Upgrading the current EU resolution framework – A focus on Bail-in and Precautionary Recapitalization

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1. Introduction

EU banking regulation has gone through a massive set of changes in the past decade, but, even if substantial improvements have been made, the realization of a fully-fledged Banking Union is still an unfinished business under many aspects. Recent case studies suggest that any pledge to avoid bailouts in the future is strictly linked to two main aspects: the fine-tuning of bail-in rules on one side and, on the other, the enhancement of the legal certainty about the limits imposed on publicly funded recapitalisations.

After the Global Financial Crisis (GFC), policymakers and financial regulators at the international level recognised that addressing the 'too-big-to-fail' issue posed by many financial institutions was an essential prerequisite for economic recovery. In particular, it is almost uncontested that banks play a pivotal role within a financial system since they provide key economic functions and represent an essential source of funding for the real economy. The policy of bail out credit institutions in financial troubles has a long history and it has usually been vindicated with the claim that letting them fail would imply higher costs, both in terms of overall public expenditures and economic slowdown. However, many analyses highlighted how this policy choice actually poses a serious threat to public finances, hinders competition and favours a risk-taking culture that magnifies the issue of moral hazard [e.g. Huertas, 2015]. These problems were severely felt in Europe, where they have been aggravated by the Sovereign Debt Crisis that exposed a perverse link between sovereign debts and the banking sector.

Indeed, in the European context, the new awareness on these issues led to a gradual but determined shift towards a policy based on burden sharing and investors' involvement in bank crisis management. On one hand, there was the need of improving the banking regulation and supervision (from both a micro and macro perspective), mainly with the introduction of a more forward-looking approach and adequate supervisory tools such as periodical stress tests or asset quality reviews. Within this domain, the aim is to prevent bank crises or to halt them at their onset. On the other hand, one of the greatest challenges was making even systemically important banks resolvable or 'safe to fail', curbing the bail-out practice. Here, the main objectives are re-stabilising ailing banks or minimising the effects their failure may have on financial stability. Firstly, to address the latter issue, a wide set of reforms has been mandated at the G20 level since 2009. Then, the work on this field has been conducted by the Financial Stability Board (FSB), which since 2011 develops and refines the principles and key attributes a sound resolution regime should possess to be effective. Substantial contributions in this field have been made also by another international standard setter, the Basel Committee on Banking Supervision (BCBS) hosted by the Bank of International Settlements (BIS).

Along these lines - and in the light of the de Larosière Report which exposed the criticalities of the EU system of financial supervision in 2009 - the EU co-legislators launched the ambitious project of the Banking Union (BU) in June 2012. It should be noted, however, that avoiding bailouts as a strategy option in bank crisis management was already a priority under the State Aid framework enforced by the EU Commission. Its 2013 Banking Communication (the latest iteration of the so-called 'crisis communications') tries precisely to strike a balance between avoid distortions of competition in the single market and preserving financial stability.

Radically reshaping the former architecture of bank regulation and supervision, the BU was supposed to rest on three pillars: a Single Supervisory Mechanism (SSM) under the aegis of the European Central Bank, a Single Resolution Mechanism (SRM) led by an independent resolution authority (the Single Resolution Board – SRB) and a European Deposit Insurance Scheme (EDIS). The overall aim was to break the vicious circle between banks and sovereigns (the so-called 'doom loop'), put an end to the practice of bailing out financial institutions using taxpayers' money, curb moral hazard and ensure financial stability. Steps ahead towards these objectives have been made, but progress seem to advance on a bumpy road. This is even more apparent with regard to a common deposit guarantee scheme to ensure depositors in the euro-area.

