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Greek and Italian 'Lessons' on Bank Restructuring: Is Precautionary Recapitalisation the Way Forward?

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Abstract

Even though the bail-in tool is potentially helpful in resolving banks in crisis, it may still create the same issues that resolution is meant to prevent and/or avoid, namely contagion, financial instability and also systemic risk. Recent cases of bank restructuring have demonstrated that there are situations in which the use of the bail-in tool could end up being dangerous for the stability of the financial system. Obviously in such cases, the write down and/or conversion into equity of the bank's liabilities must be avoided. At the same time, however, the disapplication of bail-in makes the provision of external resources necessary to rescue effectively the bank in crisis.

The EU legislator was aware of these potential issues and for this reason introduced a number of rules allowing, in certain situations, both the disapplication of the bail-in tool and the provision of external financing. Nevertheless, when the provision of external financing comes from the Member States, it has to comply with the rules of the State aid framework set by the Treaty on the Functioning of the European Union (TFEU) and applied by the European Commission. In this article, it is argued that despite the strict rules on State aid, there is still room to manage even difficult banking crisis situations in which the application of the bail-in tool could be counterproductive and therefore public intervention should take place through the so-called precautionary recapitalisation instead. However, in this regard, it is crucially important that the authorities intervene before the bank in trouble 'crosses the line' of insolvency, as some recent cases of Greek and Italian banks have demonstrated.

Key words: BRRD, resolution, bail-out, bail-in, precautionary recapitalisation, State aid framework

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I. INTRODUCTION

The global financial crisis of 2007–09 clearly showed that effective legal tools for dealing with bank crises were missing. At that time, some jurisdictions did not even have specific administrative procedures to apply to failing banks, which were therefore submitted to traditional bankruptcy proceedings.[1] However, these proceedings are usually not appropriate for banks, since they are slow and typically do not allow the continuation of their critical functions, such as payment services, lending activities and maintaining the availability of deposits to depositors.[2] For this reason, the submission of banks to traditional bankruptcy procedures is deemed to generate financial instability and also to create systemic risk, as the Lehman Brothers case clearly showed.[3]

Consequently, during the crisis, many sovereign States had to intervene by using public money to rescue their banks and avoid their failure, (so-called bail-outs).[4] With this in mind, in 2011, the Financial Stability Board published its 'Key Attributes of Effective Resolution Regimes for Financial Institutions', recommending their transposition into the domestic laws in order to 'resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions'.[5]

The Financial Stability Board's main objective was, therefore, to allow the orderly resolution of banks without impacting the public finances as was the case in the past with bail-outs. But in so doing, the resolution authorities should also aim to avoid the creation of 'severe systemic disruption'.[6] The most powerful legal instrument recommended for introduction by the Financial Stability Board to reach both of these aims is certainly the bail-in tool.

Bail-in is conceptually opposite to bail-out, as the losses of a bank in crisis are put on its shareholders and creditors instead of on taxpayers, as would happen with

[1] Such as the UK, see B Penn, 'Banking Regulation' in S Paterson and R Zakrzewski (eds), *The Law of International Finance*, 2nd ed (Oxford University Press, 2017), pp 52–53.

[2] See W-G Ringe, 'Bail-in Between Liquidity and Solvency' (2016) 33 *University of Oxford Legal Research Paper*, p 5, who argues that there is consensus about the fact that traditional bankruptcy procedures are not appropriate to deal with failing global banks as they are usually long and complicated and therefore can undermine market confidence and destabilise the financial system.

[3] See K P Wojcik, 'Bail-in in the Banking Union' (2016) 53 *Common Market Law Review* 92, arguing that the fact that Lehman was not bailed out has 'made visible the risks such failures entail for the financial system'; see P Calello and W Erwin, 'From bail-out to bail-in', (*The Economist*, 28 January 2010), arguing that a 15% haircut of Lehman senior debt would have avoided its collapse by recapitalising the bank.

[4] See F Lupo-Pasini and R P Buckley, 'International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects' (2015) 16 *European Business Organisation Law Review* 208, arguing that a bail-out occurs when 'it is the government – usually the Treasury – that rescues the failing bank through the use of taxpayers' money'; see also C Hadjiemmanuil, 'Limits on State-Funded Bailouts in the EU Bank Resolution Regime' (2016) 2 *European Economy* 91.

[5] See Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', October 2011, p 1; this document was updated in 2014, http://www.financialstability-board.org/2014/10/r_141015/.

[6] Ibid, p 3.

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bail-out. From an operational perspective, it is the use of internal resources, already provided by shareholders and creditors of the bank, in order to absorb its losses and recapitalise it. Legally speaking, it is a statutory power allowing the resolution authorities to write down the bank's capital and liabilities or convert them into equity.[7] By doing so, the losses are absorbed and the bank can be recapitalised.

It can also be seen as a method to allow an insolvent bank to return to a stable condition without using taxpayers' money.[8] It is different from liquidation since its main objective is to keep the fundamental operations of a failing bank working.[9] In order to reach this purpose, the debts of the institution are restructured on the basis of what the resolution authorities decide according to the valuation provided by an independent expert. By reducing the liabilities of the bank, the negative difference between assets and liabilities caused by the losses can be equalised. This reduction has to be made in such an amount as to restore the Common Equity Tier 1 (CET1) ratio, which has to be at least 4.5% against risk-weighted assets. In this way the bank can achieve the necessary regulatory capital to meet the conditions for authorisation and sustain sufficient market confidence.[10]

Its effectiveness derives from the fact that it is able to provide new value to the institution in crisis by eliminating shareholders' and creditors' rights. From this point of view, the write down of capital instruments and liabilities and/or their conversion into equity can be considered as a provision of new value in the form of less debts to repay in the future.

However, even though the bail-in tool can be helpful for restructuring banks in trouble, it may also create the issues that resolution is supposed to prevent and/or avoid, ie contagion, financial instability and systemic risk.[11] In order to make the legal framework properly work, it is necessary that resolution authorities are given the power to exempt the application of such a tool when it is likely to create financial

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[7] See Lupo-Pasini and Buckley, note 4 above.

[8] See C Bates and S Gleeson, 'Legal Aspects of Bank Bail-ins' (2011) 5 *Law and Financial Markets Review* 264.

[9] See J Armour, 'Making Bank Resolution Credible' in N Moloney et al (eds) *Oxford Handbook of Financial Regulation* (Oxford University Press, 2015), p 471.

[10] See M Schillig, 'Bank Resolution Regimes in Europe – Part II: Resolution Tools and Powers' (2014) 25 *European Business Law Review* 77.

[11] On contagion, see M Bodellini, 'From systemic risk to financial scandals: the shortcomings of U.S. hedge fund regulation' (2017) 11 *Brooklyn Journal of Corporate, Financial & Commercial Law* 432. On finanacial instability, see M Andenas and I Chiu, 'Financial Stability and Legal Integration in Financial Regulation' (2013) 38 *European Law Review* 342. On systemic risk, see A Rivière, 'The future of hedge fund regulation, a comparative approach United States, United Kingdom, France, Italy and Germany' (2011) 10 *Richmond Journal of Global law & Business* 263; and C Lee, 'Reframing complexity: hedge fund policy paradigm for the way forward' (2015) 9 *Brooklyn Journal of Corporate Financial & Commercial Law* 499, arguing that systemic risk is 'the risk that poses a threat to the entire financial system, either (i) directly through failure of, or significant losses in assets or liquidity to, one or more institutions, or (ii) indirectly through the effects of such events via the operation of financial markets. This concept is consistent with the G20's approach to post-crisis reforms pertaining to systemically important financial institutions and markets whose failure or severe distress may contribute to, or transmit, systemic risk'.

