O Tell Me The Truth About Bail-In: Theory and Practice

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Abstract

This Article analyzes the functioning of the European regulatory approach to the crisis of credit institutions, in the framework of EU banking supervision and in light of its early applications, with a special focus on bail-in. We investigate how the new resolution mechanisms — rooted in the principle of private sector involvement in banking restructurings — have inter-played with legal and institutional contexts still characterized by an attitude to bail-out rescues and by non-harmonized national insolvency rules. We show how and well-experimented restructuring tools have influenced the application of the new ones and, in many cases, have emphasized the defects, pitfalls and inconsistencies of the new regime, suggesting paths for reform. The Article is organized as follows. Part II sets out a summary of the common regime applicable to credit institutions within the EU, based on harmonized requirements for capital and liquidity. Part III focuses on the pre-crisis and crisis tools, as spelled out in the Bank Recovery and Resolution Directive ("BRRD"), in coordination with bordering regulatory areas, such as the regimes applicable to the liquidation of insolvent banks and State aids in the context of banking rescues. After a brief comparison with the US system (Part IV), we dwell, in Part V, on the practice of restructurings, before and after the BRRD. We specifically discuss two cases (the resolution of Banco Popular Español and the liquidation of Italian "Banche Venete") that, in our view, illustrate very well the pros and cons of the new regime. Part VI concludes offering some suggestions for possible reform.

Keywords: bail-in, BRRD, insolvency, banking law, CRD IV, Basel, ECB, Single Supervisory Mechanism, Single Resolution Mechanism, State Aid

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O Tell Me The Truth About Bail-In: Theory and Practice‡

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I. INTRODUCTION……………………………………………………………..........

II. THE EUROPEAN BANKING UNION AND THE SINGLE RESOLUTION MECHANISM ....

A. *The Banking Union and the Single Supervisory Mechanism*…………………………..

B. *Capital and Liquidity Requirements: A Bird's Eye View of Basel III and the CRR and CRD IV*………………………………………………………………………

C. *Impact of Basel III on the Banking Business and Economic Performance*………………….

D. *The Uncertain Future of the European Deposit Scheme*………………………………..

E. *Broadening our Visual: Framework of the European Financial System of Supervision*……

III. EARLY INTERVENTION, RESOLUTION AND LIQUIDATION……………………..

A. *Pre-Crisis Precautions*…………………………………………………………..

B. *Early Intervention on a Troubled Going Concern*……………………….……………

C. *Resolution of a Failing or Likely to Fail Concern: Triggers and Tools, with a Focus on Bail-in*………………………………………………………………………………..

D. *Judicial Review of Resolution Actions*………………………………………………..

E. *Liquidation*……………………………………………………………………

F. *State Aids* ..…………………………………….……………………...……..

IV. A BRIEF COMPARISON WITH THE U.S. ………………….……………….…….…

A. *The US Rules: A Summary of the Existing Framework* ……………………………….

B. *A Possible Involution: The TPRRA Bill* ……………………………………………

‡ For comments and observations, we wish to thank Andrea Resti. We are particularly grateful to Brando Maria Cremona for excellent research assistance.

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C. *Some Notable Differences Between the US and EU Models* ……………………………

V. EXPERIMENTA IN CORPORE VIVO………………………………………………

A. *When BRRD Did Not Exist: A Pre-History of Banking Rescues*………………………

B. *The Financial Crisis and the "Private Sector Involvement": Towards the BRRD, in Open Order* ………………………………………………………………………….

C. *Common Trends in the National Management of Banking Crises* ……………………

D. *BRRD (and SRMR) at Their First Steps* ………………………………………

VI. SOME REFLECTIONS ON THE BAIL-IN TOOL, FROM THEORY TO PRACTICE, AND A FEW MODEST PROPOSALS …...……………………………..….….…………

When it comes, will it come without warning
Just as I'm picking my nose?
Will it knock on my door in the morning,
Or tread in the bus on my toes?
Will it come like a change in the weather?
Will its greeting be courteous or rough?
Will it alter my life altogether?

— WH Auden, *O Tell Me The Truth About Love*, 1932-1939

I. INTRODUCTION

Love and Bail-in have little in common besides their largely unpredictable, incognizable and ineffable nature captured by the unanswered questions raised by WH Auden in the last stanza of his poem transcribed in the epigram. For regulators, banks, investors and practitioners, but more generally for society, however, a critical understanding of bail-in can be no less important, if less romantic, than of the causes and consequences of deep feelings. To recognize the risks and negative effects of unhealthy relationships might be particularly relevant both emotionally and practically, and their complexity and baffling mechanics should not impede an assessment of what is not working and should be changed. After all, in the same ballad, the Poet also wonders whether Love «*Has it views of its own about money?*», something that bail-in certainly has, as thousands of investors have unexpectedly discovered to their chagrin in the last few years, in Europe and elsewhere.

While the parallel we are drawing might seem forced, we believe that legislators, regulators and many scholars have fallen heads over hills with bail-in, with its possibly elegant but surely highly theoretical framework, underestimating its practical implications and what it needs to concretely and effectively operate. The reasons of this being enamored are different, more and less noble and pure, but as with all love affairs, after the first idyllic moments the practicalities become as important as the initial passion. This is not to say that we are pessimistic about the future of bank resolution based on the rationale of bail-in, but simply to underscore how the hasty and critical conditions in which it has been developed might have hazed and dazed a deeper understanding of its actual workings. The first few cases where the new regime applied, in the final phases of the great financial crisis commenced in 2007-2008, clearly show the many shortcomings of the new rules an suggest an understandable "escape" from bail-in.

In this perspective, the purpose of this Article is to analyze the functioning of the European regulatory framework for the crisis of credit institutions, in the light of its early applications and with a special focus on the bail-in tool. We will investigate how the new resolution mechanisms—rooted in the principle of private sector involvement in banking restructurings—have interplayed with (and tried to re-shape) legal and institutional contexts still characterized by an attitude to bail-out rescues and by non-harmonized national insolvency legislations. We will see that old and well-experimented restructuring tools have influenced the application of the new ones much more than expected and, in many cases, have contributed to shed light on defects, pitfalls and inconsistencies of the new regime, suggesting paths for reform.

The Article is organized as follows. Part II sets out a summary of the common regime applicable to the credit institutions within the EU (so-called European Banking Union), based on harmonized requirements for capital and liquidity. Part III focuses on the pre-crisis and crisis tools, as spelled out in the Bank Recovery and Resolution Directive, in coordination with bordering regulatory areas, such as the regimes applicable to the liquidation of insolvent banks and State aids granted in the context of banking rescues. After a brief comparison with the US system (Part IV), we dwell, in Part V, on the practice of restructurings, before and after the BRRD. We will focus on two cases (the resolution of Banco Popular Español and the liquidation of Italian "Banche Venete") that, in our view, are demonstrative of the progresses and contradictions of the new regime. Part VI concludes this Article, offering some suggestions for possible reforms.[1]

The problems we tackle are truly too complex, heterogeneous and multi-layered to be summed up in a formula or slogan for the improvement of the system. In a nutshell, however, the core of our proposal, based on a detailed analysis of the regulatory framework and the first applications of the BRRD, revolves around four ideas: (1) a clarification and harmonization of the concept of "public interest" relevant for both the adoption of resolution tools and State aid; (2) harmonization of national insolvency and liquidation rules or, more precisely (and realistically) of those aspects that might facilitate the adoption of the resolution decisions and a leveled-playing field; (3) a more flexible write-down requirement than the current 8%, in light of the completion of the MREL cushion; (4) greater transparency and better timing for resolution decisions.

[1] The Authors of this Article have been professionally involved, directly or indirectly and in different capacities, with some of the intermediaries whose cases are discussed briefly below. We disclose this in the interest of full transparency, however, in light of the circumstances of those activities and the approach of this Article, we believe that no conflict of interest or other possible bias has affected our analysis, and on the contrary that those activities have improved our understanding of the law in action and its practical implications.

II. The European Banking Union and the Single Resolution Mechanism

A. *The Banking Union and the Single Supervisory Mechanism*

The crisis of 2007-2008 exposed dramatically how financial supervision is seriously impaired by lack of cross-border coordination: international banking activity requires, obviously, transnational controls and crisis management.[2] The problem is not only one of effectiveness and resources, but also of incentives: national authorities incur in conflicts of interest, primarily pursuing the protection of local businesses, markets and constituencies and sub-optimal results.[3] The problem was particularly acute in the European Union, where national divergences in terms of supervision of banks (and other financial intermediaries[4]) and crisis management might hinder the development of a single market for financial activities and hamper the transmission mechanisms of—now, unitary—monetary policy.[5]

The crisis was the perfect catalyst to accelerate a centralization process whose rationale and desirability, if not necessarily political consensus, were already discernible. The EU Member States reached the agreement on the creation of a Banking Union ("BU") in the late spring of 2012. It comprises three major "pillars".[6]

The first one is the Single Supervisory Mechanism ("SSM"), pursuant to which the European Central Bank ("ECB") is the primary authority responsible for prudential supervision of banks, in cooperation with the National Central Banks ("NCBs"); it became effective in November 2014.[7] The ECB directly oversees significant banks (roughly 119 entities holding over 82% of the assets of the European banking sector[8]), while control over less-significant ones is attributed to NCBs, under the ECB indirect supervision. The second pillar is the Single Resolution Mechanism ("SRM"), which entrusts the Single Resolution Board ("SRB")—an independent, self-financed agency whose members are appointed by the EU

[2] High Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Report (2016), https://ec.europa.eu/info/system/files/de_larosiere_report_en.pdf; Rosa M. Lastra & Geoffrey E. Wood, *The Crisis of 2007-2009: Nature Causes and Reactions*, 13 J. INT. ECON. L. 531, 537-45 (2010).

[3] ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE AND THE WORK AHEAD (Penguin Press 1st ed.2013); Viral V. Acharya *et al.*, *Manufacturing Tail Risk: A perspective on the Financial Crisis of 2007-2009*, 4 FOUND. & TRENDS IN FIN. 247 ff. (2009).

[4] In this Article we will focus on banks, also considering the prevalence, in Europe, of the "universal bank" model, whereby credit institutions provide to clients, in addition to deposit and lending services, a variety of financial services, including investment and advisory services.

[5] Mario Draghi, *Benefits of European Supervision*, Speech at the ACPR Conference on Banking Supervision (Sep. 18, 2018); European Commission, *Communication for the Spring European Council: Driving European recovery*, COM (2009) 114 final (Mar. 4, 2009); *Id.*, *Communication from the Commission to the European Parliament and the Council: A Road Map towards a Banking Union*, COM (2012) 510 final (Sept. 12 2012); *Id.*, *Communication to the European Parliament, the Council the European Economic and Social Committee and the Committee of Regions: A reformed financial sector for Europe*, COM (2014) 279 final (May 15, 2014).

[6] For an overview *see, e.g.,* Christos V. Gortsos, *Institutional and Legal Aspects of the European Banking Union: Status Quo and the Way Forward*, 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3093830.

[7] *See* Regulation (EU) 2013/1024 of the Council of the European\ Union of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 O.J. (L 287) [hereinafter SSM Regulation], as well as the relevant implementing regulation: Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities, 2014 O.J. (L 141) [hereinafter SSM Framework Regulation].

[8] *See* the latest data released by the European Central Bank, available at https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html.

Council—with the task of managing resolutions of banks according to the Bank Recovery and Resolution Directive ("BRRD" or "Directive").[9] The SRB, which opened its doors in 2015 but became fully responsible for resolutions only at the beginning of 2016, works in close cooperation with the ECB (for example, the competence to declare if a bank is "Failing or Likely to Fail" —or, "FOLTF"—is of the latter: see below)[10], and the National Resolution Authorities ("NRAs", which are often, but not always, NCBs), and with the other authorities that might be involved in a resolution procedure. Finally, the BU will be completed with the erection of a third pillar, a European Deposit Insurance Scheme ("EDIS"), which is currently under construction amongst political and economic tensions.[11]

In terms of scope of application, it is worth noting that the SSM, SRM and EDIS apply (or will apply) to the nineteen countries of the Eurozone, while the underlying legislation, *i.e.* the Capital Requirements Regulation and Directive (aka "CRD IV"),[12] the BRRD, and the Deposit Guarantee Scheme Directive ("DGSD")[13], constituting the co-called "Single Rulebook", applies to all the 28 members of the European Union, including the ones that have not adopted the single currency. EU countries that do not join the Euro can voluntarily participate in the SSM and in the SRM (however, participation in the former is a pre-condition to participate in the latter). At the time of this writing, no non-Euro jurisdiction has made this option, even though some studies advocate its desirability.[14] The ECB enters in memoranda of understanding on how to cooperate on supervisory matters with the national supervisors of non-participating countries.

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[9] Directive (EU) 2014/59 of the European Parliament and the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, 2014 O.J. (L 173). *See* also Regulation (EU) 2014/806 of the European Parliament and the Council of 15 May 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, 2014 O.J. (L 225) [hereinafter SRMR].

[10] If the Member State so provides, the resolution authority may be vested with the power to declare the FOLTF status. *See* Art. 32(2) BRRD. In order to ease the coordination between supervisory and resolution authorities, the EBA has issued guidelines on the FOLTF: *see* EBA, *Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*, EBA/GL/2015/07 (May 26 2015).

[11] *See* Paragraph II.D below. The main goal of the EDIS is reducing the vulnerability of national deposit guarantee schemes to large local shocks, whilst offering a uniform insurance coverage notwithstanding the relevant geographical location of the deposits within the Banking Union. *See* European Commission, *Communication by the European Commission to the European Parliament, the Council, the European central bank, the European economic and social committee and the committee of the regions on completing the Banking Union*, COM (2015) 587 final (Nov. 24 2015); Jim Brundsen, *Germany stands firm against EU bank deposit guarantee plan*, FIN. TIMES, Oct. 11, 2017, available at https://www.ft.com/content/58c9a172-ae7d-11e7-beba-5521c713abf4; Dirk Schoenmaker & Guntram B. Wolff, *What Options for European Deposit Insurance?*, BRUEGEL BLOG (Oct. 8, 2015), http://bruegel.org/2015/10/what-options-for-european-deposit-insurance. For a recent discussion of EDIS, Christos V. Gortsos, *The European Deposit Insurance Scheme (EDIS)*, in EUROPEAN ECONOMIC LAW (Federico Fabbrini & Marco Ventoruzzo eds., forthcoming 2019).

[12] Regulation (EU). 2013/575 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012, 2013 O.J. (L 176); Directive (EU) 2013/36 of the European Parliament and the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006c/48/EC and 2006/49/EC, 2013 O.J. (L 176), implementing Basel III capital requirements for banks.

[13] Directive (EU) 2014/49 of the European Parliament and the Council of 16 April 2014 on deposit guarantee schemes, O.J. (L 173) 2014, harmonizing deposit insurance in case of a bank's need of financial assistant to pay its creditors.

[14] *See*, e.g., Zsolt Darvas & Guntram B. Wolff, *Should Non-Euro Area Countries Join the Single Supervisory Mechanism?* (Brugel Policy Contribution No. 06, 2013), available at http://bruegel.org/wp-content/uploads/imported/publications/pc_2013_06__.pdf.

Before dwelling specifically into the BRRD and the regulation of bank crisis, it is useful to offer a few additional observations on the structure and functioning of the BU.

The legal framework of the SSM is established by the SSM Framework Regulation, a complex piece of legislation that sets forth the criteria and procedures to determine the significance of financial institutions directly supervised by the ECB, the rules governing common procedures and cooperation between the ECB and the NCBs (and, in particular, the establishment of joint supervisory teams composed of ECB and NCBs personnel to oversee significant banks), relationships with supervised entities and due process principles, authorization and withdrawal of banking licenses, acquisition of qualifying holdings, control over fit and proper requirements for board members and managers, procedural provisions concerning supervision of macro-prudential requirements (essentially, capital and liquidity requirements under CRD IV), sanctions, and many other issues.

In a nutshell, it is worth mentioning, first of all, that a financial institution is significant—and therefore directly supervised by the ECB—if one of the following four criteria, defined by the European Banking Authority ("EBA"), is met: (i) size, *i.e.* if the total value of its assets (on a consolidated basis, if applicable) exceeds €30 billion;[15] (ii) economic importance for the EU economy as a whole or the specific country (more specifically, if a bank qualifies as one of the three largest banks of its Member State or its assets exceed €5 billion and 20% of the GDP of the Eurozone country where it is established); (iii) cross-border activities, if the total assets exceed €5 billion and the ratio of cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%; (iv) public financial assistance, if the bank has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility.[16] The ECB retains however a discretionary power to consider other financial institutions significant and overstepping national authorities directly exercising control thereon. Each year the ECB reviews the list of significant institutions. Changes of status from less significant to significant and vice versa can obviously occur: if a less-significant institution meets one of the abovementioned criteria, it is immediately reclassified as a significant one; on the other hand, a significant institution must fail to meet all the criteria for three consecutive years in order to be downgraded to less-significant and to be placed under direct supervision by a national authority.[17]

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[15] *See* Art. 4 SSM Regulation.

[16] *See* Art. 6 SSM Regulation. The criteria succinctly identified in the text are, in reality, quite complex and detailed. A small set of significant bank are also considered Globally Systemically Important Banks ("G-SIBs") according to the definition adopted in 2011 by the G20 and the Financial Stability Board, which considers size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity. Under EU law, Article 131 of the CRD IV defines Global Systemically Important Institutions ("G-SIIs"). These entities are subject to additional and stricter capital requirements and prudential measures. As of November 2016, there are 30 G-SIBs institutions world-wide, of which 13 located in the EU and 8 in the US (although the three biggest ones are in this country: Citigroup, JP Morgan Chase, and Bank of America), 4 in China, 3 in Japan and 2 in Switzerland. Of the European ones, 4 are in the UK, one in Germany (Deutsche Bank), 4 in France, and one in Italy (Unicredit). Source: B. Mesnard *et al.*, *Global Systemically Important Banks in Europe*, European Parliament Briefing, 2016, available at http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574406/IPOL_BRI%282016%29574406_EN.pdf.

[17] The three-year rule aims at avoiding a scenario of repeated and inefficient alternations of supervisory responsibilities between the NCAs and the ECB. Nonetheless, there are some exceptions (*see* Art. 47 SSM Framework Regulation). For example, under Art. 70 of the SSM Framework Regulation, if "particular circumstances" occur, which would make the classification of a supervised entity as significant inappropriate, the supervisory powers remain with the NCA. The issue of "particular circumstances" has laid the ground for an important judicial case. In 2014 a German *Landesbank* (to be classified as significant institution) claimed that "particular circumstances" according to Art. 70 were present, so that it should be requalified as less significant and, thus,

It's however also noteworthy to point out that certain competences are attributed to the ECB irrespective of the dimensions and significance of the entity. An important example of an area in which the ECB is the sole competent authority concerns authorizations for new banks and financial institutions, as well as the authorization to acquiring qualifying holdings or control in such entities.[18]

Among the numerous and articulated competences and powers of the ECB within the SSM, which would be impossible and not useful to discuss here in general, it is however necessary to provide a brief focus on requirements for capital, liquidity and credit risk as set forth by the CRR and the CRD IV, also in light of their relevance for resolution decisions.

B. *Capital and Liquidity Requirements: A Bird's Eye View of Basel III and the CRR and CRD IV*

The CRR and CRD IV introduced new capital, liquidity and leverage requirements for banks closely following the Basel III approach, but also adopted additional and specific measures aimed at ensuring financial stability, in particular in the area of governance and remuneration of managers.[19] By way of introduction, it is almost superfluous to underline what a constraint such (strengthened) requirements represent for the financial structure of credit institutions and their business model. This regulatory approach has contributed to the flourishment of a (lightly regulated) "shadow banking" system dominated by hedge funds and private equity players, which not only relieve banks from their illiquid assets (NPLs), but are increasingly active in direct lending activities, competing with credit institution on their core playing field.

The overall framework is based on three concepts: minimum capital requirements, private and public assessment of prescribed requirements: *i.e.* an annual self-assessment by individual institutions, the "Individual Capital Adequacy Assessment Process" or "ICAAP"; and a "Supervisory Review Evaluation Process" or "SREP", conducted by the regulators, which is also a possible basis to impose additional capital requirements on single firms.[20] Several of these requirements have been or will be phased-in over the course of a few years, becoming more stringent each year. The specific requirements that we will briefly illustrate are: (i) capital requirements (CET 1, Tier 1 and Total Capital); (ii) capital buffers (capital conservation, countercyclical, important institutions, and systemic risk buffers); (iii) liquidity requirements

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be exempt from ECB supervision). The European General Court dismissed the claim on first degree, but the case is now pending before the ECJ. *See* Case T-122/15, Landeskreditbank Baden-Württemberg v. ECB, 2017 E.C.R. 337 and, for a comprehensive analysis: Filippo Annunziata, *European Banking Supervision in the Age of the ECB. Landeskreditbank Baden-Württemberg – Förderbank v. ECB* (Bocconi Legal Studies Research Paper No. 3139567, 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3139567&download=yes.

[18] Arts. 4, 14 and 15 of the SSM Regulation. *See* Steven Schwarcz, *The Banking Union: A General Perspective*, in 1 EUROPEAN BANKING UNION: THE NEW REGIME (Luis Hinojosa Martinez & Jose Beneyto eds., 2015), at 4.

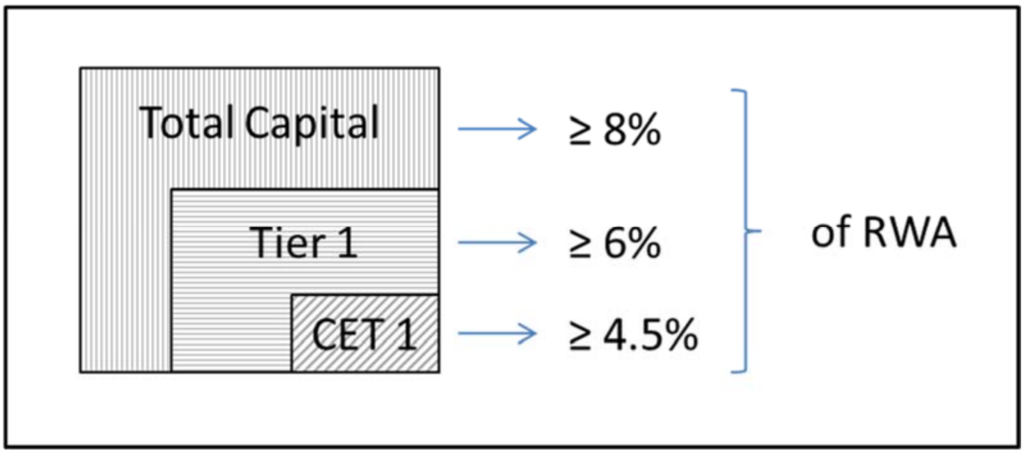
[19] Secondary sources issued in this respect also include technical standards released by the EBA. *See* Paragraph II.E below.

[20] These are the so-called "Pillar 2 capital requirements". *See* below, note **Errore. Il segnalibro non è definito.**. More specifically, Pillar 2 includes by two main elements: the institution's assessment of its capital needs (through the ICAAP) and the regulator's review and evaluation (through the SREP). Following completion of the SREP, regulators may discretionally impose additional CET1 ratio add-ons, tailored to the relevant individual bank. In this regard, the current ECB practice splits possible Pillar 2 capital additions into the following components: a first Pillar 2 requirement (P2R) which is primarily aimed at addressing risks not fully covered by Pillar 1 capital; and a Pillar 2 guidance element (P2G), which serves as guide to the additional appropriate level of capital needed to withstand future stress scenarios. *See* European Central Bank, *SSM SREP Methodology Booklet*, 2017, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_2017.en.pdf?508ca0e386f9b91369820bc927863456.

("Liquidity Coverage Requirement" or "LCR" and "Net Stable Funding Requirement" or "NSFR"). The implications and consequences of not meeting these requirements can be different, according to their different functions and rationales.[21]

Capital requirements are the first relevant set of rules. They mandate a minimum amount of capital and quasi-capital in relation to the quality of assets in terms of risk. In short, different categories of capital must represent at least a set percentage of Risk Weighted Assets ("RWA"). The three relevant categories—Core Equity Tier 1 capital or "CET 1," "Tier 1," and "Total Capital"—are ranked based on their characteristics in terms of permanence (obligation of the bank to redeem), flexibility of distribution (discretion as to the payment of dividends or other forms of remuneration), and subordination (protection of creditors in case of winding-up). Clearly enough, ordinary shares, which provide for no redemption obligation, discretionary and non-cumulative dividends, and deep subordination, are at one end of the spectrum and constitute CET 1; senior debt lays at the opposite end due to the fact that it usually provides for a maturity date, has mandatory payments (and possible default or acceleration in case of non-payment), and counterparties are only subordinated to secured creditors in case of liquidation.

Based on these principles, the major capital requirements can be represented as follows.



CET 1 includes ordinary shares, retained earnings and certain reserves and, as mentioned, is the highest-quality item in terms of permanence, distribution flexibility, and subordination. Additional tier 1 items that, together with CET 1, comprise Tier 1, include perpetual instruments that have no fixed maturity; distribution must in any case be discretionary and non-cumulative. An example might be a call option exercisable at the sole discretion of the bank (but regulatory approval is required). Tier 1 must also be convertible in ordinary shares or written down in case CET 1 is lower than a certain percentage, higher than the minimum (5.125%).

Tier 2 capital, which adds to Tier 1 to determine Total Capital, includes hybrid instruments that fall somewhere in between ordinary equity and debt, such as certain bonds and preferred shares. While they generally are securities, also regular loans might qualify. These instruments must have a maturity of over five years and may be callable by the bank after this period (but there must be no incentives to redeem). In case of winding up, Tier 2 instruments rank above Tier 1 claimants, and distributions might be cumulative and non-deferrable. Specific limitations to holders' rights in case of default or non-payment are necessary. It shall

[21] *See* ANGELO BAGLIONI, THE EUROPEAN BANKING UNION: A CRITICAL ASSESSMENT 46 (Macmillan Publishers, 1st ed. 2016).

be noted that EU and Basel III rules require a "regulatory amortization" of Tier 2 in the last five years to maturity on a straight-line basis: for example, the value of bonds expiring in 2025 will be reduced by 20%, 40%, 60%, 80% and 100% starting in 2020. For this reason, as a practical matter, Tier 2 instruments generally have a duration well exceeding the minimum five years requirement.

The determination of a bank's capital—the numerator of the fraction used to calculate minimum capitalization, and in particular CET 1—is subject to certain reductions essentially aimed at limiting uncertainties due to discretionary evaluations. For example, and without going into more technical details, deferred tax assets that require future earnings to be enjoyed are deducted. Similar deductions apply for treasury stock, goodwill and other intangibles, or specific investments in other financial institutions (this last deduction is also inspired by the goal of reducing interconnectedness).

Coming now to the denominator of the capital requirement fraction, RWA, the basic idea, obviously enough, is to value less risky assets comparatively more: greater risks imply a deterioration of the stability of the bank and its ratios. Banks can adopt one of three methodologies to weight their exposures: the Standardized Approach ("SA"), based on credit rating by recognized external credit assessment institutions ("ECAIs");[22] and the Internal Ratings Based approach or "IRB", which can either be the "Foundation" approach ("FIRB"), or the "Advanced" one ("AIRB"). As the name suggests, the last two methodologies relay on internal procedures of the financial institutions that identify specific default probabilities considering different risk factors, and apply them to classes of assets. The minimum regulatory requirements necessary to accede to these two options require very significant resources: they are therefore limited to the biggest banks.[23]

As for the SA, exposures must be divided into classes based on either the counterparty (e.g., from central governments and banks to corporations and retail clients), or type of asset (e.g., covered bonds, collective investments undertakings, gold bullion), or situation (exposures in default). For each exposure class, a weight must be applied based on the quality of the credit as determined by an external agency (for instance varying from Standard & Poor AAA to CCC+ and below): the better the rating, the lower the reduction of the value. To offer a few examples, treasury bonds issued by a central government with a S&P rating from AAA to AA- have a weight of 0%; with a rating from A+ to A-, have a weight of 20%; with a rating of BB+ or lower, or unrated, have a weight of 100%. Retail exposures, on the other hand, always call for a risk weight of 75%. In certain cases of particularly risky or poorly rated exposures, their weight can even exceed 100%: this is the case of exposures in default that can be discounted at 150%. Risk mitigating factors are considered after applying these percentages: in particular, collaterals might improve the risk profile of an exposure. Clearly enough, the lower the denominator due to a smaller risk weight, the higher the capital ratio measured.

The calculation of RWA also includes off-balance sheet assets, with a further credit conversion factor considering the lower probability of benefits. Finally, derivatives, stock lending

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[22] Financial institutions may use assessments by such external institutions in order to determine the risk weights in the standardized approach for capital purposes. Only ECAIs that have been previously determined eligible by national supervisors may be appointed to perform the above-mentioned tasks. In order to ensure a comparable approach across ECAIs and promote a consistent implementation of European rules, the joint committee of the ESAs, led by the EBA, specifies the necessary correspondence between the credit assessments issued by an ECAI and the credit quality steps set forth in the CRR.
[23] *See* Baglioni *supra* note 21, at 73.

and repurchase agreements are subject to specific evaluation rules and procedures set forth in Articles 192 ff. and 271 ff. of the CRR.[24]

Failure to meet the above-mentioned evaluation rules and procedures may lead to the ECB activating its broad early intervention powers[25] as well as to the infliction of administrative sanctions pursuant to Article 18 of the SSM Regulation. In this regard, the ECB's sanctioning power is confined to those significant institutions that fall under its direct supervision. Consequently, if violations of CRR provisions have been performed by banks classified as less-significant, the competent national supervisory authorities are vested with the power to sanction such breaches.

Since 2016, specific financial institutions are also required to meet additional requirements called "buffers."[26] Buffers have a partial functional similarity with statutory reserves mandated in certain jurisdictions for all corporations, in the sense that they are part of the net worth of a bank designed as a protective cushion for capital: their breach does not affect the operational capacity of a bank, but it limits the ability of the regulated entity to make distributions to shareholders. Four buffers are provided for in the Basel III agreement and transposed in EU rules (Art. 136 of CRD IV), phased in from 2014 through 2019. The "Capital Conservation Buffer" requires an additional amount of CET 1 equal to 2.5% of a bank's total risk-weighted exposures. The "Countercyclical Capital Buffer" is a macro-prudential tool designed as an extension of the Capital Conservation Buffer aimed at countering procyclicality. It must be accumulated in periods of economic expansion to be available, as a protection, during downturns. It is periodically calculated by the local regulatory authorities on the basis of the credit-to-GDP ratio in the regions where the bank operates, applied to the bank's exposures, indicating the additional CET 1 that must be retained. For example, for the first quarter of 2019 the Bank of Italy set the buffer at 0%. Systemically important institutions must also have a specific "SII Buffer" consisting of Tier 1 capital calculated as a percentage of exposures, depending on the category of the institution, roughly varying from 1% to 3.5%. Finally, the "Systemic Risk Buffer" is applied to the entire sector rather than

[24] Since its entry on the scene, the SSM has also made great efforts to strengthen the supervisory tools used to assess the quality of the loan portfolios and, in particular, to manage the issue of non-performing loans ("NPLs"); the progress achieved so far is remarkable, and has stimulated a large reduction of NPL ratios, thus improving the strength of Euro-area banks. In addition to NPLs, sound management of derivatives is important for the stability of a financial institution. Indeed, derivative instruments share several common features with NPLs: they are highly heterogeneous; many of them are opaque and illiquid, lacking an efficient secondary market, and hence subject to relevant downside valuation risk. Therefore, a closer scrutiny of these complex financial products is desirable. In this regard, within the European Union, banks from northern Member States display the largest exposure to this kind of instruments, whereas banks from southern Member States, often deemed more unstable, are characterized by limited exposure. Moreover, while great efforts are deployed into reducing the overall NPL stock, it may be interesting to note that derivatives exposures of banks from northern European countries still remain visibly high, and should thus be reserved closer scrutiny by competent European Authorities: indeed, according to a recent study by the Bank of Italy, in 2016 the amount of financial derivatives reported in the assets of monetary financial institutions was 4% of the total financial assets in Italy, a much lower value than in the UK (27%), Germany (8%) or France (6%): *see* Banca d'Italia, *The derivatives through the lens of the financial accounts: measurement and analysis* (Occasional Papers No. 389, 2017), available at http://www.bancaditalia.it/pubblicazioni/qef/2017-0389/index.html?com.dotmarketing.htmlpage.language=1; *see* also Baglioni, *supra* note 21, at 75.

[25] *See* Paragraph III.B below. As mentioned, the ECB is also vested with the authority of releasing banking authorisations in the Euro area, in accordance with Art. 4 of the SSM Regulation: failure to meet prudential requirements may thus lead, in a worst-case scenario, to the withdrawal of the relevant banking license from the concerned institution.

[26] These requirements do not apply to investment firms that do not underwrite securities or deal on their own accounts, and Member States can exonerate smaller firms from certain buffers.

being calculated on an individual firm basis, therefore tackling general systemic risks. Member States, through a procedure that might require approval by the European Commission, have a certain discretion in imposing this prudential tool, which might require an additional CET 1 of over 5%. It is noteworthy that the Systemic Risk Buffer might cancel off with the SII Buffer, since when they are both applied to a bank, only the higher one will need to be maintained.[27]

In terms of liquidity, the "Liquidity Coverage Ratio" ("LCR") aims at ensuring the financial viability of a bank under a stress-scenario, for a minimum of 30 days. It is determined comparing High Quality Liquid Assets" ("HQLA"), meaning unencumbered and easy-to-liquidate (or liquid) assets with the cash outflows required over 30 days in, as mentioned, a stress scenario. This measure is also phased in: in order to be compliant a the LCR was set at 60% in 2015, 70% in 2016, 80% in 2017, and 100% in 2018, meaning that from this year a bank must always be able to "survive" financially for at least 30 days in adverse conditions. In case of non-compliance with such thresholds, the abovementioned sanctioning powers vested with the ECB pursuant to Article 18 of the SSM Regulation may be triggered[28].

Art. 510 of the CRR, following the Basel III Agreement, also considers financial resilience over a medium-term horizon of one year with the "Net Stable Funding Requirement" ("NSFR"). Another difference between the LCR and the NSFR is that while the former is calculated under a stress scenario based on general market risks, the latter considers firm-specific liquidity risks, limiting overreliance on short-term funds.

