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Thinking ahead for Europe

Fine-tuning the use of bail-in to promote a stronger EU financial system

Stefano Micossi, Ginevra Bruzzone and Miriam Cassella

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Abstract

This paper discusses the application of the new European rules for burden-sharing and bail-in in the banking sector, in view of their ability to accommodate broader policy goals of aggregate financial stability. It finds that the Treaty principles and the new discipline of state aid and the restructuring of banks provide a solid framework for combating moral hazard and removing incentives that encourage excessive risk-taking by bankers. However, the application of the new rules may have become excessively attentive to the case-by-case evaluation of individual institutions, while perhaps losing sight of the aggregate policy needs of the banking system. Indeed, in this first phase of the banking union, while large segments of the EU banking sector still require a substantial restructuring and recapitalisation, the market may not be able to provide all the needed resources in the current environment of depressed profitability and low growth. Thus, a systemic market failure may be making the problem impossible to fix without resorting to temporary public support. But the risk of large write-offs of capital instruments due to burden-sharing and bail-in may represent an insurmountable obstacle to such public support as it may set in motion an investors' flight. The paper concludes by showing that existing rules do contain the flexibility required to accommodate aggregate policy requirements in the general interest, and outlines a public support scheme for the precautionary recapitalisation of solvent banks that would be compliant with EU law.

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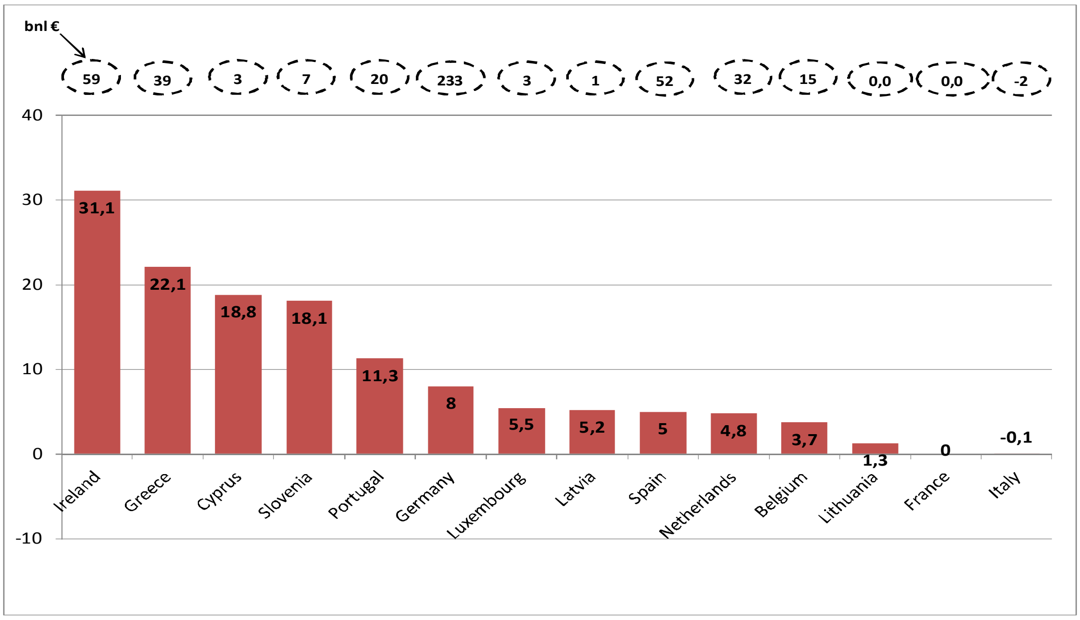
1. The rationale of the EU rules on bail-in

Since 2012, the EU regulatory framework for the banking sector has been deeply revised at record speed. Within the new system, the rules on burden-sharing and bail-in, aimed to ensure that losses of failing banks will primarily be borne by the shareholders and creditors of the banks, have come to play a central role.

The financial crisis of 2008-09 and the ensuing sovereign debt and banking crises within the eurozone led national governments to underpin the balance sheets of several banks through extensive bail-outs at the expense of taxpayers. As shown in Figure 1, in 11 member states the fiscal impact of the bail-out measures undertaken between 2008 and 2014 exceeded 3% of the 2014 GDP; in Ireland, it reached 31.1%; and in Greece, Cyprus and Slovenia, more than 18%.[1]

Figure 1. Banking sector: Net fiscal costs of state aid in 2008-14 (% of GDP)



Data sources: ECB, *Economic Bulletin*, No. 6/2015, and Eurostat for 2014 GDP.

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[1] See also Ignazio Visco, Address to the Giornata Mondiale del Risparmio, Rome, 28 October 2015.

Public outrage for these enormous losses placed on taxpayers convinced policy-makers and legislators across the Atlantic – under the auspices of the G-20 and the Financial Stability Board – that the traditional system of underpinning fractional reserve banking with an implicit public guarantee had to be discontinued, and that bank shareholders and creditors should be called in to take losses and suffer the full consequences of reckless management through bail-in, before any public back-stop could come into play.

When in 2012 the European Council acknowledged the need to break the vicious circle between sovereign and bank debt in the eurozone, the overhaul of the regulatory framework was sped up. By mid-2014, the Single Rulebook for all member states and the Banking Union legislation, establishing the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) for the eurozone, were adopted.

The new regulatory system involves higher capital requirements as well as new rules on bank resolution establishing the credible promise that shareholders and creditors would carry the full burden of bank losses, mainly through the new bail-in instrument, with three main goals. The first one is to eradicate moral hazard within the banking system by eliminating the implicit subsidy of the banking charter that had encouraged bankers to over-borrow and take excessive risks. The second goal is to make it possible for even a large bank to fail without systemic repercussions on aggregate financial stability, minimising reliance on public support. The third goal is to make sure that different national approaches to bank rescues will not undermine the internal market by resulting in different costs of funding for banks with similar creditworthiness.

During the transition to the new system, the European Commission used the control of state aid as an instrument to coordinate the response of the member states wishing to support distressed banks either by providing liquidity aid or helping them restructure and return to viability. In this connection, the legal basis to assess the compatibility of state aid with the Treaty was found in Article 107, paragraph 3, letter b, TFEU, which allows the Commission to declare state aid compatible with the Treaty if it is necessary to remedy a serious disturbance in the economy of a member state.

Since 2008, the Commission has published seven communications in which it has explained the criteria it would follow in applying Article 107(3)(b) to state aid in the banking sector, adapting its approach to the different phases of the crisis. The most recent communication (the 'Banking Communication')[2] was adopted in July 2013 to complement and update the notices on Recapitalisation and Treatment of Impaired Assets and supplement the Restructuring Communication. A distinguishing feature of the 2013 Banking Communication is that the Commission has committed to apply burden-sharing not only to shareholders but also to subordinated creditors.

