Case Study of recent Bank Resolutions in Europe and related Litigation

Workshop on the Role of the Judiciary in Bank Resolution for Judges

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1. Mandatory burden-sharing: Slovenian banks
1. Mandatory burden-sharing: Slovenian banks (1/3)

- Only a few weeks after the adoption of the Banking Communication in August 2013, the Bank of Slovenia determined that five Slovenian banks had significant capital shortfalls.

- December 2013: upon request of the Slovenian authorities, the European Commission (EC) authorised State aid to support the banks.

- One of the principal aims of the 2013 Banking Communication is to shift losses onto shareholders and creditors so as to reduce costs to taxpayers and mitigate moral hazard.

  - Holders of equity, hybrid capital and subordinated debt must contribute to reduce the capital shortfall before State aid is granted.

  - Such burden-sharing could be done mandatorily (e.g. through legislative means) or consensually (e.g. through a liability management exercise).

  - Exceptions to the burden-sharing requirement apply where implementing such measures "might endanger financial stability or lead to disproportionate results".
1. Mandatory burden-sharing: Slovenian banks (2/3)

- To meet the burden-sharing requirement, the Bank of Slovenia made use of certain powers under national law to write off the banks’ equity as well as hybrid capital and subordinated debt.

- These measures were challenged before the Slovenian Constitutional Court by a number of private and public complainants.

- The Slovenian Constitutional Court requested a preliminary ruling from the European Court of Justice (ECJ) on the validity and interpretation of the 2013 Banking Communication.

- At the core was the question about the legal nature of the 2013 Banking Communication and the scope of the EC’s discretion when it approves State aid under the Treaty of the Functioning of the European Union (TFEU).
1. Mandatory burden-sharing: Slovenian banks (3/3)

- July 2016: the ECJ confirmed that the 2013 Banking Communication is not contrary to European law

- The effect of the 2013 Banking Communication is that the EC has described in advance how it will exercise its discretion to approve State aid

- It is within the EC’s authority to generally require burden-sharing under the 2013 Banking Communication as a prerequisite for State aid approval

- Due to the safeguards built into the 2013 Banking Communication (in particular the "no creditor worse off" principle), the burden-sharing requirement does not adversely affect the right to property of the investors concerned

- The judgment also clarified that burden-sharing measures regarding foreign law debt can be based on national law and then benefit from EU-wide recognition under the Directive on the reorganisation and winding up of credit institutions (CIWUD)
2. State supported bridge bank: Banco Espirito Santo
2. State supported bridge bank: Banco Espirito Santo (1/3)

- Early July 2014: news surfaces of fraudulent conduct at BES' affiliates

- Mid July 2014: the governor of the Bank of Portugal announces that BES is sufficiently capitalised

- August 2014: Bank of Portugal splits BES into a "good" bridge bank supported by the State (Novo Banco) and a "bad" residual bank under rushed-through national legislation inspired by the Bank Recovery and Resolution Directive (BRRD)

- End of October 2014: first Portuguese legal challenge commenced by LT2 bondholder group. At least 20 more lawsuits have been filed since then

- December 2014: bondholder group commenced suit before the European General Court seeking to annul the EC's decision to approve Portugal's State aid application
2. State supported bridge bank: Banco Espirito Santo (2/3)

- End of December 2014: the Bank of Portugal stated that a loan granted by a Goldman Sachs-formed vehicle (Oak) had not transferred to Novo Banco and remained at BES

- February 2015: Goldman Sachs and a group of funds commenced litigation in the English courts seeking payment from Novo Banco of the Oak loan notwithstanding the Bank of Portugal's position that the debt was a BES liability

- The English High Court adopted a strict approach as to which resolution measures will take effect in English law under the mutual recognition requirements of BRRD

- November 2015: the Comprehensive Assessment conducted by the European Central Bank (ECB) in relation to Novo Banco revealed a capital shortfall of approximately EUR 1.4 billion

- End of December 2015: the Bank of Portugal decided to transfer senior bonds of almost EUR 2bn from Novo Banco back to BES
2. State supported bridge bank: Banco Espírito Santo (3/3)