The index is determined comparing financial sources weighted in terms of their stability (in light of type of counterparty and contractual terms: for example, capital and borrowing with a maturity exceeding 12 months has a coefficient of 100%, retail deposits of 90%, and corporate deposits with a maturity of less than 12 months of 50%), and assets weighted in terms of their liquidity (e.g. net derivatives receivables weight 100%; while cash, central bank reserves, and interbank lending with less than six-month duration, weight 0%). It is easy to see that, if a bank is financed with very stable funds (in theory, exclusively capital), and has assets that present very little risk (short-term interbank landing), there are no stable funding needs, and vice versa. To improve the NSFR, in other terms, borrowing long and lending short is necessary (so-called "reverse maturity transformation"). The CRR regulates reporting on stable funding, but does not provide for specific substantive consequences that might be triggered by a deterioration of the index.

The risk-based calculation of capital requirements showed its limitations during the global financial crisis.[29] The discretionary element that might affect the calculation of these ratios, in fact, might allow a bank to comply with the requirements while exploiting an excessive leverage. When things go south, massive deleverage can cause vicious circles and turbulences for both the individual firm and the financial sector as a whole. To curb this possible distortion, Basel III supplemented capital ratios with a simple, non-risk based measure, the "Leverage Ratio" ("LR"). LR is a fraction whose numerator is Tier 1 capital, and whose denominator is the sum of on-balance sheet exposures, derivatives exposures, securities financing

[27] Failure to comply with the capital buffer requirements set forth above may result in restrictions affecting dividend pay-outs and remuneration bonuses to management: *see* Art. 141 of the CRD IV. Moreover, in accordance with Art. 142 of the CRD IV, the institution concerned must urgently prepare a capital conservation plan containing measures aimed at restoring the capital requirements and submit it without delay to the competent authority. Non-approval of the plan may lead to even more stringent distribution restrictions as well as to the need of increasing own funds ratios.
[28] *See* note 25 above.
[29] *See* Baglioni, *supra* note 21, 36-72.

transactions exposures, and off-balance sheet items. The ratio must be at least 3%: from 2013 through 2015 the measure had only to be reported to the supervisors, from 2015 through 2018 public disclosure was necessary and, finally, starting with January 1 2018 the ratio has a Pillar 1 treatment analogous to the one reserved for risk-weighted capital requirements.

C. *Impact of Basel III on the Banking Business and Economic Performance*

After this necessary, but technical and rather dry description of the capital and liquidity requirements imposed on banks, two broader and complex issues must be mentioned to consider the actual impacts of Basel III. What have been or might be the effects of these rules in terms of: (a) Economic performance and therefore business models of banks? (b) Propensity to extend credit (can they concur to cause a credit crunch)? In other words: Are high capital requirements socially sub-optimal, and how do they affect economic growth?

Numerous studies have tackled these questions, and it would be impossible, and beyond the point, to extensively discuss them here. Obviously enough, the two questions are intertwined, and in fact might just be two ways to express the same question. In addition, it is extremely difficult to isolate the effects of Basel III rules from other economic and institutional variables affecting the banking sector: rules on resolution, the key topic of this Article, are a perfect example, but consider also monetary policy or limitations to proprietary trading such as the ones imposed by the so-called Volcker Rule or ring-fencing of banking activities.[30] Notwithstanding these limitations, it is useful to address briefly these issues.

A relatively recent qualitative study of the EBA discusses precisely the possible effects of the new regulatory framework on the banking business.[31] With specific respect to the capital requirements set forth in the CCR and CRD IV, this study indicates a possible reduction of proprietary trading and market making activities, and an increase of retail banking and hedging activities; greater geographic diversification both in terms of exposures and funding in order to minimize risk and capital requirements; a tendency to deleverage and reduce size in terms of RWA; more limited incentives to participate in securitization transactions and, of course, an overall increase of regulatory and compliance costs. Interestingly enough, however, at least some of these effects might be countered by other regulatory requirements. For example, again according to the EBA, the LCR and NSFR, which might result even more constraining than capital ratios, could determine disincentives to retain retail assets, since they are not HQLA; similarly, these requirements might push a more intense investment banking activity in order to hold liquid securities. In terms of geographic scope of banking activities, the LCR favors holding sovereign debt denominated in the same currency of the

[30] Charles Whitehead, *The Volcker Rule and Evolving Financial Markets*, 1 HARV. BUS. L. REV., 39 (2011); Darrell Duffie, *Market Making Under the Proposed Volcker Rule* (Rock Ctr. Corp. Gov. Working Paper Series No. 106, 2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990472; Matthias Lehmann, *Volcker rule, ring-fencing or separation of bank activities – Comparison of structural reform acts around the world*, 17 J. OF BANK. REG. 176 (2016).

[31] EBA, *Overview of the Potential Implications of Regulatory Measures for Bank' Business Models*, 9 February 2015, available at www.eba.europa.eu/documents/10180/974844/Report+-+Overview+of+the+potential+implications+of+regulatory+measures+for+business+models.pdf. For the purposes of finalizing the implementation of Basel III frameworks in the EU by adopting certain revisions to the CRR and CRD package, it shall also be noted that the European Commission has called the EBA to perform a comprehensive analysis so as to assess the potential impact of the different elements of the Basel reform within the EU banking sector. Consequently, the EBA is set to provide a new and detailed report containing both a quantitative and qualitative assessment of the new Basel III framework as currently implemented in the EU by 30 June 2019.

assets, and this incentive might limit international expansion; for similar reasons, in order to comply with liquidity requirements, securitizations might become more important. The need to hold liquid positions might also alter the structure of the income statement, reducing the relevance of interest rate income and augmenting the one of commissions and fees.

Even these few remarks indicate how the effects of Basel III might be very difficult to assess and might vary profoundly depending on the single financial institution. It seems clear, however, that traditional banks will probably retract from certain areas of lending and financing due to lower profitability or costs; the void however might be quickly filled in by the so-called "shadow banking sector," as already visible considering the role of private equity in financing certain businesses, for example real estate.

Predictions on the business impacts of Basel III are also offered in a 2010 McKinsey study.[32] To begin with, this analysis estimates that by 2019 the new rules will require an injection of roughly €1.1 trillion of additional Tier 1 capital (approximately 60% of all European and US Tier 1 capital existing in 2010), €1.3 trillion of short-term liquidity (50% of the outstanding figure in 2010 in the same regions), and €2.3 trillion of long-term funding. The need to comply with these requirements might reduce the return on equity, on average, by 4% in Europe and 3% in the U.S. The higher costs in terms of capital, liquidity, and funding will concern short-term retail loans (≈70 basis points), specialized lending (≈60 bps), trading books and specifically lower rated or unrated corporate bonds (≈70 bps) and bonds issued by other financial institutions (≈80 bps), and several off-balance sheet transactions, particularly OTC derivatives (≈85 bps) and corporate and financial institutions liquidity lines (in between 75 and 85 bps). Consequently, the study argues that the new rules will be less significant for well-capitalized retail banks, and be more relevant for investment banking (and to some extent corporate) banking activities. In fact, trading books, OTC derivatives, cash trading and market making, and securitizations will call for higher capital, and banks might respond by either abandoning certain activities or transferring costs on their counterparties, for example by increasing bid-ask spreads or requiring more collateral.

Mixed results characterize also the studies on the impacts of the macro-prudential tools we are discussing on cost and volume of lending and GDP growth, also depending on the situation of the country or geographical area considered. Several empirical studies suggest that stronger capital and liquidity requirements would reduce credit, the return on equity of banks and GDP growth. Greater stability of banks might however also reduce the cost of funding and indirectly favor credit; in addition, the net effect should take into account other variables often assumed equal in these studies, such as monetary policy. In fact, other research results point at beneficial effects of stricter requirements.

Both the OECD and the Macroeconomic Assessment Group of the Financial Stability Board and Basel Committee on Bank Supervision have published empirical analysis concluding that the Basel III capital requirements will negatively affect GDP. For example, a 2011 research by the OECD predicts that the full implementation of the requirements effective in 2019 will determine a reduction in GDP growth over a five-year period of -0.12% in the U.S., -0.23% in the Euro Area, and of -0.09% in Japan, with a weighted average in these areas of -

[32] Philipp Härle *et al.*, *Basel III and European Banking: Its Impact, How Banks Might Respond, and the Challenges of Implementation* (McKinsey Working Paper on Risk No.26, 2010), available at https://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/Risk/Working%20papers/26_Basel_III_and_European_banking.ashx.

0.16%.[33] Similarly, the Macroeconomic Assessment Group calculated in 2010 that a one percent point increase in capital to RWA negatively impacts GDP by -0.19% over four and a half years after implementation (even if the two studies yield different results depending on different hypothesis on whether discretionary buffers will be maintained by banks).[34] Work by researchers at the IMF indicates that Basel III will on average increase lending rates at the largest banks in the word of roughly 16 basis points. Under a given set of hypotheses concerning the elasticity of loan demand, the consequence might a long-term loan growth decline of 1.3%. The average might however be misleading since, as the Authors note, variations among single countries would be significant, from an estimated minimal effect in Canada, to an increase of lending rates of 26 basis points in Japan.[35] More nuanced results are however offered by a cross-country empirical analysis conducted by researchers at the Bank of International Settlements. A 2017 paper indicates beneficial effects of a more active use of macro prudential measures on economic performance, and particularly higher and less volatile per capita GDP growth, but only when the economy considered is very open and financially developed. In countries where these two conditions do not hold together, the impact of capital requirements might, in fact, be negative, at least in terms of GDP volatility.[36]

In short, empirical analysis offer—as it is often the case—a mixed bag. While it seems to confirm the intuitive notion that stricter capital and liquidity requirements might be suboptimal for credit and investment, affecting economic growth, the overall relevance of these effects is uncertain, in light of all the complex variables at play. Most importantly, it is extraordinarily difficult to compare these possible social costs—often concerning a sub-set of constituencies, such as borrowers or bank's shareholders—with the ones of financial crises that might be avoided.

In fact, and to conclude, an interesting theoretical paper authored by scholars from Stanford University and the Max Plank Institute attempts at debunking all major arguments raised against stricter capital requirements.[37] To simplify to the extreme an analytical discussion that ponders all major recurring issues, the Authors argue that, while stronger capital requirements might be objectionable to banks' managers and shareholders (for example, because they lower return on equity or indirectly limit tax benefits), they are socially desirable. In fact, capital requirements curb excessive leverage in a sector where the cost of debt is unnaturally low, due to the existence of explicit or implicit public guarantees in case of a bank's default.[38]

D. *The Uncertain Future of the European Deposit Scheme*

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[33] Patrick Slovik & Boris Courède, *Macroeconomics Impact f Basel III* 10 (OECD Economics Department Working Paper No. 844, 2011,), available at www.oecd-ilibrary.org/economics/macroeconomic-impact-of-basel-iii_5kghwnhkkjs8-en.
[34] BANK FOR INTERNATIONAL SETTLEMENTS, STRUCTURAL BANK REGULATION INITIATIVES: APPROACHES AND IMPLICATIONS (2010), available at https://www.bis.org/publ/work412.pdf.
[35] Thomas F. Cosimano & Dalia S. Hakura, *Bank Behavior in Response to Basel III: A Cross-Country Analysis*, 19-20 (IMF Working Paper No. 11/119, 2011), p. 19-20, available at www.imf.org/en/Publications/WP/Issues/2016/12/31/Bank-Behavior-in-Response-to-Basel-Iii-A-Cross-Country-Analysis-24870.
[36] Codruta Boar *et al.*, *What are the Effects of Macroprudential Policies on Macroeconomic Performance?* (BIS Quarterly Review, September 2017) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3042014.
[37] Anat R. Admati *et al.*, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive* (Rock Ctr. Corp. Gov. Working Paper Series No. 161, 2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349739.
[38] *Id.*, at 21-23.

A common deposit insurance scheme is the third pillar of the BU. Currently, based on a 1994 directive,[39] EU Member States have harmonized rules on deposit insurance, and all of them protect depositors up to €100,000 in case of crisis. The national deposits are however separate and country-specific. Since their solidity depends on the contributions of national banks and/or the ability of the local governments to intervene, the risk faced by depositors—and therefore the interest rates they demand, which represents an important component of funding risk for banks—varies in the different jurisdictions. This can be clearly seen as reflected by the standard deviation of interest rates on deposits from non-financial corporations and households in the different EU States, a measure that has increased from the end of 2008 due to the financial crisis and that, although having decreased from the beginning of 2013, remains quite significant (in particular for households, since corporate depositors can more easily distribute their deposits in different countries). Similarly, the differences in amount of deposits as a percentage of GDP in the different countries also confirms the non-harmonized risk profiles of banks in different jurisdictions.[40]

In a banking union, deposit insurance must be unified and centralized, for at least three sets of reasons. First, the larger size increases the efficiency and fairness of deposit insurance as, in fact, with any insurance system in which spreading risk and economies of scale favor large dimensions. Second, a centralized insurance decouples sovereign and banking risk. Third, a European deposit insurance scheme is consistent with centralized supervision and resolution powers attributed to the SSM and SRM.[41]

However, approving a common, centralized, European deposit insurance system has proven extremely difficult. The impasse is rooted in the opposition of certain governments, and specifically of Germany, to the possible mutualization of risk. The idea is that certain specific existing risks—such as government bonds on the balance sheets of banks and NPLs—must be addressed and resolved *before* shared deposit insurance should be created to avoid an unfair transfer or resources from less risky countries and banking sectors to more risky ones.[42] This principle, in itself, is correct; the problem is not so much one of principle, but rather of evaluation of the existing conditions. In this perspective, this issue has become a political question, a bargaining leverage to negotiate also on different tables. The vicious circle that it could determine is quite clear: the absence of a common insurance undermines the strength of single supervision and resolution (also because local authorities, directly or indirectly shouldering a significant part of the risk of local banks, resist power transfers to Frankfurt or Brussels); but weaker centralized supervision and resolution powers negatively affect the willingness of some countries to embrace a single deposit insurance scheme.[43]

The situation has had concrete effects on legislation. A 2015 proposal of the EU Commission, which called for a period of re-insurance of national deposit insurance schemes by an

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[39] Directive (EC) 94/19 of the European Parliament and the Council of 30 May 1994 on deposit-guarantee schemes, 1994 O.J. (L 135).

[40] For a comment on these data *see* Dirk Schoenmaker & Guntram Wolff, *Options for European Deposit Insurance*, VOX, Oct. 30, 2015, available at www.voxeu.org/article/options-european-deposit-insurance.

[41] Daniel Gros & Dirk Shoenmaker, *European Deposit Insurance and Resolution in the Banking Union*, 52 J. COMM. MKT. ST. 529 (2014).

[42] Non-Paper, *The EMU needs a stronger Banking Union but must get it right*, Sept. 8 2015, available at http://blogs.ft.com/brusselsblog/files/2015/09/Nonpaperfinal_20150910091345.pdf. According to Jim Brundsen, *Berlin fights Brussels push for deeper financial integration*, FIN. TIMES, Sept. 10 2015, available at https://www.ft.com/content/df1cf84a-57be-11e5-a28b-50226830d644?siteedition=intl#axzz3lP8EvWOC, the document reflects German views concerning the European monetary and banking unions.

[43] Daniel Gros, *Deposit Insurance: How to deal with the Missing Pillar of the Banking Union*, in 139 EUROPEAN BANKING UNION: THE NEW REGIME (Luis Hinojosa Martinez & Jose Beneyto eds., 2015), 139-52.

EU-wide fund and then a real common European fund, has been stifled. Very recently, at the beginning of October 2017, the EU issued a new legislative proposal. According to some commentators, however, this proposal is a worrisome retreat from a necessary step toward the banking union, and signals a passive acceptance of the German position.[44] The new rules, if approved, would in fact simply provide that the European fund would lend money to national funds when they run out of financial resources, with no real re-insurance, notwithstanding the label attached (and let alone co-insurance). Only a second phase, within 2022, might lead to co-insurance, but only if banks pass an "Asset Quality Review" test, which appears aimed at verifying the existence of the conditions advocated by the German government and, specifically, levels of NPLs and exposure to national sovereign debt.[45]

It shall be seen in the near future if this crucial component of the Banking Union will, in fact, be accomplished within a useful timeframe. It is in any case clear that a European Deposit Insurance Scheme remains one of the toughest and most delicate battles on the EU chessboard, one that might cast a dark shadow on the future of the Union.[46]

E. *Broadening our Visual: Framework of the European Financial System of Supervision*

The ECB and the SRB are part of a complex system of financial oversight in which different authorities with different competences and geographical scopes of action are intertwined, not always in an optimal way, or at least in a streamlined and clear way. We will discuss the specific issues concerning resolution and banking crisis in the following Part. In this Paragraph, we simply sketch the overall institutional design and major competences of the different bodies interacting with the ECB.

The first authority to mention is, of course, the European Banking Authority ("EBA"), led by a board composed of the heads of the national banking supervisors of the 28 EU Member States and established in 2011 when it substituted the Committee of European Banking Supervisors. One of the main competences of EBA is to contribute to the development of harmonized—or, identical—applicable rules in the banking and financial sectors and the establishment of the European Single Rulebook governing this area of the law.

It is interesting to take a closer look at the major regulatory acts through which EBA pursues this goal. First of all, EBA enacts Technical Standards ("TSs"), which are basically secondary rules specifying or regulating issues delegated by EU legislation. Differently from what happens in most jurisdictions, TSs are not immediately binding: They must be submitted to the

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[44] Angelo Baglioni, *Assicurazione europea dei depositi: indietro tutta*, lavoce.info, Oct. 13, 2017, available at https://www.lavoce.info/archives/49034/assicurazione-europea-dei-depositi-indietro-tutta.

[45] In this respect, it shall be noted that European supervisory expectations for the provisioning of new NPLs have recently been updated by the ECB: *see* European Central Bank, *Addendum to the ECB Guidance to banks on nonperforming loans: supervisory expectations for prudential provisioning of non-performing exposurespublished the addendum to the ECB Guidance to banks on non-performing loans (NPLs)*, Mar. 15, 2018, available at https://www.bankingsupervision.europa.eu/press/pr/date/2018/html/ssm.pr180315.en.html. The updated Addendum provides for an ECB assessment, *inter alia*, of the overall time a loan has been classified as non-performing.

[46] A recent ECB study assessed the potential exposure of a fully mutualised EDIS with a target level of 0.8% of covered deposits of the participating banking systems to bank failures under different stress and bail-in scenarios. Interestingly, the study suggests that the EDIS would be able to honour its required pay-outs, with low risk of being written-down or eroded in the event of loss rates up to 20% in a resolution scenario and 30% in an insolvency scenario. *See* European Central Bank, *Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?* (Occasional Paper Series No. 208, 2018), available at https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf.

European Commission for its endorsement—granted unless the measures are deemed contrary to EU law or disproportionate—and published on the Official Journal of the European Union (the EU Parliament and Council also have some limited review powers on EBA's acts). This undeniably convoluted procedure is suggested by the prevailing interpretation, at least by the European Commission, of the so-called *Meroni* doctrine, a case law principle derived from a leading 1956 decision of the European Court of Justice.[47] In brief, this doctrine states that EU institutions cannot delegate discretionary powers to agencies: tossing the ball back to the Commission, therefore, serves the purpose of avoiding doubts on the legitimacy of EBA's rules.[48] There is however disagreement among scholars concerning the correctness of this rigid interpretation of *Meroni*, especially in light of the evolution of the jurisprudence of the Luxembourg court.[49]

EBA also issues Guidelines and Recommendations addressed to national and EU supervisors, banks and investment firms in order to guide and harmonize supervisory practices.[50] A "comply or explain" principle applies to these acts: competent authorities and regulated entities must notify EBA of their intention to follow Guidelines or Recommendations or explain the reasons for non-compliance. EBA also publishes opinions on supervisory or regulatory matters and reports, also in as an advisor to the European legislature.

EBA is also responsible to evaluate periodically the stability, risks and vulnerabilities of the banking sector, carrying on stress-tests in cooperation with the European Systemic Risk Board ("ESRB") through the above-mentioned SREP exercise.[51] EBA can also investigate incorrect application of EU law by national authorities, mediate cross-border conflicts of attributions between authorities, and in certain emergency situations take direct decisions aimed at national authorities or financial institutions.

One distinctive feature of the institutional design of is arrangement is the distinction (although of course overlapping occur) between strictly regulatory functions, entrusted to EBA,

[47] *See* European Court of Justice [ECJ], Case 9/56, Meroni v High Authority 1958 E.C.R. 133; Merijn Chamon, *EU Agencies: Does the Meroni Doctrine make sense?*, 17 MAASTRICHT J. EUR. & COMP. L. 281 (2008); Jens-Peter Schneider, *A common framework for decentralized EU agencies and the Meroni doctrine*, 61 ADMIN. L. REV. 29 (2009).

[48] It shall be noted that the doctrine does not apply to the ECB, which is not an agency but an "institution" of the EU, and listed in its founding treaty. The same rationale indicated in the text explains, however, why the SRB—which is also an "agency", not an "institution" of the EU—only has the power to recommend and execute resolution decisions, which are formally taken by the Commission.

[49] Phedon Nicolaides & Nadir Preziosi, *Discretion and Accountability: The ESMA Judgment and the Meroni Doctrine* (Bruges European Economic Research Papers No. 30, 2014), available at https://ideas.repec.org/p/coe/wpbeer/30.html.

[50] *E.g.* EBA, *Guidelines on the assessment of the suitability of members of the management body and key function holders*, EBA/GL/2012/06 (Nov. 22 2012); Joint European Securities and Markets Authority ("ESMA") and EBA, *Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, EBA/GL/2017/12/ESMA71-99-598 (Sept. 26 2017) .

[51] The EU□wide stress tests are part of the supervisory toolkit used to assess banks' resilience to adverse shocks, identify residual areas of uncertainties, and consequently determine appropriate mitigation actions. In addition, the exercise aims to strengthen market discipline through the publication of consistent and granular data on a bank□by□bank level. In this respect, the EBA is responsible for developing a common methodology and coordinating the exercise. The 2018 EU-wide stress test involved 48 banks from 15 EU and EEA countries, covering broadly 70% of total EU banking sector assets. The adverse scenario factored in the 2018 EU□wide stress test presented a deviation of EU GDP from its baseline level by 8.3% in 2020, an increase in the unemployment of about 3.3% by 2020, a fall of the inflation by 1.9% below the baseline and a fall of residential and commercial real estate prices by 27.7% and 27.1% respectively below the baseline level by 2020. In terms of results, the abovementioned scenario would yield an impact of -395 bps on banks' CET1 capital ratio, leading to a 10.1% CET1 capital ratio at the end of 2020. *See* EBA, *2018 EU-wide stress test results* (Nov. 2, 2018), available at https://eba.europa.eu/documents/10180/2419200/2018-EU-wide-stress-test-Results.pdf.

and supervisory powers, exercised by the SSM (and the SRB), something that has intuitive pros and cons, but that is in any case quite different from what generally happens at the national level, where the supervisory authority is in charge of both enacting secondary regulation and of enforcement.

The EBA is one of the three financial industry regulators ("European Financial Authorities" or "ESAs"), together with ESMA, essentially responsible for capital markets, trading facilities, financial services, listed corporations and related issues (for example, it has direct supervisory powers on rating agencies), and EIOPA, the insurance sector supervisor. These authorities have both regulatory and supervisory powers. It follows that while macroprudential supervision is attributed, with the division of tasks mentioned, to the ECB and the EBA, microprudential supervision is entrusted with the three ESAs.

The institutional model followed at the European level, in this respect, appears to follow the so-called industry silos model in which different authorities oversee the three industries: banking, securities and insurance), and is more distant from either the single supervisor model (followed e.g. in the UK until recently) or the twin-peaks approach, in which essentially a prudential supervisor, responsible for monitoring financial stability, is coupled with a conduct supervisor, dealing with transparency and investors and clients protection. Needless to say, no system in the word falls squarely in one of these three abstract models, and contaminations are possible. In the same token, all three models present lights and shadows and have their fans and detractors, although it is undeniable that the blurring of the lines among the banking, securities and insurance industries and their products and services, raises profound questions on the effectiveness of the industry silos model, and many scholars, commentators and industry experts—including the Authors of this Article—favor the twin-peaks approach.[52]

One additional complication with the European financial infrastructure, of course, is that European authorities need to interact with 28 different national models in which a panoply of different institutional designs are followed, something that creates obvious coordination problems.[53] These institutional disconnect is sometimes exacerbated by cultural and linguistic issues, as suggested by some critiques expressed by the European Commission to the effectiveness of the so-called "Joint Supervisory Teams" composed by both representatives of the ECB and of the NCBs.[54] Progress along the line of greater integration and centralization of functions is being made, but the road to a more streamlined and coherent approach is long and winding. At the time of this writing, for example, a proposal for a new regulation

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[52] *See* Eddy Wymeersch, *The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors*, 8 EUR. BUS. ORG. L. REV. (EBOR) 237, 237-306 (2007); Donato Masciandaro, *Politicians and financial supervision unification outside the central bank: Why do they do it?*, 5 J. FIN. STAB. 124, 124-46 (2009); Andrew Godwin *et al.*, *Twin Peaks and Financial Regulation: The Challenges of Increasing Regulatory Overlap and Expanding Responsibilities* (The International Lawyer No. 49, 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2889536; Eugenia Macchiavello, *Microfinance Regulation and Supervision: a multi-faceted prism of Structures, Levels and Issues*, 9 N.Y.U. J. L. & BUS. 125, 125-97 (2012); Emilios Avgouleas, *Banking supervision and the special resolution regime of the Banking Act 2009: the unfinished reform*, 4 CAP. MKTS. L. J. 201, 201-35 (2009).

[53] Christopher P. Buttigieg, *The Institutional Models for Financial Supervision: An Analysis*, (2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2190501; Christopher P. Buttigieg, *An Evaluation of the Theories and Objectives of Financial Regulation Post the 2007-2009 Financial Crisis: A European Perspective*, 2 ELSA MALTA L. REV. 122 (2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2121334.

[54] European Commission, *Commission Staff Working Document accompanying the Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No. 1024/2013* (Oct. 11, 2017), available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017SC0336&from=EN.

attributing more direct supervisory powers to the ESAs has been submitted by the European Commission.[55]

Two other bodies that should be mentioned within the European System of Financial Supervision are the European Systemic Risk Board ("ESRB") and the European Stability Mechanism ("ESM"). The former, established in 2010 after the 2008 crisis, is hosted within the ECB and chaired by the President of the same institution. It includes representatives of the ESCBs and the European Commission, and it is responsible for the macro prudential oversight of the EU financial system and the prevention and mitigation of systemic risk. It has what we might define a primarily advisory role rather than direct supervisory functions, and in light of its monitoring of systemic risk it issues warnings and recommendations.

The ESM, on the other hand, is an intergovernmental organization whose creation is authorized by Article 136 of the TFEU and established with a 2012 Treaty (supplementing a 2011 version). It is somehow akin, in terms of functions, to the IMF: its major responsibilities are loans to Member States coupled with macroeconomic adjustment programs aimed at bailing out governments in serious financial distress (a function indirectly relevant also for the stability of the banking industry, in light of the exposure of banks to sovereign risk);[56] and banks recapitalizations, a tool that has been used so far only in favor of Spanish banks.[57]

III. EARLY INTERVENTION, RESOLUTION AND LIQUIDATION

A. *Pre-Crisis Precautions*

In the aftermath of the Financial Crisis, an international agreement emerged on the idea that banks should not face a stress situation unprepared. A great emphasis has therefore been put on the preparation of recovery and resolution plans that—at least in theory—could be promptly applied in case of trouble. The G20 took this position in 2009,[58] and subsequently both the BRRD in Europe and the Dodd-Frank Act in the US adopted this approach.[59]

As the name suggests, recovery plans—drawn up and maintained by the banks—concern less problematic situations. Essentially, they are an information and guidance tool consisting in six parts: (i) a general description of the group and business model; (ii) an analysis of critical functions and core business lines; (iii) the identification of appropriate indicators of patrimonial or liquidity deterioration also in light of (iv) specific adverse scenarios. The bank must additionally describe its (v) recovery options and prepare a (vi) communication plan. Plans should obviously take into account the group structure, and some institutions have decided

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[55] *See* European Commission, *Amended Proposal for a Regulation of the European Parliament and the Council*, COM (2018) 646 (Sept. 12, 2018), available at https://ec.europa.eu/commission/sites/beta-political/files/soteu2018-supervisory-authorities-regulation-646_en.pdf.

[56] At the time of this writing, the ESM has provided financial assistance to Ireland, Portugal, Greece and Cyprus.

[57] *See* European Stability Mechanism ("ESM"), *Conclusion of ESM financial assistance programme for Spain: an overview* (2013), available at https://www.esm.europa.eu/sites/default/files/spanish_exit.pdf; EUROPEAN COMMISSION, *Post Programme Surveillance Report Autumn 2018* (2018), available at https://ec.europa.eu/info/sites/info/files/economy-finance/ip091_en.pdf.

[58] G20, Leaders' Statement, The Pittsburgh Summit, (Sept. 24-25, 2009).

[59] With however one key difference: under the BRRD, resolution plans are adopted by the competent financial supervisor based on information provided by financial institutions, while in the US financial institutions prepare they own resolution plans that are assessed by the supervisors.

to conduct crisis simulation exercises that, not differently from fire drills, should allow their personnel to be ready to react in a stressful situation.[60]

As mentioned, this particular tool, in addition to the function of making authorities more familiar with the specific needs and potential weaknesses of supervised entities, has also and possibly primarily an "educational" aim, fostering the management's knowledge and awareness in order to facilitate early measures to go back to business as usual. In this perspective, the underlying philosophy is in line with the growing attention for "alert procedures" adopted also by national legislatures for non-financial institutions, in order to prevent insolvency.[61] Recovery plans cannot be considered binding: of course, in a real crisis, flexibility must be maintained to take into account the specific situations. The legal relevance of these documents and information raises however interesting questions. While a departure from the envisioned reaction in a real pre-crisis situation, *per se*, could not be considered a source of liability, the very existence of detailed plans may, de facto, raise the standard of diligence of directors and managers if they ignore or do not adequately consider the pre-determined indicators and mitigating actions.

Recovery plans, subject to an annual update, are submitted to competent authorities (including resolution authorities) that asses their completeness, quality and credibility. Resolution authorities, under the BRRD, have a more direct involvement in the preparation of resolution plans. In consultation with supervisory authorities they must, in fact, draw up these plans together with a resolvability assessment that might be applied when the conditions for resolution are triggered.[62]

Another interesting preparatory and preventive tool regulated by the BRRD are "Intra-Group Financial Support Agreements" ("IGFSAs"). These are essentially private contracts regulating *ex ante* the possibility, when early intervention is necessary, to provide cross-border financial assistance to group entities in distress. Groups are not obliged to stipulate IGFSAs, but they might facilitate difficult decisions in a crisis scenario; before the BRRD, in fact, there was no possible framework that could be adopted, and national authorities might have faced difficulties in coordinating their efforts. IGFSAs can provide such a framework: they are subject to a complex review and approval process, and the actual granting of support is in any case subject to authorization by the competent authority of the entity that provides financial assistance. The existence of these agreements, however, can contribute to an orderly and prompt reaction in the interest of financial stability.

B. *Early Intervention on a Troubled Going Concern.*

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[60]At least annually, institutions must submit their recovery plans to their supervisor, who performs a complete assessment of the usability of their plans and provides them with feedback. While the ECB qualifies as the supervisory authority of significant institutions, less-significant banks are subject to the supervision of the competent NCB.

[61] In relation to Italy and France, *see* Federico Pernazza, *The Legal Transplant into Italian Law of the* Procédure d'Alerte. *Duties and Responsibilities of the Companies' Bodies*, 3 IT. L. J. 553 (2017).

[62] A delicate issue concerns the elements of resolution plans that may be disclosed to the market. On the one hand, the transparency of a resolution path is key to the credibility of the restructuring strategy, as well as to clearly alert investors that they are at risk, if the bank fails. On the other hand, certain forecasts and evaluations contained in the plans obviously require confidentiality to avoid panic reaction or misunderstandings by the market. *See* Thomas Huertas, *European Bank Resolution: Making it Work!* (CEPS Task Force Report, 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2723220.

Early intervention powers (also, "EIPs"), aimed at preventing a crisis, lay in a theoretically clear but practically gray area between going concern and resolution in which supervisors—note, not the resolution authorities—have significant discretion. In terms of scope of application, it is probably easier to define the scope of EIP by considering the outer limits of these tools. EIPs are triggered by deteriorating financial conditions or specific infringements of EU capital rules, provided however that failure does not seem inevitable and resolution would not be in the public interest: if these further conditions would be met, the baton would be handed over to the resolution authority. In other words, these are preventive measures intended to prevent, not resolve a crisis.

Consistently with this approach, they are triggered by a deterioration of the economic situation of the supervised entity, e.g. in terms of liquidity, non-performing loans, leverage or capital requirements; as well as other possible infringements of the CRR or CRD IV. These measures are not automatic, and the discretion of supervisors, which remains significant, is only partially curbed by EBA guidelines attempting to ensure a certain degree of consistency among possible different approaches of supervisors, including a minimum trigger based on a 1.5% buffer above the institution's own funds, essentially relevant only for smaller banks. Practically, the adoption of early intervention measures relies significantly on the results of SREPs or material events such as a downgrade in rating or other increased risks.

EIPs include a panoply of tools, further broadening regulatory discretion. These tools range from a simple forced implementation of a recovery plan (see above), to the removal of directors or managers and appointment of a temporary administrator, to mandatory changes in the strategy or operations (e.g. liability management transactions); from specific initiatives on the corporate or financial structure such as the calling of a shareholders' meeting to adopt proper measures, e.g. issuing new shares.[63]

Article 32(4) of the BRRD governs another important measure that can be adopted in the absence of the requirements for resolution, *i.e.* for solvent banks that are not likely to fail: public support in the form of either state guarantees for new liabilities, purchase of impaired assets or extraordinary public recapitalization (public support in case of resolution is, on the other hand, regulated by Articles 56-58 of the BRRD). The use of public funds as an early intervention tool is only allowed as a last resource and must in any case comply with State aid rules.

Article 32(4) BRRD contains a long and complex list of conditions that must be met to access public support. A detailed discussion of these conditions is not necessary here; we will just briefly refer to the major ones in order to provide a general understanding of the system.[64] First, the aid must be necessary to avoid a serious disturbance in the economy of a Member State and preserve financial stability, but also represent a proportional response to the risk posed. As mentioned, the affected bank must be in a situation in which no other measures, and in particular early intervention tool, would be able to address the situation, but also must

[63] Further discussion in Andrea Guaccero, *Global Crisis, Globalization of Remedies. Comparative Remarks on the Approach to Banking and Financial Crises in the US and the EU* (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3106653.

