preference rule with the deposit guarantee scheme varies from jurisdiction to jurisdiction. For example, in Switzerland depositors will be paid as preferred creditors out of the insolvent estate first, that is out of the insolvent's bank's liquid assets, and only if the liquid assets of the insolvent bank are insufficient, will the deposit guarantee scheme cover the balance of the deposit claims, up to the relevant limit. In many countries, the depositors will be paid by the deposit guarantee scheme up to the guarantee limit first. In these countries the depositor preference rule enhances the protection of the deposit guarantee fund, which upon making a new pay-out to guaranteed depositors, will effectively take over the claims of the guaranteed depositors by way of subrogation, thus ranking ahead of senior, unsecured creditors.

It has been suggested that a depositor preference rule can have a significant impact on the way in which banking business is done. Because a significant majority of the liabilities of U.S. banks comprise deposits, in most FDIC receiverships few assets are available to meet the claims of general, unsecured - that is non-depositor – creditors. This means that there is a powerful incentive for general creditors to secure their claims, subject to compliance with regulatory requirements relating to secured lending to banks, with funding at larger banks taking place at the holding company level, rather than at the depository institution. The view has been expressed that, because of the prevalence of universal banking models in Europe, with fewer bank liabilities accounted for by deposit claims, the introduction of a depositor preference rule could have a major impact on general unsecured creditors, leading to an increase in the cost of banks' funding and greater efforts by general bank creditors to secure their claims, potentially even leading to a deterioration in the position of depositors. However, it has also been noted that the depositor preference rule in Switzerland, which has existed since the 1930s, has had no appreciable impact on the funding costs of Swiss banks.

A depositor preference regime can facilitate bank resolutions. The use of bridge banks or purchase and assumption transactions to transfer assets and liabilities to private sector purchasers can be more easily achieved when there is a depositor preference rule, because the depositor preference explicitly discriminates between depositors and senior, unsecured creditors. This makes it easier to resolve deposits and leave other senior, unsecured creditors behind in a rump entity, without having to overly compensate these creditors based on the "no creditor worse off" principle, which requires creditors to be compensated on the basis of what they would have recovered if the bank had been placed in normal insolvency proceedings.

The relationship between a depositor preference rule and a bail-in regime also needs to be carefully considered. If the claims of senior, unsecured creditors can be written down under a bail-in regime, and senior, unsecured creditors rank behind depositors in insolvency, this will obviously make senior bank bonds less attractive.

The depositor preference issue is part of a larger collage that should not be considered in isolation, but rather in the broader context of the proper design of bank resolution regimes generally. The Commission's proposed resolution directive has not endorsed a depositor preference rule at the European level. Indeed, the proposed directive contains a provision requiring Member States to ensure that under national insolvency laws deposit guarantee schemes rank pari passu with unsecured non-preferred claims, contradicting the preference that would typically be inherited by the deposit guarantee scheme by virtue of its subrogation rights following the pay-out of insured depositors. For its part the ECB has welcomed the introduction of a depositor preference rule in the Portuguese resolution legislation, noting that this reduces the risk of bank runs, reduces potential losses of insured depositors in a liquidation phase, as avoids the excessive depletion of the deposit guarantee scheme. The IMF has traditionally adopted a very favourable stance towards the depositor preference rule. It remains to be seen how this issue will play out on a pan-European level.

3. Limited bail-in regime in Ireland.

A separate topic I would like to address concerns the limited bail-in regime which has been introduced in Ireland in respect of subordinated liabilities and hybrid capital instruments.

Under the Irish legislation the Finance Minister may make a proposed subordinated liabilities order in relation to a bank's subordinated liabilities, including hybrid capital instruments, reducing those liabilities or converting them into equity capital in order to preserve or restore the bank's financial position. The factors which may be taken into consideration in making such a proposal include the extent of the State's financial support for the bank, the bank's viability in the absence of that financial support, and the likely extent to which subordinated creditors would be repaid in a winding-up of the bank in the absence of such financial support. The final order may be made or, in the event of a challenge by an aggrieved subordinated creditor, confirmed by the courts so long as the Minister has complied with the procedural requirements under the legislation, and so long as the Minister's opinion was reasonable, and not vitiated by any error of law. In other words, the scope for judicial review is somewhat limited.

In practice, the subordinated bonds and hybrid capital instruments issued by Irish banks were mostly written down through voluntary transactions, in which the necessary supermajority percentage of bondholders necessary to approve the restructuring was achieved without the need to obtain court orders. Only in one case was it necessary to obtain a court order. This success was very much based on a 'carrot-and-stick' approach, whereby bondholders knew that if they did not agree to the offer made the authorities could have recourse to the coercive procedures available under the legislation.

