# Bank Crisis Management and State Aid in the EU:

## A comparative Law and Economics analysis of bank resolution, precautionary recapitalisation and bank liquidation

Elena Ghibellini

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# Management van bankencrises en staatssteun in de EU: Een vergelijkende rechtseconomische analyse van ontbinding van banken, preventieve herkapitalisatie en liquidatie van banken

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|---|---|
| **AGCM** | Autorità Garante della Concorrenza e del Mercato |
| **AMC** | Asset management company |
| **AQR** | Asset quality review |
| **AT1** | Additional Tier 1 |
| **BPB** | Banca Popolare di Bari |
| **BPVi** | Banca Popolare di Vicenza |
| **BRRD** | Bank Recovery and Resolution Directive |
| **CCB** | Cassa Centrale Banca |
| **CET1** | Core equity tier 1 |
| **CDS** | Credit default swap |
| **CGD** | Caixa General de Depositos |
| **CJEU** | Court of Justice of the European Union |
| **CoCo** | Contingent convertible |
| **CRD** | Capital Requirements Directive |
| **CRR** | Capital Requirements Regulation |
| **DGS** | Deposit guarantee scheme |
| **DGSD** | Deposit Guarantee Scheme Directive |
| **EBA** | European Banking Authority |
| **ECB** | European Central Bank |
| **ECtHR** | European Court of Human Rights |
| **EDIS** | European Deposit Insurance Scheme |
| **ELA** | Emergency liquidity assistance |
| **EPFS** | Extraordinary public financial support |
| **ESM** | European Stability Mechanism |
| **EU** | European Union |
| **FDIC** | Federal Deposit Insurance Corporation |
| **FITD** | Fondo Interbancario di Tutela dei Depositi |
| **FMI** | Financial market infrastructure |
| **FOLTF** | Failing or likely to fail |
| **FSB** | Financial Stability Board |
| **GACS** | Garanzia sulla cartolarizzazione delle sofferenze |
| **G-SIB** | Global systemically important bank |
| **G-SII** | Global systemically important institution |

| | |
|---|---|
| **GDP** | Gross domestic product |
| **GFST** | Government financial stabilisation tool |
| **HHI** | Herfindahl-Hirschman Index |
| **HFSF** | Hellenic Financial Stability Facility |
| **HoldCo** | Holding company |
| **ICSD** | Investor Compensation Scheme Directive |
| **LAA** | Loss-absorbency amount |
| **LCR** | Liquidity coverage ratio |
| **LME** | Liability management exercise |
| **LOLR** | Lender of last resort |
| **LREM** | Leverage ratio exposure measure |
| **LSI** | Less significant institution |
| **MCC** | Mediocredito Centrale |
| **MEF** | Ministry of Economy and Finance |
| **MEIP** | Market economy investor principle |
| **MPE** | Multiple point of entry |
| **MPS** | Monte dei Paschi di Siena |
| **MREL** | Minimum requirement for eligible liabilities and own funds |
| **NBG** | National Bank of Greece |
| **NCB** | National central bank |
| **NCWO** | No creditor worse off |
| **NPE** | Non-performing exposure |
| **NPL** | Non-performing loan |
| **NPV** | Net present value |
| **NSFR** | Net stable funding ratio |
| **OLA** | Orderly Liquidation Authority |
| **OpCo** | Operating company |
| **P2G** | Pillar 2 Guidance |
| **PONV** | Point of non-viability |
| **PSI** | Private sector involvement |
| **RCA** | Recapitalisation amount |
| **REV** | Real economic value |
| **RLA** | Resolution liquidity assistance |
| **ROE** | Return on equity |
| **R&R** | Rescue and restructuring |

| | |
|---|---|
| **RWA** | Risk weighted asset |
| **SGA** | Società per la Gestione delle Attività |
| **SIFI** | Systemically important financial institution |
| **SLA** | Service level agreement |
| **SME** | Small and medium enterprises |
| **SPE** | Single point of entry |
| **SPV** | Special purpose vehicle |
| **SRB** | Single Resolution Board |
| **SRF** | Single Resolution Fund |
| **SRM** | Single Resolution Mechanism |
| **SRMR** | Single Resolution Mechanism Regulation |
| **SSM** | Single Supervisory Mechanism |
| **TFEU** | Treaty on the Functioning of the European Union |
| **TLAC** | Total loss-absorbing capacity |
| **TLOF** | Total liabilities and own funds |
| **TREA** | Total risk exposure amount |
| **T2** | Tier 2 |

# Chapter 1: Introduction

## 1. Background and subject matter

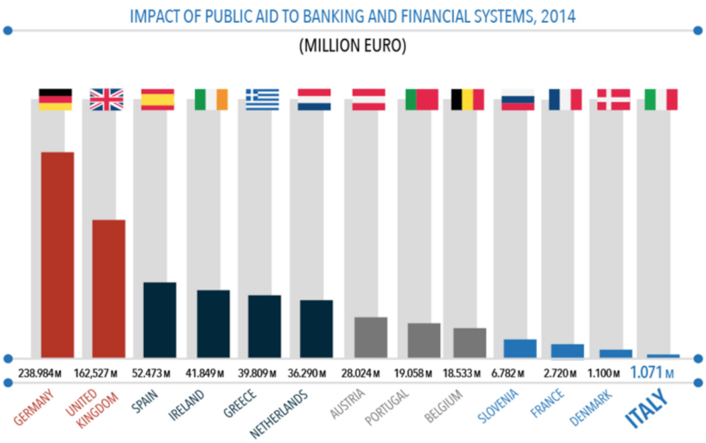
The banking sector, which is at the forefront of academic research and public debate since the outbreak of the financial crisis in 2008, as well as having sparked renewed interest with the introduction of the European Directive on recovery and resolution procedures applicable to banks (BRRD)[1] in 2014 and its more recent amendments in 2019 (BRRD2)[2], allows for research in the highly complex and relevant area in which financial regulation and competition policy become strictly interwoven. This interconnection is particularly evident when considering the management of bank failures involving recourse to public funds. In this respect, the BRRD was introduced with the aim of restructuring systemically important and interconnected banks in an orderly manner, by enabling public authorities to distribute losses among banks' shareholders and creditors (bail-in), rather than relying on taxpayers (bailouts). Yet, recent cases of bank rescues approved in Europe after the introduction of the Directive show that some degree of public intervention is still possible, despite the intended shift from bailout to bail-in. This provides the starting point for a study focusing on the interaction between resolution rules and State aid control.

### *1.1 Public support to banks during the global financial crisis*

The latest financial crisis and the consequent sovereign and banking crises within the eurozone had pushed national governments to support the balance sheets of multiple banks in distress by way of extensive bailouts, the expense of which was inevitably shouldered by taxpayers.

[1] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, (Bank Recovery and Resolution Directive, “BRRD”).
[2] BRRD as amended by Directive 2019/879/EU of the European Parliament and of the Council of 20 May 2019.

*Figure 1.1 - Impact of public aid to banking and financial sectors in € mln (2014)*




*Source:* Eurostat

The unraveling of the crisis was spurred on by a long-standing tendency towards banking sector nationalism observable in most European States[3], justifiable partially on grounds of credit allocation control - believed to be instrumental for economic development and competitiveness - as well as cover from external economic shocks, and control over monetary policy. Such parochialism has persisted, despite the increased internationalisation of operations carried out by many of the biggest banks.

The unprecedented costs faced to bail out domestic banks, especially to cope with the losses due to foreign exposures, brought to light one of the risks of financial globalisation and the harm incurred by domestic creditors and savers as a consequence of the failure of foreign banks highlighted some of the criticalities of an imperfect transnational integration.[4] In order to make do with the extraordinary circumstances, the European Commission relaxed its approach in State aid control cases involving the financial sector specifically, choosing to forgo a strict application of the relevant branch competition law, in a situation in which financial stability was primarily at stake.

[3] Véron (2013), also highlighting how, after the global financial crisis, market integration went sharply backwards compared to the period before the crisis outbreak in mid-2007.
[4] A prime example is offered by the bust of Icelandic bank Landesbanki: British and Dutch depositors, having accessed the bank's branches in their countries, had to be bailed out by their respective governments, due to Iceland only guaranteeing its own national deposits.

### *1.2 Post-crisis regulatory reforms*

As part of the regulatory overhaul following the financial crisis, within the broader framework of the establishment of a European Banking Union, the BRRD and the Single Resolution Mechanism Regulation (SRMR)[5] were introduced in 2014. The new regulatory system has introduced both higher capital requirements and new rules on bank resolution, which should - at least theoretically - establish the credible belief that shareholders and creditors would carry the full burden of the losses of a failing bank, primarily by way of the new bail-in instrument, rather than making recourse to public resources. This was also in line with strengthened core capital requirements for banks and an enhanced role for Additional Tier 1 instruments brought about by the update of the Capital Requirements Regulation (CRR2).[6]

The intended consequences of such a mechanism for the management of bank failures are threefold. Firstly, moral hazard of banking managers should be erased by removing the so-called 'implicit subsidy' for big banks, which had provided encouragement for bankers to take on excessive risks in their exposures as well as to over-borrow, due to the expectation of being bailed out in case of a crisis to avoid stability disruptions. The second aim is to allow for a system in which even large banks can be allowed to "fail" without triggering a systemic chain reaction on aggregate financial stability, while minimising the need to rely on public funds for the purposes of crisis avoidance. The third goal is to harmonise different national approaches to bank rescues, so as to tackle the issue of regulatory arbitrage and manage not to undermine the internal single market with differences in funding costs for banks with comparable creditworthiness that are located in different countries.

In addition, the framework for State aid control was also updated in order to account for the evolution of the crisis, especially considering the persistently high volatility of the financial markets as well as the uncertainty concerning the economic outlook, which resulted in a constant risk of having new serious

[5] Regulation (EU) No. 806/2014.
[6] Regulation (EU) No. 575/2013 as amended by Regulation (EU) No. 876/2019. On this point, see Lamandini and Ramos Muñoz (forthcoming) in Handbook on Capital and Liquidity Requirements for European Banks: CCR2 and CRDV, Oxford University Press.

disturbances manifest themselves once again for some Member States. This justified the preservation of the possibility for Member States to grant support measures as a safety net in times of crisis, on the basis of the conditions laid out in Article 107(3)(b) TFEU, for what concerns the financial sector. In clarifying the applicability of the updated framework for crisis rules for banks, the Commission underlined that financial stability remains the overarching objective in carrying out its assessment of aid schemes, necessarily reflecting the related macroeconomic considerations as well.

The potential need for public support to banks in distress is a recurring theme, since banking crises are cyclical, and it is of particular interest now, due to the likely effects on banks' balance sheets of the economic downturn originated by harsh governmental actions adopted to mitigate the Covid-19 pandemic. Lessons learnt in the recent past in dealing with instances of bank distress may thus prove of great relevance in tackling future challenges.

## 2. Problem Definition

The enforcement of competition law in the banking sector is well established as an issue of interest and policymakers have long struggled to define the right combination of competition rules and regulations specific to the banking industry.

The crisis of 2008 sparked two common but different reactions concerning the role of antitrust policy in the field of banking. One has considered financial stability as taking priority over all other concerns, including those of traditional competition policy, and therefore, that the normal rules needed to be suspended for the duration of the crisis.[7] The opposite view has been to fear that intervention to restore financial stability would bring about significant distortions of banking competition, and therefore to advocate that competition rules should be applied even more vigorously than usual, with the receipt of State aid being considered presumptive grounds for suspecting banks of anti-competitive behaviour. A middle ground is represented by those views which call for the persistent, simultaneous application of both set of rules (those meant to preserve financial stability and those

[7] See, among others, Kokkoris and Olivares-Carminal (2010).

meant to preserve a competitive market), by means of a proportionate use of structural and behavioural measures as conditions for the State aid and antitrust approval of any rescue scheme.[8]

When dealing with State aid, financial regulation and competition policy must be considered as inevitably intertwined. Therefore, it is important to put such policy responses in the context of the overarching architecture of regulatory policies, because the question of the link between competition and stability in the banking industry depends on the ability of prudential regulation to prevent excessively risky behaviour by bank managers and shareholders.[9] Theoretical models have made contrasting predictions concerning the relationship between bank concentration, competition and stability. Even empirical studies have brought forth mixed evidence concerning the effects of State aid on the degree of competition in different banking sectors.[10]

European State aid provisions had remained mainly unchanged since their introduction in the Treaty of Rome of 1957, which was aimed first and foremost at avoiding the conferral of any undue advantage stemming by state interventions. State aid control has traditionally been kept separated from the pursuit of other economic policies. However, crisis aid measures have been aimed at ensuring that Member States were implementing more efficient and rational economic policies. The European Commission itself has advocated that public spending should be made more efficient and effective, while also being targeted at policies that can promote growth, thus fulfilling common European objectives. With such new emphasis being put on the efficiency of public support, State aid should now be thought of as one of the instruments that can help heighten budgetary discipline and enhance the quality of public finances. It is in this sense that State aid control has increasingly become a State aid policy, bringing about a constitutional shift in the allocation of supranational regulatory competences. This shift in the conception of

[8] Lowe (2009) highlights how this balancing approach was meant to reconcile an immediate stabilisation need with a need to ensure the long-term viability of institutions without State support.
[9] Theoretical studies have been carried out by Collie (1998; 2002; 2005), Dewatripont and Seabright (2005), who have applied well-known concepts of contract theory and industrial organisation to the assessment of State aid. According to the prevailing belief among policymakers, more competition in banking leads to more instability and failures, all else equal (Boyd and De Nicolò, 2005).
[10] See, as an example, Vives (2010) and Beck et al. (2010), for a review of the contrasting empirical findings.

State aid implies that particular attention should be devoted to assessing how different policy mandates are balanced when managing the failure of financial institutions.

Since 2008, most Member States have provided some sort of support to their banking system, which has allowed the European Commission to exert an unprecedented control over the use of taxpayers' money under State aid rules. In particular, individual restructuring and resolution plans have been instrumental in fostering the reform of the European banking system and anticipating the adoption and implementation of what is known as the 'Banking Union', which was absent at the beginning of the crisis. Building on the 'Crisis Communications'[11], all State aid decisions taken by the Commission have been based on three pillars: viability, burden-sharing and competition. In order to minimise distortions of competition, the Commission imposed significant structural and behavioural measures, aimed at sanctioning, among others, risk-taking and mismanagement, and at restructuring the banking sector as a whole.

On 10 July 2013, the Commission adopted a Communication on State aid rules on support measures in favor of banks granted in the context of the financial crisis, which is applicable as of 1 August 2013. Its burden-sharing requirements apply to all State aid granted to banks. Banks intending to resort to State aid should now undertake all measures to minimise public intervention. As a consequence, the enriched regulatory framework composed of rules governing bank resolutions- both

[11] *The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis* [2008] OJ C270/8 ('2008 Banking Communication'); *The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition* [2009] OJ C10/2 ('Recapitalisation Communication'); *Communication from the Commission on the treatment of impaired assets in the Community financial sector* [2009] OJ C72/1 ('Impaired Assets Communication'); *Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules* [2009] OJ C195/9 ('Restructuring Communication'); *Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis* [2010] OJ C329/7 ('2010 Prolongation Communication'); *Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis* [2011] OJ C356/7 ('2011 Prolongation Communication'). These Communications set out how Member States could support financial institutions while still abiding by EU competition rules and thus avoiding undue distortions of competition. See Doleys (2012), arguing that such guidance helped preserve competition in the banking sector as well as providing a policy resource for Commission authorities to rely on to restructure the banking sector.

at EU-wide and eurozone level[12]- and the updated rules for crisis aid, have opened a new venue for further studies on regulation. Indeed, the framework for bank resolution has effectively introduced several resolution tools not previously available to the authorities of most Member States to manage the failure of their financial institutions. The evidence from recent cases of bank rescues in Europe shows that (i) some degree of public intervention is still possible despite the intended shift from bailout to bail-in introduced by the BRRD[13]; and (ii) different combinations of resolution tools and public support measures entail different restructurings of institutions, which need to be scrutinised by competition authorities both under State aid rules and merger rules.[14]

Therefore, a crucial issue to tackle is whether the rules on State aid and those on resolution- including the prescriptions on burden-sharing, principally applied through bail-in- are sufficiently flexible, so as to allow Member States to adopt the policy measures that are deemed to be necessary in the public interest. Whether the balancing exercise between financial stability and competition concerns has remained consistent in the assessment of aid schemes during the global financial crisis up to today is up for discussion.[15] As a matter of fact, the approach taken to the application of the new integrated framework for bank resolution and State aid control suggests that maybe it is not the case that measures enacted with a view to preserving financial stability completely rule out the possibility that competition concerns still arise, even though the regulatory framework should have decreased reliance on public support. At the very least, the mechanics that allow for the recourse to public funds in case of a bank failure- and the willingness to allow for deviations from statutory bail-in- make it difficult to

[12] Through the introduction of the BRRD and the Single Resolution Mechanism Regulation (SRMR), respectively.

[13] Including, among others, the precautionary recapitalisations of National Bank of Greece and Piraeus Bank (2015) and of Monte dei Paschi di Siena (2017); the liquidation of Banca Popolare di Vicenza (2017).

[14] Merger control is necessary in those cases where an acquisition of control of a bank by another party comes about as a result of rescue and restructuring schemes, in order to curb potential anticompetitive effects. This can entail State acquisitions, as in the case of precautionary recapitalisations, or acquisitions by market competitors, for instance, in resolution transfer schemes such as sale of business or bridge banks.

[15] This also poses a fundamental question of legal certainty and non-discrimination. See, for instance, the judgment of the European Court of Human Rights (ECtHR) of 7 July 2020 in case *Albert and Others v. Hungary* (application no. 5294/14), negating the existence of a violation of the property rights of the shareholders of banks integrated into a State-controlled scheme, as the banks' shareholders lacked standing before the ECtHR.

believe that there is sufficient flexibility to account for the peculiarities of specific countries and their banking sectors.

As for the regulatory and supervisory developments of the latest years, the establishment of the Banking Union provides an important backdrop against which to evaluate how a greater degree of sectoral integration in banking at EU level has influenced the approach to the management of banking crises. In this respect, one relevant distinction needs to be made between idiosyncratic and systemic crises and the ("desirability" of) application of the new prescriptions on resolution to either of the two instances. This constitutes a crucial point, as it appears that the recourse to bail-in would be suited only to the context of the former type of bank crisis and this, in turn, prompts the making of new considerations on which avenues for aid grants are still open. Indeed, while the Banking Union gains its footing[16], large segments of the EU banking sector still require a substantial restructuring through recapitalisation measures, but the market may not be able to provide by itself all the needed resources, when profitability appears to be permanently depressed and economic growth is scarce. Therefore, a systemic market failure might only be fixed by resorting to temporary forms of public support. However, the risk of large write-offs of capital instruments that comes with the new prescriptions on burden-sharing and bail-in could potentially set in motion a phenomenon of investors' flight, which would prejudice the new system itself, by requiring once again public support.

It follows from the discussion on bail-in applicability and the remaining scope for aid granting that some considerations must be made on the setting of prudential requirements on bank capital as well. As a matter of fact, the design of prudential rules on bank capital requirements interacts with the industrial organisation of the banking sector and, in particular, with the level of competition among banks.[17] Increased competition can lead to excessive risk-taking by banks,

[16] Only the first two pillars of the Banking Union are currently in place, namely, (i) the Single Supervisory Mechanism (SSM), for harmonised and centralised supervision of euro area financial institutions, and (ii) the Single Resolution Mechanism (SRM), for harmonised resolution of failing banks. The third pillar, i.e. a European Deposit Insurance Scheme (EDIS) is still to be established. On the benefits of the EDIS and why it is needed for a fully functioning Banking Union, see, among others, Huertas (2019) and Gortsos (2019).
[17] See Joosen et al. (2018), arguing that a "one size fits all" approach to setting capital requirements hinders the development of smaller banks by creating competitive distortions.

which may need to be counteracted by imposing tighter capital requirements. When capital requirements are set uniformly at an international level, but the levels of competition among banks in different countries do not parallel such uniformity, international spillovers inevitably arise for what concerns the financial integration of these countries.

This is relevant, in particular, in relation to MREL[18] and TLAC[19] capital requirements, which are expressly devised for the purposes of making bank resolution a sustainable process.[20] Global and European regulatory bodies and authorities developed, or even directly enshrined in law, a number of minimum standards for 'bail-inable' liabilities that financial institutions are required to hold, so as to ensure that banks maintain sufficient levels of bail-inable capital in face of a potential resolution scenario. The prescription of holding sufficient capital available for bail-in is one of the means chosen to sustain the achievement of the objective of maintaining financial stability, by enabling smooth proceedings in resolution and avoiding that investor runs be triggered when a bank's distress becomes apparent. More specifically, these requirements ensure that they are well equipped to continue their critical functions without threatening the stability of financial markets and minimising the need to resort to further taxpayer support. With respect to TLAC in particular, the Financial Stability Board has declared that: *"[t]he objective of this standard is to ensure that G-SIBs have the loss-absorbing and recapitalisation capacity necessary to help ensure that [...] critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk."*

On the basis of these considerations, it seems that there is a need to reconsider the interrelation between measures taken for stabilisation purposes and their competitive implications, in light of a regulatory framework for bank crises management which combines resolution rules and State aid rules.

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[18] Minimum requirement for own funds and eligible liabilities (Art. 45 BRRD and Art, 12 SRMR, further specified in BRRD2 in Artt. 45 to 45f and SRMR2 Artt. 12 to 12f).

[19] Total loss-absorbing capacity. Financial Stability Board, 'Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution – Total Loss Absorbing Capacity' (2011).

[20] High enough TLAC coupled with capital requirements represent the means to preempt future banking crises. Along these lines, see, inter alia, Gordon J.N. and Ringe W.-G., 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' (2015) 115 Columbia Law Review 1297; Admati A.R. et al., 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expensive' (2013) 23.

## 3. Research Question

This PhD study will provide a comprehensive and rigorous analysis of the rules on bank resolution introduced in Europe by the BRRD in their interaction with the regulatory framework disciplining State aids.

*The central question of this research project is whether the interaction between the European regulatory framework for bank resolution, as introduced by the BRRD, and State aid rules allows to minimise (potential) competition distortions when dealing with bank failures.*

Answering this question requires a detailed analysis of two issues. In the first place, it entails an assessment of the legal framework and its practical implementation, to identify which are the avenues still available to grant public funds to failing banks, both within and outside the perimeter of resolution rules, and which are the competitive concerns that may arise as a result. The second aspect is strictly related to the first and concerns how different tools and strategies available to manage bank failures entail different restructuring requirements for ailing institutions, and to what extent these can alter institutions' ownership and operational structures.

Tackling these issues is relevant not only from a positive perspective, but also from a normative one. Indeed, from the positive side, this analysis should provide clarity on the complexity of the interactions between the frameworks for bank resolution and State aid control and highlight the role of public fund granting in affecting institutions' market conduct, as well as public authorities' incentives in choosing which rescue strategies and tools to apply to different instances of bank distress. Then, as different rescue measures shape the structure and operative models of institutions in different ways, there is a possibility that the competitive structure of banking markets is altered as a consequence of bank restructurings. In this sense, the analysis has normative implications as well, by pinpointing the extent to which the regulatory framework as set and applied can actively shape institutions' and markets' conduct and structure, to assess whether its intended regulatory and policy objectives are met, and advance policy proposals in case improvements are necessary in this respect. In particular, this will concern the manner in which the State aid and resolution frameworks should be aligned and coordinated, for the purposes of efficiency, in order to facilitate risk sharing.

This study aims at providing a thorough examination of the crisis management framework, to be used as a basis upon which further research could build to empirically estimate how different measures may differently influence the competitive structure of banking markets. An updated analysis of the most recent cases of management of banks' failures will also be offered, in order to address potential issues for attention in the implementation of the norms. Particular attention in the study will be devoted to Italian banks, insofar as they offer recent examples of the application of different crisis management procedures, but the analysis must also be grounded in the comparison with other European States and the comparable measures enacted to rescue their national banks.

In this sense, this PhD study can be seen as offering a new perspective on the relationship between considerations and on financial stability and on competition in dealing with bank failures. Indeed, the focus of this work lies in the different measures and strategies deployed for stabilisation purposes, to assess whether and to what extent safeguards might be necessary to prevent undue competitive distortions, as well as how the competitive structure of banking markets might be affected as a result of failing banks' restructuring.

**4. Methodology**

The methodology chosen to tackle the research questions is functional to addressing and combining issues related to the different areas of banking regulation and competition policy, specifically with reference to State aids and to a lesser degree also to merger control.

First, the theoretical framework draws from the economic literature in the field of competition in relation to State aids and the rationale for their control, with a specific eye to their application in the banking sector. The theoretical analysis hinges on both legal and economic insights in order to pinpoint how the design of the regulatory framework could give rise to competition-relevant concerns. In this respect, different crisis management tools/strategies are assessed in each chapter.

Then, the question regarding the impact of the regulatory framework for bank crisis management and its practical application on competition indicators and the structure of European banking markets is an empirical one. Yet, this study does not intend to produce empirical estimates of such an impact through statistical and econometric exercises, due to a number of factors. In the first place, not all necessary funding cost and bank-level data are publicly available for all rescued banks[21], thus not enabling full consistency and comparability across the sample of institutions. Moreover, some of the banks relevant for the purposes of analysis are still in the implementation phase of their restructuring schemes, and thus their ownership and organisational structures are not yet "finalised". In addition, the geographical and product markets of activity of most of the institutions considered have a regional or even province-level relevance, the competitive structure of which cannot be fully gleaned from publicly available data.[22] Lastly, the fact that the implementation of the resolution framework is still relatively recent and its full application is still under development implies that the sample size of banks undergoing some form of crisis restructuring is limited to date.

In light of the above, a qualitative approach is preferred, with a view to making the analysis more flexible and better suited to provide an understanding of the complex workings of the current regulatory framework for bank crisis management. To this end, a case study is carried out, making use of all publicly available bank-specific data, decisions of the European Commission in relevant State aid and merger cases, as well as decision of national competition authorities. Indeed, while qualitative methods are applied to address the research questions, empirical evidence and studies drive the analysis, ground the discussions and inform the policy proposals advanced.

**5. Motivation and relevance**

On the basis of the reflections of the previous sections, such a study would be relevant (i) for financial institutions, in providing clarity on the regulatory framework and how it applied in practical cases, (ii) for resolution authorities, to take into account also competition-relevant implications of the bank restructuring schemes they are called to devise and implement, and (iii) for regulatory authorities, insofar as it addresses potential weaknesses in the current regulatory framework and

[21] This is partly due to the fact that not all rescued institutions were listed at the time of intervention.
[22] Granular data in this respect are available to competent authorities, but subject to confidentiality.

its interpretation, in order to pinpoint aspects that could be streamlined or made more coherent.

In addition, it is worthwhile to strike the relevance of carrying out a study on the relationship between banking competition and financial stability considerations arising from the management of cases of bank distress and how the interplay of the rules on resolution and State aid is faced with such considerations when restructuring requirements are imposed on financial institutions.

In practice, banking competition might lower interest rates and therefore improve the quality of loan applications, while at the same time lowering the need for banks to ration credit. In turn, more profitable bank customers may themselves have a lower incentive to take on risks that would potentially lead to the loss of their own charter value, therefore lowering the probability of default on loans and increasing bank stability. On the contrary, lower levels of competition could lead to higher interest rates being set, which in turn will be likely to attract riskier loan applicants (adverse selection), as well as induce borrowers to choose riskier projects (moral hazard).[23]

Systematic analyses of the relationship between the objectives of financial stability and competition now that the new resolution framework is in place in conjunction with State aid rules would be necessary to evaluate how the EU banking environment can be shaped by decisions on public financing, which should be the result of a 'compromise' between these two objectives.[24] The consolidation of the sector has also raised major questions on what are the instruments that can preserve financial stability best, while effectively addressing the problems posed by mismanaged banks at the same time.

It is straightforward to see that a preservation of the essential activities of a

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[23] However, this market process would be dampened by highly expansionary monetary policy, which is necessary for reasons of systemic financial stability preservation.

