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Assessing the effectiveness and applicability of bail-in on failing banks under the EU Resolution framework: The public interest threshold and the creditors' treatment.

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I hereby declare that the work submitted is mine and that where I have made use of another's work, I have attributed the source(s) according to the Regulations set in the Student's Handbook.

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Abstract

This dissertation was written as part of the LL.M. in Transnational and European Commercial Law, Banking Law, Arbitration/Mediation at the International Hellenic University.

The study provides an overview of the bail-in not only as a resolution tool per se, but more so as a shift of perspective of who must bear the costs and responsibility of reviving an ailing institution, especially in the EU, under the harmonized set of rules of the Bank Recovery and Resolution Directive (BRRD). The Resolution framework has entered into force on 1 January 2015, while the respective bail-in procedures are applicable for all member states since 1 January 2016. Bearing in mind the respective arguments deriving from scholars and leading industry delegates, this work aims at assessing the rationale of the bail-in tool and the goals it seeks to achieve under the relevant regime. In particular an evaluation from a legal and socioeconomic point of view will be undertaken to determine whether the departure from the recent practice of public bail-outs can be an effective strategy to satisfy public policy considerations of utmost importance; namely to preserve and restore the financial institutions' critical economic functions at the expense of the associated fundamental property rights of its stakeholders; Its creditors and shareholders.

In another chapter of the study, bail-in is examined in the context of burden sharing and by reviewing recent live cases it highlights the controversial decisions of the authorities regarding the provision of state aid to distressed banks. To that end, special attention is given to the interconnectedness and friction of the Resolution framework with the State aid framework whereby authorities of the relevant member states manipulated in many instances the respective frameworks merely to accommodate political pursuits. The systemic exception of precautionary recapitalizations is also examined in that context.

Keywords: bail-in; EU Resolution framework; public interest; State aid; precautionary recapitalizations.

Vasileios Lisgaras
8 February 2019

Preface

The financial crisis of 2008 – 2009 led to a vicious cycle of sovereign indebtedness and financial system destabilization. Such grim economic circumstances were mainly caused by governments adopting extensive bail-out schemes of banks at the expense of taxpayers. This practice also unveiled the vulnerability of the banking sector with respect to the loss of confidence from its depositors, creditors and other counterparties. A special arrangement designed for failing banks needed to be in place, -*a comprehensive resolution regime*- that provided the administrative authorities exclusive powers and tools to prevent systemic risks stemming from a bank's failure, while maintaining recourse to the taxpayers' purse to a minimum.

In the EU the resolution regime applicable is the Bank Recovery and Resolution Directive of 2014. One of its tools that drew my attention the most and motivated me to write this thesis is *bail-in.* It is the one that entails the most complexity in terms of its application due to the political, technical and economic challenges it presents especially under the detail-oriented BRRD framework.

During my research on the current subject matter I was partly inspired by the well-regarded and much cited study of the two decorated professors Emilios Avgouleas and Charles Goodhart under the title *"Critical reflections on bank bail-ins".* I tried to expand and reinforce the skepticism surrounding bank bail-ins further by elaborating on cases where the resolution authorities in select Member States were faced with serious dilemmas regarding the outcome of their respective ailing financial institutions; Namely, their continued support with the provision of taxpayers' (State) aid, or the placement of the latter under resolution and the subsequent imposition of large losses on their stakeholders. Furthermore, I tried to present a detailed overview of the recent developments and proposals with respect i.e. to the MREL requirements as envisaged by the resolution authorities, and highlighted the difficulties that many medium-sized institutions in the EU will face in adhering to such stringent and burdensome prerequisites in the liabilities side of their balance sheet.

Conclusively, it would be ungrateful of me if I failed to mention the people that contributed to this work. The following willingly or unwillingly influenced me and provided their material aid in order for me to complete this highly demanding research in the area of banking law. First of all I would like to thank Dr. Apostolos Gkoutzinis who taught the course of International Regulation of the Banking Sector in the previous academic year, as the title selection and initial motivation, though inadvertently, is attributed to his teachings. Moreover I would like to express my immense gratitude to my thesis supervisor Dr. Nikoletta Kleftouri for her invaluable support and guidance throughout the process, the lack of which would have made the conclusion of this study impossible. Lastly, I would like to thank my two best friends A.K. and V.C. for their unwavering encouragement and emotional support throughout the past few months of researching and writing.

All errors remain my own.
Vasilis Lisgaras

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1. Introduction

Bank Resolution is a huge topic these days. Resolution is a term of art, partly differentiated from the associated insolvency process which regulators seem to dislike especially with respect to large and complex financial institutes often referred to as Global and Systemic Financial Institutions, (G-SIFIs). These institutions have nowadays global reach and are structured primarily in the form of financial conglomerates with an appreciable degree of interconnectedness, complexity and impact on the global financial system.[1] During the recent financial crisis a large number of failing banks were bailed out by governments using public funds because they were considered too big to fail, (TBTF). The level of state aid to these banks was unprecedented; this led to trillions of taxpayer's money being used for the sake of rescuing large financial institutions. The high profile cases of bank failures in the international stage, (*Lehman Brothers, Fortis, Icelandic banks, Anglo Irish Bank and Dexia*),[2] revealed the urgent need for a robust legal framework to tackle these issues by ensuring the continuity of the critical economic functions of these systemic financial institutions to the real economy and containing the widespread spill-over effect to the financial system; At the same time the previously condemned practice of bail-outs had to end. Bail-outs were deemed to undermine market discipline and be sources of *moral hazard*, whilst also create a doom loop between bank debt and sovereign debt, thereby seriously impairing public finances. The examples of UK and Irish finances serve as illustrative examples of sovereign indebtedness [3] thereto.

The initial legislative proposal was finally put into effect by replacing the previous practice of rescuing, (bailing-out) failing banks to that of bail-in; with the new framework up and running systemically important financial institutions from now on are put into resolution and are allowed to fail in an orderly way. By doing so, the regulators adhere to their urge of safeguarding the resolution objectives, whilst dismantling the associated moral hazard. This new approach is based on the penalty principle, namely a shift of focus to the shareholders and creditors of an institution that ultimately ought to pay the costs of a failure. The previous notions of public subsidy are replaced by the aforementioned private

1 Joseph H Sommer, 'Why bail-in? And How!' (December 2014), 20 Econ Pol Rev Volume 2, (Special Issue: Large and Complex Banks) 207.
2 Nikoletta Kleftouri, 'Deposit protection and Bank resolution' (first edition 25 August 2015, Oxford University Press), p 165.
3 Emilios Avgouleas, Charles Goodhart, 'Critical reflections on bank bail-ins' (1 March 2015), JFR Volume 1, Issue 1 3, 4.

penalty[4] or private insurance[5] which in turn force banks to better monitor the costs of risks that they assume. Thus, by turning unsecured debt into equity regulators incentivize creditors whose claims would potentially be subject to a haircut, be more alert regarding the level of leverage a bank carries.[6] Such monitoring would substantially reduce the scale of losses a bank might suffer in the event of failure; notably, the creditors would force the bank to behave more cautiously, since the new regime includes mechanisms like early intervention and closure rather than bail-out.[7]

To that end a core principle of a healthy and competitive financial system is allowing an institution to fail in an orderly way – that is without an excessive disruption to the financial system and/or banking services and FMIs that accord critical services to society; e.g by extending credit to households and businesses, by providing guarantees, by providing clearing and settlement services of payment obligations etc. A level playing field was needed to address these issues whilst not exposing the tax payer's purse to unnecessary losses.[8] These notions were first highlighted by the Financial Stability Board's[9] International standards for effective resolution regimes, (*The Key Attributes*), agreed by the G20 leaders in 2011.[10] Under the Key attributes every jurisdiction shall provide for a designated administrative authority, (resolution authority), granted with exclusive powers to place into resolution any financial institution deemed to be systemically significant or critical if it fails, and also a resolution regime consistent with the attributes set out in this document.[11] The twelve Key Attributes remain the umbrella standard for resolution regimes, covering financial institutions of all types that could be systemic in failure. More specifically authorities are authorized to carry out bail-in, (and other resolution powers), on some Global Systemically important Banks (G-SIBS), based on firm-specific resolution strategies and plans that involve:

4 Thomas F Huertas, 'The Case for Bail-ins' (in A Dombret and PS Kenadjian (ed) De Gruyter 2013), The Bank Recovery and Resolution Directive.
5 See, in general, KPMG, 'Bail-in Liabilities: Replacing Public Subsidy with Private Insurance' (July 2012), available at: <https://docplayer.net/15205867-Bail-in-liabilities-replacing-public-subsidy-with-private-insurance.html>; Jeffrey N Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' (August 2014), Oxford Legal Research Paper Series 18/2014, available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2361347> accessed 10 January 2019.
6 John C Coffee, 'Systemic Risk after Dodd–Frank: Contingent Capital and the Need for Strategies Beyond Oversight' (2011) 111 Columb L Rev 795.
7 Ibid at n 3 (Avgouleas, Goodhart) 3, 5.
8 Bank of England, 'The Bank of England's approach to resolution' (October 2017), para 1.4 p 11.
9 The Financial Stability Board (FSB) is established to coordinate at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Its mandate is set out in the FSB Charter, which governs the policy-making and related activities of the FSB. These activities, including any decisions reached in their context, shall not be binding or give rise to any legal rights or obligations under the FSB's Articles of Association.
10 See FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', (November 2011), updated in October 2014, available at: <http://www.fsb.org/wp-content/uploads/r_141015.pdf> , accessed 4 November 2018
11 Ibid, p 5.

• writing down of equity or any other instrument that represents ownership in the firm, unsecured or uninsured claims of creditors to the extent necessary to absorb losses, all those in a manner that respects the creditors hierarchy of claims during normal insolvency proceedings;

• converting into equity or other instruments of ownership of the firm under resolution (or its successor under the same jurisdiction), all or some of the creditors' unsecured or uninsured claims subject to the creditors' hierarchy of claims in liquidation; and

• within the resolution process converting into equity or writing down any eligible convertible or contractual bail-in liabilities that have not been triggered before the initiation of the resolution proceedings and treat them in the same manner as instruments under a) or b).[12]

In a nutshell, resolution and bail-in as one of its key mechanisms represents to some extent a pre-planned contract replacing insolvency and bankruptcy process, and thus giving greater certainty[13] as regards the sufficiency of eligible capital and debt instruments to cover losses and enable rapid and non-disruptive recapitalization. Further, the bail-in tool can be used to keep the bank as going-concern and avoid the destructive effects of liquidation to the assets of a distressed financial institution.[14]

Nevertheless, resolution and in particular bail-in as a fundamental shift in treatment and accountability of who must bear the losses in case of bank failures, was not met with uniform implementation across jurisdictions. In the USA for example the process through which bail-in and the subsequent conversion of creditors' rights takes place is justified only with respect to systemically important institutions, (SIFIs), and is embedded in the resolution mechanics and architecture that applies to such institutions, the so-called Orderly Liquidation Authority, (OLA).[15] Notably, bail-in under Title II Dodd – Frank Act (DFA) is seen as a means of providing sufficient capital following the liquidation of the resolved holding company of a large financial group to its subsidiaries, for which the holding company acted as parent.[16]

12 The Financial Stability Board (FSB), Consultative Document: 'Principles on Bail-in Execution' (30 November 2017), available at: <http://www.fsb.org/wp-content/uploads/P301117-1.pdf> accessed 4 November 2018, 1.
13 Ibid at n 6 (Coffee) 797, 806.
14 Ibid at n 3 (Avgouleas, Goodhart) 3, 5.
15 Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Act (Pub L 111–203, HR 4173, in the following: "Dodd-Frank Act" or "DFA")).
16 Ibid at n 3 (Avgouleas, Goodhart) 3, 5.