The new Banking Communication was issued in the belief that the worst of the crisis was over, in order to govern the transition to the full operation of the new EU system for the recovery and resolution of banks. In this context, state aid control was meant to partially anticipate the rules on the write-down and conversion of capital instruments that were going to be included in the new resolution framework. In 2014, the BRRD (Bank Recovery and

[2] 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, 2013/C 216/01.

Resolution Directive) and the SRM Regulation,[3] which are now in force, established the conditions under which the assets of shareholders and creditors of distressed banks are bailed-in, either on a stand-alone basis or as part of the resolution procedure.

Expectations on the use of burden-sharing and of the bail-in tool by competition and resolution authorities directly affect the risk of capital instruments in the banking sector and, if not properly governed, may actually become a source of instability, rather than firming up the system. The critical distinction here – not always easy to establish in practice – is that between a crisis affecting one bank and a confidence or liquidity crisis where many banks get into trouble at the same time. The latter scenario is not a purely theoretical construct in the current phase of the banking union, with a banking system still suffering from diffuse situations of fragility as a legacy from the financial crisis and the continuing weakness of economic activity.[4] In such circumstances, weak balance sheets may push banks' shares to unreasonably low levels, raising the cost of fresh equity to prohibitive heights and, for that very reason, creating expectations of widespread banking crises possibly triggering bail-in. The ultra-low interest rates promoted by the ECB may aggravate the problem by depressing banks' profitability even further.

Thus, there is a non-negligible risk of investors fleeing the banking system in certain countries, potentially with eurozone-wide repercussions, generating a crisis that might eventually entail costs to taxpayers higher than under the previous bail-out regime. The expected stabilising effects of the new burden-sharing and bail-in system would thus be fool's gold, as in Persaud (2014), rather than the real gold we are seeking in stronger banks within a more stable financial system.[5]

It must be stressed that this problem may not be addressed through emergency liquidity assistance (ELA), provided by national central banks within the European System of Central Banks (ESCB) to solvent financial institutions facing temporary liquidity problems, as it involves raising substantial amounts of fresh capital in support of bank restructuring programmes over an extended period of time. This task clearly goes beyond the remit of central bank liquidity support.

The assumption that a private-market solution to higher capital requirements for solvent banks will always be available cannot be taken for granted – even if it would clearly be the preferred solution. Should the need arise for some form of public support in the systemic interest of financial stability, the way in which the new bail-in instrument will be used in different market settings and the ability to take full account of its systemic repercussions are of critical importance. The threat that public authorities will impose the write-down or

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[3] Directive 2014/59/EU of the European Parliament and the Council of 15 May 2014; Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014.

[4] IMF (2016), "Global Financial Stability Report", Washington, D.C., April; see especially Chapter 1.

[5] See Avinash D. Persaud (2014), "Why Bail-In Securities Are Fool's Gold", Policy Brief 14-23, Peterson Institute for International Economics, Washington, D.C. In the same vein, see Paul De Grauwe (2013), "The new bail-in doctrine: A recipe for banking crises and depression in the Eurozone", CEPS Commentary, CEPS, Brussels, 5 April; Charles Goodhart and Emilios Avgouleas (2014), "A critical evaluation of bail-in as a bank recapitalization mechanism", in F. Allen, E. Carletti and J. Gray (eds), *Bearing the losses from bank and sovereign default in the eurozone*, Philadelphia, PA: FIC Press (Wharton Financial Institutions Center); and Stefano Micossi (2016), "Banking crises yet again and how to fix it", CEPS Commentary, CEPS, Brussels, 15 February.

conversion of shareholdings and debt instruments should not go beyond what is strictly necessary in the public interest.

We will first describe the provisions on burden-sharing and bail-in in the Banking Communication of 2013 and the BRRD (section 2).[6] In section 3, we discuss the broad economic policy requirements that must be met, notably within the eurozone, in order to construct sound financial institutions with aggregate financial stability. In this regard, we argue that there are circumstances in which confidence and liquidity shocks affecting large segments of the banking system in one or many a member state must be dealt with without activating the bail-in instrument, in order to avoid greater damages to financial stability. Section 4 assesses whether existing rules on state aid and resolution are sufficiently flexible to meet the aggregate policy requirements just described. Section 5 outlines how best to implement the existing legal framework in a manner that is consistent with protecting financial stability.

2. Burden-sharing and bail-in in the current EU legal framework

2.1 The 2013 Banking Communication

The 2013 Banking Communication addresses the issue of burden-sharing in the section dedicated to recapitalisation and impaired assets measures (points 40 to 46). In the application of Article 107(3)(b), the European Commission has stated that, whenever there is a capital shortfall, it will require that any injection of public funds be preceded by all possible measures to minimise the cost of remedying that shortfall, including capital raising by the bank, burden-sharing by shareholders and subordinated creditors, and measures aimed at avoiding the outflow of funds from the bank.

As for burden-sharing, losses shall be first absorbed by equity, and then by holders of hybrid capital and subordinated debt instruments by means of conversion of their claims into equity or the write-down of the principal of their debt claims.[7]

The Banking Communication acknowledges some limiting principles on the application of burden-sharing. The first one is the requirement that fundamental rights, such as property rights, are respected (point 19). The second limiting principle is an 'exception rule' whereby burden-sharing can be derogated when implementing such measures would endanger financial stability or lead to disproportionate results (point 45). Moreover, the Commission has committed to respecting the *no creditor worse off* principle, under which bailed-in subordinated creditors shall never receive a lesser compensation for their claims than the worth of their instrument if no state aid had been granted (point 46).

2.2 Bail-in in the BRRD

The BRRD, like the 2013 Communication, aims to prevent moral hazard by making the bail-out of banks virtually impossible and announcing that any extraordinary public financial

[6] In this paper we focus on the rules on the write-down and conversion of capital instruments contained in the BRRD, since the SRM Regulation reflects the same approach.

[7] Where the capital ratio of the bank remains above the EU regulatory minimum, burden-sharing may involve the conversion of subordinated debt into equity (point 43). In cases where the bank no longer meets the minimum capital requirements, burden-sharing entails that subordinated debt may either be converted or written down (point 44).

support will normally entail at least some bail-in of shareholders and creditors, in accordance with the order of their priority claims under normal insolvency proceedings. However, the BRRD differs from the Banking Communication as it contemplates the possibility to also involve senior unsecured debt instruments as well as uninsured bank deposits in the conversion or write-down of capital instruments and, in the place of insured deposits, the deposit insurance fund.

The relevant provisions are contained in Articles 32, 34, 37, 56 and 59 of the Directive.