2. EU bank crisis management: the road so far and the way ahead

The present article is focused on the EU resolution framework, which is based on two major pieces of legislation: the Bank Recovery and Resolution Directive (Dir. 2014/59/EU, 'BRRD'), that broadly applies to all credit institutions within the EU, and the Single Resolution Mechanism Regulation (Reg. 806/2014, 'SRMR'), which covers euro-area banks. In general terms, this framework ensures the burden sharing principle by introducing 'bail-in' powers that the relevant resolution authority could use to write-down and/or convert into equity eligible debt instruments or other hybrid liabilities of a failing – or likely to fail - institution, according to a predetermined hierarchy. The aim is to improve market discipline by placing shareholders and certain debtholders at the forefront in case of financial distress, while also preserving the continuity of banks' critical economic functions. The detailed bail-in discipline is laid down in Article 43 *et seq.* of the BRRD. However, when it comes to the possibility of recapitalising an ailing bank, a tension arises between this general principle and its exception. Indeed, while many passages of the BRRD reiterate that a certain percentage of a bank's total liabilities should be bailed-in before any injection of public funds could take place, Article 32 mandates that Member State governments can apply for a so-called 'precautionary recapitalisation' if a detailed set of criteria are met.

Certain aspects of this framework are currently being reviewed by the EU Commission, that - in line with the roadmap decided by the ECOFIN – in November 2016 presented a 'banking reform package' which will also amend the Capital Requirements package (CRR and CRD). With regard to the resolution framework, one of the most relevant amendments will be the refinement of the minimum requirement for own funds and eligible liabilities (MREL) applicable to EU banks, which constitutes an essential prerequisite for an effective application of the bail-in resolution tool. According to Article 45 of the BRRD, the level of MREL is currently determined by the relevant resolution authority on a case-by-case basis and it is expressed as a percentage of a bank's total liabilities including regulatory capital. However, this rule deserve further improvements. For instance, MREL levels do not have a minimum threshold and the bank-specific targets identified by the SRB in the previous year are not binding or enforceable. Therefore, the EU Commission's proposal amending this area will constitute a much-needed improvement, also because it will adapt and integrate the Total Loss Absorbing Capacity (TLAC) requirement developed by the FSB for global systemically important banks (G-SIBs) into EU law. As the chairperson of the European Banking Authority (EBA) Andrea Enria highlighted in many occasions [e.g. Enria, 2017], consistency and proportionality will be key. Considering the specific needs and business models of different credit institutions will allow co-legislators to lower compliance, operational and administrative costs, with positive effects on bank lending and profitability.

A second weakness of the EU resolution framework is represented by a lack of harmonisation among Member States' insolvency laws, in particular the area of creditor hierarchy and subordination. These differences among Member States' legal frameworks severely undermine the legal certainty of resolution processes, increase legal risks and costs under the 'no-creditor-worse-off' principle and weaken the application of bail-in. In addition, this interplay between BRRD rules and domestic legislations results in increased bank funding costs. The current EU

Commission's proposal to address this issue and harmonise the creditor hierarchy in case of bank insolvency may need further refinement and its analysis is outside the scope of the present article, but gradually steer toward more harmonisation while taking into account the profitability of the sector seems to be a step in the right direction.

3. What could be done to render the Bail-in more credible? A proposal for the introduction of a special group of preferred shareholders

Bail-in powers serve as an instrument to overcome time-series problems by enabling governments and regulators to commit to a future behaviour: not bailing out financial institutions. In this regard, the terms of converting debt into equity are crucial. It seems preferable to have relatively easily triggered and therefore regular conversions with only little impact on the financial system as a whole. As external pressures on the authorities will be lower, such an incremental approach makes bail-ins more likely to happen, thereby reinforcing the instrument's credibility. As a starting point, the conversion into equity poses a strong incentive for shareholders not to burden the company with too much leverage. Societal costs associated with a non-optimal business model will be borne by shareholders whose part in the company would be diluted on conversion, providing a parade example for the internalization of external costs. *John C. Coffee* expands on this idea and argues for the conversion of debt into voting preferred stock [Coffee, 2011]. For reasons we will expand on in the following, it is worthwhile to consider establishing a special class of preferred shareholders carrying voting rights even before bail-in is triggered as well as rights of action to enforce bail-in terms.

