The "failing or likely to fail" as an insolvency notion under article 32 of the Bank Recovery and Resolution Directive

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Introduction

Since 2010, the EU has issued several important pieces of legislation with the aim of consolidating the Banking Union. This set of legislative instruments is known as the Single Rulebook. It is composed of the Capital Requirements Directive (CRD IV),[1] the Capital Requirements Regulation (CRR),[2] the Bank Recovery and Resolution Directive (BRRD)[3] and the revision of the Deposit Guarantee Scheme Directive (DGS).[4] Those legislative instruments, enshrined by Articles 114 and 127(6) of the Treaty for the Functioning of the European Union (TFEU)[5] and complemented by the soft law guidelines issued by the European Banking Authority (EBA), form the three pillars of the EU Banking Union.

The first pillar is the Single Supervisory Mechanism (SSM) under which the European Central Bank (ECB) is responsible for the direct prudential supervision of the EU's significant banks and the indirect supervision – through the National Competent Authorities (NCAs) – of its less significant banks. The second pillar, which is the most relevant for the purposes of this **CS'Insight**, is the Single Resolution Mechanism (SRM), which sets the resolution regime applicable to EU banks, EU financial firms and cross-border banks. The SRM aims to afford the competent authority, which is

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176

[3] 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 and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173

[4] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L 173

[5] Treaty on the Functioning of the European Union, OJ C 326

in this case the Single Resolution Board (SRB), with the tools that it needs to intervene early when bank faces financial distress so as to reduce the burden on taxpayers and to mitigate the potential negative impact of a bank's failure on financial stability. It should be noted that, in order to apply a resolution measure to a bank, the ECB and the SRB must work together. The ECB is responsible for declaring that a bank is *"failing or likely to fail"* (FOLF). After that declaration, the SRB is then entitled to assess if the bank concerned meets the remaining requirements foreseen in Article 32(1) BRRD, as will be further analysed in this **CS'Insight**. Resolution measures are applied by each respective Member-State national resolution authority (NRAs) following the instructions given by the SRB.[6] Finally, the third pillar is the European Deposit Insurance Scheme (EDIS), which is currently based on the harmonisation of the rules regarding the protection of deposits up to a certain amount (i.e., EUR 100,000). The objective of EDIS defined by the EU in 2015 was to create a European Deposit Insurance Fund that will be managed by the SRB and should be in operation in 2024.

A. SRM Pillar

As referred to above regarding the SRM pillar, the application of a resolution measure is dependent on the ECB understanding that a bank is FOLF and a subsequent assessment made by the SRB regarding the remaining requirements foreseen in Article 32(1) BRRD being met.

Firstly, the SRB will assess if there are alternative private-sector measures or supervisory action that would successfully prevent the failure of the relevant bank. If a measure is available, it should be taken instead of applying a resolution measure. If private-sector measure or supervisory action is not possible, the SRB will conduct a second assessment to understand if the resolution of the relevant bank is in the public interest. If it is considered that the resolution of the bank would be in the public interest, the SRB will adopt a resolution scheme as foreseen in the BRD. However, if there is no public interest in the resolution of a bank, that bank will be liquidated under the respective national insolvency laws. [7]

Observing the above sequence of steps, it is possible to conclude that a bank may be subject to a Member State's national insolvency laws if the above requirements are not met. This could mean that the FOLF declaration issued by the ECB sets the criteria to consider that a bank is insolvent. This possibility thus generates a possibility that the FOLF declaration raises new criteria for determining that an entity is insolvent. This is because there are

[6] Bodil S. Nielsen, *Main Features of the European Banking Union*, (2015) European Business Law Review, vol. 26, issue 6, pp. 805–822

[7] European Central Bank, *What happens when a bank is failing or likely to fail?* (16 May 2018) [https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl180516_3.en.html] accessed 8 May 2020

two recognised insolvency tests on an international level: the balance sheet test, which assesses if the value of an entity's assets is higher than its liabilities – the entity would be considered insolvent in the event of negative output (i.e., if the value of its assets is lower than the value of its liabilities); and the cash flow test, which assesses whether an entity is capable of paying its debts when due and payable. [8]

However, it should be noted that the FOLF criteria are only applicable to banks and financial firms as they have been designed to address the specific characteristics of their activities and the adverse impact that their failure would have on financial stability, while at the same time allowing for potential early intervention by the SRB – which is crucial to the success of the SRM pillar. Therefore, taking the FOLF as amounting to new criteria for determining that an entity is insolvent, regardless of the type of activity that it performs, would seem an excessive leap. On the other hand, the FOLF do form a set of criteria that may determine – depending on the non-fulfilment of the remaining conditions foreseen in Article 32(1) BRRD and on aligned political policy – whether or not a bank or a financial institution are insolvent.