[24] Limitation of public aid to the minimum and preservation of financial stability are the concurrent objectives in the State aid framework and in the resolution regime of the SRM framework. The minimisation of (undue) distortions of competition is also among the objectives of the State aid framework. As the BRRD/SRMR are indissolubly linked with the State aid regime by design, the objectives of both regimes come into play concurrently whenever some form of public support is involved in an instance of bank crisis management. In addition, considerations on limiting potential distortions of competition are explicitly embedded in the BRRD in relation to use of resolution tools, business reorganisation plans for post-resolution restructuring, and funding arrangements (see whereas 61, 66 and 69 in the preamble to the BRRD).

bank, in spite of its distress, would be beneficial both for the individual depositors and investors and for the sector at a systemic level, however one should take care to consider who is effectively bearing banks' losses in such instances. Being aware of the costs of financial instability is essential for assessing when more flexibility is required in applying bail-in rules, especially when the threat of spillovers is relevant. In addition, if the combination of resolution tools now available actually manages to decrease the costs of dealing with bank crises, some public money would be freed up for the pursuit of other social objectives.

A review of the main strands of economic and legal literature on the matter of granting public support to failing banks and the implications of the introduction of new rules for bank resolution lays out the necessary background arguments upon which the analysis of this PhD study will build.

**6. Public support to failing banks: an overview of the literature**

It is well established in the literature that State aid can bring about both beneficial and harmful effects. On the one hand, granting aid can help correct forms of market failure, be they the result of externalities, market power, or informational asymmetries, thus striving to achieve efficiency. As for the potential harm, on the other hand, aid can increase the risk of creating static and dynamic inefficiencies, insofar as it may encourage continued production by inefficient firms or alter firms' expectation and their consequent behavior. Likewise, it could lessen the degree of competition in the targeted market structures and the opportunity cost of state funds must also be taken into account, since "a euro can only be spent once".[25] Beck et al. (2010) provide an extensive review of both positions, by focusing on the specific implications they raise for the financial sector.

A growing strand of literature has been exploring the various economic trade-offs that result from bank bailout decisions, with a specific focus on the moral hazard issue and risk-taking behavior resulting from expectations and actual receipt of financial support.[26] Some works started to incorporate an important factor that

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[25] Friederiszick H.W., "European State Aid Control: an economic framework", in *Handbook of Antitrust Economics*, (Paolo Buccirossi, ed.), MIT Press 2007.

[26] Among many, see: Hellman T.F. et al., "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?", 2000, American Economic Review, 90, 1, 147-165; Demirgüç-Kunt A. and Detragiache E., "Does deposit insurance increase banking system

could impact upon bank bailout choices, which is represented by the personal interest of very same politicians involved in taking such decisions.[27]Especially in the aftermath of the recent crisis, several papers have focused on examining how financial industry legislation is affected by lobbying of special interest groups and voter interests.[28] Some authors argue that politicians sometimes engage in wasteful spending not out of negligence, but rather out of a desire to improve their chances of re-election: such decisions would stand as a signal of their commitment to supplying public goods, with the precise purpose of keeping both past and new potential voters satisfied. In addition, lobbying activity by financial institutions indeed affects the regulatory environment and might even have negative repercussions on financial stability.[29] The strong political connotations of the choice to rescue failing banks with public money become evident when evaluating the latest bank recovery measures adopted in Italy in the latest years.[30]

### *6.1 Trade-off between stability and competition*

The impact of State aid on competition in the banking system is more complicated and ambiguous to assess than it is for most other sectors of the economy. On the one hand, the failure of a single bank can actually be enough to bring about negative repercussions for its competitors through direct contagion channels. An indirect impact can also be generated through the effects on financial and collateral markets. Therefore, State aid for insolvent banks can have positive

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stability? An empirical investigation", 2002, Journal of Monetary Economics, 40, 8, 1373-1406; Dam L. and Koetter M., "Bank Bailouts and Moral Hazard: Evidence from Germany", 2012, Review of Financial Studies, 25, 8, 2343-2380; Brandao-Marques L. et al., "International evidence on government support and risk taking in the banking sector", 2013, International Finance Discussion Paper No. 1086, Board of Governors of the Federal Reserve System.

[27] See Behn M. et al., "The Political Economy of Bank Bailouts", 2016, SAFE Working Paper No. 133. The authors examine how institutional design can affect the outcome of bank bailout decisions. Their findings show that banks bailed out by local politicians in Germany tend to undergo less restructuring and perform considerably worse than other peers backed by the savings bank association. In addition, the authors have found that larger distance between banks and decision makers acts to alleviate distortions in the decision-making process, which then has ramifications in designing bank regulation and supervision itself.

[28] Mian A. et al., "Resolving Debt Overhang: Political Constraints in the Aftermath of Financial Crises", 2014, Americal Economic Journal: Macroeconomics, American Economic Association, 6(2), 1-28; Mian A. et al., "The Political Economy of the Subprime Mortgage Credit Expansion", 2013, Quarterly Journal of Political Science, 8(4), 373-408.

[29] Dewatripont M. and Seabright P., "Wasteful" Public Spending and State Aid Control", 2005, Journal of the European Economic Association, 4, 2-3, 513-522.

[30] For instance, the decision on the liquidation of Veneto Banca and Banca Popolare di Vicenza, which included recourse to public funds, made specific reference to the need to support the orderly exit of the institutions from the market to avoid generalised instability, while also needing to spare senior creditors and depositors.

repercussions for their competitor peers insofar as it prompts contagion in reversing adverse price trends on financial and collateral markets.

On the other hand, State aid can have negative consequences for competition, in that it has the ability of distorting aggregate banking activity in inefficient ways and skewing the allocation of activity across banks, to the extent that some of them receive more aid than others do. The distortive effects can come about mainly in two ways: through the reduction of the private marginal costs of certain banking activities below their true social cost, and by encouraging excessive risk-taking, which is undesirable from a social point of view.

However, international experience seems to suggest that generous recapitalisation of viable banks, together with the winding-down of non-viable ones, can be a good and even 'profitable' use of taxpayer money in terms of crisis resolution, so as to rapidly restore stability in the financial system. Dewatripont (2014) compares the European banking crisis with two other crises considered to have been dealt with successfully- the Swedish one of the 1990s and the recent US financial crisis- and two that have not- the US Savings and Loan crisis of the 1980s and the Japanese crisis that began in the early 1990s. His results point to affirm that procrastination is costly, speedy recapitalisation with public money is crucial. This goes in support of the view that, in extraordinary circumstances of distress where systemic contagion is highly likely, the objective of stabilisation should be prioritised, instead of relying on a strict application of competition preservation rules. According to Beck et al. (2010), competition and financial stability are not incompatible, thus voiding any claim that weaker competition policy criteria should be applied to banks during a crisis.

Even though no unilateral consensus has been achieved in the economic literature on the fact that a trade-off between financial stability and competition is indeed present in practice, both theoretical and empirical studies on the matter have highlighted the presence of a strong interaction between competition and the banking regulatory framework. However, many of the results available were obtained for 'normal' times,[31] while the global financial crisis has proven that there

[31] Empirical studies generally concern time spans preceding 2007, thus encompassing merely one part of a long-term economic cycle.

may be new mechanisms and channels at play through which market structure can affect system fragility.

*6.1.1 Charter value hypothesis*

What is commonly referred to in the literature as a 'charter' or 'franchise' value view of banking predicts that more concentrated and less competitive banking systems are more stable.[32] The rationale for this is that profits- which can only be extracted in situations other than perfect competition- act as a buffer against fragility and provide incentives against excessive risk-taking.

Bank owners have incentives to shift risks to depositors, since they would only participate in the upside part of this risk taking, under the protection of the limited liability. Banks have greater incentives to take on excessive risks, when competition to secure depositors is tougher and puts pressure on profits, thus causing greater fragility to arise. On the other hand, in those systems where entry is restricted and therefore competition remains limited, banks have better profit opportunities, greater availability of capital cushions, and, consequently, fewer incentives to keep an aggressive stance by taking excessive risks, with positive repercussions for financial stability. In addition, in more competitive environments, banks manage to extract lower informational rents from the relationship with their borrowers, thus having reduced incentives to properly screen borrowers, which again increases the risk of fragility. Thus, these models predict that deregulation bringing about more entry and competition[33] would lead to a higher degree of systemic fragility.

The payment system and the interbank market represent an additional channel through which competition can have a negative impact upon stability. Allen and Gale (2000) show that perfect competition can prevent banks from providing liquidity to other banks hit by a temporary liquidity shortage.[34] In fact, since all banks are price-takers in a competitive market, no single bank has an incentive to provide liquidity to a troubled peer, with the result that the bank in distress will eventually fail, having a negative ripple effect for the whole sector.

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[32] See, *inter alia*, Keeley (1990) and Demsetz et al. (1996).
[33] As was the case in the U.S. in the 1970s and 80s.
[34] Allen F. and Gale D., “Financial Contagion”, 2000, The Journal of Political Economy, 108, 1, 1-33.

A somewhat different argument follows the rationale according to which more concentrated banking systems have larger banks, which are in a position to better diversify their portfolios.[35] While the 'large-bank' argument does not rely directly on competition, it is a relevant side effect of market structure to take into consideration. However, more recent theoretical works have shown that such diversification can have negative systemic stability repercussions, if banks become increasingly interconnected and become more and more similar to each other, even though its initial effect would be beneficial in enhancing the stability of individual banks.[36] Subsequently, this could also have further repercussions on the risk-taking attitude of banks and create a tendency towards herding behavior.

One final argument is usually made with regards to the number of banks to be supervised by the authorities. If a more concentrated banking system indeed implies a smaller number of banks, this might reduce the supervisory burden and enhance the stability of the banking system overall.[37] As in the case of bank size, this argument concerns the market structure in banking, not the degree of competition that this entails.

*6.1.2 Critique to charter value hypothesis*

The opposing viewpoint posits that a more concentrated banking structure brings about more bank fragility. Boyd and De Nicoló (2005) argue that the standard argument upholding that market power in the banking sector acts to boost profits- and hence bank stability- disregards the potential impact of that very market power on bank borrowers' behavior.[38] The authors find that it is the borrowers who choose the riskiness of their investments undertaken with bank loans, rather than banks choosing the riskiness of their assets. Therefore, in addition to the asset allocation problem posed by the choice of borrowers, banks also face a contracting problem, as the interest rates they charge have an influence upon borrowers'

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[35] Many models predict the formation of economies of scale in intermediation. Among them, some examples are the ones elaborated by Boyd and Prescott (1986), Allen (1990) and Wagner (2008), as also referenced by Beck et al. (2010).
[36] Wagner (2008), *supra*.
[37] Allen and Gale (2000) find that the United States, with their great number of banks active in the market, support this particular argument, since it has had a history of much greater financial instability than the UK or Canada, whose respective banking sectors are dominated by fewer larger banks instead.
[38] Boyd J.H. and De Nicolò G., "The Theory of Bank Risk Taking and Competition Revisited", 2005, Journal of Finance, 60, 3, 1329-1343.

behavior. They also note that concentrated banking systems enhance market power, which in turn allows banks to raise the interest rate they charge to firms.[39]

Thus, in contrast to the charter-value hypothesis, the prediction made by Boyd and De Nicolò (2005) is that banks' actions will result in more risk-taking and ultimately greater fragility when banking systems are more concentrated and less competitive. Even if more competition induces banks to take greater risks, competition can still increase stability overall in the event that banks increased their equity capital as a compensation for the higher risk-taking, or that they took other kinds of risk-mitigating measures.

Moreover, advocates of the 'competition-stability' view argue that, relative to diffuse banking systems, concentrated sectors generally have fewer operative banks, and policymakers are more concerned about bank failures when the only present banks are few. As a consequence, banks in concentrated systems will tend to receive larger subsidies through implicit 'too big to fail' or 'too important to fail' policies that amplify risk-taking incentives and, in turn, increase banking sector fragility.[40] Having larger banks in a concentrated banking system could also increase the risk of contagion, resulting in the reinforcement of a positive link between concentration and systemic fragility, for which the latest financial crisis seems to provide quite a strong evidence.

Proponents of this paradigm would also disagree with the proposition that a concentrated banking system in which only a few banks detain control over the whole market is easier to monitor than a less concentrated banking system with many operators. The countervailing argument that is usually advanced against this view is that bank size is positively correlated with complexity, so that large banks are in reality harder to monitor than small ones- this can be observed in the latest crisis. In addition, the most recent trend towards consolidation in the sector has also led to the creation of financial conglomerates that are able to offer a wide array of financial services, which were previously offered exclusively by specialised institutions, and this gives rise to an ulterior factor of complication in banking

[39] The model they propose shows that higher interest rates might induce firms to assume greater risks, which, in turn, would increase the probability that banks' loans become non-performing. Similarly, higher interest rates may attract riskier borrowers through an effect of adverse selection.
[40] See Mishkin (1999), Beck et. al (2010) and Huertas (2015) in this respect.

supervision.[41]

Some tentative evidence was also found according to which banking competition does not hurt financial stability, that market structure indicators, such as bank concentration, are not good predictors of the intensity of bank competition, and that there is an important interaction between the regulatory framework and competition.[42] Data on the situation of the European banking sector pre- and post-crisis only seem to reinforce the difficulty to identify a strong univocal trend in the relationship between stability, competition and concentration- as is evident from Figure 1.2 below[43]- despite pointing to a move towards increased consolidation, thus calling for further studies on the matter.

*Figure 1.2 - Concentration ratios of EU banking sector (2001-2009)*


*Source:* ECB, Commission Services

[41] Beck, T. et al., "Bailing out the Banks: Reconciling Stability and Competition", 2010, CEPR, London.

[42] Keeley M.C., "Deposit insurance, risk, and market power in banking", 1990, American Economic Review, 80, 5, 1183-1200; Beck T. et al., "Bank concentration, competition, and crises: First results", 2006, Journal of Banking and Finance, 30, 5, 1581-1603.

[43] The majority of Member States do not appear to have experienced significant changes in concentration between 2007 and 2009- whether such index is measured by the CR5 ratio or the HHI. On the contrary, the Irish market displayed a significant concentration increase during the same period, with a raise of 13 percentage points in market share for the top five institutions, going from 46% to 59%, and the HHI index being almost doubled, compared to the pre-aid level. Spain, Germany, Finland or Slovakia experienced an accelerated concentration as well, though not with the same intensity observed in Ireland. Differently, Austria, Belgium, France and Poland experienced a de-concentration phase of their respective banking sectors during the crisis. As an example, the HHI of the Belgian banking sector decreased by more than 20% in the two years from 2007 to 2009, and its CR5 fell down around 6 percentage points.

As for the practice of the European Commission in assessing State aid schemes during the crisis, commentators tend to agree on the effectiveness of the measures taken in reigning in significant cross-country spillovers and returning aided banks to viability, in spite of the difficulties faced in assessing schemes and taking proper consideration of the specificities of different national banking sectors.[44]

*6.1.3 Empirical literature and the data*

As is the case for the theoretical one, the empirical literature studying the relationship between competition and stability has not yet reached a firm conclusion on this point either. However, there is some tentative evidence that bank competition does not hurt stability, that market structure indicators, such as bank concentration, are not good predictors of the intensity of bank competition, and that there is an important interaction between the regulatory framework and competition.[45]

In addition, there is cross-country evidence that regulatory policies that are devised to restrict entry and banks' other activities are negatively associated with bank stability. In particular, Beck et al. (2006) find that banking systems in which banks' activities are more restricted and barriers to bank entry are in place are more likely to suffer systemic banking distress, whereas no significant association is found between capital regulations and the likelihood of suffering a crisis. Limiting contestability of the banking sector appears to weaken bank stability, rather than the opposite, thus contradicting the charter-value hypothesis already discussed herein. Data on the situation of the European banking sector pre- and post-crisis only seem to reinforce the difficulty to identify a univocal trend in the relationship between stability and competition, thus calling for further empirical studies on the matter.

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[44] Koopman G.J., "Stability and Competition in EU Banking during the Financial Crisis: The Role of State Aid Control", 2011, Competition Policy International Vol. 7 No.2; Collinet J.F., "State Aid in the Banking Sector: A Viable Solution to the 'Too big To Fail' Problem?", 2014, Global Antitrust Review, 7, 137-162.

[45] Keeley (1990) provided evidence that increased competition after the relaxation of State branching restrictions imposed in the United States in the 1980s reduced banks' capital cushions and increased risk premiums- this further reflected in higher interest rates on certificates of deposit. Overall, this suggests that higher competition in the US eroded charter values and resulted in greater bank fragility in those years. There exists also an extensive strand of literature relating to the experience of the United States in more recent years that finds an inverse relationship between the scale of banks and their failure.

Part of the reason why studies come to different conclusions is that they define and measure competition in different ways.[46] Colvin (2009) argues that finding an appropriate empirical measure that manages to be simultaneously sensitive to theoretical concerns and the reality of the actual measures that can be obtained in practice is fraught with difficulty. Standard paradigms of competition appear to be inappropriate for an analysis of the banking sector due to the presence of strong informational asymmetries that are specific to financial markets.

### *6.2 State aid practice during the crisis*

Most of the analyses made on the State aid schemes approved at the height of the latest crisis come from European Commission officials themselves, giving assurances on the effectiveness of the measures in reigning in significant cross-country spillovers and returning aided banks to viability. The part of the issue that is usually brought forth in studies on this point is the difficulty that governments faced in designing appropriate measures, which, in turn, has made those very same measures difficult for the Commission to assess. Yet, this particular argument sounds unsatisfactory (Collinet, 2014).

Koopman (2011) holds that the European Commission designed a dedicated set of rules that took account of the need to respond to a horizontal shock to the banking system requiring the disbursement of large amounts of aid in record time to prevent a major economic crisis, while also recognising the significant differences existing across the banks concerned, thus abiding by the principle of proportionality. The author also emphasises that there does not seem to be much evidence that State aid control would have had a negative effect on lending to the real economy by forcing to deleverage across the board. Given that only banks with problematic business models were involved in asset divestitures, there is also no

[46] Degryse et al. (2009) provide an interesting discussion and comparison of a number of recent empirical papers investigating such competition-stability relationship. They document how a new branch of empirical industrial organisation literature has begun to circumvent the problems associated with competition indices such as the Herfindahl-Hirschman one, by measuring firms' conduct more directly, without explicitly taking market structure into account. New competition measures used in the more recent banking literature include the use of the Panzar and Rosse (1987) H-statistic, which leads to define competition as the sum of elasticities of the total interest revenue of banks with respect to their factor input prices, and the relative profit differences measure introduced by Boone (2008), who models firms as being punished more harshly for inefficiency, the more competitive is the market in which they operate.

indication that State aid control under the crisis framework has actually exerted a generalised downward pressure on lending patterns.

As for more detailed considerations on the merits of the actual aid schemes approved, Faia and Weder di Mauro (2015) provide a limited analysis of some State aid cases adjudicated during the latest crisis that showed some use of bail-in procedures. Their study, however, has more of descriptive purpose rather than aiming to be a systematic assessment of both procedures adopted and results obtained.

**7. Revision of the State aid framework: the 2013 Banking Communication**

The Commission's new Banking Communication of 10 July 2013 is the latest amendment of the state aid framework for bank restructuring based on the previous six Crisis Communications.[47] In itself, it replaces the Banking Communication, thus signaling a major change in the approach taken to bank restructuring. Indeed, it could be argued that its enhanced burden-sharing regime marks the distancing from the heavy reliance upon bailouts, impinging on already-deteriorated public finances, in favor of a shift towards more extensive use of bail-in tools.

Five years after Lehman and with the developing improvement of financial markets, the goal of revising the previous guidelines on the matter was to bring them closer to general State aid control rules, particularly to make them stricter and more responsive to timing restrictions. More specifically, the idea was to introduce more conditionality for the acceptance of bailouts and recapitalisation plans financed with public money: this was achieved by setting a clear order of priority among banks' claimholders in their contributions to burden-sharing, and by requiring the submission of a restructuring plan that must undergo approval before any public recapitalization can take place, so as to check ex ante the actual necessity and validity of the help requested. Yet, exceptions remain possible when financial stability is in danger, and when 'fundamental creditor rights' are violated. These exceptions may turn out to be very significant in fact, but the exact way in which

[47] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') (2013/C 216/01).

these guidelines will be implemented remains largely untested until now. For instance, in case of a new systemic crisis, a bank recapitalisation may be needed in the span of a weekend, which may render the condition of submission of restructuring plans for prior validation impossible to satisfy.

For what concerns recapitalisations and other impaired assets measures, these are deemed compatible only if the Member State involved demonstrates that all attempts to minimise the need for state aid have been undertaken, namely by:

1. submitting, before the restructuring plan or as part of it, a capital raising plan, which must include issues of new rights, voluntary conversion of subordinated debt, asset sales, earnings retention, and other measures envisaged along these lines;
2. changing the management and applying strict executive remuneration policies until the restructuring period is over;
3. preventing the outflow of own funds, through a restriction on dividends, buy-backs of hybrid capital instruments, acquisitions, and so on; and
4. ensuring an adequate burden-sharing: losses should be first absorbed by equity; hybrid capital and subordinated debt holders must contribute next to reducing the capital shortfall to the maximum extent possible, through the conversion or write- down of the principal of their instruments.

Among State aids, recapitalisation and impaired assets measures in particular are irreversible and may entail serious fiscal implications on the health of public finances, thus warranting a structural evaluation by the Commission. For these reasons, under the new guidelines, Member States are under an obligation to submit a capital raising plan as well as a restructuring plan, before going forth with the completion of any aid granting. For what concerns guarantees and liquidation support, instead, these schemes are no longer available for banks having a capital shortfall. The necessity of the introduction of the new communication was justified by the fragile recovery of the Member States' economies from the crisis, with continued stress on the sovereign debt market leading to financial market volatility, enabled by a generalised loss of confidence by investors, and persistent risks of contagion.

Finally, one should also take into account the exceptional macroeconomic circumstances experienced in the euro area today- especially in the context the new economic downturn triggered by the Covid-19 pandemic and the measures taken by national governments to curb its spread- as they imply that banks are in part also victims of their environment and not always the culprits in economic crises. Like in the first years of the latest crisis, while punishing outliers can be justified, it could be argued that it makes sense to be more lenient towards ‘average’ banks, which tend to suffer relatively more from severe macroeconomic downturns.[48]

**8. Interaction of State aid and resolution rules**

As the Banking Union has been established, one key element that goes to its support is represented by the shift from bailout to bail-in. It is inevitable that someone must pay for the losses when banks make mistakes and find themselves on the brink of failure. The options available to this end would be sovereigns, shareholders and creditors, or the financial sector as a whole. Now, sovereigns cannot be the first choice, if the intention is that of breaking the vicious circle that ties them to the banking sector and reinforcing the protection of taxpayers. Then, if one decides that the burden of losses must be borne by shareholders and creditors, or by the financial sector, the consequences will be the application of bail-in and the use of resolution (or DGS) funds respectively.

Within this new scenario, State aid control will remain a central element of the Banking Union, as State aid rules will continue to be applied alongside the BRRD, in order to also ensure a level playing field between eurozone Member States and the other EU States that will not adhere to the Banking Union. Any kind of public financial support- uses of deposit guarantee schemes or resolution funds therein included- will be subject to State aid control and will need to comply with these rules, both within and outside resolution procedures. Moreover, any State aid measure or resolution scheme that calls for the use of the resolution fund will need prior approval from the Commission under State aid rules before it can be effectively granted or the scheme adopted.

[48] Dewatripont M., “European banking: Bailout, bail-in and state aid control”, 2014, International Journal of Industrial Organization, 34, C, 37-43.

### *8.1 Exceptions to the 'resolution rule'*

Under the BRRD, due to the particular decision taken by the co-legislators, the granting of any State aid support is relegated to exceptional and extraordinary circumstances, as it would imply that an institution is deemed to be failing or likely to fail, therefore triggering the resolution of the entity concerned. Thus, the granting of State aid to a bank would lead to its resolution, except for very specific circumstances and conditions.

As a matter of fact, three narrow exceptions to this general 'resolution rule' have been included in the BRRD: State guarantees to emergency liquidity assistance from central banks, State guarantees of newly issued liabilities, and precautionary recapitalisations. The latter exception should be interpreted very narrowly, since the general rule for banks in distress is that either liquidation or resolution should be applied, meaning that such precautionary injections into the bank involved can only be used to cover capital shortfalls identified under the adverse scenario of a stress test or similar supervisory exercises.[49] Where any of these exceptions are used, State aid rules are the only ones that apply. Therefore, under the BRRD, State aid can only be granted in resolution scenarios, with the only exceptions being the measures mentioned above. Public support is still available in principle, but only as a last resort. To this end, any use of resolution funds- including the Single Resolution Fund- must be in compliance with State aid rules.[50]

### *8.2 The role of the European Commission*

As from 1 January 2016, the Single Resolution Board (SRB) has taken over its responsibility for bank resolution within the Banking Union, but at the same time State aid control continues playing an integral role within the Union itself. More specifically, it is not for the Commission, but rather for the respective supervisor or resolution authority, to apply the existing EU law on the subject and start the resolution procedure for the bank in question. It is a responsibility of the

[49] An in-depth analysis of the precautionary recapitalisation option and its implications for banks' competition incentives and the competitive structure of banking markets is provided in Chapter 3 of this study.
[50] Article 19 SRMR establishes that the Commission will assess whether the use of the Single Resolution Fund is in line with State aid rules by issuing Decisions.

Commission, instead, to ascertain that State aid used in resolution procedures does not unduly distort competition in the market. This means that the SRB has effectively become the ‘privileged speaker’ and collaborator of the Commission in many resolution cases. Consequently, the two will need to work closely together, since a state aid decision must be taken by the latter before any draft resolution scheme that includes the use of the Fund can be adopted by the SRB on any specific case.

It is also important to recall that the Commission’s deliberations on the granting of public aid will always be based on the resolution scheme prepared by the SRB, which includes information on the exercise of bail-in powers. Therefore, its decisions, which will be taken by making all relevant State aid considerations, will not need to extend to the design of burden-sharing arrangements applicable to shareholders and creditors. Rather, the Commission will only have to assess whether the proposal made by the Board under resolution rules also abides by the requirement of sufficient burden-sharing under the State aid framework. While this may leave open some room for discussion between the competition and resolution authorities, there seems to be no inherent contradiction in the exercise of the two activities.

Still, the preconditions and the scope of burden-sharing to be shouldered by bank creditors under State aid rules do not fully coincide with the ones prescribed for resolution procedures. Thus, there is a need to verify whether the two sets of rules are appropriately coordinated. In addition, questions have been raised as to whether the guidelines on State aid to the banking sector take sufficient account of systemic stability considerations when imposing the conversion or write-down of creditor claims.[51] Indeed, there may not be absolute confidence in the fact that bail-in provisions will not hamper financial stability. To this end, it is also critical to prevent that even the fear of predictable bail-in operations induces bank investors to run. To be able to do so, it is of paramount importance that a sufficient long-term loss absorbency capacity be accumulated, so as to reassure short-term claimholders.

[51] Gardella A., “Bail-in and the Two Dimensions of Burden-Sharing”, 2 November 2015, ECB Legal Conference.

## 9. Bail-in introduction and implications

The academic debate on the implications of the introduction of bail-in within the new resolution framework is also developing. The first observation in this sense relates to the fact that a non-negligible risk of investor flight from the banking system exists in certain countries, which can potentially bring about repercussions for the Eurozone at large, resulting in a crisis that might eventually entail costs for the taxpayers that can be even higher than they would have been under the previous bail-out regime. The stabilising effects that are attended with the systematic introduction of the new burden-sharing and bail-in requirements would not be as easily attainable as expected and the crucial distinction that must be made lies between idiosyncratic bank shocks and systemic ones (Bruzzone et al., 2014; Persaud, 2014; Avgouleas and Goodhart, 2015; Gardella, 2015).

Some empirical studies are also starting to be carried out with the aim to provide quantitative estimates of the impact of the resolution tools that are now available after the introduction of the European framework for bank rescues on the costs that would need to be shouldered to solve a bank crisis. These works have been limited mainly to econometric simulation exercises, which, nonetheless, take quite well into account the tools introduced by the new norms. Schäfer et al. (2017) found that bailout expectations have been reduced since the introduction of the restructuring regime of the BRRD, mandating bail-in.[52] The FSB (2020) found evidence that credit spreads of holding companies (holdcos) of significant institutions have increased relative to their operating subsidiaries (opcos), suggesting that resolution reforms have become increasingly credible, which is also reflected in holdcos being rated less highly than their principal opcos after the implementation of the reforms.

As for the potential reduction in crisis costs brought about by the resolution framework, Benczur et al. (2016) model a micro-simulation of the impact of the combination of bail-in tool, resolution funds and Basel III capital requirements on bank loss mutualisation at EU level. According to their study the potential costs of a crisis similar to the latest one for public finances would decrease from approximately 3.7% of EU GDP, without any of the tools now available to 1.4%

[52] A similar conclusion was also reached by Bellia and Maccaferri (2020).

with the application of bail-in, and to 0.5% when all three of the modelled elements are considered simultaneously. This could be considered as being a hefty cost reduction.