In the European Union however, the vicious cycle between bank crises and sovereign indebtedness led regulators and Euro-zone governments to a breaking point. The internationally condemned practice of bail-outs needed to be wiped out not only due to the traditional conceptual denouncement of the moral hazard, but also due to the fact that the impact of bail-outs to fiscal indebtedness in most EU countries was immense. For these purposes the European Banking Union (EBU) was created alongside the European Stability Mechanism (ESM),[17] to promote prudential regulation, supervision and effective resolution of financial institutions when necessary. Both the EU Resolution regime, based on the EU Bank Resolution and Recovery Directive (BRRD)[18] and the ESM statute[19] require the prior participation of the bank's shareholders and creditors in dealing with the costs of bank resolution. This prior participation of the bank's stakeholders to its stabilization is mainly expressed through the bail-in tool, notwithstanding the utilization of other resolution tools. In the EU however there is a bifurcation when applying the bail-in tool. The firm is either remaining a going-concern and the bail-in tool is applied to effect recapitalization of the bank to restore its health, (open-bank bail-in process), or in conjunction with other resolution powers is treated as a gone concern, (closed-bank bail-in process). Essentially a closed-bank bail-in entails the recapitalization of a successor entity to which critical balance sheet elements of the failed firm have been transferred.[20] This approach is significantly different to the DFA's practice of SIFIs resolution, where only the second approach is followed. Such bifurcation seems to create uncertainties and problems.[21]

This study consists of three main chapters. Chapter 2 provides a detailed overview of the EU resolution regime and recent developments; Chapter 3 examines bail-in in the context of burden-sharing and the interplay of the resolution regime with the Commission's state aid framework; finally, chapter 4 mainly highlights and assesses the deficiencies and applicability of the bail-in as a resolution tool stricto sensu in the BRRD. The last segment of this paper is dedicated to conclusions.

17 Intergovernmental Treaty Establishing the European Stability Mechanism of 2 Feburary 2012, T/ESM 2012-LT/en 2, available at: <https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf>.

18 Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and regs (EU) No 1093/2010 and (EU) No 648/2012, [2014] OJ L 2014 173/190 (BRRD).

19 See also 'European Stability Mechanism 'By-Laws' (8 December 2014).

20 BRRD, Art 43; Ibid at n 2 (Kleftouri), p 172 para 8.34.

21 Ibid at n 3 (Avgouleas, Goodhart) 3, 6.

2. Resolution under BRRD & bail-in mechanics

In the EU the lack of a harmonized regime to ensure uniform insolvency laws throughout the European Union with the exception of the Directive on the Reorganization and Winding-up of Credit Institutions [22] adopted in 2001, (which mostly regulated conflict of laws issues and mutual recognition rather than substantive rules for bank insolvency laws across the EU), led to the adoption of a comprehensive legal framework to deal with financial institutions in distress; the Bank Recovery and Resolution Directive (BRRD).[23] This EU-wide set of rules for bank recovery and resolution regulate and prevent bank crises and ensure the orderly resolution of failing banks with a view to minimizing the adverse effects that such an event might have on the real economy and public finances. [24] In a nutshell the bank recovery and resolution rules provide national authorities with exclusive powers to effectively deal with national and cross-border institutions that are failing or likely to fail; They can also ascertain that the negative impact of bank failures to taxpayers remain to a minimum, (by establishing bail-in rules), and provide for the operation and contribution of resolution funds, financed by the industry, to cover the funding costs of failing banks if needed. [25] The new rules as clearly stated by the Commission are not intended to replace member state bank insolvency laws, but rather to provide minimum resolution tools and powers to national authorities, leaving each member state with discretion to decide upon enacting stricter rules which better fit their own economic circumstances and domestic legal frameworks, provided that they are aligned to the principles and objectives set out in the Directive.[26] The member states were required to transpose the Directive in their domestic legislation by 31 December 2014 and to apply them from 1 January 2015. They were given an additional deadline to adopt the application of bail-in measures until 1 January 2016.[27]

Mainly this set of rules empowers national authorities to act promptly, to prevent and deal with bank crises by regulating four key elements: I) preparation and

22 Directive 2001/24/EC of the European parliament and of the council of 4 April 2001 on the reorganization and winding up of credit institutions [2001] OJ L 125.
23 Ibid at n 18 (BRRD).
24 European Commission, Communication from the commission to the European parliament and the council: 'A Roadmap towards a Banking Union' (12 September 2012), COM/2012/0510 final, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0510&from=en>, accessed 8 November 2018, p 5.

25 European Council - Council of the European Union, 'Bank Recovery and Resolution', available at: <https://www.consilium.europa.eu/en/policies/banking-union/single-rulebook/bank-recovery-resolution/>, accessed 8 November 2018.
26 European Commission, 'EU Bank Recovery and Resolution Directive (BRRD): Frequently asked questions', Press Release (15 April 2014), available at: < http://europa.eu/rapid/press-release_MEMO-14-297_en.htm>, accessed 8 November 2018.
27 BRRD, Art 130 (1).

presentation,(recovery and resolution planning),[28] II) early intervention - when the banks are seriously stressed or in breach of capital requirements,[29] III) application of resolution tools and powers at the point of non viability when the firm enters resolution, and IV) finally cooperation and coordination between national authorities in the event of a cross-border resolution of a financial group.[30] The BRRD requires member states to assign one or exceptionally more national resolution authorities the task of applying the resolution tools and powers. The resolution authority may be a central bank, a ministry of finance, or any other public administrative authorities.[31]

2.1 Objectives, conditions and general principles

With the advent of the European Banking Union (EBU), the ECB retained its central role as the monetary policy planning institution, whilst was also conferred exclusive tasks as the centralized supervisory and resolution authority in the Euro-zone area via the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). The SRM is the second pillar of the Banking Union alongside the SSM. Under the SRM the pivotal role of the centralized institution responsible for resolution is since January 2016 entrusted to the Single Resolution Board (SRB), which derives its powers from the BRRD and the SRM regulation [32] respectively. The SRB as the pan-European resolution authority for significant banks and other cross-border groups, works in close cooperation with national resolution authorities (NRAs) and its core mission is to ensure the orderly resolution of failing banks with a minimum impact on the real economy and public finances of the participating member states of the Banking Union.[33]

In essence resolution is a restructuring of a bank by the resolution authority to meet the resolution objectives which are deemed of paramount importance to the general public interest. The resolution objectives are of equal importance and are: [34] a) the continuity of critical economic functions; b) the avoidance of a spill-over effect on the financial system, in particular by preventing contagion including to market infrastructures, and by maintaining market discipline, c) the protection of public funds by minimizing reliance on

28 BRRD, Art 5; BRRD, Art 10.
29 BRRD, Art 27.
30 BRRD, Art 88.
31 BRRD, Art 3 (3).
32 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [30.7.2014] OJ L 22.
33 Single Resolution Board, ‘Resolution framework: Resolution Q&A’, available at: <https://srb.europa.eu/en/content/resolution-qa>, accessed 9 November 2018.
34 BRRD, Art 31 (2).

extraordinary public financial support; d) the protection of insured depositors and insured investors; and e) the protection of client funds and client assets. These objectives are in the view of the regulator better safeguarded than under normal insolvency proceedings, where unnecessary destruction of value and ring-fencing of assets often takes place.

In order for the resolution proceedings to initiate, the BRRD mandates that certain conditions be met. Notably, the relevant resolution authorities in consultation with the supervisory authorities must satisfy themselves that: i) the bank is failing or likely to fail (FOLTF) [35]; ii) there are no alternative supervisory or private sector measures, (such as the recovery plan drawn by the firm [36]), to prevent the failure and restore the firm to health within a reasonable time frame [37]; and iii) resolution action is in the public interest, namely the resolution objectives would not be met to the same extent had the institution been wound up under normal insolvency proceedings; The so-called *public interest threshold*. [38] With regard to the third condition the relevant authorities must undertake a deep analysis to determine the necessity and proportionality of the resolution action to achieve one or more of the resolution objectives which could have not been achieved in a satisfactory manner if the path of ordinary insolvency and liquidation procedure was followed. [39]

Notwithstanding the conditions to trigger resolution and the assessment by the authorities that the situation of the bank has seriously deteriorated to the point of non viability (PONV), the resolution authorities must honor the general principles of resolution [40]: 1) that the shareholders of the institution under resolution must bear losses first; 2) that creditors of the same class are treated in an equitable manner (pari passu treatment); 3) that no creditor shall incur greater losses than they would have incurred had the bank been wound up under normal insolvency proceedings (No creditor worse off principle); 4) that creditors of the institution shall bear losses after the shareholders, in accordance with the priority of their claims unless expressly provided otherwise in the BRRD; 5) that the management and senior management of the institution shall be replaced, unless keeping them in office is essential to achieve the resolution objectives; 6) that the management must provide all necessary assistance to facilitate resolution of the institution and the resolution objectives; 7) that all natural and legal persons are held liable, (in accordance with Member State law), and possible civil or criminal sanctions may be imposed on them

35 BRRD, Art 32 (1) (a); Art 32 (4).
36 BRRD, Art 5.
37 BRRD, Art 32 (1) (b).
38 BRRD, Art 32 (1) (c).
39 BRRD, Art 32 (5) and SRMR, Art 18 (5).
40 BRRD, Art 34 (1).

for their responsibility for the failure of the institution; and 8) that all covered deposits are fully protected.

Pursuant to the Deposit Guarantee Scheme Directive [41] the threshold of 100.000 EUR is an amount that should create a super-preference over the deposits that exceed this. It should be noted however that deposits are covered per depositor per bank. In practical terms the threshold includes the aggregated accounts that a given bank holds. Deposits held under different brand names of the same bank are not protected separately. This is not the case however where the same depositor has different deposits in multiple banks. [42]

2.2 Resolution tools and MREL

Given that the conditions for resolution have been met, the resolution authorities shall not proceed to the utilization of any resolution tool unless they ensure that the capital instruments of the relevant institution performed their loss-absorbing function in full. This power to write down or convert capital instruments may be exercised either independently of resolution or in conjunction with a resolution action, where the conditions for resolution mentioned above apply. [43] It is worth noting however that although a write-down or conversion of capital instruments alone at the PONV might restore an institution to viability when the losses are sustainable and its business model sound, yet it is more common in practice to implement the aforementioned powers at the same time as resolution tools. [44]

Resolution authorities may then proceed with the adoption of a resolution scheme, which determines what resolution tool is to be applied to the firm that better suits the circumstances, having regard of course to the previously drawn resolution plan. The resolution tools are: a) the sale of business tool, (parts of the bank are sold to one or more private sector purchasers without the consent of shareholders); b) the bridge institution tool, (transfer of part of the business to a temporary structure under total or partial public ownership to preserve the bank's critical functions or to facilitate access to deposits; c) the asset separation tool, (separation of healthy and toxic assets between *“good”* and *“bad”* banks through a partial transfer of assets and liabilities to an Asset Management Vehicle

41 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes [12.6.2014] OJ L 173.
42 Ibid at n 33 (SRB, Resolution framework: Resolution Q&A), available at: <https://srb.europa.eu/en/content/resolution-qa>, accessed 9 November 2018.
43 BRRD, Art 59 (1).
44 Ibid at n 2 (Kleftouri), para 8.33 p 171.

and/or d) the bail-in tool, [45](a mechanism to cancel or reduce liabilities of a failing bank to owners and unsecured creditors or to convert debt to equity as a means of restoring the bank's capital position to continue satisfying the conditions for authorization). [46]