The write-down and conversion of capital instruments may be exercised either independently of a resolution action or in combination with it when the conditions for resolution are met. In particular, Article 59 of the BRRD requires the write-down or conversion of capital instruments when one of the following circumstances is verified:

- when the conditions of resolution are met, before any resolution action is taken;
- when the appropriate authority determines that the write-down or conversion action is necessary to avoid the institution becoming no longer viable; or
- more generally, even when those two conditions do not apply, prior to any measure entailing an 'extraordinary public financial support'.

As to the relation between Article 59 and state aid measures, extraordinary public support is defined as:

> State aid within the meaning of article 107(1) TFEU or any other public financial support at supranational level which, if provided for at national level, would constitute State aid, that is provided in order to preserve or restore the viability, liquidity or solvency of an institution or entity (…) or of a group of which such an institution or entity forms part.[8]

The only exception to the rule whereby extraordinary financial support requires the write-down or conversion of the relevant capital instruments, are precautionary recapitalisations fulfilling the conditions set forth in Article 32(4)(d)(iii),[9] i.e. when the institution concerned is solvent,[10] and the injection of funds or purchase of capital instruments takes place "at prices and on terms that do not confer an advantage upon the institution".

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[8] BRRD, Article 2, No. 28.

[9] Moreover, when the conditions for precautionary recapitalisation set forth in Article 32(4)(d)(iii) are met, the provision of extraordinary financial support does not automatically lead to qualify the institution as 'failing or likely to fail', which is a precondition for resolution. The same holds for the conditions contemplated in Article 32(4)(d)(i) and (ii), i.e. for State guarantees to back liquidity facilities provided by central banks according to central banks' conditions, and State guarantees of newly issued liabilities.

[10] Neither of the circumstances referred to in points a, b or c of Article 32(4) nor the circumstances referred to in Article 59(3) should be present at the time the public support is granted. In particular,

- the institution does not infringe and is not likely to infringe the authorisation requirements;
- the assets of the institution are not and are not likely to be in the near future less than its liabilities;
- the institution is not and is not likely to be in the near future unable to pay its debts or other liabilities; and
- no determination has been made that the conditions for resolution are met or that the institution is no longer viable.

Article 32 specifies that such recapitalisations, which remain conditional on final approval under the Union State aid framework, shall:

- be adopted to remedy a serious disturbance in the economy of a member state and preserve financial stability,
- be of a precautionary and temporary nature,
- be proportionate to remedy the consequences of the serious disturbance of the economy and
- not be used to offset the losses that the institution has incurred or is likely to incur in the near future.

Moreover, Article 32(4) also indicates that those support measures

> shall be limited to injections necessary to address the capital shortfall established in the national, Union or SSM-wide stress tests, asset quality review or equivalent exercises conducted by the ECB, EBA or national authorities, where applicable, confirmed by the competent authority.[11]

Recital 41 of the BRRD explains that the exception contemplated by Article 32(4)(d)(iii) concerns a precautionary measure whereby the member state takes an equity stake in an institution that complies with its capital requirements, for example where the institution is required to raise new capital "due to the outcome of a scenario-based stress test or of the equivalent exercise conducted by macro-prudential authorities" but it is unable to raise capital privately on the market. This provision may be read in light of the considerations by ECB President Mario Draghi in his letter to Commissioner Joaquín Almunia on the treatment of subordinated debt in precautionary recapitalisation:

> It is essential that Member States commit credible public backstops to ensure that resources are available in case private sources of capital are insufficient in the face of capital shortfalls. (…) While we hope cases of public recapitalizations will be exceptional, they may nonetheless be needed. This does not mean that taxpayers will ultimately foot the bill. Indeed there have been several examples in the recent past where viable banks have been recapitalised with public money as a means of enhancing confidence and stability, and where the funds involved were paid back in a timely manner with the State making a non-negligible return (e.g. Banco Popolare, Natixis, Société Générale or Goldman Sachs in the US. (…)

Furthermore,

> (…) forced conversions of debt into equity may not be warranted in certain situations where a bank after an asset quality review has a level of capital that is above the regulatory minimum, but is below the hurdle rate in a stress test, or requires an additional capital buffer for any other justified reason according to the supervisor, and recapitalisation via capital planning is considered momentarily not possible or would take too long. In this situation the bank is not in resolution (i.e. is not assessed as 'failing or likely to fail' if it is not recapitalised), has a viable business model, but the supervisor still requires that it holds a higher capital cushion with the aim of enhancing confidence.[12]

[11] In September 2014, pursuant to a specific provision of the BRRD, the European Banking Authority (EBA) published some guidelines on the types of tests, reviews and exercises that may lead to support measures under Art. 32(4)(d)(iii). See EBA/GL/2014/09.

[12] Letter from Mario Draghi to Joaquín Almunia, 30 July 2013.

Summing up, the consequences of granting extraordinary public financial support pursuant to the BRRD are illustrated in Figure 2, with:

Ei = State guarantee to back liquidity support by central banks, pursuant to Article 32(4)(d)(i)

E_{ii}= State guarantees of newly issued liabilities pursuant to Article 32(4)(d)(ii)