According to these specific findings, bail-in would appear to be the one tool that contributes most to the reduction of the burden on public finances. This goes in support of the results obtained by Breuss et al. (2015), who find that bail-in is indeed effective in reducing the fall of GDP in the core countries of the eurozone, and thus brings about advantages from a macroeconomic perspective as well. Thus, preliminary empirical studies seem to point to the fact that bail-in provisions can potentially have a positive impact in trying to fight moral hazard, but Dewatripont (2014) argues that this must not mean that bank restructuring should be delayed, since this would end up raising the final cost of financial distress for taxpayers anyway, due to lower growth in GDP.

As for the broader social implications of the new rules, Götz and Tröger (2016) and Hadjiemmanuil (2017) makes the case for the exercise of discretion in the application of bail-in to particular cases like the Italian one, where there is a sufficient volume of bail-inable junior debt, but its positioning with small retail investors- especially families- makes it socially costly to write-down those securities for the purposes of bank restructuring.[53]

**10. Why a State aid control regulatory system is still relevant**

At the time of the global financial crisis, the State aid control system then in place was not properly geared to deal with the financial system specifically,[54] but the principles and mechanisms under which State aid granting is evaluated seem to

[53] On this aspect, however, the EBA and ESMA have highlighted that "*the presence of a large stock of retail holders does not in itself constitute an impediment to resolvability and does not per se justify an exemption under Article 44(3) of the BRRD or Article 18(3) of the Single Resolution Mechanism Regulation (SRMR)*". Therefore, where there is a material presence of retail investors such holdings must be given attention to in the resolution planning phase. Further, *"[a]n exemption [of such liabilities from the application of bail-in] would be justified, based on BRRD/SRMR provisions, if there are reasons to conclude that bailing in such liabilities would (i) not be possible within a reasonable timeframe, (ii) cause contagion, (iii) impair the continuity of the institution's critical functions or (iv) cause a disproportionate destruction in value. All these circumstances have to be regarded as exceptional"*. See the Statement of 30 May 2018 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).

[54] Collinet J.F., "State Aid in the Banking Sector: A Viable Solution to the 'Too big To Fail' Problem?", 2014, Global Antitrust Review, 7, 137-162.

have remained largely unvaried until today. However, given the new enriched regulatory framework that is now available for bank resolutions, the time is ripe to consider a re-evaluation of the State aid rules for the financial sector.

Some suggest that the way forward would entail the abandonment of the current State aid control rules for failing financial institutions in favor of a system that relies entirely on the use of resolution tools- bail-in at the forefront- to deal with significant banks in distress.[55] This argument is built on the fact that the introduction of a resolution instrument such as the bail-in should make a State aid control regulatory system lose relevance, insofar as banks would be pushed to self-insure by way of emission of bail-inable securities that can be called on to face potential crises. This should exclude the scenario of State interventions backed by public funds being used to rescue failing banks.[56]

However, recent examples of bank restructurings[57] demonstrate that a full shift towards bail-in, not relying on State resources, is very difficult to achieve, at least in the immediate future, and it may even be never fully possible. As such, the latest cases involving Italian, Greek, Cypriot and Portuguese banks in particular offer interesting insights on the continued relevance of the regulatory regime on State aid control as a complement to the newest resolution rules.

In addition, the unexpected economic downturn brought about by the governmental measures aimed at stemming the spread of the Covid-19 pandemic in Europe starting from the early months of 2020 has opened a scenario, according to which it is reasonable to assume that Member States would be ready to support banks in distress if a new crisis were to materialise in the short- to mid-term.

### *10.1 Public support in the context of the Covid-related crisis*

On March 19 2020, the Commission adopted a new Temporary framework for State aid to support the European economy in the context of the coronavirus

[55] Gordon J.N. and Ringe W.-G., "Bank Resolution in Europe: The Unfinished Agenda of Structural Reform", 2015, European Corporate Governance Institute (ECGI) - Law Working Paper No. 282/2015; Columbia Law and Economics Working Paper No. 507; Oxford Legal Studies Research Paper No. 4/2015.
[56] Ringe W.-G., "Bail-in between Liquidity and Solvency", 2017, University of Oxford Legal Research Paper Series, No. 33/2016.
[57] For instance, involving Italian banks Monte dei Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca, among others, analysed in depth in Chapter 5 of this work.

outbreak, based on Art. 107(3)(b) TFEU.[58] In acknowledging that the EU economy is experiencing a serious disturbance, the Temporary Framework enables Member States to make full use of the flexibility foreseen under State aid rules to support the economy, while aiming to limit negative consequences to the level playing field within the internal single market.

Point 7 of the Temporary Framework sets out that, if due to the Covid-19 outbreak, banks come to need direct support in the form of liquidity, recapitalisation, or impaired asset measures, the assessment of resolution and competition authorities will focus on addressing whether the measures meet the conditions of Article 32(4)(d) (i), (ii) or (iii) of the BRRD. At the same point, the Commission also clarifies that, in such an instance, the institutions concerned would not be deemed to be failing or likely to fail, implying that resolution would not be triggered. More importantly, insofar as such support measures would be needed to address problems linked to the Covid-19 outbreak, they would benefit from the burden-sharing exception of point 45 of the 2013 Banking Communication, which allows to spare shareholders and subordinated creditors from contributing to avoid endangering financial stability. This opens a short- to mid-term scenario in which bank failures might still need to be dealt with (at least partly) through public funds, in order to sustain the recovery of the private sector.

Yet, in addition to the difficulties stemming from the current economic downturn, national banking sectors still have to fully deal with some of the repercussions of the global financial crisis and past mismanagement- multiple financial institutions may be unable to comply with bail-in capital requirements within the imminent future and who actually holds bail-inable securities may imply significant social costs in the event of resolution. Indeed, the critical mis-selling and placement of bail-inable securities with “frail” investor categories (i.e. retail, such as families) must be addressed, as was made evident in recent resolution and rescue cases concerning Italian banks in distress, possibly through a restriction of the sale of bail-inable debt to retail investors.[59]

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[58] Communication C(2020) 1863 of 19 March 2020 from the Commission establishing a Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak.
[59] See: Götz M. and Tröger T.H., “Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in case of mis-selling?”, 2016, SAFE White Paper No. 35; C. Hadjiemmanuil, “Limits on state-funded bailouts in the EU bank resolution regime”, 2017, EBI

State aid control must cope with such difficulties, which should have ideally been prevented *ex ante*, but must now be dealt with *ex post* through the application of individual bank restructuring schemes. If triggering bail-in entails important social costs, for instance due to the involvement of retail investors and it brings about instability caused by ever-present and significant bank cross-holdings in bail-inable securities, one might argue in favor of a State aid control regime that allows for rescue measures to still be applied with public funds in an expedited manner.

Therefore, the application of the new integrated framework for bank resolution and State aid control suggests that the tension between the objectives of stability and competition is still very much a central factor in the rescue of institutions in distress, and it also affects banking markets, in terms of number, structure and ownership of market players after restructuring schemes are enacted.

It seems unlikely that a resolution system that purely relies on bail-in would be in the cards, at least in the short- and medium-term, due to the looming threat of a new banking crisis within the economic crisis triggered by the development of the Covid-19 pandemic, especially if an institution's distress were to be caused by generalised liquidity shortages or asset deterioration directly linked to the extension of Covid-related loans, due to the difficulties that banks would incur in accessing private capital sources when economic conditions are dire.

**11. Structure of the study**

The next chapters of this book delve into the details of the different resolution tools and other crisis management strategies made available by the current regulatory framework, in order to assess how are applied to deal with bank failures in practice, where some leeway for granting State funds has remained, and what are the potential implications in economic terms for the competitive conduct of banks in the market, with the final aim of putting forth some policy proposals to improve upon the credibility and sustainability of the framework.

More specifically, Chapter 2 addresses how the objectives of financial

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Working Paper Series 2017-No.2. The authors make a case for the exercise of discretion in the application of bail-in, taking into account those cases in which bail-inable securities are held by small retail investors, so as to minimise the social costs that a write-down of such securities would imply.

stability and competition have been balanced by the European Commission in authorising State support measures to failing banks during the global financial crisis, as well as analyse the interconnections between the rules on bank resolution with those on State aid control. This provides the background upon which the research is built. Chapters 3 to 6, instead, lay out the core of the analysis of this PhD study, by addressing in turn different tools and schemes made available by the crisis management regulatory framework.

Chapter 3 will focus specifically on precautionary recapitalisation, as an exception to resolution, and its implications for the competitive incentives and conduct of banks, as well as its implications for the credibility of the resolution framework overall. Chapter 4 will identify the competition-related implications arising both in resolution planning and at the stage of resolution execution, by detailing the characteristics of the different resolution tools that authorities can deploy, including the use of resolution funds and deposit guarantee funds in resolution. Chapter 5 will provide a detailed and updated examination of the latest cases of management of bank failures, which entailed different degrees of State support and different restructuring strategies for institutions, to explore how crisis management measures may affect bank structures and, as a consequence, the competitive structure of the markets in which they operate. Chapter 6 will detail the competition-relevant considerations stemming from the use of backstops for capital and liquidity assistance to banks in distress, while Chapter 7 will draw some overall conclusions from the analysis.

# Chapter 2: Financial Stability vs. Competition in Banking

## 1. Introduction

As highlighted in Chapter 1, the latest financial crisis, together with the subsequent sovereign and banking crises, have pushed governments to support a number of banks in distress by way of extensive bailouts shouldered by taxpayers.

European State aid control rules have been adapted along the years of the crisis and even later on, in order to cope with the rapidly evolving conditions of the European banking industry. The reform process developed during and after the financial crisis has tried to address major questions on what instruments can preserve stability best, while effectively avoiding competition distortions and tackling the problems posed by mismanaged banks.

In order to address the central question of this study, the bank rescue packages approved by the European Commission during the global financial crisis provide a natural starting point to assess how financial stability considerations were squared with competition ones in practice. In particular, a critical issue to assess is whether the rules on State aid and those on bank recovery and resolution are made flexible to allow Member States to adopt policy measures in the interest of preserving stability.

Studies tackling this issue rarely refer to the State aid control practice to assess whether it reflects the orientation of the legal rules in effect. Rather, scholars directly try to estimate the impact of banking competition or concentration on financial stability.[60] Moreover, another aspect that is generally overlooked in the

[60] This stream of literature is referred to as "empirical industrial organisation". Compare, among many: Hellman T.F. et al., "Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?", 2000, American Economic Review, 90, 1, 147-165; Demirgüç-Kunt A. and Detragiache E., "Does deposit insurance increase banking system stability? An empirical investigation", 2002, Journal of Monetary Economics, 40, 8, 1373-1406; Dam L. and Koetter M., "Bank Bailouts and Moral Hazard: Evidence from Germany", 2012, Review of Financial Studies, 25, 8, 2343-2380; Brandao-Marques L. et al., "International evidence on

literature is the wording of the relevant legal sources with reference to whether one objective (and possibly which one) must be prioritised.

In order to address this gap, an analysis of the European treaty provisions on State aid control will be carried out in this chapter. This will serve the purpose of identifying what is the legal relevance of addressing such a trade-off. In this sense, this study should hopefully set some of the basic building blocks for a State aid evaluation of bank rescue schemes in Europe.

Indeed, until now relatively limited importance has been attached to *ex post* evidence on what has been achieved with public funds or on the impact of State aid on competition, when applying EU State aid rules.[61] Nonetheless, it is essential for decision makers both at the national and EU level to consider the determinable results of State aid granted in the past, and the consequent lessons learnt. This will be helpful in improving the effectiveness of schemes financed with public funds and diminishing distortionary effects in the markets involved. It should also improve the efficiency of future schemes and, possibly, even future rules on State aid granting. This gains particular relevance in view of the introduction of the Temporary Framework for State aid to cope with the extraordinary crisis circumstances triggered by the Covid-pandemic. Indeed, if bank failures were to materialise as a result of the Covid-related crisis in the short- to mid-term, a scenario would arise in which public interventions would take foot anew to rescue financial institutions, without even imposing the application of burden-sharing measures (see Chapter 1). This will then raise questions regarding the safeguards and remedies which would be best suited to minimise distortions of competition.

For these purposes, the aid granting practice should be examined from the latest financial crisis, during which State aid grants significantly spiked,[62] to the

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government support and risk taking in the banking sector", 2013, International Finance Discussion Paper No. 1086, Board of Governors of the Federal Reserve System.

[61] European Commission, "Common methodology for State aid evaluation", Commission Staff Working Document, 28 May 2014, SWD (2014) 179 final. A part of the issue that is usually brought forth is the difficulty faced by governments in designing appropriate measures, which, in turn, makes them difficult for the Commission to assess. Yet, this particular argument sounds unsatisfactory. On this last point see: Collinet J.F., "State Aid in the Banking Sector: A Viable Solution to the 'Too big To Fail' Problem?", 2014, Global Antitrust Review.

[62] European Commission, "State Aid Scoreboard", autumn update, COM (2010) 701. Support directed at banks in the timeframe from October 2008 to October 2010 corresponded to approximately 39% of EU GDP. This proved to be a very sharp reversal in the trend of state aid

present day. Such analysis will need to be backed by an assessment of the progressive adjustment of State aid rules to address banks' distress. This will be instrumental to identifying why the State aid rules in place at the outset of the crisis were ill-suited to addressing the specificities of banks and an unprecedented systemic crisis.

In addition, heterogeneity in aid schemes must be taken into account. Hence, this work shall provide a description of the categories of aid that are made available by European rules concerning support to failing financial institutions. In addition, the anticompetitive effects that may result from the application of different schemes will be accompanied by an assessment of which stabilisation benefits that may bring about.

Having set the theoretical background, attention will be devoted to which remedial measures are imposed by the European Commission upon rescued institutions. Indeed, if one expects every aid scheme to bring about the same anti-competitive effects on the market, there should be evidence of the same remedial measures being requested of aided banks. This amounts to trying to answer whether the Commission's approach in this respect makes economic sense. The findings on this point should still complement the few existing studies, which appear to find that the Commission's control of public assistance to EU banks between 2008 and 2010 has had a positive impact on both financial stability and competition in the internal market.[63]

Lastly, attention will be brought to the adaptations made to European State aid control rules and how they interact with the new prescriptions on bank resolution. The aim will be to assess whether financial stability considerations still maintain a primary role with respect to competition concerns when a bank fails. This should raise the question of whether distinctions should be made in the application of bank restructuring and rescue measures, depending on the differences in stability concerns arising from idiosyncratic and systemic crises.

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granting, which had experienced an extreme low just before the crisis outbreak (from 1% of GDP in 1992 to 0.5% in 2007).

[63] See European Commission, "The effects of temporary State aid rules adopted in the context of the financial and economic crisis", Commission Staff Working Paper, 5 October 2011, SEC (2011) 1126 final; Koopman G.-J., "Stability and Competition in EU banking during the financial crisis: the role of State aid control", Fall 2011, Competition Policy International, Vol. 7 No.2.

## 2. Legal basis for state aid control in the financial sector and its adaptations

### *2.1. Treaty provisions on State aid control*

State aid control is unique to Europe and it is designed to maintain an even playing field between large and small economies, thus ensuring an equal treatment across countries and firms within the European single market. Principles referring to the control of state aid are enshrined in the treaties: articles of the Treaty of Lisbon ranging from 107 to 109 lay down the dispositions for the assessment of aids and the potential applicability of exemptions.

According to Article 107(1) TFEU, any aid that affects trade and distorts competition between Member States is unlawful, unless it falls within one of the exceptions provided in the second and third paragraphs of the same article. The *ratio legis* is straightforward on the basis of Article 3(1)(b) TFEU, which refers to the competition rules that are necessary for the establishment of the internal market.[64] Based on case law, distortions of competition are assumed to be present in most cases where selectivity in aid granting is shown.[65]

When appraising aid directed at firms in the credit sector, the relevant category of grants that "may be" compatible with the internal market is that of remedies to "a serious disturbance in the economy of a Member State" (Art. 107(3) letter b). Most of the measures taken after 2007 as a response to the unprecedented crisis situation have been approved on this basis.

### *2.2 State aid rules adaptation during the crisis*

In multiple instances the European Commission has confirmed to be aware of the peculiarity of the banking sector and the sensitivity of financial markets to one bank or another, which would warrant consideration when applying the rules on State aid. Likewise, even before the 2008 crisis broke out, the Commission had affirmed that the rules on State aid have to be applied to the banking sector by

[64] In particular, former Article 3(g) of the TEU highlighted the need for "a system ensuring the competition in the internal market is not distorted". Thus, even though state intervention favors some firms over others, thereby possibly having distortive effects in the market, it may be allowed as long as such distortion is not "excessive".

[65] On the existence of such a negative presumption, see: DG Comp Chief Economist Team, "The Economics of European State Aid Control", 2005, LEAR Conference on Advances in the Economics of Competition Law, Rome.

taking into account that an intervention can become necessary in order to avoid a systemic contagion and the emergence of panic in the financial markets.[66]

The Commission had already developed its experience in dealing with restructuring aid to ailing companies. State aid rules for this purpose were governed by the *Community guidelines on rescue and restructuring aid to companies in financial difficulties* (Rescue and Restructuring aid guidelines, "R&R").[67] These rules had been applied to bank restructuring cases in normal times.[68] However, they had remained untested for a situation of systemic crisis in the financial sector.[69]

In the context of the crisis and in relation to the financial sector, the Commission reviewed its rules. Nevertheless, the underlying principles of the R&R guidelines were confirmed: (i) restoration of long-term viability without State support; (ii) minimisation of the aid and adequate burden-sharing; (iii) measures to limit competition distortions.

The role of the financial system in providing funding to the whole economy and the possible systemic effects arising from the need for a number of European banks to restructure at the same time were also taken into account. In those circumstances, State intervention in banks' rescue and restructuring was driven by the vital need to ensure financial stability and restore market confidence.[70]

### *2.3 Crisis Communications*

The European Commission adapted the pre-existing R&R Guidelines to cope with a situation that required large amounts of support to be directed at banks in order to preserve the stability of the financial system. Six Crisis

[66] European Commission XXIV Report on Competition Policy of 1994.

[67] The Commission adopted its original Community Guidelines on State aid for rescuing and restructuring firms in difficulty in 1994 (1994/C368/02). Newer versions of the guidelines were introduced in 1999 (1999/C288/02) and 2004 (2004/C 244/02).

[68] See cases such as *Crédit Lyonnais,* C 26/95, 17 May 1995, *Banco di Napoli*, C 2495/98, 4 May 1999, *Bankgesellschaft Berlin,* C 28/2002, 14 June 2002.

[69] In spite of this, the Commission's decision in the *Crédit Lyonnais* case (*supra*) already evoked the potential systemic considerations stemming from the distress of even a single institution, acknowledging that "*[i]f factors beyond the control of the banks provoke a crisis of confidence in the system, the State may need to support credit institutions in order to avoid the damage which would be caused by a systemic crisis*".

[70] Bomhoff A., Jarosz-Friis A. and Pesaresi N., "Restructuring banks in crisis – overview of the applicable State aid rules", 2009, Competition Policy Newsletter no. 3.

Communications[71] were adopted for this purpose, taking into account the specificities of the banking sector. Taken together, they establish a comprehensive framework for coordinated action in support of the financial sector, so as to ensure financial stability while minimising distortions of competition between banks and across Member States.

The Crisis Communications, as well as the individual decisions on aid measures and schemes falling within their scope, were adopted on the basis of Article 107(3)(b) of the Treaty, which exceptionally allows for aid to remedy a serious disturbance in the economy of a Member State. Under the Crisis Communications, financial stability has been the overarching objective for the Commission, while also trying to ensure that distortions of competition between banks and across Member States were minimised. Financial stability considerations entail the need to prevent negative spillover effects that could flow from the failure of a single credit institution to the rest of the banking system. In addition, there is also a need to ensure that the banking system as a whole continues to provide adequate lending to the real economy.[72]

Moreover, the choice of soft law in the form of communications to execute the Commission's State aid responsibilities provides a politically palatable way to address government behaviour in what is a sensitive policy domain.[73] In this way, the Commission has effectively self-constrained its actions, stating how it would act in particular circumstances. Such self-binding was (and should remain) credible on

[71] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('2008 Banking Communication') (OJ C 270, 25.10.2008, p. 8); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication') (OJ C 10, 15.1.2009, p. 2); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication') (OJ C 72, 26.3.2009, p. 1); Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ('Restructuring Communication') (OJ C 195, 19.8.2009, p. 9); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2010 Prolongation Communication') (OJ C 329, 7.12.2010, p. 7) and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2011 Prolongation Communication') (OJ C 356, 6.12.2011, p. 7).

[72] See recital 7 of the 2013 Banking Communication.

[73] Doleys T., "Managing State Aid in a Time of Crisis: Commission Crisis Communications and the Financial Sector Bailout", 2012, Journal of European Integration, 34, 6, p. 549-565.

the grounds that failing to apply its own guidance would open the floor to legal challenge for violating the principle of legitimate expectations.[74]

## 3. Expectations on the anti-competitive effects of different State aid measures

It is also relevant to assess how different aid schemes were and still are addressed in practice, in accordance with the Commission's Communications. Indeed, potential distortions of competition resulting from aid schemes must be addressed. More precisely, State intervention in the banking sector can possibly entail: (i) the creation of an uneven playing field (with respect to bank cost of capital and the perception of safety and soundness); (ii) moral hazard, in the form of future excessive risk taking by the management and owners of the aided (and possibly also non-aided) banks; (iii) the distortion of the dynamic incentives to compete for non-aided firms; (iv) long-term effects in market structure; and (v) the protection of potentially non-viable institutions.

However, no State aid scheme is precisely the same. More specifically, public aid can be granted to financial institutions under four main forms: (1) guarantees on deposits, bonds, or the whole of a bank's liabilities; (2) recapitalisations; (3) "bad bank" solutions; and (4) nationalisations. Then, (5) other support measures can also amount to State aid. These will be addressed in the following paragraphs.

### *3.1 Government guarantees*

Guarantees were the first kind of aid scheme to be deployed for banks, with the purpose of improving funding access and restoring the liquidity of the wholesale

[74] Pursuant to established court practice, the right to rely on the principle of the protection of legitimate expectations applies to any individual in a situation in which an institution of the EU, by giving that person precise assurances, has led him to entertain well-founded expectations. On the judicial review of the 2013 Banking Communication relating to these aspects, see Tadej Kotnik and Others v. Državni zbor Republike Slovenije, C-526/14 of 19 July 2016 ECLI:EU:C:2016:570 (hereafter: Kotnik), Gerard Dowling and Others v. Minister for Finance, C-41/15 of 8 November 2016, ECLI:EU:C:2016:836 and Ledra Advertising Ltd and Others v. European Commission and European Central Bank, C-8/15 P of 20 September 2016, ECLI:EU:C:2016:701. In those cases, the CJEU held that the principle of legitimate expectations would not have protected the shareholders and subordinated creditors affected by the burden-sharing measures, due to the lack of precise, unconditional and consistent assurances. In its judgment the CJEU also posited that in areas such as State aid to banks, where EU institutions enjoy discretion, there cannot be a legitimate expectation that an EU institution will exercise its discretion in the same way in the future (see Kotnik, paras. 63-66).

market. Newly-issued[75] short- and medium-term debt instruments[76] are also eligible for guarantees, with a view to bolstering banks' solvency ratios and enabling them to continue lending to the real economy.

A guarantee can be granted *ad hoc* or in the context of a scheme. Under the latter scenario, eligible banks can enter into an agreement with the State, which would guarantee their newly-issued debt instruments, or specific bonds and loans. Such targeted guarantees must be appropriately remunerated through the payment of a fee to the State. In general, guarantees are used to cover the bank's short- and medium-term refinancing needs, thus having a limited duration, so as to restrict their use to the achievement of this specific purpose.[77]

### *3.1.1 Compatibility evaluation and remedies*

The Commission tends to authorise State guarantee measures as compatible with State aid rules, when the State remuneration is adequately embedded in the asset purchase price.[78] In addition, behavioural measures are required of aid beneficiaries to avoid distortions of competition. However, only some of the devised schemes that were approved during the financial crisis included restrictions on balance sheet growth[79] or made guarantees available only to solvent institutions.

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[75] Within six months, but this window-frame was extended as State aid rules were adjusted, see van Lambalgen (2018).
[76] With maturity from 3 months to three years.
[77] In most cases their duration is limited to six months. Sometimes, a provision is included for the Commission to evaluate a potential further extension to the scheme (up to a total of 36 months), depending on the needs of the specific institution concerned.
[78] Paragraph 21 of the Impaired Assets Communication stresses the fact that correct remuneration (guarantee fee) is an essential element of the burden-sharing requirement. In the case of Parex Banca (C 26/2009 of 15 September 2010), the Commission noted that "[*t*]*he objective of requiring remuneration (including, where applicable, a claw-back) is two-fold: to ensure burden-sharing and to ensure a level playing field*", thus minimising distortions of competition (para. 124). In the case of Anglo Irish Bank/INBS (SA.32504, 29 June 2011), no fee was applied for a guarantee on the basis of the fact that (i) the merged entity would only carry out the activities necessary to work out the loan book and (ii) both AIB and INBS would disappear from the Irish lending and deposit markets (para. 137).
[79] Cypriot guarantee scheme, SA.35499, 6 November 2012, para. 42; Danish guarantee scheme, NN 51/2008, 10 October 2008, para.26; Finnish guarantee scheme, N 567/2008, 13 November 2008, para.14; Greek guarantee scheme, N 560/2008, 19 November 2008, paras. 19 and 29; Italian guarantee scheme, N 520a/2008, 13 November 2008, para. 14; Dutch guarantee scheme, N 524/2008, 30 October 2008, paras. 14 and 41; Portuguese guarantee scheme, NN60/2008, 17 December 2008, para. 18; Swedish guarantee scheme, N 533/2008, 29 October 2008, para. 14; UK guarantee scheme, N 507/2008, 13 October 2008, paras. 12 and 21.

Some of them prescribed the application of restrictions on executive pay in aided institutions.[80]

### *3.2 Recapitalisations*

States can also decide to offer equity support to strengthen the capital base of financial institutions, by way of recapitalisations. A recapitalisation is completed with a capital injection into the failing bank, which is carried out either *ad hoc* or in the context of a scheme. Through such a programme, governments supply funds to banks in exchange for direct equity, preferred stock, subordinated debt or other hybrid capital instruments. This capital injection ensures that the beneficiary bank's compliance with regulatory capital requirements is restored. Indeed, in a situation of serious distress, banks may need fresh capital, which can be difficult, if not impossible to obtain due adverse to market conditions. With an eye to this issue, bank recapitalisations can improve the functioning and stability of the banking system and keep open financing flows to the economy.

The Commission takes into account the irreversible nature of capital injections, as it requires recapitalisation schemes to be accompanied by clear ex-ante behavioural safeguards on the side of the aided institutions. These must be monitored and enforced by Member States in order to avoid undue distortions of competition.[81] Such safeguards usually include: (i) balance sheet growth restrictions; (ii) acquisition bans; (iv) bans on advertising State support; (v) remuneration restrictions; and (vi) coupon or dividend bans.

#### *3.2.1 State remuneration*

Generally, the Commission has been reluctant to allow Member States to buy financial assets from banks, due both to valuation difficulties caused by the credit crisis and to a higher perceived risk of granting undue advantages to rescued

[80] Cypriot guarantee scheme, SA.35499, 6 November 2012, para. 42; Finnish guarantee scheme, N 567/2008, 13 November 2008, para.16; Hungarian guarantee scheme, N664/2008, 12 February 2009, para. 27; Irish guarantee scheme, NN 48/2008, 13 October 2008, para. 27; Latvian guarantee scheme, N 638/2008, 22 December 2008, para. 18; Dutch guarantee scheme, N 524/2008, 30 October 2008, paras. 12 and 44; Polish guarantee scheme, N 208/2009, 25 September 2009, paras. 19 and 23; Slovenian guarantee scheme, ; Swedish guarantee scheme, N 531/2008, 12 December, para. 14; Swedish guarantee scheme, N 533/2008, 29 October 2008, para. 17.