First, this would create a new constituency more senior than ordinary shareholders in terms of loss absorbency: only if ordinary shareholders are not being paid any dividends, will preference shareholder have to absorb losses. Put differently, they are the last to suffer from a financial crisis of the institution. If calibrated rightly, they stand to lose in situations in which ordinary shareholders' incentives are already skewed towards externalizing systemic risk on creditors and society as a whole. It follows from this that giving preference shareholders a say in the running of the company ex-ante the triggering of bail-in could counterbalance the risk-seeking behaviour of ordinary shareholders as a class. Ideally, the number of preference shareholders would be significant enough as to pre-empt the need to "internally resolve" institutions by bailing-in debtors in the first place.

Second, and building on this, special groups of private claimants could also be deployed to enforce – rather, threaten to enforce – the contractually determined conversion triggers vis-à-vis resolution authorities and accordingly make the success of "internal resolutions" more credible. We showed that authorities' legal and factual discretion in situations of extreme financial distress raises doubts among market participants about the actual enforcement of bail-in. This is because regulators, banks and holders of bail-inable debt form a special interest group. As such, they not only have reason to but also the necessary incentives to push for ultimately avoiding bail-in. In contrast, taxpayers constitute a large and dispersed group with accordingly lower incentives to lobby for the prevention of bail-outs. As a consequence, there is a strong need for a special interest group highly motivated to have bail-in enforced: a special group of preferred shareholders could perform this function. To this end, regulation could mandate financial institutions to issue a certain amount of preference shares. These would be lower ranked than the bail-inable debt (say, AT 1 bonds) but higher ranked than the claims the debt would be converted into (say, ordinary shares). As a result, these shareholders have an interest in bail-in taking place for they would like to get rid of the debt claimants benefitting from fixed payments. As preference shareholders, however, the conversion does not dilute their priority claims. What's more, this class should be equipped with a right of action vis-à-vis governments and regulatory authorities ("enforcement shareholders") allowing them to "kick down" the bail-inable debtors once the trigger point is reached. If calibrated rightly, the mere threat of this enforcement helps to restrict the regulator's discretion and in consequence render bail-in credible. Ideally, the preferred stock would be held by relatively few institutions with high-powered incentives and practical capabilities to sue. By suing – or threatening to sue – an agency that might otherwise shirk away from triggering or alternatively have courts enforce a bail-in, these enforcement shareholders functionally proxy for the general public and its interest in the enforcement of bail-in.

4. Precautionary Recapitalisation

Despite preventing future bailouts was one of the guiding principles behind the decision to create the Banking Union, Article 32 of the BRRD – which, in general, sets the conditions that trigger a resolution - does not entirely expunge this possibility. On the contrary, its paragraph 4(d)(iii) envisages the use of precautionary recapitalizations as an extrema ratio that shall be used to ensure financial stability and prevent that a bank's collapse may threaten a Member State's broader economy. This is consistent with Article 107(3)(b) of the Treaty on the Functioning of the European Union, which clarifies how state aid may be deemed compatible with the rules on the internal market on the condition that it is granted to ‘remedy a serious disturbance in the economy […]’. The EU Commission’s Banking Communication of 2013 further specify the parameters for such public interventions. Since the only two other options in which extraordinary public financial support could be granted – namely State guarantees on newly issued liabilities or to back liquidity facilities (Article 32 4(d)(i) and (ii)) – are meant to deal with liquidity issues [Olivares-Caminal and Russo, 2017], precautionary recapitalization is currently the sole available tool to increase the capital of a bank with public funds. However, the wording of Article 32 shows several criticalities which have a negative impact on legal certainty and leave room for different interpretations, as detailed below.

Article 32 (4)(d) of the BRRD lays down a set of conditions that should be simultaneously met to unlock the possibility of using public funds to recapitalize a credit institution. First, as mentioned above, a precautionary recapitalization should be used in order to ‘remedy a serious disturbance in the economy of a Member State and preserve financial stability’ (Art. 32 (4)(d)(iii)). It is also specified that the recapitalization must be ‘proportional to remedy the consequences of the serious disturbance’. Second, it must not ‘confer an advantage upon the institution’. Third, at the time the public support is granted the bank should not be considered ‘failing or likely to fail’. Moreover, it is stressed that precautionary recapitalizations are measures ‘of a precautionary and temporary nature’ that should be confined to ‘solvent institutions’ and for the sole purpose of addressing a ‘capital shortfall resulting from stress tests and/or quality reviews conducted at the EU or domestic level. They are not intended to ‘offset losses that have occurred or are likely to occur in the near future’. Finally, any recapitalization is ‘conditional on final approval under the EU State Aid framework’.