In this **CS'Insight**, I will argue that the notion of FOLF has, in certain circumstances, set the insolvency criteria applicable to banks and financial firms due to the specific nature of their activities. As I will point out in further detail below, these criteria cover the classic insolvency tests, add one test strictly connected to banking, one test to avoid the public funding of banks and three forward-looking tests. It should be noted that, although the FOLF notion foreseen in Article 32 BRRD is not free from critics, it grants ECB the required flexibility to effectively pursue financial stability and, at the same time, provides for an adequate banking recovery, resolution and insolvency regime.

B. Corporate Insolvency and Banking Insolvency: Why differentiate?

As referred to above, the FOLF has set – in certain circumstances – the insolvency criteria applicable to banks and financial firms, but not to any type of entity. One of the main reasons for this opinion is the required differentiation between corporate insolvency and banking insolvency. A need to differentiate the two was made evident in the wake of the collapse of the Lehman Brothers group, which was subject to traditional insolvency procedures that were ultimately inadequate to deal with the resolution or insolvency of banks,[9] especially financial conglomerates.[10]

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[8] Julie E. Margret, *Insolvency and Tests of Insolvency: An Analysis of the "Balance Sheet" and "Cashflow" Tests*, (2008) Australian Accounting Review, Vol. 12, Issue 27, pp. 59-72.

[9] See Michael Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, (2014) Economic Policy Review, Vol. 20, No. 2, pp. 1-54

[10] See Rosa Lastra and Rodrigo Olivares-Caminal, *Cross-Border Insolvency: The Case of Financial Conglomerates, Financial Crisis Management and Bank Resolution* (2009) edited by Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh, Informa, Chapter 17, pp. 269-289

Banks and financial firms require a different insolvency regime due to the specific nature of their activities, the type of creditors that they have and the negative spillovers to financial stability caused by their failure. As for their specific activities, it is unanimously accepted that banks provide vital functions to the economy, including their role as central parts to the operation of the payments system or as depositories of the deposits held by the majority of the population.[11] Also, unlike commercial companies, banks cannot continue performing their activities whilst insolvent because their main products are financial liabilities which are accepted in the economy as a means of payment.[12]

Conversely, in an insolvency scenario, commercial companies that do not perform the same vital functions as banks are usually authorised to continue their production to reorganise their business and/or to sell it during the process and, consequently, to maximise recoveries. Taking into account that banks are inoperable when insolvent and the relevant functions that they perform in the economy, being subject to the same insolvency regime as commercial companies could have, and has had, an extremely negative impact on the economy – as was evidenced by the great depression in the United States (US) in the 1930s.[13] Furthermore, even when companies are not authorised to continue operating whilst insolvent, their assets are liquidated without any significant damages to the economy overall. On the other hand, if instead of protecting the vital activities of a bank the supervisory and resolution authorities simply proceeded to close the bank and to liquidate its assets, this would reduce the value of banks and, at the same time, increase the losses suffered. As pointed out by the scholars Simon Gleeson and Randal Guynn, this approach would be equivalent to dealing with an insolvent power company by closing it and selling its turbines. [14]

Another major difference between the two insolvency regimes is the type of creditors that the different entities have. In fact, in the case of commercial companies it is possible to distinguish between commercial creditors and financial creditors. Therefore, in an insolvency scenario, a simple approach that could be followed to maximise recoveries would be to continue paying the commercial creditors (e.g., suppliers) and suspend payments to financial creditors to allow the company to remain in operation. However, in the case of banks, this distinction is difficult because it includes the generation of financial liabilities where their creditors are in some circumstances both commercial and financial. [15]

The lessons learned in the global financial crisis, as well as the reasons described in the previous paragraph, are proof that the procedures and criteria

[11] Robert R. Bliss and George G. Kaufman, U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation, (2006) FRB of Chicago Working Paper No. 2006-01

[12] Simon Gleeson and Randal Guynn, *Bank Resolution and Crisis Management: Law and Practice*, (2016) Oxford University Press

[13] Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States*, (1963) National Bureau of Economic Research Publications

[14] Simon Gleeson and Randal Guynn (n12)

[15] *ibidem*

provided under legal frameworks for the insolvency of commercial companies are inadequate when applied to banks and financial firms. Therefore, it was necessary to establish a legal regime to allow the intervention of supervisory and resolution authorities at an early stage to avoid banks' failure, the burden on taxpayers resulting from that failure and the negative spillovers on financial stability. That legal regime would necessarily require new applicable criteria to determine that a bank can recover or can be resolved or that, ultimately, it is insolvent. Notwithstanding its imperfections, that legal regime is established in the BRRD, complemented by the SRM Regulation (SRMR)[16] which contains important procedures and criteria that should be taken into account, including the FOLF criteria.