[64] For a comprehensive discussion, *see*, *e.g.*, Martin Hellwig, *Precautionary Recapitalisations: Time for a Review*, European Parliament, Directorate-General for Internal Policies, Economic Governance and Support Unit, (2017), available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602089/IPOL_IDA(2017)602089_EN.pdf; Christos V. Gortsos, *A Poisonous (?) Mix: Bail-Out of Credit Institutions Combined with Bail-In of Their Liabilities Under the BRRD – The Use of 'Government Financial Stabilisation Tools' (GFSTs)*, 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2876508.

not have reached the conditions triggering resolution (a sort of "*extrema ratio*" before resolution). Further, the economic terms of public support cannot confer an «advantage» upon the beneficiary, and must be precautionary and temporary. Such requirements are partially clarified by a set of additional rules that—in brief—require the absence of elements suggesting that the bank might encounter a liquidity or economic crisis in the near future, or that the funds cannot be used to offset current losses or losses likely to emerge in the near future. Additionally—and this is one of the most crucial and delicate issues—the EU Commission will consider acceptable only support that is necessary to cover a shortfall emerging under the adverse scenario of a stress test or similar evaluations; shortfalls emerging under the baseline scenario can, on the contrary, only be covered by private funds.[65]

Finally, public support must be in compliance with State aid rules at both the EU and national levels. With respect to the former, the EC Commission must evaluate whether the measure is compatible with Article 107 TFEU.[66] On this respect, a very important condition concerns the so-called "burden-sharing", *i.e.* the necessity, to access public resources, that existing eligible shareholders or creditors contribute to the financial effort to redress the bank. For our purposes here, it is necessary to underline that the BRRD conditions recourse to public funds on burden sharing. More specifically, resolution funds can be accessed only after an amount equal to 8% of liabilities has been covered through write-downs and/or conversions of liabilities and, in any case, remaining losses can be covered only to a maximum of 5% of the bank's liabilities. Outside a bail-in situation, the BRRD does not requires any specific burden sharing for public support in the context of early intervention.[67] The EU Commission, however, *de facto* requires burden sharing by shareholder and junior creditors in case of extraordinary public support, as well as do the internal legislations of some Member States. We will further discuss this aspect below.[68]

A few general points emerge from this quick discussion of extraordinary public support outside of a resolution scenario. The first one is, once again, the great latitude and discretion that the broad and often generic provisions attribute to the competent authorities. When combined with the necessity to coordinate different authorities and private parties at both the EU and local levels in situations with serious time constraints, it is not surprising that the necessary evaluations are hard to make and possibly subject to varying standards and approaches.

It is also worthwhile to underscore that public support outside of resolution is only permissible in a very narrow, but not very clearly defined and identifiable, set of circumstances, circumstances that only in theory cannot be considered in tension if not in contradiction. For example, support must be necessary to avoid negative effects on the economy or on financial stability, but at the same time it shall not confer a competitive advantage to the supported institution, something that sounds on the edge of an oxymoron since financial aid, almost by definition, makes the recipient more robust and competitive. In addition, while functionally aimed at avoiding negative economic effects, public support is only permissible to face losses emerging from a stress test under a hypothetical adverse scenario in a situation, however, where many other financial indicators suggest the absence of a crisis that might further deteriorate. The funds come however with several strings attached, e.g. with respect

[65] Such requirement has been decisive in the two Commission's most important decisions on precautionary recapitalization so far, in the Italian Monte dei Paschi di Siena (MPS) and "Banche Venete" cases. *See* Part V below.
[66] *See* Paragraph F below.
[67] On this issue, *see* more extensively Paragraph C below.
[68] *See* Paragraph III.F.

to their possible use to offset losses. Once again, a certain degree of fantasy is required to imagine a situation with possible negative effects for the Member State economy, serious enough that other interventions short of resolution are not sufficient, but also not serious enough that it would not deteriorate further.

One additional potential contradiction that can be found in the regulatory framework concerns the competences of the different public institutions involved. As we have seen and as it should be obvious, the decision to introduce a certain separation between the resolution authority and the banking supervisor is due to the concern that the potentially conflicting goals of resolution in a crisis scenario and supervision might hamper the effectiveness of the agencies involved. On the other hand, however, the EU Commission (primarily responsible for competition) is attributed the power to evaluate both the compatibility of public intervention with State aid rules, avoiding competitive distortions; and the respect of BRRD requirements that refer to financial stability and avoidance of economic disturbances at both a macro- and micro-level. To the extent a tension exists between these purposes, it is questionable how the Commission will balance the different goals.[69] Tension can also develop, if nothing else in the interpretation of broad and vague provisions, between Member States' governments, which might be inclined to provide public support to local banks for a number of legitimate reasons, and the compliance with State aid rules determined at the EU level.

C. *Resolution of a Failing or Likely to Fail Concern: Triggers and Tools, with a Focus on Bail-in*

(a) Triggers for Resolution

The introduction of a comprehensive resolution regime pursues two primary policy goals. The first is the adoption of an alternative to normal insolvency procedures and bankruptcy laws better suited to address failing financial institutions. A second and related objective is to limit, if not exclude, the use of taxpayers' money to bail out insolvent banks still allowing an orderly solution without causing financial instability. The financial crisis has required an unprecedented support of banks through the use of public funds, something that has been considered not only unfair and leading to moral hazard,[70] but also potentially unsustainable

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[69] *See* Paragraph III.F.

[70] On the fundamental assertion that government subsidies to banks encourages keep the cost of capital artificially low and encourage excessive risk-taking and moral hazard, *see* John C. Coffee *jr.*, *Bail-ins versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk* (Columbia Law & Economics Working Paper No. 380, 2010), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015; Thomas F. Huertas, *The Case for Bail-ins*, in THE BANK RECOVERY AND RESOLUTION DIRECTIVE – EUROPE'S SOLUTION FOR "TOO BIG TO FAIL"? 167-168 (Andreas Dombret & Patrick S. Kenadjian eds., 2013); Tobias H. Tröger, *Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime* 5-9 (European Banking Institute ("EBI") Working Paper Series, No. 12, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023184. *See* Paragraph II.C above.

While the above constitutes, now, a sort of conventional wisdom, there was a time when savings protection (calling for public support to ailing banks) was perceived to be a politically sensitive issue more than excessive risk-taking and moral hazard by banks and investors. Especially in those European countries not entirely open to market economy, the banking activity itself was conceived as a public function, thus naturally subject to State control (and potential bail-out, when needed). In Italy, for example, the private nature of the banking activity was sanctioned as late as in 1993. Interestingly, though, some courageous voices had expressed their criticism. For example, in the aftermath of the famous "Sindona crack" (*see* below, note.170), a prominent Italian jurist wondered why the poor Southern Italy's peasant—who would normally not even have, at the time, a bank account—should bear the public costs of a rescuing a failed credit institution in the rich and industrialized Northern Italy. *See* Giuseppe Minervini, *Note sull'assicurazione dei depositi bancari*, in BANCHE IN CRISI: 1960-1985 181 (Franco Belli *et al.* eds., 1987).

for public finances especially with respect to so-called "too big to fail" intermediaries.[71] Particularly in Europe, and in some EU countries, the use of public funds to support ailing banks has proven even more problematic due to the potential vicious circle determined by the large amount of investment in T-bonds, often with a significant home bias, a phenomenon incentivized by Basel rules attributing zero risk to sovereign debt issued by OECD countries.[72]

As a 2014 Memo of the European Commission surmises, «[i]n normal insolvency procedures, the primary objective is to maximize the value of assets of the failed firm in the interest of creditors. However, these may take many years, in particular for complex institutions leading to uncertainty with a knock-on effect on confidence. In contrast, the primary objective of bank resolution is to respond in a rapid and decisive manner to a bank in financial distress to maintain financial stability and minimize losses for society, in particular in relation to taxpayers, while ensuring similar results to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors».[73] To put it in a simple way, resolution attributes broad and incisive discretionary powers to public authorities, powers that at least in theory can be exercised in a timely fashion and with limited judicial review in order to facilitate a solution considered preferable vis-à-vis certain—vaguely defined—"public interests" when compared to the normal aims of a regular insolvency procedure. Of course, the idea is not new: several jurisdictions already provided for alternative procedures granting broader powers to supervisors in order to manage crises in an orderly way.[74] As Sabino

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[71] According to the ECB, in the 2008-2014 period EU Member States injected into troubled banks roughly 8% of the area's GDP, raising to 10% if State's guarantees for liabilities are computed (*see* European Central Bank, *The Fiscal Impact of Financial Sector Support during the Crisis*, 6 ECB Economic Bulletin 74 (2015). Of these resources, only 3.3% of GDP has been recovered according to other studies (Guillaume Adamczyk & Bernhard Windisch, *State Aid to European Banks: Return to Viability* (Competition State Aid Brief, 2015), available at http://ec.europa.eu/competition/publications/csb/csb2015_001_en.pdf. The US has done better in this respect. Indeed, most of the amount of resources that the federal government has used in the context of bailout programs for troubled banks under the umbrella of the Troubled Asset Relief Program ("TARP") has been repaid, while also providing a profit of approximately $30 billion to the US government: *see* https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx#Bank (last visited January 2019).

[72] On the "bank-sovereign" feedback loop, *see*, *e.g.*, Jianping Zhou *et al.*, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions* (IMF Staff Discussion Note No. SDN/12/03, 2012), at 4), available at https://www.imf.org/external/pubs/ft/sdn/2012/sdn1203.pdf.

[73] *See* European Commission, *EU Bank Recovery and Resolution Directive (BRRD) Memo: Frequently Asked Questions*, Apr. 15, 2014, 2, available at europa.eu/rapid/press-release_MEMO-14-297_en.pdf. On the inadequacy of bankruptcy procedures to handle the crisis of a systemic failing bank, *see*, in the economic literature, Andrei Shleifer & Robert Vishny, *Fire Sales in Finance and Macroeconomics*, 25(a) J. ECON. PERSP. 29 (2011). *See* also, among legal scholars, Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121 (2012), at 137 ff.; John Armour, *Making Bank Resolution Credible*, in OXFORD HANDBOOK OF FINANCIAL REGULATION 454 (Niamh Moloney *et al.* eds., 2014); Wolf G. Ringe, *Bail-in between liquidity and solvency* (University of Oxford Legal Research Paper Series, No. 33, 2016), 5-7, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2782457.

[74] For example, in Italy, the special administration procedure (*amministrazione straordinaria*) has played and still plays an important role in the early management of banking crises. It applies to solvent banks in case of serious capital deficiencies or violations of law. It contemplates the appointment of one or more commissioners designated by the Bank of Italy, who replace the board of directors and the supervisory board, and may adopt redress and restructuring measures, with wide powers including a *moratorium* on the bank's payment to face a liquidity crisis. Interestingly, the ECB—in its capacity as supervisory authority competent for early intervention measures—has recently resorted to the special administration in the case of Banca Carige S.p.A. ("Carige"), an Italian bank classified as significant institution. The decision to apply this measure followed the shareholders meeting's rejection to approve a capital increase to cure capital shortfalls. *See* also *infra*, note 224.

Cassese, a scholar of administrative law and former justice of the Italian Constitutional Court, puts it, resolution has essentially substituted a judicial procedure with an administrative one.[75]

The conditions triggering resolution under the BRRD somehow illuminate these goals. A financial institution enters resolution if three conditions are met: (a) the institution must be "failing or likely to fail" ("FOLTF"); (b) no reasonable private solution must be available, including early intervention measures or the write down or conversion of capital instruments;[76] and (c) resolution must be in the public interest.[77]

The first prong of the test requires a bank to either be insolvent or about to become insolvent based on a balance sheet (liabilities exceeding assets) or cash flow, or lack the conditions for authorization for example and particularly with respect to capital requirements and own funds (this element should allow intervention at an early stage of distress, well before financial insolvency).[78] Also significant irregularities, for example in regulatory or financial reporting or governance deficiencies might be weaknesses that, preventing continuing authorization, might lead to resolution.[79] These elements cannot be unequivocally determined, especially under serious time-constraints: in fact, the judgment on no-viability is very discretionary and extremely difficult to render in a timely fashion, also because it is largely based on data provided by the distressed institution. The absence of a possible private-sector solution, the second element for resolution, is not more straightforward to determine in an objective and quick way. How should the market be canvassed to ascertain that no competitor is interested in a buyout?

Even more slippery is the reference to "public interest". Whether resolution is in the public interest can be expressed with the idea that winding up the distressed institution under normal insolvency rules would not be preferable in light of the goals of the BRRD. These goals, however, are once again extremely broad, generic and not ranked in any specific hierarchy[80], and are even more problematic to balance due to their contradictory nature. They include: (1) ensuring the continuity of critical functions; (2) avoiding significant adverse effects on financial stability; (3) avoiding or minimizing recourse to public funds and taxpayers' money;

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75 *See* Sabino Cassese, *A new framework of administrative arrangements for the protection of individual rights* (*ECB Legal Conference 2017: Shaping a new legal order for Europe: a tale of crises and opportunities*, 2017) at 239 ff., available at www.ecb.europa.eu/pub/pub/legal/html/index.en.html.

76 *See* Art. 32(1) BRRD.

77 As a matter of principle, the resolution decision is adopted with respect (and having regard to satisfaction of requirements relating) to a *single* credit institution. A complex set of provisions regulates the possibility that the failure of a bank being part of a group spreads over the other entities of the group, so that the resolution of the parent company and other subsidiaries (in addition to the resolution of the failed institution) becomes functional in the interest of the group. *See* Art. 33 BRRD.

78 On the rationale of this provision, note that, if a bank fails to comply with the conditions for authorization, it cannot continue to operate as a going concern. Therefore, the value of its assets immediately impairs and falls below the value of liabilities, leading to a situation comparable to that of an insolvent institution.

79 On the FOLTF test and the underlying criteria, *see*, *e.g.*, Jens-Hinrich Binder, *Proportionality at the Resolution Stage: Calibration of Resolution Measures and the Public Interest Test*, (2017), 18-19, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2990379; Seraina Grünewald, *Legal Challenges of Bail-in*, in *ECB Legal Conference 2017 - Shaping a New Legal Order for Europe: A Tale of Crises and Opportunities*, 2017, available at https://www.zora.uzh.ch/id/eprint/144029/1/Gruenewald_ECB_Legal_Conference_Eproceedings_2017_12.pdf; Tröger, *supra* note. 70, at 13-15. Yet, while one may question that "likely to fail" involves a difficult *ex ante* prognosis, it should be noted that the effectiveness and credibility of a resolution (and especially the bail-in tool: *see* below in the following Paragraphs) depends on the possibility that it is triggered *before* insolvency, while the bank is not facing a liquidity outflow. *See* Ringe, *supra* note 73, at 26-28.

80 Michael Schillig, *Bank Resolution Regimes in Europe – Part II: Resolution Tools and Powers*, 25 EUR. BUS. L. REV. 67 (2014)

(4) protecting deposits, investments and other clients' funds.[81] As we extensively discuss below, the balancing of such conflictual objectives lies at the very heart of the criticism surrounding the resolutions implemented under BRRD thus far.[82]

In terms of institutional competences, the scheme of the BRRD is also quite complicated. In short, if the management body of an institution realizes that the conditions for resolution are met, it must notify the supervisory authority (essentially, either the ECB or the National authority), which in turns informs the SRB (which can also act *motu proprio*). Following the decision to initiate resolution, all competent authorities—ECB, EU Commission, ESAs, ESRB—are notified, and the public is also informed. The resolution authorities will therefore draft a resolution plan including the possible use of the Single Resolution Fund and/or State aid, which will be effective if neither the Commission nor the Council object within twenty-four hours. The actual carrying out of the resolution plan will be entrusted with the national resolution authorities, also through the appointment of a special administrator.

(b) Resolution Tools – Bail-in

Resolution authorities do also enjoy a significant level of flexibility with respect to the specific tools that can be used, ranging from the sale of the business to a private buyer, to the transfer of the business to a bridge bank publicly managed; from the separation of assets through the creation of a "bad bank" managing troubled assets, to bail-in. It is important to point out that these "tools" are not mutually exclusive, and in fact can and are combined.

The sale of business, the use of a bridge institution or of a bad bank, while can present specific features in the context of resolution, are relatively tried-and-true transactions to address financial distress and do not require a specific analysis for our purposes.[83] We will on the contrary briefly discuss the major issues of the bail-in tool.

Essentially, bail-in (similarly to other "burden sharing" mechanisms set forth by the BRRD)[84] is the statutory imposition of losses on liabilities not designed by their original terms. It is a forced, partial alteration and anticipation of priority rules applicable in case of insolvency according to which losses functional for financial stability and continuation of critical functions are borne by shareholders and unsecured creditors, allowing a so-called internal recapitalization.[85]

More specifically: on the one hand, consistent with a policy attitude affirmed in the aftermath of the financial crisis, the bail-in tool "restores" the basic insolvency principle whereby share-

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[81] *See* Art. 31 BRRD. Examples of resolution authorities' evaluations with respect to the general resolution's objectives are provided below, Part V: as we will show, face to real cases, the various decision-makers have interpreted the meaning of these objectives in different ways, generating multiple and conflicting outcomes. Also, the application of Art. 31 has evolved over time.

[82] *See* below, Part V.

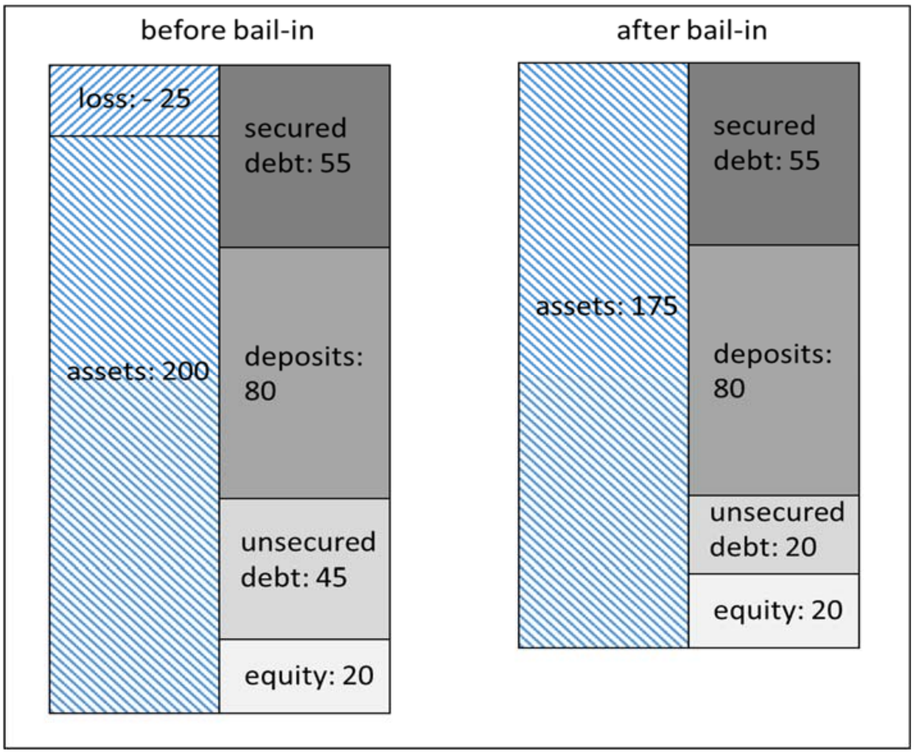
[83] As we discuss below, most banking crises are resolved through the use of such "traditional" tools, occasionally coupled with a bail-in. *See* below, Part V.

[84] *See* Arts. 59-62 BRRD.

[85] As noted by Ringe, *supra* note. 73, at 3, bail-in is a "third way" between the two opposite tools historically adopted in a bank crisis, *i.e.* "to provide central bank liquidity for banks that are illiquid, and to wind down insolvent ones" (of course, the Author cites WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 1 (1873).

holders and creditors must bear the institution's losses, according to the statutory and contractual order of priority, before any public funds are used.[86] On the other hand, as continuity in the critical functions of relevant banks needs to be prioritized (due to their systemic role in the financial system), the shareholders' and creditors' sacrifice cannot be enforced at the end of a bankruptcy procedure, where creditors satisfy themselves, *pro rata*, on what is left after liquidation of the debtor's assets; it must be enforced *ex ante*.

In its essence, the concept is straightforward and similar results can be and have been achieved through private agreements or mandatory and occasionally *ad hoc* legislative measures in specific jurisdictions. The following scheme represents in a simplified way the balance-sheet effects of bail-in.



Imagine that the deterioration of certain assets, for example non-performing loans, determines a loss of 25 of the original book value of the assets (200), with the consequent erosion of own funds. Bail-in allows the recapitalization of the bank as follows: old shareholders are wiped out, and unsecured liabilities are also written down for the remaining 5; in addition, an amount of unsecured liabilities equal to 20 is converted into shares on a pro-rata basis. In this particular example, other "bail-inable" liabilities, such as deposits in excess of €100,000, are unaffected. Bail-in can obviously lead to a change in control over the distressed bank, in which case the financial supervisor will also need to verify whether the new shareholders

[86] *See*, *e.g.*, Emilios Avgouleas & Charles A. Goodhart, *Critical Reflections on Bank Bail-ins*, in 1 J. FIN. REG. 3 (2015), at 3; Marco Bodellini, *To Bail-In, or to Bail-Out, that is the Question*, 19 EUR. BUS. ORG. L. REV. [EBOR], 365-392 (2018), at 372.

(former creditors) are fit and proper and authorize them. Needless to say, under these circumstances the issuance of new shares does not require a vote of the shareholders' or action by the board of directors.

What liabilities are eligible for bail-in? The BRRD takes a comprehensive approach providing that all liabilities are in principle subject to bail-in, with both statutory exemptions and *ad hoc* exemptions that can be granted by the resolution authorities. In the first group we find: secured liabilities up to the value of the collateral; deposits up to the amount guaranteed by a deposit guarantee scheme ("DGS", generally €100,000) that will contribute the guaranteed funds, and liabilities for contributions to DGSs; clients' assets and funds held as a separate asset protected by the law (e.g. in case of portfolio management services); liabilities arising from a fiduciary relationship (a rather ambiguous concept); liabilities toward third party financial institutions and payment or settlement systems with a maturity of less than seven days (for obvious financial stability reasons and to avoid contagion); liabilities to commercial creditors that provide critical goods or services (also a rather fuzzy distinction); liabilities toward employees for remuneration and benefits (excluding however variable remuneration); and to tax and social security authorities preferred by law.

In addition, the BRRD also allows resolution authorities to grant specific exemptions from bail-in on a discretionary basis, for example if the exclusion is necessary and proportionate for continuity of critical functions or to avoid contagion, if the costs of bail-in would exceed the benefits for other creditors, or if it is impossible to bail-in the liability in a reasonable timeframe (e.g. with respect to derivative instruments). Discretionary exemptions must however comply with the NCWO principle, since obviously any exemption of certain liabilities from possible haircuts might worsen the position of other bail-inable creditors.[87]

In terms of order of priority, equity instruments—if they have not been already written down or converted before resolution—are affected first (Common Equity Tier 1—Additional Tier 1—Tier 2), essentially followed by: (1) subordinated junior liabilities; (2) uncovered senior liabilities; (3) uncovered deposits and (4) the DGS the bank is affiliated to for the covered deposits. Each class has to be affected before the following one can be impacted, and within each class creditors are subject to pro-rata.

This approach is intended to mimic the effects of normal insolvency procedures in observance of the NCWO principle, which is the North Star of resolution procedures: no creditor can be affected more by resolution than it would in a liquidation scenario.[88] It is worth immediately pointing out, as we will discuss more extensively assessing the BRRD, that actual compliance with this principle can be extremely difficult to achieve and, especially, to determine *ex ante*. This is particularly true and problematic in the fairly common situation in which bail-inable liabilities governed by the laws of different jurisdictions exist, since insolvency

[87] Debate has sparked over the issue of recognizing in favour of retail holders of bail-inable debt a general exclusion from write-down and conversion events. EBA and ESMA, while adopting the view of providing retail investors proper and specific consideration in bail-in scenarios, highlighted that protection should still follow a case-by-case approach: exemptions pursuant to Art. 44(3) of the BRRD should therefore continue to be regarded as exceptional, and shall be granted only following a though evaluation of the specific circumstances of the particular case at hand. *See* EBA & ESMA, *Statement of the EBA and ESMA on the treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive*, EBA/Op/2018/03 (May 30 2018), available at https://eba.europa.eu/documents/10180/2137845/EBA+ESMA+Statement+on+retail+holdings+of+bail-inable+debt+%28EBA-Op-2018-03%29.pdf. *See* also below, note 238.

[88] *See* more extensively Paragraph III.E below.

laws are not harmonized.[89] Also from an international private law perspective, while within the EU the effects of bail-in should be recognized and enforced—even tough reluctance is possible[90]—, it is questionable what might happen with liabilities governed by the laws of non-EU country. In an effort to mitigate this potential problem, the BRRD requires the terms of these liabilities should include provisions clarifying the possibility of bail-in.

To summarize, the bail-in is an unprecedented mix between a "Chapter 7-like" procedure and a "Chapter 11-like" restructuring. *Like* in a corporate restructuring, the business of the insolvent institution is never discontinued, and liabilities are written off on the basis of an *ex ante* assessment of the bank's assets, which, however, are not actually disposed. *Unlike* a corporate restructuring, creditors do not vote on their write-off, as the bail-in is an authoritative mechanism: it operates by order (and discretion) of supervisory authorities. Furthermore, as certain classes of creditors need to be protected (depositors, but also creditors that are critical to the continuity in the institution's functioning), the relevant liabilities are ring-fenced from the bail-in's axe, and are exempted from write-off (or conversion).

Bail-in can limit panic, bank runs and contagion only if it is a credible and final solution to the crisis of the resolved financial institution; otherwise, it can easily turn into a fire alarm worsening the downward spiral. For this reason, it is obviously necessary to ensure that banks have a sufficient amount of bail-inable liabilities to achieve the internal recapitalization in an orderly, effective, and timely manner. The BRRD therefore mandates a Minimum Requirement of Own Funds and Eligible Liabilities ("MREL") on EU banks, precisely in order to allow bail-in. Financial authorities set, and verify on an on-going basis, specific levels of MRELs depending on the size, complexity, interconnectedness and risk profile of each supervised entity, according to harmonizing guidelines set forth by the EU Commission and the EBA.[91] MREL is calculated based on the total amount of liabilities and equity through complex evaluations, formula and calculations that would be beyond the scope of

[89] For example, Art. 108 of the BRRD, as recently amended by Directive (EU) 2017/2399, has sanctioned the priority of uncovered deposits (*i.e.* exceeding €100,000) from natural persons and SMEs over other uncovered deposits (as well as the priority for the subrogation rights of deposit guarantee schemes that have reimbursed depositors). Such Article doesn't however introduce a general depositor preference. Nonetheless, Member States are not prevented by the applicable BRRD framework to establish a such a preference in their respective national jurisdictions (*see*, in this regard, Art. 91 of Legislative Decree No. 385 of 1 September 1993, G. U. Sep. 30 1993, n. 230 (It.) [hereinafter Italian Banking Act]). While this choice of the European legislator may be appreciated from a theoretical policy standpoint, it adds to the dis-homogeneity of the European market consequently shaping different regimes.

[90] It should be noted that the BRRD creates a minimum harmonization regime: consequently, national super-equivalent implementation activity adding on to the requirements imposed by EU legislation is allowed. Member States are thus granted the option to maintain national recovery and resolution instruments, as long as these do not breach the provisions of the BRRD. In a cross-border scenario however, super-equivalent implementation by a Member State where a financial institution under resolution is located is not exempt from potential legal challenges.. Indeed, courts of another Member State whose national laws apply to instruments issued by the abovementioned institution may determine that such super-equivalent implementation is not covered within the mutual recognition provisions of the BRRD and is, as such, unenforceable. *See* World Bank, *Bank Resolution and "Bail-in" in the EU: selected case studies pre and post BRRD*, 2017, available at www.documents.worldbank.org/curated/en/731351485375133455/pdf/112265-REVISED-PUBLIC-FinSAC-BRRD-CaseStudies.pdf; Matthias Lehmann, *Bail-In and Private International Law: How to Make Bank Resolution Measures Effective Across Borders*, 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2759763.

[91] Commission Delegated Regulation (EU) 2016/1450 of the European Commission of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities, 2016/450 (2016); EBA, *Final Report on MREL. Report on Implementation and Design of the MREL Framework*, Dec. 14 2016, available at www.eba.europa.eu/documents/10180/1695288/EBA+Final+MREL+Report+%28EBA-Op-2016-21%29.pdf .

this analysis. A similar tool is the so-called "TLAC" (Total Loss Absorbing Capacity), established by the Financial Stability Board and applicable to global systemically important financial institutions ("G-SIFIs"), which will come into effect in 2019. While technical differences exist between the two measures, an effort is underway to coordinate the different requirements.[92]

MREL and similar instruments add yet another constraint on the banking business; they represent, so to speak, a side effect of bail-in that further limits the flexibility of the financial structure of a bank and, more generally, its business model, strategies and options. They also impose the creation and distribution of certain bail-inable liabilities thus making even more delicate the balance between rules designed to protect investors and incentives of banks to sell more risky instruments to their clients.[93]

The issue of sufficient loss-absorption capacity through the issuance of bail-inable liabilities is linked to the debate over two different resolution approaches: Single Point of Entry ("SPE") versus Multiple Point of Entry ("MPE"). The problem is well known in the context of insolvency of international groups and determined by the necessity to coordinate the goals and tools of these procedures with the existence of an economically integrated business operating through several formally separate legal entities governed by the laws of different jurisdictions.[94] The complexity of the BRRD and the specificity of the banking activity exacerbate this problem. In fact, resolution can be very disruptive for continuity of a cross-border group, limiting the possibility of intra-group transactions and the continuity of centralized functions at the holding level.

Stripped to its essential elements, SPE requires the adoption of a bank-holding structure and resolution to focus at the level of the entity at the top of the group rather than the single operating banks in distress. The holding corporation would be primarily required to hold bail-inable liabilities thus mitigating cross-border recognition of resolution decisions. Pursuant to the MPE approach, on the other hand, national authorities and differences in local laws might hinder an orderly and coordinated resolution and single companies comprising

[92] *See* below note 165.

[93] A further issue concerns the pricing of the newly-issued bail-inable instruments. The high degree of discretion afforded to the various institutions having a voice in the resolution decision-making process renders the risk level associated to such instruments (and the relevant pricing) quite unpredictable. Also, changes and adjustment of the MREL framework are possible along the way, so affecting the price of already issued securities and adding to the complexity of this piece of regulation. On this issue *see*, also for further reference, Tobias H. Tröger, *Why MREL Won't Help Much* (EBI Working Paper No. 13, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023185.

[94] Past experience demonstrates that the reorganization of international corporate groups is likely to be more successful, if the group is regarded as a single entity. The ideal way to pursue such goal would be by means of single and centralized insolvency proceedings: in this regard, the competent venue could be chosen based on the jurisdiction where the involved corporate group has its centre of main interests. A centralized proceeding may however result difficult to achieve, considering that all States in which group companies are incorporated should agree to transfer their jurisdiction in favour of the courts of the State where the group has its main centre of interests. In this regard, applicable U.S. legislation is open to group reorganizations being performed through a single insolvency venue (28 U.S.C. § 1408(2) (2006)). In relation to the European Union, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, 2015 O.J. (L 141), does not contemplate single group proceedings. Nonetheless, it encourages the opening of group coordination proceedings on a voluntary basis. These are primarily aimed at facilitating the effective administration of the insolvency proceedings of group companies, while fostering at the same time stronger communication ties between the national courts involved. For a comprehensive analysis, *see* Nora Wouters & Alla Raykin, *Corporate Group Cross-Border Insolvencies Between the United States & the European Union: Legal and Economic Developments*, 29 EMORY BANKR. DEV. J. 387, 388-408 (2013); Samuel L. Bufford, *International Insolvency Case Venue in the European Union: The Parmalat and Daisytek Controversies*, 12 COLUM. J. EUR. L. 429, 434 (2006).

the group might ring-fence their liabilities. SPE developed in the US with the Dodd-Frank Act also because, due to historical regulatory limits, banking groups were already organized with holding corporations. In Europe, where the universal (and operating) bank model is the norm, and in any case holding banks do not necessarily raise significant bail-inable debt, a transaction to structures coherent with the SPE approach would be complicated, costly and require time, even assuming it would be preferable in theory.[95]

(c) Bail-in, Compared to (and Combination with) Other Resolution and Insolvency Tools

While, so far, we focused on the mechanics of the bail-in, it is worth noting that recapitalization is instrumental to the turnaround of a failing institution. One may ask what is the "advantage" of the bail-in compared to other 'traditional' restructuring tools, such as, for example, the separation of the bank's profitable assets and client relationships—to be put together into a good bank and sold to a third-party purchaser—and a residual bad bank to be liquidated. In fact, when it comes to large credit institutions, an accurate division of a banking business into a "good" and a "bad" part may prove almost impossible in few hours. The bail-in, used in combination with (or in preparation for) another resolution tool, prompts an immediate restoration of capital requirements, thus helping avoid a sudden interruption of the strategic functions, preserve its going concern, buy time to identify the good business, and negotiate a transaction with an interested purchaser.[96]

Yet, the bail-in mechanism can work provided that sufficient liquidity is available or accessible to the failing bank.[97] In such case, while the bank continues its activity, liabilities are cancelled or converted into equity, and capital requirements are restored. But if the bank operates in a context of generalized distress of the financial system, or the resolution tools are activated too late in the process, a deposit outflow may be underway, and the bail-in—which realizes a purely accounting "cleansing" of an ailing institution's balance sheet—is of little help and may, indeed, accelerate the flight of those creditors whose position is at risk.[98]

Another reason why the "competitiveness" of the bail-in tool should not be overemphasized is that, in several jurisdictions, measures aimed at reducing the risk of value disruption and contagion to the banking system—a function akin to that ascribed to the bail-in—are already in place and may operate outside the context of a resolution. For example, while a statutory

[95] Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in Europe: The Unfinished Agenda of Structural Reform* (Columbia Law and Economics Working Paper No. 465, 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2361347.

[96] Moreover, to the extent bail-in prompts the conversion of certain debt into equity, bailed-in creditors may gain governance powers that may be used, for example, to start lawsuits and enforce the liability of the incumbent management. On the functions of bail-in in combination with other resolution tools, *see* expressly Art. 37(3) BRRD. According to Simon Gleeson, *Legal Aspects of Bank Bail-Ins* (FMG Special Papers, Financial Markets Group, 2012), at 16, a bail-in may also offer an *alternative* to the traditional partitioning into good-bad bank, arranging for the *entire* bank to remain solvent (thanks to the liabilities' write-off) and being sold to an interested purchaser, without putting the latter's stability at risk. In the light of the BRRD experience so far—where almost no "stand-alone" bail-ins took place—this proves to be a rather theoretical alternative. *See also* Chris Bates & Simon Gleeson, *Legal aspects of bank bail-ins*, 5 L. & FIN. MKT. REV. 264 (2011), and below, Part V.

