21 February 2017

EBF_025900

EBF POSITION PAPER
On the Commission's Proposal for a Directive on preventive restructuring frameworks and second chance of 22 November 2016 - COM(2016) 723 final

General comments:

The EBF fully supports the Commission's aim to develop the Capital Markets Union in order to diversify sources of funding for the European economy. Considering that the European economy is currently reliant in approximately 75% on banks' lending, it is crucial to ensure that the flow of banks' lending to the economy is not hampered and that the cost of the credit is not increased by unintended consequences stemming from the legislative proposal on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (the 'proposal').

Some of the provisions in the current proposal may, however, have unintended effects. In particular, if the economic interest of secured creditors is affected, the cost of the future loans will increase. To put it differently, if the recovery ratios for banks decrease, the loss given default calculations of banks will have to be adjusted accordingly. This will put further pressure on the regulatory capital ratios of EU banks and will result in follow-on effects for new business.

Moreover, the decrease of recovery ratio for banks will aggravate the problem of high level of non-performing loans in a number of European jurisdictions, which the legislative proposal should be instead addressing.

EBF's main concerns relate to the following issues:

I. Stay of individual enforcement actions.
II. Suspension of ipso facto and early termination clauses.
III. Cross-Class Cram-Down.
IV. Valuation.

EBF position:

I. Stay of individual enforcement actions (Article 6):

a) Length:

- It is currently envisaged (Article 6(4)) to grant the debtor up to 4 months a stay of individual enforcement actions of unsecured and secured creditors to safeguard ongoing negotiations in a preventative restructuring framework. However, a stay always affects the rights of creditors/banks to enforce their repayment claims or collateral.

- Under the existing Capital Requirements Regulation (CRR) in particular, a bank has to consider a repayment claim as in default if the debtor is past due more than 90 days (Article 178 CRR). Hence, the common length of the stay period should not be longer than 60-90 days. It should also be very clear that an option of an extension of the stay period can only be granted in very limited and exceptional cases, only if a majority of creditors support the extension of the stay. This prevents the risk that the original and the extension period of stay become the normal case, which would increase the volume of non-performing loans on the balance sheet of EU banks. Moreover, the extension period should not be longer than three months and there should not be more than two extension periods, i.e. a total duration of nine months.
- In addition, there should be a possibility of lifting the stay if the plan is not properly progressing and the agreement fails to be reached.

b) Illiquidity before applying the stay:

- It should be very clear that a restructuring proceeding can only be initiated if the debtor is not illiquid according to the laws of Member States.
- Otherwise there is the risk that debtors, including those with a non-viable business model, will circumvent normal collective insolvency proceedings via the restructuring proceeding and burn remaining cash up during a stay at the expense of their creditors, including banks.
- If the debtor becomes illiquid during the restructuring proceeding, it should be left to the discretion of the Members States, as envisaged in the current text, whether or not the transition to a normal insolvency proceeding should be mandatory. However, creditors should also be able to ask for a lift of the stay if it appears that the debtor is not able to pay new obligations.
- If the recovery ratios for banks decrease due to an inappropriate use of the "attractive" option of preventative insolvency proceedings, the loss given default calculations of banks would have to be adjusted accordingly with further pressure on the regulatory capital ratios of EU banks and follow-on effects for new businesses.

II. Suspension of ipso facto and early termination clauses (Article 7):

- It is a strong EBF position that netting arrangements and, in particular, early termination clauses in such netting arrangements, as well security arrangements should not be affected by the stay or at least be subject to special safeguards. In particular it is crucial to include safeguards and a limitation of the stay to no more than 48 hours in case of netting and security arrangements.
- Netting and security arrangements are expressly protected by a number of EU legislative acts, specifically the 'Settlement Finality directive', the 'Financial Collateral Arrangements directive', and the 'Bank Winding-up directive'. These acts demand the legal protection of these arrangements. Moreover, key legislative instruments for the regulation of the European financial markets, such as the CRR, the European Financial Market Infrastructure Regulation (EMIR) and the Bank Recovery and Resolution Directive (BRRD) not only require or pre-suppose the effectiveness and end enforceability of netting arrangements, they also see these arrangements as a key element to effectively mitigate counterparty risk from financial contracts. Precisely for this reason the BRRD requires special safeguards for netting arrangements and also limits the effects of stay and other resolution measures in relation to netting arrangements (as well as security arrangements).
- The current proposal sets out a very general provision on stay without providing for any safeguards for netting and security arrangements. Such a general stay

would have very serious consequences for all market participants relying on netting arrangements as well as security arrangements to monitor and mitigate their counterparty risk exposure, not least under the capital requirements regime. The general reference to the financial collateral directive in Art. 31 is insufficient to ensure an adequate level of protection of financial contracts, netting arrangements and security arrangements.