[81] For instance, competitors of Fortis Bank and KBC in Belgium and of ABN AMRO in the Netherlands complained that those banks introduced more aggressive offers after having benefited from capital injections by the Belgian, French, Dutch, and Luxembourg authorities.

banks.[82] However, the main difficulty with recapitalisation schemes concerns the calculation of the proper remuneration rate for the State granting the aid.[83] This difficulty stems from the diversity of objectives that can pursued through recapitalisation schemes. Indeed, such schemes may be aimed at: (i) avoiding the insolvency of individual credit institutions; (ii) strengthening banks' capital ratios to facilitate the recovery of inter-bank lending; and/or (iii) preventing a reduction in credit supply to the real economy.

*3.2.2 Remedies*

In turn, they may also raise different competition and systemic concerns, insofar as they may confer undue competitive advantages to the aid recipients or complicate the return to normal market functioning. In order to account for this variety of objectives and concerns, the Recapitalisation Communication points to two key elements which should be factored into the remuneration rate of capital injections, namely: (i) closeness to market prices; and (ii) exit incentives, i.e., incentives to redeem the State as soon as possible.[84] In turn, it introduces a distinction between fundamentally sound, well-performing banks, on the one hand, and distressed, less performing banks, on the other hand. The lower risk profile of the former category of institutions would justify a lower remuneration rate than for those belonging to the latter category.

The Commission takes into account the irreversible nature of capital

[82] In the case of Spain, the Commission's reluctance was overcome by limiting such purchases to highly rated covered bonds and asset backed securities by means of an auction process. See Commission press release IP/08/1630 of November 4, 2008: "State aid: Commission approves Spanish fund for acquisition of financial assets from financial institutions".

[83] On the calibration of State remuneration, the Recapitalisation Communication defers to the recommendations of the ECB recommendations of 20 November 2008: the rate of return for fundamentally sound banks should be based on a price corridor, with the rate of return on subordinated debt as a lower bound and the rate of return on ordinary shares as an upper bound. Distressed banks would require a higher remuneration, instead. However, remuneration is no longer an issue when State capital injections are combined, on equal terms, with significant participations (30% or more) by private investors. In those circumstances, the Commission accepts the remuneration set in the deal as reflecting the market price (Recapitalisation Communication, §21). The Lithuanian bank support scheme (cases N 200/2009 and N 47/2010, 5 August 2010) deviated from the ECB recommendations, by basing the remuneration on sovereign CDS spread rather than the bank one. The Commission approved it, since the remuneration exceeded the one that would have arisen from ECB recommendations (para. 104).

[84] Recapitalisation Communication, §19. It is in a similar vein that Art. 31 CRR should also be read. More specifically, the provision allows for some redeemable capital instruments to be included in CET1 capital instruments, with the aim of striking a balance between prudential requirements on capital adequacy and the need to ensure the temporary nature of public support granted.

injections, as it requires recapitalisation schemes to be accompanied by clear ex-ante behavioural safeguards on the side of the aided institutions, as indicated by the Restructuring Communication.[85] These must be monitored and enforced by Member States in order to avoid undue distortions of competition.[86] Such safeguards usually include: (i) balance sheet growth restrictions; (ii) acquisition bans or claw-back mechanisms, e.g. in the form of levies on the aid recipients; (iv) bans on advertising State support; (v) remuneration restrictions; and (vi) coupon or dividend bans. Banks are usually also prohibited from offering their customers terms (rates) that cannot be matched by their un-aided competitors. The latter prohibition may take the form of price-leadership clauses or limitations on the bank's position in league tables.[87]

Additional measures to limit distortions of competition are usually also required in the form of structural remedies. These can amount to divestments of stand-alone viable businesses, or carve-outs of business entities potentially capable of entering as new market players, which is especially relevant when the reference

[85] Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (OJ C 195, 19.8.2009).

[86] For instance, competitors of Fortis Bank and KBC in Belgium and of ABN AMRO in the Netherlands complained that those banks introduced more aggressive offers after having benefited from capital injections by the Belgian, French, Dutch, and Luxembourg authorities.

[87] Price leadership bans were generally imposed when the aid beneficiary was already in a "privileged" position in the market, creating the risk that the aid would enable them to adopt aggressive commercial practices. On the legal literature on State aid to banks, including also descriptions of price leadership bans, see Laprévote et al. (2017). Lyons & Zhu (2012) note that price leadership bans limit the beneficiary bank's ability to compete and, as a consequence, should also dilute rivals' incentives to compete. Dijkstra and Schinkel (2019) found evidence that the price-leadership bans imposed upon rescued Dutch banks shifted the Dutch mortgage market from a competitive to a collusive price leadership equilibrium. Price leadership bans were imposed with respect to: Fortis, (case NN 42/2008, 3 December 2008), Commerzbank (case N 244/2009, 7 May 2009), Northern Rock (case C 14/2008, 28 October 2009), ING (case C 10/2009, 18 November 2009), KBC (case C 18/2009, 18 November 2009), Landesbank Baden-Württemberg (case C 17/2009, 30 June 2009), Aegon (case N 372/2009, 17 August 2010), Sparkasse KölnBonn (case C 32/2009, 4 November 2009), ABN AMRO (case C 11/2009, 5 April 2011), OVAG (case SA.31883, 19 September 2012), Hypo Tirol (case SA.34716, 4 October 2012), DMA (with respect to Dexia, in the decision of 28 December 2012), FIH (case SA.34445, 11 March 2014). In the case of KBC, the Commission also made another relevant point, observing that a price leadership ban may not be necessary in markets where significant pro-competitive structural commitments have already been made, proving the interrelation of structural and behavioural commitments in stemming competition concerns. However, as also observed in the literature by Lyons & Zhu (2012), no clear pattern was followed by the Commission in imposing behavioural measures on pricing. Indeed, among the cases mentioned, different bans implied, alternatively, that (i) the bank could not offer more favourable rates than its cheapest or best priced competitors, (ii) could not offer more favourable rates than its largest competitors, (iii) or could not offer more favourable rates than the best priced competitor among the top 10 market players. From an analysis of more recent bank rescue cases, it seems that after the introduction of the 2013 Banking Communication (Section 5), the Commission is no longer requiring price leadership bans, possibly on the crest of criticism of such measures for the distortionary potential.

markets are relatively concentrated.

### *3.3 "Bad bank" solutions*

A specific form of loss absorption for institutions in distress can be achieved through the creation of so-called "bad banks". With the establishment of such entities, banks are granted a delay on reimbursements due to their creditors until the financial system stabilises once more and assets recover value. Bad banks can be privately held by the bank in trouble[88], the banking sector at large, or the State. Nevertheless, they are to all effects completely separate legal entities.

Relieving financial institutions of their impaired assets can contribute to a strengthening of their balance sheets, a renewal of access to liquidity and a reduction in leverage. The downside risk that *ex post* losses on the impaired assets will turn out to exceed *ex ante* expected losses is borne by the bad bank/SPV, i.e. possibly from the State. Hence, such measures allow the bank to remove uncertainty about possible future losses on a given portfolio of impaired assets and further rating migrations. This in turn frees up capital, as it no longer needs to be held to the same extent in order to cover possible unexpected losses. However, bad bank schemes raise fundamental competition policy problems also as regards the determination of the new book value of the transferred assets.

#### *3.3.1 Compatibility evaluation*

As for the compliance of asset relief measures with State aid rules, the Commission assesses such schemes under the Impaired Assets Communication, which lays down the methodologies for the valuation of the impaired assets, as well as the necessary State remuneration for the aid provided, and the reference criteria to evaluate the aid granted. Among all criteria set for State aid rules compliance, the Commission assesses how the measures implemented abide by requirements on *ex ante* transparency and disclosure of asset impairments.[89] The adequacy of the

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[88] As in the German bad bank scheme, in accordance with the "Bad Bank Act" that came into force on 23 July 2009 (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*). In particular, the Act set out three distinct models for asset relief: a special purpose vehicle (SPV), a federal law resolution agencies model and a state law resolution agencies model.

[89] Transparency is intended as vis-à-vis the Commission, as well as the national authorities and independent experts involved. In the case of Northern Rock (case C 14/2008, 28 October 2009), the Commission noted how this served the twofold purpose of identifying the amount of aid embedded in the asset relief measure and evaluating whether the aid addresses a temporary problem or the

burden-sharing of the costs related to the transfer of assets between the government and the bank's shareholders and creditors is also verified as part of the assessment. The Commission tends to consider the measures involving State guarantees and asset transfers as compatible with the internal market when the State remuneration is embedded in the asset purchase price. In line with the Commission's decision-making practice on asset relief measures, the assessment of the necessary remuneration for capital relief is based on a transfer at the real economic value (REV) of the portfolio at stake, even if lower than the actual transfer value. If the transfer price of the assets is equal or lower than the market value at the time of the transfer, the creation of an asset management company for the purposes of asset disposal does not imply State aid. Differently, when the transfer price exceeds the market price, the impaired asset measure involves State aid, and it can be declared compatible if the transfer price of the assets is not higher than their real (or underlying long-term) economic value.[90]

The REV of a portfolio can be estimated as the sum of the discounted expected cash flows accruing from holding the portfolio until maturity. In other terms, it corresponds to the net present value (NPV) of the stream of expected cash flows, reflecting the losses that can reasonably be expected to materialise over the remaining life of the assets, without considering market failures related to confidence crises resulting in liquidity shortages, excessive risk aversion or excessive product complexity. The appropriate discount rate (and risk premium) is then determined by relying on an estimation of cash flow volatility.[91]

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beneficiary bank is technically insolvent (para. 107). In addition, in the decision on Banka Celje/Abanka (case SA.38522, 16 December 2014), the Commission looked positively at the fact that independent consultants had been involved in the review the quality of assets within the 2013 Asset Quality Review exercise conducted at national level, and that the asset valuation had been performed by the Bank of Slovenia (para. 115).

[90] The burden-sharing principle requires that losses on impaired assets (i.e. the difference between the nominal value and the real economic value) are borne by the bank, rather than by the State. This is achieved through a write-down of the assets from their nominal value to their real economic value. See, as an example, impaired asset measures to the benefit of ING (case C 10/2009, 31 March 2009, para. 72) and Landesbank Baden-Württemberg (case C 17/2009, 30 June 2009, para. 75). Where impaired asset measures entail the use of asset guarantees, burden-sharing can be achieved through the retention of a first loss that would be commensurable to a write-down. This was highlighted, again, with respect to Landesbank Baden-Württemberg (case C 17/2009, 30 June 2009, paras. 75-76).

[91] Conceptually, the REV can be estimated by averaging the NPV over a long list of possible scenarios (for example through a Monte Carlo simulation). The different outcomes of the scenario analysis constitute a distribution of possible realisations that allows an assessment of the riskiness of

### 3.4 *Nationalisations*

In the case of nationalisations, instead, the State takes over all (or a significant part) of the assets of a bank in distress. In most cases, the aim pursued through such programmes is to recover banks' health, so as to hopefully return it to the private sector at a later stage.

However, a nationalisation in itself is not a form of State aid. Rather, the capital injected through into the troubled bank through nationalization measures can give rise to State aid concerns. Insofar as the capital injections can be assimilated to recapitalisations, the crucial requirements which banks are expected to abide by are those on adequate burden-sharing and State remuneration.

### *3.5 Other measures that may amount to State aid*

#### *3.5.1 Bond loan schemes*

Bond loan schemes are one form of measure available to bolster banks' liquidity position.[92] Banks usually obtain funds on the money market, where the main participants are other banks and the European Central Bank (ECB). However, if banks lack assets qualifying as eligible collateral, they may experience problems in obtaining funds on the money market. Such liquidity issues can be addressed through bond loan schemes, which entail a loan by the State of government bonds that can be used as collateral in interbank and refinancing transactions of the ECB, to enable the aid beneficiaries to tap into the money market for liquidity. In this respect, the Commission explained that the economic effect of such schemes is similar to that of guarantees, thus calling for the application of a fee calculated in the same manner as guarantee fees.[93]

#### *3.5.2 Emergency liquidity assistance*

Central banks can provide emergency liquidity assistance (ELA) to failing banks, acting as a lender of last resort (LOLR). Within the Eurozone, the decision to grant ELA is at the discretion of national central banks, but the ECB has veto power

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the underlying portfolio (the uncertainty around the expected loss and the tail risk, i.e. the probability of ending up with very large losses).

[92] These were introduced by Greece (bond loan scheme), Cyprus (special government bonds scheme) and Poland (support measures related also to treasury bonds).

[93] See case N 560/2008 for the Greek bond loan scheme.

on such decisions. This raises the question whether ELA can be considered as a national measure and whether it constitutes State aid. The Commission has held that liquidity assistance does not constitute State aid, if the following cumulative conditions[94] are met:

i) the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package;
ii) the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value;
iii) the central bank charges a penal interest rate to the beneficiary; and
iv) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

ELA is discussed in detail in Chapter 6 of this work.

*3.5.3 Deposit guarantee schemes*

In several cases concerning State aid to banks, Deposit Guarantee Schemes (DGSs) are also used to rescue and restructure ailing credit institutions. Since DGSs are designed for the protection of retail depositors and are limited to a fixed maximum threshold amount, they do not generate any State aid issue. However, when a deposit protection fund is used to bail out a bank, EU State aid control rules actually apply.[95]

In addition, DGSs are often financed through contributions of the banking industry. This raises a question of whether DGS-related support measures involve State resources. The determinant factor to discern this is whether the funds

[94] Codified in point 51 of the 2008 Banking Communication and reprised in point 62 of the 2013 Banking Communication.
[95] This concerned the cases of *Banesto* (case M 455/1994) and *Banco di Sicilia* (case C 16/1998), for instance. More recently, See also Tercas (case SA.39451, 23 December 2015, paras. 41 and 112). The General Court overturned the decision of the Commission in the Tercas case, as (i) the aid granted to Tercas had a purpose other than the repayment of the depositors of a bank placed under compulsory liquidation procedure and did not fulfill a public law mandate, but rather the intervention was in the interest of the DGS members; (ii) the DGS was a private law consortium whose corporate bodies were appointed by the general meetings of its members, thus having no structural link with public authorities; and (iii) the Bank of Italy did not have power to require the DGS to grant financial support to ailing banks and there was no definite proof that its representatives influenced the DGS's decision to intervene. Other cases in which DGS funds were involved in bank restructurings in the recent past include NordLB (case SA.49094, 5 December 2019), as well as Italian Carige Banca and Banca Popolare di Bari (cases discussed in detail in Chapter 5).

employed for the aid measure are under public control.[96] This is the case, for instance, when the contributions are compulsory under State legislation and are managed in accordance with it.[97] In that regard, the Commission has held that "the mere fact that resources are financed in part by private contributions is not sufficient to rule out the public character of those resources since the relevant factor is not the direct origin of the resources but the degree of intervention of the public authority within the definition of the measure and its method of financing".[98]

### 4. How did the Commission strike the balance between stability and competition during the financial crisis?

Guarantees, recapitalisations and impaired asset measures deployed during the crisis years aimed to (i) restore the viability of beneficiary banks; (ii) underpin the supply of credit to the real economy; and (iii) reduce counterparty risk, thus preserving financial intermediation activities impacting upon the real economy. More particularly, the objective was to remove uncertainties around banks' assets exposures, while improving banks' solvency position and access to market funding, and to avoid negative feedback loops, whilst increasing bank lending to the real economy.

As a matter of fact, despite capital injections, uncertainties regarding the exposure of banks continued to undermine confidence in the banking sector and weakened the effect of the government support measures. Then, the complexity of several bank structured securities and the asymmetric information problems that came with it, together with widespread financial panic and the drying up of funding channels, led to excessively low market values for bank assets, overshooting expected losses.[99]

Another market failure that aid measures aimed to tackle was the possible feedback loop between the real economy and the financial sector, giving rise to contagion and second-round effects. Given banks' approach of targeting relatively

[96] Compare AB Ukio Bankas, case SA.36248, 14 August 2013, para. 55; Magyar Kereskedelmi Bank, case SA.40441, 16 December 2015, para. 82. See also Asimakopoulos (2019) in relation to the Tercas case.
[97] Compare case N 407/2010, 30 September 2010, para. 28; case SA.36248, 14 August 2013, para. 54; case NN61/2009, 29 June 2010, para. 97.
[98] Banca Romagna Cooperativa, case SA.41924, 2 July 2015, para. 36.
[99] Krishnamurthy A., "How Debt Markets Have Malfunctioned in the Crisis", 2010, Journal of Economic Perspectives, 24(1), p. 3 – 28.

stable capital and leverage ratios, when losses occur, available capital decreases and leverage increases. In the absence of private capital providers, banks will tend to sell assets or stop renewing or rolling over loans, in order to restore their original leverage levels. This puts downward pressure on the asset prices, prompting a further round of losses, which may trigger yet another round of asset sales. These negative externalities hamper the supply of credit to the real economy.[100]

### *4.1 Assessment of aid compatibility*

In accordance with the Restructuring Communication, in order to be compatible with the internal market under Article 107(3)(b) TFEU, the restructuring of a financial institution must: lead to the restoration of the long-term viability of the bank; include a sufficient own contribution (burden-sharing) by the aid beneficiary itself; and contain sufficient measures that limit any distortion of competition. To this end, the Commission conditioned the authorisation of rescue schemes and individual measures to a range of behavioural and structural conditions. Among these were: divestitures of non-core business activities and other downsizing; commitments to prevent distortive behaviour by the rescued bank; and replacement of senior management, sometimes combined with the setting of salary caps. When burden-sharing could not be ensured ex ante institutions were bound to contribute at a later stage with the introduction of claw-back clauses and the completion of in-depth restructuring.[101]

In general, these conditions impacted different actors including shareholders, other investors, managers and the beneficiary institution itself. The fact that the EU State aid control system has provided for restructuring measures, also produced the side effect of avoiding moral hazard, in addition to protecting

[100] Adrian T. and Shin H., "Liquidity and Leverage", 2010, Journal of Financial Intermediation, 19(3), p. 418–37.

[101] For example, see the decision on asset guarantees to the benefit of BayernLB (case SA.28487, 5 February 2013), where the Commission required a claw-back to reimburse the amount above the REV covered by the guarantee (para. 147), and allowed the claw-back to be completed over a timespan of six years (paras. 148-150). As for the imposition of far-reaching restructuring, instead, an example is offered in relation to UNNIM Banc, to which the Spanish State had granted an asset protection scheme (case SA.33733, 25 July 2012). In that instance, the Commission deemed that a claw-back clause would have been incompatible with the sale of the bank to a third party, since the bidders in the tender offer would have been compensated in advance the potential cost of the claw-back, by incorporating demands on additional support measures in their offers (para. 132). Therefore, in-depth and far-reaching restructuring was required instead to approve the measure as compatible with the burden-sharing principle (para. 133).

competition. This additional benefit entails that the incentives of bankers to take excessive risk in the expectation of a bailout should have been limited.[102]

The rationale of these counter-measures requested of aided banks was to reach a tentative approximation of the "normal" market conditions that would have occurred in the absence of State aid. As a general objective, the rules on banks' restructuring aimed to balance short-term financial stability and long-term concerns for the preservation of normal market functioning, a single market in financial services and undistorted competition.

This balance also reflected the development and evolution of the crisis. Indeed, at the beginning of the financial turmoil, safeguarding financial stability was the overarching objective. Therefore, a wide range of rescue measures, comprehensive of loans, guarantees and recapitalisations, were temporarily allowed. However, the objective of restoring financial stability in effect ruled out the possibility for the Commission to prohibit the proposed rescue measures. As a matter of fact, with the crisis framework the Commission departed from the "one time, last time-principle" for the granting of rescue aid.[103]

### *4.2 Different forms of burden-sharing*

Conditions for access to aid measures were laid down in order to ensure a coordinated approach and a level playing field, but this was only partially achieved. Indeed, the Commission has shown some differentiation among aid schemes in requiring slightly different remedial measures depending on the type of aid deployed.[104] However, eligibility requirements for access to aid were mostly left to the discretion of the single Member States. The underlying intention was to accommodate and reflect country- or institution- specific circumstances.[105]

More specifically, burden-sharing by shareholders, as well as hybrid and

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[102] Vives X., *Competition and Stability in Banking: the Role of Regulation and Competition Policy*, 2016, Princeton University Press.
[103] Point 7 of the Restructuring Communication stipulates that provision of additional aid during the restructuring period should remain a possibility if justified by reasons of financial stability.
[104] Capital injections were accompanied by stronger behavioural commitments by aid beneficiaries, in view of their irreversibility. The approval of guarantees and asset relief schemes, instead, was more reliant on the application of a proper State remuneration.
[105] Gerard D.M.B., "Managing the Financial Crisis in Europe: The Role of EU State Aid Law Enforcement ", in M. Merola M., Derenne J. and Rivas J. (eds.), *Competition Law at Times of Economic Crisis - In Need for Adjustment?*, 2013, Bruylant, Brussels.

subordinated debt holders took different forms. As for shareholders, these encompassed: (i) dilutions;[106] (ii) write-downs[107]; (iii) capital raising;[108] (iv) being left at the bad bank, in case of entity separations;[109] (v) nationalisations;[110] or even (vi) dividend bans.[111] As for hybrid and subordinated debt holders, instead, burden-sharing was completed[112] by means of: (i) liability management exercises (LMEs)[113]; (ii) being left at the bad bank, in case of entity separations[114]; or (iii) coupon bans.[115]

### *4.3 Discretion in the choice of remedial measures*

The Commission also endeavoured to leave a margin of discretion to Member States in devising remedial measures to avoid or correct distortions of

[106] The most common burden-sharing mechanism, which 'penalises' shareholders by heavily reducing their stakes (possibly until complete wipe-out). See some examples in: Dexia (case C 9/2009, 26 February 2010, para. 200); Aegon, N 372/2009, 17 August 2010, para. 110); SNS REAAL (case N 371/2009, 28 January 2010, para. 77); Catalunya Banca (case SA.33103, 28 November 2012, para. 82); Allied Irish Banks/EBS (case SA.29786, 7 May 2014, para. 121); Bank of Ireland (case N 546/2009, 15 July 2010, para. 216); Royal Bank of Scotland (case N 422/2009, 14 December 2009, para. 216).

[107] See Kaupthing Bank Luxembourg, case N 344/2009, 9 July 2009, para. 72.

[108] Capital raising can be a form of burden-sharing insofar since it entails additional capital contributions from shareholders. See, as examples, the cases of Landesbank Baden-Württemberg (case C 17/2009, 30 June 2009, para. 97), NordLB (case SA.34381, 25 July 2012, para. 156).

[109] This implies that shareholders lose control of the bank and their stakes in it without financial compensation. Among others, see Amagerbanken (case SA.33485, 25 January 2012, para. 125).

[110] Entailing acquisition of control by the State through a complete wipe-out of existing shareholders. Among others, this was enacted, among others, for Northern Rock (case C 14/2008, 28 October 2009, para. 149), Anglo/INBS, (case SA.32504, 29 June 2011, paras. 165-166), Banco Português de Negócios (case SA.26909, 27 March 2012, para. 18: "*nationalised [...] at zero price*"), Parex Banka (case C 26/2009 of 15 September 2010, para. 53) and Hypo Real Estate (case C 15/2009, 18 July 2011, para. 121).

[111] Among others, see FIH (case SA.3444511, 11 March 2014, para. 133), Royal Bank of Scotland (case N 422/2009, 14 December 2009, para. 217). KBC (case C 18/2009, 18 November 2009) offers a specific example of burden-sharing of shareholders can only be reconducted to a dividend ban, as no other explicit mention to burden-sharing is made in the Commission's decision.

[112] In a number of cases, the Commission's decision did not make any mention of burden-sharing by subordinated shareholders. This applied to: SachsenLB (case C 9/2008, 4 June 2008); Fortis (case NN 42/2008, 3 December 2008); IKB (case C 10/2008, 21 October 2008); WestLB (case C 43/2008, 12 May 2009); Kaupthing Bank Luxembourg (case N 344/2009, 9 July 2009); UNNIM Banc (case SA.33095, 30 September 2011); Quinn Insurance (case SA.33023, 12 October 2011); FHB (case C 37/2010, 22 February 2012).

[113] See, as examples, Bank of Ireland (case N546/2009, 15 July 2010, para. 217) and Allied Irish Banks/EBS (case SA.29786, 7 May 2014, para. 122), where subordinated debt was bought back by the banks involved at a discount over the instruments' book value.

[114] Examples include Northern Rock (case C 14/2008, 28 October 2009, para. 150); Dunfermline (case NN 19/2009, 25 January 2010, para. 120); Parex banka (case C 26/2009, 15 September 2010, para. 148) and TT Hellenic Postbank (case SA.31155, 16 May 2013, para. 51).

[115] Cases include, among others, ABN AMRO (case C 11/2009, 5 April 2011, para. 315); Bank of Ireland (case SA.33443, 20 December 2011, para. 160); Banco Português de Negócios (case SA.26909, 27 March 2012, para. 239). On the ban of coupon payments, BAWAG (case N 640/2009, 22 December 2009) offers a surprising example, as the coupon ban appears to have been deemed by the Commission as sufficient means to absolve burden-sharing requirements.

competition arising from aid granted. Remedial measures ranged from structural measures (e.g. sale of assets or subsidiaries) to behavioural constraints (e.g. acquisition bans, price leadership bans, bans on advertising on the back of state support). Such measures were imposed not only to limit distortions between aided and non-aided banks, and between banks in different Member States, but also create conditions for the development of competitive markets after the crisis.[116]

Structural remedies, which serve the purpose of reducing the market presence of the aid beneficiaries[117], took different forms, encompassing (i) divestments[118], (ii) downsizing[119] (either through balance sheet reductions[120] or reductions of branches and staff[121]), and (iii) focus on core activities.[122] Behavioural constraints also varied across rescue schemes. More specifically, with respect to recapitalisation schemes, (i) restrictions on remuneration[123] and (ii) bans on advertising the receipt of State aid[124], were imposed with the highest frequency, followed by (iii) dividend and coupon bans[125], (iv) acquisition bans[126], and (v)

[116] Point 32 of the 2009 Restructuring Communication highlighted that the balance of structural and behavioural remedies to aid was to be struck in consideration of the size and the relative importance of the bank on its market, and the measures must be tailored to market characteristics (i.e. concentration levels, capacity constraints, the level of profitability, barriers to entry and to expansion), in order to preserve competition.

[117] This is particularly relevant in cases where the aided bank continues to exist as a standalone entity after rescue, rather than in rescues that split institutions into more entities, for instance, as, in the latter case a downsizing of the beneficiary should already occur by virtue of the rescue itself.

[118] As examples: Lloyds (case N 428/2009, 18 November 2009); ING (case C 10/2009, 18 November 2009, para. 143); Royal Bank of Scotland (case N 422/2009, 14 December 2009).

[119] In instances where the aided banks were small, the Commission waived downsizing, on the assumption that the limited size would limit competition distortions. As an example, see T Bank (case SA.34115, 16 May 2012, para. 56).

[120] As examples: ING (case C 10/2009, 18 November 2009, para. 143); HSH Nordbank (case SA.29338, 20 September 2011, para. 266); Bank of Ireland (case SA.33443, 20 December 2011, para. 179).

[121] See, Lloyds (case N 428/2009, 18 November 2009) as an example of imposition of branch divestments; ING (case C 10/2009, 18 November 2009) and Royal Bank of Scotland (case N 422/2009, 14 December 2009) for internal headcounts.

[122] To overhaul the strategic direction of the beneficiary with a view to ensuring its viability (see, in this sense, BayernLB - case SA.28487, 5 February 2013, para. 50) or to free up liquidity and fund the restructuring (WestLB - case C 43/2008, 12 May 2009, para. 77).

[123] Making State aid less attractive, by restricting the remuneration of beneficiaries' senior management. Such remedies were imposed in almost all State-wide recapitalisation schemes, with the exception of Austria, Portugal and Spain.

[124] Aimed at preventing institutions from using the aid to expand their activities. See, as examples: Greek recapitalisation scheme (N 560/2008, 19 November 2008); German recapitalisation scheme (case N 625/2008, 12 December 2008); Polish recapitalisation scheme (case N 302/2009, 21 December 2009).

[125] With the aim of incentivising banks to reimburse the capital injected: see the Slovak bank support scheme (case N 392/2009, 8 December 2009, para. 65) and the Greek bank support scheme (case N 560/2008, para. 61).

limitations on balance sheet growth.[127] Guarantee schemes, instead, were mostly accompanied by combinations of advertising bans, remuneration restrictions and balance sheet growth limitations.[128]

Table 2.1 summarises the conditions for the approval of different aid schemes by the Commission, prior to the update of State aid requirements (Section 5). Annex 3, instead, provides a structured overview of the remedies and burden-sharing measures required for aid schemes approved after the BRRD came into force.