[97] In case of liquidity shortages, the Euro-area financial institutions may rely on the ECB's support through the emergency liquidity assistance tool ("ELA"). The ELA aims to provide central bank money to solvent financial institutions that are facing temporary liquidity problems, and is operated independently of normal monetary policy operations. Moreover, ELA is exempt from being subject to bail-in provisions.

[98] On the relationship between bail-in and bank liquidity, *see*, *e.g.*, Gleeson, *supra* note.96, at 16-17; Ringe, *supra* note. 73, at 4 ff. As the latter Author illustrates at 20-23 (and *see* also here above)—if (and only if) activated in a timely manner, the bail-in may also act as a stabilizing tool and prevent the risk of a bank run.

automatic stay is often triggered upon the declaration of insolvency of a bank (which in Europe implies the revocation of the banking license under CRD IV), in some jurisdictions the supervisory authority may consent to a temporary continuation of the banking services. Alternatively, pre-insolvency procedures are sometimes set forth, whereby the bank's board of directors is removed and state-appointed commissioners take office, typically to guide the ailing bank towards an orderly dismissal of non-strategic assets and a restructuring.[99]

Finally, we mentioned the MREL/TLAC as complementary to the bail-in to make it function properly. However, when the BRRD came into force and was implemented in the jurisdictions of the Member States, the bail-in became immediately operative regardless of the completion of the MREL process. Thus, a bail-in could be triggered by order (and discretion) of the supervisory authorities, even if a cushion of bail-inable liabilities was not available to the concerned bank.[100] The unavailability of eligible liabilities added to the issue of "legacy" liabilities. Private investors that had lent money (namely subscribing to subordinated bonds) to a bank in a time where the bail-in did not exist in their legal system were not excluded from the scope of application of the new rules—a problem that, in some jurisdictions, is referred to as "retroactivity of the bail-in".[101] As we will see, this "transitional" issue has

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[99] Italy, having a significant past experience in banking rescues, offers interesting examples of both tools. Art. 70 of the Italian Banking Act provides for the (pre-insolvency) special administration procedure, already described at note 74 above. Indeed, even in an insolvency context, the bank under "administrative compulsory liquidation" (*liquidazione coatta amministrativa,* the special insolvency procedure applicable to Italian banks and financial institutions) may be authorized to temporarily continue its essential operations (such as payment services), "if necessary and with the purpose of increasing the value of the assets to be dismissed" (art. 90.3 of the Italian Banking Act). The complex interplay between these tools and the BRRD tools are analyzed by Raffaele Lener, *The Implementation of BRRD and the Banking Crisis in Italy*, in 2017 RIV. DIR. SOC., at 722, and Lorenzo Stanghellini, *La disciplina delle crisi bancarie: la prospettiva europea* (Banca d'Italia Quaderni di Ricerca Giuridica No. 75, 2013), available at https://www.bancaditalia.it/pubblicazioni/quaderni-giuridici/2014-0075/Quaderno_n-75.pdf, at 174-176.

[100] It is noteworthy that, in the public debate that preceded the enactment of the BRRD, the idea of a *contractual* bail-in was defended as preferable to the *authoritative* bail-in eventually implemented. In 2010, the Basel Committee on Banking Supervision, *Proposal to ensure loss absorbency of regulatory capital at the point of non-viability* (2010), available at https://www.bis.org/publ/bcbs174.pdf, introduced the concept of contingent capital instrument ("CoCos"), meaning hybrid financial instruments that may converted into capital upon occurrence of certain liquidity events. Clearly, both types of bail-in bring to a similar outcome (the recapitalization of the institution), but only in the contractual bail-in the creditor's consent is obtained (*ex ante*), and only in respect of pre-determined trigger events. On this matter, *see* Coffee *jr.*, *supra* note 70; Charles W. Calomiris & Richard J. Herring, *Why and how to Design a Contingent Convertible Debt Requirement* (Wharton School Working Paper, 2011), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1815406; Andreas Cahn & Patrick Kenadjian, *Contingent Convertible Securities: From Theory to CRD IV*, in EUROPEAN BANKING UNION 270 (Danny Busch & Guido Ferrarini eds., 2015). Eventually, a solution of compromise prevailed in the legislative process for the BRRD: statutory bail-in was adopted but, at the same time, the issuing of CoCos (or other "contractual bail-in instruments") was expressly recognized for the purposes of meeting the MREL threshold. Under Art. 45(13) BRRD, the decisions taken by the resolution authorities on the MREL of each institution (or group) "may provide that the minimum requirement for own funds and eligible liabilities is partially met at consolidated or individual level through contractual bail-in instruments". *See* also Tröger, *supra* note 93, at 21-22.

[101] Conversely to the CoCos idea (where a contractual bail-in may prevent the authoritative bail-in), Art. 55 BRRD mandates Member States to require institutions to include in bail-inable liabilities "a contractual term by which the creditor or party to the agreement creating the liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due". In this way, the statutory (authoritative) bail-in is factored into the contractual terms, in an attempt to overcome the complex international private law issues stemming from application of bail-in to an institution that has issued financial instruments regulated under the law of third party countries (*see* above, note 100). But, needless to say, bail-in cannot be easily "contractualized" (retroactively) in financial instruments issued before its statutory introduction.

played a decisive role in the way banking restructuring have been crafted in the pre- and post-BRRD era.

D. Judicial Review of Resolution Actions.

As we already mentioned, recovery and resolution in the BRRD is an administrative procedure, as opposed to traditional insolvency procedures that are either judicial or conducted under the control of a court, in which authorities have broad and sweeping powers and judicial review is limited not to hinder the effectiveness of the adoptable measures. In fact, resolution, and particularly the bail-in tool, can infringe upon fundamental rights set forth by either the European Charter of Fundamental Rights of 2000, or the European Convention on Human Rights, such as the right to property, the freedom to conduct a business, and—due also to the urgency with which these measures are adopted—the right to a fair trial.[102]

An analysis of these rights would be utterly outside the scope of this Article: our goal here is simply to offer a general understanding of the major judicial review issues arising out of the BRRD. Considering the jurisprudence of the European Court of Human Rights and the ECJ, we can observe that interferences with individual rights in the context of procedures aimed at addressing the crisis of a financial institution are allowed if they are in the public interest, are proportionate and—in case of takings of property—fair compensation is provided. Public interest and proportionality, while elusive concepts in their practical applications, are obviously pursued by the BRRD and resolution authorities. The existence of fair compensation, for example for a bondholder whose credit is canceled off, is more questionable, however the NCWO principle provides a basis to argue that affected parties do not receive less than the actual value of their rights or claims.[103] As we will see, this seems a very questionable conclusion.

More broadly, the case law that has developed in this area might have been effectively summarized by Michael Schillig: "*ex ante* judicial review is not required, and the requirements for a prior notice and hearing may be dispensed with in the interest of safeguarding financial stability and the rights of depositors and creditors. *Ex post* judicial review is a necessity, with one level of jurisdiction being sufficient. Procedures may be expedited and confidential. The scope of review must, however, be comprehensive. The standard of review may be limited to an arbitrariness assessment, owing to the wide margin of discretion afforded to public authorities in delicate economic areas such as banking and financial regulation".[104]

To be a little more specific, talking about judicial review we need to distinguish at least three issues: jurisdiction (in the sense of power to adjudicate), standing and standard of review.

Considering jurisdiction, a first issue is that resolution under the BRRD requires both acts of European bodies, and specifically the SRB, and of the national resolution authorities. The general principle here is a formal one pursuant to which acts adopted by the European authorities can be challenged in front of the ECJ, and acts adopted by the national authorities

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[102] *See* Paul Artemou, *Rights of European Union Depositors Under Article 17 of the Charter of Fundamental Rights After the Cyprus Bail-Out*, 28 PACE INTL. L. REV. 205 (2016); William B.T. Mock, *Human Rights in Europe: Commentary on the Charter of Fundamental Rights of the European Union*, 108 (William B.T. Mock *et al.* eds., 2010); Michael W. Müller, Creditor protection in bank resolution: a case for international investment arbitration?, 10 CAP. MKTS. L. J. 276 (2015).

[103] *See* MICHAEL SCHILLIG, RESOLUTION AND INSOLVENCY OF BANKS AND FINANCIAL INSTITUTIONS 113 (Oxford University Press ed. 1st ed. 2016). The Author argues that affected creditors should also be recognized a right to effective judicial review, which shall be unhindered by "practical impediments".

[104] *Id.* at 115.

can be challenged in national courts. This feature obviously raises a first delicate question in terms of harmonization and equal treatment, considering that national judicial systems present a common core of general principles but also significantly different approaches, rules and standards (just consider the existence of special administrative courts), which can determine differences in available remedies. Additionally, the distinction between the jurisdiction of the ECJ and national courts is far from clear-cut. In principle, for example, the general resolution scheme is adopted by the SRB, but to the extent that it simply provides for a blueprint for resolution, and its enforcement is delegated to national authorities, it is questionable whether it might (at least concretely) be challenged in European courts. The answer probably depends on the degree of discretion granted to national authorities, in the sense that the greater the discretion, the more solid is the ground for jurisdiction of national courts. This extremely important issue, however, is neither settled in the applicable legislation, nor cleared by case law or scholarly interpretations. On the other hand, national courts faced with litigation based on the activity of national authorities in furtherance of a SRB's resolution scheme might be required to refer questions to the ECJ by way of a preliminary ruling (pursuant to Article 267 of the TFEU). Applicants have however limited and uncertain protections against the decision of a local court not to refer a question to the Luxembourg Court.

Also, in terms of standing to sue, we find a not entirely straightforward picture. Decisions of the Commission concerning State Aid or Fund Aid, as well as objections to the resolution scheme adopted by the SRB, are subject to judicial review under Article 263 TFEU. Therefore, they can be challenged by Union Institutions and Member States (privileged applicants) and by natural and legal persons. The latter two, however, only if the decision is "addressed to them" or is "of direct and individual concern to them", a notoriously vague standard. In fact, since the resolution scheme is addressed to national resolution authorities, it is questionable whether the financial institution, its managers, shareholders and creditors have standing to challenge it directly. The *Plaumann* test, named after a 1963 ECJ decision,[105] should apply, but it offers only limited guidance on their right to sue in the ECJ.

Finally, also review standards are far from being entirely clear and predictable. While, in theory, lack of competence, violations of the Treaties, applicable laws, general principles of law or procedural requirements, and misuse of powers are grounds for a challenge, the precise scope of these boundaries is complex at best and confusing at worst. The picture is further complicated by the significant discretion granted to public authorities in economic matters, as it emerges both from case law[106] and is made explicit by Recital (89) of the BRRD. One of the possible grounds for review is whether the evidenced used is factually accurate, reliable, and consistent; and whether it contains all the relevant information and substantiates the conclusions reached; but these elements can be very slippery in the highly technical field we are discussing.

Articles 85 and 86 of the BRRD require Member States to ensure judicial review at the national level, but with significant limitations justified by the urgency of the procedures and the need for effective resolution. The directive distinguishes between judicial review of "Crisis Prevention Measures" (essentially, measures dealing with recoverability and early intervention preceding resolution) and "Crisis Management Measures" (resolution decisions and powers). *Ex-ante* judicial review or approval is possible, but not required. States can adopt it, but courts are subject to very strict deadline: a decision must be taken within 24 hours, and the competent authority must act immediately after the court's response. *Ex-post* judicial

[105] [ECJ], Case 25/62 Plaumann & Co v Commission 1963 E.C.R. 95.
[106] *See e.g.* [ECJ] Case C-12/03 P Commission v Tetra Laval 2005 E.C.R. I-987 par. 39.

review must be provided for, but subject to several limitations: the lodging of an appeal (the term is used in the Directive in the sense of any judicial challenge) does not suspend the effects of the decision, which becomes immediately effective with a presumption that its suspension would be against public interest. In addition, the eventual annulment of a resolution authority's decision does not affect any consequent decision or act based on the challenged decision, and the only possible remedy are monetary damages.

In short, judicial review of resolution decisions (and early intervention measures) is possible, but it is significantly limited coherently with the overriding necessity of swift action. Even more troubling, the essential pillars of judicial review in terms of jurisdiction, standing and applicable standards are uncertain and unsettled. While this is partially inevitable in a relatively new regime, it seems particularly problematic in an area in which the relevant authorities have very broad, incisive and discretionary powers that might infringe on fundamental rights of individuals and legal entities.

E. Liquidation and NCWO Principle

When the conditions for resolution are not met, an insolvent or otherwise compromised entity can be liquidated according to national law. Insolvency procedures vary significantly among different Member States but, as we have discussed, their premises and goals are different from resolution. Simplifying, the latter aims at preserving and enhancing what could be saved of an ailing going concern, ensuring the continuity of essential functions, and providing for an orderly liquidation of the rest. Winding up and liquidation, on the other hand, are aimed at selling all the assets of the debtor and satisfying its creditors *pro-rata* and *pari passu* according to their order of priority, eventually eliminating from the market the failed intermediary. In this case the goal is to maximize the value of the assets and protect, over other interests, the ones of creditors. In addition, while national laws differ in this respect, liquidation is generally a judicial procedure or, more precisely, is conducted under the strict control of a court; resolution is on the other hand essentially an administrative procedure in which, as we have discussed, the relevant authorities enjoy extensive and discretionary powers.

Liquidation and resolution, however, are not entirely incompatible and alternative. In fact, resolution can and often includes "elements" of liquidation, for example, when a "bad bank" (typically, the insolvent bank, the "good business" of which has been transferred to a third-party acquirer) is put under liquidation. Similarly, outside of the scope of the BRRD national procedures can present elements of both resolution and liquidation: consider the case of the "Banche Venete" in Italy (see below, subparagraph V.D(c)), in which a good bank was sold to a large banking group, and the residual bad banks were put under receivership.

One issue that has not received a lot of attention, either in EU law or in scholarly comments, is whether during resolution it might become apparent that the requirements for resolution no longer exist, and liquidation should be initiated. For example, during resolution it might become clear that avoiding liquidation is not, or no longer, in the public interest. Can resolution be transformed into liquidation under these circumstances? The BRRD does not offer a clear answer, but—as we will see—resolution authorities have frequently faced a "failure" of the resolution attempt, and a consequent need to resort to either a "phase 2 resolution" or a "post-resolution" liquidation of bad banks or asset management companies.[107]

One of the most important connections between resolution and liquidation is, of course, the no-creditor-worse-off ("NCWO") principle, which requires an evaluation of the hypothetical effects of liquidation. The BRRD requires a first evaluation of the possible effects of liquidation before resolution, which is relevant also to define a resolution strategy that would respect the NCWO principle (so-called "*ex-ante* valuation"). However, as soon as resolution starts, an "*ex-post* valuation" should also be initiated with the aim of determining the hypothetical liquidation value of the different positions and claims: if this exceeds what creditors have received in case of bail-in, they can obtain monetary compensation. There is no specific deadline for either resolution or this evaluation. This is probably inevitable since the purpose is to compare the hypothetical results of liquidation with the actual ones of resolution, but it might postpone significantly the protection of creditors, with little consideration for the time-value of money.

The NCWO assessment poses a series of critical issues, some of which already "materialized" in the experience of the first BRRD cases.[108] First, it appears that the calculation of the outcomes of liquidation should be based on the information reasonably available to the authorities at the time of resolution[109] - and not on the basis of the information available when the *ex post* evaluation is finalized—and this result has to be compared with the actual results of resolution. This option is questionable. In fact, it does not ensure that creditors will not be treated worse than how they would have been treated in liquidation, but rather than how they would have been treated based on an *ex ante*, hypothetical (theoretical?) assessment of the consequences of liquidation. It might happen that during resolution information is acquired or events occur that suggest that, in fact, the outcome of liquidation might have been significantly better than what was originally imagined.

The problem is potentially compounded by the fact that, while the evaluation is entrusted with an independent expert, the expert can be the same individual or entity who conducted the *ex ante* evaluation, with the obvious consequence of a possible (at least "intellectual") conflict of interest. Finding that resolution in fact was worse than liquidation for some creditors suggests an erroneous *ex ante* valuation or decision to proceed with resolution. Of course, the *ex post* evaluation can be challenged in court, but that is obviously not a perfect protection.[110]

Further, one should consider that the decision to resolve a credit institution might be taken even when it is not financially insolvent.[111] This might determine what we will call the NCWO paradox: the regulatory approach requires a comparison between the results of a procedure applicable *before* insolvency, with the ones that would emerge from liquidation *after*

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[107] The Novo Banco case (in Portugal) and the HETA case (in Austria) are just two examples, with radically different solutions provided by the national authorities. *See* below, Part V.

[108] *See* below, Paragraph V.D, especially with respect to the Banco Popular resolution.

[109] *See* World Bank, *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD* (2017), available at http://documents.worldbank.org/curated/en/100781485375368909/pdf/112266-REVISED-PUBLIC-0317-FinSAC-BRRD-Guidebook.pdf.

[110] Interestingly, a similar issue arises in (Chapter 11-like) restructuring proceedings of "normal" corporations. A restructuring plan (involving sacrifice of creditors) may be upheld to the extent the creditors' position is not sacrificed more than under a bankruptcy scenario (*see*, *e.g.*, for a comprehensive analysis, Arturo Bris *et al.*, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 3 J. FIN. 1253 (2006)). However, a "normal" restructuring is subject to approval of (at least) a majority of the affected classes of creditors, while resolution is enforced regardless of any creditor's approval.

[111] *See* above, Paragraph C.

insolvency has occurred. This seems a bit similar to a situation in which a physician decides to amputate the broken finger of a patient even in the absence of gangrene, because this will allow him more time to treat other patients (the "public interest" requirement of resolution). NCWO evokes the idea that the doctor might justify the decision arguing that the patient is not worse off than in case of gangrene. The patient might object, however, gangrene had not set in yet…[112]

As a further problematic issue—especially for institutions that operate cross border—the liquidation scenario, on which the NCWO test is based, inevitably refers to national legislations, as bank insolvency rules are not harmonized through the EU.[113] For example, rules governing the creditors' hierarchy in insolvency may significantly differ among member States, so that a creditor might "pass" or "fail" the NCWO test depending on the jurisdiction where the failed bank would be declared insolvent: uninsured depositors and intragroup claims are just two examples of liabilities that are often treated differently in national insolvency procedures.[114]

Last, but not least, the NCWO test (which focuses on the position of individual creditors) critically interferes with the public interest assessment (see above). In fact, the recovery chances of a creditor of a wound-up bank and one of a resolved bank depend on the side effects of insolvency in both scenarios. In a liquidation scenario, the creditor's expectations attach to the value at which the failed bank's assets may to be sold to competitors; such value, in turn, depends on the impact that the winding up of the distressed institution may have on the market where such competitors operate. On the other hand, a creditor in a resolution scenario relies on the long-term viability of the redressed institution (*i.e.* the objective of the bail-in) which, in turn, depends on the possible chain (contagion?) effects triggered by the bail-in. As we analyze below, the assessment of such side market effects played a crucial role in the first BRRD experiments, leading in some cases to short circuits and paradoxical outcomes.

F. State Aid

As we mentioned, EU Treaties attribute to the European Commission the supervisory and decisional powers on the matter of State aids. When the financial crisis destabilized the

112 To be sure, one might argue that the decision to enter into resolution is taken once it is ascertained that there is no reasonable prospect that any alternative measure would prevent the failure within a reasonable timeframe (Art. 32(1)(b) BRRD). Using the same surgery simile, the physician amputates the finger because she is sure that gangrene will set. Yet, the unsettling thing is that a private creditor—that has no voice in the resolution process—suffers a *certain* loss in light of (and to prevent) an *estimated* non-viability of the bank. And, in addition, the *amount* of such (certain) loss is determined on an a (further) estimate of a liquidation scenario that will never occur.

113 Directive 2001/24/EC on the reorganization and winding up of credit institutions does not serve this purpose, as its limited function is to ensure that the principle of home-country control (of supervisory authorities and courts) operates also in case of insolvency, and that all assets and claims (including those involving foreign subsidiaries of the insolvent bank) are treated equally regardless of their location. For a thorough discussion, *see* Jens-Hinrich Binder *et al.*, *The Choice Between Judicial and Administrative Sanctioned Procedures to Manage Liquidation of Banks: A Transatlantic Perspective*, 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244334. *See* also below, Paragraph V.B.

114 As mentioned, Art. 108 BRRD (as recently amended by Directive (EU) 2017/2399) only ensures a partial harmonization of certain substantive rules governing the ranking of deposits in insolvency procedures. *See Id.*, at Recital (16), and above, note 89.

banking sector across Europe and an era of bail-outs began, an harmonized resolution framework had not even been conceived as a bill and the Commission was the only European institution withy authority to interfere with the rescue decisions by the national governments.

The approach of the Commission underwent a real metamorphosis over time. At the early stage of the crisis, the authority followed a lenient approach. In a Communication of 2008, it indulgently included several aids (both to the generality of the banks in a Member States and to individual failing institutions) within the category of "aid(s) … to remedy a serious disturbance in the economy of a Member State" that, as such, may be compatible with the internal market pursuant to Art. 107(3)(b) of TFEU.[115] Yet, the 2008 Communication set forth a few conditionalities to the aids. For example, it distinguished between aids to "fundamentally sound" banks facing a liquidity crisis and to institutions affected by inefficiencies, poor management or risky strategy: as, in the latter case, a public financial support may significantly alter competition within the relevant markets, the aids were allowed only subject to "far-reaching restructuring" and compensatory measures to mitigate market distortions.[116] Even with these *caveats*, the framework set out by the Commission was extremely flexible and, *de facto*, inaugurated a sort of "run on the aids", with generally negative effects on the competition in the banking industry across the EU.[117]

The Commission followed up with six further communications, whereby it strengthened the conditions for the granting of aids.[118] The arrival point—reached in the aftermath of the sovereign debt crisis of 2011 and the launch of the Banking Union project in 2012—is the well-known "2013 Banking Communication".[119] A screw-turn with respect to the initial benevolent approach is evident, also from a procedural standpoint. For example, Member States must now pre-notify the Commission of their intention to grant financial support to an ailing institution, so to start a "negotiation" process where the EU institution is actively involved.[120] More importantly, the Commission introduced new substantive conditions for aid granting. Some look quite obvious, such as requiring a change of the beneficiary bank's

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115 *See* European Commission, *Communication from the Commission - The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*, 2008 O.J. (C 270) 02. In particular, according to Art. 107 of the TFEU, "[…] any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market". However, aids primarily aimed at remedying serious threats to the economy of a Member State constitute an exception, and can thus be deemed compatible with the internal market.

116 *See* European Commission, *supra* note 115, § 14.

117 At an EU level, competition suffered distortions because not all States were equally engaged in rescuing their banking sector. For example (and somewhat paradoxically), the Italian banks did not benefit from significant State aids during the 2007-2013 period (the opposite took place in Germany, Spain, Ireland and the UK, not to mention other smaller countries). In part, this was due to the apparent solidity of the Italian institutions during this period, thanks to a lesser exposure to the international markets, but also to a delayed discovery of their real NPL stock.

118 For a summary, *see* Stefano Micossi, Ginevra Bruzzone & Miriam Cassella, *Bail-in Provisions in State Aid and Resolution Procedures: Are they consistent with systemic stability?* (CEPS Policy Briefs No. 318, 2014), at 3-4, available at https://www.ceps.eu/system/files/PB%20318%20SM%20et%20al%20Bail-in%20Provisions%20in%20State%20Aid%20and%20Resolution%20Procedures%20final_0.pdf.

119 *See* European Commission, *Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis*, 2013 O.J. (C 216) 01, [hereinafter 2013 Commission Banking Communication].

120 *See* 2013 Commission Banking Communication, § 32. Note that the dialogue between the Commission and the Member State "applying" for the granting of State aids is based on a "capital raising plan established by the Member State and the bank and endorsed by the competent supervisory authority".

management and the adoption of strict remuneration policies until completion of the restructuring process, as well as policies restricting the distribution of dividends, buybacks and other outflows of own funds.[121]

Two other (less obvious) conditions cut the raw flesh of any restructuring supported by public funds. First, the emergency approval of "blind" recapitalizations or bailouts is no longer allowed. The granting of aids is subject to the prior approval of a credible restructuring plan.[122] The function of this requirement is to ensure that aids are directed only to institutions committed to restore their long-term viability. Alternatively, if a going concern may not be preserved, States may grant aids in the context of (and to safeguard) an orderly wind-down of the failed institution. There is a way-out for States willing to overcome the restructuring plan requirement, but only if the competent supervisory authority confirms that the "blind" aid is necessary to preserve financial stability.[123]

Second, the restructuring process must ensure an adequate burden sharing, *i.e.* "all capital generating measures including the conversion of junior debt […] be exhausted".[124] In practice, the "burden sharing" principle enshrined in par. 19 of the second listed Communication mandates the "reduction" of all the equity and the conversion (and possible write down) of the junior debt. Burden sharing, however, must comply with the NCWO rule.[125] Comparing the Commission's burden sharing requirement with the BRRD's (and SRMR's) bail-in tool, one immediately notes two material discrepancies. To begin with, while the bail-in contemplates the sacrifice of shareholders and *all* creditors of the failed bank (excluding insured depositors and other creditors exempted from the bail-in), under the 2013 Commission Banking Communication only shareholders and *junior* creditors are affected. In addition, unlike the bail-in within the resolution framework, States may avoid the Commission's burden sharing if the financial stability is not put at risk.[126]

As already noted, there are several intersections between the resolution framework and the State aid regulation. Ideally, the BRRD attempted to "factor" into its comprehensive system the principles that also justify the restrictions to the granting of public support to credit institutions. Still, the State aid rules maintain their autonomy, and their interplay with the resolution mechanism is not always linear. One example has to do with precautionary recapitalizations, *i.e.* the most critical terrain of clash between the resolution principles and the Member States' prerogatives to support (not failing, but … ailing) financial institutions.[127] As we noted above, under the BRRD/SRMR, one of the requirements for a precautionary recapitalization (or other extraordinary public financial support) to be authorized is that the public financial support is approved under the Union State aid framework.[128] Here, by definition, no bail-in applies (as the recapitalization occurs out of a resolution scheme), but the

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[121] *Id.*, §§ 37-39; 47-48.
[122] *Id.*, § 50: "a Member State will have to notify a restructuring plan to the Commission and obtain State aid before any recapitalisation or impaired asset measures are taken".
[123] *Id.*, § 50.
[124] *See* 2013 Commission Banking Communication, § 19. The Commission explains: "In the first phases of the crisis, Member States did not generally go beyond the minimum requirements set by State aid rules […] and creditors were not required to contribute to rescuing credit institutions for reasons of financial stability. […] The sovereign debt crisis has […] made clear that such a policy could not ensure financial stability in the long term, in particular for Member States in which the cost of bank bail-outs significantly weakened their fiscal position". *Id.*, §§ 17-18.
[125] *Id.*, § 46.
[126] *Id.*, § 45.
[127] *See* above, Paragraph B.
[128] *See* Art. 32.4(d) BRRD.

Commission's burden sharing requirement *does* apply, although in its "smoother" form that preserves senior creditors and uninsured depositors from write-down.

Another example of interplay between the two sets of rules concerns the adoption of resolution actions involving the granting of public aids, the SRB must refrain from approving such actions until the Commission has positively assessed the use of public support under Art. 107 TFEU.[129] As we noted already (Paragraph II.B above), such interplay requires the Commission to separate, from an organizational standpoint, its function as decision-maker on the State aids and as institution vetting the SRB resolution proposal, which may generate potential conflicts of interest and purposes.[130]

A third area of overlap concerns the alternative between resolution and liquidation under the BRRD framework. As discussed, if there is no public interest to resolution, a failing institution will normally face liquidation according to national insolvency rules, so "escaping" the bail-in trap.[131] If, however, State aids are granted to support the orderly liquidation process, the burden sharing shall kick in again, but leaving senior creditors untouched. It is quite easy to guess that national policy-makers, worried about senior creditors' protests following a bail-in, may push towards a liquidation solution, possibly with granting of public aids.

More generally, in all these cases, the simultaneous operation of the two regulatory frameworks has proven to be a difficult playground for policy- and decision-makers, highlighting a source of possible short-circuit in the European regulation of the banking crises. We provide and analyze examples in Part V below.

IV. A Brief Comparison with the US

The American and European credit institutions share common foundations on which their respective regulatory frameworks are built. Basel III provides the same capital requirements to banks that operate on both sides of the Atlantic, although the international parameters interplay with different accounting and prudential rules. Likewise, the pre-crisis and insolvency measures in the two continents draw from the Financial Stability Board impulse after the 2007-2008 financial crisis and have comparable features.[132] Even so, remarkable differences exist, less due to the obviously diverging legal traditions[133] than to strategic choices operated by lawmakers and regulators. The latter type of differences are the most interesting for the purposes of the critical analysis that follows.

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[129] *See* Art. 19 SRMR.
[130] *See* also Micossi *et al.*, *supra* note 118, at 7.
[131] Art. 32, paragraphs 1, 2 and 5, BRRD.
[132] *See* above, Paragraph II.B. And *see*, generally, Binder *et al.*, *supra* note 113, at 1.
[133] Needless to say, the US boasts a uniform bankruptcy law system, which (without prejudice to the operation of state rules covering certain matters of creditor protection) provides a uniform ground for the resolution and liquidation of credit institutions. To the contrary, the European Member States have not harmonized their national insolvency rules (apart from limited aspects aimed at fostering the mutual recognition across the EU of administrative and court decisions), nor does it exist a system of federal courts to enforce such rules. Therefore, as mentioned, the EU harmonized resolution framework is subject to national implementation and adaptation. Due to the many inconsistencies stemming from the relationship with profoundly different national insolvency rules, the "level playing field" is sometimes illusory. *See* below, Paragraph V.D and Part VI.

A. *The US Rules: A Summary of the Existing Framework*

To summarize the US framework in a sketchy (and inevitably incomplete) way, it is useful to recall that, until 2010, insolvent depository banks (*i.e.* those whose clients benefit from the insured deposits coverage under the Federal Deposit Insurance Corporation, "FDIC") were—and are—subject to a special federal administrative procedure regulated under the Federal Deposit Insurance Act ("FDIA").[134] Non-bank (and non-insurance) financial companies, namely including bank holding companies, were subject to ordinary (court-based) corporate insolvency proceedings under the US Bankruptcy Code. In practice, before and during the 2007-2008 crisis, the insolvency regime applicable to holding companies was all but "ordinary", as demonstrated by the massive recourse to bailouts in the Bear Sterns, Bank of America and AIG cases—just to make a few examples. Yet, in September 2008, in an awkward attempt to stop bankers' and shareholders' moral hazard, the US authorities adopted a peculiar "hands-off" approach with Lehman Brothers. Thus, one of the top five investment banks worldwide, uniquely interconnected with the global derivatives market, was stuck in "normal" Chapter 11 proceedings, causing the abrupt collapse of its international activities and contributing significantly to the aggravation of the global crisis.[135]

In 2010, consistent with the FSB guidelines, Title II of the Dodd-Frank Act[136] introduced a new "administrative option" (called "orderly liquidation authority", or "OLA") for resolving non-bank financial companies that pose systemic risks, such as broker dealers and financial institutions supervised by the Board of Governors of the Federal Reserve System and recognized as systemically important financial institutions ("SIFIs").[137] As with depository banks, the Dodd-Frank Act empowers the FDIC with special powers to resolve a failing institution. The FDIC may exercise its powers if three cumulative conditions are met. First, the restructuring of the institution through contractual arrangements is not possible, that is, no private sector solution is available.[138] Second, the application of ordinary liquidation (*i.e.* under Chapters 7 or 11 of the US Bankruptcy Code) would lead to economic inefficiencies. Third, the bankruptcy of the institution could endanger financial stability. In addition, the institution must be failing or likely to fail, according to net asset, financial and regulatory parameters referring to (i) the possible commencement of a procedure under the US Bankruptcy Code, (ii) the material erosion of the institution's capital, (iii) negative net assets, or (iv) the institution's inability to pay its obligations in the normal course of business.[139]

Once the procedure opens, the FDIC acts as receiver vested with management powers *in lieu* of the removed directors of the failing institution. The authority exercises its powers with the aim of maximizing the value of the institution's assets "within the context of the *ordinary*

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[134] Federal Deposit Insurance Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 873). 12 U.S.C., §§ 1811-1835. For an effective summary of the functioning of the FDIA mechanisms, *see* Binder *et al.*, *supra* note 113, at 20-24.

[135] HENRY M. PAULSON JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM (Hachette, 1st ed. 2010); Rosalind Wiggins *et al*, *The Lehman Brothers Bankruptcy A: Overview* (Yale Program on Financial Stability Case Study 3A-V1, 2014), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2588531.

[136] 12 U.S.C., §§ 5381-5394.

[137] More specifically, the applicability of the OLA regime extends to companies (whether holding or subsidiaries) for which profit deriving "financial activities" (as defined under 12 U.S.C., § 1843(k)(4)) account for 85% or more of the total profits.

[138] On the issuance of CoCo bonds as private sector solution in the US system, *see* Philippon & Salord, *Bail-ins and Bank Resolution in Europe. A Progress Report* (International Center for Monetary and Banking Studies and CEPR Paper, 2017), available at https://cepr.org/sites/default/files/news/GenevaSpecialReport4.pdf, at 10.

[139] Title 12 U.S.C., § 5383(b).

liquidation"[140]. Thus, the purpose of the US resolution model is exclusively a liquidation of the insolvent entity. The regulatory framework does not contemplate an "open bank" restructuring.[141] The FDIC has the typical powers of a European resolution authority, including the sale of assets to a third party,[142] the transfer of assets to a bridge financial company,[143] the transfer of assets or liabilities to a third party (such as a "bad bank"),[144] and the bail-in.[145]

As to the latter tool, the FDIC may write off equity and debt to cover existing losses of the failed institution. However, such write-off is only functional to a liquidation of the insolvent entity's activities and cannot be used to enhance the long-term viability of a restructured institution. In other words, the resolution authority may only resort to the bail-in to allow a continuation of activities to the extent it increases the chances of a value maximization in liquidation. The NCWO principle governs the application of the bail-in. Therefore, no claim may be written off if the creditor would suffer a loss greater than at the outcome of the liquidation process.[146]

Like in Europe, the resolution authority enjoys a significant discretion in the application of the general principles concerning the equal treatment of creditors and the pecking order, in the event of both bail-in and other resolution tools.[147]

We underline that the resolution procedure envisaged under the Dodd-Frank Act does not replace the Bankruptcy Code procedures ordinarily applicable to non-bank financial institutions. Such procedures shall apply whenever the FDIC does not deem a resolution appropriate according to the criteria above.

Although the US resolution framework is not closely intertwined with a state-aid regulation as it happens in Europe, the Dodd-Frank Act sets forth limitations to government financial support to a resolved institution. *De facto*, the intervention of the Orderly Liquidation Fund is limited to 90% of the total consolidated assets of the financial institutions, based on the most recent published financial statements.[148]

B. *A Possible Involution: The TPRRA Bill*

When we are writing, US Congress is discussing a bill reforming the Dodd-Frank Act's OLA.[149] The bill—aimed at introducing a Taxpayer Protection & Responsible Resolution

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140 Title 12 U.S.C., § 5390(a)(1)(B) (emphasis added).