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instability, but, at the same time, in these cases the provision of external resources has to be allowed in order to make the restructuring effective.

Looking at the new EU regime, this article argues that, despite the presence of strict rules on State aid measures, there seems to be space to manage even difficult bank crisis situations in which the application of the bail-in tool could be detrimental and therefore should be avoided or reduced. In such cases, it seems that the rules give a minimum amount of flexibility to allow for the provision of public assistance mainly in the form of the so-called precautionary recapitalisation. However, unless the rules are amended, to be effective such a strategy has to be put in place in a prompt and timely fashion, as some recent Greek and Italian cases have demonstrated.

The article is divided into six parts. After the introduction, Part II discusses the new EU bank restructuring legal framework; Part III analyses pros and cons of the bail-in tool; Part IV deals with the provision of external resources discussing both the resolution funds and the government financial stabilisation tools; Part V looks at the precautionary recapitalisation focusing on some recent cases; and Part VI provides the conclusions.

II. THE NEW EU LEGAL FRAMEWORK

The European Parliament and the Council of the European Union implemented the Financial Stability Board's principles in 2014 by adopting Directive 2014/59/EU (the so-called Bank Recovery and Resolution Directive, hereinafter BRRD).[12] The BRRD represents, at EU level, the new legal framework for effectively dealing with banks crises, avoiding – or at least minimising – the use of taxpayers' money.[13] It mainly provides that the administrative procedure which banks in crisis are submitted to is the so-called 'resolution', through which the resolution authorities are empowered to apply the resolution tools (ie the sale of business tool under articles 38 and 39, the bridge institution tool under articles 40 and 41, the asset separation tool under article 42 and the bail-in tool under articles 43 and following) in order to achieve one or more of the resolution objectives.[14] These objectives are: '… (a) to ensure

[12] See Financial Stability Board, note 5 above. Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

[13] Rec 67 BRRD states that 'An effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers', whilst Rec 1 underlines that during the crisis Member States were forced to save banks by using taxpayers' money. In this regard, see European Central Bank, 'The Fiscal Impact of Financial Sector Support During the Crisis' (2015) 6 *ECB Economic Bulletin*, p 80, which states that 'General government debt in the euro area increased by 4.8% of GDP over the period from 2008 to 2014 owing to financial sector assistance … The debt impact of financial sector support varied considerably across countries. Financial sector support led to a substantial increase in government debt of around 20% of GDP in Ireland, Greece, Cyprus and Slovenia. It also had a high impact in Germany, especially owing to measures taken at the onset of the crisis, and in Austria and Portugal, mainly as a result of more recent interventions. By contrast, government debt in Italy and France was hardly affected by financial sector support'.

[14] See Armour, note 9 above, who describes resolution as an 'administrative process in which the goal is to protect the liquidity needs of short-term creditors, especially depositors, and to manage financial

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the continuity of critical functions; (b) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (e) to protect client funds and client assets …'[15]

A bank is submitted to resolution when: (1) it is deemed by the competent authority to be failing or likely to fail;[16] (2) there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe; and (3) a resolution action is necessary in the public interest.[17]

It follows that, for a failing bank (or one that is likely to fail), there are essentially two alternative potential options to choose from: (1) submission to insolvency proceedings;[18] or (2) submission to resolution. The main factor driving the authorities in making such a choice is the 'public interest'.[19] The concept of 'public interest' appears to be closely connected with the resolution objectives, mainly maintaining financial stability and taxpayers' interest protection. If, in case of a bank crisis, these objectives cannot be reached with the bank's submission to insolvency proceedings, then the public interest can be safeguarded only through the resolution procedure.[20]

This means that the authorities have to assess whether the failure of a bank and its following submission to insolvency proceedings can generate financial instability by impacting the system and, if they think there is such a risk, then the solution is the application of the resolution tools, provided that this institution is effectively resolvable.[21] On the other hand, if the crisis of a bank is not able to generate financial

(F'note continued)

assets in a way that preserves their value and the franchise value of the failing institutions'; see also W-G Ringe, note 2 above, who defines resolution as 'an umbrella term that describes the process of handling a distress bank, based on the objective of minimizing the societal costs of a bank failure'. See Art 2(1)(1) BRRD.

[15] See Art 31 BRRD.

[16] According to Art 32(4) BRRD.

[17] See Art 32 BRRD.

[18] Normal insolvency proceedings are defined, according to Art 2(1)(47) of the BRRD, as 'collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person'.

[19] In addition to the circumstance in which there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe.

[20] See Art 32(5) BRRD.

[21] See Rec 49 BRRD, under which 'The resolution tools should therefore be applied only to those institutions that are failing or likely to fail, and only when it is necessary to pursue the objective of financial stability in the general interest. In particular, resolution tools should be applied where the institution cannot be wound up under normal insolvency proceedings without destabilising the financial system and the measures are necessary in order to ensure the rapid transfer and continuation of systemically important functions and where there is no reasonable prospect for any alternative private solution, including any increase of capital by the existing shareholders or by any third party sufficient to restore the full viability of the institution…'. See Art 15(1) BRRD.

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instability – for instance because it is very small and not closely interconnected with many other financial institutions – then such a bank can be submitted to winding down or normal insolvency proceedings, according to the law of its jurisdiction, as there is no public interest to protect.

However, it is worth noting that in practice it can be rather difficult to understand in advance if the failure of a bank will create financial instability and, as a consequence, trigger the submission to resolution in light of the public interest. In this regard, some criteria have been elaborated; for example, the Bank of England has established some thresholds which act as a guide for choosing between the submission of the institution to modified insolvency proceedings or to resolution. These thresholds are: (1) amount of assets exceeding GBP 15 billion; and (2) a number of transactional accounts exceeding 40,000.[22] In contrast, in 2015 the Bank of Italy submitted to resolution a bank (Carichieti) with just EUR 4.7 billion of assets, implying that even the failure of a bank with such a limited amount of assets could impact the system and hurt the public interest.[23] Conversely, on 23 of June 2017, the Single Resolution Board decided that due to the particular characteristics of Banca Popolare di Vicenza and Veneto Banca, and their specific financial and economic situation, their submission to resolution was not necessary in the public interest.[24]

III. THE BAIL-IN TOOL: PROS AND CONS

Even at EU level, the most significant resolution tool is now bail-in, due to its capability to restore the unbalanced ratio between own funds and liabilities of the

[22] See Bank of England, *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL): Responses to consultation and statement of policy*, November 2016, http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelpolicy2016.pdf.

[23] See Banca d'Italia, *Information on the resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara crisis*, 22 November 2015, https://www.bancaditalia.it/media/approfondimenti/2015/info-soluzione-crisi/info-banche-en.pdf?language_id=1.