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[126] See, among others: the Spanish recapitalisation scheme (case N 28/2010, 28 January 2010); the Portuguese new recapitalisation scheme (SA.34055, 30 May 2012); KBC (case C 18/2009, 18 November 2009); Lloyds (case N 428/2009, 18 November 2009).

[127] Only applied in the context of the Greek and UK recapitalisation schemes (respectively, case N 560/2008, 19 November 2008 and case N 507/2008, 13 October 2008).

[128] See, among others, the Swedish guarantee scheme (case N 533/2008, 29 October 2008), the Dutch guarantee scheme (case N 524/2008, 30 October 2008), the Finnish guarantee scheme (case N 567/2008, 13 November 2008), the Cypriot guarantee scheme (case SA.35499, 6 November 2012).

***Table 2.1 - Compatibility and remedies related to different aid measures***

| **Aid** | **Compatibility** | **Remedies** | |
|---|---|---|---|
| | | **Structural** | **Behavioural** |
| **Guarantees** | State remuneration | | - Advertising ban<br>- Acquisition ban<br>- Dividend/coupon ban<br>- Balance sheet growth limitation<br>- Remuneration restriction<br>- Pricing restrictions |
| **Recapitalisations** | Burden-sharing<br>State remuneration | - Divestments<br>- Balance sheet reductions<br>- Reduction of branches and staff<br>- Focus on core activities | - Advertising ban<br>- Acquisition ban<br>- Dividend/coupon ban<br>- Balance sheet growth limitation<br>- Remuneration restriction<br>- Pricing restrictions |
| **Impaired Assets Measures** | Discount (valuation)<br>State remuneration | - Divestments<br>- Downsizing<br>- Focus on core activities | - Advertising ban<br>- Acquisition ban<br>- Dividend/coupon ban<br>- Balance sheet growth limitation<br>- Remuneration restriction<br>- Pricing restrictions |

*Source:* own elaboration

Such flexibility in approach has been a key element in the Commission's strategy to use competition law enforcement as a means for stabilisation. In particular, the Commission has endeavoured to provide legal certainty to market operators by acting swiftly according to exceptional procedures. The aim in taking such a stance was to restore confidence in the market, on the one hand, while preserving the possibility and legitimacy of its own role in the management of the crisis.[129]

To sum up, the severity of the crisis pushed the Commission to extensively approve bank rescue plans, in an attempt to stabilise the financial system and

[129] See s*upra* note 104.

restore market confidence. In order to minimise competition distortions to some extent, behavioural and structural measures were required of aided banks, trying to mimic "normal" market conditions somehow. However, when the burden-sharing of the costs of failure from the banks themselves was deemed difficult to achieve, more leniency was applied to allow aided banks to "make up" *ex post* for the aid received. This flexibility in approach also served the purpose of keeping the Commission stably in control of its crisis management role.

However, the stabilisation objective effectively ruled out more in-depth economic analysis regarding the impact of rescue measures on banking market structure and competition. The choice to leave some discretionality to Member States also led to differences in approach and reach of the rescue measures adopted. This is likely to have had different consequences on market structures in different countries, possibly reinforcing the already existing structural differences among banking sectors.

**5. State aid control rules update: 2013 Banking Communication**

After the critical phase of the financial crisis, one would expect the balancing of the objectives to start tilting towards the creation of conditions for the return to normal market functioning, since risks to financial stability have decreased. In this vein, the Commission's new Banking Communication of 10 July 2013[130] provided the latest amendment of the state aid framework for bank restructuring.

It lays down the ground rules for a "new normal" in State aid rules applicable to instances where bank support is needed. One could argue that its enhanced burden-sharing regime marks the distancing from the heavy reliance upon bailouts, impinging on already-deteriorated public finances, in favour of a shift towards more extensive use of bail-in tools.[131] Burden-sharing means that any aid is

[130] Communication from the Commission on the application, from 1 August 2013, of updated State aid rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication") (2013/C 216/01).

[131] On the strengthening of burden-sharing, see point 13 of the 2013 Banking Communication: "*The adapted Crisis Communications can also ensure more decisive restructuring and stronger burden-sharing for all banks in receipt of State aid in the entire single market*"; and again point 41 more specifically recites that "*adequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid*

kept to a minimum, and the bank and its capital holders contribute to the restructuring costs as much as possible with their own resources.[132] This should contribute to addressing moral hazard and creating appropriate incentives for their future behaviour. As moral hazard is tackled, the assumption is that the reduced need for aid will in turn lessen competition concerns.

### *5.1 Assessment of compatibility*

The assessment of the compatibility of aids still relies on balancing their negative effects on trade and competition in the common market with the positive effects in helping to achieve well-defined objectives of common interest. Balancing these effects takes into account the impact of the aid on the social welfare of the EU. Such a balancing exercise is aimed at checking whether a specific aid measure is necessary in the public interest, whether it produces an incentive effect (i.e. the aid solves the problem), and whether it is proportionate to address the problem (i.e. the same result could not have been achieved with less aid and in a shorter time horizon).

Thus, when it is necessary and proportionate in order to address market failures, aid measures may be considered compatible with the common market. The European Commission has wide discretion in such compatibility assessment,[133] but its decisions remain subject to review by the EU Courts. Such assessment must involve "the appreciation and weighting of different elements of an economic and social nature within a pan-European context". However, due to a lack of legislative power, the Commission cannot lay down general and abstract binding rules

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*capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent. Such contributions can take the form of either a conversion into Common Equity Tier 1 or a write-down of the principal of the instruments*". This is certainly more definite than the provision embedded in the 2008 Banking Communication, which laid down the following in point 22: "*Aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources*."

[132] Indeed, write-down of subordinated and hybrid debt holders took hold as a burden-sharing mechanism after the introduction of the 2013 Banking Communication, which increasingly aligned approaches to rescues. Cases imposed a "wipe-out" or "full write-down", aligning the treatment of such instruments to equity, in this respect. Only some of the many examples in this regard include: Nova Ljubljanska Banka (case SA.33229, 18 December 2013, para. 154); SNS REAAL (case SA.36598, 19 December 2013, para. 92); Banif (case SA.43977, 21 December 2015, para. 131); Abanka (case SA.38228, 13 August 2014, para. 140).

[133] Granted in line with art. 108(3) TFEU, as acknowledged by the European Court of Justice in the *Kotnik* case (Case C 526/14).

governing which aid may be considered compatible with the internal market on the grounds of Art. 107(3)(b) TFEU.[134] Rather, an act of 'soft law' such as the Banking Communication will not be *de jure* or *de facto* binding upon Member States[135], thus entailing that "a Member State might be able to show that, despite the lack of burden-sharing (or the non-fulfilment of any other criterion laid down in the Banking Communication), aid to an ailing bank still meets the requirements of Article 107(3)(b) TFEU".[136] It would then be for the Commission to analyse the aid's compatibility on the basis of the principles of the Treaty.

The framework developed with the interpretation of Art. 107(3)(b) was explicitly designed as a temporary response to the crisis. Still, it continues to apply in revised form on the grounds that "stress in financial markets and the risk of wider negative spillover effects persist". However, as the market conditions have changed, the premise that practically all banks need to be rescued is not viable anymore. Thus, there is less need for structural rescue measures granted solely on the basis of a preliminary assessment, while postponing the in-depth assessment of the restructuring plans to a later stage.

### *5.2 Restructuring plan requirement*

Indeed, the new Banking Communication establishes the principle that recapitalisation and impaired asset measures will be authorised only after approval of the bank's restructuring plan. In light of this, public recapitalisation schemes are in principle not available in accordance with the Communication, unless they are aimed at small institutions or are such as to preserve financial stability. Recital 7 of

[134] Opinion of Advocate General Wahl in *Kotnik*, para. 36-37.
[135] For a discussion on this point, see also Bouchagiar (2017).
[136] *Ibid.*, para. 44. For Advocate General Wahl, this could happen in case the proposed solution would be less costly than burden-sharing measures for reasons related to procedural obstacles. For instance, in the case of Caja Castilla-La Mancha (NN 61/2009, 29 June 2010) due to legal constraints, subordinated debt holders had to be transferred to the acquiring entity. So, in order to ensure burden-sharing, the acquirer was bound to an obligation not to exercise any call options during the period it enjoyed financial support from the Spanish Deposit Guarantee Fund. Another example is offered by SNS REAAL (case SA.36598, 19 December 2013): considering the involvement of separate legal entities with their own capital position and particular commitments on capital transfers, the Commission accepted the non-application of burden-sharing to the hybrid debt-holders of REAAL Insurance (para. 92). In other instances, the lack of burden-sharing by subordinated debt holders can be justified by the fact that no outstanding subordinated debt instruments remains in the banks, which automatically makes the application of write-down or conversion impossible to conduct (see Magyar Kereskedelmi Bank, case SA.40441, 16 December 2015; Cooperative Central Bank, case SA.43367, 18 December 2015). Therefore, the latter instances would not amount to an application of the burden-sharing exception.

the preamble to the Communication highlights that "financial stability remains of central importance in the Commission's assessment of State aid to the financial sector […]". Thus, the Commission appears willing to approve national support measures for reasons of financial stability and the objective of financial stability may justify a financial institution's access to State aid. However, it also requires that such aid is limited to the minimum necessary and it is granted only after appropriate contributions by the banks' shareholders and creditors are made.

### *5.3 Reinforced burden-sharing*

A somewhat flexible interpretation of the Commission's discretion may justify extensive precautionary recapitalisations of weak banks without making use of the bail-in tool if the banking system of a specific Member State is extensively undercapitalised and there are no private capital sources that can remedy the situation.[137] A precautionary recapitalisation consists in the injection of State funds into a solvent bank when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure conditional on final approval under the EU State aid framework, without triggering the resolution of the bank. A more detailed analysis on precautionary recapitalisations will be made in Chapter 3.

Further indications on the contributions that the banks and their shareholders must make are laid down in recital 19 of the Banking Communication, which states the following:

*"Before granting any kind of restructuring aid, be it a recapitalisation or impaired asset measure, to a bank all capital generating measures including the conversion of junior debt should be exhausted, provided that fundamental rights are respected and financial stability is not put at risk. […] Therefore, before granting restructuring aid to a bank Member States will need to ensure that the bank's shareholders and junior capital holders arrange for the required contribution or establish the necessary legal framework for obtaining such contributions."*

[137] On these points see, among others: Micossi S., Bruzzone G. and Cassella M., "Fine-Tuning the Use of Bail-in to Promote a Stronger EU Financial System", CEPS Special Report No 136, April 2016; Hadjiemmanuil C., "Limits on State-funded Bailouts in the EU Bank Resolution Regime", EBI Working Paper Series 2017 - no.2.

Moreover, recital 11 clarifies that:

*"In its assessment of burden-sharing and measures to limit distortions of competition the Commission assesses the feasibility of the proposed measures, including divestments, and their impact on the market structure and entry barriers. At the same time, the Commission has to ensure that solutions devised in a particular case or Member State are coherent with the goal of preventing major asymmetries across Member States which could further fragment the single market and cause financial instability, impeding recovery within the Union."*

Recital 20 instead posits that enhanced burden-sharing implies a reduced need for measures addressing distortions of competition. This is due to the fact that a higher participation in the restructuring costs by the aid recipient lowers the need for additional State resources. In turn, this should alleviate competition concerns. In any event, such measures should be calibrated in a way that enables to approximate as much as possible the market situation that would have materialised if the beneficiary of the aid had exited the market without being rescued. Therefore, abiding by the more precise burden-sharing requirements of the new Communication would appear to be the crucial condition to minimise competition distortions.

*5.3.1 Exception on stability grounds*

However, the Banking Communication also provides for an exception, whereby statutory burden-sharing can be derogated from whenever its implementation would endanger financial stability or lead to disproportionate results (point 45). This could apply to cases where the aid amount required is small in comparison to the bank's risk weighted assets and the original capital shortfall has been significantly reduced through capital raising measures. The Commission will decide about the potential application of the exception on a case-by-case basis.[138]

[138] This exception was applied, for instance, with respect to Alpha Bank (case SA.43366, 26 November 2015, para. 96) and Banco CEISS (case SA.36249, 12 March 2014, paras. 102-104).

**6. How does the interplay between the "newer" State aid rules and the resolution regime strike the balance between stability and competition?**

As far as the wording of the 2013 Banking Communication seems to suggest, the objectives of stability and competition are kept on equal footing, mainly by virtue of strengthened burden-sharing. However, these two objectives are not the only relevant ones, as more sweeping measures aimed at tackling moral hazard issues are included as well. The latter in particular aim at effectively addressing the long-acknowledged problems posed by mismanaged banks. Indeed, the focus has been shifted on tackling moral hazard through enhanced burden-sharing requirements, implying that this should be enough to lessen competition concerns as well.

Moreover, within the framework of the European Banking Union, the updated State aid control rules must now interact with the new rules on bank resolution and, in particular, the new Directive for bank recovery and resolution (BRRD)[139] and the Single Resolution Mechanism (SRM) Regulation.[140] These were devised to reduce the impact of bank failures on the economy and, in particular, to help ensure that the costs of failure are not borne by taxpayers, thus reducing the burden on public finances.

The main objective of resolution is to ensure the orderly unwinding of a bank that is failing, while preserving the continuity of its critical functions, such as the payment system, in order to protect financial stability and depositors. This must be achieved by minimising at the same time reliance on extraordinary public financial support.[141] For this purpose, the BRRD entrusts national authorities with crisis management and bank resolution tools, including specific powers to impose losses on shareholders and unsecured creditors ("bail-in"). For the euro area, such tools and powers are conferred through the SRMR upon the SRB, in its role of central resolution authority within the Banking Union. This ensures that the likelihood of taxpayer-financed bailouts is reduced and the burden of a bank's failure costs is borne by its internal stakeholders.

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[139] Directive 2014/59/EU.

[140] Regulation (EU) no. 806/2014, which translates BRRD provisions making them directly applicable in Eurozone Member States.

[141] As stated in art. 14 of the SRM Regulation.

Having established the shift in approach to bank distress, it becomes clearer how the State aid control regime becomes intertwined when dealing with failing banks. Within this new scenario, State aid control will remain a central element of the Banking Union, as State aid rules will continue to be applied alongside the BRRD and SRMR, in order to also ensure a level playing field between Eurozone Member States and the other EU States not adhering to the Banking Union. Thus, it is now worthwhile to delve into specific instances that require the interaction of state aid and resolution rules in practice.

More precisely, the BRRD itself establishes the obligation for Member States to ensure that, when exercising resolution actions, the State aid framework is complied with, when applicable.[142] Therefore, the use of resolution tools does not automatically qualify as state aid.[143] The criteria to determine whether the exercise of a resolution tool or power constitutes State aid are the same as for any other measure under the EU State aid framework. In line with this, the test for the Member State to notify that measure as aid to the Commission will be that of the general State aid framework.[144] However, it is not for the Commission, but rather for the respective supervisor or resolution authority, to apply the existing EU law on the subject and start the resolution procedure for the bank in question. It is a responsibility of the Commission, instead, to ascertain that State aid used in resolution procedures does not unduly distort competition in the market.

Under the BRRD, the particular decision of the co-legislators is to find a way to sever the "doom loop" between sovereigns and banks. Such a loop results from banks holding sovereign bonds and the sovereign losing market access during a debt crisis. When this happens the value of bank portfolios falls and the institutions need help from the government to stay solvent. In turn, this increases borrowing pressure on the already stressed sovereign. In order to stop this negative feedback effect, the BRRD rules establish that the granting of any State support inevitably implies that an institution is deemed to be failing or likely to fail. Therefore, this would be an automatic trigger for resolution of the entity concerned. In this sense, the granting of state aid to a bank will lead to its resolution. However,

[142] Art. 34(3) BRRD.
[143] Recital 47 of BRRD preamble.
[144] EBA Q&A 2015_2182 published on 10 March 2017.

some instances in which the use of public funds is allowed in conjunction with resolution are still envisaged and allowed, for instance in the form of precautionary measures pursuant to Art. 32(4)(d) BRRD and Art. 18(4)(d) SRMR or financial stabilisation tools within the meaning of Art. 56 BRRD. Thus, a distinction should be made between the use of public money within and outside resolution proceedings, accompanied by an evaluation of how the Directorate General Competition (DG Comp) of the Commission assesses such instances.

### *6.1 BRRD – use of public funds within resolution*

Under the new framework depicted, losses arising from failing banks must effectively be paid by their own shareholders and creditors, through bail-in, or by the industry itself. To enable the latter, a Single Resolution Fund (SRF),[145] funded through bank contributions, is currently being set up, but recourse to it will only be possible after appropriate burden-sharing by shareholders and creditors. Therefore, access to the SRF is only possible after an institution's loss-absorption capacity has reached "the minimum amount of bail-in",[146] corresponding to 8% of the bank's total liabilities.

Any use of the resolution fund must be in compliance with State aid rules. This is due to the fact that, even though its resources come from bank levies, which are private, the compulsory nature of the contributions, together with the attribution of the power to decide of its use to a public authority, and the resulting economic advantage for the beneficiary (or other undertakings) may bring about competition concerns. The same reasoning applies to the use of deposit guarantee funds, as highlighted by the Commission's decision on State aid to Italian bank Tercas (discussed in Chapter 4).[147]

Article 19 of the SRMR establishes that the Commission will assess whether the use of the SRF is in line with State aid rules by issuing Decisions. In the

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[145] Managed by the Single Resolution Board (SRB), which is the body tasked with ensuring the orderly resolution of significant banks in the eurozone.
[146] As per the wording of recital 80 of the SRM Regulation.
[147] Indeed, an intervention qualifies as State aid where the aid (i) is imputable to the State and (ii) it is funded through public resources. For the first requirement to be met, public authorities must be involved in the decision whether to grant the aid. As for the second point, the funds used for the aid must be under the control of public authorities. See General Court, judgment of 19 March 2019, Joined Cases T-98/16, T-196/16 and T-198/16, *Italy et al v Commission*.

exercise of this assessment, the Commission will base its decisions upon the same substantive and procedural rules applying to the use of all resolution aid. Consequently, the SRB and the Commission will need to work closely together, since a State aid decision must be taken by the latter before any draft resolution scheme that includes the use of the Fund can be adopted by the SRB on a specific case.

It is also important to recall that the Commission's decisions on the granting of public aid will always be based on the resolution scheme prepared by the Board, which includes information on the exercise of bail-in powers. Therefore, its decisions, which will be taken by making all relevant state aid considerations, will not need to extend to the design of burden-sharing arrangements applicable to shareholders and creditors.

Rather, the Commission will only have to assess whether the proposal made by the Board under resolution rules also abides by the requirement of sufficient burden-sharing under State aid rules. While this may leave open some room for discussion between the competition and resolution authorities, there seems to be no inherent contradiction in the exercise of the two activities. Still, burden-sharing requirements under the Banking Communication are less extensive than BRRD ones[148], so competition considerations appear to remain somewhat secondary to the stabilisation purposes of resolution procedures.

It is beyond the scope of this specific chapter to address those instances where the use of other resolution tools involves State aid considerations. However, this issue will be addressed in detail in Chapter 4, in order to highlight the continued relevance of the State aid control framework in spite of the introduction of the rules on bank resolution.

[148] Point 42 of the Banking Communication clarifies that "[*t]he Commission will not require contribution from senior debt holders (in particular from insured deposits, uninsured deposits, bonds and all other senior debt) as a mandatory component of burden-sharing under State aid rules whether by conversion into capital or by write-down of the instruments*." On the contrary, the resolution framework includes senior debt and uninsured deposits among the categories of liabilities that can be bailed-in for loss absorption and recapitalisation purposes. However, such a provision in the Banking Communication would still not pre-empt banks to extend the scope of liabilities participating in burden-sharing measures, if they so decided. This was the case for Piraeus Bank, (case SA.43364, 29 November 2015) and National Bank of Greece (case SA.43365, 4 December 2015), within their precautionary recapitalisation schemes, as also addressed in Chapter 5.

### *6.2. BRRD – use of public funds outside of resolution*

As anticipated, under the BRRD, State aid can only be granted in resolution scenarios but for three narrow exceptions. Namely, these are: State guarantees to emergency liquidity assistance from central banks; State guarantees of newly issued liabilities; and precautionary recapitalisations. As for the latter, such precautionary injections into the bank involved can only be used to cover capital shortfalls arising under the adverse scenario of a stress test.

The BRRD does not exclude completely the possibility of a bailout, in that it prescribes that any extraordinary public financial support will entail at least some bail-in of shareholders and creditors before any external funds can be disbursed to the benefit of the distressed bank. The bail-in must be conducted in accordance with the order of their priority claims set for normal insolvency proceedings.

The only exception to the rule establishing that any extraordinary financial support requires the write-down or conversion of the relevant capital instruments is indeed the case of a precautionary recapitalisation, as per the conditions set in Article 32(4)(d)(iii) BRRD and Article 18(4)(d)(iii) SRMR. In particular, this option is applicable when the institution concerned is solvent and any injection of capital or purchase of instruments involved for the purposes of its rescue is completed "at prices and on terms that do not confer an advantage upon the institution". The measures detailed in Art. 32(4)(d) BRRD and Art. 18(4)(d) SRMR can be exploited "in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability", to the condition that they "shall not be used to offset losses that the institution has incurred or is likely to incur in the near future".

In this case, the provision of State aid is external and independent from the resolution procedure. Therefore, State aid rules are the only ones that apply. Within this framework, competition rules take over in order to mitigate the potentially destabilising effects of resolution, with the guaranteed solvency of the bank acting as an "extenuating circumstance" for aid granting. This consideration will prove useful in the next chapters of this dissertation, as it provides an example of how crisis resolution rules interact with different market structures and different bank solvency and liquidity positions.[149]

### *6.3. Other exclusions from bail-in for reasons of financial stability*

As a testament to the relevance of financial stability concerns when applying resolution tools, some provisions are present in the BRRD and SRMR that allow for bail-in exceptions in specific instances. In particular, recital 72 of the BRRD preamble establishes that: "*resolution authorities should be able to exclude or partially exclude liabilities where necessary to avoid the spreading of contagion and financial instability which may cause serious disturbance to the economy of a Member State*".

Art. 44(3)(c) BRRD instead provides for the (partial) exclusion from the application of write-down or conversion powers in some exceptional circumstances, where the bail-in tool is applied. Among such circumstances, there is the inclusion of those cases where "*the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union*".

Both of these provisions confirm the primary role attributed by the resolution framework to financial stability considerations. However, they also raise one additional issue regarding the viability of resolution strategies. If the application of bail-in, which should be the mechanism effectively ensuring burden-sharing and own contributions by the banks and their shareholders and creditors, can be vouched, then considerations related to competition will always come second to financial stability concerns.

As a consequence, the question would turn to what bank failure would not bring about systemic financial stability concerns. Since resolution is a strategy devised for significant banks and these are the very same institutions that tend to be highly interconnected, it could happen more often than originally thought that triggering bail-in would destabilise the system. Then, the viable alternative would

[149] See, in particular, Chapter 5 for an in-depth analysis.

once again be to rescue banks with public funds.

In turn, the choice between resolution (with bail-in) and a rescue with public money will critically depend on the ability of banks to build sufficient amounts of bail-inable securities that can be easily written down in resolution without causing investor flights or contagion among institutions. More on this point will be said in a later section of this chapter, trying to distinguish between idiosyncratic and systemic bank failures. Indeed, the different stability concerns arising in the two instances have different implications for the application of resolution or State aid measures.[150]

**7. Other "caveats"**

Be it as it may, Article 107 TFEU remains the only binding legal rule for what concerns the substantive criteria for State aid control. In line with this, Member States are still free to notify the Commission of any measure that they deem compatible with Article 107(3)(b), even if the conditions set out in the Communications are not met. In turn, the Commission is bound by duty to evaluate their compatibility with the Treaty provisions.

The compatibility of any aid measure or scheme is assessed through matching with the conditions laid down in Article 107(3)(b) and, for it to be verified, it should be sufficient to demonstrate the following:

i. the existence and serious nature of a disturbance in the economy of a Member State;

ii. the power of the disturbance to affect the whole of the economy of the Member State in question; and

iii. the need for the application of the aid measure in the general interest and its proportionality to remedy the disturbance, together with the acknowledged absence of measures of a less distortive nature able to attain an equivalent result.

Once it is acknowledged that parts of the EU banking industry may still

[150] See Gardella (2015).

need the injection of substantial amounts of new capital in order to clean their balance sheets and restore their normal lending activities, and that private sources of capital may be insufficient to that end, then the competent authorities should be open to the possibility of resorting to well-devised capital injections bolstered by public backstops.

Expectations on the use that will be made of burden-sharing and of the bail-in tool by competition and resolution authorities are enough to impact directly the risk of capital instruments in the banking sector. As a consequence, if not properly governed, they may actually become a source of instability, rather than steadying the system. In light of the considerations made, it is also useful to examine whether the described framework would follow the same steps in dealing with both idiosyncratic and systemic bank crises.

**8. Idiosyncratic vs. systemic crises**

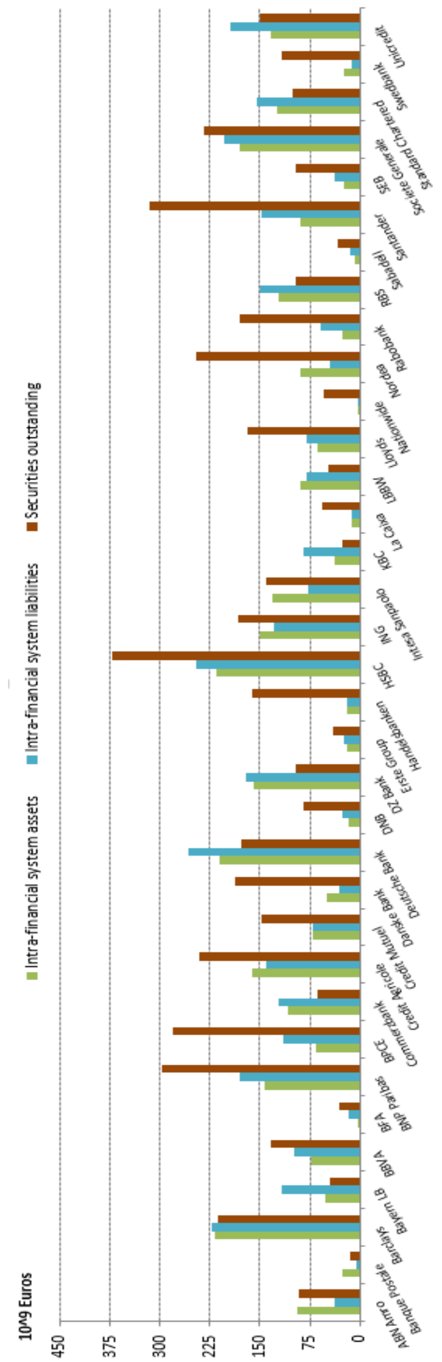
Although not easily established in practice, the distinction that is worth making is the one between an idiosyncratic shock only concerning one bank and a liquidity or confidence crisis that troubles many banks at the same time. In these circumstances, weakness in balance sheets may create expectations of widespread banking crises possibly prompting bail-in, which can end up being a self-fulfilling mechanism. However, as the banking sector develops a more interconnected and cross-border dimension, even an idiosyncratic risk can be difficult to disentangle from generalised negative effects that extend beyond the single bank in financial distress. Both size and level of interconnectedness of a bank must be taken into account, when assessing the detrimental effects stemming from mismanaged expectations on the handling of resolutions.

Even though it would be the preferred option, the assumption that a private-market solution to higher capital requirements for solvent banks will always be accessible cannot be taken for granted. If the need for some form of public support ever arose, in the interest of preserving systemic financial stability, the ability of the relevant authorities to take full account of the market settings and systemic repercussions of the chosen measures are of critical importance.[151]

This becomes particularly relevant when one considers the complex tangle of cross-holdings in place among European financial institutions. Figure 2.1 depicts the degree of interconnectedness reached by the European global systemically important banks in terms of assets and liabilities cross-exposures.

[151] Tröger (2018) acknowledges that a relaxation of the assumption of investor rationality might trigger bank runs even absent verifiable reasons to believe an institution to be in distress, thus impeding bail-in application.