141 Of course, this does not mean that the failing institution's activities are necessarily interrupted or wound down. To the contrary, the FDIC may spin off one or more profitable businesses from the insolvent entity and sell those to a third party (*e.g.* through a sale of assets: *see* below, in the text), so to safeguard its value. In practice, the main difference between the US and the EU model concerns the viability of the bail-in of an operating financial companies ("open-bank bail-in"): *see* below in the text.

142 12 U.S.C., § 5390(a)(1)(D). The institution's merger with a third party is also contemplated (§ 5390(a)(1)(G)), an outcome that may be reached also in Europe, through a combination of the sale of the institution shares to a third-party purchaser (*see* Art. 38 BRRD) and a subsequent "ordinary" merger with such purchaser. *See* below, Part V.

143 12 U.S.C., § 5390(a)(1)(F).

144 12 U.S.C., § 5390(a)(1)(G).

145 12 U.S.C., § 5390(a)(1)(M).

146 12 U.S.C. § 5390(d)(2). In this regard, creditors should, at a minimum, receive as much as they would have received had the institution been subject to 11 U.S. Code Chapter 7 procedures.

147 12 U.S.C. § 5390(b)(4).

148 12 U.S.C., § 5390(n). For further details, *see* Philippon & Salord, *supra* note 138, at 12.

149 *See* S. 1840 114th Cong. (2015) (Taxpayer Protection and Responsible Resolution Act). For a preliminary (but starkly critical) discussion, *see* Adam J. Levitin, *Analysis of the Taxpayer Protection & Responsible Resolution Act*

Act ("TPRRA")—follows an animated debate, started after the election of President Trump, on the opportunity to repeal Title 2 of the Dodd-Frank Act and replacing it with a new special insolvency procedure for SIFIs, to be transposed as Chapter 14 in the US Bankruptcy Code.[150] Actually, the TPRRA proposal creates a new Chapter 14, but does not replace the OLA. Indeed, while Chapter 14 would become a sort of default procedure for a SIFI's insolvency, the federal authorities would preserve their power to apply the Dodd-Frank resolution.[151]

From a procedural standpoint, the new Chapter 14 does not seem to go too far from a traditional Chapter 11 model. The new insolvency procedure would be mainly court-based (instead of subject to the FDIC administrative control) and the failing institution's management would remain in control. The main feature of the TPRRA is a sort of standardized resolution tool, consisting in the sale of selected asset and liabilities of the failing institution to a bridge entity, with the notable exclusion of any equity or "capital structure debt".[152] The latter category—that would remain with the bankruptcy estate, under a NCWO clause—includes any unsecured debt *other than* liabilities towards any counterparty of a "qualified financial contract", such as derivatives and repos.[153] A trustee appointed by the bankrupt institution's management would manage the bridge entity, with a view to sell it to a third party acquirer and use the proceeds to pay the liabilities not assumed by the bridge entity.[154]

C. *Some Notable Differences Between the US and EU Models*

Let the TPRRA proposal aside, and focusing on the US legislation currently in force, it is easy to note the numerous analogies with the SSM (and BRRD) framework—which is consistent with the common FSB roots.[155] For example, in both Europe and the US, resolution

of 2018 (Chapter 14 Financial Institution Bankruptcy Proposal), November 2018, available at www.ssrn.com. For comments to the bill *see* Senate Judiciary Committee Hearing on Bankruptcy for Banks and Proposed Chapter 14, HARV. L. SCH. BANKR. ROUNDTABLE (Dec. 4, 2018), available at http://blogs.harvard.edu/bankruptcyroundtable/tag/tprra/.

150 Initially, the Trump Presidency and the Republican Party supported a full repeal of the OLA, as a part of their general deregulation program. In early 2018, the US Treasury Department issued a report on the possible OLA reform. The report recommended not to repeal the Dodd-Frank procedure—as this would end up increasing systemic risk and potentially strengthen capital requirements on the most relevant institution—but rather to adopt a new "Chapter 14" procedure to make resort to resolution less frequently and only in exceptional circumstances. *See* The Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform. Report to the President of the United States, Pursuant to the Presidential Memorandum Issued April 21, 2017*, February 21, 2018, available at home.treasury.gov. *See* also Binder *et al.*, *supra* note 113, at 8. The bill under discussion follows this approach.

151 *See* TPRRA, Section 6. As one commentator puts it, "[i]t is hard to imagine regulators preferring Chapter 14 to OLA because Chapter 14 has fewer tool for ensuring a smooth landing than OLA" (Levitin, *supra* note 149, at 2-3). Thus, it is possible that, in practice, resort to Chapter 14 would be rare, but the proposed reform would nevertheless "undermin[e] regulator's' ability to derisk megabanks through the Dodd-Frank living will process". In fact, since a SIFI could satisfy the Dodd-Frank requirement of setting out a credible resolution plan by simply stating that it would resolve in Chapter 14 (*see Id.*).

152 Interestingly, the TPRRA would introduce a 48-hour moratorium as a result of an institution entering in Chapter 14. On the debated issue of moratorium in resolution and insolvency procedures, *see* below, Part VI.

153 In other words—and with some simplification—counterparties of qualified financial contracts are "automatically" safeguarded, which is not necessarily the case in an OLA (or BRRD) resolution scenario, where, indeed, the relevant liabilities might be written down and the operation of close-out netting provisions typically included in derivative contracts is limited. *See*, for references, Arts. 44.2, 44.3, 49 and 68-71 BRRD.

154 *See* TPRRA, Sections 1405-1406.

155 *See* Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011, available at http://www.fsb.org/wp-content/uploads/r_111104cc.pdf .

is a procedure managed by an administrative authority (the SRB and the national resolution authorities, on the one side, the FDIC, on the other), as opposed to a bankruptcy court. The triggers of resolution are also very similar, although—as two commentators correctly pointed out[156]—the requirement based on the concept of financial stability is more precisely crafted in Europe, limiting the discretion of the resolution authorities.[157] Finally, the resolution tools are *de facto* identical, besides the characteristics of the bail-in tool in the two systems (see below).[158]

Even so, the two systems depart from each other on a number of issues, reflecting the policy choices of the regulators, as well as the different institutional framework.

(i) As to the <u>scope of application</u> of the special regime, the EU Directive includes (concisely)[159] all banks and investment firms, as well as financial holdings companies, while the OLA carves the insured depository institutions out. The broader scope of the EU legislation scope may be explained bearing in mind the model of "universal bank" predominant in Europe, where the depository bank and the financial service businesses normally co-exist within the same institution.[160] In fact, the European bailouts typically concerned banks acting (also) as depositary institutions.

(ii) As to the <u>resolution authorities</u>, the US shows a streamlined structure, where the FDIC operates as single federal resolution authority. The complex EU framework reflects a fragmented institutional context, where significant institutions are supervised at the ECB level, while the others at a national level. This justifies the existence in Europe of a number of resolution authorities equal to the number of the Member States participating in the SSM system, plus the SRB.[161] Ideally, all such authorities apply harmonized rules. However, the implementation of the BRRD leaves room for adaptation to national legal systems that significantly differ from each other as to the private and insolvency law foundations on which lay the (seemingly uniform) resolution rules (see item (v) below).

(iii) Another material difference concerns the resolvability at a group level and the related adoption of the <u>SPE vs. MPE approach</u>. As mentioned before, the MPE strategy is the rule under the EU framework, where a holding company may be resolved even if it does not meet the resolution requirements, provided that one or more subsidiaries do meet them, or resolution at the holding level is necessary to resolve such subsidiaries or the entire group. Conversely, the US adopts, with few exceptions, a SPE model. Therefore, the resolution triggers are verified at the holding company or at the subsidiary level, and there are limited possibilities to resolve

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156 *See* Philippon & Salord, *supra* note 138, at 20-21.

157 *See* Art. 31.2 BRRD, where the resolution objectives are declined with respect to the "continuity of critical functions", the need to avoid a "significant adverse effect" on, specifically, "market infrastructures", while the US rules more generally refer to the "economic inefficiencies" potentially stemming from resort to a normal insolvency proceeding.

158 Philippon & Salord, *supra* note 138, at 22-23, believe that such similarities between the two systems imply analogous inefficiencies in the resolution mechanisms. Among the critical aspects the two authors highlight, there are (i) an overly large scope of interpretation of the conditions for opening the resolution proceedings, (ii) a lack of decisional role and responsibilities for senior creditors, (iii) uncertainty about the exceptions and privileges that the resolution authorities may discretionally grant to specific creditors upon application of the bail-in tool. We touch upon some of these topics in Part VI below.

159 For a more detailed description, *see* Art. 1.1 of BRRD, as well as Part II above.

160 *See* note 3 above.

161 *See* above, Part. II.A.

the holding company if only one or more subsidiaries meet the resolution conditions.[162]

(iv) The bail-in is different in scope in the two systems. In Europe, an "open bank" bail-in is theoretically practicable. Resolution authorities may apply the bail-in tool to recapitalize a failing institution in order to restore its long-term viability. In the US, the bail-in tool may only be used in a gone-concern context (possibly coupled with the sale of business or assets to a bridge institution or a third party), where the resolved bank ceases to exist as an autonomously operating entity. As we will discuss, this difference—often stressed by jurists—is not so relevant in practice, as the EU authorities have experimented "open-bank" bail-ins very seldom thus far.

(v) Finally, a less evident, but essential divergence concerns the "drop point" of the resolution proceedings, once again depending on the different impact of the federal/EU legislation on the state/national legal systems. In the US, the resolution mechanism interplays with federal insolvency rules, both ordinary (the US Bankruptcy Code) and special (the FDIA). Within the EU, an harmonized regime for the winding-up and liquidation of banks does not exist, apart from very limited rules of mutual recognition of liquidation proceedings opened in the various Member States.[163] Therefore, the outcome of a European resolution is not merely the consequence of the application of uniform rules across the EU, but rather the intersection of such rules with each Member States' liquidation regime. In other words, the same resolution rules may lead to different concrete outcomes when applied in different Member States, thus undermining the predictability and effectiveness of those very rules, and rendering the Banking Union a more utopic goal. The NCWO test represents an evident example of this issue: divergent underlying insolvency rules (significantly varying from one country to another) influence the outcome of the test, so that, for instance, due to a different national pecking order, the same creditor may suffer write-down in the resolution of a Spanish bank, while it may not if the bank is German. We will provide in Part V some examples of this issue.

V. EXPERIMENTA IN CORPORE VIVO

When the theoretical framework of the new EU rules is factored into practice, one immediately realizes that new concepts and mechanisms are forced to live with (and be contaminated by) the models and toolboxes of traditional banking restructuring. Sometimes, such combination gives rise to fertile compromises, some other to (more or less admitted) failures: these are mostly due to the endogenous drawbacks of certain BRRD rules (as already highlighted above), as well as to the interplay with exogenous factors that act as sand in the wheels of the brand-new resolution architecture. In the next pages we will discuss these outcomes in detail. But it should not come as a surprise that, after barely three years from the BRRD coming into force, many are ready to bet that no systemic credit institution shall ever experience an "out-and-out" bail-in, as the rules describe it;[164] and few actually believe that the

[162] Please *see* Part II for a brief discussion of the rationale underlying the two approaches.

[163] For additional details, *see* below, Part VI.

[164] In this vein, *see* Tobias H. Tröger, *supra* note 70, at 4, ironically predicting "that the bail-in tool under the BRRD is likely to fail". *See* also Bruno Inzitari, *Crediti deteriorati (NPL), aiuti di stato nella BRRD e nella comunicazione sul settore bancario del 30.7.2013 della Commissione Europea*, in 69 BANCA BORSA E TIT. CRED. 650-651 (2016), arguing that the credit institutions that received significant public aid through precautionary recapitalizations (such as Monte dei Paschi di Siena S.p.A. in Italy) have such a systemic (and political) relevance that they are

BRRD vessel may navigate a new banking crisis in the future without being significantly (although prematurely) refurbished.[165] All the above, while a considerable bunch of litigation is still looming over the resolutions laboriously implemented thus far.[166]

The remainder of this part is organized as follows. First, we plunge into the history of banking turnaround, to recollect the traditional tools used to rescue failing institutions in the past decades. Second, we review various strategies used by the European Member States when approaching the burden sharing, the bail-in and the other new resolution principles during the great financial crisis after 2008, when the BRRD was still at a bill stage or not yet implemented. Third, we analyze the first years of BRRD application and discuss the most relevant cases decided at the level of the newly-set up Single Resolution Board. On this background, we highlight the most critical aspects of the first EU resolution experiments, in order to put forward, in Part VI, some modest suggestions for reform.

A. *When BRRD Did Not Exist: A Pre-History of Banking Rescues*

There is a Paleozoic of banking rescues in Europe. In a time when insolvency rules were not harmonized—and State aid limits were less stringently applied face to systemic institutions' failure—bail-outs were the rule, and governments used to ensure full protection of creditors and depositors through abundant recourse to taxpayers' funds. While much has been said about the policy reasons that discourage the bail-out of credit institutions,[167] less attention has been devoted to the legal tools whereby bail-outs were realized. Yet, they are important to understand the transplant of the BRRD mechanisms into domestic practices and the first resolution experiments.

Typically, in the face of a failing bank with systemic relevance, governments exercised *ad hoc* powers to combine (i) insolvency rules, (ii) private market solutions, and (iii) public funding.

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not only "too big to fail", but also "too big to bail in". A similar view from a number of qualified practitioners, after the experience of Banco Popular, Monte dei Paschi di Siena and the "Banche Venete", is referred to in Louise Bowman, *Banking: Throwing the bail-in out with the bath water*, Euromoney, September 18, 2017, available at https://www.euromoney.com/article/b1bmc8jnrl7pbq/banking-resolution-brrd-on-the-run. *See* also Paragraph III.D above and Part VI below.

165 *See*, *e.g.,* Stefano Micossi *et al.*, *Fine-tuning the Use of Bail-in to Promote a Stronger EU Financial System* (CEPS Special Report No. 136, 2016), available at https://www.ceps.eu/publications/fine-tuning-use-bail-promote-stronger-eu-financial-system. Sometimes, a reform is specifically invoked to tighten the BRRD requirements whereby public support may be granted to ailing credit institutions: *see*, with respect to the issue of precautionary recapitalizations, Martin G. Götz *et al.*, *Taking Bail-in Seriously – The Looming Risks for Banking Policy in the Rescue of Monte dei Paschi di Siena* (SAFE Policy Letter No. 54, 2017), available at https://safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_54.pdf. As of this writing, a limited reform process of the BRRD is undergoing. The European Commission has approved a *Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms* and submitted it to the Parliament and Council within a wider "banking reform package" also including amendments to the SRMR, the CRR and the CRD IV (the latest version of the proposal is dated June 25th, 2018, and available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&mode=XML&reference=A8-2018-0218&language=EN). The proposed amendments to the BRRD focus, *inter alia*, on changes to the MREL framework (to implement the TLAC standard adopted in 2015 by the Financial Stability Board) and the introduction of a resolution authority's power to suspend the reimbursement of deposits or payment of other obligations by a bank declared failed or likely to fail, while the decision of resolution is still pending (moratorium). For a preliminary summary and comment, *see*, *e.g.*, Mariken van Loopik & Maurits ter Haar, *EU Banking Reform Package, New Capital and Loss-Absorption Requirements*, 2017, available at https://www.debrauw.com/wp-content/uploads/2017/02/Banking-Reform-Package.pdf.

166 *See* below in this Part V.

167 *See* above notes 70-72 and accompanying text.

Under a recurring scheme, the ailing institution was put into liquidation, but the government directed that its "good" business—essentially composed by performing loans (on the assets side) and sight deposits, bonds, and strategically selected financial and commercial debt (on the liabilities side)—be transferred to a sound institution, often together with the old bank's employees. As liquidation normally implies the immediate forfeiture of the authorization to operate as a bank (the "banking license"), the transfer to the acquiring bank would normally occur immediately before or simultaneously with the opening of the liquidation procedure, so as to guarantee that the "good" business is transferred as a going concern (with no interruption in its core functions) and avoid further losses. Of course, the transferred business would incorporate an "imbalance", *i.e.*, the liabilities transferred to the acquirer were higher than the assets. The imbalance was normally covered in cash through public funds, often drawn from deposit protection schemes[168], or advanced through a low-rate, long-term financing by the central bank.[169] The failed "old bank" remained there with its losses—which affected the shareholders, but not the bulk of its creditors (bondholders and the depositors), pulled to safety with the acquirer—bad loans to be collected, lawsuits to be started against the former directors and officers, and claw-back actions to recover voidable preferences. An alternative to the above, more cumbersome for the acquirer, was the merger of the failed bank into a solid institution.[170]

A central issue in the above rescue scheme was (and still is today) the ring-fencing of the acquiring bank from contingent liabilities backfiring from the "old bank.[171] In order to shield

[168] *See*, *e.g.*, in Italy, the *Fondo interbancario di tutela dei depositi* (FITD, Interbank Deposit Protection Fund), an originally privately-formed consortium, then become mandatory in 1996 and funded through the annual contributions from the participating banks: *see* Lener, supra note 99, at 705. On the complex relationship between resolution and deposit guarantee schemes, *see* below in this Part V.

[169] Such advance is currently prohibited under Art. 123.1 of the TFUE: "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States […] in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities […] shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

[170] It is interesting that, in Italy—the jurisdiction we are more familiar with—the formula for bail-outs with Central Bank support was crystallized into a piece of legislation and used in a variety of rescues after the famous crack of Banca Privata Italiana, controlled by Michele Sindona, a Sicilian financier connected with the Italian and American mob. Interestingly, Mr. Sindona's financial collapse also had tangible repercussions in the US, as he exercised control over the renowned Franklin National Bank. The demise of this bank in 1974 was indeed one of the first notable instances in which federal regulators changed their previous passive attitudes and supported a major financial institution in the winding down of its operations, in order to prevent a global economic damage: *See* MARCO MAGNANI, SINDONA. BIOGRAFIA DEGLI ANNI SETTANTA 141 (Einaudi, 1st ed. 2016). For a recollection of rescues in Italy in the 1970s-1980s, *see* Lener, *supra* note 99, at 704-705; EDOARDO RULLI, CONTRIBUTO ALLO STUDIO DELLA DISCIPLINA DELLA RISOLUZIONE BANCARIA 113-123 (Giappichelli, 1st ed. 2017) (also describing the European Commission's position in the State aid issue at that time).

[171] A European private lawyer may easily recall that the transfer of business as a going concern often implies the joint and several liability of the purchaser for the seller's obligations in relation to the transferred business. To continue with the Italian example, Art. 2560 of the Civil Code (regulating the parties' liability vis-à-vis third parties in a transfer of business) sets forth the joint and several liability of the purchaser for any debt that the seller had registered in its own account at the time of transfer. Moreover, the purchaser is liable for the seller's outstanding debts to employees, social security and tax authorities, even if such debts are not registered in the seller's account. A similar approach can be recognized in the German Code of Commerce (*Handelsgesetzbuch*), which at Section 25 ff. also establishes an extension to the purchaser of the liability relating to debts previously incurred by the seller and arising out of the business being transferred. Nonetheless, such regime may be derogated by the parties by means of specific arrangements.
As we will see, the above issues have tormented authorities and practitioners—and still are the cause for a massive stream of litigation—in the Italian most recent recovery transactions, both inside and outside the BRRD scope. *See* below, subparagraph D(c).

the acquirer from this risk, a two-step process was sometimes put in place: first, the "good" business is spun off into a "clean newco", then the "newco" is merged into the acquiring bank. As this technique was not always waterproof, legislators provided for *ad hoc* shielding rules aimed at protecting those who acquire assets or an entire business from a bank in liquidation.[172]

An advanced version of the bail-out scheme contemplated—in addition to the above—the creation of a separate "bad bank", that is, a newly-formed company (sometimes a bank itself, or a licensed lending institution) to which the failed bank transfers its entire portfolio of non-performing loans.[173] The function of a "bad bank" is twofold. First, it promptly relieves the failed entity from assets that cannot be realized or disposed of quickly on the market.[174] Second, the bad bank pays (or commits to pay) a price for the transfer of the non-performing loans. As a result, the liquidation process is smoothed out, the "old bank" in liquidation earns a value from the transferred assets immediately or, at least, may rely on the future reimbursement of a (normally state-guaranteed) loan.[175] A similar process took place, for example, with the Crédit Lyonnais restructuring, in France.[176]

B. *The Financial Crisis and the "Private Sector Involvement": Towards the BRRD, in Open Order*

As one may easily note, the "pre-historic" tools of banking rescues are close relatives of three (out of four) "resolution tools" set out by the BRRD. The sale of business is regulated under

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[172] *See*, *e.g.*, Art. 90.2 of the Italian Banking Act; *see* in Germany Section Section 64(s) n. 2 of the German Banking Act (*Kreditwesengesetz*) as amended by the German Law on Risk Schielding entered into force since 1 July 2015. In relation to the United Kingdom, ring-fencing provisions are included within the Financial Services (Banking Reform) Act 2013. The purpose of provisions of this kind is not only to protect the acquirer, but—even before—to ensure equal treatment of the failed bank's creditors, *i.e.* to avoid that, as a consequence of a joint and several liability of the acquirer, certain creditors are able to recover their claim entirely against the "good bank", while those left with the "old bank" only receive few cents on the euro (or nothing).

[173] For avoidance of doubt: the bank is "bad" not because it is insolvent, but due to the poor quality of the assets contributed to it. Compliance of the bad bank with the minimum capital requirements are normally ensured through injection of public funds. *See* Simon Gleeson, *supra* note 96, 10-12 (also referencing examples from non-EU jurisdictions).

[174] This especially concerns those distressed but still "alive" positions (called "past due" or "unlikely to pay" loans in the Basel framework) that, having chances of restructuring, cannot be managed by a bank in liquidation, for reasons that are both organizational and regulatory. For example, a non-performing debtor may need to be refinanced and, if it has revolving credit lines in place, it may need to draw additional funds to finance its day-to-day activity. A bank in liquidation is normally prevented from carrying on such financing activity which may imply the incurring of new operational risks.

[175] The value at which the non-performing loans are transferred to bad banks is a hot topic. When a bad bank is funded through public resources, a sale above "market values" could be regarded as a state aid to the selling entity. Once again, Italy functioned as a test animal: in 2016, the Commission agreed on the structure of a State guarantee (remunerated at market conditions) on the securitization of non-performing loans (so call *bad loan securitization guarantee*, or "GACS"), being a guarantee on the senior tranches of securitization bonds issued after repackaging of the loans. For a description, *see* B. Mesnard, *"Bail-ins" in recent banking resolution and State aid cases. In-depth analysis*, European Parliament Briefing, 2016, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/574395/IPOL_IDA(2016)574395_EN.pdf.

[176] Crédit Lyonnais was among France's biggest banking institutions, directly owned by the State. Starting from the early 1990's, the institution experienced considerable financial difficulties as a consequence of being entangled in numerous financial scandals. Eventually, the French government intervened directly by funding a capital increase and moving troubled liabilities into a newly-created 'bad-bank', with losses being assisted by a State guarantee. Such measures were the subject of detailed scrutiny by the European Commission, which imposed severe limitations but ultimately upheld the bail-out in light of pursuing the goal of preserving general financial stability. *See* Commission Decision of 20 May 1998 concerning aid granted by France to the Credit Lyonnais group, 1998 O.J. (L 221).

Art. 39. The BRRD's "bridge institution" (Art. 40) is the "newco" to which a "good bank" may be contributed while an interested purchaser is sought. The "asset separation tool" (art. 42) regulates the transfer to one or more asset management vehicles (*i.e.* "bad banks") of assets, rights and liabilities of a failing bank or a bridge institution. Indeed, if one looks at the "objectives" of resolution under the BRRD—*i.e.* "to ensure the continuity of critical functions" of the institution, "to avoid a significant adverse effect in the financial system", to "prevent[ ] contagion", "to protect depositors", "to protect client funds and client assets"[177]—it may conclude that, with the obvious exception of the protection of public funds, the "old" bail-out instruments were just crafted to achieve all these objectives.[178]

Face to this apparent continuity, what is the "game change" determined by the BRRD? The answer is in the combination of the traditional rescue tools with the (new) bail-in tool[179] and, more generally, with the new legal mechanisms that ensure the "private sector involvement" in the failing bank's losses. Of course, this outcome reflects a revolution in the scale of values across the financial crisis begun in 2007, as we described in Paragraph III.C. But the BRRD's bail-in is only the arrival point. From the Northern Rock bailout in early 2008 to that point, there is network of curvy paths. In fact, while the BRRD is still at the stage of a bill, two main drivers craft a new regulatory landscape in the years immediately following the financial crisis, in virtually all European countries: an increasingly strong application of the "burden sharing" principle[180] and the evolution of the old restructuring instruments into a more streamlined resolution process.

Yet, Member States follow different strategies to reform their national legislations.[181] We group such strategies under three main sets: (i) implementation of a regulatory framework that closely follows the BRRD principles; (ii) promotion of a centralized management of failed banks' redress, through a public "bad bank"; (iii) conservative approach, aimed at preserving, as much as possible, the traditional way to the management of banking failures. Due to their influence on how the BRRD has been subsequently implemented, it is worth briefly analyzing the characteristics of each set.

(a) First Strategy: Pre-implementation of the BRRD Principles

In a first group of Member States, all severely hit by a crisis that spread from the banking sector to the sovereign debt and the real economy, a strong sacrifice of private creditors is imposed in the context of rescue programs sponsored by super-national bodies, such as the

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[177] *See* Art. 31.2 BRRD.

[178] Indeed, the BRRD brings in some improvements to reinforce the effectiveness of the old tools. The regulatory regime applicable to the corporate transactions under resolution is simplified (*see*, *e.g.*, Arts. 38.8 and 38.9). Certain private or insolvency law restrictions, that might hinder the viability of a resolution tool, are waived. *See*, *e.g.*, art. 37.8 BRRD, which neutralizes national rules on the "voidability or unenforceability of legal acts detrimental to creditors", in respect of "transfer of assets, rights or liabilities from an institution under resolution to another entity by virtue of the application of a resolution tool or exercise of a resolution power".

[179] *See* Simon Gleeson, *supra* note 96, at 16. As we will see, under the BBRD the bail-in tool has normally been used in combination of another resolution tool (most often, the sale of business). *See* below, Paragraph V.C.

[180] As discussed, the driver for the burden sharing implementation is the EU Commission's "doctrine" on State aids to ailing banks. *See* Paragraph III.F above.

[181] In the following pages, we often refer to a document by the World Bank's Financial Sector Advisory Center (FinSAC), which offers an interesting recollection on the most relevant European cases of banking resolutions across the financial crisis: *see* World Bank, *Bank Resolution and "Bail-in" in the EU: Selected Case Studies Pre and Post BRRD*, 2016, available at http://pubdocs.worldbank.org/en/120651482806846750/FinSAC-BRRD-and-Bail-In-CaseStudies.pdf [hereinafter FinSAC Paper].

IMF, the ECB and the European Commission (so called Troika). In these countries, resolution principles akin to those enshrined in the yet-to-come BRRD are applied to all systemic banks, with a view to favor a consolidation of the national banking industry.

Cyprus represents the most draconian example of this strategy.[182] Under the "Cyprus Resolution Law" of 2013—enacted in the wake of the agreement reached between the local government and the financial ministers of the Euro area (Eurogroup)—Laiki Bank, one of the two systemic institutions in that country, is resolved with total wipeout of shareholders, junior and senior bondholders. Uninsured depositors (*i.e.* clients with deposits above €100,000) are forced to a haircut of about 47.5% in what remains, to date, the only case of depositors' sacrifice within the Euro area.[183] Following a pattern common to most European resolutions, the bail-in of Laiki is accompanied by the adoption of other tools (separation and sale of assets). Most loans, shareholdings and certain liabilities are transferred to a bad bank, while the good bank (including insured deposits) is transferred to the Bank of Cyprus, the other systemic bank in the country, also subject to resolution. Uninsured deposits are kept in the bad bank, which receives shares in the Bank of Cyprus.[184] These measures are implemented while a prolonged freezing of deposits is underway and controls on capital export are introduced.

In Greece, under the supervision of the Troika, as many as 14 banks were resolved from 2011 to 2016, 13 of which before the BRRD regime came into force in 2015. Indeed, Greece was one of the first countries to pass a resolution law in October 2011, inspired by the same policy principles that would underlie the BRRD later in time. For example, the Hellenic banks experience the different valuation phases of the kind the BRRD requires in a resolution scenario.[185] Likewise, authorities resort to resolution tools such as the sale of business to private acquirers (in 12 cases) and the transfer of viable assets and deposits to bridge banks

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[182] In part, the crisis of the Cyprus banking system was a by-product of the Greek sovereign debt crisis, as the two systemic Cypriot banks (Laiki and Bank of Cyprus) held a massive amount of Greek government bonds, subject to restructuring in 2011. *See*, *e.g.*, Jeromin Zettelmeyer, Christof Trebesch & Mitu Gulati, *The Greek Debt Restructuring: An Autopsy*, in 28 ECON. POL'Y (2013), at 513-563; Panicos O. Demetriades, *Political Economy of a Euro Area Banking Crisis*, in 41 CAMB. J. ECON. (2017), at 1249-1264.

[183] *See* Alexander Michaelides, *Bank of Cyprus (BoC) and Laiki: Resolution via Public Support and Bail-in, Including of Uninsured Depositors (2013)*, in FinSAC Paper, *supra* note 181, at 18-22; Giovanni Battista Donato, *The Cyprus Crisis and Legal Protection of Foreign Investors*, 2015, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2586946. Interestingly, the bail-in of uninsured depositors took place when the Cyprus Parliament refused to approve a bill envisaging an "horizontal haircut" (in the form of a tax) on all deposits (including *insured* deposits!), in the range of 6.75% to 9.9%. It is also important to note that the Laiki bail-in was mostly imposed to foreigners, as a large number of depositors in the Cypriot banks is not resident in the country.

While Laiki Bank is the only pre-BRRD bail-in within the Eurozone, it also represents the most significant example of pre-BRRD bail-in within the entire EU: another case occurred in Denmark in 2011, where the senior creditors and depositors of Amagerbanken—a small, non-systemic institution totaling €4.5 billion of assets—underwent a 41% haircut. *See* Alexander Schäfer, Isabel Schnabel & Beatrice Weder di Mauro, *Bail-in Expectations for European Banks: Actions Speak Louder than Words* /European Systemic Risk Board Working Paper Series No. 7, 2016), available at https://www.esrb.europa.eu/pub/pdf/wp/esrbwp7.en.pdf?24fe2a93d6fa9fa23cf019798c6375a9, at 7-8. *See* also (with more granular estimates on the level of private sector involvement in such case, Philippon & Salord, supra note 138, at 29.

[184] *See* Philippon & Salord, *supra* note 138, at 32.

[185] The resolution authority carried out an initial, pre-resolution valuation, mainly based on public data, to estimate the funding gap of a failing bank. This preliminary valuation was followed, within a period of six months, by a review carried out by an independent auditor, aimed at determining the fair value of the assets and liabilities transferred to the acquiring bank or the bridge institution. *See* Maria Mavridou, Aikaterini Theodossiou and Triantafyllia Gklezakou, *Several Greek Banks and Foreign Branches: Resolution via Public Recapitalization and Bail-in and State Aid Issues (2009-2015)*, in FinSAC Paper, *supra* note. 181, at 29-35.

capitalized by the resolution authority (in 2 cases).[186] Yet, compared to the Cyprus case, the private sector involvement in Greece is milder: no 'real' bail-in is implemented and the private sector involvement is limited to shareholders (in all cases) and junior bondholders (only in two cases). Most of the failing banks' capital gaps are filled through extensive liability management exercises ("LMEs"), based on the *consensual* conversion of bonds into equity, and through State's subscription of common equity and preference shares.[187]

Massive State aids were allowed despite a *moderate* burden sharing within the flexible links of the European Commission's guidelines,[188] while the BBRD was not yet in place. Some authors have convincingly argued that, had the authorities applied the Directive's requirement whereby a minimum 8% private sector involvement must be enforced before any public funds are injected into a bank[189], then senior debt and even deposits would have been affected, with the consequent trigger of a downward spiral generating an even grimmer crisis and domino effects for the other banks.[190]

Another country resorting to the Troika intervention, Portugal, provides a further example of pre-implementation of the BRRD regime. Unlike in Cyprus and Greece, only one systemic Portuguese bank, Banco Espírito Santo ("BES"), was put in resolution.[191]

The BES resolution followed a two-step process. A first phase took place in August 2014, when BES faced a liquidity shortfall. The ECB decided to suspend its status as Eurosystem monetary policy counterparty and the Portuguese Central Bank (in its capacity as resolution authority) directed BES to transfer to Novo Banco, a newly-formed bridge institution, its entire business, with the exception of subordinated debt, liabilities to major shareholders and managers, and most contingent liabilities. Novo Banco was fully funded by the national resolution fund, which, in turn, resorted to State loans.[192] BES shareholders and subordinated bondholders were entirely sacrificed (they were left with the resolved entity, put into liquidation), based on a valuation provided by an independent advisor. The position of senior creditors was not affected *initially*.[193]

However, the BES resolution run into some pitfalls of the process, already highlighted above: the divergence between the *ex ante* valuation *ex post* resolution,[194] and the sudden onset of contingent liabilities, giving rights to unexpected losses and threatening the long-term stability of the bridge bank.[195] It turned out that, in the pre-resolution valuation of BES, its assets

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[186] *Id.*, at 33.

[187] Total funds (public and private) injected in the Greek banking system for recapitalization purpose in the period 2011-2015 amount to €63 billion, 37.8 of which covered by State subscription of new shares. *See Id.*, at 32.

[188] *See* Barney Reynolds & Ellerina Teo, *Public Recapitalization under the BRRD and the EU State Regime*, in FinSAC Paper, *supra* note 181, at 35-37.

[189] *See* Paragraph III.C above.

[190] *See* Mavridou *et al.*, *supra* note 185, at 34. The authors conclude: "When attempting a counterfactual 'what if' assessment of the developments that might have occurred if the BRRD had been in place when the crisis started, one may find it difficult to see how financial stability would have been efficiently protected under the BRRD".

[191] BES was the third larges bank in Portugal, a significant credit institution under the Single Supervisory Mechanism: *see* Ana Rita Garcia, *Banco Espírito Santo, S.A.: Resolution via a Bridge Bank Including a Re-Transfer*, in FinSAC Paper, *supra* note 181, at 52.

[192] Such loans did not count as a State recapitalization, given that the State did not provide any direct equity to either Novo Banco or the Resolution Fund.

[193] *See* Garcia, *supra* note 191, at 55.