[24] See European Commission, *State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo*, Press Release IP/17/1791, 25 June 2017, http://www.ec.europa.eu, which states that the two banks are small Italian commercial banks mainly operating in regional areas. As of 31 December 2016, Banca Popolare di Vicenza had around 500 branches and a market share in Italy of around 1% in terms of deposits and around 1.5% in terms of loans, with total assets of slightly below EUR 35 billion. At the same time, Veneto Banca had around 400 branches and a market share in Italy of around 1% in terms of both deposits and in loans, with EUR 28 billion of total assets. See Single Resolution Board, *The SRB will not take resolution action in relation to Banca Popolare di Vicenza and Veneto Banca*, 23 June 2017, http://srb.europa.eu, regarding both banks 'This conclusion is based on the following grounds: the functions performed by the Bank, e.g. deposit-taking, lending activities and payment services, are not critical since they are provided to a limited number of third parties and can be replaced in an acceptable manner and within a reasonable timeframe; the failure of the Bank is not likely to result in significant adverse effects on financial stability taking into account, in particular, the low financial and operational interconnections with other financial institutions; and, normal Italian insolvency proceedings would achieve the resolution objectives to the same extent as resolution, since such proceedings would also ensure a comparable degree of protection for depositors, investors, other customers, clients' funds and assets'.

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institution in trouble. Article 2(1)(57) of the BRRD, defines the bail-in tool as '… the mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution under resolution …'

Despite its potential ability to make a failing bank viable again, some issues remain. The most critical aspect is that the application of the bail-in tool can generate the same consequences that resolution should prevent and/or avoid, mainly financial instability. This can happen when by writing down the bank's liabilities, its insolvency problems are transmitted to its creditors. In other words, bail-in could act as an accelerator of contagion generating the so-called domino effect.[25]

For this reason, the EU rules allow the resolution authorities to exempt some liabilities from being bailed-in.[26] In particular, according to Article 44 (3)(c) of the BRRD, the resolution authorities have the power to exempt some liabilities from being bailed-in, if the application of such a tool could generate financial instability. This can occur if a significant portion of the liabilities is held by other banks and financial institutions since by writing them down, the insolvency problems of the failing bank are likely to be transmitted to the creditor banks and financial firms.

Accordingly, the Commission Delegated Regulation (EU) 2016/860 Article 8 states that, in deciding whether or not to exempt some of the bank's liabilities from being bailed-in, the resolution authorities should, if the application of such a tool could create direct contagion, 'assess, to the maximum extent possible, the interconnectedness of the institution under resolution with its counterparties'.[27] If such an application might create indirect contagion, these authorities should 'assess, to the maximum extent possible, the need and proportionality of the exclusion based on multiple objective relevant indicators'.[28]

The legislative choice to provide the resolution authorities with the power to exempt the application of the bail-in tool in such situations is beneficial in light of the public interest to avoid financial instability. In fact, facing a bank's crisis, the resolution authorities are the only institutions in a position to properly understand whether the use of the bail-in tool is beneficial or detrimental with regard to both the effective resolution of the failing institution and the public interest to avoid the creation of financial instability. However, if they decide not to use the bail-in tool, the problem is that to make the resolution work, some additional external resources

[25] See M Bodellini, note 11 above.

[26] Art 44(3) BRRD.

[27] Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 [2016] OJ L144/11: Art 3 defines direct contagion as 'a situation where the direct losses of counterparties of the institution under resolution, resulting from the write-down of the liabilities of the institution, lead to the default or likely default for those counterparties in the imminent'. Art 8 states that such an assessment 'shall include all of the following: (a) consideration of exposures to relevant counterparties with regard to the risk that bail-in of such exposures might cause knock-on failures; (b) the systemic importance of counterparties which are at risk of failing, in particular with regard to other financial market participants and financial market infrastructure providers.'

[28] Ibid, Art 3 defines indirect contagion as 'a situation where the write-down or conversion of institution's liabilities causes a negative reaction by market participants that leads to a severe disruption of the financial system with potential to harm the real economy.' Art 8 lists relevant indicators.

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have to be provided. In other words, if such exemptions are applied, then a corresponding amount of alternative resources have to be found in order to adequately recapitalise the bank.[29]

IV. THE PROVISION OF EXTERNAL RESOURCES

External resources to resolve a bank can come from so-called external financing arrangements – also known as resolution funds – within some stringent limitations or, in particularly serious situations, from the Member States in compliance with the State aid framework through the so-called government financial stabilisation tools.

A. The resolution funds

The BRRD has introduced some forms of external financing called 'resolution financing arrangements', commonly known as resolution funds. These resolution funds are 'filled' through mandatory contributions from banks, but they should not be used directly to absorb the losses of the institution under resolution or to recapitalise it. Under Article 44(5) of the BRRD, they can intervene in the resolution proceeding only if: (1) a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of the total liabilities including own funds of the institution has been made through write down, conversion or otherwise; and (2) their contribution does not exceed 5% of the total liabilities including own funds of the institution. This aspect represents a potential problem since in order to use these funds, a significant amount of liabilities has to have been previously bailed-in. This means, from the opposite point of view, that if the resolution authorities consider it appropriate not to apply the bail-in tool to such a significant extent, then the resolution funds cannot be involved in the bank's resolution. This makes these instruments usable only when a relevant number of liabilities can be written down or converted into equity without the risk of financial instability.

In addition, such resolution funds have already proven not to be well equipped to help resolve significant banks. Indeed, four small, local Italian banks (Banca delle Marche, Cassa di Risparmio di Ferrara, Banca Popolare dell'Etruria e del Lazio and Cassa di Risparmio della Provincia di Chieti) were resolved at the end of 2015 before bail-in rules entered into force.[30] To do this, the Italian Resolution Authority combined some resolution tools, such as separation of the assets, bridge bank and burden sharing, and, at the same time, the Italian Resolution Fund provided fresh financial resources.[31]

[29] See Rec 73 BRRD; also Hadjiemmanuil, see note 4 above, arguing that 'new financing may be needed either to provide the liquidity which is indispensable for operational continuity rests and/or to bring the bank back to acceptable levels of capitalisation'.

[30] The bail-in tool rules entered into force just the 1 January 2016.

[31] See Banca d'Italia, note 23 above. See Banca d'Italia, *Annual Report of the National Resolution Fund*, 28 April 2016, https://www.bancaditalia.it/media/notizia/national-resolution-fund-annual-report-2016.

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The total amount of money used by the Italian Resolution Fund to resolve such four small banks has so far been EUR 3.7 billion, which is much more than the losses borne by shareholders and subordinated creditors, ie EUR 870 million.[32] In order to raise this amount of resources, the Italian fund had to borrow a large sum of money from the three largest Italian banks, as the regular contributions of the banking system were not enough.[33]

It is true that if bail-in had been applied (with the write down or conversion into equity of many more liabilities) the amount of money provided by the Fund would have been more limited, but what can be derived from these cases is that resolution funds should be better equipped as currently they could have serious problems in helping resolve significant banks.