As mentioned above the bail-in tool can be further divided into an *open-bank* bail-in and a *closed-bank* bail-in. In an open-bank resolution the authorities try to stabilize the bank as a going-concern by recapitalizing it through write-downs and conversions of liabilities to equity. Hence its critical functions remain protected without unnecessary disruption of the financial system and without recourse to public bail-outs. This process saves time for the authorities in order to reorganize the bank or wind-down parts of its business in an orderly manner. Furthermore, during this process its shareholders are severely diluted or wiped out; the previous management of the bank is replaced and its business plan reorganized. In a closed-bank resolution however, the entity is split in two; the bad bank and the good bank or bridge bank. The latter is a newly created institution which continues to operate while the former undergoes normal liquidation. The creditors that are not deemed systemic are left with the bad bank and incur losses in the context of liquidation, or are transferred to the new bank and their claims are written down or converted to equity. [47] Bail-in would apply a priori to any liability that is not explicitly excluded from it [48] and in exceptional circumstances where the resolution authority is given discretion to exclude certain liabilities from the scope of bail-in. [49]

For bail-in to be an effective and credible tool, the BRRD requires that all institutions established in the EU should meet at all times a minimum requirement for own funds and eligible liabilities (MREL) that could readily be exposed to loss in resolution. [50] This is expressed as a percentage of the institution's aggregate amount of own funds and eligible liabilities. MREL ensures the overall effectiveness of resolution by guaranteeing the loss absorption and recapitalization capacity of an institute in the event of resolution. The BRRD stipulates that the MREL should be tailored to bank-specific features by acknowledging its size, business model, funding model, risk profile and the adversities identified to implement the resolution strategy. MREL targets are set by the resolution authorities after consultation with prudential supervisors based on the criteria set out in the Directive and further specification by the EBA. [51]

45 BRRD, Art 37 (3).
46 Ibid at n 26 (European Commission, EU Bank Recovery and Resolution Directive (BRRD): Frequently asked questions).
47 Ibid.
48 BRRD, Art 44 (2).
49 BRRD, Art 44 (3).
50 BRRD, Art 45 (1).
51 BRRD, Art 45 (6) & (2).

MREL seeks to achieve the same objectives as the TLAC (Total Loss-Absorbing Capacity), standard developed by the FSB to accommodate the ease of resolution regarding G-SIFIs at the international level, though it has been formulated rather differently in some respects. The implementation of the TLAC standard is still an ongoing process in the EU, yet the European Commission has published a set of legislative proposals in this regard as of November 2016. The MREL requirement on the other hand is a separate burden on the bank's balance sheet alongside its prudential minimum capital requirements; its calibration is closely connected to the prudential capital requirements as some of its features refer to them and capital instruments held by banks are also eligible for MREL. [52]

The MREL policy has not yet become binding for most banks under the SRB's remit in the EBU. Binding decisions on MREL have been issued by the SRB during the *2017 resolution planning cycle* [53] for the majority of the largest and most complex banks in the EBU at consolidated level, mostly being G-SIFIS and banks with resolution colleges in the Banking Union. For the rest of banks in the BU the SRB has only set non-binding informative MREL targets pending formal decisions, thus preparing them to comply with increasing requirements in the future. It is the SRB's aim to gradually proceed with setting binding MREL standards for all banking groups by 2020, as stressed in its Multi-Annual Work Proramme.[54]

*52*Single Resolution Board, 'List of public Q&As on MREL', available at:
<https://srb.europa.eu/sites/srbsite/files/list_of_public_qas_on_mrel_-_clean.pdf, accessed 13 November 2018>.
*53*Single Resolution Board, 'SRB resolution planning 2017' (30 November 2016), available at:
<https://srb.europa.eu/sites/srbsite/files/20161128_slides_industry_dialogue_resolution_planning.pdf> accessed 13 November 2018, p 6.
54 Single Resolution Board, 'SRB Multi-Annual Planning and Work Programme 2018', available at:
<https://srb.europa.eu/sites/srbsite/files/srb_multi-annual_planning_and_work_programme_2018_final.pdf> accessed 13 November 2018, p 16.

3. Resolution framework vs State aid framework

Recent developments have shown that the interaction and interconnectedness of mandatory burden sharing of the bank's internal stakeholders, (bail-in), in the context of resolution and the Commission's perception of State aid in favor of credit institutions can be problematic at times. With the advent of the resolution framework in 2014 the BRRD shifted the de facto powers to exercise and trigger resolution from the Commission to the designated resolution authorities. Yet 10 years after the collapse of Lehman Brothers, the interaction between the EU resolution framework and the EU state aid rules still remain a rather gray area that poses unanswered questions; namely, should governments be able to rescue failing banks in distress despite the new rules enacted to eliminate public bail-outs, and if yes under what conditions? [55]

As mentioned above the BRRD is implemented in the Euro-zone via the Single Resolution Mechanism which comprises the SRB as the centralized resolution authority, and the Single Resolution Fund (SRF), a fund used as a last resort to facilitate resolution once shareholders and creditors have first borne losses. The SRB owns and administers the SRF and shall grant access to it on the sole condition that it will be used to ensure the effective application of resolution tools and exercise of resolution powers. [56] The TFEU however in exceptional cases allows for aid granted by a member state to remedy a serious disturbance in its economy. [57] The main objective of the European Commission in its pursue to accommodate the principles of the internal market, is to maintain financial stability, whilst ensuring that the state aid granted is not capable of distorting competition between banks and across member states and that is kept to a minimum degree. Further, state aid is prohibited until a restructuring plan is presented and approved by the European Commission. National authorities shall prove to the Commission that all private sector

55 Dr Andreas Wieland, Christoph Arhold, Kai Struckmann, Michael Immordino, Dr Luis Correia da Silva, Peter Hope, Nicole Robins, 'The new bank resolution scheme: The end of bail-out?', (29 September 2016) White & Case/Insight, available at: <https://www.whitecase.com/publications/insight/new-bank-resolution-scheme-end-bail-out> accessed 15 November 2018, p 1.
56 See at n 32 (SRM Reg), Art 67; Single Resolution Board, 'List of public Q&As on MREL' :*"The SRF is composed for a transitional period of 8 years of national compartments until it becomes fully mutualised,* (see SRM Reg. Art. 77)*, It is built up over time from ex-ante contributions from the banking sector raised at the national level by NRAs. The SRF's target level by 31 December 2023 is to reach the threshold of 1% of the aggregate covered deposits of all credit institutions in the Banking Union. Since July 2016 a total amount of 10.8 billion EUR was collected from nearly 4000 institutions in contributions. Its target size is dynamic and can be adjusted depending on the amount of covered deposits"*, available at: < https://srb.europa.eu/en/content/resolution-qa> accessed 13 November 2018.
57 Article 107 (3) TFEU.

measures have been exhausted and the situation has become critical so as to require the minimum possible state aid. [58]

The European resolution framework and the subsequent termination of bail-outs require that prior to any form of public recapitalization; a bank must be put into resolution provided that the prescribed conditions apply. Thus, a prior mandatory burden sharing is imposed to the shareholders and creditors of up to 8% of the institution's total liabilities through bail-in or otherwise, before resolution authorities can have access to public funding qualifying as state aid, i.e in the form of capital injections, government financial stabilization tools and the use of resolution funds or deposit guarantee funds. With respect to the insolvency hierarchy, equity and subordinated debt holders must be bailed-in first, followed by the senior creditors and the uninsured depositors at a later stage, provided that their claims are necessary to be written-down or converted to reach the 8% threshold. Only depositors that are protected by their respective national Deposit Guarantee Scheme (DGS) are automatically exempted from this requirement. [59]

The only exception whereby the injection of public funds may not trigger resolution is through the mechanism of pre-emptive recapitalizations set out in article 32 (4) (d) BRRD. This article permits extraordinary public financial support (EPFS) provided that the injection is precautionary, is granted after a failed stress test and specifically addresses capital shortfalls implied by an adverse scenario. Moreover the institution must be solvent in order to receive any public sector aid and not deemed to likely to fail in the future under the FOLTF test in the BRRD. Public sector support can be given, (except from capital injections) in the form of state guarantees to back central bank liquidity and in the form of other newly issued liabilities. Again this public involvement must comply with the EU state aid rules. [60]

The conditions applicable regarding the EU state aid granted to banks in distress are further specified in the *2013 Banking Communication* from the Commission. [61] This framework contains detailed rules scrutinized and defined by the Commission as regards the provision of state aid to banks. Attention must be had however to the fact that the 2013 Banking Communication was enacted prior to the Resolution framework of 2014 and thus is not fully in terms with it. This may possible create frictions especially with regard to the amount of burden sharing. An illustrative example of this reality can be the contribution of

58 Ibid at n 2 (Kleftouri), para 8.60 p182.
59 Ibid.
60 Ibid at n 55, (Wieland, Arhold, Struckmann et al) p 2.
61 Communication from the Commission on the application, from 1August 2013, of State aid rules to support measures in favor of banks in the context of the financial crisis (‘Banking Communication’) [30.7.2013] OJ C 216.

senior debt holders to the restructuring costs of a bank. Both under the State aid and Resolution frameworks a mandatory burden sharing of the bank's internal stakeholders, (shareholders and creditors) is mandatory prior to any remedial aid provided by the sovereign. However unlike the BRRD, the 2013 Banking Communication does not require the senior debt holders to participate in the burden sharing.[62] This is of particular importance in circumstances where the option of bail-in is not adopted by the BRRD; such as in cases of preemptive recapitalizations, where the Banking Communication seems to be more lenient in its approach to burden sharing than that of the BRRD.[63]

Notwithstanding the significance of burden sharing preached by the Banking Communication, there is an exception to it; namely where under extraordinary circumstances burden sharing would be disproportionate or would create impediments and adverse effects to the preservation of financial stability. Thus, no measures would be implemented to that effect. This exception could be applicable 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"*.[64] These measures may include under para. 35: rights issues; a voluntary conversion of debt instruments into equity; a liability management exercise; capital generating sales of assets; portfolios or securitizations; earnings retention and other measures reducing capital needs.

It goes without saying that this reservation may prove to be beneficial for an institution and avoid a bail-in if at the same time resolution under the BRRD can be avoided. It is however the Commission's tendency to interpret this provision narrowly and allow this exception in exceptional cases. On the other hand not all public intervention in favor of a distressed bank necessarily constitutes state aid. This is particularly the case when state resources are utilized and governments decide to intervene in an institution in a manner that does not confer any specific advantages thereto or by means of an ordinary private investor.[65]

3.1. Lessons learned from Greece and Italy

The next section examines and presents live cases whereby national resolution authorities and the Commission adopted inconsistent and controversial decisions with regard to the provision of state aid to the respective ailing institutions of the member states

62 Ibid at n 55 (Wieland, Arhold, Struckmann et al) p 2.
63 Ibid.
64 Banking Communication, para 45.
65 Ibid at n 55, (Wieland, Arhold, Struckmann et al) p 2.

concerned. These examples reinforce the view held by many that the approach followed in each case may be subject to political expediency and not to public policy considerations.