[194] *See* Paragraph III.E above.

[195] As we have seen, this issue was already critical in the "pre-history" of the banking restructuring: *see supra*, subparagraph (a).

had been overestimated so that the write-off of liabilities was insufficient. At the end of 2015, the resolution authority was forced to a U-turn.[196] It directed the bridge institution ("Novo Banco") to transfer back to BES about €2 billion of (liabilities related to) non-subordinated bonds subscribed by institutional investors, so as to unburden the Novo Banco's balance sheet, "internalize" its unexpected losses and avoid injection of new public funds.[197] The impact on the international investors' confidence on the Portuguese system was dramatic[198] and gave rise to a strand of litigation still undergoing in Portugal, in the UK, and before the EU institutions.[199] The Portuguese experience taught a lesson to regulators and policymakers: resolution can be a "long-release" process, where side-effects may be devastating if liabilities of the failed entity are not correctly valued or the bridge entity is not adequately ring-fenced.

(b) Second Strategy: Centralized Management of the Banking Crises

Instead of accelerating an "atomistic" implementation of the BRRD principles, other Member States opted for a centralized management of banking resolutions.

Spain provides an interesting example. The profound restructuring of its banking system, affected by a generalized impairment of real estate assets and mortgages, was managed under the guide of two State-owned agencies: the Fund for Orderly Bank Restructuring ("FROB"), in charge since 2009 for channeling public funds to capitalize a large number of ailing institutions, and the Sociedad de Gestión de Activos Procedentes de la Restructuración Bancaria ("SAREB"), a public/private asset management company set up to act as assignee of the

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196 *See* Press Release, Banco de Portugal approves decisions that complete the resolution measure applied to BES (Dec. 29, 2015), available at https://www.bportugal.pt.

197 Unlike the first step of the BES resolution, the *ex post* re-transfer of liabilities took place when BRRD had been implemented in Portugal. Under Art. 40.7 BBRD, "[r]esolution authorities may transfer shares or other instruments of ownership, or assets, rights or liabilities back from the bridge institution in one of the following circumstances", including "the possibility that the specific shares or other instruments of ownership, or assets, rights or liabilities might be transferred back is stated expressly in the instrument by which the transfer was made". Reportedly, the Banco de Portugal's option to re-transfer assets was originally contemplated by the resolution of BES. *See* Garcia, *supra* note 191, at 56.

198 *See* Thomas Hale, *The Novo Banco Debacle and the Rule of Law in Europe*, FIN. TIMES, Jan. 19, 2018, available at https://ftalphaville.ft.com/2018/01/19/2197893/the-novo-banco-debacle-and-the-rule-of-law-in-europe.

199 Goldman Sachs International, one of the institutional investors hit by a Banco of Portugal's retransfer order in 2014, brought a first litigation. As the debt instruments retransferred to BES were subject to jurisdiction of the English courts, Goldman challenged the resolution authority's decision in the UK, arguing that a private debt instrument, governed by English law, could not be subject to the authoritative decision of a foreign resolution authority. After a favorable first instance decision (*Goldman Sachs International v Novo Banco SA* [2015] EWHC 2371 (Comm), 7 August 2015), the appellate court adjudicated the case in favor of Novo Banco. The Supreme Court confirmed the appellate judgment, on the assumption that the Banco of Portugal's retransfer decision should be interpreted as a reorganization measure for the purpose of Art. 3 of Directive 2001/24/EC on the reorganization and winding up of credit institutions and, as such, subject to mutual recognition within the EU (*Goldman Sachs International v Novo Banco SA, Guardians of New Zealand Superannuation Fund & Ors. v Novo Banco SA*, [2018] UKSC 34). On this case—focusing on one of the most critical issues of the common resolution regime in Europe, *i.e.* the impact of resolution on cross-border investments and contractual relationship—*see*, *e.g.*, Lehmann, *supra* note 90.

Other strands of litigation concern the 2015 retransfer decision and were brought by institutional investors such as Blackrock and Pimco. These investors complained, *inter alia*, that the Banco of Portugal's decision broke the *pari passu* principle in the treatment of senior creditors in a resolution process, as the authority's decision was allegedly targeted only to bonds governed by Portuguese law, so as to create a disincentive for legal actions by foreign investors. For a summary of the investors' claim, *see* www.novonotegroup.com, a website dedicated to the case. *See also* Lehmann, *supra* note 90.

distressed portfolios (loans and foreclosed assets) of the resolved banks.[200] In 2012-2013, FROB recapitalized 10 Spanish banks applying the fundamental resolution principles (*i.e.* burden sharing and NCWO, based on independent expert valuation and), and the impaired assets of the failed banks were not transferred to private acquirers, but to SAREB, in exchange for State-guaranteed bonds issued by the latter.

Two noteworthy points emerge from the Spanish experience. First, the centralization of all the "bad" assets in a single management company favored economies of scale and mitigated the risk of fire sales on a depressed market.[201] Second, policy-makers addressed the legal and political complexities of the private sector involvement in a clever way. The infringement of senior debt was avoided. The holders of subordinated instruments were offered the opportunity to join *ad hoc* LMEs, with the option to receive equity or senior debt in the resolved bank, subject to haircut of the face value of their holdings.[202] The triggers of LMEs were rooted in the pre-existing Spanish insolvency legislation (instead of brand-new legal concepts), so to deflate the risk of legal challenges pointing to the "retroactivity" of the resolution mechanisms.[203] Overall, these devices have reduced significantly the amount of litigation.[204]

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[200] For a description of the reorganization process in the Spanish banking industry, based on a *Memorandum of Understanding on Financial Sector Policy Conditionality* entered into between the Government and the EU institutions (including the European Stability Mechanism, ESM) in 2012, *see* María Guinot Barona & Alfonso Cárcamo Gil, *Saving Banks: Resolution Via Pubic Recapitalization, The Creation of an Asset Management Vehicle and Bail-in (2012)*, in FinSAC Paper, *supra* note 181, at 66-72.

[201] This solution echoes the Swedish management of the banking crisis during the 1990s and has become a model for other jurisdiction (*e.g.*, the Italian "Atlante Fund": *see* below).

[202] *See* Guinot Barona & Cárcamo Gil, *supra* note 200, at 68-70.

[203] *See Id.*, at 70. Special arbitration mechanisms and compensation systems (financed by the Spanish Deposit Guarantee Fund) were set up to indemnify former holders of hybrid instruments. This solution also smoothed out the sacrifice imposed to investors that had been victims of mis-selling conducts (on such issue, *see* subparagraph B(c) below).

[204] The opposite happened in Slovenia, another EU country that, like Spain, has centralized the management of the non-performing assets of the entire national banking system on the newly-created Bank Asset Management Company (BAMC). Meanwhile, all the four Slovenian major banks and two other non-systemic institutions were resolved. The private sector was involved (limited to shareholders and junior creditors) to satisfy the European Commission's requirement for the authorization of banks' recapitalizations through State aids. As a result, junior creditors of the resolved banks were written down by way of a central bank's decision that—in the eyes of a number of challenging shareholders and bondholders—retroactively affected both the investors' property rights, protected under Art. 17 of the Charter of Fundamental Rights of the Union. Deciding on a request for preliminary ruling by the Slovenian Constitutional Court, the European Court of Justice affirmed that the "burden sharing" requirement imposed by the 2013 Commission's Banking Communication is compatible with the Treaties and the Charter (*see* 1958 E.C.R. 133[ECJ], Case 14/526, Tadej Kotnik and Others v Državni zbor Republike Slovenje, 2016) [hereinafter *Kotnik*]. According to the Court, the burden sharing imposed by the 2013 Commission Banking Communication does not run afoul of the "property" right of a subordinated creditor insofar the latter is entitled to be indemnified upon discovery, *ex post*, that it would have been better off in a liquidation scenario instead of a resolution. In other words, the NCWO principle "saves" the legality of a (possibly retroactive) creditor's sacrifice in resolution (*see Kotnik*, §§ 63-75). The Court also established a reinforced motivation requirement on the burden sharing in each case, arguing that the 2013 Commission Banking Communication is not a binding legislative instrument and, therefore, the burden sharing cannot operate as a matter of course. On *Kotnik*, *see*, *e.g.*, Valia Babis, *State Helps Those Who Help Themselves: State Aid and Burden-Sharing* (University of Cambridge Faculty of Law Research Paper No. 62,2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2858360. *See* also Hellwig, *supra* note 64, at 9-10, underlying the importance of the ECJ's reasoning in the context of precautionary recapitalizations under Art. 32(4) BRRD. As precautionary recapitalizations are implemented *outside* (and as a substitute for) resolution, the burden sharing is subject to the stringent motivation requirements set forth in *Kotnik*. This opens the way to the possibility that the State compensates the written-down creditors, as it happened in Italy with the crisis of Monte dei Paschi di Siena S.p.A.: *see* below, subparagraph B(c).

A further example arises out of the experience of the Dutch bank SNS Reaal ("SNS").[205] Accrued losses in SNS's real estate investments caused the bank to go below its capital ratio requirements. Consequently, in February 2013 the Dutch Ministry of Finance ordered the transfer of SNS's equity and subordinated bonds to the Dutch State, whereas liabilities towards subordinated creditors not represented by securities were transferred to a bad bank (later put into liquidation). In fact, one author[206] identified the action of the Dutch government as an open expropriation of SNS's shareholders and subordinated bondholders, resulting in a state-funded capital relief amounting to approximately €1 billion. Whereas this case took place around two years prior to the entry into force of the BRRD in the Netherlands, the final result may have not been substantially different had the BRRD been already applicable, as expropriated shareholders and subordinated debt holders would probably still have suffered full write-down of their holdings.

(c) Third Strategy: Follower's Approach

A third group of European Member States addressed the management of banking crises less proactively. In fact, such countries tried to maintain their traditional approach to banks' restructuring (see Paragraph A above), seeking for a laborious and instable compromise with the new burden sharing requirements imposed by the European rules on State aids (namely, by the 2013 Banking Communication) and, thereafter, the BRRD principles.

Italy is a very demonstrative example.[207] When the financial crisis was in its early stages, the Italian authorities tried to replicate the well-experimented model of the pre-2007 era, *i.e.* liquidation of the ailing institution, transfer of its viable assets and deposits to a "good bank" (or directly to a competitor), intervention of a deposit guarantee scheme to cover the "imbalance" between the assets and the liabilities transferred to the good bank.[208]

Finally, it is worth noting that other (national) courts have adopted a less submissive stance than the ECJ, holding that a bail-in measure may possibly conflict with property rights: *see* the Austrian Constitutional Court decision in the HETA case, below in subparagraph V.D.(a).

[205] *See* Hans-Joachim Dübel, *The Capital Structure of Banks and Practice of Bank Restructuring* (CFS Working Paper No. 4, 2013), available at https://www.ifk-cfs.de/fileadmin/downloads/publications/wp/2013/CFS_WP_2013-4.pdf; Lynette Jannsen & Jouke Tegelaar, *How to Compensate Expropriated Investors? The Case of SNS Reaal*, in 2016 J. INT. BANK. L. & REG. 162, at 162-65 (2016).

[206] *See* Matthias Haentjens, *What happens when a Systemically Important Financial Institution Fails: Some Company Law Observations re. SNS Reaal* (Hazelhoff Research Paper Series No. 3, 2014), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436901.

[207] But it is not the only one. For an account of the restructuring of Dexia—a group formed in 1996 from the merger of Belgian, Luxembourg and French state-owned banks—*see* Philippon & Salord, *supra* note 138, at 29-30. The Group was rescued through State recapitalizations in 2008 and 2012 (totaling €11.85 billion), with no direct involvement of the private sector. Of course, shareholders indirectly suffered losses from the write-down of assets and the dilution following the recapitalizations. Anglo-Irish bank provides an example of even greater bail-out, with State aids granted reaching, in aggregate, almost €30 billion (plus State guarantees on a vast array of liabilities). *See Id.*, at 30.

[208] *See*, *e.g.*, the restructuring of Banca Valle d'Itria e Magna Grecia (2010), Banca MB (2011), Banco Emiliano Romagnolo (2011), and others. *See* Lener, *supra* note 99, at 705-706. To understand the "path-dependent" approach initially followed by the Italian policy-makers, one should not overlook that the financial crisis hit the Italian banks less severely than their European and US competitors, due to their relatively scarce openness to the international financial markets (and, especially, the derivatives markets). Starting from 2011, the Italian banking system began to falter, as a consequence of both the general economic downturn (which increased the NPL stock in most banks' portfolios) as well as the sharp decrease in the price of the Italian sovereign bonds, in which most banks had massively invested. Italian banks were a victim of the "bank-sovereign" feedback loop: *see* Tröger, *supra* note 70, at 5; Zhou *et al.*, *supra* note 72, at 4.

This path-dependent scheme shattered in 2015. The European Commission sanctioned the Italian government for the deposit guarantee scheme ("FITD") intervention to rescue Banca Tercas, a small saving bank based in southern Italy.[209] The Commission found that, although the FITD is not a public entity but a consortium of private banks, it acted "on behalf" of the Italian State. Thus, the funding by the guarantee scheme was an illegitimate State aid, since no adequate burden sharing had taken place.[210]

This setback arrives in the midst of a harsh turmoil of the financial sector, when the crisis of the sovereign debt has infected the balance sheet of prominent banks such as Banca Monte dei Paschi di Siena S.p.A. ("MPS"). The Italian authorities start exploring a variety of strategies. The *first*—and most "BRRD-friendly"—solution comes on stage at the end of 2015, to manage the failure of four small-medium banks headquartered in central Italy.[211] It relies on the combination of private sector involvement and State aids, consistent with the principles of the BRRD, just implemented in Italy with the temporary—but noteworthy—exclusion of the bail-in tool.[212] The four banks are put into resolution under the direction of the Bank of Italy,[213] resorting to a combined use of the bridge institution, asset management company and sale of assets tools. Specifically, the entire "good" business of each bank is transferred to a newly-formed bridge entity, while NPLs and liabilities to shareholders and subordinated creditors are subject to reduction and write-down.[214] The old bank is wound up. As a full bail-in is not triggered, the new bridge institutions need further capital, injected by the Italian Resolution Fund: a type of State aid approved by the European Commission. The old banks transfer their NPL portfolios to REV S.p.A., an *ad hoc* asset management company, financed by the Resolution Fund and by private loans from other banks. Some 18 months later, the four bridge institutions are sold to UBI Banca S.p.A. and BPER S.p.A., two national competitors.

This approach to the BRRD resolution, as "mild" as it can seem (it carefully avoided bail-in), bumped into the politically sensitive issue of "mis-sold savers". Groups of vociferous retail investors—wiped out in resolution—started to complain that thin-capital banks, anxious at quickly filling their capital gaps after negative stress tests, had induced them to buy

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209 *See* EUROPEAN COMMISSION, *Commission Decision of 23.12.2015 on the state aid SA.39451 (2015/C) (ex 2015/NN) implemented by Italy for Banca Tercas*, C (2015) 9526 final (Dec. 23, 2015).

210 The Commission argued that, as the deposit guarantee scheme was funded through mandatory (instead of spontaneous) contributions from the participating banks, the FITD intervention in a failing bank could not be considered voluntary, but *de facto* imposed by the government. *See* Lener, *supra* note 99, at 710.

211 Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara. *See* Bank of Italy, *Information on the Resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, CariChieti and Cassa di Risparmio di Ferrara crises*, 2015, available at https://www.bancaditalia.it/media/approfondimenti/2015/info-soluzione-crisi/index.html?com.dotmarketing.htmlpage.language=1. *See* also Bodellini, *supra* note 86, at 380-381.

212 The BRRD was implemented less than one week before the resolution of the four banks (*see* Legislative Decrees No. 180 and 181 of November 16 2015, G.U. Nov. 16, 2015, n. 277 (It.)). Under a transitional regime, the entry into force of the bail-in tool was postponed until January 1st, 2016.

213 Somewhat surprisingly, the Bank of Italy found a public interest for the resolution of each of such banks, even if their *aggregate* market share barely reached 1% of the Italian market—a good example of the debatable and non-predictable public interest test under the BRRD. *See* above, Paragraph. III.C, and below, Part VI.

214 No senior creditors' sacrifice was imposed, although theoretically this would have been a viable solution to re-balance the current value of the assets and liabilities transferred to the bridge institutions. But this would have required the use of the bail-in tool, which—as said—was not applicable yet in Italy. Criticism on this solution has been raised by Ringe, *supra* note 73, at 29-30. *See* also Silvia Merler, *Italy's Bail-in Headache*, Bruegel, 2016, available at http://bruegel.org/2016/07/italys-bail-in-headache.

shares and subordinated bonds in violation of the MiFID rules.[215] They claimed that the resolution had infringed their rights, even more so because it applied retroactively to financial instruments issued years before the new legislation entered into force, a situation also occurred in Spain, Slovenia and other countries. An *ad hoc*, State-funded compensation for mis-sold holders of subordinated instruments[216] did not stop the protests against the much-blamed "retroactivity of the bail-in".[217]

Against this background, the Italian policymakers resorted to a *second strategy*, mindful of the recent Spanish and (less recent) Swedish "centralized" experiences (see under Paragraph B above). In early 2016, the government and the Bank of Italy sponsored the creation of an investment fund, participated by Italian institutional investors, including the major Italian banks and insurance companies, several banking foundations, and Cassa Depositi e Prestiti (a long-term investment company participated by the government and partly financed through postal deposits). With its initial €4.25 billion endowment, the fund—allusively named "Atlante" ("Atlas")—had the twofold mission of *(i)* relieving the banking system from the burden of its impressive stock of non-performing loans,[218] and *(ii)* capitalizing those

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[215] Specifically, in the years of the financial crisis, the Italian banks resorted to the issue of a huge number of Additional Tier 1 and (even more) Tier 2 instruments, levering on the widespread belief that a subordinated financial instrument, when issued by a bank, was "safe by definition". The boilerplate disclaimers routinely inserted in the issuers' prospectuses did not gain much attention, as investors (mostly households and SMEs) relied on the fact that, in the "old" banking crises, subordinated creditors were normally bailed out. An aggressive commercial policy by the issuing banks fed this conviction. Inspection reports by the supervisory authorities have now ascertained that many ailing banks (in particular, the four banks referred to in the text, MPS and the two Banche Venete) massively sold shares and subordinated instruments to retail investors in violation of the suitability, appropriateness and conflict of interest rules. For empirical evidence on the placement of bank bonds to retail investors (approximately 80% of total bond funding in the two-year period July 2007-June 2009), *see* Renato Grasso *et al.*, *Bond Issued by Italian Banks: Risk and Return Characteristics* (Consob Working Paper No. 67, 2010), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1919524, at 5-6. On the impact of the mis-selling practices on the law and policy of the Italian banking resolutions, *see*, *e.g.*, Götz *et al.*, *supra* note 165, at 2; Philippon & Salord, *supra* note 138, at 39; Lener, *supra* note 99, at 711; *Id.*, *Bail-in bancario e depositi bancari fra procedure concorsuali e regole di collocamento degli strumenti finanziari*, in 69 BANCA, BORSA E TITOLI DI CREDITO, I, 287 (2016); Giuseppe Guizzi, *Il bail-in nel nuovo sistema di risoluzione delle crisi bancarie. Quale lezione da Vienna?*, in 32 CORR. GIUR., 1485 (2015); Rulli, *supra* note. 170, at 82-88.

[216] The retail investors who have subscribed or bought subordinated bonds of the four banks may apply for the payment a lump sum (if they purchased the bonds before the publication of the BRRD text of the EU Official Journal), or, alternatively, start special arbitration proceedings to obtain compensation of damages resulting from mis-selling practices. The financial burden of such compensation is levied on a "Solidarity Fund", funded through private banks' compulsory contributions. *See* Art. 1(855), of Law No. 208/2015, G. U. Dec. 30 2015, n. 302 (It.). Recently, Law n. 145/2018, G. U. Dec. 31, 2018, n. 62/L (It.) has extended certain compensation measures to mis-sold shareholders, simplifying even more the procedure to ascertain the relevant unlawful conducts. Interestingly, the EU Commission has upheld (so far) the compensation of subordinated creditors for mis-selling damages in the context of a banking restructuring, since it conceives such compensation measures as a form of social protection. *See*, *e.g.*, European Commission, *Factsheet – State aid: How the EU rules apply to banks with a capital shortfall,* 25 June 2017, available at http://europa.eu/rapid/press-release_MEMO-17-1792_en.htm: "In situations where banks that have mis-sold financial instruments have left the market, it is up to Member States to decide whether to take exceptional measures to address social consequences of mis-selling as a matter of social policy. This falls outside the remit of State Aid rules".

[217] Actually, in the "four banks" case, the bail-in provisions did not retroact, simply because they had not come into force yet. To be sure, the perceived retroactivity concerned the burden sharing provisions, which, in the view of the retail investors, were not adequately disclosed in the prospectuses accompanying the issuance of the subordinated financial instruments. Arguments on the alleged retroactivity of the resolution regime are critically examined in Guizzi, *supra* note 215, at 1493-1494.

[218] The latest data, from June 2018, show that ratio between the stock of NPLs (including provisions) and all loans was 10.2% for Italian banks, for an overall NPL amount equal to approximately €220 billion. *See* BANK

banks that, although not being in a "fail or likely to fail" situation, had negative SREP results and needed a capital reinforcement.[219]

Set up with such ambitious "systemic" goals, Atlante found itself short of ammunitions to pursue them effectively. A significant portion of its funds was used to capitalize (and acquire control of) Banca Popolare di Vicenza and Veneto Banca, two institutions in deep water at the time.[220] Atlante channeled its remaining resources to purchase NPLs, but, despite an interim recapitalization and the set-up of a twin fund named "Atlante 2"[221], such intervention proved insufficient, alone, to improve the asset quality of the banking sector.

As a *third strategy*, the Italian government explored the precautionary State recapitalization of a failing bank.[222] This scheme was used to preserve the solvency of MPS, the most ancient bank in the world and the third Italian bank by size until few years ago. While, for the time being, the specter of a failure has been pushed away, the €6.6 billion State intervention in MPS under is still the subject for a heated debate.[223,224]

A thorough assessment of the precautionary recapitalization tool falls outside the scope of this Article.[225] Yet, it may be useful to summarize the main reasons that, once all market

OF ITALY, Financial Stability Report No. 2 (2018), available at https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/2018-2/index.html.

219 Atlante took its first steps in an untested middle-ground between private and public intervention. For example, its mission was to become a shareholder of under-capitalized banks, but the timing of its intervention (just before such banks entered a "resolution" territory) was key to avoid that the Atlante's support (sponsored by the Italian government) be regarded as an unauthorized State aid. Likewise, Atlante operated to "centralize" the purchase (and the subsequent management) of the Italian banks' NPLs, cautiously moving between the effort to pay a price higher than the "fire sale" offers typical of foreign hedge funds, and the risk of being accused of State-subsidized overpricing.

220 With hindsight, this proved to be an illusory rescue, as, few months thereafter, the two Banche Venete slipped from Atlante's shoulders into bankruptcy (*see* below, subparagraph III.C(b)).

221 *See* Lener, *supra* note 99, at 715-716.

222 On precautionary recapitalization, *see* above, Paragraph III.B.

223 The MPS recapitalization was realized as a three-step transaction, broken down as follows: (A) In order to enforce "burden sharing" required under the State aid regulation, a mandatory debt-to-equity swap was set forth, whereby MPS Upper Tier II bonds were converted into ordinary newly-issued MPS common shares; (B) Concurrently with the debt-to-equity swap, the State subscribed to other new MPS common shares, reaching control of the bank; and (C) As a compensation measure to retail investors, the former subordinated bondholders (now shareholders) were given the opportunity to exchange the shares just subscribed with newly-issued senior bonds, having the same maturity as those previously converted into equity. The exchange was subject to the condition that the investors definitively waived, by way of settlement, any claim relating to the commercialization of the subordinated financial instruments previously subscribed. The exchanged shares were eventually transferred to the Italian government (thus reaching a 68.2% control stake in MPS), for a consideration paid to the bank. This structure was upheld by the European Commission, which approved the aid granted by the Italian State as consistent with the burden sharing and NCWO principles. MPS is now solvent, has a 13.0% CET1 and has registered new profits in 2018. On the MPS recapitalization, *see*, for a summary on the transaction structure, Banca Monte dei Paschi di Siena, *2017-2021 Restructuring Plan*, 2017, available at https://www.gruppomps.it/en/investor-relations/download-center/business-plan-capital-increase.html. *See* also, *e.g.*, Götz *et al.*, *supra* note 165; Bodellini, *supra* note 86, at 385-387, Lener, *supra* note 99, at 716-720, Hellwig, *supra* note 64, at 17-27; Bowman, *supra* note 164.

224 The Italian government is trying to reiterate the precautionary recapitalization strategy in the recent case of Carige. After the ECB put Carige into "special administration" (*see* above, note 74), the Italian government intervened by decree, approving a State-backed guarantee scheme up to €3 billion for the bonds that Carige will issue to finance its future operations. The decree also authorized the Italian State to acquire up to €1 billion in Carige shares by the end of September 2019, under a precautionary recapitalization scheme closely inspired to the model applied for MPS. *See* Law Decree No 1 of January 8 2019, G.U. Jan. 8 2019, n. 6 (It.). As of this writing, this option remains as a theoretical "back-stop", as no recapitalization has been approved yet.

225 For references, *see* Paragraph III.B above.

alternatives seemed exhausted, induced the government to opt for a direct State intervention instead of leaving MPS to its fate (*i.e.* sliding to insolvency and ensuing resolution). First, a significant amount of resources of the (still infant) Resolution Fund had already been used in the "four banks" resolutions of 2015.[226] Calling the Fund to intervene in the resolution of an institution as big as MPS would have implied a massive recourse to additional contributions from the rest of the Italian banking system, hitting on an already fragile ground and putting at risk the stability of other credit institutions.[227] Second, a severe write-off of liabilities in a resolution context would have exacerbated the mis-selling issue—already emerged during the "four banks" turnaround—making the crisis politically unmanageable.[228] Third, the potential resolution of MPS, potentially hitting on institutional investors' claims, could have triggered a flight from the Italian market, as Portugal with the Novo Banco bail-in had experienced few months before.[229]

C. *Common Trends in the National Management of Banking Crises*

Despite the different strategies followed by various Member States, a few common tendencies emerge from the comparative account above. As we try to demonstrate in the following Paragraphs, such pre-BRRD tendencies are key to understand the adaptive reactions of European States when the Directive becomes the law.

(i) A first trend is the <u>very limited, if not exceptional, use of the bail-in tool</u> with involvement of senior creditors. While all jurisdictions experimented different forms of private sector involvement, in no Member States—with the exception of Denmark in 2011 and Cyprus in 2013[230]—the authorities relied exclusively on the internal sources of an insolvent bank to resolve the crisis.[231] "Open bank" bail-ins and other "stand-alone" resolutions also remain theoretical options.[232] Generally, the solutions adopted across the EU contemplate a combination of burden sharing (which, however, is normally limited to shareholders and, to a variable extent, subordinated bondholders) and other tools, *i.e.* sale of assets and/or transfer of assets and liabilities to a bridge entity or an asset management company.

Of course, each case has its own history and specificities. For example, in some cases the bail-in may have been avoided because, while restoring the minimum capital requirements of a failed bank, it can do nothing to resolve a liquidity crisis.[233] In other

[226] *See* above in this subparagraph.
[227] *See* Bodellini, *supra* note 86, at 386.
[228] To understand the dimension of the problem, it should be considered that, only in 2008, €2.2 billion of MPS Upper Tier II bonds were issued to retail investors, most of them concentrated in the areas of the country where the MPS distribution network was particularly strong. To be sure, as already pointed out (*see* note 204 above), the European Commission does not prohibit the State compensation of the victims of mis-selling, even if they are subordinated creditors wiped out under the resolution rules. Apparently, though, also in consideration of the other factors mentioned in the text, the Italian institutions decided to keep away from resolution, and pursue a less traumatic and "agreed" exit strategy. This decision has been the subject of much criticism: *see*, among others, Hellwig, *supra* note 64, at 22-27; Götz *et al.*, *supra* note 166, *passim*.
[229] *See* above, subparagraph B(b).
[230] *Supra*, note 183 and accompanying text.
[231] For an estimate of the public and private participation to European banking restructurings during the financial crisis (although based on a limited sample), *see* Philippon & Salord, *supra* note 138, at 33-34.
[232] *See* Bodellini, *supra* note 86, at 375 and ff.
[233] *See* subparagraph III.C(c). Yet, if the bail-in is used in combination with other resolution tools, the liquidity may come from outside (acquirer of assets, bridge institution), let aside any emergency liquidity assistance or public intervention after the bail-in has been exploited (*see*, *e.g.*, Arts. 37.10, 56 and 58 of the BRRD).

instances, the sacrifice of (senior) creditors may have not met the NCWO test. Alternatively, in still other cases, the bail-in may have proven unfit to ensure the long-term viability of the failed institution.[234] Yet, in our view, other "systemic" considerations, as they emerge from the following points here below, may validly explain from a general standpoint the authorities' reluctance to use the bail-in tool.

(ii) Virtually all the restructurings that took place during the financial crisis were accompanied by <u>significant public intervention</u>. While the "mantra" of private sector involvement has become the *fil rouge* of all banking restructuring policies during the last decade, this has not prevented the decision-makers to charge at least one portion of the rescue costs on the taxpayers—more than a relic of the old bail-out scheme. By the way, this does not seem to be a "prerogative" of Southern European countries, but rather a uniform policy trend across the EU (as the Dexia case, among others, demonstrates).

One might note that this approach is not inconsistent with the BRRD architecture, where public support is contemplated in many different forms, even in the context of resolution: the use of government stabilization tools is just what the European rules provide for "the very extraordinary situation of a systemic crisis" (Art. 37.10 BRRD). However, in most cases, the injections of public funds—even if consistent with the State aid framework—would hardly satisfy the stringent requirements set forth by the Directive, namely the condition that "a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of the total liabilities including own funds of the institution under resolution […] has been made by the shareholders and the holders of other instruments of ownership […] through write down, conversion or otherwise" (see Art. 37.10(a)). In the FinSAC (World Bank) recollection of case studies on pre-BRRD bank resolutions in the EU, the following question is often asked: what if the BRRD requirements had been already applicable? A recurring answer in the country analyses is that, had the 8% requirement under Art. 37.10(a) been applied to any public recapitalization, this would have implied the involvement of the *senior creditors* (sometimes including depositors) in the restructuring process. This would have stressed the systemic effects of the crisis of a single institution, eventually raising the overall resolution costs.[235]

(iii) In several cases, the policymakers' choices were conditioned by the issue of <u>mis-selling of shares and subordinated instruments to retail investors</u>. From a legal standpoint, past malpractices in the distribution of financial instruments should not affect the functioning of a banking restructuring. Each European country is required to

[234] Even under the BRRD, there is no *requirement* to use the bail-in tool nor are they situations in which the bail-in is mandated by law. Indeed, the resolution authorities may apply the bail-in "*only if* there is a reasonable prospect that the application of that tool […] will restore the institution […] to financial soundness and long-term viability" (emphasis added); which may not occur in practice.

[235] *See,* for example, the country reports concerning Cyprus, Greece, Italy, the Netherlands, and Slovenia. Of course, these reports rarely quantify the amount of higher costs stemming from a failed public intervention—a difficult exercise, as it deals with theoretical hypotheses. Yet, it is remarkable that such a high number of EU countries have come to the same conclusion, which seems to confirm some scholarly opinions on the pro-cyclical effects of "internal" restructurings: *see* Avgouleas & Goodhart, *supra* note 86. The same seems to hold true in the post-BRRD landscape: *see* below in this Paragraph.

enforce prospectus liability,[236] as well as the rules of conduct in the provision of investment services (such as investment advice or placement of securities).[237] Therefore, in principle, mis-sold buyers of subordinated bonds hold intact their contractual or tortious liability claims, even if their securities have been wiped out in resolution. However, in a situation where the issuing bank has directly placed a massive number of instruments to its own depositors and clients, prospectus liability or MiFID claims can be toothless remedies. Either plaintiffs would have little or no chance of recovery (if the bank is put into liquidation) or, even worse, such claims would put at risk the long-term viability of a just resolved institution.[238] This point—in addition to the fear of claims related to the "retroactivity of bail-in" issue (see item (iv) below)—explains why policymakers have opted for special (out-of-resolution) compensation mechanisms to restore the mis-sold investors (as in Italy), or have run complex LMEs, providing for a reduced write-off on those investors that agree to waive their mis-selling claims (as in Greece, Austria or in the MPS case).

(iv) Generally, the national decision-makers have refrained from an "orthodox" use of the new resolution principles, with a view to reduce litigation risks. For example, a fine-tuning in the identification of the liabilities to be reduced or converted has mitigated the risk of claims for unlawful "retroactivity" of burden sharing mechanisms.[239] In other cases, the entry of the bail-in into force was delayed to a later time.[240] Unsurprisingly, these expedients did not prevent any litigation: written off investors have claimed the violation of property rights[241] and invoked the immunization of their contractual positions against a resolution ordered by a foreign authority.[242]

The above (pre-BRRD) tendencies suggest two preliminary conclusions. First, the transition from a model of bank turnaround based on public rescue to one based on the private sector involvement has taken longer than expected, especially in jurisdictions where retail investors had significantly invested in securities issued by banks. With hindsight, we can affirm that policymakers often underestimated the issue of "retroactivity" and constitutionality of the

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[236] *See* Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, 2017 O.J. (L 168), Art. 11: "Member States shall ensure that their laws, regulations and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus".

[237] *See* Directive (EU) 2014/65 of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 O.J. (L 173), Arts. 24-30 [hereinafter MiFID II].

[238] *See, e.g.,* EBA & ESMA, *supra* note 87. Indeed, according to the two European authorities, "[e]ven in the absence of mis-selling cases, the consequences of the application of bail-in to retail debt liabilities, in cases of significant exposures, could also present specific challenges from the perspective of contagion effects and financial instability. From a general perspective, bailing in retail holders may affect overall confidence in the financial markets" (at 16).

On the complex issue of placement (and mis-selling) of subordinated debt to retail investors (which cannot be treated extensively here), *see* Andrea Resti, *Should the Marketing of Subordinated Debt Be Restricted/Different in One Way or the Other? What to Do in the Case of Mis-selling?*, paper requested by European Parliament's Economic and Monetary Affairs Committee, March 2016, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/497723/IPOL_IDA(2016)497723_EN.pdf. This Author invokes a "thorough implementation" of the (strengthened) MiFID II rules on conflicts of interest to curb inadequate pricing procedures and distortive remuneration practices in the self-placement procedures.

[239] *See* the Spanish example, as described in subparagraph V.B(b) above.

[240] As in Greece and Italy: *see* subparagraphs V.B, (a) and (c), above.