After its entry into force at the beginning of 2015, the EU recovery and resolution framework has been tested on several occasions. In 2015 the EU Commission approved the precautionary recapitalization of two Greek banks, i.e. Piraeus Bank and National Bank of Greece (NBG). Early this year, Banco Popolare di Vicenza (BPV) and Veneto Banca (VB) in Italy have been deemed not eligible neither for a resolution nor for a precautionary recapitalization, hence paving the way to their liquidation under the Italian insolvency law (*liquidazione coatta amministrativa* or forced administrative liquidation). Conversely, Banca Monte dei Paschi di Siena (MPS) has been deemed to meet all the conditions required for a precautionary recapitalization, which eventually has been approved by the EU Commission in July 2017. Finally, the case of Banco Popular in Spain currently represents the only resolution that has been conducted under the full responsibility of the SRB. Drawing on these practical applications of the EU’s bank recovery and resolution rules, many commentators highlighted the shortcomings of the current framework.

Moreover, since Article 129 of the BRRD mandates that a broad review of its implementation should be carried out by the EU Commission in mid-2018, a reflection on possible paths for reform is due.

At the time of writing, even if different reform proposals and policy recommendations have been put forward [Hellwig, 2017; Olivares-Caminal and Russo, 2017; Philippon and Salord, 2017; Véron, 2017], it is possible to identify certain aspects on which the literature seems to agree. The first and, presumably, less contentious issue that should be addressed is given by the discrepancies among different language versions of the BRRD. More precisely, while in the English version of the directive it is stated that the extraordinary use of public funds should seek to 'remedy a serious disturbance in the economy […]', the German version uses the verb 'to prevent'. Moreover, as odd as it may sound, both the French and Italian versions use the phrase 'to prevent or remedy'. Choosing between one of the two options, or conversely keeping both the verbs, could alter (lowering or raising) the level of Member States' discretion in requesting a precautionary recapitalization. Whatever the choice, which also depends on the calibration of other passages of Article 32, the sentence should be consistent in all the different language versions.

It would be desirable to address, or at least reduce, the vagueness affecting certain key aspects. As *Véron* noted, there are too many instances in the wording of Article 32(4) that are too open to interpretation. Due to space constraints, the following will be used as the sole explanatory example. Concepts such as 'a serious disturbance in the economy' and the point at which this last is likely to put 'financial stability' in danger lack a clear and precise legal definition, even if efforts to clarify the latter circumstance have been made by the EU Commission. *Olivares-Caminal* and *Russo* argued that even if this ambiguity may hinder legal certainty, on the other hand it allows the relevant authorities to exercise a desirable level of discretionary flexibility on a case-by-case basis. However, as *Hellwig* pointed out, the current set-up runs the risk of delaying a prompt intervention and it is likely to create tensions between Member States and the relevant authorities at the EU level, exacerbating the political climate. Placing the discipline of 'extraordinary public financial support' outside Article 32, which is dedicated to the conditions for resolution, could be a first step to rationalize the matter. Secondly, the very scope of the objectives of an extraordinary public support may be restricted. Alternatively, a bold – and politically difficult – move would be to refine the above-mentioned concepts and then lift the competence for precautionary recapitalizations at the EU level altogether. This would require further harmonization, and more burden-sharing among Member States, but also constitute a solid step towards a truly integrated BU.