B. The Government financial stabilisation tools

The BRRD has also introduced two different government financial stabilisation tools which can be used by Member States during the resolution of an institution.[34] They are: (1) public equity support tool under Article 57; and (2) temporary public ownership tool under Article 58. Both of these can be used only as a last resort measure – after the other resolution tools have been applied – with a view to transferring the holding in the resolved institution to the private sector as soon as commercial and financial conditions allow it. Yet the critical point is that these two tools can be applied only: (1) when the use of the resolution tools is not enough to avoid a significant adverse effect on the financial system; or (2) when the application of the resolution tools do not suffice to protect public interest, where extraordinary liquidity assistance from the central bank has previously been given to the institution; or (3) in relation to the temporary public ownership tool, when the application of the resolution tools do not suffice to protect the public interest, where public equity support through the equity support tool has previously been given to the institution. Further conditions to be met in order to use these tools are that: (1) a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of total liabilities including own funds of the institution under resolution has been made by shareholders and creditors through write down, conversion or otherwise; (2) it shall be conditional on prior and final approval under the Union State aid

[32] They just had EUR 46.6 billion of aggregate total assets, EUR 30.1 billion of aggregate net customer loans and EUR 19.5 billion of aggregate deposits; see European Commission, *State aid: Commission approves resolution plans for four small Italian banks Banca Marche, Banca Etruria, Carife and Carichieti*, Press Release IP/15/6139, 22 November 2015, http://europa.eu/rapid/press-release_IP-15-6139_en.htm; these four banks jointly represented only 1% of the Italian system wide deposits; see Banca d'Italia, note 23 above. See Banca d'Italia, *Annual Report*, ibid. See Banca d'Italia, 'Questions and answers on the solution of the crises at the four banks under resolution' available at https://www.bancaditalia.it/media/approfondimenti/2016/d-e-r-quattro-banche/index.html?com.dotmarketing.htmlpage.language=1.

[33] ie Unicredit, Intesa San Paolo and UBI Banca; see Banca d'Italia, *Annual Report*, note 31 above, 'for 2015, the ordinary contribution amounted to approximately EUR 588 million'.

[34] See C Hadjiemmanuil, 'Bank resolution financing in the Banking Union' in J-H Binder and D Singh (Eds), *Bank Resolution. The European Regime* (Oxford University Press, 2016), p 177.

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framework, which means that they have to be authorised by the Commission according to the provisions of its Communications.[35] These forms of public assistance can be given only in particularly serious situations when the crisis of a bank can undermine the financial stability of the system as a whole, for example in the case of a big bank's crisis or of systemic crisis. This interpretation is confirmed by the provisions of Recital 57 of the BRRD, which states that the Commission in assessing the government stabilisation tools, in light of Article 107 TFEU, should also assess whether 'there is a very extraordinary situation of a systemic crisis justifying resorting to those tools …'

But, as in the case of resolution funds, what makes the government financial stabilisation tools inappropriate and even counterproductive in particularly difficult situations is that before their use, a relevant amount of liabilities has to be bailed-in.[36] As a consequence, when the resolution authorities think that the use of the bail-in tool can endanger the stability of the financial system and therefore it should not be applied, then these tools are not utilisable either.

V. THE PRECAUTIONARY RECAPITALISATION

In light of all these limitations, the way allowing the use of public money without the corresponding duty to bail-in a huge amount of liabilities can be found in the so-called precautionary recapitalisation.[37] Even if the BRRD never uses the expression

[35] Between 2008 and 2011, the Commission adopted six communications to provide details about the criteria to use in assessing the compatibility of State aid with the provisions of the TFEU, the so-called 'Crisis Communications': *The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis* [2008] OJ C270/8 ('2008 Banking Communication'); *The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition* [2009] OJ C10/2 ('Recapitalization Communication'); *Communication from the Commission on the treatment of impaired assets in the Community financial sector* [2009] OJ C72/1 ('Impaired Assets Communication'); *Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules* [2009] OJ C195/9 ('Restructuring Communication'); *Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis* [2010] OJ C329/7 ('2010 Prolongation Communication'); *Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis* [2011] OJ C356/7 ('2011 Prolongation Communication'). Then, in 2013, in light of the adoption of the new regulatory architecture, the Commission published the so-called 2013 Banking Communication, *Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication')* [2013] OJ C216/1. This latter Communication also allows the application of the 'burden sharing' tool to subordinated creditors and for the request of a restructuring plan to be adopted and approved before obtaining the aid. Accordingly, State aid measures can be given only if equity and subordinated debt holders are involved in absorbing the losses through the conversion and/or the write down of their instruments.

[36] For this reason Hadjiemmanuil argues that the Government Financial Stabilistation Tools cannot be seen as 'a substitute for bail-in, but only as a complement to it', see note 4 above.

[37] See S Micossi et al, 'Fine-Tuning the Use of Bail-in to Promote a Stronger EU Financial System', (2016) 136 *CESP Special Report*, p 7, https://www.ceps.eu, in which this legal tool is clearly defined as

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'precautionary recapitalisation', the concept can be derived from the wording of Article 32(4).[38] According to Article 32(4)(d), in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support can take the form of a precautionary recapitalisation, which is 'an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution' where the institution is not failing or likely to fail.[39] These measures 'shall be confined to solvent institutions and shall be conditional on final approval under the Union State aid framework ... shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the institution has incurred or is likely to incur in the near future'.[40] Such recapitalisations 'shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, EBA or national authorities, where applicable, confirmed by the competent authority'.[41]

Paraphrasing the words of Article 32(4) of the BRRD, the European Central Bank has provided a definition of precautionary recapitalisation, according to which 'a precautionary recapitalisation describes the injection of own funds into a solvent bank by the state when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure that is conditional on final approval under the European Union State aid framework. It does not trigger the resolution of the bank'.[42]

Similarly, also Banca d'Italia, dealing with the Monte dei Paschi case, has created a definition of precautionary recapitalisation as 'a measure provided under European legislation (the Bank Recovery and Resolution Directive – BRRD) in exceptional

(F'note continued)

the only way under the new legal framework to provide public assistance to banks without the need to write down liabilities or convert them into equity.

[38] It is worth noting however that the Commission Communication *The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition* C(2008) 8259 final, states that 'the ECOFIN Council of 2 December 2008 recognised the need for further guidance for precautionary recapitalisations to sustain credit, and called for its urgent adoption by the Commission. The present Communication provides guidance for new recapitalisation schemes and opens the possibility for adjustment of existing recapitalisation schemes.'

[39] As regards the meaning of the expression 'in order to remedy a serious disturbance in the economy of a Member State' see R Olivares-Caminal and C Russo, *Precautionary recapitalisations: time for a review? In-depth analysis*, (European Parliament, July 2017) PE 602.092, p 10, http://www.europarl.europa.eu. See B Mesnard et al, *Precautionary recapitalization under the Bank Recovery and Resolution Directive: Conditionality and case practice*, (European Parliament, 5 July 2017) Briefing PE 602.084, paras 1–3 https://www.europarl.europa.eu.

[40] Art 32 (4) BRRD; see also Mesnard et al, ibid, paras 4–8.

[41] Art 32 (4) BRRD.

[42] 'What is a precautionary recapitalization and how does it work?' (*European Central Bank*, 27 December 2016) http://www.bankingsupervision.europa.eu.

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circumstances, to remedy a serious disturbance to the economy of a Member State and preserve financial stability. In these cases, in order to strengthen the capital of a bank, extraordinary State aid of a precautionary and temporary nature is permitted as long as the bank is solvent and the intervention is compliant with the rules on State aid. These rules mean that a State can only intervene after the subordinated bonds have been converted into equity (the burden sharing principle)'.[43]

This means that precautionary recapitalisation can take place when a bank, although in need of recapitalisation, is not deemed to be failing or likely to fail.[44] In this regard, the underlying assumption justifying the public intervention is that the capital shortfall of such banks could quickly deteriorate as a consequence of 'a serious disturbance in the economy' of a Member State and then generate financial instability.