[241] *See*, *e.g.*, the *Kotnik* case (note 204 and accompanying text).

[242] *See* the BES turnaround (note 199 and accompanying text).

resolution rules in the BRRD legislative process: a progressive enactment of the resolution tools should have gone hand-in-hand with the creation of clearly marked "bail-inable" liabilities. Otherwise, the litigation risk may undermine the full deployment of resolution effects.[243]

Second, the pre-BRRD experience suggests that "exogenous" circumstances may complicate the "bail-in vs. bail-out" alternative, more than is suggested by theoretical exercises. We already mentioned situations where relying at least in part on the taxpayers' funds may be regarded as a "lesser evil" to minimize contagion to the financial system.[244] Mis-selling claims (and the related contingent liabilities on the resolved entity) may also represent a lingering threat to an effective resolution, making it difficult to quantify the resources needed to restore the investors adequately. In such circumstances, resorting to public financing to compensate the retail investors, or implementing LMEs supported by public funds, may appear a less troubling solution.[245]

D. *BRRD (and SRMR) at Their First Steps*

The deadline for the Member States to transpose the BRRD was December 31, 2014.[246] And, as mentioned, some States were late in the implementation process, or deliberately delayed the application of certain provisions, such as the bail-in tool. As a result, when the BBRD became applicable across the EU, most restructuring processes arisen during the financial crisis were already closed or still subject the applicable pre-BRRD national regimes, along the multi-faceted policy lines described above.

Even so, the analysis of the post-BRRD landscape is no less interesting, not only in respect of the few cases where the Directive has been *applied* (for the first time), but—even more—in respect of the cases where it has *not* been applied, raising questions about the future of this piece of regulation. As we discuss below, in case of failure of significant banks (*i.e.* those subject to the SSM), only in one case (Banco Popular) the authorities resorted to the BRRD toolbox. In all other cases, the resolution option has been discarded: a somewhat counter-intuitive result, as one would expect that a procedure based on the "public interest" requirement would apply to systemic institutions rather than minor ones. In the following Paragraphs, after describing the characteristics of the main turnarounds under the BRRD regime, we investigate the possible causes of the current state of things.

(a) Two Bail-ins, with Uncertain Outcomes

If we exclude the resolution of two Greek banks and four small banks in Italy (carried out under the BRRD rules, but to the notable exclusion of the bail-in tool: see above), the first

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243 The importance of having a sufficient layer of long-term, high quality and easy to bail-in capital as a condition for the proper functioning of a system based on the private sector involvement is often underlined: *see* Micossi *et al.*, *supra* note 118, at 9; Tröger, *supra* note 70, at 10. Of course, there are example of "virtuous" countries where a step-by-step approach to the bail-in model has been carefully planned.

244 After all, one of the resolution objectives is "to avoid a significant adverse effect on the financial system, in particular by preventing contagion" (Art. 31.2(b) BRRD). Failing the possibility to pursue such objective would *per se* prevent the viability of a resolution.

245 *See* Philippon & Salord, *supra* note 138, at 41.

246 *See* Art. 130 BRRD.

resolutions entirely governed by the BRRD took place in Austria and Denmark, with two "full-scale" bail-ins.[247]

In October 2015, the Danish authority (Finansiel Stabilitet) put Andelskassen J.A.K. into resolution and directed a new bridge institution to take control of the entire capital of the resolved bank (Art. 40.1(a) BRRD).[248] All shareholders and junior creditors were wiped out. In addition, most senior creditors and uninsured depositors (apparently, all were Danish residents) incurred a 100% haircut.[249] Despite the speed of this "orthodox" bail-in process (with apparently low litigation rates), its outcome has not been successful, as the sale of the bridge bank to a third party acquirer has not been completed and, therefore, the bridge bank itself has been forced into liquidation.[250] This result raises some concerns. Ideally, supervisory authorities choose resolution as a less costly alternative compared to bankruptcy, but one may wonder whether they factored into this calculation the risk of future losses incurred by the resolution fund in the ensuing liquidation of the bridge bank.

A more turbulent process took place in Austria. Here, the BRRD was applied in the queue of a restructuring process already commenced before the Directive was transposed—a sort of "square" resolution. On March 2015, the Austrian Financial Market Authority ("FMA") decided to resolve HETA Asset Resolution AG ("HETA"), an asset management vehicle (bad bank) created the year before, in the turnaround of Hypo Alpe-Adria-Bank International AG ("HBint"), a failed bank nationalized in 2009.[251]

[247] We do not discuss here the Novo Banco "tail" already described in subparagraph V.B(a) above. As mentioned, senior liabilities of a failed bank toward professional investors were *first* (pre-BRRD) transferred to a bridge institution, *then* (post-BRRD) transferred back (and, consequently, *de facto* written down) to the old bank in a sort of "phase 2" resolution.

[248] *See* Jens Verner Andersen, Pamela Lintner & Susan Schroeder, *Andelskassen: Resolution Via Bridge Bank and Bail-in Including of Uninsured Depositors (2016)*, in FinSAC Paper, *supra* note 181, at 24-28. Apparently, the resolution of Andelskassen was in the public interest, as it was necessary to allow critical functions of this bank to continue (*see* Finansiel Stabilitet, *First Decision on the Resolution of Andelskassen J.A.K. Slagelse under Kontrol*, October 5th, 2015, available at www.finansielstabilitet.dk).

[249] Andersen *et al.*, *supra* note 248, at 27. A detail of the bail-in measures is reported in Finansiel Stabilitet, *Second Decision on the Resolution of Andelskassen J.A.K. Slagelse under Kontrol*, October 5th, 2015, available at www.finansielstabilitet.dk. The final expert valuation (issued 6 months after the resolution decision) estimated that losses under liquidation would have been 50% higher than in resolution. All creditors subject to bail-in were written down to zero: *see* Finansiel Stabilitet, *supra* note 248. A couple of creditors—whose claim had been allegedly written off in violation of the NCWO principle—were compensated *ex post* pursuant to Art. 75 BRRD (*see* Paragraph III.D above).

[250] For further details, *see* Andersen *et al.*, *supra* note 248, at 28.

[251] *See* Johanna Lincoln and Pamela Lintner, *HETA: The Resolution of an Asset Management Vehicle*, in FinSAC Paper, *supra* note 181, at 9 ff. It may be worth noting here that the HBInt restructuring gave rise to an important litigation on the compatibility of (pre-BRRD) resolution principles with the constitutional rights of creditors. Certain written-off subordinated creditors of HBInt challenged in court the cancellation of their rights under an *ad hoc* Austrian statute. The case reached the Austrian Constitutional Court, which declared that a write-off targeting the subordinated creditors was in breach of the Austrian constitutional principles. Interestingly, the Austrian constitutional judges did not sanction the write-off as a violation of the property right, but rather highlighted that the subordinated creditors had been discriminated based on the maturity date of their respective claims, in breach of the NCWO principle.
See: Verfassungsgerichtshof (VfGH) [Constitutional Court], Jul. 3, 2015, G239/14, available at https://www.ris.bka.gv.at/Dokumente/Vfgh/JFR_20150703_14G00239_01/JFR_20150703_14G00239_01.pdf. *See* Rulli, supra note 170, at 84-85.

HETA represented a perfect candidate for the "public interest" test, as its activities were branched out in Croatia and Slovenia and it provided essential services to the Austrian banking system.[252] The Austrian authority decided to bridge the significant capital gap emerged in the bank's valuation through a full bail-in of all shareholders and subordinated creditors, and a 54% haircut of the senior debt. The FMA also exercised its powers under Art. 63 of the BRRD to cancel all interest payments on the senior bonds and extend their maturity to 2023.

Among the liabilities hit by the bail-in haircut, there were bonds issued by HETA and secured by a Carinthia State guarantee. The bondholders started litigation to enforce the State guarantee, following the default of the issuer, and challenged the HETA resolution[253]. In the light of the complex legal issues stemming from the case,[254] and the consequent (potentially unsustainable) financial burden for the public purse,[255] the State of Carinthia proposed a buy-back of all HETA secured debt instruments in exchange for a new State-issued zero-coupon bond or, alternatively, a cash payment. The acceptance of the offer was conditional upon a comprehensive waiver of all lawsuits and actionable claims. Again, like in several pre-BRRD experiences, a *consensual* LME, coupled with a litigation settlement, turned out to be the preferable system to escape from the uncertainties of the bail-in regulation.

(b) Resolution Grows Up: The First Failure of a "Relevant Institution"

With the resolution of Banco Popular Español S.A., the Single Resolution Board takes the field for the first time.[256] Since 2016 Banco Popular, heading the Spanish sixth biggest banking group and subject to the ECB's supervisory authority,[257] had been facing capital needs, rating downgrades and an increasing difficulty to access financing from the market. In 2017, deposits started to outflow (about €20 billion), amidst fears of a possible bank run. On June 6th, 2017, the ECB decided that the bank was "failing or likely to fail" and, the following day, the SRB decided to place the institution under resolution.

The resolution actions, based on a provisional valuation of the assets and liabilities of Banco Popular,[258] are a combination of write down and conversion of capital instruments (Art. 59 BRRD) and sale of business tool (Art. 38 BRRD). They include: (i) the complete reduction of the current bank's shares, (ii) the complete write down of all Additional Tier 1 capital instruments, (iii) the conversion of all Tier 2 instruments into new shares, and (iv) the transfer

[252] Lincoln & Lintner, *supra* note 251, at 12.

[253] Nevertheless, litigation ensued because HETA was not licensed to operate as a bank (only as a lending institution) and, therefore, its status of institution subject to resolution was questionable. To be sure, the Austrian transposition law expressly classified HETA as a resolvable entity, but certain creditors challenged this legislative decision in court (including before the Constitutional Court of Austria). The case was referred to the European Court of Justice, then withdrawn as a result of the settlement entered into between the Austrian authorities and the creditors in September 2016 (*see* in the text).

[254] Reportedly, it was unclear, for example, whether the third-party guarantor is able to recover from HETA (at what rate?) the sums paid to the bondholders. *See* Lincoln & Lintner, *supra* note 251, at 13.

[255] Apparently, the State of Carinthia faced a risk of €6.4 billion, approximately three times its annual budget. *See Id.*, at 13.

[256] On the SRB as European centralized decision-maker for the turnaround of banks supervised under the SSM, *see* above, Paragraph II.A.

[257] Total assets of the Banco Popular Group amounted to €147 billion in early 2017; non-covered, non-preferred deposits amounted to €34.8 billion. *See* SRB, *Decision of the Single Resolution Board in its executive session of 7 June 2017, concerning the adoption of a resolution scheme in respect of Banco Popular Español S.A.*, available at https://srb.europa.eu/en/node/315, at 17.

[258] *See* Deloitte, *Hippocrates – Provisional Valuation Report*, Jun. 6, 2017, available at srb.europa.eu.

of all such new shares to Banco Santander S.A. (the largest Spanish bank) for the symbolic consideration of €1. In the following months, Santander starts a €7 billion rights issue to address the provisioning deficit that Santander uncovered in Banco Popular's books. The recovery of the failed institution is completed without any public financial support.[259]

The Banco Popular case certainly marks a milestone in the BRRD history, but also leaves a trail of questions on the future of the European resolution regime. On the one hand, the first resolution managed at an EU level appears to be a "perfect" realization of the policy objectives underlying the BRRD: preservation of the essential functions carried out by a systemic bank, full involvement of private investors in the loss coverage, market recapitalization, no State intervention. On the other hand, the resolution of this medium-size institution spotlights the ambiguities of the European regulatory framework, in terms of uncertainty of the resolution requirements, discretion in the valuations on which the creditors' losses are based, and limited predictability of the authorities' decisions.[260]

Let us consider the following points:

(i) <u>FOLTF ("fail or likely to fail") decision</u> – The ECB declared the FOLTF status of Banco Popular based on an alarming liquidity shortage that had no foreseeable options to be restored.[261] This decision has been the subject for criticism as, according to certain institutional investors, the liquidity crisis was induced by the Eurosystem's denial of access to emergency liquidity assistance, despite Banco Popular's requests.[262] Now, in principle, the resolvability of a credit institution should be assessed without taking into consideration its potential access to ELA.[263] However, commentators have suggested that, had the Central Bank granted liquidity assistance, this could have restored some minimum depositors' confidence, thus mitigating the risk of a bank run and positively affecting the FOLTF assessment. Regardless of the validity of such arguments, this case highlights a short circuit of the decision-making process in a resolution: the FOLTF status of a resolved bank ends up being dependent … on discretional actions previously taken (or not taken) by the same authorities that are in charge for deciding on the institution's failure.[264]

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259 For a fact summary of this case, *see* European Parliament, *Briefing – The resolution of Banco Popular*, 2017, available at http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602093/IPOL_BRI%282017%29602093_EN.pdf.

260 Indeed, as we discuss below, the number of questions increases as the Banco Popular resolution is compared to the SRB decision (taken only few days after) not to resolve two insolvent Italian banks (the so called "Banche Venete"), also subject to the SSM.

261 *See* European Central Bank Press Release, *ECB determined Banco Popular Español S.A. was failing or likely to fail*, (Jun. 7, 2017). *See* also SRB, *supra* note 257.

262 On June 5th, 2017, Banco Popular had requested €2 billion of emergency liquidity assistance (*see* European Parliament, *supra* note 259, at 2). As was reported in a court filing by the challenging investors, "[d]espite Banco Popular's requests for emergency liquidity assistance to calm the panic and stabilise its liquidity position, Spain initially denied liquidity assistance altogether, and then granted only about a third of what Banco Popular had requested to overcome the ongoing run on the bank". *See* Christopher Spink, *Banco Popular shareholders seek Santander info to fight Spain*, REUTERS (Mar. 6, 2018), available at https://www.reuters.com/article/banco-popular-shareholders-seek-santande/banco-popular-shareholders-seek-santander-info-to-fight-spain-idUSL5N1QO66S.

263 *See* BRRD, Art. 15.1. But *see* also BRRD, Recital 41: "The need for emergency liquidity assistance from a central bank should not, *per se*, be a condition that sufficiently demonstrates that an institution is or will be, in the near future, unable to pay its liabilities as they fall due".

264 This adds on the intrinsic unpredictability of the FOLTF prognostic diagnosis, which is based on future predictions, as the "likeliness of failure": *see* Tröger, *supra* note 70, at 13. *See* also, for a critical judgment of the

(ii) Public interest assessment – The SRB held the resolution of Banco Popular necessary "to ensure the continuity of *critical functions*" carried out by this credit institution, as well as "to avoid significant adverse effects on financial stability, in particular by *preventing contagion*, including to market infrastructures, and by maintaining market discipline".[265] As to the critical functions, the risk of discontinuance in the deposit services and the cash services were particularly relevant to the SRB decision.[266] The contagion risks were described only sketchily, in terms—for example—of "increased uncertainty with regard to the rest of Spanish national banks" and "increase [of] the cost of funding for other institutions with a similar business model". This description seemingly fails to demonstrate a clear contagion risk, although—of course—we are not in a position to judge the merits of this (obviously discretional) SRB assessment.

Yet, two points are noteworthy for the purposes of the discussion that follows. First, the decision assumes, without demonstrating it, that Banco Popular has *preserved* its market share and systemic role across the crisis.[267] This approach is starkly in contrast with that adopted in the Banche Venete case, where—as we will discuss—the declining market share of these two banks (originally qualified as "significant institutions" within the Euro area) has been key to exclude their systemic relevance and, therefore, the existence of a public interest to resolution.[268]

Second, the SRB stresses the systemic risks deriving from the withdrawal of the banking license because of the initiation of an ordinary insolvency procedure (as opposed to resolution, where continuity of services is unaffected). Apparently, Spanish law does not contemplate legal mechanisms allowing the bank to provide its essential services (*e.g.*, payment services) on a temporary basis even after the opening of insolvency proceedings. Had those mechanisms been available like in other jurisdictions,[269] a smoother transition could have been ensured *also* in liquidation and, perhaps, the public interest assessment could have been different. This demonstrates that, despite the resolution rules are part of an harmonized regulatory framework (BRRD), the (non-harmonized) *national* insolvency rules may be even dispositive for deciding whether a failed institution is worth being resolved or not.

(iii) Choice of resolution tool – The resolution plan adopted by the SRB for the Banco Popular Group in December 2016 had identified the *bail-in* "as preferred resolution tool" in the event of failure.[270] Barely six months after, in its resolution decision, the same authority reconsidered its prior assessment, holding that "it cannot be ensured that [the bail-in tool] would immediately address the liquidity situation of the Institution, hence, restoring it to financial soundness and long-term viability". Instead, the SRB resorted to the *sale of business* tool, subject to write down and conversion of capital

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FOLTF decision in the Banco Popular case, Martin F. Hellwig, *Valuation Reports in the Context of Banking Resolution: What Are the Challenges?* (Discussion paper of the Max Planck Institute for Research on Collective Goods No. 6, 2018, Bonn), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3209192, at 14-15.

[265] *See* SRB, *supra* note 261, at 12 (emphasis added).

[266] Reportedly, Banco Popular had a 5% to 10% market share in such services.

[267] Most quantitative data, on which the SRB public interest analysis is based, refer to December 2016, almost 6 months before the resolution decision is adopted. *See* SRB, *supra* note 257.

[268] In theory, though, it may be questionable whether the size and market share Banco Popular may be such as triggering risks for financial stability: *see* Bowman, *supra* note 164, reporting one operator's opinion (referred to MPS) that "the fourth- or fifth-largest bank in a country should not be a risk to the system".

[269] Such as in Italy: *see* below, subparagraph (c).

[270] *See* SRB, *supra* note 257, at 4-5.

instruments.[271] Once again, this change in the SRB's assessment may signal that—as the pre-BRRD experience had suggested—the bail-in is not suitable to operate as self-standing tool in a resolution process, especially when the failing institution undergoes a liquidity shortage.

Consistent with the choice not to apply the bail-in, the SRB—based on the independent valuation—excluded the reduction/conversion of any senior creditor.[272] With hindsight, we know that such limited involvement of creditors prevented the Banco Popular's capital requirements from being entirely restored before the business was sold to Santander, thus increasing the size of its huge recapitalization.[273] The SRB decision seems to confirm the reluctance of the resolution authorities, even post-BRRD, to affect the position of senior creditors to restore its long-term viability in case of insolvency: a reluctance probably mindful of the Novo Banco and HETA experiences, where the involvement of institutional investors has resulted in a systemic distrust and caused an unsustainable amount of litigation.

(iv) Independent Valuation – The independent valuation underlying the SRB decision has been the target of much criticism for its lack of transparency and the merits of the estimates adopted.[274] In particular, the author of the valuation provided a range of values comprised between a "best case" and a "worst case" estimate; it then provided a "best estimate" within the range. While under the "worst case" scenario losses towered at €8.2 billion, the "best estimate" scenario limited losses to €2 billion. In the opinion of some commentators and investors, the latter figure is suspiciously close to the exact amount of AT1 and T2 instruments to be written down—as if … the valuation exercise was precisely fine-tuned on the desired level of private investors' involvement.[275]

Such speculations—that, of course, we are not in a position to verify—are probably fueled by the rather concise content of the (provisional) valuation, carried out in only 12 days.[276] For example, it is not always easy, for an external reader, to identify the

[271] *See Id.*, at 19. The SRB also expressed a negative assessment with respect to the bridge institution tool ("even if combined with the asset separation tool"), "given that the bridge institution aims to maintain access to critical functions and sell the Institution within a timeframe of, in principle two years, and to the extent that the sale of business tool achieves the same result within a short timeframe, the sale of business tool is considered to achieve the resolution objectives more effectively than the bridge institution tool."

[272] On the uncertainties surrounding the application of the private sector involvement mechanism under Art. 59 BRRD, *see* Tröger, *supra* note 70, at. 18-19.

[273] The SRB itself seems to reckon this. In a passage of its decision, the European authority states: "The Valuation informs the SRB that in view of the independent valuer, the conservative estimate of the adjusted equity of the Institution is a negative amount of €8.2 billion. It follows from the ratio of Article 20(10) SRMR that such amount, including buffers, shall be decisive. However, in light of the bid received from the Purchaser and in accordance with the principles set out in Article 15 SRMR […] the SRB has refrained from ordering further actions in addition to the ones set out herein". *See Id.*, at 22.

[274] *See*, *e.g.*, Sherman&Sterling LLP, *Case Study of recent Bank Resolutions in Europe and related Litigation*, 2017, available at http://pubdocs.worldbank.org, at 26.

[275] For an account of such criticism, *see Id.*, at 26; *see* also Spink, *supra* note 262. On the actions taken by Santander to settle the litigation started on this issue, *see* Banco Santander, *Santander announces a commercial action for retail customers affected by the resolution of Banco Popular*, (Jun. 13, 2017), available at https://www.santander.com/csgs/Satellite/CFWCSancomQP01/en_GB/pdf/Santander_announces_a_commercial_action_for_retail_customers_affected_by_the_resolution_of_Banco_Popular.pdf.

[276] *See* Deloitte, *supra* note 258, at 3.

assumptions underlying the various scenarios outlined, nor the criteria adopted to single out the best estimate within the "best-worst case" range.[277] Moreover, all the estimates include a "buffer" for additional losses, as required under Art. 36 BRRD,[278] but one struggles to understand the criteria for the relevant quantification and, indeed, the amount of the buffer itself. The above confirms the uncertainties and the discretion leeway that characterizes this pivotal step in resolution proceedings.

(c) Too Big to Fail, Too Small to Bail in: The Liquidation of the "Banche Venete"

(c.1) *Off the BRRD Radar*

Banca Popolare di Vicenza S.c.p.A. ("BPVi") and Veneto Banca S.c.p.A. ("VB")—two Italian banks of comparable size, both headquartered in the wealthy and entrepreneurially-intensive region of Veneto, in north-eastern Italy—underwent a sort of parallel crisis. At the end of 2014, before their crisis become epidemic, the aggregate share of the two "Banche Venete" (as they are commonly dubbed) was just below 3% of the Italian lending market and 1.69% of the national deposits-taking market.[279] However, at a local level, the two players had a prominent role.[280] Consistently, the size of their assets had attracted both institutions under the single supervisory mechanism, subject to the ECB authority.

The causes of crisis are rooted in a poor corporate governance system and bad lending practices. Face to a sharp decline in both banks' profitability, capital coefficients and credibility—as well as evidences of malpractice[281]—the supervisory authorities called for an urgent intervention, through a market recapitalization or, failing market support, through resolution or liquidation.

[277] To be sure, this apparent lack of clarity is also due to several omitted parts contained in the redacted version of the valuation made publicly available. The omitted parts concern extremely delicate chapters of the report, such as "*Legal Contingencies*".

[278] *See* above, Paragraph III.E.

[279] Data from SRB, *Decision of the Single Resolution Board concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A.*, Jun. 23, 2017; and SRB, *Decision of the Single Resolution Board concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A.*, Jun. 23, 2017, both available at https://srb.europa.eu/en/content/banca-popolare-di-vicenza-veneto-banca.

[280] Veneto Banca's market share in the Veneto region was around 4% for deposits and 5% for loans. As to Banca Popolare di Vicenza, 4.5% and 6.5%, respectively. *See* European Commission, *State Aid SA. 45664 (2017/N) – Italy – Orderly Liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid*, C (2017) 4501 final (Jun. 25, 2017), available at http://ec.europa.eu/competition/state_aid/cases/264765/264765_1997498_221_2.pdf, at 3-5.

[281] Both banks had been required to derecognize several hundreds of million Euro from their CET 1 capital, following ECB inspections in 2015. A practice that came under the spotlight of the supervisory authority concerned the so-called "financed capital". That is: the bank encourages (according to some court precedents: forces) a household or SME being in the process of receiving a credit facility to use a portion of the borrowed money to subscribe new shares of the bank, a mechanism somehow reminiscent of a financial assistance (which, in Europe, is forbidden unless stringent procedural requirements are met). This censorable commercial practice allowed the banks, for a while, to gather massive equity resources from their own clients. Through this mechanism, the banks kept their common equity coefficients high and artificially sustained the "grey market" price of their shares (note that neither bank, despite its dispersed ownership structure, was listed on a stock exchange, another element adding to the lack of transparency surrounding these institutions). But, in exchange, they embarked in the risk that disgruntled clients stopped honoring their loans claiming that they had suffered a damage as a consequence of mis-selling or other unlawful practices—something that contributed to worsen the credit quality of the banks' portfolios.

Initially, a capital injection from the Atlante fund seemed to ensure the survival of these two distressed (but technically not failed) institutions.[282] However, this did not stop the deposit outflows, giving rise to new liquidity shortage and solvency issues. A merger plan between the two Banche Venete did not take off.

In early 2017, an intense dialogue ensued among the ECB, the SRB and the Italian institutions (*i.e.* the government and the Bank of Italy, the latter in its capacity as national resolution authority), exploring several possible exit strategies. The idea of a "precautionary recapitalization" on the MPS model[283] was abandoned face to the impossibility to comply with Art. 32(4)(d) BRRD, namely with the prohibition to use the public funds to offset losses incurred or likely to be incurred by the two banks in the near future.[284]

Vis-à-vis an inevitable insolvency,[285] the resolution would seem the most natural response, but it, too, was eventually rejected by the SRB. As surprising as it may be—compared to the Banco Popular case coming on stage in the very same weeks—the European resolution authority stated that resolution was not viable due to lack of the public interest requirement.[286] According to the SRB assessment, the Banche Venete had played a systemic role *in the past*, but the prolonged crisis had determined a sharp decline in their market shares, and the national relevance of the functions marked as critical in the banks' own resolution plans (*i.e.* deposit-taking, lending, and payment and cash services) had progressively vanished.[287] Indeed, according to the SRB, other competitors had replaced the ailing institutions "in an acceptable manner and within a reasonable time frame": in other words, the market had absorbed the effects of the Banche Venete crisis without excessive trouble.[288]

(c.2) *An Orderly …But Not Ordinary Liquidation*

The non-viability of resolution opened the way to the "ordinary" liquidation of the two banks, governed by Italian law. "Ordinary" deserves the inverted commas, because the complex transaction envisaged by the Italian and European authorities is actually far from a straightforward liquidation. Rather, it has similarities with the "old" bank rescues described in Paragraph V.A, where liquidation was coupled with the intervention of a competitor, supported by State aids.[289]

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282 In 2016 Atlante injected €3.4 billion as new equity into the Banche Venete: *see* subparagraph V.B(c) above. As a result, Atlante became the owner of a shareholding equal to, respectively, 99.33% of BPVi and 97.64% of VB. *See* SRB, *supra* note 279, at 5.

283 *See* subparagraph V.B(c).

284 The intention of the Banche Venete to formally apply for a precautionary recapitalization was notified to the ECB in March 2017: *see* SRB, *supra*, note 279, at 7. Note, however, that in 2017 both banks benefited from public aid in the form of State guarantees (about €10 billion) on newly issued liabilities pursuant to Art. 32(4)(d)(ii)

285 The ECB assessed that the both Banche Venete were "deemed to be failing in the near future", due to persisting infringement of the capital requirements and lack of perspective to generate or raise the capital needed. *See* SRB, *supra* note 279, at 10.

286 *See* SRB, *supra* note 279, at 11-21.

287 The SRB reckoned the *regional* significance of the two banks in the Veneto area, but it deemed that, *nationwide*, the orderly liquidation of BPVi and VB would not have a significant adverse effect on the financial stability. *See* below for a more detailed discussion of this issue.

288 *See* SRB, *supra* note 279, at 13.

289 A commentator noted that the measures implemented in the Italian case are very similar to those implemented for the resolution of the Greek Panellinia Bank, through a transfer of assets and liabilities to Piraeus Bank in 2015: *see* Silvia Merler, *Critical functions and public interest in banking serves: Need for Clarification?*, European Parliament, Directorate-General for Internal Policies of the Union, Economic Governance Support Unit, 2017, available at http://bruegel.org/2017/12/critical-functions-and-public-interest-in-banking-services-need-for-clarification/, at 8; *see* also B. Mesnard, A. Margerit and M. Magnus, *The orderly liquidation of Veneto Banca and*

In fact, while on June 25th, 2016 (a Sunday), the two institutions were put in "compulsory administrative liquidation",[290] in the night of June 26th an "aggregated compound" (*insieme aggregato*) of assets and liabilities was sold to Intesa Sanpaolo S.p.A., one of the two biggest Italian banking groups, for the consideration of €1. The assets within the "compound" did *not* include the NPLs, as well as those assets deemed not functional to the continuation of the banking activities. The liabilities, including all deposits, senior bonds and inter-bank liabilities, were carefully delimited to exclude all shareholders' and subordinated bondholders' claims, as well as claims deriving from mis-selling in the placement of the shares and subordinated bonds.[291] A crucial note: as no deposit was affected, there was no need for intervention of the Italian deposit guarantee scheme—which meant no need for other banking institutions to contribute to the rescue. On Monday morning, the offices and branches of two banks re-opened under the new brand, with no cutoff in their normal functions to clients and markets.[292]

Of course, in the "aggregate compound" transferred to Intesa Sanpaolo, the book value of the liabilities largely exceeded the book value of the "good" assets. This aggregate "unbalance" ("*sbilancio*," ultimately valued as much as ca. €6.4 billion) was managed through a legally smart mechanism. Intesa Sanpaolo financed the debt arising from this "negative price" by granting each of the Banche Venete a fixed interest rate, 5-year term facility, for a nominal value equal to the respective quota of the "unbalance". The facilities are guaranteed by the State (up to a cap of €6.3 billion). The chances for the Banche Venete to honor their debt to Intesa Sanpaolo depend on the rate of recovery on the NPLs left with the banks in liquidation (nominal value of about €10 billion). In April 2018, the liquidation officers transferred the NPL portfolio, almost entirely, to Società di Gestione Attivi S.p.A. ("SGA"), a State-owned asset management company.[293] SGA will pay the price for the transferred loans gradually over time, as the loans are paid or recovered, after deduction of its costs—in substance, a "pay-as-you-can" mechanism more akin to a servicing than a non-recourse transfer. In turn, the Banche Venete will use such proceeds to reimburse the loan to Intesa Sanpaolo.

Such a complex transaction could hardly be executed at an acceptable level of risk under the "ordinary" legislative framework. Indeed, special "tailor-made" provisions were urgently put in place few hours before the banks were put into liquidation.[294]

Banca Popolare di Vicenza, European Parliament Briefing, 2017, available at http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602094/IPOL_BRI%282017%29602094_EN.pdf, at 6. At national level, though, the model for the State-aid assisted turnaround of the Banche Venete was the liquidation of Banca Romagna Cooperativa, a small cooperative bank rescued in 2015.

[290] *Liquidazione coatta amministrativa, i.e* the Italian ordinary procedure applicable to wind-up banks.

[291] As with MPS and the "four banks", the contingent liabilities arising from mis-selling practices (including, but not limited to the "financed capital" practice described above) represented a lingering threat to the turnaround of the Banche Venete.

[292] Intesa Sanpaolo re-employed all the Banche Venete employees. Subsequently, in fulfilment of Italy's commitments with the European Commission, a portion of the staff has been laid off.

[293] Quite curiously, SGA is not a newly-formed "bad bank". It was created with the bailout of Banco di Napoli, a former significant credit institution in southern Italy, the assets and liabilities of which were also sold to Sanpaolo Bank in 1995.

[294] Law Decree No. 99 of June 25, 2017, G. U. Jun. 25 2017, n. 146 (It.), subsequently converted into Law No. 121 of July 31, 2017, G. U. Aug. 8 2017, n. 184. Among the many provisions covered by the "Banche Venete Decree", the following pillars are noteworthy:

(i) A strong ring-fencing of the acquirer with respect to (actual and contingent) liabilities arising from the transaction, based on the principle that the acquirer only faces the liabilities expressly encompassed within the transferred "compound". These provisions were functional to: (a) realize the burden sharing by the shareholders and subordinated bondholders of the two Banche Venete—they were left with the bankruptcy estate of the (c.3) *State Aids*

Undoubtedly, the issue of State aids in the Banche Venete liquidation raised much of the clamor surrounding this case. In fact, in addition to the €6.3 billion guarantee for the financing of the "unbalance", the Commission approved the granting of additional public aids: (a) a non-refundable contribution (€3.5 billion) to cover the Intesa Sanpaolo's capital shortfall arising from the lower quality assets transferred to the acquirer;[295] (b) a contribution (€1.285 billion) to the costs of integration of the "aggregate compound" within the acquirer's group; (c) an €4 billion guarantee in respect of the *ex post* retransfer of "high risk" loans from Intesa Sanpaolo to the liquidation estates;[296] (d) an €1.5 billion guarantee covering the indemnity obligations of the two Banche Venete in case of breach of the representation and warranties granted upon transfer of the compound to the acquirer; (e) various *ad hoc* tax easements.[297]

The Commission's reasoning, supplemented by the counterfactual analysis submitted by the Italian authorities,[298] explains the rationale underpinning such a massive public aid (in the area of €17 billion, should all the above-mentioned guarantees be enforced), within a regulatory framework where bail-outs are ideally banned.

The starting point comes from the SRB decision: as there was no public interest to resolve the Banche Venete under the BRRD, the only alternative left is the ordinary winding up of the insolvent banks. Pursuant to applicable Italian law—so goes the Commission's argument—winding up would mean, in principle, a "piece-meal" liquidation of the banks' assets, at fire sale prices and with "sudden interruption of the ordinary business of the liquidating entit[ies]". Such outcome would cause "relevant losses in charge to non-professional and non-protected customers, as well as the […] termination of credit relationships both for households and SMEs"—in other words, a "*serious disturbance*" in the economic system, "especially at local level".[299] As discussed (see Paragraph III.F above), these circumstances justify the granting of a State aid aimed at mitigating such disturbance.[300]

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two insolvent institutions, with virtually no chance of recovery; (b) protect the acquirer from other contingent liabilities, first of all those arising from the commercialization of shares and subordinated bonds of the failed banks (mis-selling claims);

(ii) A complex mechanism to adjust the perimeter of the transaction *ex post* (through subsequent retransfer of assets and liabilities to the liquidation estates), based on the outcome of a due diligence exercise carried out after the acquisition of the compound. Intesa Sanpaolo was also granted the right to transfer back to the insolvent institutions certain loans that, as of June 26, 2017 were performing but classified as "high risk" (*i.e.* with high probability of default), in the event that such loans are reclassified as non-performing in the following years.

A significant strand of litigation has arisen on the provisions under (i) above, as several mis-sold shareholders and subordinated bondholders tried to enforce against Intesa Sanpaolo their claims for compensation of damages arising from prospectus liability or malpractices in the distribution of securities by the Banche Venete. They allege that such compensation claims should be excluded from the burden sharing mechanism, regardless of the State Aid decision and the Law Decree provisions stating that such claims remain with the liquidated entities. Thus far, no such claim has reached the Italian Supreme Court or the Constitutional Court.