- April 2016: institutional investors filed lawsuits against the Bank of Portugal to challenge the re-transfer in December 2015

- November 2016: English Court of Appeal reversed the decision of the High Court in February 2015, taking a much broader approach to the principle of mutual recognition

- July 2017: at first instance, the European General Court dismissed the action for annulment as inadmissible due to applicants not having legal standing to bring proceedings. Other litigations commenced in Portugal are still pending

- July 2017: the EC approved the sale of Novo Banco to Lone Star under the EC Merger Regulation, but the process still requires separate approval from the EC under the State aid rules and the completion of other challenging conditions (such as the liability management exercise)
3. Resolution of a former bank: Heta Asset Resolution
3. Resolution of a former bank: Heta Asset Resolution (1/3)

- Heta is the "bad bank" that was established as a wind-down vehicle to assume and manage large parts of a failed Austrian bank – Hypo Alpe Adria

- As BRRD only applies in relation to credit institutions and certain MiFID firms, the Austrian legislator explicitly made Heta subject to the Austrian BRRD implementation law (BaSAG)

- March 2015: the Austrian Financial Market Authority (FMA) issued an administrative ruling initiating the resolution of Heta under BaSAG and suspending the maturity of certain liabilities of Heta until the end of May 2016

- Since March 2015: several creditors filed lawsuits in Germany and Austria against Heta as well as the region of Carinthia as guarantor

- May 2015: the Munich court of first instance refused to recognize the moratorium on the basis that the application of BaSAG to Heta goes beyond the scope of BRRD
3. Resolution of a former bank: Heta Asset Resolution (2/3)

- January 2016: Carinthia's compensation fund (KAF) made an offer to buy back all of Heta’s debt instruments secured by the state guarantee, but this was not accepted by the creditors with the required majority.

- April 2016: the FMA specified the next steps for the resolution of Heta, including details as to the intended bail-in ratios.

- June 2016: further to the Vienna Commercial Court and the Federal Administrative Court of Austria, the District Court of Frankfurt am Main referred the question of whether Heta falls within the scope of BRRD to the ECJ.

- Similarly, the Constitutional Court of Austria decided to suspend a pending complaint against the BaSAG regime until the decision of the ECJ.
3. Resolution of a former bank: Heta Asset Resolution (3/3)

- September 2016: the KAF submitted a new buy-back offer that was accepted with the required majority at the beginning of October. The EC confirmed that the settlement does not constitute new State aid

- The successful acceptance of the buy-back offer has significantly reduced the litigation risk of Heta and Carinthia
  - The creditors who accepted the buy-back offer submitted a comprehensive waiver in favour of Heta and Carinthia, waiving all lawsuits and actionable claims
  - The plaintiffs therefore withdrew most of the pending lawsuits
  - Due to the termination of the underlying national proceedings, the related referrals to the ECJ were withdrawn as well
3. Precautionary recap (Greece): Piraeus Bank
4. Precautionary recap (Greece): Piraeus Bank (1/3)

- October 2015: the major Greek banks went through a Comprehensive Assessment (AQR and stress tests) conducted by the Single Supervisory mechanism (SSM)

- Piraeus Bank expected State aid to be required to fill the capital shortfall

- As a condition to receiving State aid, burden-sharing must occur in accordance with the 2013 Banking Communication

- However, Piraeus Bank wished to fill the capital hole without going into a fully fledged resolution under BRRD (implementation of the bail-in tool only became due in January 2016)

  - Under BRRD, receipt of public funds generally indicates that the bank is "failing or likely to fail", which triggers resolution

  - By way of exception, State aid may be given without the bank going into resolution if it is considered "precautionary recapitalisation" under Article 32(4)(d)(iii)
4. Precautionary recap (Greece): Piraeus Bank (2/3)

- A "precautionary recapitalisation" must not be used to offset past losses or losses that are likely to be incurred in future

- This means that the AQR and "base case" of the stress test must be covered through private capital, leaving only the "adverse case" to be met by public funds

- Analysis of ways to implement burden-sharing outside resolution
  
  - Limits to burden-sharing through BRRD mechanism
  
  - Limits to burden-sharing under HFSF Law (this is the Greek national law that sets out certain powers that can be applied in relation to a credit institution that requests support from the Hellenic Financial Stability Fund)
  