It should be also noted that the English version of the Directive just refers to the case in which this tool is employed 'in order to remedy a serious disturbance in the economy of a Member State', whilst the Italian, the French and the Spanish versions also mention the case in which it is used in order to avoid a serious disturbance in the economy of a Member State.[45] Obviously such a wording difference is significant in practice, since in the first case the capital shortfall is due to a serious disturbance in the economy of a Member State that has made the recapitalisation necessary in order to preserve financial stability, whilst in the second one, the tool is used with the aim of avoiding a situation in which the bank's capital shortfall creates a serious disturbance of the economy of a Member State which in turn could generate financial instability. Also, the availability of the precautionary recapitalisation tool to use to avoid a serious disturbance of the economy should allow for public intervention even outside a general crisis scenario, when it is deemed that the potential distress of a given bank could seriously impact the economy.

However, the very point is that this instrument can be employed only outside the scope of a resolution procedure. This is mainly the case of banks that are not deemed by the competent authorities to be failing or likely to fail but still in need of recapitalisation. The new BRRD provisions allow such banks to be recapitalised with public money but some conditions have to be met. First, such banks have to be assessed as solvent by their competent authorities. Then, their need of capital injection has to be pointed out by the results of stress tests. And obviously, as the recapitalisation is carried out by the States with public money, the rules of the State aid framework apply.[46]

[43] See Banca d'Italia, *The "precautionary recapitalization" of Monte dei Paschi di Siena*, 29 December 2016, https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/index.html?com.dotmarketing.htmlpage.language=1.

[44] With regard to precautionary recapitalisation, the European Central Bank has defined a bank as solvent 'if it fulfils the minimum capital requirements (ie Pillar 1 requirements). In addition, the bank should not have a shortfall under the baseline scenario or the relevant stress test'; see note 42 above.

[45] The Italian version reads 'al fine di evitare o rimediare a una grave perturbazione dell'economia di uno Stato membro'; the French version reads 'a fin d'empêcher ou de remeédier à une perturbation grave de l'économie d'un État membre'; the Spanish version reads 'a fin de evitar o solventar perturbaciones graves de la economia de un Estado miembro'.

[46] See Hadjiemmanuil, note 4 above, who argues that due to the application of all these limitations it will be very difficult in practice to make use of such a tool.

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A. The interplay between Article 32(4) of the BRRD and the State aid framework

Generally speaking, EU rules limit the possibility for a Member State to intervene in a bank's rescue by using public money.[47] Article 107 TFEU states that any State aid is incompatible with the internal market, unless it qualifies as one of the narrow exceptions set out in Article 107(2) TFEU or unless it has been approved by the Commission for one of the reasons set out in Article 107(3) TFEU.[48] In relation to banking bail-outs, the most conceivable justification to allow public intervention, according to Article 107(3)(b) TFEU, is 'to remedy a serious disturbance in the economy of a Member State'.

Between 2008 and 2011, the Commission adopted six communications to provide details for the criteria to use in assessing the compatibility of State aid with the provisions of the TFEU.[49] Then, in 2013, in light of the adoption of the new regulatory architecture, namely the Banking Union and the new bank resolution regime, the Commission published the so-called 2013 Banking Communication, providing for the application of the 'burden sharing' tool to subordinated creditors and requesting the adoption of a restructuring plan to be approved before obtaining the aid.[50] Accordingly, now State aid can be given only if equity and subordinated debt holders are involved in absorbing the losses through the conversion and/or the write down of their instruments. However, it is worth noting that the Commission has also always stressed that its main goal in the State aid authorisation process in the banking sector is to ensure financial stability.[51] And, for this reason, according to the 2013 Banking Communication, it has the power to exclude the application of the

[47] See M Dewatripont, 'European Banking: Bailout, Bail-in and State Aid Control' (2014) 34 *International Journal of Industrial Organization* 40, who points out that the EU is 'the only jurisdiction in the world with State Aid Control policies'.

[48] See G Lo Schiavo, 'State Aids and Credit Institutions in Europe: What Way Forward?' (2014) 25 *European Business Law Review* 45.

[49] See note 35 above.

[50] As regards the so-called Banking Union, see F Capriglione, 'European Banking Union. A Challenge for a More United Europe' (2013) 1 *Law & Economics Yearly Review* 5; N Moloney, 'European Banking Union: Assessing its Risks and Resilience' (2014) 51 *Common Market Law Review* 1609; J-H Binder, 'The Banking Union and the Governance of Credit Institutions: A Legal Perspective' (2015) 16 *European Business Organisation Law Review* 467. On the new bank resolution regime, see J-H Binder, 'Resolution: Concepts, Requirements, and Tools', in J-H Binder and D Singh (eds), *Bank Resolution: The European Regime* (Oxford University Press, 2016), p 25; C Enoch 'The Bank Recovery and Resolution Directive: An International Standards Perspective', in J-H Binder and D Singh (eds), p 61; I Kokkoris and R Olivares-Caminal, 'The Operation of the Single Resolution Mechanism in the Context of the EU State Aid Regime', in J-H Binder and D Singh (eds), p 299. On the Banking Communication, see note 35 above. On 'burden sharing', see G Lo Schiavo, note 48 above, who argues that 'burden sharing entails that the aid shall be limited to the minimum necessary and that the beneficiary undertakes the required level of "own contribution" in order to receive the State aid'; see also Mesnard et al, note 39 above, p 3, stressing that burden sharing 'means that the costs of a bank rescue should be minimized by the contributions from shareholders, creditors (through voluntary liability management exercises and a coupon and dividend ban), managers as well as the bank itself (for instance through the sale of assets and various cost reductions).' On the final point see Dewatripont, note 47 above.

[51] See Micossi et al, note 37 above.

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burden sharing mechanism when this 'would endanger financial stability or lead to disproportionate results'.[52]

B. The Greek cases

It is interesting to remark that the precautionary recapitalisation under Article 32(4)(d)(iii) of the BRRD has been already authorised twice.[53] In 2015, both Piraeus Bank and the National Bank of Greece failed the 2015 Comprehensive Assessment in the baseline as well as in the adverse scenario.[54] Therefore, the two banks were requested by the European Central Bank to increase their capital of EUR 4.933 billion and EUR 4.602 billion, respectively.[55]

Due to the significant amount of capital to raise and the difficulties that the Greek economy was experiencing, it soon became clear that the only feasible solution was precautionary recapitalisation for both institutions. The Hellenic Financial Stability Fund (HFSF) played a pivotal role in recapitalising the two intermediaries. At the beginning, it acted as a backstop to facilitate private subscriptions of capital and then as a real underwriter providing the missing resources necessary to fill the gap highlighted by the Comprehensive Assessment.[56]

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[52] See 2013 Banking Communication, note 35 above, point 45, under which, burden sharing can be excluded when implementing the Communication would endanger financial stability or lead to disproportionate results; see Micossi et al, note 37 above, arguing that 'on the basis of these criteria, it is reasonable to expect that the prudential recapitalisation of a solvent bank, following a stress test, would not entail the risk of losses for junior creditors even where, due to general market conditions, there is a need for some temporary public support'; see also Hadjiemmanuil, note 4 above, arguing that the 2013 Banking Communication 'is framed in terms sufficiently flexible for enabling the approval of almost every conceivable solution by way of "exception". What must be doubted, however, is the actual willingness of the Commission to soften its stance. At present, all indications suggest that, even in the face of a simmering crisis with potentially highly detrimental consequences, such as that affecting the Italian banking sector, the Commission remains unperturbed and unwilling to budge. With the final entry into full effect of the BRRD's provisions on burden-sharing on 1 January 2016, the Commission has found additional reasons for doing so'.