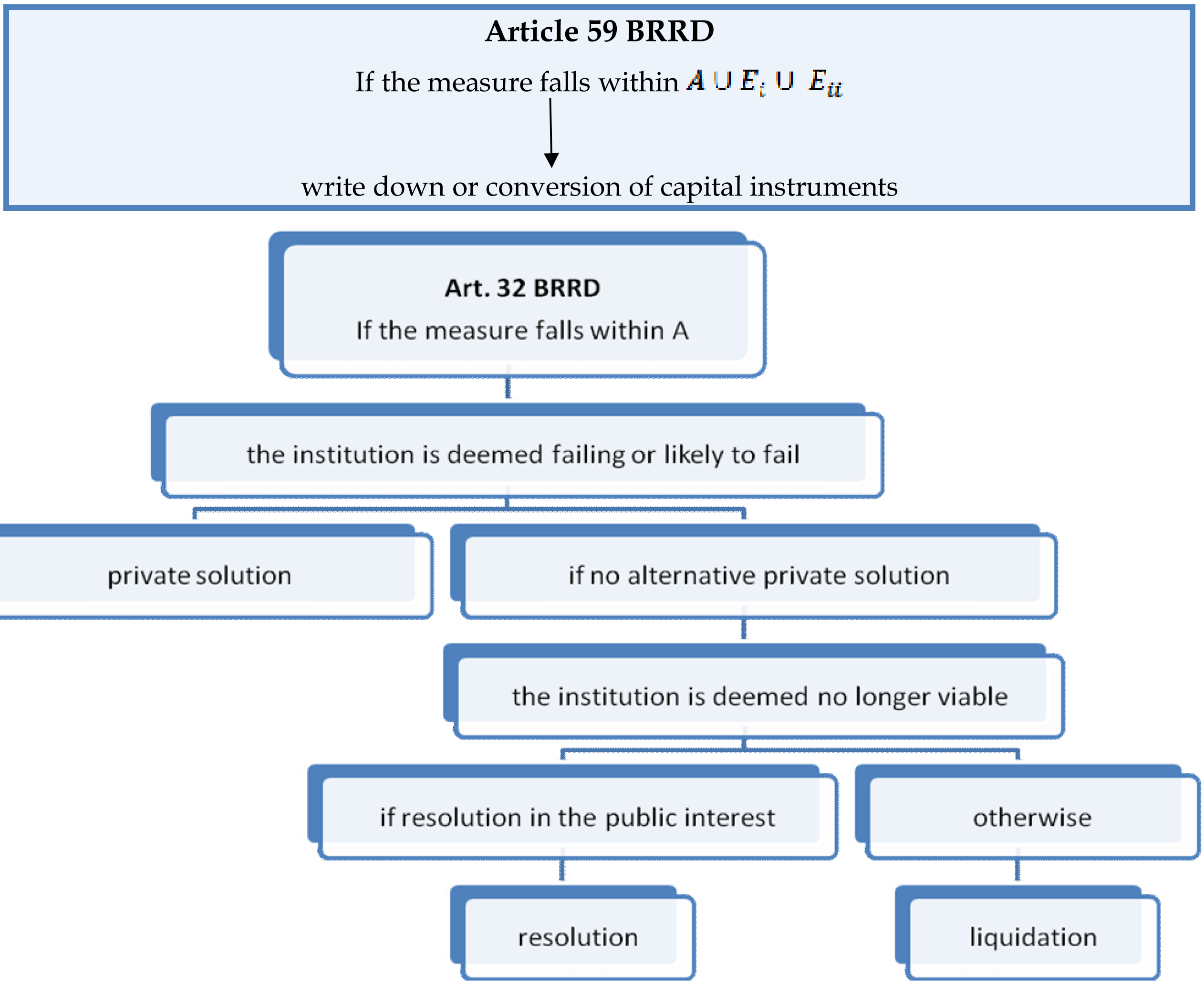
E_{iii}= Precautionary recapitalisations pursuant to Article 32(4)(d)(iii)

A= Residual category of extraordinary public financial support different from E_i, E_{ii} and E_{iii}; and

U as the symbol for *union* in set theory.

Then, A U E_i U E_{ii} U E_{iii} defines all instances of extraordinary public financial support.

Figure 2. Extraordinary public financial support



Source: Authors' own configuration.

It may be seen that the BRRD opens the way to precautionary recapitalisations as the only way of providing extraordinary public support to banks without falling into the conditions for write-down or conversion of capital instruments, let alone the start of resolution. On the other hand, any other form of state aid, including state guarantees on bank liabilities would entail the write-down or conversion of capital instruments issued by the bank.

Besides contemplating the possibility of precautionary recapitalisations not preceded by the write-down or conversion of subordinated debt, the BRRD, like the Banking Communication, also provides some principles and criteria for the application of bail-in and, more generally, the write-down and conversion of capital instruments, as follows.

a. Priority of claims

For loss absorption or recapitalisation in resolution procedures, the shareholders will bear the first losses and the creditors of the institution will bear losses after the shareholders in accordance with the order of priority claims under normal insolvency proceedings (bail-in), whereas covered deposits are fully protected (Article 34(1) (a, b, h)). The authorities shall follow the priority of claims under national insolvency proceedings also for write-down and conversion of capital instruments outside resolution proceedings (Article 60).

b. 'No creditor worse off' principle

The 'no creditor worse off' principle shall apply; the counterfactual are the losses that would have been occurred if the institution had been wound up under the normal insolvency procedures (Article 34(1)(g)).[13]

c. Alternative financing sources in resolution procedures

Pursuant to Article 37, a general principle of resolution procedures is that the resolution authority may seek funding from alternative financing sources through the use of government stabilisation tools provided in Articles 56 to 58 only in "the very extraordinary situation of a systemic crisis" and after a contribution to loss absorption and recapitalisation of bail-inable assets equal to an amount not less than 8% of total liabilities.

Resolution funds, financed by the banks (Articles 99-107) may be used only to the extent necessary to ensure the effective application of the resolution tools, and cannot be used directly to absorb the losses or to recapitalise the institution. Moreover, the adoption of a resolution scheme entailing state aid or resort to resolution funds is made conditional on the approval by the Commission under state aid rules.

d. Ad hoc exclusions of certain liabilities from bail-in

Article 44(3) of the BRRD provides the possibility of totally or partially excluding, in exceptional circumstances, certain liabilities from the application of the write-down or conversion powers when certain conditions are met, including: that the exclusion is strictly necessary and proportionate to the effectiveness of the policy measure aimed to prevent financial instability; that the exclusion is necessary to avoid contagion effects; and that the application of bail-in to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in. Specific provisions regulate the passing on of the losses to other creditors and the possible contribution of resolution financing arrangements, conditional on a prior contribution from shareholders and creditors for an amount not less than 8% of total liabilities; moreover, the contribution of resolution financing arrangements cannot exceed 5% of total liabilities.

[13] Some concerns on the effectiveness of the safeguards for the application of the 'no creditor worse off' principle may be found in Giuseppe Boccuzzi (2016), "The New European Framework for Banking Crisis Management. Will it be enough?", *Open Review of Management, Banking and Finance*, and the literature cited therein (footnote 15) (https://openreviewmbf.org/2016/03/12/the-new-european-framework-for-banking-crisis-management-will-it-be-enough/).

In exceptional circumstances, the resolution authority may seek further financing from other financing sources after the 5% limit has been reached, provided that all unsecured non-preferred liabilities other than eligible deposits have been written off (Article 44(7)).

e. Public back-stops

Ancillary provisions to the bail-in tool include provisions on public back-stops (government financial stabilisation tools, consisting either of a public equity support tool or temporary public ownership), which can be used as a last resort, having assessed and experimented with the other resolution tools to the maximum extent practicable whilst maintaining financial stability (Articles 56-58).

The BRRD has now been transposed into the legislation of most member states. In the meantime, it has become clear that the current challenges for economic policy in the eurozone aimed to ensure the proper operation of the financial sector are more complex than what emerges from a model basically aimed to prevent moral hazard by the management of individual banks.

3. What economic policies of general interest?

The rules on burden-sharing and bail-in that have been described respond to the twin policy goals of maintaining a level playing field in the internal market while ensuring that henceforth the costs of bank failures are borne by banks' shareholders and creditors rather than by taxpayers. By preventing moral hazard, these features are expected to promote a healthy and stable financial system.

