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DIRECTORATE-GENERAL FOR FINANCIAL STABILITY, FINANCIAL SERVICES AND CAPITAL MARKETS UNION

Horizontal policies
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NOTE FOR THE EUROGROUP

Subject: POLICY PERSPECTIVE ON CORPORATE INSOLVENCY FRAMEWORKS[1]

Purpose of the note:

This note intends to discuss corporate insolvency frameworks from a policy perspective, building on the Eurogroup workstream on insolvency frameworks in the context of the Eurogroup thematic discussions prepared by the EPC in euro area formation.

This note sets out to describe:

1. The importance of efficient and more convergent corporate insolvency frameworks across the EU for economic resilience and financial stability, and the Capital Markets Union, as well as its relevance in value recovery for a likely growing stock of non-performing loans (NPL) of banks post-COVID;

2. The recent work undertaken by the Commission in the context of corporate insolvency;

3. The forthcoming initiative to enhance the convergence of insolvency frameworks and to monitor the efficiency of value recovery for banks.

In presenting these different fields of action, the paper will focus on their relevance for the financial system, and on the implications for banks as creditors.

INTRODUCTION

In a statement published in April 2016[2], the Eurogroup identified the relevance of efficient insolvency frameworks for facilitating adjustment processes within the euro area, while improving the business environment and supporting private investment. The Eurogroup also recognised that this would support deeper financial integration within the euro area, which would be beneficial for the strengthening of the Banking Union, fostering growth and resilience to asymmetric shocks, while also contributing to building the Capital Markets Union. The Eurogroup agreed on a number of principles and

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1 This is a technical background paper prepared by the Commission services. It does not represent the Commission position and does not bind the Commission in any way.

2 https://www.consilium.europa.eu/en/press/press-releases/2016/04/22/eg-statement-nationaln-insolvency-frameworks/

benchmarks for insolvency frameworks, and to take stock of the progress on a regular basis. In November 2020[3], the Eurogroup further emphasised the importance of developing secondary markets and reforming insolvency frameworks to manage NPLs and contribute to reducing risks in the Banking Union. More recently, in February 2021, the Eurogroup took stock of the solvency situation in the corporate sector and agreed that insolvency frameworks will also need to be strengthened in order to ensure swift and effective action and minimise economic fallout in the aftermath of the COVID-19 crisis.

This note contributes to the series of thematic discussions held at the Eurogroup, aiming to coordinate the policy response to the recovery of the COVID pandemic. It therefore recalls the relevance of corporate insolvency frameworks for economic resilience – in particular in the post-COVID context, underlines the need for further harmonisation and convergence of insolvency frameworks and proposes a way forward for monitoring progress.

1. Importance of efficient and more convergent corporate insolvency frameworks to enhance economic resilience

Efficient corporate insolvency frameworks are of key significance both for limiting and managing the accumulation of non-performing loans in banks' balance sheets and, hence, for financial stability. The banking sector and secondary markets for non-performing loans would benefit from enhanced predictability of the outcome of value recovery. The economic consequences of the COVID-19 outbreak, arising from direct and indirect restrictions imposed on many sectors, have created financial difficulties for previously healthy firms while aggravating the financial distress of firms which had already been struggling before the crisis. This effect has already set in and is likely to continue as time progresses. Member States have reacted with temporary relief measures that included debt moratoria and/or a suspension of the (creditors') right and the (debtor's) obligation to file for insolvency. Once they expire, the numbers of insolvencies is expected to spike in at least some Member States.

Banks are the principal source of credit to the economy. They are particularly dependent on being able to recover value from loans granted or collateral in order to reduce the risks from an accumulation of non-performing loans. Funds not recovered by banks are funds not available for other, more competitive businesses. At the same time, effective value recovery under loan enforcement and insolvency frameworks is also important for the Banking Union. Well-functioning insolvency frameworks will be needed to ensure (re)allocation of productive resources in the corporate sector.[4] Conversely, inefficient, arbitrary, or unpredictable insolvency procedures can translate into significant costs for the Member States concerned, and for the wider euro area and European economy.[5]

At the EU level, cross-country differences in insolvency regimes lead to fragmentation of EU capital markets and result in higher costs of financing for companies. The access to

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[3] https://www.consilium.europa.eu/en/press/press-releases/2020/11/30/statement-of-the-eurogroup-in-inclusive-format-on-the-esm-reform-and-the-early-introduction-of-the-backstop-to-the-single-resolution-fund/

