GSK Update

18 October 2016

ECJ confirms burden-sharing by investors and subordinated creditors in a bank's crisis

Important judgement regarding the future practice of EU bank resolution and recovery rules

Executive Summary

> On 19 July 2016, the European Court of Justice, in a case regarding state aid granted to five Slovenian banks in trouble and authorised by the European Commission under its so-called "Banking Communication", held that the adoption of this Banking Communication was correct. Although it does not bind Member States, it is a proper self-limitation of the Commission's discretion in dealing with bank-related state aid measures.

> This does not affect the Commission's duty to assess every single case individually. However, if a bank rescue measure is not in line with the Banking Communication or with the new EU bank recovery and resolution regime (under BRRD and SRM Resolution, and in Germany under the SAG and the AbwMechG), it is unlikely that (a) the Commission will approve it, thereby deviating from the Banking Communication rules, and (b) it will not declare measures incompatible with EU law. It might request the repayment of state aid, even if this endangers the relevant bank's existence; this is the risk of the relevant Member State and bank.

> Since the case now decided by the Court of Justice occurred, the EU has introduced its above-mentioned bank recovery and resolution regime. An important part of this regime is the burden-sharing of shareholders and subordinated creditors via a so-called "bail-in".

> According to the Court of Justice, burden-sharing by shareholders and subordinated creditors can well be used as a condition for granting state aid in order to avoid or reduce banks' capital shortfalls (as it is set forth in the Banking Communication).

> This cannot be jeopardised by the principle of the protection of legitimate expectations, by property rights or under EU company law, as long as such burden-sharing does not exceed what is necessary to overcome the relevant bank's capital shortfall.

> Burden-sharing measures also fall within the scope of "reorganisation measures" under the EU Bank Winding-up Directive.

> As a result, this judgement is not just clarifying the (state aid) rules to be applied in the Slovenian case at hand, but it contains important lessons in regard of future bank rescue, recovery, resolution and insolvency measures, for example in Italy and Portugal (and, if ever necessary, in Germany as well), by both the new Single Resolution Board as well as by the national bank resolution and supervisory authorities.

1. The ECJ's new decision and its importance

Overshadowed by the dramatic developments and discussions in the aftermath of the United Kingdom's Brexit referendum[1] and in Germany by a netting-unfriendly decision of the country's highest court on civil matters (BGH) and the helpful reactions by supervisors and legislators[2], the European Court of Justice ("**ECJ**") on 19 July 2016

[1] See GSK Update, The Brexit and its legal consequences, 13 July 2016

[2] See GSK Update, Netting-unfriendly reasoned BGH decision published, 21 June 2016

delivered an important and far-reaching decision in regard of measures to be taken in the context of a European bank's crisis.[3]

At first glance, this ECJ decision deals with EU state aid law, in particular with the European Commission's "**Banking Communication**" applicable as of 1 August 2013[4], and its application in the context of five Slovenian banks[5] in trouble. Under this Banking Communication, the burden-sharing by shareholders and subordinated creditors is a prerequisite to the authorisation of state aid by the Commission. Therefore, at a further look, the ECJ decision in fact deals with banking regulation, in particular with the interpretation of the EU's bank recovery and resolution rules.

What the ECJ now held was that

(i) it was correct for the Commission to adopt the Banking Communication (although such a publication does not bind the Member States, it is a proper self-limitation on the Commission's discretion in dealing with bank-related state aid measures),

(ii) it was correct that the Commission's Banking Communication stipulated the burden-sharing by shareholders and subordinated creditors as a prerequisite to the authorisation of state aid,

(iii) these results are neither jeopardised by the principle of the protection of legitimate expectations nor by the property rights by such shareholders or subordinated creditors or

(iv) by certain EU company law provisions,

(v) the Banking Communication must be interpreted as meaning that the measures for converting hybrid capital and subordinated debt or writing down their principal must not exceed what is necessary to overcome the relevant bank's capital shortfall, and

(vi) the EU Bank Winding-up Directive of 4 April 2001[6] must be interpreted as meaning that such burden-sharing measures fall within the definition of this directive's "reorganisation measures".

In this context it is noteworthy that since the case decided by the ECJ occurred, the EU has introduced its Bank Recovery and Resolution Directive ("**BRRD**")[7],implemented in Germany by the Recovery and Resolution Act *(Sanierungs- und Abwicklungsgesetz* - "**SAG**")[8], and the Single Resolution Mechanism ("**SRM**") Regulation[9], in Germany accompanied by the Settlement Mechanism Act (*Abwicklungsmechanismusgesetz* - "**AbwMechG**"*).*[10] Under this new bank resolution regime, the burden-sharing of shareholders and subordinated creditors via the so-called "**bail in**"[11] has become an important part of the legislative body dealing with banks in crises[12], and the state aid rules are just another part of these rules.