  - Implementation of consensual burden-sharing through liability management exercise (LME)
4. Precautionary recap (Greece): Piraeus Bank (3/3)

- Piraeus Bank and regulators combined the following steps:
  - Issuer substitution – bank substituted as issuer to bring instruments within the scope of BRRD/HFSF Law
  - Amendment of HFSF Law to include senior creditors – senior debt was brought within the scope of a potential bail-in as envisaged by the Eurogroup statement
  - LME – consensual conversion of bonds into equity, reducing liabilities and boosting CET1 capital
  - Capital increase – in addition to LME, new investors subscribed for new shares
  - State aid – capital injection by the Hellenic Financial Stability Fund to fill outstanding capital shortfall as "precautionary recapitalisation"
5. Precautionary recap (Italy): Monte dei Paschi di Sienna
5. Precautionary recap (Italy): Monte dei Paschi di Sienna (1/3)

- July 2016: in the EU-wide stress test carried out by the European Banking Authority (EBA) and the ECB MPS stood out as the worst performer showing negative equity as a result of the "adverse case"

- December 2016: as MPS's attempts to raise private capital on the markets had failed, the Italian authorities decided to apply for State aid in the form of a "precautionary recapitalisation"

- June 2017: after lengthy discussions between the EC, the ECB and the Italian authorities, an agreement in principle was reached to restructure MPS with the help of taxpayer money

  - Putting MPS into resolution under BRRD would have meant bailing in 8% of total liabilities – including senior creditors and large deposits if necessary – before involving taxpayer money

  - In a "precautionary recapitalisation", only the more limited burden-sharing requirements under the 2013 Banking Communication have to be respected
5. Precautionary recap (Italy): Monte dei Paschi di Sienna (2/3)

- The collapse of Banca Popolare di Vicenza and Veneto Banca inadvertently helped revive MPS's plan to sell EUR 26 billion in NPLs which was a prerequisite for the EC’s approval of a "precautionary recapitalisation"

- Italy’s industry-backed rescue fund Atlante II had been in talks with MPS for months with a view to invest into mezzanine and junior tranches of a NPL securitisation, but the deal looked to have collapsed

- Atlante II had earmarked funds to invest in bad loans from the two Veneto banks. After the two Veneto banks were put into orderly liquidation these funds could be diverted into the MPS deal

- July 2017: as part of MPS's restructuring plan the EC formally approved a capital injection by the State. To meet the burden-sharing requirements under the 2013 Banking Communication, the bank's shareholders and junior bondholders contributed through debt-to-equity conversions and dilution of existing shares
5. Precautionary recap (Italy): Monte dei Paschi di Sienna (3/3)

- Separately, MPS announced that retail junior bondholders who were mis-sold would be entitled to a compensation
  - Their bonds would be converted into equity. The shares would then be bought from eligible investors who would be paid in more secure senior instruments of MPS
  - The EC confirmed that such compensation is an entirely separate consideration to burden-sharing under the State aid rules

- Under BRRD, the EC is due to review if the framework for "precautionary recapitalisations" is still needed in the current economic climate
  - The framework has been questioned by critics on the ground that it provides a flexible loophole allowing Member States to circumvent the no bail-out principle
  - Others defend the wiggle-room granted by the framework arguing that the State aid rules as well as the political checks and balances at EU level are sufficient to prevent opportunistic behaviours
6. SRM resolution without State aid: Banco Popular
6. SRM resolution without State aid: Banco Popular (1/3)

- April 2017: the chairman indicated that the bank needed a capital increase and raised the possibility of selling the bank to a competitor

- In light of rating downgrades, further alarming announcements by the bank and continuous negative press coverage, the bank faced increasing deposit outflows

- 6 June 2017: due to the stressed liquidity situation, the ECB decided that the bank was "failing or likely to fail" and immediately notified the Single Resolution Board (SRB) in line with the decision-making process of the Single Resolution Mechanism (SRM)

  - According to the ECB, "the significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due"