A third problem is the protection of retail investors. Since the State aid rules always require some sort of private investor participation, further harmonization – above the level envisaged under the current EU Commission's proposal on creditors' hierarchy – is required among domestic bank insolvency regimes as an essential complement to the BRRD/SRMR framework. More uniformity is needed about the kind of investors that can buy bail-in-able instruments and on the conditions under which they will be converted. This issue, exemplified by the recent Italian cases, should be tackled also from a supervisory perspective. Many mis-selling practices have been put in place on a large scale and amounted to a regulatory and supervisory domestic failure. Enhancing financial literacy and investors' awareness would also constitute a useful, albeit not sufficient, improvement.

Lastly, both *Hellwig* and *Véron* noted that the conditions laid down in Article 32 (4)(d) for a precautionary recapitalization may undermine the very success of the operation and are, to some extent, mutually incompatible or even unrealistic. For instance, it is difficult to imagine how an extraordinary public support, granted to an institution that it is not able to raise funds on its own in the market – as exemplified by Veneto Banca and Banca Popolare di Vicenza -, could not constitute an 'advantage'. However, this shortcoming is one of the less serious if compared with the other restrictions. All together, they deserve an in-depth analysis and careful consideration.

This is only a brief summary of the issues that need to be addressed in the short term. However, even if there is room for improvement, the rationale for the introduction of a 'precautionary recapitalization' tool is still strong and any proposal to discharge it altogether from the BRRD should be cautiously considered. Indeed, as *Véron* noted, this tool has been introduced within the EU resolution framework for both transitional and permanent reasons. The former was to phase in the 'bail-in' rationale within Member States legal frameworks, while the latter was to envisage a measure to deal with extremely adverse banking crises and is still present. This is the same line of reasoning recently expressed by the chair of the SRB Elke König at the 2017 Financial Stability Conference in Berlin, who expressly stressed how it is always better for a regulator to have as much tools as possible in its regulatory toolbox, despite the fact they will be actually used or not. Even if *Philippon* and *Salord* indeed pushed for ratcheting up the conditions for granting extraordinary public financial support with sound arguments – in particular by imposing more creditor burden-sharing – a compromise is needed between what would be ideal and what is politically feasible, especially at present.

5. Conclusion

In the next years, the banking sector will face many difficult changes. While the sheer amount of NPLs still constitutes a serious legacy issue affecting bank's profitability, with negative effects on their lending capacity, other problems such as competition from new technologies and regulatory compliance costs will further impact on their businesses. As the EBA highlighted, it will be important to fine tune the current banking reform proposals in order to ensure a certain degree of proportionality. Considering the specific needs and business models of regulated banks will allow co-legislators to lower compliance, operational and administrative costs, with beneficial effects on the banking sector and, in turn, the real economy. Of course, this should not amount to a reduction in the quality of supervision.

With regard to the bail-in, as *Véron* noted, shifting from a bail-out policy to a bail-in approach that forces private investors to bear the losses and share the burden of ailing banks' costs still represents the more advisable policy option. However, the effectivity of bail-in powers significantly depends on the extent to which the relevant authority can and intends to restrict its discretion. Although the use of regulatory bail-in powers is encouraging in this respect, their proliferation alone is not enough to make a successful resolution of financial institutions credible. For this purpose, private claimants with an interest in enforcing the terms and condition of the regulatory determined contingent convertible contracts should be installed. To this end, regulation should mandate the creation of a class of preferred shareholders with an interest to "kick down" bail-inable debtors.

On the other hand, the reasons which originally pushed policymakers towards the implementation of the precautionary recapitalization are still present at the moment. However, the literature has highlighted various shortcomings in the current BRRD/SRMR framework that should be addressed. Firstly, the inconsistencies among different language versions should be fixed. More in general, the ambiguity of certain key concepts undermine the legal certainty regarding precautionary recapitalization procedures and may trigger or sharpen political disputes between EU regulators and domestic governments. Secondly, investor protection should be strengthened by improving bail-in rules and priority rankings among bondholders. This represents a true challenge especially in precautionary recapitalizations, during which Member States may be led more by political considerations than sound economic policies. With this regard, the harmonisation of domestic bank insolvency regimes would represent a much-needed improvement. Lastly, it would be advisable for Member States - even if it seems not politically viable in the short-term - to develop a common approach towards the integration of a public intervention mechanism at the European level.

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