As a result, the ECJ decision is not just clarifying the rules to be applied in the Slovenian case at hand, but it contains important lessons in regard of future bank rescue, recovery, resolution and insolvency measures by both, the new EU Single Resolution Board ("**SRB**") in Brussels and by the national bank resolution authorities, for example in Germany the Financial Market Stabilisation Authority (*Finanzmarktstabilisierungsanstalt* – "**FMSA**") and to some degree the Federal Financial

[3] ECJ, judgement of 19 July 2016 in the case C-526/14; see also ECJ Press Release No. 80/16 of 19 July 2016.
[4] Communication from the Commission on the application of state aid rules to support measures in favour of banks in the context of the financial crisis, Official Journal ("**O.J.**") 2013, C 216, p. 1.
[5] Nova Ljubljanska banka, Nova Kreditna banka Maribor, Abanka Vipa, Probanka and Factor banka.

[6] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, O.J. 2001, L 125, p. 15.
[7] Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (…) of 15 May 2014, O.J. 2014, L 173, p.190.
[8] *Sanierungs- und Abwicklungsgesetz* of 10 December 2014, Federal Law Gazette (*Bundesgesetzblatt* – „**BGBl.**") 2014 I, p. 2091, last amendment by a law of 30 June 2016, BGBl. 2016 I, p. 1514.
[9] Regulation (EU) No. 806/2014 of the European Parliament and of the Council 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 (…) of 15 July 2014, O.J. 2014, L 225, p. 1.
[10] *Abwicklungsmechanismusgesetz* of 2 November 2015, BGBl. 2015 I, p. 1864.
[11] Article 28 of the SRM Regulation and articles 46 *et seqq.* of the BRRD, in Germany implemented by sections 89 *et seqq.* of the SAG, slightly modified by article 1 of the AbwMechG.
[12] See for an overview GSK Update, *Bankenunion Teil 2*: Single Resolution Mechanism (SRM) – *Neue Regeln zur Bankensanierung und –abwicklung*, 15 September 2015.

Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – *"**BaFin**"*).

This ECJ decision might also turn out to be of particular relevance in the context of possibly forthcoming bank rescue activities in Portugal and in particular in Italy, where banks have a tradition of selling their own shares and/or bonds to their private customers and such customers are thus not protected under deposit protection schemes set up under respective EU rules[13]. There politicians would now like to rescue such banks in trouble without including such private customers (their voters) in a burden-sharing, but still need to be in line with the respective state aid requirements.

2. Facts

As a result of the global financial markets crisis, the (Central) Bank of Slovenia (*Banka Slovenije*) found in September 2013 that five Slovenian banks showed significant capital shortfalls. Because of these shortfalls the banks did not have sufficient assets to satisfy their creditors and to cover the value of deposits. The reaction of the Bank of Slovenia was a decision about exceptional measures to effect the recapitalisation (of two of them), the rescue (of one of them) and the winding up (of the last two) of the banks (so-called "**contested measures"**).

On 18 December 2013, the granting of state aid which the Slovenian authorities had been given to the banks was authorised by the European Commission. This included the writing off of equity capital as well as of hybrid capital and subordinated debt (together "**subordinated rights**"). Such subordinated rights share specific characteristics with both debt and equity products. In case of the issuing bank's insolvency or winding up, holders of subordinated debt are paid after the holders of ordinary bonds, but before (equity) shareholders. In exchange for the financial risk which their holders have to bear, the financial instruments related to subordinated rights offer a higher rate of return.

Private individuals as well as the *Državni svet Republike Slovenije* (the Council of State, Slovenia) and the *Varuh človekovih pravic Republike Slovenije* (the Slovenian Ombudsman) required the *Ustavno sodišče* (Constitutional Court, Slovenia) to review the constitutionality of the measures. Those applications refer to the compatibility of the provisions of the banking law, on which the above-mentioned measures are based, with the Slovenian Constitution and especially with the principle of non-retroactivity, the principles of protection of legitimate expectations and proportionality, and the right to property. The Slovenian Constitutional Court had, therefore, approached the ECJ for clarification, as the measures had to be assessed in the context of the Commission's Banking Communication.

3. ECJ ruling

a) Banking Communication is valid, not binding the Member States but the Commission itself

In its ruling, the ECJ states that the Commission may indeed adopt guidelines such as the Banking Communication. However, the Banking Communication is not binding the Member States. Within the assessment of the compatibility of state aid measures with the internal market the Commission has the possibility to adopt guidelines in the exercise of its wide discretion. With these guidelines the Commission establishes criteria on the basis of which it proposes to assess the compatibility of the measures with EU law and limits the exercise of its discretion. However, the adoption of the guidelines (here the Banking Communication) does not relieve the Commission of its obligation to consider the specific circumstances of each individual case. This means that the Commission has to authorise the requested state aid proposed by a Member State, if it is in accordance with EU law. In exceptional circumstances, even in case the proposed state aid

[13] Directive 2014/49/EU of the European Parliament and of the Council on deposit protection schemes of 16 April 2014, O.J. 2014, L 173, p. 149.

does not fulfil the criteria of the said guidelines, the Commission may authorise it.