C. The FOLF criteria

Article 32(1) BRRD foresees the steps for the application of a resolution measure to a bank instead of national insolvency laws. Firstly, the supervisory entity (i.e., the ECB) after consulting the resolution authority (i.e., the SRB) declares that an entity is FOLF. After that declaration, the SRB assesses if there is any private or supervisory measure which may allow the recovery of the entity – if so, that measure will be applied. In the absence of a private or supervisory measure that is able to recover the relevant bank, the SRB conducts a second assessment to analyse if a resolution measure is required in the public interest under Article 32(5) BRRD. If there is a public interest in resolving the bank, the entity will be subject to a resolution measure. However, if there is no public interest, that entity should be subject to liquidation under the respective national insolvency law, at least theoretically. [17]

Taking the above into account, the FOLF assessment represents the first phase in the process that could end with a bank's recovery, resolution or insolvency. Under Articles 32(4) BRRD and 18(4) SRMR, there are four tests – which in my opinion also comprise three forward-looking tests, to assess if an entity is FOLF:

- **Authorisation test**. The first test refers to the fact that an entity is FOLF if an entity is currently infringing the requirements for continuing its operation ("authorisation test") or if there are objective elements to determine that the entity will, in the near future, infringe those requirements ("forward-looking authorisation test");
- **Balance sheet test**. The second test considers that an entity is FOLF if its assets are less than its liabilities ("balance sheet test") or if there are objective elements to determine that this situation will occur in the near future ("forward-looking balance sheet test");

[16] 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, OJ L 225

[17] Dominik Freudenthaler and Pamela Lintner, *Conditions for taking resolution action and the adoption of a resolution scheme*, (2016) in Pamela Lintner (n1), Chapter 14

- **Cash flow test**. The third test considers that an entity is FOLF if it is unable to pay its debts or other liabilities as they fall due ("cash flow test") or if there are objective elements to determine that this situation will occur in the future ("forward-looking cash flow test");
- **Public funding test**. Finally, the fourth test considers that an entity is FOLF if it requires "extraordinary financial support" which is defined as state aid according to Article 107(1) TFEU and other public financial assistance ("public funding test"). [18]

Due to the difficulties in interpretation which may arise regarding the application of these tests, namely the forward-looking tests, EBA was mandated to issue guidelines to clarify the application of these concepts, as provided in Article 32(6) BRRD. As a result, in 2016, EBA issued its guidelines to clarify the application of the FOLF tests (EBA guidelines). [19]

EBA guidelines provide a useful tool to understand the assessment of the tests, especially the forward-looking tests, by providing several objective examples. By way of example, the EBA guidelines foresee a situation where there is an indication that an institution is experiencing difficulties to fulfil its obligations (e.g., execution of payments in the settlement system) as a potential event that meets the criteria of the forward-looking cash flow test.

However, it should be noted that the circumstances foreseen in the EBA guidelines are not exhaustive, nor should they be automatic. In fact, the supervisory entity should conduct a case-by-case assessment taking into account the specific characteristics of each entity in order to conclude if that entity should be declared as FOLF. This is also the view of the banks, which, when consulted regarding the EBA guidelines, requested that all of these tests should be subject to supervisory judgement rather than an automatic declaration that an entity is FOLF when one of the examples granted by the EBA is met. [20]

Notwithstanding EBA guidelines, the FOLF does have critics as to its certainty and predictability. Indeed, it is argued by some scholars that, if the economy is in financial distress, the market will not be able to anticipate if the ECB will consider that an entity is FOLF and, subsequently, if the SRB will decide on the application of a supervisory measure (e.g., emergency liquidity assistance) or a resolution measure. This situation could potentially lead to market participants requesting increasing returns to invest in banks. [21]

[18] Michael Anderson Schillig, *The (Il-)Legitimacy of the EU Post-Crisis Bailout System,* (2018) King's College London Law School Research Paper No. 2018-18

[19] European Banking Authority, *Final Report: Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*, (2015) EBA/GL/2015/07

[20] European Banking Authority, *Final Report: Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*, (2015) EBA/GL/2015/07

[21] Chiara Primerano, *Failing or likely to fail: time for a normative reconsideration?*, (2019) Aperta Contrada Riflessioni su Societá, Diritto, Economia

In my opinion, these concerns are being addressed by the ECB and the SRB through daily supervision and transparency. As for daily supervision, it should be noted that, under the SSM, the ECB has a deeper knowledge of the day-to-day business of each bank and it is, therefore, at least in theory, in an optimal positional to assess whether supervision or a private measure is capable of recovering a bank. Consequently, the risk of uncertainty seems to be reduced in the sense that before considering that an entity is FOLF, the ECB has several crisis management powers [22] that it can use prior to starting a FOLF assessment.