These rules aim to correct the incentives of bankers at the microeconomic level and therefore mainly focus on the predicaments of distressed banks on a case-by-case basis. However, these goals do not exhaust the list of worthy policy interventions deserving recognition under the TFEU. Indeed, there are grounds to argue that resort to burden-sharing by banks' shareholders and creditors should be excluded in the presence of a confidence and liquidity shock hitting large segments of the banking system, to make room for the precautionary recapitalisations of solvent banks that are explicitly permitted by the BRRD.

Two main analytical propositions are relevant in this context from an economic standpoint. The first one is almost trivial, but nonetheless highly relevant at all times and everywhere: banks are fragile institutions, dependent on their creditors' confidence that their claims on the banks will always be honoured. The slightest doubt over the safety of these obligations may start a run on individual banks, rapidly spreading to the entire banking system. While deposit insurance has all but eliminated the occurrence of runs on insured deposits, other incarnations of the liquidity crises have materialised in the recent past, e.g. in the form of wholesale funding markets shutting up entirely for certain banks and banking systems, and banks' shares and bonds indexes in financial markets falling to levels that raise the spectre of insolvency for viable institutions.

The evaporation of bank liquidity is the critical element setting a system-wide confidence crisis apart from a situation of insolvency of individual banking institutions. The dividing line, however, is uncertain and possibly shifting with aggregate economic and financial conditions.[14] The insolvency of a large bank or banking group may generate a confidence

[14] In Lombard Street (1875), Walter Bagehot did not say this explicitly, but obviously had in mind liquidity crises affecting many or all banks, regardless of their solvency. For comparison, see J.

crisis spreading to the entire banking system; and the evaporation of liquidity engendered by a confidence crisis may well push into insolvency banks that were initially solvent.

The second proposition concerns specifically the eurozone, which is more exposed to confidence and liquidity shocks than a 'normal' banking system as a consequence of sharing the currency without a common fiscal back-up. At the root, the problem arises because, unlike nation states, the eurozone lacks a risk-sharing system for sovereign debts and, as a consequence, the doom loop between sovereign and banking crisis is always liable to re-emerge.[15] Banking union was supposed to resolve the problem, but it hasn't due to the missing third leg of the system, that is the supranational deposit insurance system. The specific task of this crucial third leg precisely is that of removing the risk of large idiosyncratic liquidity shocks hitting the entire banking system of a member state, with potential repercussions on sovereign debts and, in extreme cases, even sovereign solvency.

National deposit insurance does not suffice as it insures depositors against the risk that their bank goes bust and can't reimburse their deposits (up to the limit of €100,000), but it does not provide insurance against the risk of a confidence crisis hitting much of the banking system of a member state, leading to large outflows of liquidity towards banks in other member states and effectively drying up cross-border inter-bank funding, as we witnessed in 2011-12.

Effects of this type may have been generated by the resolution decisions taken in some member states of the eurozone in 2014 and 2015, which suddenly alerted investors to the reality of the new regulatory regime – which by an ill-fated decision also applies to securities issued before the regime change, whose risk characteristics were thus modified without warning by regulators.

The bouts of acute instability and overly low prices in EU bank securities markets in early 2016 may indeed be due to this surprise, also in view of the continued uncertainty surrounding the future application of bail-in in different jurisdictions. As a case in point, market information indicates that the bail-in of Novo Banco senior unsecured bonds, at the end of 2014, in the context of the resolution of the Portuguese Banco Espirito Santo, has resulted in the shutting down of the market for that type of bonds for all but the strongest banks in EU financial markets. Similarly, especially depressed stock prices for Italian banks have emerged following the resolution of four local banks in November 2015.[16] On the other

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Bradford DeLong (2012), "This Time, It is Not Different – The Persistent Concerns of Financial Macroeconomics", in Alan Blinder et al. (eds), *Rethinking Finance,* New York, NY: Russell Sage Foundation (http://delong.typepad.com/20120411-russell-sage-delong-paper.pdf).

[15] IMF (2016), "Global Financial Stability Report", Washington, D.C., April and also Nicolas Veron (2015), "Europe's Radical Banking Union", Bruegel Essay and Lecture Series, Bruegel, Brussels. As reported by Veron, the Euro Summit declaration of June 2012 included a commitment to allow resort to the ESM, the new European financing facility, to recapitalise banks. According to key witnesses, leaders agreed that this would also extend to 'legacy' banking debts already covered by Ireland and Spain, and possibly at a later stage also to buy Italian and Spanish bonds, effectively turning the ESM into a risk-sharing mechanism. In the ensuing weeks, however, Germany and other eurozone member states backtracked on this commitment, placing the financial risk of direct recapitalisations back onto the member states.

[16] For a detailed assessment of how burden-sharing has been applied by the Commission in 2009-14, see Francois Charles Laprévote and Mélanie Paron, "The Commission's Decisional Practice on State Aid to Banks: An Update", *European State Aid Law Quarterly* 1/2015, pp. 88-116 (in particular Table 2, p. 102, and p. 111). In 2015-16, new cases involving burden-sharing by debt holders include Banif in

hand, burden-sharing has been applied in carefully circumscribed situations, such as the recent resolution of Hypo Alpe Adria, at least so far with no discernible destabilising effects on the rest of Austria's financial system; but the Austrian government paid €1.23 billion to the German Länder of Bavaria to settle all legal claims by BayernLB, which had owned an important stake in Hypo Alpe Adria.

The very design of subordinated financial instruments liable to be converted into equity may help avoid 'cliff effects' of bail-in, in the context of ongoing exercises by the EBA for determining the minimum requirement for own funds and eligible liabilities for bail-in – the so-called MREL.[17]

The risk of such idiosyncratic shocks remains high – as was shown by the acute instability besetting banking markets in early February 2016, which was due to two concomitant elements. The first is the continuing presence in the balance sheets of EU banks of large holdings of impaired assets (some €900 billion, of which about one-third was concentrated in Italy), which in the main are the legacy of falling economic activity. And the second is the low profitability of (large segments of) the EU banking system, owing not least to the impact of the ECB's ultra-expansionary quantitative easing (QE) policies on banks' interest-rate margins. Figure 3, drawn from IMF (2016), illustrates the strong empirical correlations between these two factors and banks' stock valuations.

A cross-border deposit insurance, as has now been proposed by the European Commission with its draft regulation European Deposit Insurance Scheme (EDIS), would play an important role in reducing this risk.[18] But at the very bottom, the spectre of instability will not go away as long as the banking system is not substantially recapitalised. Notable efforts are being undertaken in several member states to restructure and recapitalise the banks, under the auspices of the supervisory authorities. Also due to the scarcity of public resources, private market arrangements are being pursued and represent by far the preferred solution. However, overly depressed valuations of banks' stock in capital markets and the need for many banks to tap capital markets at the same time may make private sources of capital insufficient to meet the system's needs.