[53] See Mesnard et al., note 39 above, p 3.

[54] The 2015 comprehensive assessment comprised two main pillars: (1) an Asset Quality Review (a point-in-time assessment of the accuracy of the carrying value of banks' assets as at 31 December 2014 and provided a starting point for the stress test); and, (2) a stress test. The exercise was led by the European Central Bank, which conducted it in close cooperation with the national competent authorities (NCAs) and was supported by external advisers (including auditors, consultants and appraisers). See 'Note on the 2015 Comprehensive Assessment' (*European Central Bank*) https://www.bankingsupervision.europa.eu/pdf/ca/2015-11-14_note_comprehensive_assessment.en.pdf?e09834c6564ab84419970599701b5c9c. See European Commission, *State aid: Commission approves aid for Piraeus Bank on the basis of an amended restructuring plan* Press Release IP/15/6193, 29 November 2015, http://europa.eu/rapid/press-release_IP-15-6193_en.htm; and European Commission, *State Aid SA.43365 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece* C(2015) 8930 final, 4 December 2015, http://www.ec.europa.eu.

[55] See European Commission, IP/15/6193 and C(2015) 8930 final, ibid.

[56] Ibid.

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In accordance with the 2013 Commission's Banking Communication, the banks first succeeded in increasing their capital through the involvement of private investors. Piraeus Bank managed to raise EUR 1.340 billion of capital from the market and also succeeded in a significant liability management exercise (LME) converting notes in newly issued ordinary shares and creating EUR 602 million of additional equity capital.[57] Similarly, National Bank of Greece raised EUR 757 million of capital from the market and succeeded in a significant liability management exercise converting notes in newly issued ordinary shares and creating EUR 717 million of equity capital.[58] The remaining junior and senior bonds and hybrid securities, that did not accept the liability management exercise, as well as the US preference shares which were not targeted by it (for which the Bank's liabilities amounted to EUR 197 million) were converted into ordinary shares in line with the Hellenic Financial Stability Fund law. This bail-in like exercise generated EUR 302 million of capital.[59]

The remaining amount of capital (EUR 2.720 billion for Piraeus Bank and EUR 2.706 billion for National Bank of Greece) was provided by the Hellenic Financial Stability Fund partly (ie 25%: EUR 680 million and EUR 676 million) through subscription of new ordinary shares, and partly (ie 75%: EUR 2.040 billion and EUR 2.029 billion) through subscription of CoCos.[60] Both transactions were carried out

[57] As of October 2015, the Piraeus Bank had an outstanding amount of EUR 592 million of bonds, ie EUR 365 million of senior notes, EUR 211 million of Tier 2 subordinated notes and EUR 16 million of Tier 1 subordinated notes. As part of the LME launched by the Bank in 2015, the noteholders were offered a conversion of their notes into newly issued ordinary shares from the capital increase (50% par value for Tier 2 subordinated notes, 100% for Tier 1 and senior notes) or a small amount of cash (ie 43% par value for senior notes and 9% for subordinated notes). The majority of holders of notes who participated in the meetings convened on 4 November 2015 voted in favour of the mandatory exchange of all those bonds into non transferable receipts. The noteholders who had not participated voluntarily were therefore obliged to exchange their notes. Consequently, the transaction generated a 100% participation rate through activation of contractual collective action clauses, creating EUR 602 million equity capital for the Bank (including accruals as well as the net of tax capital gain resulting from the 50% conversion of hybrid into shares). Given the 100% participation rate, the Single Supervisory Mechanism approved on 13 November 2015 the LME as a capital raising measure for the full nominal amount, ie EUR 602 million in the capital raising plan. The 2015 LME settled on 27 November 2015. As a consequence, following the 2015 LME conducted by the Bank, the liabilities of the Bank no longer include hybrid and subordinated capital instruments, or senior unsecured debt instruments; see European Commission, IP/15/6193, note 54 above.

[58] EUR 457 million was raised through the international offering and EUR 300 million through the domestic offering; see European Commission, C(2015) 8930 final, note 54 above. The Bank launched the 2015 LME, completed on 11 November 2015, offering the holders of any outstanding subordinated and senior, unsecured bonds and hybrid securities conversion of their instruments into newly issued ordinary shares, based on different proportions of their nominal amounts depending on the instruments' seniority, at the Offer Price. The participation generated EUR 717 million of capital; see European Commission, C(2015) 8930 final, note 54 above.

[59] See European Commission, C(2015) 8930 final, note 54 above

[60] CoCos issued by the banks and held by the HFSF are eligible as CET1. The payment of coupon is annual, fully discretionary, and can be made in cash or in shares. The coupon amounts to 8% of the nominal of the CoCos. No dividend can be paid on the Banks' common stock if the Banks have decided

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entirely according to the burden sharing principle laid down in the 2013 Banking Communication.

The shareholders dating from before the 2013 recapitalisation have been nearly fully diluted since the shares issued in November 2015 represent the vast majority of the total shares of the Banks. Due to the combination of these factors, the burden-sharing by shareholders has been sufficient. In particular, the objective of the requirement of the 2011 Prolongation Communication to ensure that the State subscribes new shares at a price which is sufficiently low, allowing for dilution and burden-sharing by existing shareholders (and sufficient remuneration on the shares subscribed), has been achieved. In the case of Piraeus Bank, regarding burden-sharing by subordinated debt holders, before it was yet known whether the private capital increase would be successful, Greece had committed that before any new State aid was granted to the Bank, the latter had to convert in CET1 the entire amount of the outstanding hybrid capital and subordinated debt instruments in order to ensure compliance with the requirements of 2013 Banking Communication. That commitment aimed at ensuring that all existing hybrid capital and subordinated debt holders would fully contribute to the restructuring costs of the Bank before the HFSF stepped in. The contribution of both the hybrid capital and subordinated debt holders, and that of the senior unsecured debt holders, was already achieved to the maximum extent possible with the 2015 LME. The results of 2015 LME ended with a 100% participation rate for all instruments and the full elimination of all existing hybrid capital, subordinated and senior unsecured debt instruments. The terms of the 2015 LME towards the junior bondholders complied with State aid requirements as they were structured as debt to equity swap, with an option of the cash component at symbolic level (9 cents to the Euro), which was taken up by a very small proportion of the bondholders. The 2015 LME exceeded the minimum level burden-sharing sought for State aid purposes, which does not require contributions of senior unsecured debt holders.[61] In the case of the National Bank of Greece, the contribution of both the hybrid capital and subordinated debt holders, and that of the senior unsecured debt holders, was already partially achieved with the 2015 LME. With regard to the contribution obtained from the senior creditors, the 2015 LME exceeded the minimum level burden-sharing sought for State aid purposes, which does not require contributions of senior unsecured debt holders.[62]

(F'note continued)

not to pay the previous coupon in full. CoCos will automatically convert if a second annual coupon is missed (not necessarily consecutive). Conversion is also automatic if at any time the CET1 ratio of the Banks, calculated on a solo or a consolidated basis falls below 7%. Finally, the holder of the CoCos has the right to ask its conversion on the 7th anniversary of the issuance. In the event of conversion following a trigger event, the holder receives an amount of shares equal to 116% of the initial principal amount divided by the issuance price of ordinary shares in the framework of the 2015 capital increase. The Banks have the right – but no obligation – to repay the CoCos. CoCos can be transferred by the HFSF to another holder with the consent of the Banks and the regulator, as is laid down in the HFSF law; see European Commission, IP/15/6193 and C(2015) 8930 final, note 54 above.

