KEY POINTS

- The "No Creditor Worse Off" compensation scheme comes into effect after resolution of an institution by giving the right to compensation from an industry-funded scheme.
- An independent valuer is required to disregard any provision of financial support to the institution under resolution.
- The effectiveness of the compensation scheme as a safeguard for creditors in resolution, and as a tool to avoid discrimination claims or other litigation, depends very much on the level of compensation being satisfactory.

Feature

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Bad banks and the "No Creditor Worse Off" compensation scheme

This article considers whether the increased risk of discrimination claims by foreign investors, which arises when the "good/bad bank" mechanism under the Bank Recovery and Resolution Directive (BRRD) is applied to more complex institutions, can be alleviated by the "No Creditor Worse Off" (NCWO) compensation scheme.

THE "GOOD/BAD BANK" MECHANISM

The Bank Recovery and Resolution Directive establishes a 'framework for the recovery and resolution of credit institutions and investment firms' (Art 1(2)). This minimum harmonising measure seeks to prevent institutions from failing, or where they are failing, to ensure that their resolution can be achieved at either a national or cross-border level in the EU, without causing systemic disruption, and without spending taxpayers' money.

The "asset separation tool" (Art 42) is one of four resolution "tools" available for resolution authorities, and allows the balance sheet of a failing institution to be split and a transfer of its 'shares, assets or liabilities … to one or more asset management vehicles' (AMV) (Art 42(1)) with the aim of selling it, or winding it up. This is not a new concept, but is rather a version of the "good bank/bad bank" approach, which has been in existence since the 1980s. In essence, the "good bank" contains desirable or marketable assets, whereas the "bad bank" contains assets which the failing institution needed to be relieved from.

The asset separation tool must be used in conjunction with at least one other tool. For instance, it may be used:

- as a precursor to the sale of shares or other equity instruments, or the sale of assets and/or liabilities to a private party for a purchase price to maximise the value of the assets being sold (Arts 38 and 39);
- after a bridge institution has been established, to determine which assets are moved to the bridge institution (Art 41); and
- in conjunction with the bail-in tool to convert to equity or reduce the principal amounts of claims or debt instruments that are transferred pursuant to the sale to a purchaser or establishment of a bridge institution (Arts 43–55).

There are numerous examples of the difficulties in conducting that valuation assessment in practice. For instance, in Italy in the 1990s, the state had to absorb losses because the bank's assets were not properly valued on transfer to the "bad bank", effectively sheltering shareholders from responsibility for the losses and resulting in a high cost for the state.[1] Using state resources to provide assistance in this manner can constitute illegal state aid, such as where there is an absence of genuine market failure or the level of assistance is disproportionate.

Concerns about illegal state aid[2] explain the "watered down" version of "a bad bank" agreed by Italy and the European Commission earlier this year. Rather than setting up a government funded bad bank to house non-performing loans, Italian banks will be able to securitise non-performing or "bad" loans, with senior debt tranches benefitting from a government guarantee priced at market rates, to cap the losses of potential buyers. As there is a "market price" mechanism these state guarantees are intended not to constitute state aid, but by offering lower prices for the guarantee initially, early interest may be generated in the scheme.[3]

Whilst the "good/bad bank" mechanism is difficult to apply in practice, some indicate that these difficulties are magnified many times over where the institution's business is more complex; especially where it has significant assets or liabilities governed by foreign law or held through foreign branches or subsidiaries. One of these difficulties is managing the prospect of litigation over either direct or indirect discriminatory treatment of creditors based on nationality. For example, in *K Chrysostomides & Co v Council* (Case T-680/13) the applicant's claims included breach of non-discrimination principles after resolution authorities decided to bail-in depositors with uninsured deposits over €100,000 as shareholders to recapitalise the Bank of Cyprus and the Laiki Bank, whilst insured deposits were exempt.

More recently, BlackRock Inc and other institutional bondholders of Portugal's Novo Banco, have challenged the Bank of Portugal's decision to transfer their securities to the "bad bank" Banco Espirito Santo,[4] from which Novo Banco was carved after a government bail-out in 2014.[5] Portugal's central bank is said to have given retail bondholders preferential treatment over largely foreign institutional bondholders when it moved foreign bond debt to the "bad bank".

Application of the "good/bad bank"

mechanism, like any resolution action, is expressly subject to the provisions of the Charter, including Art 21(2), which prohibits any discrimination on grounds of nationality. As stated in recital (13) of the BRRD:

> '… where creditors within the same class are treated differently in the context of resolution action, such distinctions should be justified in the public interest and proportionate to the risks being addressed and should be neither directly nor indirectly discriminatory on the grounds of nationality.'

There are many reasons why resolution authorities may deliberately seek to discriminate on grounds of nationality when applying the "good/bad bank" mechanism. Resolution authorities are inevitably subject to political pressure to ensure the greatest possible protection of their local retail banking customers. Further, resolution authorities will be aware that, as the deposit protection scheme for deposits under €100,000 (Directive 2014/49/EU) will normally take effect when a bank is failing, the national government will be keen to avoid having to make up the shortfall of any haircut on smaller deposits. Again, this may incentivise national resolution authorities to prevent depositors of amounts under €100,000 suffering losses, who are typically local retail banking customers.

In addition, resolution authorities must consider whether their application of the "good/bad bank" mechanism is inadvertently discriminatory. For instance, a state may have treated foreign creditors in a less favourable manner by, for example, forcing particular depositors, or deposits, to be the subject of a bail-in in such a way that primarily affects foreign individuals, or by providing less favourable associated guarantees for certain assets, which are primarily held by foreign investors.