An injection of public funds to several institutions may then become the only alternative to continuing economic stagnation at best, or a banking crisis at worst. In this specific

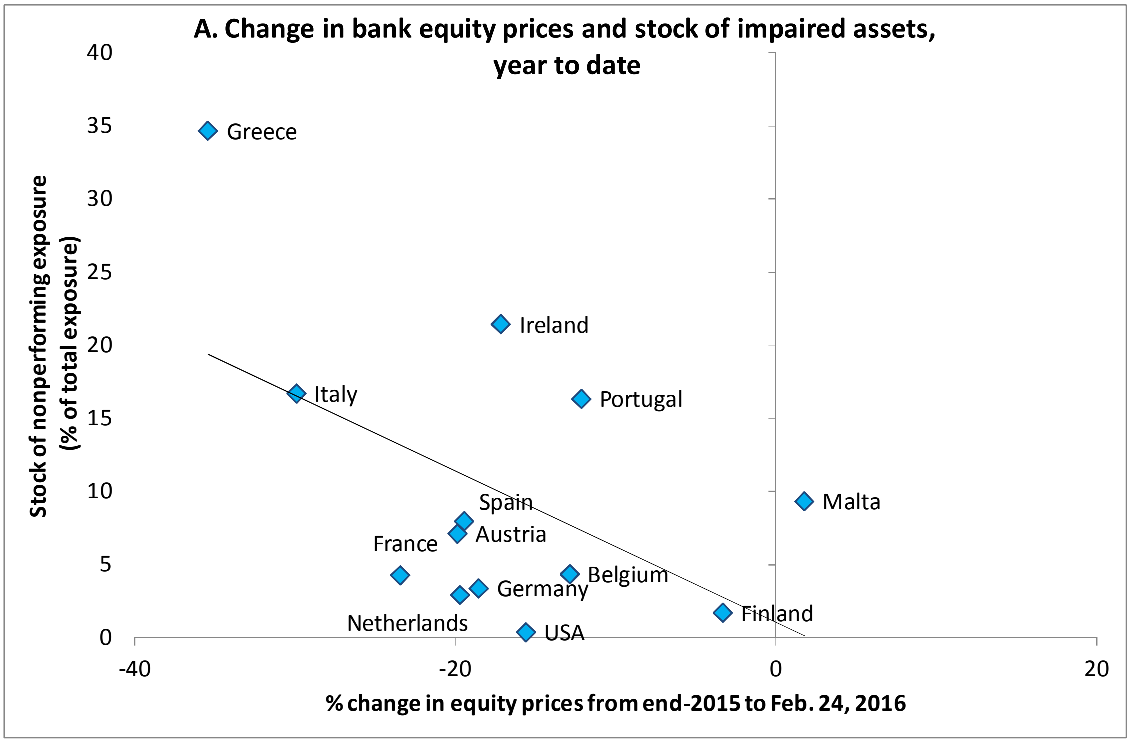
Portugal, Banca Marche, Banca Etruria, Carife and Carichieti in Italy, Pyreus Bank and National Bank of Greece, and Heta (the 'bad bank' created in the resolution of Hypo Alpe Adria) in Austria.

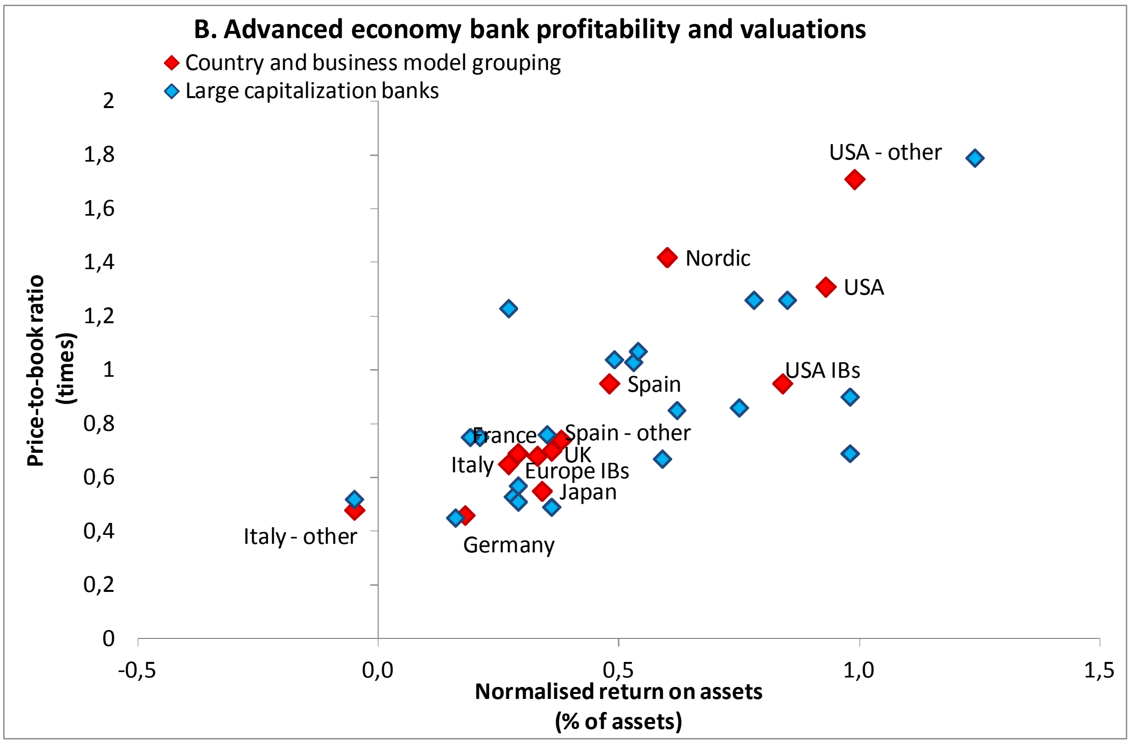
[17] With the MREL, European authorities will ensure that banks have enough liabilities to absorb losses in case of failure, and, therefore, shareholders and creditors should shoulder much of the recapitalisation burden, instead of taxpayers. The MREL, which is assessed individually per institution (no common pillar 1 standard), will take into account the recapitalisation needs based on the preferred resolution strategy and it will have a quantitative floor based on total liabilities. Last but not least, the resolution authorities will have discretionary powers to establish a MREL that considers the individual idiosyncrasies of each institution.

[18] European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 final. The system would, of course, have to be backed by a deposit insurance fund of appropriate size – which could well absorb the funds accumulated at the present time in national deposit insurance systems. And the governments of the member states would have to stand ready to back the supra-national insurance fund with their budgetary resources, in case of a banking crisis of major proportions – which by the way would be made less likely by the very existence of such a fiscal back-stop. The ESM may well be the instrument of choice to provide such a back-stop.

contingency, public support for the precautionary recapitalisation of solvent institutions should be recognised as a policy of general interest, in the meaning of Article 107(3)(b) TFEU, and thus be permitted without triggering the burden-sharing instruments.