[295] Technically, the contribution corresponds to a recapitalization of the transferred activities up to a CET1 ratio of 12.5%. *See* European Commission, *supra* note 280, § 36.

[296] *See* note 294 above.

[297] For a summary, *see* European Commission, *supra* note 280.

[298] *Id.*, §§ 48-49; §§ 104-106.

[299] *Id.*, § 49. The Italian authorities mentioned a "credit crunch" that "could hit around 55,000 firms, for an aggregate shortfall of ca. €22 billion, without taking into consideration the second round effects".

[300] The Commission did not see a risk of distortion in competition stemming from the aid granting, as the insolvent banks were wound up and ceased to exist as stand-alone entities. Put differently, the aids are not used by the former Banche Venete to continue to offer products and compete with other players. *See Id.*, §§ 110-116.

The Commission verified that an adequate burden sharing was in place. In fact, shareholders and subordinated creditors remained with the entities in liquidation, with only theoretical chances to recover any claim and in a position that was no worse off than if the two banks had undergone liquidation without any public support.[301]

(d) Banco Popular and Banche Venete in the Mirror: How Many Pitfalls in the Resolution Framework?

(d.1) *The "Public Interest" Crux*

The SRB and European Commission decisions in the Banche Venete case leaves the reader puzzled. How comes that, during the same weekend, two European authorities apparently reached opposite conclusions on the same set of circumstances: the SRB ascertaining the absence of a public interest to justify a resolution of the two Italian failed banks, the Commission upholding that a ca. €17 billion State aids are "necessary in order to remedy a serious disturbance in the Italian economy"?[302] And a strictly-related question also arises: how comes that, barely two weeks apart, Banco Popular is subject to resolution with no State intervention, whilst the Banche Venete—which aggregately owned a similar position in terms of market share—"escape" the BRRD and benefit from such a huge public aid?

A first possible answer lies in the different meaning (and interpretation) of the requirements set out in the BRRD context, on the one hand, and in the State aid regulation, on the other. According to Art. 32(5) BRRD, "a resolution action shall be treated as in the public interest if it is necessary for the achievement of […] one or more of the resolution objectives", one of which is "to avoid a *significant adverse effect* on the financial system [of a Member State], in particular by preventing *contagion*" (see Art. 31(2)(c), emphasis added). Under Art. 107(3)(b) of the TFEU, State aids may be compatible with the internal market, if they are finalized to remedy a "*serious disturbance*" in a Member State's economy.[303] Despite the apparent similarity of the two concepts, each authority interprets them differently.

In the SRB approach, the parameter for measuring a "significant adverse effect" or "contagion" is the financial and operational connection of the failing bank with the other financial institutions—a parameter that is typically, although not necessarily, appreciated at a national or international level. In the Banco Popular and Banche Venete decisions, the European resolution authority assessed the position of such banks in the *national* funding and deposit-taking markets, their degree of interconnectedness with the financial market infrastructures (*e.g.*, payment and clearing systems), their relevance for the debt market. The effects on the "real economy"—though ideally relevant in the public interest assessment[304]—are mentioned only residually. This approach is understandable considering that "ensur[ing] continuity of critical functions" is the first resolution objective under Art. 31(2) BRRD and the rationale of the resolution itself has to do the maintenance of essential infrastructures of the financial market.[305]

[301] *Id.*, §§ 117-122.
[302] *Id.*, § 47.
[303] Note that the "serious disturbance" concept is also recalled in Art. 32(4)(d) BRRD, as a requirement justifying the precautionary recapitalization of a solvent bank.
[304] See SRB, *Critical Functions: SRB Approach in 2017 and Next Steps*, available at https://srb.europa.eu/sites/srbsite/files/critical_functions_final.pdf, § 40.
[305] *See*, *e.g.*, Hellwig, *supra* note 64, at 10-13.

By contrast, the assessment of compatibility of a State aid is based on a more comprehensive valuation of the "serious disturbance" and its effects on the economic environment. While the 2013 Banking Communication[306] identifies financial stability as the "overarching objective" in the Commission's decisions, the latter has committed to take into account (also) "the macroeconomic environment which affects both banks' viability and the need for the real economy […] to continue to have access to credit from healthy banks".[307] In this context, the Commission leaves to Member States "to decide whether they consider a bank exit to have a serious impact on the *regional* economy, *e.g.* on the financing of small and medium enterprises in the regional economy, and whether they wish to use *national* funds to mitigate these effects".[308]

In sum, different policy targets and interpretations may lead to opposite decisions about the systemic relevance of a same bank failure. In principle, this outcome is not at odds with the BRRD architecture. The Commission's decision arrives later in the process, once the SRB has *already* exercised its power to assess public interest to resolution. In other words, there is no formal conflict between the two decision-makers.[309]

Yet, the overall regulatory picture lacks consistency. In a *resolution* scenario, no use of "government financial stabilization tools" is allowed until at least 8% of the total liabilities have been used to cover losses and recapitalized the institution.[310] In a *liquidation* scenario, no such requirement exists, and the granting of public financing is only subject to the European Commission's approval. Now, the different approach to "public interest" followed by the SRB and the Commission leads to a paradoxical outcome. The contradiction lies in that, while a main objective of resolution is "to protect public funds by minimising reliance on extraordinary public financial support" (art. 31.2(c) BRRD), the rigorous scrutiny of the centralized resolution authority ends up favoring a solution (liquidation) where this very objective is frustrated.[311]

Note that this short circuit also alters the functioning of the NCWO test, which is crucial to verify the maximum sacrifice applicable to creditors in resolution. If State aids grant a higher protection to creditors in a liquidation scenario, then the "bar" for accessing resolution raises significantly, arguably beyond the point envisaged by the EU policymakers.

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306 For a brief account of the various Commission's communications on the State aids to banks during the financial crisis, *see supra*, Paragraph III.F.

307 *See* 2013 Banking Communication, § 9. *See* also § 25.

308 *See* European Commission, *State aid: How the EU rules apply to banks with a capital shortfall – Factsheet*, June 25th, 2017, available at http://europa.eu/rapid/press-release_MEMO-17-1792_en.htm (emphasis added).

309 For a defense of the BRRD consistency in the Banche Venete case, *see*, *e.g.*, the explanation provided by the chairman of the SRB: Elke König, Presentation of the Annual Report to the European Parliament's Committee on Economic and Monetary Affairs (Jul. 11, 2017). *See* also Bowman, *supra* note 164, presenting various commentators' and market players' opinions defending the overall solidity (and positively assessed flexibility) of the BRRD framework.

310 *See* Arts. 37(10) and 56(3) BRRD (and *supra*, Paragraph III.B).

311 Put another way: the SRB (reasoning according to the scheme: if no contagion on the *national* financial system → then no public interest under BBRD → then no resolution) closes the door to resolution but opens the window to State aids, because the Commission (reasoning according to the scheme: if contagion on the *regional* economy → then serious disturbance under TFUE → then approval of State aids) will be inclined to authorize the use of taxpayer's money within the liquidation process. *See* also, in this vein, Merler, *supra* note 289, at 16; Binder *et al.*, *supra* note 113, at 11; Binder, supra note 79, at 18-20.

(d.2) *What If…? A Counterfactual Analysis of the Two Cases*

In the conclusive part of this article, we return on the suboptimal outcome described above, with a proposal to overcome it.

Yet, according to several commentators, the "public interest issue" in the Banche Venete transaction should not be confined to a purely technical discussion. Indeed, some argued that the European and Italian authorities used the public interest test in an intentional design to circumvent the BRRD. The SRB—so the argument goes—purportedly refused to recognize a public interest to the resolution of the two banks, because they wanted to put the file in the hands of the national politicians and open the gate to a windfall of State aids ultimately borne by the taxpayer—a return to the logic of bail-out. This strategy is especially stigmatized as, in the very same days, Banco Popular received an "orthodox" resolution treatment.[312]

We do not contest that, as it normally happens with bank crises, political interests have interplayed with the decision-making process.[313] Indeed, one may maliciously think that the SRB was not unhappy to avoid a (potentially expensive) intervention of the Single Resolution Fund and … handle the "hot potato" over to the Italian taxpayers. However, we believe that an accurate counterfactual analysis of the Banche Venete case—in comparison with the Banco Popular case—may offer some backlight elements for further reflection.

To begin with, let us consider some similarities between these two (apparently distant) turnaround formulae. The analogies seem to confirm, as already highlighted above, that some BRRD "core brands" struggle to take root. First, in both cases the authorities resorted to the sale of business tool (although in different regulatory environments).[314] This solution is in line with a persistent (pre- and post-BRRD) trend, where the scheme of the business combination (coupled or not with the transfer of bad assets to a management company) largely prevails with respect to a stand-alone solution, such as that envisaged by the (much boasted) bail-in tool.[315]

Second, the private sector involvement in the two cases was qualitatively identical. The write-down of creditors was contained up to the holders of T2 instruments, whilst all senior creditors (including all depositors, but also retail and institutional bondholders) were spared. Of course, one may object that, had the Banche Venete been subject to resolution (without State aids), senior creditors would have likely been affected more than it happened in Spain. Without considering the criticism raised around the independent valuation of losses in Banco Popular,[316] we put forward a counter-objection: had the Banco Popular valuation highlighted losses affecting also senior creditor position, can we expect that the transaction would have

[312] References to press articles and columns may be found in Binder, *supra* note 311, at 19-20, note 58, and Tröger, *supra* note 70, at 17-18, note 87-88.
[313] Indeed, it should be considered that the Banche Venete crisis reached its acme less than one year before the general Parliament elections in Italy, thus in a very delicate phase for the Italian political system. *See* Tröger, *supra* note 70, at 26, note 52.
[314] This analogy is also highlighted by Merler, *supra* note 289, at 8.
[315] It cannot be forgotten, here, that the bail-in tool, originally set forth as resolution instrument for Banco Popular, has been abandoned in favor of the sale of business. *See* above, notes 270-271 and accompanying text. This trend seems to confirm—as did the Danish and Austrian experiences: *see* above—the drawbacks and uncertainties of the bail-in tool, as forecasted by several scholars (*see, e.g.*, Jens-Hinrich Binder, *Resolution: Concepts, Requirements and Tools*, in BANK RESOLUTION: THE EUROPEAN REGIME 27 and ff. (Jens-Hinrich Binder & Dalvinder Singh eds., 2016); Schilling, *supra* note 80, at 91; Avgouleas and Goodhart, *supra* note 86, at 17 and ff.
[316] *See* above, note 275 and accompanying text.

been completed relying exclusively on the internal resources of the failed bank? The traumatic experience of senior creditors' sacrifice in Cyprus, Portugal and Austria suggests a cautious guess. Even the more so, if one considers that the SRB assessed that the bail-in was not an adequate tool for resolving Banco Popular.

This brings us back to the core of our counterfactual analysis.

Let us first suppose a hypothetical scenario where also the Banche Venete are subject to the BRRD treatment (this scenario assumes that the SRB was 'wrong', as it should have ascertained the public interest to resolution). In such scenario, as we know, State aids would have been possible only provided that (*inter alia*) not less than 8% of the total liabilities of the two banks have contributed to absorb losses (Art. 37.10 BRRD). Based on the balance sheet of the failed entities, this would have entailed a sacrifice of senior bondholders, including a number of institutional investors—although a large slice of senior bonds (about € 10 billion) benefitted from a State guarantee under Art. 32(4)(d)(ii). Looking at the Novo Banco and HETA precedents, it's easy to guess that a haircut on institutional investors would have triggered a flight from the Italian bank debt market. The consequent costs for the entire banking system (and the spill-over effects on the real economy) could have easily exceeded those of the State aids granted in the actual rescue.

Alternatively, one may think of a voluntary intervention of the national deposit guarantee scheme, *i.e.* based on spontaneous contributions by the banks participating to the system. While this solution is not prevented by Art. 37.10 BRRD (no State aids are involved),[317] it would have hardly been practicable in a situation of generalized stress of the banking system, where many institutions were not in a position to bear such a burden *pro rata*, and the most solid banks were reluctant to sustain, alone, the entire effort.

Under a third, more realistic, scenario, the Banche Venete are subject to liquidation (consistent with the SRB decision), but the State does not grant any support and—we may reasonably assume—no market participant is able to take over the failed institutions. Now, the decision to put the banks into liquidation[318] would have triggered, *ipso facto*, a frightening chain of events: (i) a statutory *moratorium*, whereby, *inter alia*, any reimbursement of deposits is blocked from the day on which the State-appointed receivers take office;[319] (ii) the ensuing activation of the deposit guarantee scheme, which, in accordance to the European regulatory framework, must reimburse *all* insured deposits within 7 business days of the date of *moratorium*'s commencement;[320] (iii) the consequent call to all the banks participating in the deposit guarantee scheme to pay *pro rata* extraordinary contributions to fund such an impressive reimbursement (approximately €8.6 billion).[321] Now, in June 2017, when several institutions (MPS is the biggest example) were facing serious capital and liquidity needs, the call to contribute would have just created a perfect storm.

When regarded in this light, the (certainly unique) rescue of the Banche Venete, compared to the Banco Popular resolution, is less puzzling than it appeared and, in any case, is less the outcome of a "conspiracy" against the European rules than it is of the ordinary application

[317] On the relationship between (voluntary vs. mandatory) contributions to resolution funds and State aids, *see* above, note 210 and accompanying text.

[318] In Italy, such decision is under the responsibility of the Ministry of Economy and Finance, upon proposal by the Bank of Italy.

[319] *See* Art. 83.1 of the Italian Banking Act. For a comparative analysis of *moratoria* provisions in national laws on banking insolvency, *see* Binder *et al*, *supra* note. 113, at 20 ff.

[320] *See* Art. 96-*bis*.2 of the Italian Banking Act.

[321] *See* Bank of Italy, *La crisi di Veneto Banca S.p.A. e Banca Popolare di Vicenza S.p.A.: Domande e risposte*, 2017, available at https://www.bancaditalia.it/media/notizie/2017/crisi-banche-venete/index.html.

of the BRRD framework.[322] Indeed, despite the "public interest paradox" addressed above, the solution adopted with the Banche Venete is consistent with the view—well rooted in the BRRD—that resolution is an exceptional remedy, also for banks supervised at the ECB level, while liquidation is the default solution.[323] It is even a rational outcome, especially in those jurisdictions—such as Italy—where there are legal instruments to avoid the disruption of a bank's essential functions even under liquidation.[324] Consistent with this finding, the counterfactual analysis of the two cases highlights that a "State aid-free resolution" does not seem to be a viable solution in a context of generalized weakness and undercapitalization of a banking sector if no sufficient bail-inable instruments are available. The domino effects may be socially (and perhaps financially) costlier than a public aid.

VI. SOME REFLECTIONS ON THE BAIL-IN TOOL, FROM THEORY TO PRACTICE, AND A FEW MODEST PROPOSALS

Although several important bank turnarounds took place under the BRRD already, it is perhaps untimely to draw conclusive remarks on the European resolution regime. Most bank failures originated under the great financial crisis since 2008 have been managed under national regulations in force prior to the Directive's enactment. Likewise, future trends are difficult to predict, as the most relevant experiments of application of the BRRD—those managed under the SRB jurisdiction—are profoundly conditioned by the somewhat unique circumstances in which they took place.

Nonetheless, some reflections are worthwhile, focusing on the "theory-to-practice" gap that emerges from our survey of the major cases above.

On the surface, the early applications of the BRRD appear consistent with the principles inspiring the Directive. Most notably, the European resolution authority (SRB)'s interpretation of the resolution requirements is squarely in line with Recital 46, whereby "[t]he winding up of a failing institution through normal insolvency proceedings should always be considered before resolution tools are applied". In fact, the Banche Venete and the ABLV cases

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[322] We do not agree on the swift judgment by Ringe, *supra* note 71, at 29-30, who claims that the non-application of bail-in tool in countries hit by a generalized lack of confidence in the banking system (such as Italy), is simply the outcome of regulatory capture, cognitive biases, as well as the "reluctance of regulators to apply the new rules".

[323] This result is consistent with the "public interest test", as set forth in Art. 32.5 BRRD, whereby "a resolution action shall be treated as in the public interest if […] winding up of the institution under normal insolvency proceedings would not meet those resolution objectives [*i.e. those referred to in Art. 31 BRRD*] to the same extent". *See* Binder, *supra* note 79, at 7-8. Merler, *supra* note 289, at 13.

It is noteworthy that, after the Banche Venete case, the SRB has refused, again, to declare the public interest to resolution of other institutions within the SSM, despite their international ramifications. This happened with ABLV Bank (a prominent Latvian institution) and its Luxembourg subsidiary, neither of which passed the "public interest test". *See* Single Resolution Board Press Release, *The Single Resolution Board does not take resolution action in relation to ABLV Bank AS and its subsidiary ABLV Bank Luxembourg S.A* (Feb. 24, 2018), available at https://srb.europa.eu/en/node/495. On the SRB attitude to exclude public interest even with institutions supervised under the SSM, *see* Binder *et al.*, *supra* note 113, at 11.

[324] Both Banche Venete were allowed to continue to carry out certain activities for a period of time after the commencement of the insolvency procedure, in accordance with the Italian Banking Act. *See* Ministerial Decrees of June 25, 2017 No. 185 and 186, G. U. Jul. 31 2017, n. 177 (It.). From the reading of the SRB decision in the Banco Popular case (*see* above), we understand that such a solution would have not been practicable in Spain—which raises the issue of the lack of harmonization of the national insolvency rules, addressed in Part VI below.

suggest that resolution remains an *extrema ratio*, applicable only when the continuity of the critical failed bank's functions is at risk, with expected contagion at a national level (at least).

Furthermore, the private sector involvement (another pillar of the resolution architecture) seems now realized: the sacrifice of shareholders and subordinated creditors of a failed bank has become the rule. Yet, the involvement of *senior* creditors remains exceptional and, *de facto*, almost never takes place if the failed institution raised capital on the international debt markets. As discussed, the (BRRD) bail-in tool has applied only twice: in one case, it involved a bank (Andelskassen) with a relatively low degree of cross-border interconnectedness whilst, in the other case (HETA), the sacrifice of the senior bondholders has been mitigated through a liability management exercise based on a consensual settlement of the creditors' claims. Under the BRRD, no depositors' haircut has taken place thus far.

Then, the gap between theoretical policy framework and applied experience becomes larger. In fact, during the first three years of Directive's application, several "exogenous" factors have started to erode the foundations of a legal framework too often conceived to operate like in a *vacuum*, immune from the interaction of other market and political forces. Let us consider the following aspects.

(i) The choice between liquidation and resolution should be guided by the "endogenous" public interest test (Art. 32.5 BRRD).[325] In practice, however, as the Banche Venete case demonstrates, the decision-making process seems influenced by an "external" factor, such as the availability of State aids. Since State aid regulation is subject to a milder burden sharing (shareholders and subordinated creditors only, instead of the Directive's fearsome "8% requirement" applicable under resolution),[326] the winding up of a failed bank becomes the preferable option for governments driven by the desire to minimize creditors' write-down. Decision-makers underline that a strong haircut to senior creditors would cause a "significant adverse effect" to the financial system—something not in line with the goals of the resolution. Yet, they favor a solution that fails to minimize the public financial support: an outcome at odds with a fundamental policy rationale of the entire resolution regime. This is somehow understandable (also) politically since, notoriously and obviously, a smaller constituency having more to lose from a given decision can exercise greater pressure than the general citizenry, when the individual effects of a different decision would be negligible.

(ii) The national (non-harmonized) rules governing the "ordinary" liquidation of failed banks also influence the viability of the resolution tools "from the outside." To make one example—suggested by the Banco Popular case—liquidation gives way to resolution whenever the (national) rules do not provide effective instruments to ensure, at least temporarily, the continuity of the critical functions carried out by the faltering institution once it is wound up. By contrast, if national rules provide for adequate legal tools to avoid an abrupt interruption in the essential services, the winding up option becomes more "competitive" compared to resolution.

(iii) A third external factor affecting the use of resolution tools and bail-in concerns the credit institutions' balance sheet. As mentioned, resolution—and, specifically, bail-in—may function effectively if a sufficient "cushion" of liabilities is available for (statutory or contractual) write-off (see the discussion on MREL and bail-inable liabilities:

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325 *See* above, Paragraph III.C.

326 Art. 37.10 BRRD. *See* above, Paragraph III.B.

subparagraph III.C.(c) above). When pointed towards "common" (non-MREL) liabilities—especially bonds issued before the new regulation came into force—the bail-in faces such high litigation risks[327] and potential contagion effects, triggered by a possible flight of institutional investors, that it remains theoretically applicable, but practically unviable. In this light, the decision-makers' refrain from extensively applying the bail-in tool should not be regarded as an attempt to circumvent the rules, but rather as the outcome of an unaccomplished transition towards the new regime, especially in jurisdictions where the banking sector still suffers from the legacy of the financial crisis.

(iv) A fourth exogenous factor has to do with past practices in the capital raising by credit institutions, especially in southern Europe. Massive and widespread mis-selling conducts have characterized for years the distribution of shares and AT1/T2 capital instruments to retail investors, lured by attractive interest rates offered by a trusted issuer. Indeed, capital-starved banks would often tie the placement to clients of equity or junior debt instruments with the offer of new credit at favorable conditions—thus also putting credit quality at risk. The mis-selling factor acts as sand into the wheels of bank restructurings. The amount of litigation increases significantly, because mis-sold investors do not accept their sacrifice on the altar of burden sharing. At the same time, no acquirer is in a position to buy the business of the failed bank if it includes unpredictable contingent liabilities towards defrauded investors. As a result, a State intervention becomes inevitable, contrary to the principles of the BRRD.[328]

The above external factors add to the "endogenous" shortcomings of the resolution framework, which we discussed in Part III:

(a) We have much stressed the inner uncertainty of the requirements for the resolution's trigger. The "public interest test" is a conundrum for authorities and market players called to interpret and apply it. The "FOLTF test" is no less dependent on administrative discretion and prognostic evaluations. Same for the assessment on the existence of a "reasonable prospect" to prevent the institution's failure (art. 32.1(b) BRRD) (see *supra*, subparagraph III.C.(a));

(b) As pointed out in a commentary to the European resolution regime effectively titled "Too Complex to Work", a vast room for discretion surrounds the choice among different resolution tools and, when the bail-in is selected, among the liabilities to be sacrificed and the type of sacrifice (*i.e.* write-off, conversion, amendment of terms, etc.).[329] The unpredictable outcome of such choices has a clear impact on the value of the equity and debt instruments of any bank and the relevant cost of capital.[330] The above complexities increase due to the inextricable interplay among different (national and supranational) supervisory authorities, each following (legitimately) its own institutional agenda and purposes;

(c) The NCWO test—the architrave on which the bail-in architecture is built—rests on a crumbling ground, both conceptually and practically. As we showed above (Paragraph

[327] On the "retroactivity of the bail-in" in certain EU jurisdictions, *see* above, note 101 and accompanying text.
[328] As discussed, the European Commission maintains that measures of State-funded compensation to mis-sold investors are not prohibited under Art. 107 TFUE. *See* above, notes 216 and 238.
[329] Tröger, *supra* nt. 70. As noted, the authorities enjoy much discretion in the establishment of the liabilities that are exempted from the bail-in tool. *See* Arts. 44.3 and 44.4 BRRD.
[330] On the impressive effects that regulator's discretion may have on the pricing of bonds issued of European banks, *see* Bowman, *supra* note 164, reporting experts comments on the AT1 and T2 interest rate spreads after the Banco Popular resolution.

III.E), the legality of a creditor's write-down under bail-in is assessed by comparison with respect to a counterfactual (liquidation) which, by definition, shall not occur—thus making this exercise highly evaluative and raise fairness questions. In addition, the NCWO test is carried out *ex ante*, before the bail-in itself is enforced, so that potential valuation errors can only be compensated with hindsight, in court. Moreover, and paradoxically, the test predicates an "apples-and-oranges" comparison between a sacrifice *caused by* insolvency and one imposed *to prevent* insolvency. In the practical experience, we offered examples of NCWO tests based on assumptions and hypotheses not clearly spelled out and, thus, difficult to double check.[331]

Not all the drawbacks set out above have (or will have in the future) an equal impact on the resolution architecture. For example, the issue of financial instruments "retroactively" affected by (previously unknown) resolution tools will likely disappear in the future, once banks have progressively replaced their capital with instruments issued under the new rules. Other drawbacks, though, are more problematic and likely to last in the future.

Some corrections may be envisaged to smooth out certain inefficiencies. They are "endogenous" (*i.e.* they address the BRRD provisions), but are meant to react against the critical interference of the "exogenous" factors outlined above. Not all of them require amendments to the current legislative framework.

(1) Public interest requirement: harmonizing the relevance of local impacts from banking crises. – As discussed, a *punctum crucis* in the application of the resolution framework concerns the relevance of the local vs. regional impact of a bank's crisis: the European resolution authority (SRB, focused on the disruption in continuity of financial services) is inclined to exclude it, while the Commission (attentive to the impact of State aids on the real economy) tends to reach the opposite conclusion. This may unravel the functioning of the public interest test, which lies at the core of the resolution architecture.
We are not willing to take stance, here, on whether the SRB should pay greater attention to the real economy impacts of regional defaults or the European Commission should revise its position so far on the "*serious disturbance*" requirement under Art. 107.3(b) TFEU; and, of course, each authority needs to focus on its supervisory Rather, we believe that the authorities should engage in providing general, possibly consistent and more predictable guidance on the criteria they would follow to base their case-by-case assessment. This approach would help reduce the risk of opportunistic exploitation of the regulatory framework to revive the bail-out specter.[332] Although it is not legislatively required to do so, EBA could support this 'harmonization' process.

(2) National insolvency rules. – The lack of harmonization among national rules governing the ordinary winding up and liquidation of credit institutions is another challenging factor for the efficient functioning of the resolution mechanisms. As many scholars pointed out (and we tried to highlight in Part V), a progressive harmonization of the

[331] *See supra*, subparagraph V.D(b).

[332] Let us suppose, for example, that the SRB and the European Commission agree that, in principle, banking functions that are critical at a local/regional level matter for both resolution and State aids purposes. In such case, if the SRB ascertains the public interest to resolution in a "local" crisis, the Commission could still authorize the granting of State aids, but, consistently with the BRRD framework, aids would be subject to the 8% burden sharing requirement. This 'harmonization process' would also help streamline the NCWO assessment, as the comparison between liquidation and resolution would be less dependent on the State aid variable.

national liquidation rules would rationalize both the assessment on whether an institution must enter resolution and the NCWO test.[333]

We understand that a full harmonization, though desirable, would hardly be practicable in the current political phase.[334] However, there are specific aspects on which an harmonization effort could focus, such as, for example, in relation to the ranking of debt instruments in the liquidation hierarchy. Of course, an EU-standardized pecking order would be unworkable[335] and not even functional for the purposes of an efficient resolution process. Nonetheless, more limited (though ambitious) efforts could be pursued. For example, the treatment (and possible subordination) of intragroup liabilities could be harmonized, so as to ease the resolvability of banks subject to foreign control, or bank groups with subsidiaries and ramifications in third countries. On a different field, several commentators and institutions (*e.g.*, the ECB)[336] have encouraged the enactment of a general European "depositor preference rule", sanctioning the seniority of *all* deposits (including uncovered deposits) with respect to any other unsecured liabilities.[337] Such intervention would differentiate and clarify the degree of risk attached to deposits and unsecured financing (as well as operational liabilities), thus making the pricing of unsecured bonds more predictable and reduce the uncertainty of the NCWO test.[338]

(3) Graduation in the "8% requirement" – Although the private sector involvement in banking crises has gradually become the norm, several pre-BRRD counterfactual analyses reckon that the degree of contagion stemming from a failure would have been higher had the access to government stabilization tools been subject to write-down/conversion of at least 8% of total liabilities, as the BRRD currently provides.[339] This would have frustrated one of the fundamental goals of resolution: avoiding adverse effects on the financial system.

As discussed, our criticism about this requirement—conceived as a rampart against the specter of bail-out—originates from the observation that, when it was introduced, the passive side of most European banks' balance sheets was not 'prepared' to the new bail-in paradigm.[340] While we do not ignore that the building of an adequate MREL

[333] As discussed, the harmonization of banking insolvency law has been essentially limited, so far, to certain international private and procedural law aspects. For references, *see* above, note 113.

[334] For example, it is probably utopian to envisage a convergence of all Member States towards an ordinary insolvency procedure entirely managed by administrative authorities (rather than by the judiciary). On this topic, *see* Binder *et al.*, *supra*, note 113.

[335] Such matter is inextricably related to country-specific foundations of private law. In particular, the order of debts within an insolvency "waterfall" ultimately depends on the types and categories of contracts and obligations recognized in each jurisdiction. Indeed, the debt ranking originates from policy assessments and balances that would be perturbed in the effort for harmonization within the common market. The same applies to other insolvency-related matters, such as the computation of interests in insolvency, or the realization of collaterals. For interesting country-specific examples, *see*, *e.g.*, Philippon & Salord, *supra*, note 138, at 44-45.

[336] *See* European Central Bank, *Opinion of the European Central Bank of 8 March 2017 on a proposal for a directive of the European Parliament and of the Council amending Directive 2014/59/EU as regards the ranking of unsecured debit instruments in insolvency hierarchy,* CON (2017) 6 (Mar. 8, 2017), par. 1.4.

[337] *See* above, note 89.

[338] *See* Binder *et al.*, *supra* note 113, at 15. Conversely, Member States have reached a high degree of harmonization with respect to insolvency ranking attributable to the second level unsecured liabilities and the subordinated debt (including, but not limited to AT1 and T2 liabilities): *see* Arts. 108.3 (as amended by Directive (EU) 201/2399) and 48.1 BRRD.

[339] *See* above, Paragraph III.B.

[340] *See* above, subparagraph III.C(c).

cushion might be complicated (not least, for the pricing difficulties that several commentators have highlighted),[341] we believe that the minimum rate of liability absorption should be proportional to the amount of bail-inable liabilities available to each credit institution. Such measure could curb spillover effects of resolution whenever a previous crisis has thinned the amount of liabilities available for conversion and write-down.[342] Of course, this flexibility should be accompanied by vigorous supervisory action, so to accelerate the satisfaction of MREL requirements within a reasonable timeframe, provided that—once again—clear and predictable criteria for MREL determination are in place, and a review mechanism is provided for.

(4) Timing and transparency of valuations. – In resolutions, time is of the essence. The *ex ante* valuation functional to inform the decision to enter resolution or liquidation—as well as to identify the liabilities to be written down or converted—is carried out in a handful of days. Such a time constraint certainly goes to the detriment of information and accuracy, as a real due diligence of a complex institution cannot realistically be completed.

An EU reform bill currently under discussion tries to address the timing issue by ensuring that the resolution authority may order a suspension in the payment of a FOLTF entity's obligations, including deposits, for up to two working days.[343] The promoters of such proposal expect that a *moratorium* would block the liquidity outflow and buy time for the authorities to complete their evaluation. We are doubtful that the benefits from such a moratorium would exceed the costs.[344] We are sure, though, that such measure would not solve the entire valuation problem, as many issues are conceptual and do not depend on time.[345]

Our proposal follows two drivers. First, instead of buying time for concluding a valuation exercise, the Directive should anticipate the duty to initiate it, providing that a confidential valuation process (for resolution purposes) must start as soon as insolvency symptoms are detected.[346] Ideally, the authorities' duty to initiate a valuation pursuant to Art. 36 BRRD could be linked to certain solvency, liquidity, and asset quality coefficients, as arising from SREP or ordinary accounting information. Second,

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[341] *See* note 93 and accompanying text.

[342] For a different, but related, proposal, *see* Philippon & Salord, *supra* note. 138, at 42: "during the transition period to full MREL, we should not take too harsh a stance on retail investors, even if this creates some costs for the taxpayers. Compensating retail investors during what is clearly a regime shift is unlikely to create moral hazard and is likely to increase political support for the entire process."

[343] *See* Art. 33a of the *Proposal* cited in note 165 above. The suspension power would be applicable provided that (i) the FOLTF requirement is satisfied, (ii) there is no immediately available private sector measure that would prevent the failure of the institution and (iii) the suspension is necessary, at the same time, to avoid further deterioration of the financial conditions of the failing bank and to reach the determination about the entry into resolution (or the choice of the appropriate resolution actions). If the suspension also concerns insured deposits, the resolution authorities shall allow depositors to withdraw an appropriate daily allowance for the period of suspension.

[344] For a critical opinion on this proposed measure, *see*, *e.g.*, Hellwig, *supra* note 264, at 18-19, holding that the mere possibility of a moratorium on payouts "is likely to exacerbate the difficulties" of the failing institution, as it could accelerate a bank run. We may confirm that in countries (such as Italy) where national legislation provides for a pre-liquidation moratorium, such instrument has been used only exceptionally in a fistful of cases.

[345] For a thorough discussion, *see* Hellwig, *supra* note 264, at 14 and ff.

[346] Currently, the BRRD does not provide a clear starting time for the valuation exercise. Art. 36.1 only sets the arrival time, by stating that valuation is carried out "[b]efore taking resolution action or exercising the power to write down or convert relevant capital instruments".

higher motivation and transparency standards should be required in each valuation, especially if provisional. In particular, being mindful of the Banco Popular experience, adequate guidelines should set out criteria to determine the "buffer for additional losses" required under Art. 36.9 BRRD. Likewise, when different scenarios are envisaged, the choice of the values within the range should be adequately motivated.

* * *

We have set out above some proposals aiming at improving the functioning of the BRRD framework in light of the recent experience. Should these proposals be implemented, the number of unsettling doubts about the bail-in would hopefully become … smaller than the number of unanswered questions about love in Auden's ballad.

Meanwhile, we are convinced that resolution (and bail-in, in particular) should remain an *extrema ratio* when early intervention measures are exhausted, and that the application of the ordinary insolvency rules poses a threat to the stability of the financial system.

As one author convincingly argued, the resolution mechanisms offer the infringement of individual creditors' rights as a consideration for the safeguard of the financial system.[347] This exchange takes place in a context where the decisions on a failed institution's survival are taken in the span of a weekend, with the support of an inevitably limited set of information, including projections and assessments that are hardly verifiable. Wide public authorities' discretion plays hide-and-seek with constitutional guarantees. No creditor has a voice in the resolution process; and creditors' protection can only rely *ex post* judicial remedies, generally of little consequences. In this perspective, the reluctance of regulators in applying the new tools is not surprising and, in our view, should not be condemned. Indeed, while political contingencies (as well as regulatory inconsistencies) have certainly influenced the decision-makers, their resort to traditional insolvency mechanisms (instead of resolution) relies on an accurate counterfactual analysis. In most cases, this appears in line with the fundamental proportionality principle enshrined in the BRRD itself (Art. 32.5).

Love, by its nature, should resist any proportionality claim. With bail-in, it's a different story.

[347] *See* Binder, *supra* note 79, at 23.

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