3.1.1. The Piraeus Bank case

As discussed above with the enactment of the 2014 resolution regime the European legislator shifted the competence to trigger resolution and exercise resolution powers that were so far exercised by the Commission, to the banking and resolution authorities. Until then the Commission acted as the EU's de facto resolution authority imposing burden sharing, restructuring and resolution plans to troubled banks as precondition for the approval of state aid. The BRRD went one step further by introducing early intervention and burden sharing of the bank's stakeholders in all member states even against senior debt holders. Nonetheless the Commission in the *Piraeus bank* decision (SA.43364 (2015/N), [66] provided its own interpretation regarding the conditions upon which a bank should enter resolution. The Commission in its decision not only used additional criteria to determine a resolution entry not foreseen by the BRRD, but also acted in violation of its role by exercising resolution powers now belonging to resolution authorities. [67]

Under Article 32 BRRD the resolution authorities are responsible to examine whether the conditions stipulated in this article are met and whether they are sufficient to trigger resolution. One of these criteria is the failing or likely to fail test (FLTF). The failing or likely to fail test is conducted by the resolution authority in consultation with the supervisory authority and is satisfied if either of the criteria set out in the article are met; one of them being the requirement of extraordinary public financial support, (EPFS), with the exception of the aforementioned preemptive recapitalizations. [68] In the *Piraeus bank* decision the Commission argued that if an institution is experiencing a capital shortfall evidenced by an asset quality review (AQR) base scenario stress test, it must be deemed FLTF and be put to resolution. This controversial decision raises three serious considerations: [69]

First, a stress test shortfall, even in an AQR/base scenario is not on itself capable to determine that an institution is failing or likely to fail. Because a resolution action (bail-in) has inherently significant and adverse effects on fundamental property rights, the BRRD provides an exhaustive set of criteria that constitute triggers for resolution. A stress test

66 European Commission, 'Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank' State Aid SA.43364 (2015/N) – Greece C(2015) 8626 final, [Brussels 29.11.2015] available at: <http://ec.europa.eu/competition/state_aid/cases/261238/261238_1733314_89_2.pdf> accessed 20 November 2018.
67 See infra at n 69 (Chamsaur) 40.
68 BRRD, Art 32 (4) (d) i, ii, iii
69 Amelie Champsaur, 'Playing with Fire' (2016) 35 Int'l Fin L Rev 40.

shortfall whether in AQR/base or adverse scenario form is not one them and neither is a failure to meet a capital increase deemed necessary by the banking supervisor following the results of a stress test. What is more, the determination of FLTF must be undertaken in the context of Article 36 BRRD; namely a *“fair, realistic and independent”* valuation of the institution's assets and liabilities must be carried out first. A stress test comprises a set of reviews of categories of portfolios and assets being analyzed based on sampling methodologies. These methodologies are constructed by the relevant EU authorities themselves implementing hypothetical stress scenarios and can hardly be considered *“fair, realistic and independent”*. Stress tests merely demonstrate the level of capital a given institution needs in order to be overcapitalized to the point where the supervisor deems that the institution is prudent, not the amount of recapitalization an institution needs to remain viable, ie when the bail-in tool is utilized. [70]

Secondly, the Commission in its decision proclaimed in essence the prohibition of preemptive recapitalizations. The Commission contended that preemptive recapitalizations can be used to cover shortfalls deriving from adverse scenarios and not from AQR/base scenarios. This position is not supported by the EU legislator since nowhere in Article 32 and the EBA guidelines implementing it, is a distinction made between AQR, base and adverse shortfalls. On the contrary the only prerequisite is that the amount of capital injection shall not exceed the total shortfall. [71] Moreover the Commission held that preemptive recapitalizations cannot be used in AQR/base shortfalls because the latter entail and prove *“loses incurred or likely to be incurred in the near future”*. This position is ill-founded because an institution can have an AQR/base shortfall, meaning that it needs to raise capital in order to comply with the target capital ratios established in the stress test results without necessarily incurring or likely to incur losses. The 2014 Comprehensive assessment [72] for several Euro-zone institutions serves as an illustrative example to that respect. Contrariwise an institution can suffer losses despite being healthy and not having evidenced a stress test shortfall, ie due to a scenario of a massive fraud. At the end of the day as mentioned above, the FLTF condition must be assessed not on the basis of the losses evidenced in a stress test shortfall but according to an independent valuation

70 Ibid.
71 Ibid.
72 European Central Bank, 'Aggregate report on the Comprehensive Assessment' (October 2014), available at: <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/aggregatereportonthecomprehensiveassessment201410.en.pdf?68911b281b9d831540bb474c334437e7>, accessed 20 November 2018.

carried out pursuant to article 36 of the BRRD. Therefore there can be no presumption that stress test shortfalls imply actual or imminent losses. [73]

Thirdly, the Commission held that the lack of private sector participation to a contingent capital increase entails that the institution requires EPFS and therefore meets the FLTF test. It is however the case that an institution may sometimes require EPFS not because it is internally unhealthy or non-viable but because the external circumstances and the unstable economic environment discourage private investors' appetite, (see e.g BRRD Recital 41). [74] Especially now that bail-in is in force and it applies without any priority given to new funds, it is more than natural the private sector investors being discouraged particularly in periods of uncertainty and instability, regardless of the financial position of the relevant bank. Investors' reluctance can also be aggravated following sector-wide stress tests, which may reveal the need for recapitalizations of a significant portion of banks, thus reducing the urge of investors to recapitalize any individual bank. [75]

To sum up the question that arises is whether the Commission in the case above had any legal basis to even make the assessments as to the FLTF test. Nowhere in the BRRD or in the framework does the Commission enjoy competence to assess whether a bank meets the FLTF test or whether it should be placed into resolution. [76] As J Laitenberger [77] puts it: *"It is for the respective supervisor or resolution authority, and not for the Commission, to apply this EU law and put a bank in resolution. The responsibility of the Commission is to ensure that State aid used in resolution does not unduly distort competition"*. [78] The BRRD under article 32 provides only a limited set of circumstances that constitute triggers for resolution that must apply cumulatively and by no means is the provision of state aid an automatic trigger for resolution. The solution proposed for the Piraeus bank case by the Commission: e.g. to raise the threat of resolution if the private sector would not participate to a capital increase through capital injections or liability management exercises, in order to cover the entirety of the AQR/base shortfall and regardless of the institution's prudential situation, violates the BRRD and unduly and

73 Ibid at n 69, (Champsaur) 40-41.
74 Recital 41 of the BRRD: *'Furthermore, the provision of extraordinary public financial support should not trigger resolution where, as a precautionary measure, a Member State takes an equity stake in an institution, including an institution which is publicly owned, which complies with its capital requirements. This may be the case, for example, where an 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 which includes a requirement that is set to maintain financial stability in the context of a systemic crisis, but the institution is unable to raise capital privately in markets'.*
75 Ibid at n 69, (Champsaur) 40, 41.
76 Ibid.
77 Johannes Laitenberger is the Director-General of DG Competition. He took office on 1 September 2015. Under the political guidance of Commissioner Vestager, he manages the Directorate-General within the framework set by its mission statement and work program.
78 Johannes Laitenberger, 'From bail-out to bail-in: laying foundations for a restructured banking sector in Europe' (25 January 2016), Presentation in Lisbon: "Banking Union and Competition", available at:
<http://ec.europa.eu/competition/speeches/text/sp2016_04_en.pdf> p 7.

disproportionately infringes fundamental property rights. Due to bail-in risk such capital increases in periods of financial instability create extreme dilutions of shareholders and subordinated debt holders and must be carried out with due process and the safeguards of property rights set forth in the BRRD. As a result EU institutions and the relevant resolution authorities are exposed to significant risk of legal challenge.[79]

3.1.2. Veneto Banca, Banca Popolare di Vicenza and Banca Monte dei Paschi di Siena (MPS).

The course followed by the Italian government in order to tackle the problems of its ailing financial sector was the subject of a heated debate and questioning of the existing resolution regime. In April 2016 its government sponsored the creation of a private-backed bank rescue fund to address these issues. The roots of the problem stemmed from the high levels of non-performing loans (NPLs) of up to 360 billion EUR that the Italian banks held in their balance sheets, which were an obstacle to economic recovery. As a result Italy turned to its private sector for rescue and a 4.21 billion EUR back-stop fund was created, *Atlante 1*. [80] The fund was sponsored by *Cassa Depositi e Prestiti* [81] (a state-owned institution), by banks, insurers and other institutional investors such as the Italian banking foundations. Its aim was to ease Italy's financial system by purchasing eligible NPL portfolios and also newly issued shares of banks not satisfying their SREP capital requirements. *Atlante 1* was subsequently backed with a guarantee scheme by the Italian government so as to encourage a wide range of private investors. This type of government guarantee was not found by the Commission to have amounted to state aid, since it held that the state risk undertaken was limited and the state's remuneration was on ordinary market terms. Ultimately however the rescue plan was proved insufficient and the fund resources were drained in June 2016 when the fund acquired shares worth 2.5 billion EUR of two ailing Italian banks; *Veneto Banca and Banca Popolare di Vicenza*. Hence in August 2016 a second private back-stop fund was created, *Atlante 2*, [82] in order to deal with the pressing issues of another institution; *Banca Monte dei Paschi di Siena (MPS)*. [83]

The controversial rescue plan of *MPS* through a precautionary recapitalization under a special insolvency procedure of the Italian law, unveiled some significant deficiencies of

79 Ibid at n 69 (Champsaur) 40, 42.
80 Ibid at n 55, (Wieland, Arhold, Struckmann et al.) p 2.
81 See online at: <https://en.cdp.it/>, accessed 23 November 2018.
82 Atlante 2 online at: <http://www.bankpedia.org/index.php/en/100-english/f/24297-fondo-atlante-2>, accessed 23 November 2018.
83 Ibid at n. 55, (Wieland, Arhold, Struckmann et al.) pp 2, 3.

the bail-in rules. [84] The EBA's 2016 sector-wide stress test [85] indicated that MPS nursed in its balance sheet a high amount of NPLs which in turn contributed to a large reduction to its Common Equity Tier 1 (CET1) capital.[86] The Italian government provided a guarantee to *MPS's* privately funded recapitalization initiative and that action was deemed by many to entail a preferential treatment to its senior bondholders, though the state aid was labeled as contingent and might never be used.[87] The Commission did not qualify the provision of the guarantee by the Italian government as state aid, since it held that the state acted in its commercial capacity by replacing an ordinary market participant. [88]

Thus the case of MPS serves as a prime example of a member state being resourceful and trying to avoid the unavoidable while it might be argued that it constitutes a breach of the state aid framework. It is however hard to contemplate the Commission's policy in this instance, as the rationale of the BRRD is to ensure that a bank is allowed to fail in an orderly and uniform manner by minimizing the use of state aid and without causing financial instability. To that end, A. Miglionico [89] notes: *"The recourse to financial assistance increased the reliance on aid and undermined the BRRD rules. This means that precautionary recapitalization under the BRRD has deliberately been left as a loophole for cases where bail-ins cannot work"*. [90]

The inevitable liquidation of Veneto *Banca and Banca Popolare di Vicenza*, following a decision by the SRB in 23 June 2017, though they were considered FOLTF, was justified by the fact that there was no public interest in resolving these banks and they'd better be liquidated under normal insolvency proceedings. [91] Albeit the absence of public interest the non-acquired part of institutions received liquidation aid as a pretext to mitigate economic disturbance and adverse effects on the market at the regional level; namely the aid was justified by the Italian government's own assessment of local effects of liquidation. However the authority to make such an assessment lies with the SRB. Therefore it can be argued as Andrea Enria denotes: *"two different definitions of "public interest have been*

84 Commission, 'State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena', (Brussels, 4 July 2017), Press Release, available at: <http://europa.eu/rapid/press-release_IP-17-1905_en.htm>, accessed 23 November 2018, p. 2.
85 European Banking Authority, '2016 EU-Wide Stress Test' available at:
< https://eba.europa.eu/documents/10180/1519983/EBA_TR_IT_J4CP7MHCXR8DAQMKIL78.pdf>, accessed 23 November 2018, p 2;
86 Andrea Miglionico, 'Rescuing failing banks for financial stability: the unintended outcomes of bail-in rules' (2018), I.C.C.L.R. 608, 612.
87 Bank of Italy, 'The "precautionary recapitalization" of Banca Monte dei Paschi di Siena', (2016), available at:
<https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/index.html?com.dotmarketing.htmlpage.language=1> accessed 23 November 2018.
88 Gert Jan Koopman, 'Market based solutions to bank restructuring and the role of State Aid Control: the case of NPLs' (Brussels, 9 November 2016), Speech delivered at the ECMI Annual Conference available at:
<http://ec.europa.eu/competition/speeches/text/sp2016_09_en.pdf>, accessed 23 November 2018, pp.11–12.
89 Andrea Miglionico, Lecturer in Banking and Finance Law, University of Reading School of Law.
90 Ibid at n 86 (Miglionico) 608, 612-613.
91 Single Resolution Board, "The SRB will not take resolution action in relation to Banca Popolare di Vicenza and Veneto Banca", (Brussels 23 June 2017), Press Releases: available at: <https://srb.europa.eu/en/node/341>, accessed 27 November 2018.