*Figure 2.1 - Interconnectedness of European Global Systemically Important Institutions (G-SIIs)*




*Source:* European Banking Authority (EBA), End-2016 G-SIIs Disclosure Exercise

According to the data provided by EBA with its end-2016 G-SII Disclosure Exercise, multiple banks (and other financial institutions) hold subordinated debt instruments issued by other banks for roughly €30 billion. Subordinated debt instruments of banks can be easily written down and converted into equity, in accordance with the rules on resolution. Therefore, such a tangle of cross-exposures, especially in Member States with stagnant economies, could end up triggering systemic contagion in the event of a bank failure. As a consequence, the unintended result is that the use of the bail-in tool could actually endanger the soundness of the system at a 'macro' level if the crisis is not idiosyncratic in nature.[152] If financial stability indeed has primacy over other public policy considerations where bank crises are concerned, a deviation from bail-in back to bailout solutions may be considered.

Therefore, it is important to make sure that the goal of replacing bailouts with bail-in does not lead to instability: in the words of Dewatripont (2014), "financial stability can be very costly, and in fact much more so than bailouts".[153] In this sense, it is critical to prevent that even the fear of predictable bail-in operations induces bank investors to run. To be able to do so, it is of paramount importance that a sufficient "long-term loss absorbency capacity" be accumulated, so as to reassure short-term claimholders. Such difficulties in the balancing of different objectives point to the fact that regulation can alleviate the trade-off between stability and competition but not eliminate it.[154]

Another lesson worth keeping into consideration in the future is that procrastination usually entails considerable costs, when it comes to dealing with banking crises. Instead, swift recapitalisations through bailouts that use public money may actually end up being a good investment for taxpayers if they act to jumpstart economic growth (Dewatripont, 2014). In addition, if such bailouts were shouldered with the use of previously accumulated funds and they helped protect average banks against exceptionally adverse macroeconomic shocks, while punishing their poorly performing peers, their adverse impact for what regards

[152] See De Bandt O., Hartmann P., "Systemic Risk in Banking: A Survey", in Goodhart C. and Illing G., "Financial Crisis, Contagion, and the Lender of Last Resort", 2002, Oxford University Press, p. 249 and ff.
[153] Dewatripont M., "European banking: Bailout, bail-in and state aid control", 2014, International Journal of Industrial Organization, 34, pp. 37-43.
[154] See s*upra* note 101.

moral hazard concerns could be restrained.

Therefore, even in its primacy, the objective of financial stability preservation is not as straightforward to define as one might expect. Indeed, the choice of a resolution strategy, which is based upon the aim to avoid contagion effects between banks from the failure of a single institution, could in itself destabilise the system. This is due to a legacy of cross-holdings and interconnections in securities among European financial institutions. Thus, the issue could be traced back to a question of choosing between bail-in and bailout once again. This is also in line with Bernard, Capponi and Stiglitz (2017) who find that, with a large amplification of a bank shock due to a high degree of interconnectivity in the network, the state (social planner) "cannot credibly threaten the banks not to intervene himself and a public bailout is the only incentive-compatible rescue option".[155] A similar argument was also echoed by Haldane (2012), stating that "if governments are risk-averse and wish to smooth the pain across taxpayers and across time, then bail-out may look attractive on the day".[156]

## 9. Concluding remarks

European State aid control rules applied to the banking sector take into account the specificities of banks and the different anti-competitive effects that different rescue measures for failing institutions can bring about.

The severity of the financial crisis pushed the European Commission to extensively approve bank rescue plans, in an attempt to stabilise the financial system and restore market confidence. There was a general convergence between the conditions imposed on aided banks to tackle moral hazard and to prevent restrictions of competition, even though eligibility requirements for access to aid were not homogeneous across countries.

Likewise, the objectives sought by the Commission were broader and included, prominently, restoring the long-term viability of the EU banking system. However, when the burden-sharing of the costs of failure from the banks was

[155] Bernard B., Capponi A. and Stiglitz J.E., "Bail-Ins and Bail-Outs: Incentives, Connectivity, and Systemic Stability", 2017, Columbia Business School Research Paper No. 17-45.
[156] "On being the right size", speech by Mr. Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Institute of Economic Affairs' 22nd Annual Series, The 2012 Beasley Lectures, at the Institute of Directors, London, 25 October 2012.

deemed difficult to achieve, more leniency was applied to allow aided banks to "make up" *ex post* for the aid received.[157] This flexible approach taken by the Commission effectively kept it in control of its crisis management role.

The primary objective was the preservation of financial stability, but this went at the expense of a more sophisticated economic approach in evaluating the consequences of rescue schemes on market structure and competition in the longer term. However, in those extraordinary circumstances, timeliness was of essence and it is difficult to imagine how else the Commission could have approached such a high number of intertwined failures of significant banks.

As burden-sharing has direct implications for the funding costs of institutions, the different approaches applied during the financial crisis might have exacerbated differences in funding costs among institutions and countries, depending on the approach applied in bank rescues, possibly distorting institutions' competitive standing in the relevant markets. Indeed, burden-sharing achieved through a dividend ban is much less intrusive and effective than a complete wipe-out or heavy dilution of existing shareholders and subordinated debt holders. The fact that more substantial structural remedies were imposed through balance sheet reductions and divestments upon those beneficiaries that emerged as standalone entities after rescue, compared to cases in which entities were split, would appear to be consistent with the assumption that no increases in beneficiaries' market power should have come about after rescues.

On the point of behavioural remedies instead, pricing-related restrictions such as price-leadership bans were particularly intrusive in terms of controlling competitive conduct of beneficiaries in the market, compared to other behavioural compensatory measures; while acquisition bans and balance sheet growth restrictions would have had the effect of maintaining beneficiaries' size unaltered after aid. In this sense, such remedies should have contributed to preserving the competitive structure of the relevant markets to the greatest extent possible, by limiting consolidation of entities or stemming increases in market shares.

[157] See *supra* note 104.

After the global financial crisis, State aid control rules have been updated and new European rules for the orderly resolution of failing banks have been introduced. Yet, it seems to be the case that financial stability concerns still take a front seat when facing bank crises, even though "normal times" would call for renewed attention to "normal market conditions", including undistorted competition. This is not to say that the State aid control regime has become useless in its application to the banking sector. On the contrary, depending on whether a bank crisis can be identified as idiosyncratic or systemic, the use of public funds can still be a viable rescue option, to which State aid control rules will apply.

Therefore, one can envisage a situation in which small banks can be helped with liquidation aid and then leave the market, whereas the choice of measure to help significant banks in distress will depend on considerations related to financial stability. Indeed, the ultimate choice of strategy could be traced back to the one between bail-in and bailout, with State aid control still retaining its relevance. In order to be able to choose resolution (with bail-in) instead of a bailout, banks must have at their disposal sufficient amounts of bail-inable securities, whose write-down does not bring about systemic contagion or investor flights (see Chapter 4). However, this brings back to the issue of having "too big to fail" banks, which are still put in a better position to weather a crisis compared to their smaller competitors.

# Chapter 3: Precautionary Recapitalisation

## 1. Introduction

The resolution rules introduced by the BRRD[158] have replaced the assumption that a failing bank's claimants will be reimbursed with public funds (bailout) with one of mandatory burden-sharing of the bank's losses by shareholders and unsecured creditors (bail-in). The regulators' expectation is that such a replacement should also reinforce market discipline as a result. Such a shift in preferences from bailout to bail-in represents some relevant progress for the EU policy framework addressing some of the vulnerabilities of the financial sector. However, the experience developed along the years in dealing with banking crises suggests that this shift can hardly be definitive. Accordingly, the BRRD preserves the possibility of granting public support by way of government guarantees and precautionary recapitalisations. Precisely the latter will be the focus of this chapter, in which the potential impact of such a tool on the conduct of European banks in Europe will be addressed.

From a policy-oriented perspective, maintaining precautionary recapitalisation as a viable rescue option can be justified both on transitional grounds, as a means through which flexibility can be applied while the Banking Union is on its path to completion, and permanent ones, as a way to still allow public intervention in dire crisis scenarios. Additionally, precautionary recapitalisation could also be used as an early intervention measure, thus excluding forbearance costs that would most likely arise if other solutions were applied at a later stage of more serious distress, therefore entailing costs that would be lower than those associated with the application of any other resolution tool, bail-in included.

Having established as much, one core issue remains central within the EU regulatory framework for bank crises management: under which conditions should

[158] Directive 2014/59/EU.

governments still be able to support banks in distress? The EU resolution framework is designed to ensure an orderly wind-down of failing financial institutions. Yet, surprisingly, the interaction between the EU resolution framework and the EU State aid rules raises a number of unresolved questions. In order to start tackling some of them, it is worthwhile to consider the literature that explores how the expectation of a bailout can influence bank behaviour as concerns risk-taking and competition incentives. This will serve the aim of establishing a baseline against which to evaluate how bank rescue policies impact banking markets.

For the purpose of this analysis, after a literature review on the anticipated effects of a bailout expectation on bank conduct (section 2), the third section will tackle bank recapitalisations and their potential anticompetitive effects. After highlighting the legal and economic aspects pertaining specifically to precautionary recapitalisations, the following sections draw from those specificities to draw a comparison between regular recapitalisations and precautionary ones in terms of expected impact on bank conduct.

## 2. Literature: the effects of bailout anticipation

A strand of literature developed before the latest financial and debt crises of the period between 2008 and 2013 has focused on investigating the correlation between the likelihood of systemic crises and banks' anticipation of being bailed out by their governments.

Acharya and Yarulmazer (2007) show that while the too-big-to-fail guarantee is explicitly a part of bank regulation in many countries, bank closure policies also suffer from an implicit too-many-to-fail problem: when the number of bank failures is large, the regulator finds it optimal *ex post* to bail out some or all of them. When the number of bank failures is small instead, failing banks can be acquired by the surviving banks. This gives banks incentives to herd and in turn magnifies the risk that many of them may fail together.

Acharya, Shin and Yorulmazer (2010) look at how policy interventions to resolve bank failures affect the ex-ante choice of bank liquidity. They show that liquidity support to failed banks (bailout) decreases banks' incentives to hold liquidity, as such a policy limits fire-sale opportunities. Thus, even though interventions to resolve banking crises may be desirable ex post, they affect bank liquidity in subtle ways.

Farhi and Tirole (2012) show that, where monetary policy is non-targeted, banks choose to correlate their risk exposures, and private borrowers may choose to increase their interest-rate sensitivity following bad news about future needs for liquidity.

Chari and Kehoe (2013) develop a model through which they show that, without commitment, governments have incentives to bail out firms by buying up their distressed debt and renegotiating their contracts with managers. From an ex ante perspective, however, such bailouts are costly because they worsen incentives and thereby reduce welfare. Chari and Kehoe show that limits on the debt-to-value ratio of firms mitigate the time-inconsistency problem by eliminating the incentives of governments to undertake bailouts.

Keister (2016) studied the issue of choosing between a bailout or a bail-in intervention in a model of financial intermediation with limited commitment. When a crisis occurs, policymakers will arrange fiscal transfers that partially cover intermediaries' losses. The anticipation of this bailout distorts ex ante incentives, leading intermediaries to become excessively illiquid and increasing financial fragility. However, the outright prohibition of bailouts is not necessarily desirable either: while it induces intermediaries to become more liquid, it may still lower welfare and leave the economy more susceptible to a crisis.

Nolan, Sakellaris and Tsoukalas (2016) argued that banks and other firms which are bailed out should suffer a penalty contingent on that bailout to remove excessive risk-taking by internalising the bailout costs. They also show that policies such as solvency or leverage constraints are sub-optimal because they are time inconsistent just at the point when governments and regulators confront the central problem of financial regulation. The government cannot commit not to bail out bankers with those policies in place. It follows that the non–zero correlations between credit spreads and bond spreads observed during periods of financial crisis reflect suboptimal government policies that do not remove bankers' incentive to take excessive risks.

Bernard, Capponi and Stiglitz (2017) developed a framework to analyse the consequences of alternative designs for interbank networks, in which a failure of one bank may lead to others. They analysed the conditions under which governments can credibly implement a bail-in strategy, showing that this depends on the network structure. They found that a bail-in strategy is more credible with more dispersed networks. The intuitions behind their findings are twofold: (i) a threat of no-intervention is more credible in sparsely connected networks when the shock is large or interbank recovery rates are low, and (ii) banks can be incentivised to make larger contributions to a subsidised bail-in if the network is more sparsely connected.

Keister and Mitkov (2019) studied the interaction between a government's bailout policy during a banking crisis and individual banks' willingness to impose losses on their investors. In the constrained efficient allocation, banks facing losses immediately cut payments to withdrawing investors. In a competitive equilibrium, however, these banks often delay cutting payments in order to benefit more from the eventual bailout. In some cases, the costs associated with this delay are large enough that investors will choose to run on their bank, creating further distortions and deepening the crisis.

The implications of these findings for the implementation of bank rescues is threefold. First, the anticipation of government support, including in the form of recapitalisations, is costly ex ante as it affects banks' liquidity choices, distorts incentives and reduces welfare as a result. Second, in highly interconnected banking sectors, the use of recapitalisations with public funds, through the means made available by the regulatory framework after the introduction of the BRRD, might become more credible than the application of bail-in to deal with the failure of a bank, when there is a risk that it would trigger the subsequent failure of a number of other interconnected institutions. Third, a full prohibition of government support can still be welfare reducing, thus calling for some degree of intervention to be retained in exceptional circumstances, combined with appropriate competitive safeguards and appropriate prudential policies to limit excessive risk-taking.

## 3. Recapitalisations

In the context of a crisis in the financial markets, bank recapitalisations can serve a number of purposes.[159] First, they contribute to the preservation of financial stability and help restore the market confidence necessary for the recovery of inter-bank lending. Moreover, the injection of capital into a bank through a recapitalisation offers a cushion in recessionary times that enables loss absorption and limits the institution's risk of insolvency. This follows from the fact that capital injections address a widespread perception that higher capital ratios are necessary in view of the past underestimation of risk in banking activities and the increased cost of funding.

Second, recapitalisations can also have the objective of ensuring continued lending to the real economy. Banks that are fundamentally sound may prefer to limit their lending activity in order to keep risk-taking under control and to preserve higher capital ratios. In this framework, a state capital injection may prevent restrictions in credit supply as well as limit the spill over of the financial markets' difficulties to other business sectors and the broader real economy.

Third, State recapitalisations may also be a response to the insolvency that some institutions might face as a result of the specific business model or investment strategy they chose to pursue, thus being deployed to restructure institutions whose failure would be detrimental to the economy, and requiring a restructuring plan that modifies the 'faulty' or excessively risky business model to ensure renewed viability and sustainability. Alternatively, a capital injection through public resources providing emergency support to an individual institution may also help to stem the systemic spillovers that could arise from its insolvency in the short term. In the longer term, instead, recapitalisations could either bolster the return to long-term viability of the beneficiary banks or support their orderly wind-up.[160]

Additionally, recapitalisations maintain market structures unaltered, as they carry ailing institutions through restructuring and leave them operative in the market after intervention. Therefore, such measures do not diminish the number of market operators, which in theory should ensure that competitive forces are

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[159] Beck T. et al., "Bailing out the Banks: Reconciling Stability and Competition", 2010, CEPR, London.
[160] As acknowledged in the 2008 Recapitalisation Communication, para. 6.

preserved, but they do so in an artificial way, laying the ground for the use of policies relying on public funds, which are still eventually liable to distort competition, as described in the following section.

### *3.1 Competition concerns stemming from recapitalisations*

Since recapitalisations involve the use of taxpayer money, EU State aid rules require that public funds are only injected in a bank that is profitable in the long-term. This implies that the bank must undergo in-depth restructuring so as to ensure its long-term viability. Moreover, the state must be sufficiently remunerated for its capital injection. As detailed in the European Commission's 'Recapitalisation Communication' of 2008[161], potential distortions of competition on three different levels must be taken into account whenever a recapitalisation scheme or measure is proposed.

First, recapitalisation by a Member State of its own banks should not create an undue competitive advantage for those banks over other institutions in other member states. Access to capital at considerably lower rates than competitors from other Member States, lacking an appropriate risk-based justification, may have a substantial impact on the competitive position of a bank operating within the European single market. Excessive aid being granted in one country could also trigger a subsidy race among member states. Thus, in order to preserve a level playing field across states, it is necessary to establish a coherent and coordinated approach to the remuneration of public capital injections, and to the other conditions attached to recapitalisation. Indeed, uncoordinated and unilateral action in this area may also undermine efforts to restore financial stability.

Secondly, recapitalisation schemes that do not appropriately differentiate beneficiary banks on the basis of their risk profiles may confer an undue advantage to distressed or less-performing banks compared to their fundamentally sound and better-performing peers. If this instance materialises, both market competition and bank incentives are distorted, moral hazard increases and the overall competitiveness of European banks might be weakened as a result. Therefore, a proportionate approach in the amount of aid granted and the behavioural and

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[161] "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", OJ 2009 C-10/2.

structural safeguards requested of banks, on the basis of their riskiness, and taking account potential underestimation of risk prior to intervention, should ensure the preservation of fair competition between banks.

Thirdly, the remuneration required by the State for a public recapitalisation[162] should not put those banks that do not receive the public funding in question but still seek additional capital on the market- in a competitive position that is significantly disadvantaged. In addition, the application of a public scheme that crowds out market-based operations will hinder the return to normal market functioning.

Any proposed recapitalisation has the potential to produce cumulative competitive effects at each of the three levels just described. In dealing with such competition concerns, a balance must be struck between the objectives of restoring financial stability, ensuring continued lending to the real economy and containing the risk of widespread bank insolvency. Indeed, banks must have terms of access to capital that are sufficiently favourable in order to make the recapitalisation measure as effective as necessary. At the same time, the conditions tied to any recapitalisation measure should ensure that a level playing field is maintained and that a return to normal market conditions can be achieved in the longer term. Therefore, State interventions should be proportionate and temporary. Additionally, they should be designed in a way that provides incentives for banks to redeem the State as soon as market circumstances allow it, in order to foster a competitive and efficient European banking sector.

If aid reduces marginal costs, it is more likely to distort competition in the short run compared to aid that affects fixed costs. This is due to the fact that changes in marginal costs influence firms' short-run pricing decisions. As State aid

[162] The 2008 Recapitalisation Communication specified that "*[w]here State capital injections are on equal terms with significant participation (30 % or more) of private investors, the Commission will accept the remuneration set in the deal*". On the basis of the Eurosystem recommendations of 2008, the same Communication held that "*the required rate of return by the government on recapitalisation instruments for fundamentally sound banks - preferred shares and other hybrid instruments - could be determined on the basis of a "price corridor" defined by: (i) the required rate of return on subordinated debt representing a lower bound, and (ii) the required rate of return on ordinary shares representing an upper bound*". The 2011 Prolongation Communication further specified that the Commission would assess the remuneration of capital injections on the basis of the issue price of the shares, with subscriptions needing to be completed "*at a sufficient discount to the share price (after adjustment for the "dilution effect") immediately prior to the announcement of the capital injection to give a reasonable assurance of an adequate remuneration for the State*".

often enables lower prices, improved quality or innovation, it is possible that the aid could benefit consumers in the short term, but have an adverse effect in the longer term.[163] Therefore, the market definition exercise in State aid assessments may need to focus more on the long-run effects of the aid. In the event of a recapitalisation, it seems to be the case that the application of interest rates lower than market ones would have an effect on marginal costs. Therefore, market-oriented pricing of capital injections is generally considered to be the best safeguard against the creation of disparities in the level of bank capitalisation, as a result of the grant itself, and an improper use of the capital received.

## 4. "Precautionary recapitalisation"

The transition from the old 'bail-out' to the new 'bail-in' regime was correctly identified as complex and difficult, not least due to the considerable heterogeneity in terms both of legal regimes and of banking sector structures present in different Member States.[164] On top of this, the incompleteness of the banking union entails the need to apply transitory arrangements allowing to deal with potential policy mismatches among countries. In this sense, precautionary recapitalisation can be seen as a means of applying flexibility to heterogeneous national situations, which are bound to impede the full creation of a level playing field under common rules in the short term.

### *4.1 Defining precautionary recapitalisation*

EU law does not provide a specific definition of the expression "precautionary recapitalisation". Interestingly, such an expression is not even present in the text of the BRRD. However, the concept derives directly from the wording of Article 32(4)(d) of the BRRD, which states that, as a general principle, an institution should be deemed as failing or likely to fail if *"extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes the form*" of "*an injection of own funds*

[163] European Commission, "Ex post assessment of the impact of state aid on competition", November 2017, at www.ec.europa.eu.
[164] Goodhart C. and Avgouleas E., "A Critical Evaluation of Bail-Ins as Bank Recapitalisation Mechanisms", 2015, Journal of Financial Regulation, 1, 1, 3-29. In a similar vein, see also Bodellini (2018).

*or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution*".[165]

In a more precise way, the ECB has provided a definition of "precautionary recapitalisation", identifying it as "*an injection of own funds into a solvent bank by the state when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure that is conditional on final approval under the European Union State aid framework. It does not trigger the resolution of the bank*".[166]

Similarly, the Bank of Italy has also advanced a definition of precautionary recapitalisation in addressing the Monte dei Paschi case recently, classifying it as "*a measure provided under European legislation (the Bank Recovery and Resolution Directive – BRRD) in exceptional circumstances, to remedy a serious disturbance in the economy of a Member State and preserve financial stability. In these cases, in order to strengthen the capital of a bank, extraordinary State aid of a precautionary and temporary nature is permitted as long as the bank is solvent and the intervention is compliant with the rules on State aid. These rules mean that a State can only intervene after the subordinated bonds have been converted into equity (the burden-sharing principle)*".[167]

According to Article 32(4)(d) BRRD and Article 18(4)(d) SRMR, financial support can be provided to remedy a serious disturbance in the economy of a Member State and preserve financial stability in one of the following forms: (1) a State guarantee to back liquidity facilities provided by central banks; (2) a State guarantee on newly issued liabilities; or (3) an injection of own funds or purchase of capital instruments.

These three potential means of financial support cannot be considered as alternatives that the authorities can use to solve the same problem, but rather they

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[165] The EBA has provided guidance to improve coordination between supervisory and resolution authorities in the determination that an institution is failing or likely to fail. See the EBA's 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).

[166] See ECB, "What is precautionary recapitalisation and how does it work?", 27 December 2016, at www.bankingsupervision.europa.eu.

[167] Banca d'Italia, "The 'precautionary recapitalisation' of Monte dei Paschi di Siena", available at www.bancaditalia.it.

constitute different options for the achievement of two different purposes, namely: to either boost liquidity or to increase capital. Accordingly, the use of State guarantees to back liquidity facilities provided by central banks under Article 32(4)(d)(i) of the BRRD, as well as of State guarantees on newly issued liabilities under Article 32(4)(d)(ii) of the BRRD are tools aimed at enabling the bank to solve liquidity problems that are only temporary. A precautionary recapitalisation, as provided for under Article 32(4)(d)(iii) of the BRRD, instead, allows the bank to increase its capital to comply with minimum regulatory capital requirements in the event of a future significant crisis manifesting itself under a so-called adverse scenario. Indeed, these tools appear to have the goal of satisfying different needs of the bank in question: the first two address liquidity needs, whereas the latter targets future solvency after the failure of the adverse scenario in a stress test.

Article 32(4)(d)(iii) BRRD and Article 18(4)(d)(iii) SRMR enable Member States to support those banks in which a capital shortfall is highlighted by national, SSM- or Union-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank (ECB), European Banking Authority (EBA) or national authorities, in case of a serious disturbance in the economy. If any of those exercises reveals that a bank has a capital shortfall, and the institution cannot rectify such a shortfall by raising funds on the market, then precautionary recapitalisation can become a viable solution. In this context, State aid can only be granted to prepare for possible capital needs of a bank that would materialise if economic conditions were to worsen, but it does not trigger resolution of the bank in question. For the purposes of precautionary recapitalisation, the ECB has defined a bank as solvent if "it fulfils the minimum capital requirements (i.e. Pillar 1 requirements). In addition the bank should not have a shortfall under the baseline scenario of the relevant stress test".[168]

Furthermore, precautionary recapitalisation measures should serve the purpose of preventing a serious disturbance in the economy rather than remedying it. However, the wording of the Italian, French Portuguese and Spanish versions of Article 32(4) of the BRRD is different from the English one, as they also encompass the case of avoiding a serious disturbance in the economy. This

[168] *Ibid.*

discrepancy might generate the grounds for a different application of the same tool in different countries, in particular with regard to the timing of the rescue intervention, thus potentially weakening the desired uniformity in approach in dealing with bank crises in Europe.

### *4.2 Conditions for application*

For what concerns the applicability of such a tool, the conditions set by the BRRD for the granting of a precautionary recapitalisation are fairly detailed. They encompass conditions on the balance sheet testing and the ascertained viability of the bank in question, as well as the competitive impact of the measure itself, the economic and financial stability in the market, while also establishing general principles according to which the intervention should be precautionary, temporary and proportionate.

More specifically, the main conditions for a precautionary recapitalisation are the following:

1. The aid is granted "in order to **remedy a serious disturbance in the economy of a Member State and preserve financial stability**": this refers directly to the wording of Art. 107(3)(b) TFEU to possibly find aid to be compatible with the internal market.
2. The extraordinary public financial support consists in **"an injection of own funds or purchase of capital instruments"**: this limits the forms of support that can qualify for the exemption at Art. 32(4)(d)(iii) BRRD.
3. The price and terms of the recapitalisation should **not "confer an advantage upon the institution"**: this seems to suggest that capital injections should be concluded on market terms.[169]
4. Precautionary recapitalisations "shall be **confined to solvent institutions**": in accordance with the clarification offered by the EBA, this means that, currently and in the near future, the institution: (i) does not and is not likely to infringe the conditions for 87uthorization; (ii) does not and is not likely to hold less assets than liabilities; and (iii) does not and is not likely to be unable to pay its debts as they fall due.

[169] The previous stance by the Commission on the use of Art. 32(4) BRRD made reference to an "undue advantage", as meaning an "advantage incompatible with the internal market under State aid rules".

5. The measure shall be **"conditional on final approval" under State aid rules:** the measure must obtain an approval by the Commission prior to any capital being injected into the bank, thus implying a scrutiny of the appropriateness of the burden-sharing arrangements and of a restructuring plan.[170]
6. Those measures shall be of a **"precautionary and temporary nature"**: the word "precautionary" refers to the fact that past losses cannot be covered through the recapitalisation, but rather the measure should be a precaution in the face of future unanticipated losses. The "temporary" aspect, instead, suggests that the State should be in a position to recoup its investment in the future. This can usually be achieved with an injection of capital in the form of contingent convertible bonds, which enables the bank to repay the State, if its capital position improves later on. Differently, an equity injection in the form of ordinary shares would not offer a similar degree of flexibility.[171]
7. The precautionary recapitalisation shall be **"proportionate" to remedy the consequences of the serious disturbance in the economy**: the recapitalisation must be limited to the amount necessary to address the capital shortfall identified in the stress test or equivalent supervisory exercise.
8. The measure shall **not be used "to offset losses that the institution has incurred or is likely to incur in the near future"**: this entails that past losses or losses that will be incurred with a high degree of certainty cannot be offset by a precautionary recapitalisation. Thus, if any losses come to light from an asset quality review or the baseline scenario of a stress test, they must be covered by private funds.

[170] As per recital 50 of the 2013 Banking Communication.
[171] Such difference between the two categories of instruments, if the conditions for the inclusion of capital instruments subscribed by authorities in emergency situations in CET1 instruments (pursuant to Art. 31 CRR) and those for the redemption or repurchase of CET1 and Additional Tier 1 and Tier 2 instruments (pursuant to Artt. 77 and 78 CRR)- in accordance with the procedures delineated in Artt. 29-32 of Commission Delegated Regulation (EU) 241/2014- materialised simultaneously. The point of distinction between CoCo- or equity-based precautionary recapitalisations will be addressed again in Chapter 5, where the specificities of the precautionary recapitalisation benefitting Italian Monte dei Paschi di Siena is looked at in detail.

*4.3 Conditions for the Commission's approval*

As for the approval under State aid rules in particular, the crisis rules on banking laid down in the European Commission's 2013 Banking Communication require that:

1. the use of taxpayer money is limited through appropriate burden-sharing measures. This is ensured through contributions by shareholders and subordinated debt holders, while depositors and senior creditors instead are not required to contribute[172];
2. a credible and effective restructuring plan to ensure the bank is viable in the long-term without further need for State support;
3. distortions of competition are limited through proportionate remedies.

