14 June 2016

FINANCIAL MARKETS LAW COMMITTEE

European Commission
Directorate-General Justice
Unit A 1 Civil Justice Policy - Secretariat
Rue Montoyer 59, 2/74
1049 BRUSSELS
Belgium
By email: JUST-CIVIL-COOP@ec.europa.eu

Dear Sir/Madam,

Consultation on an effective European insolvency framework

The Financial Markets Law Committee (the "FMLC" or the "Committee") is an independent body of legal experts established to identify issues of legal uncertainty in the financial markets, which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC is grateful for the opportunity afforded by the European Commission's recent *Consultation on an effective insolvency framework within the European Union* (the "**Consultation Paper**") to highlight legal uncertainties which arise from a lack of consistency between Member States' insolvency laws.[1] The Consultation Paper seeks, *inter alia*, to gather views on the efficient organisation of corporate restructuring procedures and the role that a harmonised insolvency framework can play in avoiding the build-up of non-performing loans ("**NPLs**") in the financial system. The IMF has highlighted several studies which show that high levels of NPLs undermine the ability of banks to support and stimulate economic activity.[2] Specifically, NPLs raise banks' cost of capital, resulting in lower levels of lending to the real economy and higher borrowing costs for businesses and this disproportionately affects SMEs since they are often highly dependent on bank finance.[3]

The FMLC recognises that creditors' and investors' uncertainty concerning legal outcomes—particularly as to the enforceability of loans and the effectiveness of restructuring initiatives—is inhibiting the efficient resolution of NPLs in Europe and it agrees with the Banking Union Communication that "enhancing legal certainty… is particularly relevant for the success of strategies to address the problem of non-performing loans in some Member States".[4]

Criteria for identifying NPLs

In the E.U. (as elsewhere), specific criteria for corporate loans to be classed either as "impaired" or as "non-performing" vary between jurisdictions.[5] The Committee concurs with the view, expressed by others,[6] that the absence of a harmonised definition of NPLs and/or the lack of shared criteria by which loans can be recognised as impaired makes it more difficult effectively to resolve them. This, in turn, may contribute to a situation in which NPLs remain on the balance sheet of the lender and build-up there. The Committee would, therefore, urge the Commission to take such action as it may deem appropriate to establish a definition of NPLs or to build consensus on shared criteria for impairment.

Once identified, the effective resolution of one or more NPLs will be enhanced by an insolvency regime which works in an efficient manner, together with any applicable regulation, to facilitate a restructuring of the debtor's business. In light of this, the FMLC has identified a number of areas where divergence in Member States' corporate insolvency

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laws could usefully be addressed in order to improve certainty and predictability of restructuring outcomes. The paragraphs below also touch on areas where greater certainty in the legal or regulatory framework could potentially facilitate the secondary market in distressed debt and reduce the build-up of NPLs in the financial system.

Restructuring Moratorium

The Committee notes that, although legal systems in most Member States offer some form of stay on enforcement actions while a corporate restructuring is pending, the terms and conditions on which moratoria are available vary widely.[7] This divergence increases uncertainty in respect of the likely success of a restructuring and, ultimately, the recovery rate for creditors. It can also increase the costs for prospective cross-border investors of due diligence on distressed loans. The Commission itself has recognised that a stay should be available to facilitate restructuring and, in March 2014, it recommended that Member States implement a stay for a period of no more than four months.[8]

Last year, in an *Evaluation of the Implementation of the Commission Recommendation of 12.3.2014*, the Commission observed that there has been little convergence in the terms and conditions imposed on moratoria by Member States in response to its earlier recommendation.[9] It concluded that this lack of progress means "continuing legal uncertainty and additional costs for investors in assessing their risks and continuing barriers to the efficient restructuring of viable companies in the EU". The FMLC agrees that, in order to aid certainty and predictability, clear, harmonised yet flexible rules on the granting of a stay should be implemented in the E.U. It also concurs with the view, expressed in Article 13 of the *Commission Recommendation of 12.3.2014*, that stay provisions must strike a fair balance between the need to prevent precipitative action by creditors, whilst at the same time maintaining the predictability of contractual arrangements between debtors and creditors.

A closely-related point is that, in some European jurisdictions, it is uncertain whether a creditors' agreement establishing a stand-still period during out-of-court restructuring negotiations would be enforceable or legally valid. This is an issue of legal uncertainty which could usefully be resolved at the E.U. level.

Valuation Methodology

It would appear that, even within a single legal system, dramatically different determinations of a company's value can arise depending on whether the valuation is carried out on a liquidation basis or a "going concern" basis.[10] Across Europe, however, there is not only no common agreement on which criterion should be used and in which cases but there is also no standardised methodology for valuing a business on either basis.[11] Indeed, in some jurisdictions there simply are no rules on valuation.[12] This lack of consistency and/or legal certainty leads to unpredictable outcomes for creditors, particularly in a cross-border context. One consequence is likely to be that banks and other creditors are less effective in offering restructuring solutions when faced with a non-performing asset.