applied, one at the EU level and another one by national authorities", [92] which may compromise the consistent application of the EU resolution framework. Thus, the criteria to assess the public interest and consequently determine whether to follow the course of normal insolvency proceedings or resolution are still quite vague. Moreover EU regulators have wide discretion in assessing whether a bank is insolvent or FOLF, which leads to inconsistency of treatment of distressed financial institutions and political maneuvers from Member states to avoid bail-in and seek public support. [93]

3.1.3. The controversial quest for public interest

Conversely, to further elaborate on the lack of inconsistency and divergent regulatory treatment of distressed banks there is the paradigm of *Banco Popular*. In this case the SRB concluded that the institution is FOLTF and that the adoption of a resolution scheme was in the public interest. [94] *Banco Popular* was resolved through the sale of business and bail-in tools mentioned above by transferring all its shares and capital instruments to *Banco Santander SA* with no involvement of state aid.[95]

The fact that there is no clear-cut definition of public interest in the BRRD is evidenced through these illustrative examples of inconsistent treatment of institutions in distress. This raises serious concerns over the effectiveness of EU rules; notably as explained, wide powers are granted to supervisory authorities to evaluate the financial situation of failing institutions. At the same time there is an uncertainty spread among the bank's investors i.e shareholders and subordinated debt holders, as the triggers for haircuts are ill-defined.[96] It is safe to infer thereafter as A. Miglionico notes: *"that the bank insolvency regime remains subordinated to state aid"*. [97] This approach enables member states to provide biased treatment and proclaim national champions, while simultaneously protect institutions whose failure could potentially trigger domestic political implications.

92 Andrea Enria serves as the chairperson of the European Banking Authority (EBA) since 2011. On 7 November 2018 he was nominated by the Governing Council of the European Central Bank as the new Chair of the ECB Supervisory Board; Benoit Mesnard, Alienor Margerit, Marcel Magnus, 'The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza' (European Parliament, 25 July 2017), available at: <http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602094/IPOL_BRI(2017)602094_EN.pdf> accessed 27 November 2018, p 8.
93 Ibid at n 86 (Miglionico) 608, 613.
94 Commission Decision (EU) 2017/1246 of 7 June 2017 endorsing the resolution scheme for Banco Popular Español SA C(2017) 4038: "*The resolution of the Spanish bank can be regarded as private bail-in capital without intervention of the state"*.
95 Benoit Mesnard, Alienor Margerit and Marcel Magnus, 'The resolution of Banco Popular' (European Parliament, 28 August 2017), available at: <http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602093/IPOL_BRI(2017)602093_EN.pdf> Accessed 27 November 2018, p 3.
96 Robert Smith, 'Banco Popular serves as a harsh lesson for coco debt holders', *Financial Times*, 8 June 2018, available at: <https://www.ft.com/content/ec2d4b84-6a35-11e8-b6eb-4acfcfb08c11>, accessed 27 November 208.
97 Ibid at n 86 (Miglionico) 608, 614.

In the *MPS* case there was a widespread market supply of subordinated bonds to retail investors with no transparency whatsoever in terms of the potential risks associated therewith. [98]Hence, the Italian government introduced a compensating scheme for the affected retail investors whereby they were allowed to convert the subordinated debt securities into equity. [99] It can be argued however that this policy bypassed the principle of bail-in on subordinated debt holders that is applicable pursuant to the burden sharing principle when state aid is granted.

As evidenced above the rules contained in the BRRD allow for wide discretion on the member states and competent resolution authorities to implement the necessary policy measures to protect the public interest. Nevertheless, the Directive does not provide a clear definition on the scope of public interest and public intervention. [100] In particular the BRRD does not provide a straightforward definition of the *"interest to preserve financial stability and remedy a serious disturbance in the economy"*; [101] As a result the interpretation of art. 32 (4) (d) of the BRRD concerning state aid is not clear and the suitability of the public measure to restore the equity of a distressed bank, (as with the precautionary recapitalization of *MPS*), is to say the least questionable. Moreover there is also no clear distinction between the concepts of precautionary recapitalizations and extraordinary public financial support. Article 32 of the BRRD considers these two terms homogeneous while in reality they should be regulated as different instruments. [102] It can be observed conclusively that the BRRD leaves ample discretion to competent authorities to construe the applicable regime in a way that is inconsistent with the public interest. [103]

98 European Commission, 'Statement on an Agreement in principle between Commissioner Vestager and Italian authorities on Monte Dei Paschi di Siena (MPS)', Press Release (1 June 2017), available at: <http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm>, accessed 30 November 2018.

99 "MPS will compensate retail junior bondholders who were mis-sold by converting these bonds into equity and buying those shares from the retail investors. MPS will pay retail investors in more secure senior instruments"; See European Commission, 'Statement on an Agreement in principle between Commissioner Vestager and Italian authorities on Monte Dei Paschi di Siena (MPS)' (2017).

100 Stefano Micossi, Ginevra Bruzzone and Miriam Cassella, 'Fine-tuning the use of bail-in to promote a stronger EU financial system', CEPS Special Report No.136 (April 2016), available at: <https://www.ceps.eu/system/files/CEPS%20SR%20No%20136%20Bail-in%20StateAid%20and%20Public%20Interest.pdf> accessed 30 November 2018, pp 16–17,

101 Rodrigo Olivares-Caminal and Costanza Russo, 'Precautionary recapitalization: time for a review', (European Parliament, 11 July 2017), Note provided in advance of the public hearing with the Chair of the Single Resolution Board in the Committee on Economic and Monetary Affairs (ECON), p 10.

102 Christos V Gortsos, 'Last resort lending to solvent credit institutions in the euro area before and after the establishment of the Single Supervisory Mechanism (SSM)' (Frankfurt, 1–2 September 2015) Paper presented at the ECB Legal Conference: 'From Monetary Union to Banking Union, on the way to Capital Markets Union: new opportunities for European integration', available at: < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2688953> Accessed 30 November 2018, p 6

103 Ibid at n 86 (Miglionico) 608, 617.

4. Bail-in centered resolution in the EU

In the previous chapter the main focus of the study was directed towards the inevitable friction between the EU resolution framework and the state aid framework, whereby the existing resolution regime contained certain loopholes and ambiguity that allowed for the relevant authorities and member states to circumvent the principles of bail-in in terms of burden sharing, and resort to the public subsidy forms (bail-outs) of the past. This chapter will be more oriented to the challenges that the banking industry faces in applying the bail-in principle as a resolution tool per se and will highlight the deficiencies of the new framework in its effort to terminate the TBTF practice. In essence it will try to find the middle ground between the previously inconsistent approaches highlighted in the previous chapter and the difficulties in adhering to the new strict rules as prescribed by the new regime.

4.1. Market Discipline

The key ingredient of the new framework as mentioned above is the involvement of the bank's creditors in resolving failing banks (bail-in); it is the one that entails more technical and political complexity and the one that is likely to have a more profound impact on the institution's business model and corporate strategies. [104] It is clear that the EU held high hopes in the effectiveness of bail-in an approximation of which was followed in Cyprus in March 2013. [105] The strict prerequisites of the BRRD leave as an absolute last resort the injection of ESM funds borrowed by the member state to remedy its ailing financial sector. These regulations intend to tackle the moral hazard and alleviate the need for mutualization of liabilities for bank rescues in the Euro-zone. [106] Nevertheless as explained, the dogma of minimization of state aid is not an absolute one and it can be circumvented through the government stabilization tools subject to very strict conditions

104 Fernando Restoy, 'Bail-in in the new resolution framework: Is there an issue with the middle class?' (Bank for International Settlements, Naples, Italy 23 March 2018), speech at the IADI-ERC International Conference: "Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes", available at: <https://www.bis.org/speeches/sp180323.htm>, accessed 4 December 2018, p 2.
105 European Stability Mechanism, 'FAQ – Financial Assistance of Cyprus', available at: <https://www.esm.europa.eu/sites/default/files/faq-financialassistanceforcyprus.pdf>, accessed 4 December 2018; See also Avgouleas, Goodhart: *"While the authorities would say that the Cypriot case was very different, given the absence of the resolution tools provided by the BRRD, we feel that its implementation gave important further momentum to the adoption of bail-in processes"*.
106 Ibid at n 3 (Avgouleas, Goodhart) 3, 13.

prescribed in the BRRD, [107] and pursuant to the state aid rules that are approved by the Commission in accordance with Article 107 TFEU.

One of the key desiderata of the new regime was to instill market discipline and shift the burden of dealing with a distressed institution by compelling mandatory private sector involvement (PSI). However desirable market discipline can be established if investors can predict the risk of their debt instruments being written-off or converted with reasonable certainty. Unfortunately the bail-in tool under the BRRD and the SRM-Reg provide for a highly complex framework where ample discretion is given in a multitude of authorities to dictate the triggers for PSI, and thus require significant inter-agency cooperation and information sharing. This can lead to the assumption held by many that the bail-in tool under the BRRD is likely to fail. [108] Market discipline makes certain that banks' funding is sensitive to the risks they have undertaken and can serve as a backstop to the excessive risk-taking and leverage of the past, where banks conducted business under implicit government guarantees. [109] However this structure requires a bail-in mechanism that allows for ex ante prediction of investment outcomes and a close monitoring of bail-in capital instruments that can be achieved only in the case of certain investors' portfolios with adequate risk-bearing/management capacities.[110]

4.2. The “open bank” bail-in as an effective resolution strategy

In the EU the utilization of an “open bank bail-in” aims at restoring to health an ailing institution while preserving its critical functions and maintaining it as a going-concern. It can also be used as a substitute to liquidation to resolve a banking group or parts of the group in conjunction with other resolution tools. There are four pivotal considerations that must be borne into mind when following a bail-in process: timing, market confidence, scope of restructuring and accurate calculation of losses. [111]

The resolution authority is faced with a difficult task in identifying the right timing in implementing the bail-in tool in a process that extends beyond the specially designed bail-able debt. If the resolution authority triggers bail-in too early, it risks another round of bail-ins being effected since the full scale of losses may not have been revealed yet. If it triggers it at a later stage and the full scale of losses is revealed, it risks a potential

107 BRRD, Art (37) (10); Art (56); Art (58).
108 Tobias H Tröger, ‘Too complex to work: A critical assessment of the bail-in Tool under the European Bank Recovery and Resolution Regime’, (6 February 2018), EBI Working Paper series 2017 - no 12, p 4.
109 Tobias H Tröger, ‘Regulatory Influence on Market Conditions in the Banking Union: the Cases of Macro-Prudential Instruments and the Bail-in Tool’ (2015) 16 EBOR 575, 588 figure 3.
110 Ibid at n 108 (Tröger) p 4.
111 Ibid at n 3 (Avgouleas, Goodhart) 3, 14.

creditors' flight that do not possess eligible bail-able debt. Imposing large losses on private sector creditors might also bring forth legal concerns which could unduly delay resolution; Thus it can be argued that bail-outs might be less susceptible to legal suits than bail-ins.[112] A contagion effect might also ensue, causing a creditor flight from other banks and thus spreading fear throughout the financial system even if those banks are adequately capitalized with eligible bail-in-able debt. As Timothy Geithner notes there must be a strong backstop to keep other firms that are facing similar problems, from disseminating fears of additional failures and haircuts to their creditors. [113]

Moreover market confidence in the bailed-in firm must be reestablished quickly so as to retain its commercial integrity and repay the liquidity support that was granted to it by the central bank. [114] This is relevant in terms of how fast the capital position of the bank will be restored, (or in the case of a *"closed-bank resolution"* that of the new bank). The situation is substantially aggravated when the institution has entered into an irreversible state, with customers, creditors and depositors quickly disappearing.