Figure 3. Banks' profitability, impaired assets and stock valuations





Source: IMF Global Financial Stability Report, April 2016.

Unless this aspect is clarified, the Union may be caught in a trap. If it doesn't act, or allow its members to act, to foster the recapitalisation and restructuring of its banks, the economy will continue to stagnate and a confidence crisis will erupt sooner or later. If public authorities act decisively to reduce the risk of a banking crisis, by accelerating the clean-up of banks' balance sheets and a stronger capital base, they are likely to provoke that financial crisis immediately by scaring bank creditors and investors with the threat that their claims on the banks will be destined for the waste-paper basket.

4. Are the rules on the control of state aid and the BRRD sufficiently flexible?

In view of the current challenges for economic policy, a crucial issue is whether the rules on state aid and the rules contained in the BRRD, including the rules on burden-sharing and bail-in, are sufficiently flexible to allow member states to adopt the policy measures that may be necessary in the public interest, as has been described in the previous section.

4.1 Article 107(3)(b) TFEU

As to the substantive criteria for state aid control, as noted by Advocate General Nils Wahl in his opinion in *Kotnik and others*,[19] the only binding legal rule is Article 107(3)(b). In the area of state aid, the Commission is not empowered to lay down general and abstract binding rules governing, for instance, the conditions for application of Article 107(3)(b). Therefore, the Banking Communication is an act of soft law, whereby "for reasons of transparency and in order to ensure equal treatment and legal certainty", the Commission announces how it intends to apply Article 107(3)(b) in certain situations. The Commission is bound by these acts of soft law, meaning that it may not depart from them unless giving a valid reason for doing so, provided that they are not contrary to the Treaties or other applicable legislation.

On the other hand, the European Commission has the exclusive competence to assess the compatibility under Article 107 of individual aid measures or general aid schemes. In that assessment, "which involves the appreciation and weighting of different elements of an economic and social nature within a pan-European context",[20] the Commission enjoys a broad discretion; however, all Commission decisions in application of Article 107 are subject to review by the EU Courts, which are the ultimate interpreters of EU law.

Although some case-law indicates that the possibility to consider state aid compatible pursuant to Article 107, paragraphs 2 and 3, is an exception to the prohibition rule and therefore must be interpreted narrowly,[21] Article 107(3)(b) seems flexible enough to ensure that the control of state aid does not result in decisions incompatible with the general interest. After all, the whole process of modernisation of the control of State aid undertaken by the Commission since 2012 pursues the objective of promoting 'good aid', aimed at correcting market failures, while impeding 'bad aid' and minimising the distortions of competition that may result from public intervention.

Thus, under the general principles of EU law, for aid measures or schemes to be considered compatible under Article 107(3)(b) it should be sufficient to demonstrate:

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[19] Opinion of Advocate General Wahl, case C-526/14, *Kotnik and others*, 18 February 2016.

[20] Ibid.

[21] See point 56 of the opinion of AG Wahl and the case-law cited therein.

a. the existence of a disturbance in the economy of a member state,
b. the serious nature of that disturbance,
c. the capability of the disturbance to affect the whole of the economy of the member state concerned and not merely that of one of its regions or parts of its territory[22] and
d. the necessity of the aid measure or scheme and its proportionality to remedy the disturbance, in the general interest, as well as the absence of alternative and less-distortive measures to attain an equivalent result.[23]

Several points of the Banking Communication indicate the intention by the Commission to design a system for the application of Article 107(3)(b) capable of taking into account all the relevant public policy objectives. The Commission acknowledges that the overarching objective in the application of Article 107 in support of the financial sector is to ensure financial stability, while minimising distortions of competition between banks and across member states in the Single Market (points 2 and 7). When applying state aid rules to individual cases, the Commission takes account of the macroeconomic environment that affects both banks' viability and the need for the real economy of a given member state to continue to have access to credit from healthy banks (point 9). Where large parts of a member state's financial sector need to be restructured, the Commission will take a 'coordinated approach' in its assessment of individual banks' restructuring plans so as to provide for a system-wide response (point 10).

At the same time, the Banking Communication places some constraints on the use of the different types of public support. Guarantee schemes will continue to be available in order to provide liquidity to banks without a capital shortfall as defined by the competent supervisory authority and may only be granted for new issues of senior debt.[24] Moreover, the Communication states that before granting any kind of restructuring aid, whether a recapitalisation or impaired asset measure (point 19), the Commission will 'normally' (points 41 and 43) and 'in principle' (points 43 and 44) require burden-sharing, in order to ensure that state aid, and therefore bail-out, does not go beyond what is strictly necessary, in line with the general principles of EU law (point 15).

Finally, the Communication also acknowledges that burden-sharing cannot be required where it may infringe fundamental rights (point 19), endanger financial stability or lead to disproportionate results (point 45).

Thus, on the whole, the approach of the Banking Communication to the application of Article 107(3)(b) seems capable of ensuring, when needed, the correction of market failures in the general interest in case of a serious turbulence in the economy. However, the adequacy of the approach also depends on the willingness of the Commission to apply the proportionality principle formally endorsed in points 19 and 45 of the Communication.

Some concerns, in this respect, arise from the very specific and narrowly construed circumstances which the Communication refers to when explaining how the exception to burden-sharing contemplated by point 45 will be applied, as well as from public declarations whereby representatives of the Commission seem 'unwilling' to consider any public policy

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[22] Ibid. and the case-law cited therein. The opinion of AG Wahl adds that recourse to the legal basis of Article 107(3)(b) TFEU seems even more justified when several member states are affected by a serious disturbance of their economy deriving from a global financial crisis.

[23] See point 53 of the opinion of AG Wahl.

[24] Banking Communication, point 23 and points 56-61.

justification different from the narrowly construed exceptions mentioned in the Communication.[25]

In principle, as stressed by AG Wahl,[26] member states remain free to notify to the Commission aid measures which they consider compatible with Article 107(3)(b) even without meeting the conditions set out in the Banking Communication and the Commission is under duty to "diligently examine the compatibility of such aid measures in the light of the Treaty provisions".[27] Importantly, in his opinion in *Kotnik,* AG Wahl states:

> What is key is that, from a legal point of view, a Member State might be able to show that, despite the lack of burden sharing (or the non-fulfilment of any other criterion laid down in the Banking Communication), aid to an ailing bank still meets the requirements of Article 107(3)(b) TFEU. Situations can indeed be imagined, in addition to those already provided in the Banking Communication itself, in which a government might show that the rescue and restructuring of a bank is, for example, less costly to the State and quicker and easier to manage, if no burden sharing measure vis-à-vis all or some of the investors referred to in the Banking Communication is adopted.[28]

4.2 Interpreting the provisions of the BRRD

While point 45 of the Banking Communication allows the Commission, for any kind of State aid, to avoid burden-sharing when it is not necessary and proportionate, the BRRD allows avoidance of write-down and conversion of capital instruments only for precautionary recapitalisations, as has been shown, subject to the conditions set forth in Article 32(4)(d)(iii).[29] Recapitalisations must be strictly necessary and proportionate and cannot be used to offset losses that the institution has incurred or is likely to incur in the future.