At first glance, these ECJ findings seem to speak in favour of those, for example in Italy, who would like to rescue certain banks with public monies in order to protect private investors from burden-sharing. However, if such a rescue measure is not in line with the Banking Communication (i.e., also – and even more so – with later adopted EU bank recovery and resolution rules), it is (a) unlikely that the Commission can be convinced to deviate from its own rules and accept such state aid and (b) the risk of the respective Member State and of the relevant bank that the Commission will declare such measure to be incompatible with EU law and will order the repayment of such state aid, even if this leads to the insolvency of the bank.

b) Burden-sharing by shareholders and subordinated creditors as a condition for granting state aid

The ECJ further held that the burden-sharing by shareholders and subordinated creditors can well be used as a condition for granting state aid. Within the scope of the Commission's discretion, it can refuse state aid for companies which do not contribute to improve their financial situation. Granting public money in such a case is not regarded as compatible with the internal market. Therefore, the Commission adopted the criterion of the burden-sharing of shareholders and subordinated creditors in regard of the costs of a restructuring in order to reduce capital shortfalls. The said burden-sharing is, *inter alia*, necessary in regard of the problem of "moral hazard". This means that a person is inclined to take higher risks when potential negative consequences are borne by the general public. As a result, burden-sharing by shareholders and subordinated creditors can be used as a condition for the granting of state aid.

c) Protection of legitimate expectations and property rights

The court also held that neither the principle of protection of legitimate expectations nor a property right is an argument against the burden-sharing by investors and subordinated creditors.

aa) Protection of legitimate expectations

The applicability of the principle of protection of legitimate expectations requires precise, unconditional and consistent assurances. Apart from the fact that the shareholders and subordinated creditors of the concerned banks did not receive a guarantee from the Commission for overcoming the capital shortfalls, they also did not get an assurance that their investments will not be affected. Moreover, the fact that at the first stage of the international financial markets crisis some subordinated creditors were not requested to share the burden, does not speak in favour of a violation of this principle of law, as they were "not capable of engendering a legitimate expectation (…) that they would not be subject to burden-sharing measures in the future." Even supposing that such reasons were inapplicable, the public interest, namely in ensuring the stability of the financial system while avoiding excessive public spending and minimising distortions of competition, would be overriding.

bb) Property right protection

Moreover, property rights are in the ECJ's view not an argument to the contrary either, as shareholders are in any event liable for the debts of the bank up to the amount of its share capital. In order to absorb the losses of the bank, they should be involved to the same extent as in case of the absence of state aid. Also the subordinated creditors' property rights are, in the ECJ's view, not as affected as in the event of the insolvency of the bank, as a non-granting of public money would lead to a situation in which they lose their entire investment.

d) Decision by the general meeting of a company

As the ECJ further pointed out, the EU Directive 2012/30/EU[14] provides in essence that any increase or reduction in the capital of a public limited liability company needs a decision by the general meeting of the company. However, the Banking Communication is in the court's view compatible

[14] Directive 2012/30/EU of the European Parliament and of the Council on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies (…) in respect of the formation of public limited liability companies and the maintenance and alteration of their capital (…) of 25 October 2012, O.J. 2012, L 315, p. 74.

with this directive. In a particular situation, if the relevant Member State believes it necessary to adopt burden-sharing measures without the permission of the general meeting, that circumstance cannot question the validity of the Banking Communication. Such measures are only justified in case of serious disturbances of a Member State's economy as well as with the purpose of the avoidance of a systemic risk and the ensuring of the stability of the financial system.

e) Scope of the measures

In any event, bank rescue/burden-sharing measures must not go beyond what is necessary to cover the capital shortfall of the relevant bank.

f) Burden-sharing measures fall within the scope of "reorganisation measures"

Finally, the ECJ held that burden-sharing measures are covered by the term "reorganisation measures" (defined as "measures 'which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims'") within the meaning of the EU Winding-up Directive. The purpose of these measures is to preserve or re-establish the financial situation of a credit institution because they are aimed at restoring the financial position of a bank and to overcome its capital shortfall.

4. And now?

The ruling of the ECJ confirms the validity of the Commissions' Banking Communication the purpose of which is to limit the amount of state aid to what is necessary, as otherwise such aid would lead to distortions of competition. The fact that the criteria are not binding the Member States means that they do not have to request burden-sharing by shareholders and subordinated creditors. But the relevant Member State as well as the bank in trouble bear the risk that the Commission will not authorise the state aid granted if the criteria of the Banking Communication are not fulfilled. Then it may order the aid to be repaid, which might well imply the death of the relevant bank. Ultimately, the decision lies within the discretion of the Commission. This was not the case in the scenario to be decided by the ECJ, as Slovenia had granted state aid authorised by the Commission and based on measures which provide the burden-sharing of the shareholders and subordinated creditors.

In the future, exceptions of the "bail-in" rules under EU law will only be possible for the purpose of safeguarding the financial stability or if it would otherwise lead to a disproportional result.

Currently, for example, Italy has the interesting idea that, in case of the burden-sharing by all shareholders and subordinated creditors, the state should pay compensation at least to private persons (sometimes referred to as "small savers" although their savings by investments in bank shares or bonds might in fact not be so small).

In other words, the ECJ decision is important and helpful but it has not clarified everything in regard of the relationship between banking regulatory (in particular resolution) measures, on the one hand, and state aid rules, on the other hand.

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