In order to give creditors greater certainty and predictability, the Commission should, in the view of the FMLC, consider harmonising Member States' approaches to valuation. There may also be merit in setting harmonised standards for the use of expert valuations in corporate insolvency proceedings. Valuations of creditors' interests are relevant to the exercise of any powers to reduce the interests of dissenting creditors (often referred to as "cramdown") and of any voting rights by the creditors themselves. They may also be relevant to the issue of priority financing in restructuring. At present, Member States' courts do not adopt a uniform approach to the use of valuation experts in a restructuring

and, in particular, to the question of by whom they may (or must) be appointed (i.e., debtor, creditor or court).

A related issue concerns the regulatory treatment of loan collateral valuation by banks. A report from a Working Group established by the Vienna Initiative on Banking Coordination suggests that collateral valuation problems have contributed to inertia in the secondary markets for NPLs in some European jurisdictions.[13] In particular, the report says, out-of-date and over-optimistic collateral valuations by banks have created a price gap as between buyers and sellers of loan portfolios. Reducing regulatory leniency on collateral valuation would help narrow this price gap and can, in consequence, be expected to facilitate the secondary market in NPLs.[14]

Other issues

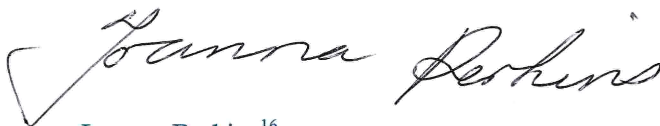
Other impediments to a successful restructuring may include the regulatory treatment of debt-to-equity swaps, which is a common restructuring technique. Here, rules which prevent financial institutions from owning a business or prevent an investor from acquiring a shareholding in certain companies above a certain percentage of the total shares may present problems for creditors.

Uncertainty regarding the legal effectiveness of the assignment of credits in a cross-border transaction could deter prospective investors in distressed debt. This issue was aired in the context of the adoption of Regulation (EC) No 593/2008 on the law applicable to contractual obligations (Rome I), with particular reference to Article 14 of that Regulation.[15]

Finally, the Committee agrees that it would be helpful to introduce the basic standards and measures set out at question 4.2 of the Consultation Paper and that these would contribute to recovery rates for NPLs.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,



Joanna Perkins[16]
FMLC Chief Executive

Copied to: Olivier Guersent, Director General, DG Financial Stability, Financial Services and Capital Markets Union

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[1] Published 23 March 2016, the Consultation Paper is available at: https://ec.europa.eu/eusurvey/runner/InsolvencyJUSTA1

[2] See, for example, IMF Staff Discussion Note, "*A Strategy for Resolving Europe's Problem Loans*", September 2015 and European Investment Bank, "*Unlocking lending in Europe*", October 2014.

[3] See European Parliament paper on "*Non-performing loans in the Banking Union: stocktaking and challenges*", March 2016.

[4] COM(2015) 587 final, 24.11.2015. The Commission should not, however, underestimate the risk that any attempt at harmonising substantive insolvency law will in itself create uncertainties. The Committee would, therefore, urge the Commission to consider carefully the potential unintended consequences of reform. **In particular, care should be taken to ensure that any proposed new insolvency laws do not jeopardise provisions of the *acquis* designed to safeguard the efficient functioning of the financial markets infrastructure in the event of the insolvency of a market participant.**

[5] See David Bholat, Rosa Lastra, Sheri Markose, Andrea Miglionico and Kallol Sen, "Non-performing loans: regulatory and accounting treatment of assets" Bank of England Staff Working Paper No. 594, April 2016.

[6] *Ibid.*

[7] For a helpful summary of the stay provisions in various European jurisdictions, see Association for Financial Markets in Europe ("**AFME**"), *Potential economic gains from reforming insolvency law in Europe*, February 2016, available at: http://www.frontier-economics.com/documents/2016/02/afme-report_potential-economic-gains-reforming-insolvency-law-europe.pdf at Appendix A.

[8] See Commission Recommendation of 12.3.2014 on a new approach to business failure and insolvency.

[9] Available at: http://ec.europa.eu/justice/civil/files/insolvency/02_evaluation_insolvency_recommendation_en.pdf.

[10] See "The Valuation of Distressed Companies—A Conceptual Framework" by Michael Crystal QC and Rizwaan Jameel Mokal, published by International Insolvency Institute and available at: http://www.iiiglobal.org/sites/default/files/3-_060419crystal.pdf. See, in particular, the discussion at p14 et seq.

[11] *Supra* n.7.

[12] *Supra* n.7.

[13] See summary document published by the Working Group on NPLs in Central, Eastern and South-Eastern Europe (CESEE), March 2012, available at: https://www.imf.org/external/region/eur/pdf/2012/030112.pdf

[14] *Ibid*, paragraph 7.

[15] See British Institute of International and Comparative Law, *Study on the Question of Effectiveness of an Assignment or Subrogation of a Claim against Third Parties and the Priority of the Assigned or Subrogated Claim Over a Right of Another Person—Final Report*, 2010, available at: http://www.ec.europa.eu/justice/civil/files/report_assignment_en.pdf

[16] The FMLC is grateful to Sanjev Warna-kula-suriya (Slaughter and May) and Professor Rosa Lastra (Queen Mary, University of London) and representatives of the European Bank for Reconstruction and Development for their comments and contributions. It is also indebted to AFME for early sight of the report cited in this paper (*supra* n.5).