[61] See European Commission, IP/15/6193, note 54 above.

[62] Ibid.

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C. The Italian cases

From a slightly different perspective, some recent Italian cases seem to demonstrate that both the possibility of avoiding – or at least reducing – the application of the bail-in tool and the provision of public financing, which can be obtained together with the use of the precautionary recapitalisation tool, might be very helpful instruments to effectively rescue banks in crisis that are not failing yet.

This is the rescuing strategy that will be used for Monte dei Paschi di Siena.[63] But for some months, this was also supposed to be the strategy for rescuing both Banca Popolare di Vicenza and Veneto Banca.[64] After being submitted to stress tests, the European Central Bank requested that all of them should be consistently recapitalised.[65] In such a difficult situation, it was and still is very hard to find a market solution where other private financial players are willing to be involved in the recapitalisation. But the very point is that both the lack of intervention by the authorities and the simultaneous submission to resolution of these three banks with the bail-in of a significant amount of liabilities could generate financial instability, probably not only at national level.[66]

All of these banks were already issuing bonds with State guarantee under Article 32.4 (d)(ii) of the BRRD on the grounds of being considered solvent by the supervisor.[67]

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[63] See European Commission, *State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena*, Press Release IP/17/1905, 4 July 2017, http://europa.eu/rapid/press-release_IP-17-1905_en.htm, which states that '[t]he two conditions for this agreement are now both fulfilled, namely the European Central Bank, in its supervisory capacity, has confirmed that MPS is solvent and meets capital requirements, and Italy has obtained a formal commitment from private investors to purchase the bank's non-performing loan portfolio'; see also European Commission, *Statement on Agreement in principle between Commissioner Vestager and Italian Authorities on Monte dei Paschi di Siena (MPS)*, STATEMENT/17/1502, 1 June 2017, http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm; see also Mesnard et al, see note 39 above, which states that Monte dei Paschi di Siena (MPS) 'stood out as the worst performer among all 51 banks which were scrutinised during the EBA's 2016 EU-wide stress test, according to the results published on 29 July 2016: under the adverse scenario, MPS' fully loaded CET1 capital ratio was reduced from 12.07% at the end of 2015 to -2.44% at the end of 2018, that is to say a reduction by EUR 10.1 billion (1451 basis points).'

[64] See Mesnard et al, note 39 above, underlining that 'the two banks confirmed in April 2017 that the capital shortfall estimated by the ECB in the adverse scenario of the 2016 stress test amounted to EUR 3.3. billion and EUR 3.1. billion respectively. The two banks are planning to merge and have applied for a precautionary recapitalization, claiming that the January 2017 capital increases adequately address the shortfall in the baseline scenario.'

[65] Banca Popolare di Vicenza was asked to increase its capital of EUR 3.3 billion, Veneto Banca its capital of EUR 3.1 billion and Monte dei Paschi di Siena its capital of EUR 8.8 billion; see 'Veneto banks' bonds rise on hopes state bailout deal is close', (*Reuters*, 4 April 2017) http://uk.reuters.com/article/italy-veneto-banks-bonds-idUKL5N1HC204; see also 'Monte dei Paschi says ECB loan audit ended, may affect its solvency' (Reuters, 21 March 2017) http://uk.reuters.com/article/us-italy-banks-monte-dei-paschi-idUKKBN16S0W9.

[66] They were among the 15 largest Italian banks.

[67] See Banca Popolare di Vicenza *Successful completion of the offering of Euro 1.25 billion bond guaranteed by the Italian Government*, Press Release, 20 February 2017, https://www.popolarevicenza.it; Monte dei Paschi di Siena, *BPMS: Board approves preliminary results as at 31 December 2016*, Press Release, 9 February 2017, http://english.mps.it/media-and-news/.

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However, on 23 June 2017, the European Central Bank determined that both Banca Popolare di Vicenza and Veneto Banca were failing or likely to fail as they repeatedly breached supervisory capital requirements.[68] Consequently, precautionary recapitalisation could no longer take place and subsequently the two institutions have been submitted to winding up under the Italian law on the basis of the lack of public interest for resolution as determined by the Single Resolution Board.[69] Still, in a contradictory way, the Commission has approved State aid measures to facilitate the liquidation of the two institutions, apparently implying that there is a public interest to maintain financial stability (at least in their geographical area) to protect with the use of public money.[70]

On the other hand, precautionary recapitalisation will be used to solve the crisis of Monte dei Paschi since the European Central Bank has confirmed that the bank is solvent and the Commission has authorised the State aid.[71] The use of this mechanism will avoid Monte dei Paschi's resolution and the institution will be recapitalised with public money provided by the Italian State, after the losses have been absorbed by shareholders and subordinated creditors, who, in turn, can seek compensation from the bank for having been mis-sold junior bonds.[72]

In this context, what has to be underlined is that these cases prove that there could be situations where the use of public money, instead of the resolution tools, can be more appropriate and effective in light of the public interest. In other words, cases could occur in which the States' intervention can be less costly and more beneficial for the public than the bail-in tool both in a going-concern and in a gone-concern scenario.[73]

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[68] See European Central Bank, *ECB deemed Veneto Banca and Banca Popolare di Vicenza failing or likely to fail*, Press Release, 23 June 2017, https://www.bankingsupervision.europa.eu.

[69] See Single Resolution Board, *The SRB will not take resolution action in relation to Banca Popolare di Vicenza and Veneto Banca*, Brussels, 23 June 2017, https://srb.europa.eu/en/node/341; see also European Commission, 'State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo', Brussels, 25 June 2017, available at www.ec.europa.eu.

[70] See European Commission, IP/17/1791, see note 24 above.

[71] See European Commission, STATEMENT/17/1502, see note 63 above; European Commission, IP/17/1905, see note 63 above.

[72] See European Commission, IP/17/1905, see note 63 above, where it is remarked that 'in order to approve the state injection, MPS's shareholders and junior creditors have contributed €4.3 billion to limit the use of taxpayer money as required by EU state aid rules.'

[73] See Micossi et al, note 37 above, quoting a letter sent by Mario Draghi to Commissioner Joaquìn Almunia mentioning some examples of banks recapitalised with public money and then sold to private investors with the States making good returns (eg Banco Popolare, Natixis, Société Générale and Goldman Sachs); in the US the so-called Paulson scheme in 2008 allowed recapitalization of banks with public money and then the sale of their shares with the Treasury making a net gain see P Veronesi and L Zingales, *Paulson's Gift* (National Bureau of Economic Research, 2009) Working Paper 15458, *passim*; accordingly see E Avgouleas and C Goodhart, 'Critically Reflections on Bank Bail-ins' (2015) 1 *Journal of Financial Regulation* 8, arguing that in the US the Troubled Asset Relief Program (so-called TARP) and other forms of bank recapitalisation performed by the Treasury in 2008 'did not prove to be loss-making'.

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VI. CONCLUSIONS

Some recent cases have made it clear that the authorities think that there are situations where it is better to avoid the application of the bail-in tool, or at least to limit the use of such a tool. Even if, in principle, this is a powerful and effective instrument, at the same time it may generate or exacerbate the issues that resolution, as an administrative procedure, should prevent and/or avoid, such as contagion, financial instability and systemic risk. The new legal framework introduced with the BRRD addresses these issues by providing the resolution authorities with the discretionary power to decide, on the basis of Article 44, whether and to what extent to apply the bail-in tool, when there is the risk of creating financial instability by so doing.

