Finanziato dall'Unione europea NextGenerationEU
Ministero dell'Università e della Ricerca
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Contingent liabilities in the context of a sale of business

Proportionality in Bank Crises: the Case of Retail Banks

PRIN Pro.Re.BA - International workshop

Siena - October 18, 2024

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- Proportionality in the treatment of contingent liabilities
- Interferences with the creditors' hierarchy
- Strategies to deal with contingent claims in a sale of business

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TERMINOLOGICAL NOTE

- **Using 'contingent claims' as encompassing:**
  - *Provisions: liabilities giving rise to an accounting provision as relating to a probable outflow of funds that can be reliably estimated (litigation claims having more than a 50% chance of being asserted in court, etc.)*
  - *Contingent liabilities (*off-balance sheet*): not recognized as accounting provisions as relating to obligations not probable at the time of the estimate or that cannot be reliably estimated (guarantees; liabilities assessed as unlikely, etc.)*

- **See IAS 37 for the classification of undetermined assets and liabilities**
  - *Proposed CMDI reform builds on that classification to provide for a different treatment in case of a bail-in*

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THE RELEVANCE OF PROPORTIONALITY IN THE TREATMENT OF CONTINGENT CLAIMS

- **Two different meanings of proportionality:**
  - with the respect to a legislative choice, the balancing of different values and interests involved
  - the reasonableness of the regulatory treatment of different situations

- **The treatment of contingent liabilities raises issue along both those dimensions**

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The rationale for a different treatment of contingent claims

- ***In principle*, the contingent nature of a claim should not affect its treatment**
  - *The ranking of a claim does not depend on its degree of certainty*
- ***In practice*, uncertainties make the case for distinguishing contingent liabilities in bank crises**
  - *Time misalignment between the action (ideally, very quick) and the crystallization of the claim (often distant in time)*
  - *The effectiveness of the action relies on the stability and finality of its effects*

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RESPONSES TO THE DEMAND FOR SPECIAL TREATMENT

- **<u>In the case of bail-in</u>, '*ad-hoc*' exemption pursuant to Art. 44(3) BRRD**
  - *See EBA technical advice of March 6, 2015*
  - *This would <u>favor</u> contingent claims*
  - *The CMDI reform goes further in that direction*

- **<u>In a SoB</u>, (most commonly) leaving behind contingent liabilities with the residual entity**
  - *Banco Espirito Santo, Veneto Banca, Banca Popolare di Vicenza, … the list is long*
  - *This would <u>unfavor</u> contingent claims*

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EFFECTS ON THE CREDITORS' HIERARCHY AND NCWO

- **Both responses aim to provide certainty**
  - *Certainty to the market as to the effects of the bail-in*
  - *Certainty to the third-party purchaser as to the value of the acquired business*

- **Yet, both approaches result in altering the claims waterfall**
  - *Deviations from the* pari passu *principle*
  - *Inversion of the creditors hierarchy*

Are these deviations proportionate?

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PROPORTIONALITY AND ALTERATION OF THE WATERFALL

- **Art. 5, par. 4, EU Treaty: proportionality demands that the interference be functional to a public objective and limited to what necessary**

- **Clear and understandable *rationale* for the treatment of contingent claim**
  - *Does it make any sense distinguishing between 'provisions' and 'contingent liabilities' as proposed in the CMDI reform?*

- **The treatment is designed on a case-by-case basis**
  - *Is the general exemption of contingent liabilities proposed in the CMDI justified?*

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PROPORTIONALITY AND PROPERTY RIGHTS

- **The different treatment may result in a violation of the NCWO**
  - *It would possibly concern* contingent creditors *in a SoB or* all the other creditors *in a bail-in*
  - *No 'flight-to-quality' of contingent liabilities in a liquidation*
- **In this regard, proportionality demands compensation mechanisms**
  - *The issue has raised sparking litigation in several SoB cases*

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CONTINGENT LIABILITIES AND SALE OF BUSINESS

- **Dealing with contingent liabilities is key to making the SoB practicable**
  - *The UNIDROIT's Legislative Guide has identified the SoB as the preferred strategy for non-systemic banks*
  - *Recommends to allow partial transfers carving-out unattractive parts of the bank business, including contingent claims (§§ 234, 249, 265)*
  - *Not a practicable solution in all cases, absent a compensation mechanisms*

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CONTINGENT LIABILITIES AND SALE OF BUSINESS

- **It is striking the different regulatory approach between *bail-in* and SoB**
  - *Lack of a system to expedite the transfer other than simply living contingent claims behind*
  - *At odds with the proportionality principle, intended as a standard to assess the regulation of different situation*

- **A proposal could draw from the contractual and regulatory mechanisms developed to reduce uncertainty regarding contingent assets**
  - *'Loss-sharing agreement' used in the practice of the P&A transactions carried out by the FDIC*
  - *A similar contractual arrangement was used in the case of the Venetian Banks*

CONTINGENT LIABILITIES AND SALE OF BUSINESS

- **Contingent claims could be transferred to the purchaser with a guarantee**
  - *A reputable guarantor (e.g., the DIS) covers the difference if the contingent liabilities have been underestimated*
  - *Payment by the guarantor may (or may not) give rise to the guarantor's subrogation right against the residual entity*

- **When the legal framework provides for a subrogation right, it may be appropriate to set a cap**
  - *The guarantor's subrogation reduces the recovery for those creditors left behind*
  - *That reduction cannot go so far as to violate the NCWO*

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THE BENEFITS OF THE DESCRIBED APPROACH

- **The described approach seems to better comply with proportionality**
  - *The practicability of the SoB is preserved*
  - *Interferences with the creditors' hierarchy are limited and, in any case, it avoids violations of the NCWO*
  - *In case of legal subrogation, the use of external resources may be absent or limited to the amount not recovered (or exceeding the cap)*
  - *Compatibility with state aid rules is an issue, but DIS may pursue its mandate with other forms of intervention (within the limit of the 'least-cost test')*