In an attempt to head off discrimination claims, the Bank of Portugal has promised some compensation to foreign institutional bondholders, based on the NCWO commitment. The effectiveness of this strategy in avoiding litigation is clearly dependent upon the nature of compensation available according to the NCWO principle.

THE NCWO PRINCIPLE

NCWO is one of the "general principles" under the BRRD and so applies to all resolution tools. It recognises that resolution tools can adversely affect private property rights by requiring that:

> 'no creditor shall incur greater losses than would have been incurred if the [resolution] entity … had been wound up under normal insolvency proceedings' (Art 34(1)(g)).

If a creditor has assets, which are not transferred out of the "bad bank", he will – without NCWO – effectively subsidise the transferors by bearing the shortfall between the assets and liabilities of the "bad bank" in insolvency proceedings, whilst the transferors continue as creditors of the new "good bank".

In practice, NCWO comes into effect after resolution of an institution by giving the right to compensation from an industry – funded scheme (Art 75) where:

- there has been a partial transfer of a bank's shares, assets, or liabilities by sale or establishment of a bridge institution (Art 73(a)), or use of the bail-in tool to write down claims or convert them to equity (Art 73(b)); and
- an independent valuer demonstrates the shareholders or creditors suffered greater losses in resolution than under normal insolvency proceedings (Art 74).

NCWO arguably assists the application of the "good/bad bank" mechanism as it:

- protects the rights of shareholders and creditors without the need to bring discrimination claims or other litigation;
- alleviates any concerns of resolution authorities that their actions may have been inadvertently discriminatory;
- preserves the overall efficacy of the BRRD resolution tools by obviating the need, for example, of an *ex ante* judicial review of a resolution authority's decision.

The effectiveness of the NCWO compensation scheme as a safeguard for creditors in resolution depends upon the quality of the *ex post* valuation under Art 74 for 'assessing whether shareholders and creditors would have received better treatment if the institution under resolution had entered into normal insolvency proceedings'. Draft regulatory standards on valuation – currently under consultation – seek to specify the general principles that an independent valuer must apply. Nevertheless, the guidance, albeit limited, given in Art 74(3)(c) is that 'any provision of extraordinary public financial support to the institution under resolution' should be disregarded, which is itself telling. In effect, by disregarding any existing or planned government financial support of an institution subject to resolution, it indicates that valuation exercises may legitimately amount to liquidation of assets at prices far below their fair market value or "fire sales".

This issue was considered in relation to the UK's NCWO compensation scheme under s 60(2) of the Banking Act 2009, in *Harbinger Capital Partner v Caldwell and Another* [2013] EWCA Civ 492. The Court of Appeal held that the independent valuer's assessment of shares in Northern Rock as worthless at the time of its nationalisation, was legitimate, with the effect that no compensation was due according to the NCWO principle. The independent valuer's approach, which the Court of Appeal approved, was that when deciding whether creditors would have suffered greater losses under normal insolvency proceedings first, any increase in value which resulted from the provision of financial support to Northern Rock was to be deducted,[6] and secondly, the valuer could legitimately assume a "fire sale" of the assets as the basis for assessing their value.[7]

Whilst the right to compensation based on NCWO may alleviate the concerns of national resolution authorities that foreign

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investors will bring non-discrimination claims as a result of their application of the "good/bad bank" mechanism to complex institutions, it will only do so if the level of compensation available under NCWO is satisfactory. If not, the NCWO compensation scheme will do little to stem the flood of litigation. Moreover, as distressed asset valuations and nil compensation findings are not inconsistent with the NCWO scheme, there is a risk not only that private property rights are insufficiently protected by it (as little or no compensation may be ultimately payable to foreign investors whose assets are placed in the bad bank under the NCWO compensation scheme) but also that the principle is used by resolution authorities as a means of justifying an application of the "good/bad bank" mechanism which discriminates on grounds of nationality. ■

1 http://dealbook.nytimes.com/2015/02/13/when-a-bad-bank-is-a-good-idea/
2 http://europa.eu/rapid/press-release_MEMO-15-6394_en.htm
3 http://europa.eu/rapid/press-release_IP-16-279_en.htm
4 http://www.reuters.com/article/funds-lawsuit-novo-banco-idUSL5N1781TN
5 http://europa.eu/rapid/press-release_IP-15-6381_en.htm
6 See: paras [107] – [114] of the judgment.
7 See: paras [124] – [129] of the judgment.

Further Reading:

- The no-creditor-worse-off principle from a valuation perspective: standing in the shoes of a hypothetical liquidator [2014] 4 JIBFL 233.
- The EU Recovery and Resolution Directive: preventing another financial crisis [2013] 10 JIBFL 641.
- LexisPSL: Restructuring & Insolvency: State aid for financial institutions – the Banking Communication.

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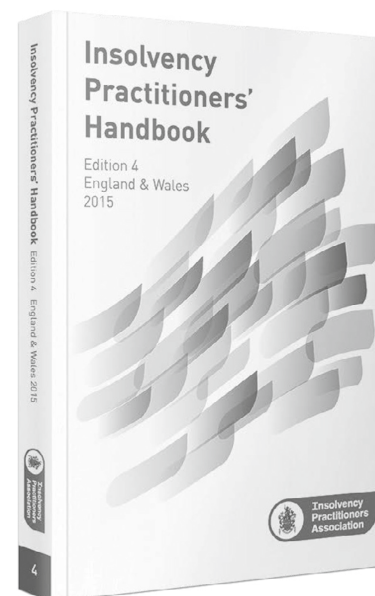

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