As per art. 32(4)(iii), the price and terms at which the recapitalisation is completed should also not "confer an advantage upon the institution". This wording seems to exclude any capital injection not completed on market terms that a private investor would also accept, as well as to require burden-sharing, achieved also through a heavy dilution of existing shareholders of the beneficiary, which results in a loss of control. In this respect, the level of dilution would be scrutinised in accordance with the State aid framework considered as related to the height of the issue price of the shares subscribed by the State for the recapitalisation[173]: the higher the issue price, the lower the number of shares obtained by the State, and thus the lower the level of dilution. The 2013 Banking Communication requires *full burden-sharing* by shareholders[174], stipulating that losses are first absorbed by

[172] Differently, in resolution, senior creditors and uncovered depositors are included among those whose holdings can be bailed-in. This creates a mismatch in the scope of instruments that can be written down and converted into equity between the State aid framework and resolution rules. This issue is at the core of a number of bank restructurings completed in recent years- analysed both later in this chapter and in Chapter 5 of this book- which, either through liquidation or through exceptions to resolution, managed to escape a full bail-in application, as they underwent scrutiny exclusively under the State aid framework.

[173] See, for instance, the Commission's decision in the restructuring of Irish bank PTSB, case SA.33311, 20 July 2011, para. 81, in which the Commission positively evaluated that the chosen issue price per share resulted in a high level of dilution.

[174] Prior to the introduction of the 2013 Banking Communication, the Commission did not set a specific ex ante threshold for burden-sharing, even though it expressed doubts in some cases that the burden-sharing by shareholders was sufficient. Some examples include: HSH Nordbank, C 29/2009, 22 October 2009, where the issue price was deemed to be too high and, as a result, minority shareholders benefited disproportionately by not being completely diluted (para. 72); Royal Bank of Scotland (RBS), N 422/2009, 14 December 2009, where the issue price of the B shares was above the share price of RBS, having a less dilutive effect than a standard ordinary share issuance or rights

equity (point 41), which would seem to indicate a required dilution level of 100%.[175]

In addition, it is also worthwhile to remember that the very purpose of the precautionary recapitalisation provision is to enable a bank, which is "unable to raise capital privately in markets" (recital 41 of the BRRD), to raise it from public sources without triggering resolution. It is worth noting that in the Commission's decisions on the use of exemptions contained in Article 32(4) BRRD and Article 18(4) SRMR, the wording used refers to the conferral of an "undue advantage", which is "an advantage incompatible with the internal market under State aid rules".[176] In this sense, the Commission acknowledges to some extent that any recapitalisation granted when a bank is unable to raise capital privately in the markets favours the beneficiary, thus involving State aid.

Then, one other crucial point related to the application of precautionary recapitalisation is the fact that Art. 59(3)(e) of the BRRD excludes the requirement to write down or convert capital instruments into equity in the event of a precautionary recapitalisation. This is the caveat that makes the precautionary recapitalisation tool become a 'safeguard' clause included in the State aid regime to spare creditors from burden-sharing, if it can endanger financial stability or lead to disproportionate results. Since the holders of debt instruments subject to bail-in have mostly been other financial institutions until now, the bail-in tool could transfer losses from one institution to another, risking contagion. This markedly highlights the fragile nature of the European banking sector.

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issue, thus going against the concept of burden-sharing, yet compensated by some of the hybrid-like features of the B shares (para. 140). See van Lambalgen (2018) for a discussion of the different means through which dilution has been accepted by the European Commission in its State aid practice.

[175] However, in practice the Commission has also accepted "almost complete" dilutions, rather than full ones. This was the case for the Cypriot Cooperative Central Bank, SA.35334, 24 February 2014, where Cyprus acquired 99% of the shares and voting rights of the bank, while the existing shareholders were diluted down to a 1% participation, in order to preserve some of the cooperative characteristics of the institution concerned (para. 139). The same happened also with reference to the four Greek banks rescued in 2015 (see Chapter 5).

[176] European Commission's decision C(2015) 8930 of 4 December 2015 (SA. 43365 (2015/N)-Greece).

### *4.4 Justifications for keeping the "precautionary recapitalisation" option*

According to the categorisation used by Schwarcz (2018), precautionary recapitalisation can be considered as a form of intervention combining aspects of both 'reactive' and 'proactive regulation', as it constitutes a variation to resolution, but also to traditional bankruptcy proceedings. As it is envisaged as an exception which is pre-defined and acknowledged in the BRRD, it can be seen either as a pre-planned enhancement of the framework enabling an intervention to improve resolvability as soon as some signs of financial trouble start to materialise, or as rescue entailing a partial burden-sharing of losses bolstered by public funds, which avoids putting the institution into liquidation. Whether the measure tilts more towards one interpretation or the other largely depends on the time at which it is applied. Indeed, the closer to a bank's insolvency it is granted, the more it will resemble a rescue variating from traditional bankruptcy. Differently, if it is applied when the financial position of the bank is still strong, despite its possible deterioration in case the adverse scenario of the stress test materialises in the future, it would veer towards a definition of resolvability enhancement, without delaying the application of a full-fledged bail-in.

The inclusion of the precautionary recapitalisation option in the EU bank crisis management toolbox can be justified on the basis of considerations of both a transitional and a permanent nature. As a matter of fact, a transitional motivation is presumably why the possibility of eliminating precautionary recapitalisation as an option[177] was included at the end of Art. 32(4) BRRD, by asking the European Commission to review its "continued need" by the end of 2015 "and the conditions that need to be met in the case of continuation". However, the European Commission did not submit such a report within the 2015 deadline and still has not submitted one so far, possibly because it considered it as too early to make an informed assessment.

A permanent motivation for maintaining the precautionary recapitalisation tool instead derives from the experience in the United States in 2008, which demonstrated that extraordinary public financial support might be warranted in situations of particularly severe financial instability. It is also broadly

[177] Though not the other options of public support granting via guarantees.

acknowledged in the economic literature that there is a case for public intervention in the event of a systemic crisis.[178]

### *4.5 "Public interest test" and "serious disturbance in the economy"*

The rationale that is common to both bank resolution, through the application of the bail-in tool, and precautionary recapitalisation is that those failing financial institutions whose operations are relevant to the economy of a Member State should be saved by way of internal contributions in the former case, or through public money when bail-in would bring about financial instability in the latter case. Therefore, it is essential to consider the concept of "public interest" that would justify the application of either of those crisis management strategies to a bank failure.

In accordance with Art. 32(5) of the BRRD and Art. 18(5) SRMR,[179] the public interest criterion for bank resolution is considered to be satisfied if the operation "achieves and is proportionate to one or more of the resolution objectives specified in the regulation and if the winding up of the entity under normal insolvency proceedings would not meet those resolution objectives to the same extent". The prevailing view among scholars is that the public interest test, which provides the justification for resolution, is met only when an economic disturbance or systemic risk is clearly demonstrated.[180] Still, the vague formulation of the public interest test has proven to be problematic in the assessment of the recent bank restructuring cases, since it leaves substantial discretion to the relevant resolution authorities.[181]

The approach to the assessment of public interest applied by the SRB hinges on the definition of "critical functions" present in the BRRD and SRMR, thus considering that significant adverse effects on financial stability would exist only if such consequences materialised at the level of one or more Member States.[182]

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[178] Avgouleas and Goodhart (2015), *supra* note 163.
[179] Stated in identical terms in Art. 18(5) of the SRMR.
[180] Alvaro S. et al., "The marketing of MREL securities after BRRD - Interactions between prudential and transparency requirements and the challenges which lie ahead", 2017, CONSOB Legal Research paper No. 15.
[181] Binder J.H., "Proportionality at the resolution stage: Calibration of resolution measures and the public interest test", 2017.
[182] See SRB's "Approach to the Public Interest Assessment", published in July 2019.

However, since national authorities apply different criteria in their assessment, different conclusions can be reached on what can entail a sufficient public interest, such that would justify a resolution action. The existing inconsistency and fragmentation, which persist to some degree both within the SSM and within the SRM, is not helped by a 'multi-layered' system of litigation along national lines, which increasing the complexity of the existing regime further. This creates grounds for an amplification of uncertainty in the applicability of the rules and contribute to magnify differences in crisis management approaches within the European Union.[183]

Moreover, the other condition that must materialise in order for a precautionary recapitalisation to be justifiable is that the failure of the bank concerned might create a "serious disturbance in the economy of a Member State". On this point, Olivares-Carminal and Russo (2017) argue that the lack of a clear and univocal definition of "serious disturbance" in the economy and "financial stability" leaves to authorities a significant degree of discretion in the determination of the circumstances in which aid can be provided. This leaves regulators and supervisors with a degree of flexibility in deciding on the need to possibly provide extraordinary financial support on the basis of their assessment.[184] The expectation that likely would follow is that recourse to public finances could be made without particularly relevant hindrances in the end. To assess whether this is actually the case, it is important to turn to the actual cases of precautionary recapitalisations granted until now.

### *4.6 Precautionary recapitalisation in practice: some "theoretical" points for attention*

There have been only few actual cases in which precautionary recapitalisations under the BRRD have been granted so far: two Greek banks in late 2015, whose precautionary recapitalisations can currently be viewed as broadly

[183] In this vein, see Lastra, Russo and Bodellini (2019), arguing for a specification of criteria to inform the development of the choice between resolution and liquidation for ailing banks, as well as for a more coherent interpretation of the concept of 'public interest' from a financial stability perspective. Schillig (2020) argues in favour of removing the public interest test as a trigger for resolution action, thereby extending the resolution regime to all institutions irrespective of their size and significance, in order to enhance the credibility of the crisis management framework and protect national budgets, thus lessening the bank-sovereign feedback loop.

[184] Olivares-Carminal R. and Russo C., "Precautionary recapitalisations: time for a review", 2017, available at: www.europarl.europa.eu.

successful, and more recently Monte dei Paschi di Siena (MPS) in Italy. A precautionary recapitalisation was also requested without success by Italian banks Banca Popolare di Vicenza and Veneto Banca, on grounds of a lack of public interest justifying the need to keep the banks in the market. The two banks were then liquidated under normal insolvency proceedings, with the addition of public support to preserve local financial stability while enabling the market exit of the two institutions. Another instance of public support granted in liquidation to smoothen the market exit of an ailing bank was also offered in relation to Cyprus Cooperative bank. All of these cases are discussed in depth in Chapter 5 of this dissertation. However, some points related the "theory" relevant for the application of such measures are worth mentioning here.

### *4.6.1 Proportionality and the choice of crisis management measure*

In the first place, one could argue that the issue highlighted by recent cases of crisis management in Europe concerns the failure to apply regular insolvency proceedings in favour of a bailout scheme. This reflects the lacking uniformity across European Member States in setting common standards for dealing with insolvencies when banks lie below the "public interest threshold".[185] If this is perceived as being politically unacceptable, then one possible solution could be to combine the harmonisation of resolution principles applicable to non-systemically relevant banks with stricter State aid rules. In this way, the difficulties stemming from the application of the resolution toolbox to all banking institutions, irrespectively of their size, and to all related insolvency cases could be bypassed.[186] Indeed, the European toolbox for bank resolution should not be considered as an all-encompassing solution applicable to every bank insolvency, regardless of bank size, complexity and interconnectedness with other intermediaries. The reasons for some cases to be treated differently are rooted in the principle of proportionality.

[185] See the European Parliament (2018) for a review of the reasons for harmonising insolvency laws. Some of the issues arising from a lack of common standard as regards insolvency proceedings in Europe were highlighted by the failure of ABLV, which was managed through a liquidation for ABLV Latvia followed by a resolution for its subsidiary in Luxembourg, due to the different liquidity and solvency situations of the two group entities (see the statement by ABLV on the decisions by the ECB and the Luxembourg Court: https://www.ablv.com/en/press/2018-03-09-the-court-recognises-the-soundness-of-ablv-bank-luxembourg-s-a-which-can-now-be-sold-to-new-investors). See also Valiante (2016) for a review of the areas in addition to the resolution framework where insolvency law harmonisation could be beneficial.
[186] Binder (2017), *supra* note 180.

### *4.6.2 The distinction between liquidity and solvency in the choice of crisis management measure*

Some controversial aspects of supervisors' and judges' treatment of bank insolvency and resolution cases should also be addressed. First of all, they seem to take for granted that a bank's zero valuation is a consequence of the entity's insolvency, which follows from the fact that it must have accumulated more liabilities than assets.[187] This appears to rule out the possibility of 'false positives', i.e. entities that are merely illiquid, but are nonetheless treated as insolvent.

However, liquidity is different from solvency. Indeed, the former indicates the extent to which a bank has sufficient cash (or other assets that can quickly be converted into cash) to meet immediate and short-term obligations. The latter instead measures the ability to pay debts as they come due, as assessed by the holding of assets in excess of liabilities. If such a distinction between liquidity and solvency were not established, every time a bank or State is illiquid, one would also conclude that it is insolvent. Nonetheless, some authors actually dispute the ability of the market or public authorities to distinguish between illiquid and insolvent institutions, especially in times of crisis or when the valuation of their assets is due to complex future predictions.[188] This brings to light another critical point in the functioning of the crisis management tool of precautionary recapitalisation, which is the ability to determine that a financial institution is still solvent but not illiquid. If such distinction is not easily established, once again the uniform application of such a tool at European level might still be hindered by different interpretations in different countries or instances.

## 5. Liquidation aid

As resolution and liquidation become two alternative options to manage a bank failure, the two differ substantially also for what concerns the legislation applicable to the use of public funds. Indeed, the BRRD applies to the former scenario, whereas liquidation is regulated by national insolvency laws and proceeds in accordance with the national legal order.

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[187] Alvaro et al. (2017), *supra* note 179.

[188] Goodhart C., "Liquidity risk management", Financial Stability Review – Special Issue: Liquidity, 2008, p. 35.

Differently from resolution, in the case of liquidation, the failing bank is unable to return to viability and would anyway exit the market. Indeed, if the drafting of an acceptable restructuring plan proves impossible, then the failing institution must be "wound up in an orderly fashion". The 2013 Banking Communication posits that liquidation should always be considered when a bank cannot be returned to viability. However, there might be instances in which, while the wind-up of a small institution may not threaten financial stability at the European level, its exit from the market exit may still affect the regions where such a bank is active. Therefore, Member States should evaluate whether they consider that the bank exit would have a serious impact on the regional economy.[189]

In this situation, the 2013 Banking Communication foresees the possibility for States to use public resources in order to mitigate the de-stabilising impact of the exit of an ailing bank from the market.[190] Still, this is subject to the usual burden-sharing requirements envisaged by State aid rules and clear commitments on the effective exit of the ailing institution from the market to ensure that competition distortions are minimised. As a matter of fact, in liquidation cases, the Commission generally imposes restrictions on the economic activities of the bank involved, in order to curb competitive concerns. Additionally, liquidation plans need to abide by the criteria set in sections 2 to 4 of the Restructuring Communication, much in the same way required for restructuring plans.

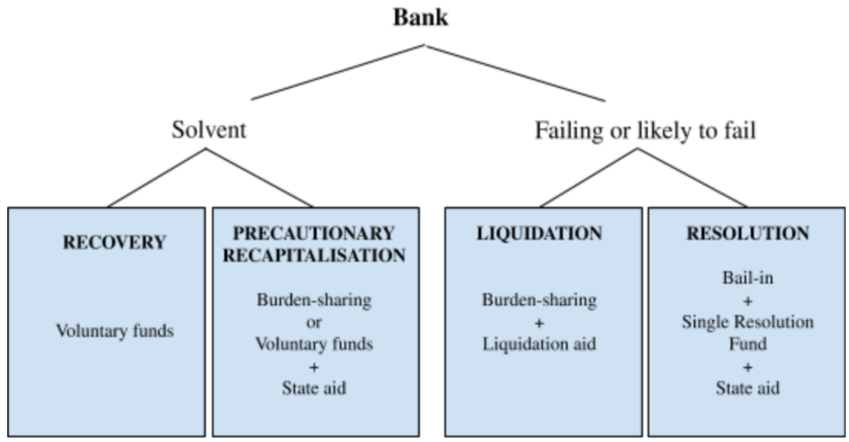
The approach taken to deal with the crisis of the two Venetian banks has one main implication, which entails that the risk of a serious economic disturbance within a region of an EU Member State may still allow the relevant national government to use public funds to curb the risk of a significant adverse effect on the

[189] E.g. impact on SME financing in that region.

[190] Recently, the Italian government has approved provisions to ensure that compulsory administrative liquidation processes for small banks with total assets of up to €5 billion (with the exception of cooperative credit banks) can be managed in an orderly manner with State support due to the exceptional circumstances of the Covid-related crisis ("Decreto Rilancio", converted into Law No.77/2020). Under the Decree, the Ministry of Finance is authorised to grant State aid to facilitate the purchase of a failing bank's assets and liabilities, business/business units and account portfolios by another bank. These measures include (i) the conversion of the deferred tax assets of the bank in liquidation or of the purchaser into tax assets (even if not recognised in the financial statements), (ii) the granting of a guarantee to the purchaser on some of the items transferred, and (iii) aid to the purchaser if these measures are insufficient. These measures would be subject to (i) confirmation by the European Commission that they are compatible with State aid rules and (ii) a Ministry of Economy and Finance decree, taking into account any indications by the Bank of Italy.

financial system, possibly engendering contagion, in a manner that would otherwise be forbidden under the BRRD framework.

In clarifying the link between resolution and liquidation, the BRRD as recently amended ('BRRD2')[191] highlights that banks that are likely to fail but do not enter resolution due to the absence of a "public interest" must be "wound up in an orderly manner in accordance with the applicable national law". Thus, the options for restructuring institutions in the current combined regime of resolution and State aid rules can be visualised in the graph below.




*Source*: own elaboration

In accordance with how the regulatory framework is set now, public funds may be provided in the form of liquidation aid in insolvency on terms that are less restrictive than those that would apply if resolution funding arrangements were used instead. As a consequence, it may be that some creditors receive a better treatment under insolvency than they would under resolution. A crucial point to note, then, is that there may be distorted incentives for the relevant authorities in their public interest assessment, if they have compelling enough reasons to avoid the allocation

[191] Amending Directive (EU) 2019/879.

of losses to some classes of debt holders under the extensive requirements that the resolution framework would entail.[192]

Another relevant concern relates to the 'calibration' of the public interest assessment. If a high bar is set for finding a public interest, a misalignment would be established between European supervision of banks carried out at within the Single Supervisory Mechanism framework and crisis management, which would remain national in nature, due to the fact that SSM-supervised banks may not meet the public interest threshold, which would justify a resolution.[193] This could generate further uncertainty in the applicability of the rules and possibly amplify differences in crisis management approaches within the European Union.

**6. Bailout expectations impact on bank behaviour**

It is now worthwhile to turn to the issue of bank behaviour and how the expectation of possibly being on the receiving end of a precautionary recapitalisation might influence it. To this end, the definitions of bank "significance" and "serious disturbance" in the economy caused by a bank failure must be elaborated upon. Indeed, these two concepts play a crucial role in the determination of which crisis management tool to apply in case a bank is failing. In turn, they might thus affect banks' behaviour in relation to their possible anticipation of a State rescue.

Insofar as a "serious disturbance in the economy of a Member State" can be considered as an exogenous event outside of a bank's control, then a precautionary recapitalisation should not generate a moral hazard problem.[194] However, no official EU document elaborates on the definition of serious disturbance in the economy or on the elements that need to be present in order to assess that such a disturbance has indeed materialised. Therefore, due to the flexibility granted to authorities in the determination of the existence of such a disturbance, one implication that follows is that a bank can still form expectations on the likelihood

[192] This is a point raised, among others, by Restoy, Vrbaski and Walters (2020) and noted in the context of the liquidation of the two Venetian banks by Asimakopoulos (2018), with reference to the fact that the political reasons for the Italian State to avoid a full-fledged bail-in in order to spare retail investors in particular were clearly evident.
[193] Deslandes, Dias, Magnus (2019).
[194] Olivares-Carminal and Russo (2017), *supra* note 183.

of being bailed out through a precautionary recapitalisation, if there is the perception that the bank is indeed relevant for a State's economy.[195]

Moreover, since banks are supervised on an ongoing basis, the repeated interaction with the relevant supervisors might influence their expectations on the evaluation they could receive and what (if any) corrective measures would potentially be required of them in case a supervisory exercise yielded negative results. In the area of State aid, the right to rely on the principle of legitimate expectations presupposes that "precise, unconditional and consistent assurances" originating from authorised, reliable sources have been given to the person concerned by the competent authorities of the European Union.[196] The introduction of the rules on bank resolution should have eliminated the formation of expectations as regards the potential receipt of public aid, thus rendering such a principle ineffectual as grounds for litigation. However, the continued presence of an option such as the one for access to a precautionary recapitalisation might undermine this assumption.

Indeed, if a bank is "significant enough", it might develop *ex ante* expectations that it will be bailed out by the State in case a capital shortfall is found after a stress test. Then, the crucial point upon which rests the choice of banks that would warrant being rescued lies in the definition of significance of an institution. The case of Veneto Banca and Banca Popolare di Vicenza, to which precautionary recapitalisations were denied, seems to point to a definition of significance that relies on the cross-border relevance of a bank's operations. In this sense, the holding companies of the biggest European banking groups with relevant international activities could form the expectation to be bailed out in case of a failed stress test, posited that they in any case remain solvent.

Then, national political interests are still prevalent in choices related to banking sector rescues, which might imply individual States are not willing to defer power to European authorities as regards the management of their own banks'

[195] Micossi S., Bruzzone G. and Cassella M., "Fine-Tuning the Use of Bail-In to Promote a Stronger EU Financial System", 2016, CEPS Special Report, No. 136.
[196] Opinion of Advocate General Wahl in case C-526/14, *Kotnik*, 18 February 2016, point 62.

distress.[197] In theory, a State could even declare one of its banks to not be systemically relevant at European level, in order to deal with its restructuring at the national level, thus avoiding supranational interference. Even the blurred definition of significance or systemic relevance resulting from the "public interest test" grants a leeway for different interpretations, which might enable governments to circumvent resolution rules, lessening the credibility of the overall regulatory framework devised for the management of bank failures as a result. Therefore, competent authorities and Member States might still be reluctant to use resolution tools, which were designed to protect taxpayers, for fear of hampering financial stability and creating contagion instead. In some other cases, national authorities are even reluctant to place their banks under resolution. Those fears result from interconnectedness and contagion effects in the banking system and the financial system as a whole, as well as from legacy problems, such as the sale of bail-inable securities to small retail investors in countries such as Italy and Spain, which make resolution less politically palatable.

**7. Stress test results impact on bailout expectations and bank behaviour**

In addition to the concepts of "bank significance" and "serious disturbance in the economy of a Member State", one other element that can trigger a precautionary recapitalisation must be addressed, namely the finding of a capital shortfall in the adverse scenario of a stress test. There is a whole strand of literature examining whether information disseminated through the disclosure of the outcomes of stress tests reduces the opacity of banks' activities (Morgan et al., 2014; Cardinali and Nordmark, 2011; Beltratti, 2011; Ellahie, 2012; Petrella and Resti, 2013). Most studies conclude that stress tests indeed unveil valuable information for market participants, thus playing a role in attenuating bank opacity.[198] "Even outside of a period of crisis, the disclosure of stress test results and assessments provides valuable information to market participants and the public, enhances transparency, and promotes market discipline" (Bernanke, 2013).

[197] Véron N., "Precautionary recapitalisation: time for a review?", 2017, Bruegel Policy Contribution Issue n. 21.

[198] Georgescu et al. (2017) have also assessed the implications of the 2014 Comprehensive Assessment and the 2016 EBA EU-wide stress test in this respect, finding that the stress test disclosures revealed new information that was priced by the markets and enhanced price discrimination, with the impact on bank CDS spreads and equity prices tending to be stronger for those banks that performed worse in the stress test exercises.

Therefore, on a basic level, the recourse to stress tests could have pro-competitive effects, insofar as it enables the dissemination of information regarding the bank's capital position and viability, thus exposing its resilience to economic shocks and its overall "quality" to current and potential investors and depositors.

As for the potential impact of a stress testing exercise on bank behaviour, it seems unlikely that a bank can act so that it will be able to fail a stress test *ad hoc*, for the precise purpose of being bailed out. This is made more evident by the fact that even the finding of a capital shortfall depends upon a number of different conditions being verified at the same time. Indeed, "a capital shortfall with respect to one or more of the prudential capital requirements only arises if all of the supervisor's assumptions prove correct".[199]

In addition, stress tests carried out by the EBA, for instance, do not contain a pass/fail threshold. Rather, their purpose is to inform the supervisors' ongoing review of banks, enabling them to support the repair of banks' balance sheets, by assessing institutions' ability to meet applicable minimum and additional capital requirements under stressed scenarios. This should also imply that the financial institutions involved in such an exercise could not anticipate whether they would be at the margin between passing and failing. As a consequence, their behaviour before the communication of the stress test results should not have been much altered, as concerns the anticipation of a potential bailout.

Along these lines, transparency or stress test exercises possibly carried out by supervisors without prior knowledge of the institutions concerned might have even less of an impact on banks' expectations of receiving State support, as they lack the element of public disclosure that could push institutions and the market to anticipate that a potential intervention - be it private or public in nature- might become necessary to bolster the capital position of a bank in the future.

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[199] Alvaro et al. (2017), *supra* note 179, noting that such an assumption cannot be taken as rule and, in any case, if burden-sharing is imposed immediately, it would be hard for the shareholders and creditors affected to have a counterfactual on the basis of which they could demonstrate whether the shortfall indeed existed or their write-down and conversion was a self-fulfilling prophecy.

## 8. Market structure and competition implications of precautionary recapitalisation vs. liquidation aid

Having established from a theoretical point of view what are the potential competitive concerns arising from precautionary recapitalisations and from liquidation aid, it is also worthwhile to compare the two sets of measures to assess whether different implications for the competitive structure of the market in which aided institutions operate could arise when either of the two is applied. Precautionary recapitalisations, like all recapitalisations, maintain the market structure in which the aided firms operate unvaried. This is due to the fact that the number of market operators is unaltered, with such measures preserving the ailing bank as a standalone entity in an "artificial" way, as, in the absence of support, the bank would possibly not be able to recoup losses and revert to a sufficient level of capitalisation. In the case of liquidation instead, the ailing bank, or a consistent part of it, would be forced to exit the market, thus reducing the number of market operators and consolidating the market, possibly also transferring portfolios rights and liabilities to competitors, in case those would be necessary to curb financial instability or to pursue public policy objectives such as the protection of depositors.

Both kinds of measures would be disciplined by State aid rules as delineated in the 2013 Banking Communication, as they escape the resolution framework. Thus, in either case, appropriate State remuneration, burden-sharing and behavioural safeguards will be required, on the basis of the amount of aid granted, whether the bank will exit the market or not after intervention, and the efforts made to minimise reliance on public support.

### *8.1 Burden-sharing and acquisition of control*

As for burden-sharing, in both cases, no mandatory intervention in loss absorption and recapitalisation will be required of senior debt holders and depositors. This would imply that, by comparison with resolution, both measures would have competitive drawbacks in terms of allowing a reduced scope of contributions by shareholders and subordinated creditors to limit the recourse to public support. However, there might be a difference between the two measures, as, in the case of insolvency, shareholders and subordinated creditors contribute by being left in the part of the bank that will be liquidated, thus having their claims fully annulled[200], while a precautionary recapitalisation, which does not lead to the exit of the beneficiary from the market could be completed on the basis of a less extensive burden-sharing consisting of subordinated debt conversion into shares and a significant- albeit not complete- dilution of existing shareholders.[201] In this respect, a precautionary recapitalisation would favour banks' investors more than liquidation aid would and possibly have more distortionary effects on competition, by not limiting to a comparable extent the recourse to public funds.

From the point of view of acquisition of control of the aided entity by a competitor, liquidation would lead to a consolidation of activities in the hands of other market operators immediately at the time of rescue, while, in the case of a precautionary recapitalisation, this aspect would only be relevant in case the standalone beneficiary is take over from the State by a competitor, instead of any already existing minority shareholders, at a later stage. In this sense, if the latter did not occur, an event of liquidation might alter the competitive structure of the market, by leading to consolidation, while a precautionary recapitalisation would not.

### *8.2 Market impact*

Ultimately, the difference between the two means of intervention in terms of impact on the competitive structure of the market in which the ailing bank is active will also hinge on: (i) the relative size and market presence of the bank before any intervention is applied; (ii) the size and "market relevance" of potential portfolios of assets, liabilities, or business lines transferred to an acquiring entity; (iii) the relative size and market presence of the acquirer. Indeed, if only small banks were liquidated, with little to no relevant critical functions or assets warranting a transfer to remaining competitors- which would not establish an overlap of activities between the merging entities that would significantly alter market shares- competition concerns from consolidation in liquidation would be very limited.