At the same time, it is obvious that if the bail-in tool is not applied (or just partially applied) then alternative resources have to be provided to effectively restructure the bank in crisis. From this point of view, the BRRD provides the resolution authorities with some potentially useful tools such as the external financing arrangements and the government financial stabilisation tools.

However, the weakness of the resolution funds is that at this point they do not seem to be adequately equipped to provide sufficient resources to resolve significant banks. In addition, they can be used only after the bail-in tool has been previously and significantly applied. It follows that it is not possible to exempt many liabilities from being bailed-in and at the same time have the intervention of such funds.

With regard to the government financial stabilisation tools, the main shortcoming is that they are seen as a last resort measure to use after all the other resolution tools have been applied. This means that their use presupposes the bail-in of a huge amount of liabilities. Additionally, being a form of public intervention, the limitations of the State aid framework apply. These legal constraints can make it very difficult in practice to effectively benefit from the possibility to exempt the application of the bail-in tool when this could generate financial instability.

On the contrary, the precautionary recapitalisation is not a tool to use during the resolution of a failing bank. Indeed, it can be used only if the bank that needs to be recapitalised is not failing or likely to fail. This means that this instrument can be used without the need to previously submit the bank to resolution with the strict application of the bail-in tool.

Accordingly, the way in which this tool is regulated in the BRRD looks consistent and coherent. In fact, it can be used – outside a resolution procedure – when the difficulties of a solvent bank in need of recapitalisation (according to the result of a stress test) might impact the economy of a Member State and generate instability. It is obvious that in such a context the write down of the bank's liabilities could just exacerbate the issues that the recapitalisation aims to solve. This is why, in carrying out a precautionary recapitalisation, the previous bail-in of the bank's liabilities is not a mandatory requirement.[74]

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[74] Even if Art 32(4) BRRD clearly states that previous losses and losses that the bank is likely to suffer in the near future cannot be offset with public money.

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Still, due to the use of public money, the State aid rules have to be applied. As a consequence, generally, before the precautionary recapitalisation can be performed, the burden sharing mechanism takes place, with the write down of capital instruments and subordinated debt instruments. However, the Commission is given the power to avoid the write down of such instruments when this 'would endanger financial stability and lead to disproportionate results'.[75]

It follows that there could be cases in which a bank is recapitalised with public money and its shareholders and creditors are not involved in 'bearing the burden'. Apparently the case where equity instruments are not written down is merely theoretical as such a strategy can excessively increase moral hazard. On the contrary, the disapplication (or the partial disapplication) of the burden sharing rules with regard to subordinated creditors sometimes can be reasonable and beneficial. This could occur when subordinated debt is held by other financial institutions and its write down could trigger contagion and then financial instability. The possibility to use the precautionary recapitalisation, therefore, even if potentially in contrast with the BRRD resolution objective to protect taxpayers, could be useful in particular situations.

In the two Greek cases, a recapitalisation with public money was the only way to avoid the submission of Piraeus Bank and National Bank of Greece to resolution as they failed the stress tests under both the baseline and adverse scenarios. After the publication of the results, they managed to raise private funds to address the capital shortfall under the baseline scenario and in so doing they became eligible for the application of a precautionary recapitalisation which allowed them to cover even the shortfall under the adverse scenario with public money.[76] Accordingly, from the opposite perspective, the simultaneous submission to resolution of two of the four largest Greek banks could have seriously impacted the domestic economy that was already experiencing a very difficult situation. That is what moved the authorities to perform a public precautionary recapitalisation.[77]

Similarly, looking at the Italian banking system, the simultaneous crisis of three significant banks (with the risk that more institutions will get into trouble in the near future) has represented a very serious problem.[78] Their submission to resolution at

[75] See note 52 above.

[76] See European Commission, IP/15/6193 and C(2015) 8930, note 54 above.

[77] See European Commission, ibid; the latter states that 'the measures are granted to remedy a serious disturbance in the Greek economy and to preserve financial stability in the Greek banking sector.'

[78] The health of the Italian banking system is in a serious condition as, according to a survey published by Mediobanca on the basis of the 2015 balance sheets, there are 114 banks with non-performing loans (NPLs) representing 2 to 8 times the value of their regulatory capital; see Mediobanca, *Focus on the Italian Banking System 2015*, https://www.mbres.it/en/publications/leading-italian-companies; see also International Monetary Fund, 'A strategy for resolving Europe's problem loans', Staff Discussion Note, SDN/15/19 September 2015, p 9, pointing out that NPLs are a serious problem for many financial institutions and are particularly common in countries that rely mainly on bank financing, as is the case in the Euro area. Huge numbers of NPLs on the banks' balance sheets reduce their profitability, by increasing funding costs and tying up the capital. This in turn negatively impacts credit supply and ultimately the growth of the entire economic system; in Italy, the NPL problem is particularly serious as

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the same time and a strict application of the bail-in tool as well as no intervention of the authorities at all could have generated financial instability. That is why for some months, precautionary recapitalisation was considered to be the most appropriate solution with regard to all of them, since it would have allowed a more 'lenient' write down involving just some instruments and the provision of public money for the recapitalisation.

However, after a rather long negotiation between Banca Popolare di Vicenza and Veneto Banca, on one side, and the Italian and European authorities on the other, the European Central Bank claimed that the banks were failing or likely to fail and therefore ineligible for precautionary recapitalisation. As a consequence, immediately afterwards they were submitted to winding down under the Italian insolvency law on the grounds that, according to the Single Resolution Board, there would have not been a public interest to protect them with the resolution procedure. At the same time, however, in a contradictory way, State aid measures have been approved by the Commission in order to orderly manage their liquidation, implying that there is a collective interest that needs to be protected with the use of public money. Conversely, with regard to Monte dei Paschi, the State intervention to recapitalise the institution has been approved.

Obviously, it has to be kept in mind that public interventions (ie bail-outs) should be the exception and not the rule in the new legal framework and, accordingly, the final goal must be for the State to find a way to sell its shares in the recapitalised banks as soon as the market conditions allow it to recover the invested amount.[79]

Drawing conclusions from the Greek and Italian cases, it can be argued that in the new legal framework the authorities should always seek to intervene at an early stage when the banks are still solvent. Afterwards, indeed, due to the limitations of the current rules and the high number of different authorities that are involved in the process, it might be very difficult to effectively act using public resources in order to avoid the creation of financial instability. Thus, there is still little room to manage difficult crisis situations by employing public money, but from now onwards the authorities' intervention must be increasingly more prompt and timely than was the case in the past. After all, also in the context of bank restructuring time is money.

(F'note continued)
their total value in 2014 was around EUR 300 billion, ie 17% of all loans; see N Jassaud and K Kang, *A Strategy for Developing a Market for Nonperforming Loans in Italy* (IMF, 2015) Working Paper 15/24.

[79] And from this point of view it has been argued that the use of CoCos is more effective, see Mesnard et al, note 39 above, p 2, which states that 'an injection of capital in the form of contingent convertible bonds typically complies with this requirement, since the bank can, if its capital position improves later on, repay the State in full. An injection of equity in the form of ordinary shares does not offer the same flexibility in practice.'

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