There should also be an accurate valuation of the losses incurred, including those that are not yet realized, in order to avoid an additional round of bail-ins to make up for the deficit. Experience during the financial crisis has shown that bank losses have been seriously underestimated. To avoid the aforementioned danger of underestimation the new accountants employed by the resolution authority will most likely apply a bad scenario, (or even a worst case scenario), method in calculating losses to be borne by the bailed-in creditors so as to avoid a further round of bail-ins. This generalized asset value free fall will most likely put to the test the existing valuation practices of other banks as the general public may start doubting the published accounting methods, thus causing a contagion effect. [115]

4.2.1 The affected players

Generally speaking every bank is funded by three types of creditors:

- Banking creditors, comprising retail and wholesale depositors that use the provision of payment, custody, and clearing services of the bank.
- Investment business creditors, comprising swap counterparties, trading counterparties and others with similar claims from trading activities such as

112 Ibid 3, 14 – 15.
113 TF Geithner, 'Stress Test: Reflections on Financial Crises', (Random House 2014) 306.
114 See n 1 (Sommer).
115 Ibid at n 3 (Avgouleas, Goodhart) 3, 15 – 16.

exchanges and clearing systems, and other investment business counterparties (ie. counterparties conducting repo activities).

- Financial creditors, including almost exclusively long-term creditors of the bank such as bond holders and other long-term unsecured lenders of the bank.[116]

Normally when a banking group is resolved only the third category of creditors should participate to the loss absorption and recapitalization needs of the bank since the banking creditors and investment business creditors hold claims against the unaffected operating subsidiaries. This is not the case however in the EU where resolution is being carried out at the legal entity level. Under BRRD investment business creditors may fall outside the scope of application of bail-in via pre-designed exemptions. [117] Thus it may be the case that the majority of the burden is shifted to the other two classes of creditors, namely the long-term investors and the uninsured depositors.

Nonetheless, one seemingly valid point of a bail-in centered policy is that it better serves the interests of domestic taxpayers as opposed those of foreign investors; this argument however is to say the least quite weak and controversial. In particular the whole *“rescue”* plan of Cyprus was advocated by the need to protect the depositors of Cypriot banks at the expense of Russian investors. On the same footing foreign bondholders of Icelandic banks were in some sense penalized so as to protect domestic depositors. [118] Yet those foreign investors will most probably not stay idle to such an eventuality and will either flee when they realize that they are being targeted, or demand a higher-risk premium. As a result the residual part of the bank's bondholders will eventually consist of other (non-bank) financial entities that are constituents of the same country. This would further contribute to the nationalization of the banking system. By having a purely domestically funded institution, the effect of transitioning from bail-out to bail-in will in essence have the effect of transferring the burden of loss from national taxpayers to another group of domestic payers, that of the pensioners and savers. It is therefore hard to contemplate why the latter have better capacity to absorb the losses and pay the penalty of a bank failure over the former. [119] Charities, small and medium-sized pension funds, or individual savers via pension funds, albeit the fact that they have willingly become creditors of the bank, lack the expertise to perform a monitoring function to the risks

116 Clifford Chance, ‘Legal Aspects of Bank Bail-ins’ (May 2011) available at: <https://www.cliffordchance.com/briefings/2011/05/legal_aspects_ofbankbail-ins.html>, accessed 5 December 2018 p 7; See also at n 3 (Avgouleas, Goodhart) 3, 16.
117 Ibid at n. 3 (Avgouleas, Goodhart) 3, 16.
118 S Goodley, ‘Bondholders May Take Legal Action Against Iceland over Failed Banks’ The Guardian (7 November 2010) available at: <https://www.theguardian.com/business/2010/nov/07/iceland-banks-bondholders-legal-action>, accessed 12 December 2018.
119 Ibid at n. 3 (Avgouleas, Goodhart) 3, 17.

undertaken by the institution; Accordingly, this group of investors can hardly contribute to a bank's governance and would seem unfair to impose on them the penalty of a failure. On the contrary, it would be reasonable to infer that they were tricked into buying bail-in-able debt. [120] A viable solution would be for the resolution authorities to activate the discretionary safeguards of the BRRD [121] and exempt from the application of bail-in liabilities held by these vulnerable parts of savers' population that are at the same time stable sources of cheap funding and weak monitors of banks' business risks. These measures could alleviate any widespread contagion.

4.2.2. Governance issues

Bailed-in creditors, especially those whose stakes at the bank will be converted into new securities will be a rather fragile group of investors that are complex to handle, time-consuming and prone to litigation. Faced with serious costs and lack of expertise the original creditors will most likely sell out their claims to those that specialize in such situations, the so-called *vulture hedge funds*. [122] As seen in the case of *Co-op bank* ownership may ultimately fall in the hands of this group of hedge funds. [123] Another example is that of Cyprus where bailed-in Russian depositors ended up having a large share of ownership in Cypriot banks. [124]

In theory bail-outs despite their well-known disadvantages provided governments the capacity to directly supervise who is to run the rescued bank. Despite the safety net existing that the new management shall be approved by the supervisory authorities, nonetheless the culture, pursuits and structure of a bank governed by these *vulture funds* will substantially differ from that of a bailed-out bank. The solution proposed by many, in placing caps on how much bail-in-able debt a creditor can hold would hardly alleviate the situation and probably entail a prohibition under EU law. Moreover it could restrict the liquidity of the market for bail-in-able debt and could impose a large burden on banks

120 A Persaud, 'Why Bail-In Securities Are Fool's Gold', (November 2014), Peterson Institute for International Economics, Policy Brief 14-23, available at :< https://piie.com/publications/pb/pb14-23.pdf> accessed 12 December 2018.

121 BRRD, Art 44 (3) (c), (d).

122 Katherine Burton and Katia Porcekanski, 'Vulture Investing' Bloomberg/Quicktake (31 May 2017), available at: <https://www.bloomberg.com/quicktake/vulture-investing>, accessed 14 December 2018.

123 As E Avgouleas and C Goodhart explain, *"Co-op Group, which owned the Co-operative Bank outright, eventually bowed to the demands of a group of bondholders, including US hedge funds Aurelius Capital and Silver Point Capital, and agreed to a restructuring which left them with a 30 percent stake in the bank"*; see also M Scuffham, 'Co-op to cede control of bank to bondholders', Reuters (21 October 2013) available at: <http://uk.reuters.com/article/2013/10/21/uk-coop-bank-bondholders-idUKBRE99K05O20131021>, accessed 14 December 2018.

124 A Illmer, 'Russia's Rich Dominate Cyprus' Largest Bank' Deutsche Welle, (18 October 2013) available at: <http://www.dw.de/russias-rich-dominate-cyprus-largest-bank/a-17146540>, accessed 14 December 2018.

having to hold insufficient amounts of bail-in-able debt, thus forcing them towards public bail-outs.[125]

4.2.3. Legal considerations

Notwithstanding that in all EU jurisdictions bail-in regimes have been given statutory force, it is doubtful that a series of litigation will be avoided once the bail-in process is activated.[126] In cases where bail-in frameworks extend beyond eligible bail-in-able debt, many courts will adjudicate that such regulations are directly abusing fundamental rights of property, which are embedded in the states' constitutions and international treaties. Legal suits will ensue by shareholders and creditors, invoking claims that their stakes have been unlawfully diminished and the value of their respective instruments of debt/ownership on the firm erased or seriously reduced.[127] The *"no creditor worse-off"* than liquidation principle stipulated in the BRRD[128] seems unlikely to prevent the anticipated stream of litigation. Contrariwise, it would intensify the latter. Where the result of administrative action is that bailed-in creditors receive a demonstrably lower return than they would have received had the bank proceeded into disorderly liquidation, the inevitable question is by whom they should be compensated[129] and in what form?

Furthermore, a significant segment of the costs of resolution could be exhausted in settling conflicts of interest among creditors.[130] This is particularly the case where as mentioned above the ownership of the firm under resolution is concentrated among *vulture hedge funds* that specialize in lobbying and obtaining larger proceeds. This argument can be reasoned further by examining of who bears the costs of resolution in the case of bail-outs and bail-ins respectively. In the first instance a rather small charge is imposed on the totality of taxpayers, whereas in the case of bail-ins a large portion of the costs is imposed on a small group of creditors with legal expertise and with the capacity to act in concert to pursue their claims, thus spiking the total costs of litigation. An illustrative example is that in the previously imposed publicly-funded bail-outs every taxpayer's tax liability increased a little, whereas in the case of bail-ins a small portion of creditors will incur great losses and as a consequence will have strong incentives to litigate.[131]

125 Ibid at n 3 (Avgouleas, Goodhart) 3, 18.
126 S Gleeson, 'Legal Aspects of Bank Bail-Ins', (2012), LSE Financial Markets Group Series Special Paper 205. available at :< http://www.lse.ac.uk/fmg/assets/documents/papers/special-papers/SP205.pdf>, accessed 14 December 2018.
127 Russia Today, 'Russian Depositors Begin Seizing Property of Cypriot Banks', (12 April 2013), available at: <https://www.rt.com/business/laiki-cyprus-banks-arrest-765/>, accessed 14 December 2018.
128 BRRD, Art (73) (b).
129 Ibid at n 126 (Gleeson).
130 DC Hardy, 'Bank Resolution Costs, Depositor Preference, and Asset Encumbrance' (2013) IMF Working Paper 13/172, available at: <http://www.imf.org/external/pubs/ft/wp/2013/wp13172.pdf>, accessed 15 December 2018, pp 10-12.
131 Ibid at n 3 (Avgouleas, Goodhart) 3, 18 - 19.

4.2.4 Funding implications

During the past few years there have been a series of quantitative studies of the *"subsidy"* effect provided by governments in the form of tacit bail-out guarantees to SIFIs that were deemed too-big-too-fail. [132] The evidence indicates clearly that large and complex institutions are more eager to invest in riskier assets and accumulate higher risk-profile portfolios than other banks. [133] This form of subsidy is mainly criticized for the fact that it distorts competition unfairly and undesirably at the expense of smaller competitors. By having access to lower funding costs, larger banks benefit from the *net interest margin* (NIM)[134] and can provide lower interest rates therefore surpassing smaller competitors.[135] The new regime undoubtedly intended to restore the equilibrium between small and large banks; but shifting the intermediation away from larger banks towards smaller ones is in essence a way of shifting it from a safer, better regulated and more transparent place to a riskier less regulated and unexplored environment. [136] It can be argued additionally that this implicit subsidy benefits bank borrowers who can acquire loans at lower interest rates; it is because of their sheer size that these institutions operate at lower costs, thus allowing them to provide more attractive loan terms.[137]

Undoubtedly so, the key desideratum of the bail-in centered regime was to instill market discipline, whereby creditors exposed to the risk of a bank failure would have stronger incentives to monitor and encourage the management of the bank to seek more prudent and cautious policies, as opposed to the more profit-seeking and risk-taking pursuits of the shareholders. Though noble the cause may be, and undoubtedly paving the way for a more prudent behavior, yet market discipline failed to establish itself years after the advent of the financial crisis, while investors in bail-in-able debt still face serious

132 J Santos, 'Evidence from the Bond Market on Banks' "Too-Big-To-Fail" Subsidy' (March 2014) 20 Federal Reserve Bank of New York, Econ Pol Rev (Special Issue: Large and Complex Banks); K Ueda and B Weder Di Mauro, 'Quantifying the Value of the Subsidy for Systemically Important Financial Institutions' (2011), IMF Working Paper 12/128; Z Li, S Qu and J Zhang, 'Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions' (January 2011) Moody's Analytics Quantitative Research Group; DP Morgan, KJ Stiroh, 'Too Big To Fail After All These Years' (September 2005) Federal Reserve Bank of New York Staff Reports, no 220.