[4] https://www.consilium.europa.eu/media/47879/technical-note-to-eg-on-euro-area-imbalances-12012021.pdf

[5] European Banking Authority, Report on the dynamics and possible drivers of non-performing exposures in the EU banking sector, 22 July 2016.

affordable financing is even more relevant in the COVID situation where businesses face sizeable liquidity issues. Harmonisation or at least convergence of corporate insolvency rules (non-bank, meaning not extending to specific rules for banks or other financial companies) is one of key structural reforms necessary for a genuine integration of national capital markets across the EU and attracting funding for firms. This would bring a particular value added to the euro area economy, as it would increase private risk sharing and thus the resilience of the monetary union. It could also contribute to strengthening the international role of the euro by attracting additional international investors to the euro area economy. The motivation is straightforward: creditors tend to invest in jurisdictions where insolvency frameworks are simple and effective in protecting their interests in case of debtors' defaults. However, Member States' insolvency regimes differ substantially and in some cases are not as efficient as they could be reflecting both complexity of rules and lack of judicial capacity. Both of these characteristics make it difficult for creditors to anticipate the length and outcome of value recovery, making it hard to adequately price the risks, in particular in a cross-border context.

2. RECENT EU-LEVEL INITIATIVES IN THE AREA OF CORPORATE INSOLVENCY

In 2019, the EU adopted the Restructuring and Insolvency Directive (based on a Commission proposal foreseen in the 2015 Capital Markets Union Action Plan).[6] This Directive requires Member States to have in place certain key elements for effective preventive restructuring frameworks, designed to avoid the insolvency of viable companies. As regards the possible impact on bank as creditors, it is crucial that restructuring frameworks include effective provisions to determine viability, avoid futile restructuring attempts, and preserve the interests of creditors. The deadline for transposition into national law was originally 17 July 2021; however, by the deadline of 17 January 2021, 23 out of 27 Member States had notified the Commission that given particular difficulties in implementing the new Directive, they would avail themselves of the option to work towards an extended deadline of 17 July 2022. The Directive is an important milestone towards avoiding piecemeal liquidation of viable businesses. However, it does not harmonise key elements of core insolvency proceedings, which involve reorganization after a company becomes insolvent or a liquidation of the business and distribution of proceeds to the creditors. Another Commission proposal put forward in March 2018 on rules for accelerated extrajudicial collateral enforcement, i.e. value recovery from defaulting loans out-of-court, is still in discussions by the co-legislators.

Upgrading the 'law on the books' will not – on its own – be sufficient to deliver better outcomes. Congestion of courts is at the bottom of the long duration of loan enforcement and insolvency proceedings in many Member States. Its effects can be further exacerbated by national rules and legal practices that may even dis-incentivise speeding up of proceedings. Long proceedings lead to further asset depreciation and may act as a deterrent to using formal enforcement proceedings. Any legislative improvements would hence need to be accompanied by investment in the enforcement infrastructure in the most critical Member States in order to boost efficiency and predictability.

As per the 2017 Council Action Plan to tackle non-performing loans, the Commission services have undertaken a benchmarking of national loan enforcement (including insolvency) frameworks in order to obtain a reliable picture, based on real-case data, of

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6 Directive (EU) 1023/2019 of 26 June 2019 on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures.

the outcomes experienced by banks in practice when enforcing loans against a borrower in formal court proceedings.

Following a Call for Advice from DG FISMA, the European Banking Authority undertook an ad-hoc data gathering from a representative sample of voluntarily participating banks from all Member States. The data were analysed and linked with input from the Member States, in a coordinated exercise, on qualitative features of their national frameworks. The analysis identified a number of possible factors that can contribute to efficient value recovery. In the area of corporate insolvency, it revealed wide disparity between Member States not only in terms of features of their respective national regimes, but also in terms of time to recovery and recovery rate, i.e. features which impact on banks' value recovery from non-performing loans.

3. ONGOING EU-LEVEL WORK ON CORPORATE INSOLVENCY

(a) Insolvency convergence

The insolvency benchmarking exercise revealed that national insolvency regimes across the EU differ in their design and in their practical implementation. National insolvency systems embody choices made regarding the appropriate balance between creditor and debtor interests, as well as, for example, different national choices regarding the priority enjoyed by employees, public utilities and tax authorities in the process. The close links with other areas of national law make harmonisation of insolvency laws challenging and suggests that a targeted approach focussed on certain features is advisable. The December 2020 Euro Summit (in inclusive format) underlined the need, in the context of the work on the 2020 Capital Markets Union Action Plan, that “the impediments to progress on the more complex and structural areas put forward in the Action Plan should be identified.”