- It is therefore of paramount importance to include express and adequate safeguards and exception in respect of financial contracts and netting as well as security arrangements. At the very least, safeguards and limitations in line with those foreseen under the BRRD should be included in order to avoid clearly unfair and imbalanced effects on the solvent counterparties. Such safeguard provisions would have to include, inter alia, clear time limits on the preliminary stay (48 hours), specific safeguards regarding the subsequent measures following such stay (such as a transfer of the portfolio or winding-up), including permitting a termination during the stay where key contractual obligations are no longer observed (in particular provision of collateral etc.). It is simply inconceivable that the restructuring framework is intended to grant significantly broader and far-reaching rights and impose significantly more onerous risks and burden on the solvent counterparties than the BRRD regime.
- Moreover, Article 7 refers to the term of "executory contracts", which is defined in Article 2(5). It is not clear where this term comes from and what it means in detail. We in particular do not fully understand which consequences a stay will have on revolving credit lines and revolving securities such as storage assignment and global assignment and on other banking-related issues.
- It should be clarified in the text that, in case of any existing credit lines (revolving credit lines and revolving securities such as storage assignment and global assignment and other banking related issues), whether drawn down before commencement of restructuring proceedings or not, any new drawings should be subject to the agreement of a lender. This is crucial so as not to increase the potential indebtedness. It should be clarified that creditors should not be obliged to provide any additional funding to an entity that is under restructuring.

III. Cross Class Cram Down (Article 11):

- Under the current wording of the draft directive, if one class of affected creditors which would receive any payment or other consideration if the normal ranking of liquidation were applied, voted in favour of the plan, the plan could be confirmed, even if this class represents a very small percentage of all the affected creditors which would receive any payment or other consideration if the normal ranking of liquidation were applied. EBF takes the view that the possibility of a cross class cram down of a class of creditors should be limited to situations where those classes of the affected creditors representing the *majority* in amount of the claims, which would receive any payment or other consideration if the normal ranking of liquidation were applied, voted in favour of the plan.

IV. Valuation (Article 13):

- The envisaged valuation for affected shareholders takes as reference the going concern enterprise value while the "best interest of creditors test" as defined in Article 2(9) is based on a liquidation scenario. This reference will be highly unfair towards affected creditors as it ultimately bears the risk that the preventive insolvency proceeding will restructure the legal entity in favour of the shareholders, but at the expense of the creditors. As the proceedings can be initiated before the debtor becomes insolvent it can be expected that any proposed plan provides for a

better recovery rate than the one expected in an insolvency proceeding and thus the criteria of the "best interest of creditors test" would nearly always be satisfied. The test does not ensure a fair comparison as it does not reflect the legal possibility of the creditor to an (early) pre-insolvency enforcement of his claims and collateral. It will not increase the acceptance of preventative insolvency proceedings among creditors. If the recovery ratios for banks decrease because of an inappropriate 'best interest test', the loss given default calculations of banks have to be adjusted accordingly with further pressure on the regulatory capital ratios of EU banks and follow-on effects for new businesses.

- Therefore, we consider that the "the best interest of creditors test", as defined in Article 2(9), which is currently based on liquidation, whether piecemeal or sale as a going concern, should be changed. The test should be based on the hypothetical recovery rate the creditor would expect if he proceeded to an enforcement of his claims at the earliest moment possible.

V. Other issues:

a. Subject matter and scope (Article 1):

- It is currently envisaged (Art. 1, paragraph 2) that the Directive shall not apply to procedures (preventive restructuring, discharge) that concern debtors who are, among other things, natural persons who are not entrepreneurs. But then, under paragraph 3, Member States may extend the application of the discharge procedure to over-indebted natural persons who are not entrepreneurs.
- The reasons for the over-indebtedness of an entrepreneur and that of a consumer or a natural person who are not entrepreneurs can be essentially different. Therefore, the remedies must also be different. For the discharge of natural persons who are not entrepreneurs the admission requirements should be different, eg. preventing the access to the discharge when the over-indebted person acted dishonestly or in bad faith and also when he acted with fault or negligence.
- Moreover, it is important to specify that the legal framework proposed in the text is without prejudice to other existing procedures of different nature only based on a creditors' contractual agreement that may exist in Member States.

b. Distinction between viable and non-viable business (Article 8):

- The proposal lacks a clear description when a business is considered viable and when not. Therefore, it should be required that any restructuring proposal should as soon as possible be confirmed with an opinion of an independent third party stating whether the business is viable or not. In other words, the viability test should be a requirement for the opening of the proceedings. Any later time is too late. The assets of the debtor or the value of collateral dilute once the restructuring proceeding is opened. Moreover, Article 8(1)(g) of the proposal should be amended so that this opinion or reasoned statement is not delivered by the person responsible for the proposal of the restructuring plan but an independent third party.

c. Protection for new financing and interim financing (Article 16)

- The EBF is of the position that, while the new financing should be encouraged, collateral positions of creditors existing prior to any new financing must be protected and in no way impacted by new or interim financing, unless mutually agreed with collateral holders.

d. Appeals (Article 15):