133 G Afonso, J Santos, J Traina, 'Do "Too Big To Fail" Banks Take on More Risk?' 20 Federal Reserve Bank of New York, Econ Pol Rev (Special Issue: Large and Complex Banks); M Brandao, LR Correa and H Sapriza, 'International Evidence on Government Support and Risk Taking in the Banking Sector' IMF Working Paper 13/94 (2013); B Gadanetz, K Tsatsaronis and Y Altunbas, 'Spoilt and Lazy: The Impact of State Support on Bank Behavior in the International Loan Market' (2012) 8(4) Intl J C Bank 121.

134 Investopedia, Net Interest Margin, (March 19 2018) reviewed by James Chen, available at: <https://www.investopedia.com/terms/n/netinterestmargin.asp>, accessed 15 December 2018.

135 R Gropp, H Hakenes and I Schnabel, 'Competition, Risk-shifting, and Public Bail-Out Policies' (2011) 24 Rev Fin Stud 2084, available at: <https://www.coll.mpg.de/pdf_dat/2010_05online.pdf>, accessed 16 December 2018.

136 Ibid at n. 3 (Avgouleas, Goodhart) 3, 19.

137 A Kovner, J Vickery and L Zhou, 'Do Big Banks Have Lower Operating Costs?' (March 2014), 20 Federal Reserve Bank of New York, Econ Pol Rev, Volume 20 Number 2, (Special Issue: Large and Complex Banks), available at: <http://business.cch.com/BANKD/EconomicPolicyReview-Kovner-03262014.pdf>, accessed 16 December 2018.

adversities in assessing the stability of bank balance sheets. [138] Additionally, if a bank is failing and the bail-in tool is indeed implemented, it would probably amplify procyclicality effects. [139] The weaker the banks become after the ensuing restructuring and recapitalization, the harder and more expensive it would be for them to have access to new funding. Despite the fact that increased creditor monitoring fosters more prudent and cautious policies, in the event of a generalized recession, the financial and banking system in a given sovereign will seem weaker. In that regard the ECB has been skeptical about bailing-in bank bondholders.[140]

Of course a counterargument might be that the previous vicious cycle of sovereign and bank indebtedness, which lead to the fiscal derailments of the past is in essence being eradicated; but should the costs of bank recapitalizations be too high, it would be doubtful if it is worth shifting the burden from the taxpayers to the pension funds, insurance companies, domestic investors and ultimately the remainder of banks. If the regulator is forced to choose the lesser of two evils, does that entail that people's pensions must be put at risk? It is highly debatable that should the crisis change form, it would be genuinely less severe and more contained than before. [141]

Another aspect of forcing banks to issue bail-in-able debt may not be at first glance the costs of such an endeavor but rather that of adverse selection. [142] To that end an excessive relaxation of the subordination requirement for MREL under the BRRD is a dangerous experiment. A smooth and unencumbered application of the bail-in tool to the rest of the financial system requires bail-in-able securities to be clearly identified by investors as such. The new regime ought to have stipulated that securities which could eventually be bailed-in should ideally be issued under clear contractual terms that establish explicit conversion triggers and fix their subordination to non-eligible liabilities. [143]

138 E Avgouleas and J Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (2014) 41 J Law and Society 28.

139 Will Kenton, 'Procyclic', (12 April 2018) Investopedia, Insights/ Markets & Economy: *"Procyclic refers to a condition of positive correlation between the value of a good, a service or an economic indicator and the overall state of the economy. In other words, the value of the good, service or indicator tends to move in the same direction as the economy, growing when the economy grows and declining when the economy declines"*, available at: <https://www.investopedia.com/terms/p/procyclical.asp>; Ibid at n. 3 (Avgouleas, Goodhart) 3, 20.

140 In his 30 July 2013 confidential letter to the then competition commissioner Joaquin Almunia, the ECB's President Mario Draghi was reported to have expressed key concerns about the EU's bail-in regime under the draft BRRD. In particular, Draghi was reported, by Reuters, who saw the letter, to have said that *'imposing losses on junior creditors in the context of such "precautionary recapitalizations" could hurt subordinated bank bonds' and then adding: '... structurally impairing the subordinated debt market. . .could lead to a flight of investors out of the European banking market, which would further hamper banks' funding going forward'. Reuters, 'Draghi asked EU to keep state aid rules for banks flexible'* (Milan, 19 October 2013) <http://www.reuters.com/article/2013/10/19/us-banks-bondholders-draghi-idUSBRE99I03B20131019>, accessed 16 December 2018.

141 Ibid at n 3 (Avgouleas, Goodhart) 3, 21.

142 Steven Nickolas, 'Moral Hazard vs Adverse Selection', Investopedia (20 December 2017), available at: <https://www.investopedia.com/ask/answers/042415/what-difference-between-moral-hazard-and-adverse-selection.asp>,accessed 16 December 2018.

143 Ibid at n 104 (Restoy) p 5.

The issuance of bail-in-able debt may also affect banks' choice of assets. Because banks are forced to issue a minimum amount of eligible/bail-in-able liabilities (MREL), as a percentage of total liabilities, (and own funds), rather than as percentage of risk-weighted assets, it will produce higher costs for institutions with a large portfolio of assets with a low risk-weighting (ie. mortgages). These institutions usually hold small amounts of capital in proportion to their total liabilities.[144]

4.2.4.1 The middle class issue

The resolution framework as envisaged in the BRRD is quite stringent; it heavily restricts the availability of public funds and the utilization of the SRF unless 8% of the institution's total liabilities have contributed to its loss absorption and recapitalization needs. Hence the institutions are obliged to hold on their balance sheets a minimum amount of liabilities and own funds subjected to bail-in in the event of resolution (MREL). This policy is quite novel even for the Key Attributes' standards. As a consequence much is left to the resolution authorities (and the SRB in the Banking Union) to determine the characteristics of MREL.

Undoubtedly, the SRB has opted for a demanding approach. MREL requirements will be set at approximately twice the regulatory capital, [145] namely around 25-27% of risk-weighted assets (RWAs) on average for institutions under the SRB's remit. [146] This exceeds even the standards set by the FSB for G-SIFIs and will be probably imposed to most if not all significant institutions in the BU and not only to those deemed globally systemic. Thus by conservative estimates, (see *F. Restoy*), the European banking industry will need to offset a shortfall of eligible liabilities that could exceed 117 billion EUR. [147] This data can be extracted by the SRB and corresponds to banks that held 80% of total assets of SRB banks. By other estimates, for instance that of the EBA, the total shortfall for significant EU banks could be between 130 billion EUR to 285 billion EUR depending on the final calibration of the MREL eligibility criteria. [148]

144 Ibid at n 3 (Avgouleas, Goodhart) 3, 20.
145 "*The reference used by the SRB is twice the sum of Pillar 1 and Pillar 2 requirements plus the combined buffer requirements plus a market confidence charge".* See SRB, 'Minimum requirement for own funds and eligible liabilities (MREL): SRB policy for 2017 and next steps', (December 2017), available at: <https://srb.europa.eu/sites/srbsite/files/item_1_-_public_version_mrel_policy_-_annex_i_-_plenary_session.pdf>, accessed 21 December 2018, p 10.
146 D Laboureix, Single Resolution Board, 'Sixth industry dialogue: 2017 MREL policy', (21 November 2017) available at: <https://srb.europa.eu/sites/srbsite/files/20171120_6th_industry_dialogue_item_2_mrel_dominique_laboureix.pdf>, accessed 21 December 2018, pp 6-7, 14.
147 Ibid p 14; See also n 104 (Restoy), p 4.
148 European Banking Authority, 'Quantitative update of the EBA MREL report', (December 2017), available at: <https://eba.europa.eu/documents/10180/1720738/Quantitative+update+of+the+EBA+MREL+Report.pdf>, accessed 21 December 2018, p 13.

These alarming findings can become particularly disturbing if we contemplate the business model of most medium-sized banks in the EU and Banking Union. The majority of significant institutions under the SRB's remit that follow a traditional business model whereby they lean on deposits and capital to acquire the necessary funding to conduct business, will face extreme hardship in making up for the huge shortfall, given of course that they have limited access to capital market financing. To that end by taking a peek on the relevant data and research, around 70% of significant banks under the SSM's direct supervision are not listed, 60% of them have never issued convertible instruments and 25% have not issued subordinated debt either. [149]

In that regard F. Restoy [150] gives an illustrative example; Notably if an ordinary medium-sized bank with a traditional business model and most of its funding deriving from equity and deposits, holds capital above the minimum regulatory threshold by say 25%, it will have to issue eligible and preferably subordinated instruments of up to at least 0.75 of its regulatory capital given that MREL is set at twice regulatory capital. Bearing in mind that the required reimbursement of newly issued subordinated debt is between half and two thirds of the return on equity of the firm, such MREL requirements will entail that a bank will have costs between 30 and 40% of its annual pre-tax profits. [151]

Thus it is more than clear that the extent of the shortfall and the potential impact of such strict requirements might have on a large part of the banking industry, will dictate the SRB's approach. In particular MREL requirements should always be imposed to make the specific resolution plans of the institutions feasible. An absence of a deadline and a long transitional period to meet the MREL requirements will not serve this purpose. An extensively long period for banks to meet the MREL requirements, (given that most of them are not yet compliant with the respective criteria), will impair the bail-in resolution strategies during this transition and will imply that institutions will have to subject uninsured deposits to bail-in in order to catch the 8% threshold and subsequently gain access to the SRF. This strategy would be dangerous and politically destabilizing. [152]

If bail-in conditions and the associated TLAC/MREL requirements solidify themselves as stringent as currently proposed, they could have a profound impact on banks' business models. Especially on those who lack the capacity to resort to capital markets and issue subordinated or convertible liabilities to meet the required amounts of

149 Ibid at n 104 (Restoy), p 4; Data extracted from SNL Financial.
150 Fernando Restoy, Chairman of the Financial Stability Institute, Bank for International Settlements.
151 Ibid at n 104 (Restoy), p 4.
152 Ibid at n 104 (Restoy), pp 4-5.

bail-in-able debt. Thus, it is quite possible that relevant elements of the resolution framework, which relies on the principle of bail-in, could be applied to those institutions that not only meet the public interest threshold for the use of resolution powers but whose size and business models allow them to draw large amounts of subordinated liabilities from the markets that could be bailed-in in resolution, without risking financial stability. For the remainder of institutions unable to meet their TLAC/MREL requirements, resolution authorities must satisfy themselves that their failure will not meet the public interest condition and endanger financial stability, since the alternative to resolution is regular insolvency proceedings. [153]

As a consequence the effectiveness of the resolution framework requires the division of the banking system into two well defined sections. The first one comprising large systemic banks able to resort to capital market financing, that could be subject to resolution including bail-in in case of failure, and the second one comprising non-systemic banks that could be subject to regular insolvency procedures. That leaves outside a portion of *middle class* institutions whose failure could be considered systemic but their business model disallows them from meeting the stringent MREL requirements. [154]

4.2.5. Liquidity issues

Within an ongoing bail-in process it is quite possible that the ailing financial institution would only be able to conduct business along the lines of emergency liquidity assistance. Yet the amount of assistance in the form of lifeline liquidity from central banks, (ie. the ECB and resolution funds), could be seriously confined by the lack of high-quality collateral to back that assistance in the form of loans, and by the restrictions to seek the aid of taxpayers and impose losses on them. This process could be more intensive and cumbersome if a number of institutions have to be resolved at the same time. In the end liquidity support would be directed at safeguarding critical economic functions of the bank whilst other parts of the business are resolved. [155]