  - Current BRRD reform proposals include additional moratorium powers that would allow resolution authorities to temporarily stop creditors withdrawing funds when a bank is facing difficulties
6. SRM resolution without State aid: Banco Popular (2/3)

- 7 June 2017: the SRB triggered the resolution and launched an accelerated sale process
  - Under the resolution scheme, the shares in Banco Popular, including the entire business of the bank, were transferred to Santander for one euro
  - Prior to the sale, the ordinary shares and AT1 instruments were written down and the T2 instruments were converted into shares (which were subsequently transferred to the purchaser)
  - On the same day, the EC endorsed the resolution scheme in accordance with the SRM, noting that the scheme involved neither State aid nor aid from the Single Resolution Fund
  - Under the SRM, the Spanish National Resolution Authority (FROB) is responsible for the implementation of the resolution scheme
- 13 July 2017: Santander launched a compensation scheme for retail investors affected by the resolution of Banco Popular
6. SRM resolution without State aid: Banco Popular (3/3)

- Several investors filed appeals before the Appeal Panel of the SRB, but the panel has no jurisdiction regarding SRB’s resolution decisions.

- More than 50 legal actions have been filed with the European General Court against the SRB and in some cases also against the EC. Plaintiffs include a broad range of investors.

- Reportedly some investors also plan to make a claim against the Spanish state via international arbitration.

- The main points of criticism relate to the ongoing supervision by the ECB, comments made by the SRB shortly before the resolution, the speed of the decision-making process and the transparency of the underlying valuation.

- According to the provisional valuation obtained by the SRB, the bank was worth negative EUR 2bn in the "base case". This figure is almost identical to the total value of the bank’s AT1 and T2 instruments which means that the bank’s senior debt could be left untouched.
7. Orderly liquidation under national law: Veneto banks
7. Orderly liquidation under national law: Veneto banks (1/3)

- Both Banca Popolare di Vicenza (BPVI) and Veneto Banca have a very high amount of non-performing loans and have been loss-making for several years.

- After failed attempts to raise capital the banks were rescued by Atlante in 2016.
  - Atlante was set up as rescue fund backed by Cassa Depositi e Prestiti (a state-owned institution) and several other financial institutions to recapitalize weak Italian banks and purchase portfolios of NPLs.
  - The involvement of Atlante was cleared under State aid rules, since the EC concluded that Cassa di Depositi e Prestiti invested pari passu with private investors.

- Since 2016 Atlante invested approximately EUR 3.4 billion in BPVI and Veneto Banca to avoid a resolution of the banks.

- Despite the rescue by Atlante the banks continued to suffer from deposit outflows.
7. Orderly liquidation under national law: Veneto banks (2/3)

- The Italian government initially pursued a "precautionary recapitalisation", but ultimately this was not an option due to the lack of private capital resources to cover losses the banks were likely to incur in the future.

- 23 June 2017: the ECB concluded that BPVI and Veneto Banca were "failing or likely to fail" due to breaches of regulatory requirements that would justify the withdrawal of their license.

- However, on the same day, the SRB decided that resolution action is not warranted in the public interest so that the banks should be wound down in insolvency proceedings at national level.

- According to the SRB, neither of the banks provide critical functions and their failure is not expected to have a significant adverse impact on financial stability.

- The approach taken by the SRB suggests that in future small banks are more likely to go into orderly liquidation under national law than resolution under the SRM.
7. Orderly liquidation under national law: Veneto banks (3/3)

- 25 June 2017: the EC approved State aid for the orderly market exit of BPVI and Veneto Banca under Italian insolvency law, involving the sale of some parts to Intesa
  
  - Intesa offered to buy the "good" parts of the banks for a symbolic purchase price of 1 euro. The EC confirmed that the measures do not constitute aid to Intesa, because Italy selected the buyer in an open, fair and transparent sales procedure
  
  - Shareholders and junior bondholders participated in the losses, but no BRRD bail-in was used, which would have included senior bonds holders and unguaranteed deposits
  
  - Critics therefore push for the harmonisation of national insolvency laws and a tightening of the 2013 Bank Communication to avoid "wrong incentives"

  - Junior bonds will not be transferred to Intesa, but affected holders may be eligible for compensation
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