- Article 15(4)(b) may incentivise creditors, particularly lower ranking creditors, to use their nuisance value by voting against the plan. Furthermore, where it is considered fair to provide certain creditors a compensation in deviation of the priority ranking or a higher compensation than similarly situated creditors (e.g. compensation in full to small creditors), such compensation should be part of the plan proposal so that all classes can vote on such distribution.
- Moreover, it is envisaged that in cases where minority creditors have suffered unjustifiable detriment under the plan, Member States can consider a monetary compensation for dissenting creditors payable by the debtor or the creditors who voted in favour of the plan. This concept has a deterrent effect on creditors who would otherwise support the plan. Such contribution of a creditor who – unlike an equity holder - does not participate in the economic success of the company lacks economic and legal justification.
- Therefore we consider that Article 15(4)(b) should be deleted.
- Furthermore, a second hearing system should not be imposed. The mere challenge regime has proved to be effective and agile in some Member States.

e. Second chance for entrepreneurs

i. Access to discharge (Article 19):

- The partial repayment of debt should be compulsory, so the Directive should envisage that Member States shall ensure that a full or partial discharge of debt is conditional on a partial repayment of debt by the entrepreneur.
- A balance between the rights of the debtor to the potential benefits of a second chance and the rights of creditors must be achieved so as to ensure that there are benefits for all parties involved. Otherwise creditors could become more cautious, the access to financing could be restricted (higher interest rates, more security/guarantees required etc.) and the suppliers could also require further assurances. In this way the potential benefits of the discharge could be frustrated.
- Furthermore, full debt discharge may result to be counterproductive, since it does not promote a responsible entrepreneurship model.

ii. Discharge period (Article 20):

- Three-year discharge is in many cases – though not always - an unattainable goal, even in Members States with relatively well-established second chance regimes. It is likely that many Members States will make heavy use of the limitations allowed in the proposal. This may have a profound impact on creditors and may translate in increased charges of future loans. In case the three-year discharge period is upheld, the provisions restricting access to discharge must be upheld unchanged as well. This applies in particular to repeated access to discharge procedures (Art. 19(1)(c)). Otherwise second chance can be used in an inflationary manner.
- Moreover, we believe that not only excessive, but also too short length of discharge procedures can trigger low recovery rate and deter banks from providing loans, as debtors may try to avoid the payment by moving their COMI to a more favourable jurisdiction.
- In relation to Article 20(2), we consider that, on expiry of the discharge period, the discharge of debt and exemption benefit should be given by a judicial or administrative authority for the following reasons:

i. In order to grant the existence of a third party act (judicial or administrative resolution) with a binding effect, which would permit creditors (and any other person) to know with certainty if the debtor´s debt has been exempted or not.

ii. In addition, judicial intervention is necessary in order to verify whether the repayment plan has been fulfilled or not. Without this judicial intervention, the debtor would be able to obtain (a few years after) an exemption benefit without a proper verification of its repayment plan compliance.

iii. Finally, a judicial decision is also necessary in order to solve or verify certain situations where creditors have the right to revoke a repayment plan due to the breach of the debtor´s undertakings or other circumstances (i.e. if debtor has substantially improved its economic situation by receiving an inheritance or by any other acts of disposal) or to reverse the discharge if it is subsequently proven that a debtor acted fraudulently to avail himself/herself of the discharge.

iii. Limitation (Article 22):

- Under Art. 22, it is currently envisaged that Member States may maintain or introduce provisions restricting access to discharge or laying down longer periods for obtaining a full discharge or longer disqualification periods in certain well-defined circumstances and where such limitations are justified by a general interest, in particular where: (a) the over-indebted entrepreneur acted dishonestly or in bad faith towards the creditors when becoming indebted or during the collection of the debts; (b) the over-indebted entrepreneur does not adhere to a repayment plan or to any other legal obligation aimed at safeguarding the interests of creditors; (c) in case of abusive access to discharge procedures; (d) in case of repeated access to discharge procedures within a certain period of time.
- These limitations should be compulsory, so the Directive should envisage that Member States shall ensure provisions restricting access to discharge or laying down longer periods for obtaining a full discharge or longer disqualification periods in certain well-defined circumstances and where such limitations are justified by a general interest, at least in the above cases.
- With reference to the case referred to in point (d), for the same reasons as in point 1, it would be important to fix a limit to the repeated access to discharge procedures (eg. maximum twice). Furthermore, it would be important to fix a minimum time limit between the different requests for discharge.
- The directive shall in no way prevent honest debtor to continue servicing their debt even after the discharge is granted.

f. Change of COMI during restructuring proceedings

- The debtor should not be in a position to change its centre of main interest (COMI) during a restructuring proceeding. The acceptance of the preventive restructuring proceedings among creditors would be seriously damaged if debtors were in a position to misuse the proceedings to obtain time to shift their COMI to another jurisdiction.

g. Definitions (several Articles):

- The concepts of "*likelihood of insolvency*", "*absolute priority rule*", "*restore the viability*" and "*strong likelihood that a restructuring plan will be adopted*" should be either further detailed or reconsidered.

- The concept of "*strong likelihood that a restructuring plan will be adopted*" is very hard to assess and, as such, it is not operative in practical terms. This concept may be replaced by the indication of a certain majority of creditors. For instance, in Article 6(6), instead of this concept, it might be set out that, creditors representing more than 50% of the total aggregated value of credits support (either by means of a resolution taken in a general assembly for that purpose or simply by subscribing a letter or other document) the extension of the stay period.