Central banks and resolution funds will probably be unwilling to bind themselves to pre-agreed liquidity assistance in all instances. Moreover, there is the issue of cross-border liquidity assistance concerning international banking groups, whereby each central bank will only provide assistance in its own currency. [156] A robust resolution plan drawn in

153 Ibid at n 104 (Restoy), p 5.
154 Ibid at n 104 (Restoy), p 6.
155 Ibid at n 3 (Avgouleas, Goodhart) 3, 21.
156 International Monetary Fund, Board Paper, ‘Cross-Border Bank Resolution: Recent Developments’, (2 June 2014), available at: <http://www.imf.org/external/np/pp/eng/2014/060214.pdf>, accessed 26 December 2018, pp 15–17.

advance will be of essence and resolution authorities will need to satisfy themselves that another route is available without the provision of any liquidity; namely a plan that involves the immediate winding down of the failed entity via a series of rapid sales and transfers. Yet this strategy would undermine the core principle of the open bank bail-in regime, that is the continuation of the resolution entity and/or of its operating subsidiaries as going-concern.[157]

4.2.6 Creditors' flight and contagion effects

One key factor of the effectiveness of taxation is that the taxed cannot easily evade it. The only way to evade taxation is by migrating, however that comes along with large transitional costs. On the contrary creditors when they sense that they are being targeted as a consequence of bail-in can simply withdraw or sell their claim. Therefore, when the bail-in mechanism is triggered and the need for large scale recapitalizations arises, it will likely cause a capital flight and a significant increase in funding costs. Creditors who sense in advance that they are being on the spotlight, and creditors of institutions that are constituents of the same country with a similar business model, will have reasonable incentives to withdraw deposits, sell debt, hedge their stakes or purchase credit protection at a higher premium, thus ultimately severely disrupting the markets. These actions might prove to be detrimental to a single institution[158] and potentially have wider implications to market confidence, a point that is also underpinned by bail-in supporters. [159] Experience has shown that market tendencies to resort to panic during sector-wide stresses would most certainly produce contagious and destabilizing effects once a generalized bail-in mechanism is triggered.

Given that the threshold of protection for guaranteed deposits is relatively law, a significant segment of uninsured large depositors might flee to other banking schemes that offer more attractive interest rates such as the contemporary *Chinese shadow banks*.[160] However it is true that equity holders and bondholders cannot flee in the same manner that depositors can, but financial counterparties can easily do and will swiftly do so if they

157 Ibid at n 5 (KPMG) p 7.
158 C Randell, 'The Great British Banking Experiment –Will the Restructuring of UK Banking Shows Us How to Resolve G-SIFIS?' (November 2011), (Paper prepared for the LSE Financial Markets Group Conference on 'Banking Structure, Regulation and Competition').
159 S Micossi, G Bruzzone and M Casella, 'Bail-in Provisions in State Aid and Resolution Procedures: Are they consistent with systemic stability?' (21 May 2014), CEPS Policy Brief No 318, available at: <https://core.ac.uk/download/pdf/20380155.pdf>, accessed 27 December 2018, pp 8-9.
160 Bloomberg, 'A Guide to China's $10 Trillion Shadow-Banking Maze', (June 7 2018), Markets / Bloomberg News, available at: <https://www.bloomberg.com/news/articles/2018-06-07/a-guide-to-china-s-10-trillion-shadow-banking-maze-quicktake> accessed 26 December 2018.

sense that the bailed-in bank does not possess a robust capital layer. [161] If these truly run the equity and bondholders will most certainly follow and by doing so they will drive many of the firm's assets rapidly down to a degree that it would be virtually impossible for the bank to acquire new funding, or roll over existing maturing bonds. Naturally, the situation that will be formed would be particularly unattractive. Credit extension in such circumstances would probably cease, leading to a further asset value free fall and exposure of other banks to the risk of insolvency. An initiative to exclude from the application of bail-in all depositors might reduce the danger of contagion but would not remove it completely.[162]

161 Ibid at n 1 (Sommer).
162 Ibid at n 3 (Avgouleas, Goodhart) 3, 21 – 22.

5. Conclusions

This study provided a comprehensive analysis of the bail-in centered regime in terms of the legal, socioeconomic and political challenges that surround its implementation and overall effectiveness. It is by no means the purpose of this overview to demonize this new shift of perspective in dealing with banks in financial distress, but rather to raise awareness with respect to the implications it might have on a wide array of sectors. Undoubtedly so, (quoting the words of a leading practitioner): *"Bail-in under the BRRD is complicated"*. [163] This statement stems from the fact that it derives from a highly complex bank resolution legal framework. It grants resolution and supervisory authorities ample discretion to decide upon sensitive matters that could have divergent outcomes and could often produce controversial or non-consistent decisions. The cases presented, (supra in 3.1.1, 3.1.2 and 3.1.3), serve as typical examples in that respect. These cases manifestly indicate that the European resolution framework offers many routes for the authorities to stabilize ailing institutions; As a result, mandatory burden sharing of the banks' creditors and the degree thereof in the form of a private penalty for their failure, can be somewhat subjugated to political bullying. Ultimately, bail-in centered resolution under the BRRD can produce satisfactory outcomes ex post yet it is uncertain whether it can reinstate market discipline; namely risk-reflect pricing of bank capital ex ante. [164]

Perhaps a more radical solution proposed by some scholars is needed. That is the disentanglement of bail-in and the subsequent creditors' participation from the broader resolution process and the dependence of the former on the uncertain resolution outcomes. To that end bail-in should be confined solely as a tool for the recapitalization of a distressed bank essentially detached from the imminent restructuring of its business structure, (i.e. with the utilization potentially of the sale of business or asset management tool), which inherently requires case by case analysis and wide discretion. [165]

The highly discretionary trigger event should be replaced with a clearer trigger event by restricting the private involvement to specially designated capital instruments, thus pre-determining the scope of bail-in. These alternative instruments may include a sufficiently

163 Simon Gleeson, 'The Architecture of the BRRD – A UK Perspective' in Danny Busch and Guido Ferrarini (eds.) European Banking Union (OUP 2015) para 12.36.
164 Ibid at n 108 (Troeger), p 33.
165 Thomas F Huertas, *'Safe to Fail: How Resolution will Revolutionize Banking'*, (Pal-grave Macmillan 2014), in safe to fail chapter: *(distinguishing between the determination of the resolution trigger, the stabilization over the proverbial weekend, and the restructuring with the sale of assets, discontinuation of business lines etc.)*82, 89; Ibid at n 108 (Troeger) p 33.

high amount of contingent convertible instruments (*CoCo-bonds*) [166] on a bank's capital layer. One key feature of *CoCo-bonds* and other convertible instruments is that they can be utilized at an earlier stage independently of the initiation of resolution [167] and thus incrementally contribute to a bank's recapitalization, if need be. Therefore, desirable market discipline can be achieved by enhancing predictability of creditors' contribution in going-concern scenarios and equipping them with more certainty. [168]

The regulation of TLAC and MREL provide some certainty in that regard, (in terms of high quality financial instruments subjected to bail-in), yet the stringent requirements as envisaged by the authorities should severely restrict from the majority of European Banks in the future the option of raising necessary funding to retain authorization. Most European universal banks today lack profitability and fall in the category of medium-sized institutions, which are further squeezed by international competition from large systemic institutions with continuous access to capital market financing. In order to preserve the no-bail-out principle, many of these institutions unable to meet the strict requirements, will be put to ordinary insolvency proceedings and liquidation, albeit considered systemic. This may lead to the disruption of their critical economic functions, the very notion that the resolution regime sought to protect under the *public interest threshold*. Thus, a *special insolvency regime* applicable to this segment of *middle class* institutions might be the safest route. This new regime should acknowledge the peculiarities of the financial sector, and in contrast to the ordinary insolvency procedure which aims at maximizing profit to satisfy creditors, will mitigate the adverse impact of banks' failure and will not lead to unnecessary destruction of value. [169]

In the EU there is a need to develop a harmonized *special insolvency regime* for financial institutions given the divergence of insolvency rules applied at the domestic level and the incapacity of many institutions to adapt to a common resolution framework operated by a single European authority. In that respect it is worth noting the recent

166 Darell Duffie, 'A Contractual Approach to Restructuring Financial Institutions' in George P Schultz, Ken E Scott, and John B.Taylor (eds), *Ending Government Bailouts as We Know Them* (Hoover Institution Press, 2010), p 109, pp 109-110; Ceyla Pazarbasioglu et al, 'Contigent Capital: Economic Rationale and Design Features' (2011) IMF Staff Discussion Note SDN/11/01, 7-8, available at: <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf>, accessed 5 January 2019; Mark J Flannery, 'No Pain, No Gain? Effecting Market Disci-pline via 'Reverse Convertible Debentures'' in: Hal S Scott (ed), *Capital Adequacy Beyond Basel: Banking: Securities, and Insurance* (OUP 2005), p 171, 173, pp 175-182.

167 Enrico Perotti and Mark Flannery, 'CoCo bonds as a way of preventing risk', (2011) VOXEU policy contribution <http://voxeu.org/article/coco-bonds-way-preventing-risk>, accessed 5 January 2019.

168 Ibid at n 108 (Troeger) p 9.

169 Ibid at n 104 (Restoy) p 6.

proposal of the US Treasury to develop a new Chapter 14 of the US bankruptcy Code [170] for financial institutions that meet specific criteria.

Everyone acknowledges that bail-ins are far superior to bail-outs in the case of idiosyncratic failures, however in the event of a sector-wide shock the bail-in tool may prove itself insufficient. Hence, a credible government backstop[171] should be in place to ease any rational and irrational fears of investors in bail-in-able debt that could otherwise flee at a moment's notice. This is also of particular importance as regards deposits in Euro-zone member states, where depositors in the same currency may migrate from member states with weaker sovereigns to more solvent ones.[172] Other critical issues may concern the rapid restoration of market confidence in the failed firm, the accurate valuation of its losses and the successful restructuring of its franchise profile to develop a sound business model.

170 US Department of the Treasury, 'Orderly liquidation authority and bankruptcy reform', (21 February 2018), available at: <https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf>, accessed 5 January 2019.
171 Ibid at n 3 (Avgouleas, Goodhart) 3, 29.
172 D Schoenmaker, 'A Fiscal Backstop to the Banking System' (July 2014), Duisenberg Business School, DSF Policy Paper No 44.

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List of abbreviations

AQR	Asset Quality Review
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1
CoCos	Contingent Convertibles
DFA	Dodd-Frank Act
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EBU	European Banking Union
ECB	European Central Bank
EPFS	Extraordinary Public Financial Support
ESM	European Stability Mechanism
EU	European Union
FMIs	Financial Market Infrastructures
FOLTF	Failing or Likely to Fail
FSB	Financial Stability Board
G-SIBs	Global Systemically Important Banks
G-SIFIs	Global Systemically Important Financial Institutions
MPS	Monte dei Paschi di Siena
MREL	Minimum Requirement for own funds and Eligible Liabilities
NCWO	No Creditor Worse Off
NIM	Net Interest Margin
NPEs	Non-Performing Exposures
NPLs	Non-Performing Loans
NRAs	National Resolution Authorities
OLA	Orderly Liquidation Authority
PONV	Point of Non-Viability
PSI	Private Sector Involvement
RWAs	Risk-Weighted Assets
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TBTF	Too Big To Fail
TFEU	Treaty for the Functioning of the European Union
TLAC	Total Loss-Absorbing Capacity