However, the interpretation of these provisions must still respect fundamental rights, notably regarding the impact of the rules on bail-in on property rights. The Directive recalls the 'no creditor worse off' guiding principle. It is clear, however, that the application of the 'no creditor worse off' principle is conjectural and complex and it is therefore not sufficient to exclude *a priori* that the discipline may affect property rights.

The right to property, protected both by the European Convention of Human Rights (ECHR) and by Article 17 of the Charter of Fundamental Rights, is not absolute and must be viewed in relation to its function in society. Consequently, the exercise of the right of property may certainly be restricted by national or EU rules, but only provided that those restrictions correspond to objectives of public interest pursued by the Union and do not constitute, in relation to the aim pursued, an improper or disproportionate interference.

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[25] Point 45 of the Banking Communication mentions the circumstance "where the aid amount to be received is small in comparison to the bank's risk-weighted assets and the capital shortfall has been reduced significantly" in particular through capital raising measures endorsed by the supervisory authorities.

[26] Point 40 of the opinion.

[27] Ibid.

[28] Opinion of AG Wahl, point 44.

[29] Moreover, guarantees shall not trigger the resolution procedure only if they are not part of a larger aid package and should never be used for equity claims (BRRD, recital 41).

In this perspective, for instance, if some provisions of the BRRD requiring bail-in were to endanger financial stability and therefore did not correspond to an objective of public interest, it might be argued that they would also be incompatible with the Charter of Fundamental Rights.

Summing up, in light of the discussion above, for the application of both Article 107(3)(b) and the BRRD, it would be possible to challenge before the Courts decisions by the Commission or resolution authorities if they failed to take sufficiently into account the general interest of promoting aggregate financial stability and other worthy goals of general economic policy.

5. Treaty-compatible bank recapitalisations

Once they recognise that the banking system in a specific country may face substantial requirements of fresh capital, and that private sources of capital may well be insufficient, the competent authorities should then be ready to open the way to well-designed precautionary recapitalisations, supported by appropriate public backstops.

What comes to mind is the positive experience of the Paulson scheme in the US in 2008, when the largest US banks were recapitalised with public resources – in the form of expensive privileged shares to be paid back within a defined time period. This opened the way to deep restructuring of their balance sheets and thus establishing the conditions for their return to sound health. The banks were able to repay fully the public capital injections within the required time schedule, with a net gain for the Treasury as well as substantial creation of net value for society.[30]

Taking into account both Article 107(3)(b) and the BRRD, a Treaty-compatible scheme allowing the member states to address the current predicaments of the EU banking system could encompass the following broad features:

a. Each bank interested in participating in the capital-raising programme would be required to present a restructuring programme able to restore adequate profitability and obtain its approval by the supervisory authority; supervisory authorities may put pressure on banks showing weak capital and balance sheet structures to participate; in line with Article 32(4)(d)(iii) of the BRRD, the capital requirements for each bank should correspond to the shortfall established by the supervisory authorities, and the interventions shall be of a precautionary and temporary nature and shall be proportionate to eliminate the consequences of a serious disturbance.

b. National authorities would elaborate a public support scheme for precautionary recapitalisations strictly necessary to fill a possible funding gap for a broad restructuring programme of its banks, and submit it to the European Commission for approval under EU state aid rules; the Commission will ascertain that the programme is not improperly used to offset legacy losses of the institutions; recognition by the Commission that the programme is Treaty-compatible would exclude burden-sharing under state aid rules; the public aid would be granted on terms that do not confer an advantage and shall be paid back by the banks in due course (consistent with Article 32(4)(d)(iii) of the BRRD).

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[30] Pietro Veronesi and Luigi Zingales (2009), "Paulson's Gift", NBER Working Paper 15458, National Bureau of Economic Research, Cambridge, MA (www.nber.org/papers/w15458).

c. As a further option, the ESM facility for bank recapitalisations may be activated in this context to complement national resources, as already provided for by Article 15 of the Treaty establishing the ESM, again with no prior bail-in of banks' creditors.

This approach would not entail any subsidy or market distortion in the evaluation of impaired assets, which each bank would have to handle on its own, based on current market conditions. These measures may in no instance be assimilated with measures entailing the bail-out of failing banks, which require burden-sharing in order to educate investors and avoid moral hazard. Treating the two situations in the same way, under a 'one size fits all' approach would be deeply misguided.

In order to assuage uncertainty as to the viability of such a programme and thus underpin stronger market confidence, the Commission might consider updating the 2013 Banking Communication in order to take into account the evolution of the economic situation, and provide new and broader examples of the conditions under which – for a transitional phase – the Commission would be ready to consider a state aid measure or regime compatible under Article 107(3)(b) without burden-sharing.

6. Conclusions

In the early phase of banking union, the EU banking system is still plagued by widespread fragilities that are a major source of uncertainty, raising the spectre of a broad-based liquidity crisis in large segments of the banking sector. Under the current interpretation of burden-sharing rules by competent authorities, this situation may be perceived by investors as foreshadowing the risk of write-down or conversion of banks' debt instruments.

The elimination of legal uncertainty as to what precisely is permitted to help the banks raise substantial capital with public resources is of paramount importance. Litigation before the Court of Justice of the European Union, or waiting for the review of the BRRD provisions in 2018, would entail delays and uncertainties that might prevent an effective response to the urgent policy requirements of the eurozone and the EU economy, as described in this paper. Rapid action is needed to reinvigorate the financial system ensuring that, overcoming the legacy of the crisis, banks return fully able to play their role as lenders to the real economy and therefore contribute to re-launching economic growth.

As we have argued, there is ample room to interpret and apply Article 107(3)(b) TFEU and Articles 59 and 32 of the BRRD in a way that is consistent with the public interest, the Charter of Fundamental Rights and the proportionality principle. In particular, once it is acknowledged that the banking industry has to confront head-on its substantial requirements for fresh capital, and that private sources of capital may be insufficient, then the competent authorities should be ready to open the way to well-designed precautionary recapitalisations, supported by public back-stops.

Many member states in the eurozone and the European Union are still enmeshed in stagnating economic conditions, which are due in no small part to the inability to tackle decisively the structural weaknesses of banks and restore their ability to support the real economy with adequate lending. Resolving this issue cannot and should not be delayed by an unduly restrictive interpretation of EU rules, which already contain all the required margins of flexibility.

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