As regards to transparency, the ECB has so far tried to adopt a transparent approach by providing non-confidential versions of its FOLF assessment procedure, as regarding the ABLV case.[23] In that case, ABLV was considered to be FOLF as it met the forward-looking cash flow test. The entity was a subsidiary of a US bank, which the US authorities considered to be a financial institution related to money laundering operations. This classification resulted in ABLV suffering reputational damages, leading to an abrupt wave of deposit withdrawals and a limited ability to obtain liquidity from the markets. In its assessment, the ECB took into account not only historical cases on reputational damages, by referring the case of VEF Bank,[24] but also the liquidity needs and the inability of implementation of a potential liquidity recovery plan.

Although not critic-free, as mentioned above, the FOLF criteria provide ECB with a flexible instrument allowing for a transversal application of the SRM pillar to banks with different types of businesses, irrespectively of different risk exposures.[25] In my opinion, this flexibility is necessary due to the fact that banks are moving targets concerning their financial situation and, therefore, it is neither possible nor advisable to set crystallised criteria to define whether or not a bank is FOLF.

D. FOLF: criteria for banking recovery, resolution and insolvency

The BRRD, by introducing the notion of FOLF, establishes the criteria to determine if a bank should, depending on the result to the SRB's assessment, be subject to a recovery measure (which includes supervisory measures), a resolution measure if public interest exists or, ultimately, if a bank is insolvent.

[22] Simon Gleeson and Randal Guynn (n12)

[23] European Central Bank, *'Failing or Likely to Fail' Assessment of ABLV Bank, AS*, (2018) [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.2019_FOLTF_assessment_ABLV_Bank_AS~48046b4adb.en.pdf] accessed 8 May 2020

[24] See Alexander Masharsky, *Tendencies and Factors of Regulation of Development in Latvian Banking System*, (2013)

[25] Jens-Hinrich Binder, *Resolution: Concepts Requirements and Tools*, (2014), Jens-Hinrich Binder and Dalvinder Singh (eds.), Bank Resolution: The European Regime, Oxford University Press, 2015/2016

FOLF not only contains the two classic insolvency tests, but also provides a test related with the bank's activity (the authorisation test), another test to avoid the public funding of a bank (the public fund test) and the three forward-looking tests described in the previous section. Furthermore, the notion is needed to draw a clear distinction between the insolvency regime applied to commercial companies and the framework applied to banks taking into account the different goals sought by those regimes. Indeed, ultimately FOLF provides a set of criteria that afford the ECB and the SRB with the flexibility that they need to ensure the robustness of the financial institutions that are part of the financial system.

However, and to ensure that FOLF provides criteria that are effective towards banking recovery, resolution and insolvency, suitable aligned political policy becomes increasingly important in this regard.

The Member States and the EU Institutions should ensure that, if an entity is considered to be FOLF and the remaining requirements of Article 32(1) BRRD are not met, that entity should be liquidated under national insolvency laws and no additional measures will be taken contrary to the goals of SRM, including placing burdens on taxpayers. This was not what happened in the cases of Banca Popolare di Vicenza and Veneto Banca. In those cases, the ECB declared those banks were FOLF, while the SRB concluded that there was no private sector or regulatory alternative to recover the banks and that there was public interest in their resolution under the BRRD. In theory, those banks ought to have been liquidated under Italian insolvency laws.

However, what actually happened was that a part of those banks was sold to Intesa Sanpaolo, with the Italian State granting cash injections of €4.785 billion and state guarantees of up to a maximum of €12 billion to make it possible to complete the transaction.[26] The grounds for this state aid approval was the potential disruption to the economy of a region of a Member-State rather than the entire economy of that relevant Member-State as foreseen in Article 107(3)(b) TFEU. That decision jeopardises the effective application of the SRM and the use of FOLF as criteria for pursuing banking insolvency in that it could lead to a situation in which that pillar and notion will only work until the case is referred to national insolvency laws.

[26] European Commission-Press Release, *State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo*, (June 25, 2017) [https://ec.europa.eu/commission/presscorner/api/files/document/print/en/ip_17_1791/IP_17_1791_EN.pdf] accessed 8 May 2020

Conclusion

This **CS'Insight** has argued that FOLF sets the criteria for determining, depending on the SRB's assessment, the recovery, resolution or insolvency of a bank.

The creation of a new notion was needed due to the specific nature of banks' activities and the negative spillovers to financial stability that could potentially arise as a result of their failure.

Without prejudice to the academic debate surrounding the uncertainties raised by the notion of FOLF, its flexibility is needed for the ECB and the SRB to provide an appropriate response where banks face potential financial distress.

The notion of FOLF acting as an effective set of criteria towards tackling insolvency in the banking sector is also dependent on aligned political policy, as shown by the cases of state aid granted to Banca Popolare di Vicenza and Veneto Banca.