As per its commitment in the Capital Markets Union Action Plan, the Commission is working to enhance convergence of corporate insolvency laws. Among the elements to be analysed for possible enhanced convergence are the definition of what constitutes a state of insolvency (deciding when a company should be obliged to undergo formal insolvency proceedings); avoidance/claw-back actions to replenish the insolvency estate in case of fraudulent or not-at-arm’s-length transfers; asset tracing; the ranking of claims, including the position of secured creditors in insolvency; and court capacity. The Commission will consider either proposing a legislative instrument for minimum harmonisation of certain targeted elements of corporate insolvency laws, or coming forward with a non-legislative initiative to increase convergence.

(b) Monitoring of value recovery

The benchmarking exercise was a useful snapshot of the insolvency landscape. However, in light of ongoing reform efforts at national level, it will be important to obtain a dynamic picture of the efficiency of national loan enforcement frameworks in order to (i) monitor progress on how well banks are equipped to deal with those non-performing loans where formal court proceedings are needed as a last resort and as a default option to inform other solutions, and to (ii) understand the effects of, and need for potential review of, EU legislative measures.

Since insolvency reform is not a short-term initiative at any level, it should be sufficient to have new information about the efficiency of insolvency regimes, for example, every two years rather than on an annual basis. From the perspective of banks as creditors, the efficiency of insolvency regimes is measured by how much of the outstanding amount can be recovered (recovery rate), and how long the recovery takes (time to recovery), to allow for discount over time. While banks would thus be the beneficiaries of a better understanding of how well loan enforcement works, the costs of the data collection exercise need to be proportionate and it will be of the essence to adapt expectations on the amount of data to be collected to the necessity to limit the reporting burden on banks. As announced in the new Capital Markets Union Action Plan, the Commission is currently conducting a feasibility assessment which will, *inter alia*, explore a possibility of how to the extent possible to build on the existing data collection processes and recycle existing data. Any new insolvency benchmarking exercise should also consider lessons learned from the previous exercise conducted by the EBA. Therefore, if the feasibility assessment concludes that a recurrent insolvency benchmarking is possible and desirable, a proportionate mandatory reporting obligation for banks may need to be introduced to ensure sufficient coverage across all Member States and to address the issues revealed by the first voluntary exercise.

The Commission services are presently analysing how suitable data could be obtained, ideally building on existing reporting, and how the data quality could be enhanced, e.g. through more precise definition of attributes, for future replications of the benchmarking exercise. In order to improve data quality and comparability, definitions would need to be tightened. Such definitions would need to be elaborated together with the banking industry and supervisors. In this regard, the ECB, involving stakeholders, has already developed a large set of data attributes for its AnaCredit project and these attributes are publicly available. It may therefore be desirable to use, for the assessment of recovery outcomes, the loan attributes as already reported by banks to AnaCredit to avoid duplicating (i) the work needed to arrive at workable data points and (ii) reporting efforts of banks.

The Restructuring and Insolvency Directive already contains certain data reporting requirements. Those requirements, however, will not on their own be sufficient for a comprehensive assessment of value recovery. Once these obligations enter into force (2024), however, they could be integrated in the benchmarking exercise, for example as a plausibility check.

Finally, in order to ensure a holistic view of the progress with the Member States' insolvency regimes, it may be desirable to continue also with the qualitative assessment of national frameworks.

CONCLUSION

The work-streams presented in this paper demonstrate the importance of core non-bank corporate insolvency regimes as a key feature of the legal framework with profound and multiple effects on economic resilience, capital market integration and stability of the financial/banking system. Because insolvency law has such pervasive effects, and is so deeply encoded in national legal traditions, largescale harmonisation would be a challenge. However, a series of targeted initiatives can be envisaged to improve financing conditions for the economy and to safeguard financial stability. The Commission services will take forward the planned actions and report on their progress in the appropriate fora, given the relevance of this work-stream for the both the euro area and the EU 27.

Questions for discussion:

1. Do Ministers agree that improving insolvency legal frameworks to make them more efficient and enhancing judicial capacity to handle NPLs can help to increase the proportion of debt value that can be recovered, particularly in the context of the COVID-19 crisis?
2. Which avenue would Ministers consider most conducive to improving insolvency frameworks with a view to banks' ability to contribute to the post-COVID-19 recovery through new lending?
3. What measures do Ministers consider most conducive to enhancing convergence of insolvency frameworks to build a Capital Markets Union?