The 'carrot-and-stick' approach also contained coercive elements that have been the subject of an important recent decision before the English High Court. In *Assenagon v. Anglo Irish Bank* Anglo-Irish Bank issued subordinated notes governed by English law which were mainly held by professional investors, including the claimant, a Luxembourg fund which had purchased €17 million principal amount of these notes at distressed prices. Using the technique of exit consents, within a framework of collective action clauses permitting a supermajority of the bondholders to amend the key financial terms of the notes, Anglo-Irish Bank invited the note-holders to exchange the old notes for new notes having a principal amount of 20 cents per euro, and to amend the old notes to give the bank the right to redeem the notes at a price of one cent for every thousand euro. This effectively destroyed the value of any old notes which did not participate in the exchange. Over 90% of the noteholders participated in the exchange, which was a sufficient supermajority to destroy the old notes held by the dissenting minority. The Luxembourg fund did not participate, and ended up receiving €170 for its €17 million notes.

This exit consent technique essentially placed the note-holders in the prisoner's dilemma of game theory. The English High Court rejected the legality of the technique, stating that its only function is the intimidation of a potential minority, based on the fear of any individual member of the class that, by rejecting the exchange and voting against it, he will be left out in the cold. The Court held that there is a restriction on powers conferred on a majority of a special class of securities in order to enable that majority to bind a minority. The powers given must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only, and may not be used to destroy the minority holders' rights.

The case is subject to appeal. It is noteworthy that the U.S. courts have upheld the exit consent technique in the past. So, we will probably have to wait to know the long-term implications of this decision for the use of exit consents in future debt restructurings taking place against the background of a bail-in regime.

A more controversial bail-in topic in Ireland concerns the decisions by the Irish authorities to repay the senior bondholders in the nationalised Anglo Irish Bank. While the Irish authorities did wish to legislate for a bail-in of senior debt, the ECB advised the Irish authorities to honour the outstanding senior debts of Anglo. As ECB Board member Jörg Asmussen has noted, this assessment was made at a time of extraordinary stress and great uncertainty in financial markets. More recently, ECB President Draghi has noted that the question of burden sharing with senior bond holders is evolving at the European level, through ongoing discussions on an EU resolution directive. As the proposed directive currently stands, such burden sharing with senior bondholders could be achieved through the directive's bridge institution and sale of business tools, as well as, from 2018, the bail-in tool.

4. Limited bail-in regime in Spain.

I will now briefly address the recently adopted Spanish resolution legislation, which introduces a limited bail-in regime for subordinated debt and hybrid capital instruments. Among other things, the legislation confers powers on the Spanish Fund for Orderly Bank Restructuring - the FROB – to propose what are called "management activities of hybrid capital instruments and subordinated debt" in respect of banks undergoing restructuring or resolution processes. These management activities include potentially mandatory conversions into ordinary shares and reductions in the nominal value of debt instruments.

The FROB may act whenever it considers the management activities necessary to ensure a proper distribution of the costs of restructuring or resolving a bank or to preserve or restore the financial position of a bank which receives financial support from the FROB. The management activities are binding over banks, their subsidiaries and the holders of the relevant instruments.

Given the high concentration of retail Spanish investors holding subordinated debt securities and preferred shares issued by Spanish banks, the legislation centralises appeals against the FROB's decisions before a particular chamber for contentious administrative proceedings of the National High Court. The legislation envisages that, instead of relying on the FROB's coercive powers, recourse may also be made to voluntary exchange offers in which investors would consent to a restructuring of their investments.

5. Impact of resolution on central bank claims.

It is important to note that central bank lending operations in the Eurosystem are collateralised, whether through repo or pledge operations. Moreover, under the EU Settlement Finality Directive, the rights of central banks to the collateral security provided to them in central bank operations may not be affected by insolvency proceedings against central bank counterparties. Taking account of these two elements – the secured nature of a central bank's loans, and the insulation of the central bank's collateral from counterparty insolvency proceedings – central bank claims will inevitably enjoy a preferential treatment in resolution processes, ending up on the balance sheets of healthier bridge banks or third party purchasers, instead of being left behind in rump entities to be liquidated. Also, so far as concerns the bail-in tool, the proposed resolution directive reinforces this position by exempting secured liabilities, whether under collateral arrangements or repo transactions, from the scope of the bail-in tool, at least up to the limit of the collateral provided.

6. Conclusion.

I will conclude at this point. I have sought to highlight some of the interesting legal issues arising out of the resolution legislation emerging in the EU/IMF programme countries. In particular, I have focused on the debate surrounding the introduction of a depositor preference rule in Europe, the impact of such a rule on resolution processes, the limited bail-in regimes introduced in Ireland and Spain and some of the litigation challenges that these regimes have thrown up. Finally, I have briefly touched on the special position of central bank lending operations.

Thank-you very much for your attention.