[200] See Commission decision C(2017) 4501 of 25 June 2017 (SA.45664 (2017/N) – Italy) on the liquidation aid to Banca Popolare di Vicenza and Veneto Banca, para. 32; Commission decision C(2014) 5682 of 3 August 2014 (SA.39250 (2014/N) – Portugal) in the case of Banco Espiritu Santu, with reference to the wind-down of the bad bank, para. 89.

[201] This was the case for Monte dei Paschi: see Commission decision C(2017) 4690 (SA.47677 (2017/N) – Italy) of 4 July 2017, para 17, subpara. iv.

Along the same reasoning, if only significant banks with functions essential to the economy warranted being rescued as standalone entities through a precautionary recapitalisation, consolidation achieved through the later acquisition of the beneficiary by a competitor could have more serious effects on the competitive structure of the market, potentially calling for remedies such as divestitures and behavioural safeguards, depending on the combined market share of the merging entities and the existence of other qualified competitors exerting a disciplining effect. In this sense, once again, the threshold set for finding the existence of a public interest that would justify the preservation of a bank, or its critical functions, will be crucial in determining the severity of the (potential) competitive distortions arising from the rescue measures and the related remedies applied by competition authorities to avert the danger of establishing or reinforcing dominant positions in the market.

In light of the above, the financial stability justifications for the application of the aid measures discussed would go hand in hand with (potential) competitive distortions to be addressed with appropriate remedies and with a desirable increase in the degree of alignment of burden-sharing impositions across different aid schemes approved by the Commission.

**9. Bank recapitalisation prospects in Covid-times**

After the considerations of the previous sections, it is worthwhile to turn to considering to what extent the unprecedented circumstances of the economic crisis triggered by the Covid-19 pandemic and the lockdown measures put in place by Member States to stem its spread could affect, which prompted a relaxation of the State aid framework for non-financial firms, could also alter the approach to the rescue of financial institutions.

In this regard, point 7 of the Temporary Framework[202] sets out that, if due to the Covid-19 outbreak, banks were to need direct support in the form of liquidity, recapitalisation, or impaired asset measures, the assessment will rest on whether the measures meet the conditions of Article 32(4)(d) (i), (ii) or (iii) of the BRRD (thus including the option of a precautionary recapitalisation). The same point clarifies

[202] Communication C(2020) 1863 of 19 March 2020 from the Commission establishing a Temporary Framework for State aid measures to support the economy in the current Covid-19 outbreak.

that, in such a case, beneficiaries would not be deemed to be failing or likely to fail, thus not triggering the condition for resolution. More importantly, however, insofar as such support measures would be needed to address problems linked to the Covid-19 outbreak, they would benefit from the burden-sharing exception of point 45 of the 2013 Banking Communication, therefore sparing shareholders and subordinated creditors from contributing.[203]

Some authors have advocated for the organisation of precautionary recapitalisation measures at European level by putting the European Stability Mechanism in charge of them, in order to support the European banking system in these unprecedented times.[204] This extraordinary concession of a deviation from both resolution and State aid burden-sharing requirements hinges on the reasoning that, where asset deterioration concerned mostly Covid-related loans extended or liquidity shortages were due to a generalised contraction, it is reasonable to suppose that public intervention would be warranted, in order not to exacerbate the economic crisis through additional instability potentially brought about by wide-spread requests for banks to recapitalise privately when market conditions are already dire.

Differently, if a bank's distress were the result of severe misconduct- including money laundering- or terrorist financing-related issues, of a single institution- then resolution would probably remain a viable option, insofar as the crisis remains idiosyncratic, with limited spillover and negative reputational effects for other institutions. Indeed, the relaxation of the State aid requirements makes

[203] In Italy, explicit provisions on support measures to preserve financial stability in view of the pandemic-related crisis were included in the so-called "Decreto Rilancio" of 19 May 2020 (converted into Law No.77/2020). The decree authorises the Ministry of Economy and Finance, until end-2020, to guarantee bonds issued by Italian banks, for a total amount of up to €19 billion. The State guarantees will be subject to: (i) verification by the Bank of Italy or the ECB that the banks concerned meet their capital requirements, and (ii) approval by the European Commission under the State aid framework. Even if banks requiring such aid do not meet these requirements, they will remain eligible to receive the aid, as long as their equity is still positive and they have an urgent need for a liquidity boost.

[204] See Schularick, Steffen and Tröger (2020) for a discussion on the prospects regarding the management of potential bank failures in the context of the pandemic-triggered crisis. Arner, Avgouleas and Gibson (2020) suggest a combination of balance sheet restructuring and the use of AMCs to manage NPLs to approach systemic bank crises or those caused by unexpected exogenous factors, as is the case for the current disruption in economic activity caused by the Covid-19 pandemic, holding that these crises call for the preservation of financial stability as the primary goal policy-makers should pursue, rather than the containment of moral hazard.

explicit reference only to capital or liquidity needs arising as a consequence and in the context of the Covid-19 crisis.

## 10. Concluding remarks

The European legislator has provided tools so that banking crises can still be managed even in situations in which the application of the bail-in tool could be counterproductive. Indeed, public intervention by way of the so-called precautionary recapitalisation is one of the available crisis management tools. However, in this regard, it is crucial that the authorities intervene before the bank in trouble 'crosses the line' of insolvency, as some recent cases of Greek and Italian banks have demonstrated.

The applicability of the precautionary recapitalisation tool is justified on both transitional and permanent grounds, in order to facilitate the progress of completion of the Banking Union, as well as to account for severe cases of financial instability, in which the application of bail-in instead would be undesirable. However, due to vagueness in the wording of Art. 32(4) of the BRRD, national governments and European authorities are left with a certain degree of discretion in choosing which instances and institutions warrant the granting of a precautionary recapitalisation. Indeed, the "public interest principle" set out in Article 32(5) BRRD, which justifies precautionary recapitalisations, is likely to remain inextricably linked with and influenced by national biases, which might result in economically inefficient outcomes.

It seems that the anticipation of receiving a precautionary recapitalisation would not significantly alter bank behaviour *ex ante*, compared to "regular" recapitalisations, due to the requirement that the aid beneficiary is solvent and that a stress test surely highlights a capital shortfall in an adverse scenario. However, if this is considered in the context of the resolution framework, which established precautionary recapitalisation as an exception to be applied in specific and extraordinary circumstances, it could raise issues concerning the credibility of bail-in to tackle bank crises, which, in the long term, might imply a re-adjustment of banks' credit ratings[205] and a change in funding costs.

The academic and policy debate regarding the viability of the precautionary recapitalisation instrument has built favourable arguments in support of its preservation as part of the EU bank crisis management toolkit. Some proposals are now being advanced, exploring options to improve and strengthen the overall policy framework.

As part of the debate that might concern the text of the BRRD itself, assessing anew the necessity of keeping the precautionary recapitalisation instrument available might become more pressing for the evaluation of the sustainability of the broader framework of bank crisis management rules. This crucially relies on whether precautionary recapitalisation can only be justified on transitional grounds or on the basis of more permanent considerations. More specifically, the precautionary recapitalisation tool kept as a permanent tool in the crisis management framework could be effective in ensuring financial stability when there is a threat of a serious disturbance in the economy. However, this beneficial effect must be weighed against the drawbacks arising from the potential creation of an expectation of public assistance for the banks. This point would be crucial for the credibility and sustainability of the resolution framework as established. Further considerations on avenues for an improved application of precautionary recapitalisations in practice will be made in Chapter 5 of this work.

[205] On evidence that credit ratings are seen as a high-credibility tool, helping market investors to better exercise market discipline, see, among others, Rocamora, Suárez and Monjas (2020), who have looked at MREL-eligible debt instruments in particular.

# Chapter 4: State Aid and competition-related issues in resolution planning and execution

## 1. Introduction

The aim of the BRRD and the resolution framework it introduced, as anticipated in previous chapters, is to enable failing banks to be resolved and restructured in an orderly manner, without disrupting the financial system or the real economy while minimising costs for taxpayers. When exercising their resolution powers, resolution authorities should take into account the objectives set by the regulatory framework, with the aim to choose the tools and strategies that best achieve the objectives that are relevant in the event of a specific bank failure. Specifically, the BRRD set out that resolution should (i) ensure the continuity of critical functions[206]; (ii) avoid significant adverse effects on financial stability, especially by preventing contagion, including to market infrastructures, and by maintaining market discipline[207]; (iii) protect public funds by minimising reliance on extraordinary public financial support[208]; (iv) protect depositors covered by the Deposit Guarantee Scheme Directive (DGSD) and investors covered by the Investor Compensation Scheme Directive (ICSD)[209]; and (iv) protect client funds and client assets.[210]

Depending on the single banks concerned, not all resolution objectives might be equally relevant, thus calling for tailoring the application of resolution tools to the specificities and structure of each banking group. Different resolution tools have different implications for how a failing bank is restructured and in which form it remains operative on the market after intervention. This is relevant insofar as competitive concerns may arise in the application of resolution tools and

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[206] Recitals 1, 4, 5, 25, 45, 49, 70, 72, 90, 114, and 125 of the BRRD.
[207] Recitals 3, 4, 11, 13, 14, 18, 24, 29, 38, 40, 41, 45, 49, 63, 67, 92, 97, 99, 102, 108, and 132 of the BRRD.
[208] Recitals 1, 5, 8, 31, 45, and 67 of the BRRD.
[209] Recitals 45, 71, 110-112 of the BRRD.
[210] Recital 45 of the BRRD.

strategies, and the competitive structure of the banking market might be altered after resolution on the basis of the restructuring completed.

Therefore, the focus of this chapter lies on the relationship between aspects relating to banking groups' operative structures and how these may be shaped in the planning phase to prepare for resolution as well as in the execution of resolution schemes, through the application of different resolution tools under the BRRD. The aim is to address the competition-relevant issues arising from resolution execution through different tools, as well as how banks might be re-organised and restructured both in the preparatory phase to resolution in order to improve resolvability and when a resolution action is taken. To this end, the analysis will assess how intrusive the powers of resolution authorities may be in resolution planning and execution and to what extent they can include impositions on changes to the structure of institutions, and, as a by-product, of the banking market. Both resolution planning and the setting of minimum requirements on bail-in-eligible liabilities will be addressed, to then move to the different resolution tools available under BRRD resolution, and finally to the recourse to resolution funds and deposit guarantee schemes in enacting resolution schemes.

## 2. Resolution preparedness: resolution plans and MREL

### *2.1 Resolution planning*

The preparation for a potential failure is one of the key elements of the resolution framework. To this end, a first means through which all preparations to manage an event of potential distress are laid down in resolution plans. The purpose of drafting resolution plans is to ensure a bank's resolvability, by obtaining a full understanding of the institutions and their critical functions, identifying and addressing any impediments to their resolvability, and making necessary preparations for resolution to be implementable, if needed.[211] The resolution planning process consists in the first instance of an assessment on the feasibility and credibility of liquidation in case of failure, which is the default option for failing banks. If, however, the bank has critical functions and core business lines that would need to be preserved, thus justifying resolution in the public interest, the

[211] For more details, see, as an example, Schillig (2015) in Haentjens and Wessels (eds.), p. 81 and 90.

resolution strategy needs to be determined. This usually entails a choice between a single point of entry (SPE) or a multiple point of entry (MPE).[212] For resolution authorities to be able to make an optimal use of the tools at their disposal to either liquidate or resolve a bank in an effective manner in accordance with the preferred resolution strategy, all substantive impediments to the resolution of a bank need to be identified and addressed.[213]

Essentially, resolution plans set out options for the resolution of a bank, based on the resolution tools provided for in the BRRD, and must not assume any access to extraordinary public financing or emergency liquidity assistance from central banks. Requirements on resolvability may significantly influence banks' models of operation, affecting a number of aspects encompassing group funding, service provision and booking of products. It might be beneficial for banks to make changes to their organisational, legal, business, and financial structure also in going concern, in particular insofar as the simplification of the various internal structures can contribute to improving their resolvability. In practice, a number of banks have indeed simplified their structure, based on motivations relating to considerations of internal governance, financial performance, as well as to meet regulatory or supervisory demands.[214]

### *2.1.1 Powers to address or remove impediments to resolvability*

The assessment of a bank's resolvability carried out by the relevant resolution authority in the context of resolution planning is a two-step process,

[212] See Fernández Fernández (2020) for a comparative review of the advantages and disadvantages of the two approaches to resolution.
[213] Article 17(5) BRRD and the corresponding Article 10(11) SRMR provide resolution authorities with a range of powers they can deploy to remove banks' impediments to resolvability before their failure. Such powers to intervene can be used if measures proposed by banks themselves are deemed to be insufficient to address or remove resolvability impediments. The EBA has further specified both measures and powers to reduce or remove impediments to resolvability in specific guidelines. See EBA Guidelines on the specification of measures to reduce or remove impediments to resolvability and the circumstances in which each measure may be applied under Directive 2014/59/EU (EBA/GL/2014/11) of 19 December 2014. De Groen (2019) analyses the current status of the process to identify and address impediments to resolvability of European banks, especially those under the remit of the SRB. From the analysis, it appears that the SRB relies more on banks to address resolvability impediments, rather than taking on a more proactive role and no notification to the EBA has been made so far when banks are not considered to be resolvable, thus raising the issue that improvements are needed in this respect to safeguard level-playing field for banks and ensure their resolvability, also through heightened disclosures.
[214] Examples include banking groups such as Bankia, DZ Bank, Groupe BPCE and Rabobank. See De Groen (2019).

through which the authority first communicates its assessment to the bank and allows to propose measure to address and remove any identified impediments, and then possibly requires the bank to implement additional measures, if unsatisfied with those already proposed or taken. In this context, resolution authorities have the power to require changes to the structure and organisation of banks or banking groups with a view to removing impediments to the application of resolution tools and strategies, ensuring the resolvability of the entities concerned. The measures that can be imposed upon institutions include:

- limiting maximum individual and aggregate exposures;
- divesting specific assets;
- limiting or ceasing specific existing or proposed activities;
- restricting or preventing the development of business lines or sale of products;
- changing the legal or operational structures of the entity or any group entity under its control, so as to reduce its complexity and ensure that critical functions can be legally and operationally separated from other functions, if needed;
- setting up a Union parent financial holding company; and
- issuing eligible liabilities.

Such powers should establish sufficient incentives for banks to avoid an external imposition of changes to their operational models by investing on improving resolvability on their own terms before being forced to do so by resolution authorities. The most 'intrusive' means of intervention that resolution authorities have at their disposal, due to their having direct implications for the structure of institutions and how those structures might be reshaped in anticipation of resolution, are those providing for asset divestments and changes to operational and legal structures, aimed at easing the separability of critical functions in resolution. Since resolution authorities' powers in this respect would apply in a business-as-usual state, the intrusiveness of the available measures is less significant than early intervention[215] ones, even though some similarities exist with respect to the limitation of specific activities and divestment of (risky) assets. As

[215] Early intervention measures are applied by supervisory authorities, as disciplined by Art. 104 of Directive 2013/36 ('CRD IV').

the practical implementation of resolvability assessments by resolution authorities in Europe is still a work in progress[216], there is no evidence to be drawn yet on the actual willingness and ability of authorities to impose wide-sweeping measures to reorganise and restructure institutions already in the resolution planning phase, if substantive impediments to resolvability are identified. However, it is reasonable to expect that any effect would likely be self-contained and mostly concern institutions' internal functioning, thus being less likely to have systemic effects on market structures.

*2.1.2 Resolvability assessment*

Resolvability is a resolution group matter, as the resolution objectives should be met at the level of resolution group.[217] Indeed, BRRD2 formalises that the resolvability assessment should be carried out at the level of the resolution group as well as at the banking group level. Annex C to the BRRD lists the factors that should be taken into account by resolution authorities in making their resolvability assessments. Not all will be given equal weighting as they might be more or less relevant to different institutions, depending on the specific characteristics of the bank considered. In broad terms, the areas of focus for the assessments should relate to the legal, operational and financial structures of a banking group. These entail considerations around the following:

- governance structures;
- the suitability of liability structures for an effective execution of bail-in;
- data and management information systems capabilities;
- intra-group transactions and booking practices;
- critical functions and operational continuity;
- legal entity structures.

A bank's liability structure is one of the primary determinants of its resolvability, affecting the availability of loss-absorbing capacity that can be drawn

[216] De Groen (2019).
[217] 'Resolution group' is defined in Art. 2(83b) BRRD as (a) a resolution entity and its subsidiaries that are not: (i) resolution entities themselves; (ii) subsidiaries of other resolution entities; or (iii) entities established in a third country that are not included in the resolution group in accordance with the resolution plan and their subsidiaries; or (b) credit institutions permanently affiliated to a central body and the central body itself when at least one of those credit institutions or the central body is a resolution entity, and their respective subsidiaries.

on in resolution, as indicated by the bank's level of MREL-eligible liabilities, which is discussed more in detail in Section 2.3 below.

Resolution planning requires the mapping of services to critical functions, as well as of functions to legal entities, pushing banks to take a more resolution-entity focused approach to prepare for the application of resolution tools, if needed. Any complexity in the structures delivering critical functions needs to be scrutinised, in order to ensure smooth separation at the time of resolution, if necessary.[218] Maintaining critical operations running through resolution and the subsequent restructuring of the bank is one of the principal objectives of the resolution framework.

At a minimum, the resolvability assessment relating to operational continuity would focus on banks' analysis and documentation of their service level agreements, which must be robust to resolution events. Legal entity structures should also not inhibit the application of resolution tools, as resolution powers will be applied at the level of resolution entities, with the contracting entities and terms of its contract being more relevant than the bank's internal operating structure.

### *2.2 SPE vs. MPE resolution strategies*

In defining which approach to apply for the application of a resolution strategy to a banking group, the appropriateness of either an SPE or an MPE approach hinges on the operational structure of each bank and on the related spillover risks.[219] If a bank's operations are highly interdependent and complementary, with direct spillovers among entities in different jurisdictions, an SPE strategy would be more suitable. Otherwise, for more cross-border banks with a more decentralised structure, an MPE approach would be more efficient.[220] Yet, in evaluating the two approaches, other aspects should be also taken into account, including the likelihood that the chosen resolution strategy will actually be implemented in different jurisdictions, by different national resolution authorities,

[218] One option sometimes pursued for the simplification of complexities in this regard entails operational subsidiarisation, through the establishment of a standalone legal entity within the group not carrying out any regulated activities, but only dedicated to housing the services necessary to support critical functions, centralising contracts and services.
[219] For an analysis in respect of global banks, see Bolton and Oehmke (2019).
[220] *Ibid.*

and the tension between the autonomy of group subsidiaries autonomy, which would enable separability, and the efficiency of the overall group.[221]

However, either at the resolution planning stage or at the time of resolution execution, national regulators might find the SPE to be against their individual interest, due to the size of the cross-jurisdictional cash flow transfer.[222] If then there is an ex post failure of the envisaged SPE strategy, host country authorities might ring-fence the local branch or subsidiary of the bank involved.[223] On the other hand, an MPE approach relies on the autonomy of legal entities operating in different jurisdictions, enabling separability along national lines within the same cross-border banking group. However, it has the downside of producing costly or inefficient outcomes where intra-group interdependencies are strong.

*2.2.1 Separability*

One of the aspects addressed in the assessment of resolvability which is tightly related to banks' structure, complexity and interdependencies is the extent to which a group is separable. Separation is required for all partial transfer strategies and asset deals. There is no legal definition of what separability means in the context of an MPE strategy, apart from indications that an MPE strategy is more suitable to more decentralised banks. In broad terms, resolvability in the context of an MPE strategy is the same as resolvability in the context of a SPE approach, in the sense that the objective is to ensure that, post-resolution, the resulting entity can continue to operate, following a change of ownership and management. In that sense, it is useful to think about interactions between the resolution group or entity to be separated and the parent as a relationship between a recipient and the provider of a service or function that is being outsourced.

In devising a transfer strategy, in the first instance, the resolution authority should define the resolution objectives in relation to the planned separation. The chosen resolution strategy, be it a transfer of assets and liabilities to a bridge institution or to an AMC, depends on the specific situation and on the resolution objectives that have been identified as being of essence in the particular

[221] For a more detailed discussion on this point, see Schoenmaker (2016).
[222] *Supra*, note 220.
[223] Huertas (2014), Schoenmaker (2016).

circumstances relating to the institution. The resolution objectives build the foundation of all discretionary decisions which have to be taken in determining the transfer units and calculating the exact perimeter of the transfer. A transfer unit is intended here as the smallest possible group of assets, liabilities and rights that should be transferred together. In order to determine the transfer units, the core assessment should focus on which connections between the transfer items should be protected, either due to legal obligations or based on a discretionary decision in order to ensure the realisation of one or more resolution objectives.

#### 2.2.1.1 Practical considerations on separability for the execution of transfer strategies

The operational and financial continuity of the new legal entity- in particular in case of a bridge bank and AMC- have to be taken into consideration when optimising the transfer portfolio. This entails accounting, among others, for service level agreements (SLAs) for IT continuance, human resources, access to financial market infrastructures (FMIs), initial funding and refinancing options. As for how these conditions might change depending on the approach chosen for the point of entry at which resolution tools will be applied, an MPE strategy could allow for separability at the level of group subsidiaries, to address which subset of assets, liabilities and rights of a specific subsidiary should be kept together.

Indeed, MPE strategies may involve the application of multiple SPE resolutions to different parts of the firm, such as separable geographical blocs. An MPE strategy should then ensure that the resolution actions applied at each point of entry are consistent across the banking group. Where an SPE strategy is chosen, instead, an identification should be made of the operational subsidiaries that should remain open and operative in resolution if losses are upstreamed and absorbed at the top of the group and the parent or holding company down-streams capital and liquidity in support of subsidiaries. The strategy should also verify whether certain group entities are sufficiently separable to be resolved separately, if necessary, for instance when the losses of specific subsidiaries exceed the loss absorbing capacity of the parent or holding company.

In case the separation determined by the chosen resolution strategy is completed by way of a share acquisition of the separated part of the entity in resolution by a third party, it will be the responsibility of the acquirer to ensure the operational viability of the transferred entity, as there would be an immediate acquisition of control by another already existing institution. Otherwise, where the separation consists in the detachment of part of an entity with the final aim to render it self-standing after resolution, all of the appropriate financial, legal and operational arrangements to allow the entity to have the necessary means to remain viable should already be accounted for at the resolution planning stage. Then, it might be the case that the separated entity is acquired by a third party at a later stage.

Depending on how broad the perimeter of the transfer is set and which critical functions or core business lines it includes, the competition-relevant implications of the transfer strategies might differ. Where only a reduced portfolio of assets is transferred, there might be no significant alteration of the competitive structure of the market after resolution. On the other hand, if the transfer perimeter encompasses most assets and liabilities of the failing institution, with the exception of non-performing loans for instance, then the impact on the market structure could be more pronounced and will undergo scrutiny by antitrust authorities on the basis of the market presence of both the transferred entity and its acquirer, if the areas of activity of the two happen to overlap. In order for an acquisition to be cleared under the applicable competition rules, the post-merger market shares should not indicate the existence or creation of a dominant position of the entity emerging from the transfer, and, to this end, the presence of other qualified competitors active in the same market segments will also be evaluated favourably. More details in this respect are highlighted in Section 3.

### *2.3 MREL*

Together with effective resolution planning, the setting of a minimum requirement for own funds and eligible liabilities (MREL) contributes to ensuring that no public money is required in case of a bank's failure. The BRRD and SRMR requirements, which set out for banks to build and maintain sufficient loss-absorbing capacity to support the preferred resolution strategy, are intended to facilitate the feasibility of bail-in when the time comes for resolution to be enacted. More specifically, credit institutions are required to hold a sufficient amount of MREL at all times, consisting of own funds instruments and eligible liabilities that can be used by resolution authorities to absorb losses and recapitalise an institution that is failing or likely to fail.

The calibration of the requirement is based on two components: (i) a loss absorbency amount (LAA), equal to the sum of the bank's Pillar 1 and Pillar 2 capital requirements and its fully-loaded combined buffer requirement, which should ensure the full coverage of losses in the event of resolution; and (ii) a recapitalisation amount (RCA), equal to the sum of Pillar 1 and Pillar 2 capital needed to maintain a banking license together with a buffer to ensure market confidence after resolution, which should restore the capital position of the bank.

To be eligible as MREL, instruments should be (i) issued, (ii) fully paid-up (iii) with a remaining maturity of at least one year, and (iv) not guaranteed or funded by the institution itself. The BRRD2 has introduced an additional leverage-based dimension to compute external and internal MREL requirements. More specifically, LAA and RCA should not only be computed as a percentage of the total risk exposure amount (TREA), but also as a percentage of the Leverage Ratio Exposure Measure (LREM). Therefore MREL will need to be expressed as two ratios to be met in parallel: (i) as a percentage of TREA; and (ii) as a percentage of the LREM.

*2.3.1 Computation base*

The choice of the measure for MREL and TLAC computation might have different implications for how requirements are allocated across banks, depending on whether the benchmark for calibration is based on risk-weighted assets, total assets, or leverage exposure.[224] Indeed, measures based on risk-weighted assets have been found to lead to requirements which are comparatively heavier for smaller banks, while total assets and leverage exposures appear to be more aligned across banks, irrespective of their size.[225] Thus, using a leverage ratio-based requirement would allow for an MREL calibration that is proportionate with capital requirements, depending on which buffers are included. This approach should also enable to implicitly account for total assets, as they are generally strongly correlated

[224] Berger, Hüttl & Merler (2016) find a size bias depending on the basis of computation of the requirement.
[225] *Ibid.*

with leverage exposure. The fact that the BRRD2 and SRMR2 have introduced the requirement of a "double" MREL calibration based on RWAs and LREM should alleviate size-related biases compared to the previous formulation of the requirement and, as a consequence, ensure a more balanced and fair approach.

MREL is set both on a consolidated basis for the banking group or resolution group and on an individual basis for single resolution entities. Depending on the preferred resolution strategy, MREL levels may vary across entities within the same group. The purpose is to ensure that all entities which are relevant for the execution of the resolution strategy have levels of MREL which are sufficient and correctly positioned within the group to effectively execute the actions envisaged in the plan. As MREL is institution-specific, resolution authorities' calibration of the requirement should also take care to ensure a level playing field across different banks in the industry and prevent undue competitive distortions. In this sense, MREL calibrations must be guided by the principle of proportionality, in order to ensure that the different MREL targets for credit institutions, as measured in terms of their risk-weighted assets, are comparable with those of similar peers and balanced around the average targets of other national and Banking Union banks, as well as being appropriately reflective of to the single banks' size, business model and risk profile.[226]

*2.3.2 Proportionate calibration of MREL*

Already in 2015, the Bank of England advanced the view that resolution strategies should be assigned according to bank size, by requiring banks above a certain threshold to hold an MREL consistent with bail-in, and small banks to hold an MREL consistent with liquidation, entailing a recapitalisation amount of zero. Such a simplification has the purpose of limiting the discretion of resolution authorities and clearly signaling which strategy will be applied to recapitalise and restructure which banks, in case of distress. The revised BRRD and SRMR have

[226] Lamandini and Ramos Muñoz (2019). See also case 8/18 decided by the SRB Appeal Panel, who found "*no reasons to reject the Board's argument that, in such circumstances, an increase of MREL to 8% 14 of TLOF would most likely imply a disproportionate approach vis-à-vis peers active in the [same national] market but also in the Banking Union and could possibly have unintended consequences of serious distortion of the competitive level playing field*" (para. 34). As reported by the EBA (2020), the National Bank of Romania, in its role of resolution authority has made direct reference to the fact that the MREL recapitalisation amount is "benchmarked against the capital position of peer institutions" (see annex to EBA Quantitative MREL Report).

effectively incorporated such considerations, allowing supervisors to accept a lower bail-in buffer from those banks with limited access to capital markets.

### 2.3.2.1 Calibration based on size and choice of resolution tool

One other relevant aspect to consider is that the BRRD2 and CRR2 effectively introduced an harmonised requirement for full MREL subordination applying to G-SIBs and 'top tier' banks[227] or 'fished' banks[228], but left discretion to authorities as regards other institutions.[229] This, on the one hand, allows to retain flexibility in adjusting bail-in requirements to different bank models, but on the other hand, affects banks' funding structures in different ways, if no full subordination is imposed with respect to institutions other than G-SIBs and 'top tier' banks.

As anticipated, MREL is differently calibrated for small banks, for which no recapitalisation amount is required as their preferred resolution strategy will most likely consist of liquidation under national insolvency procedures, as their failure is less likely to pose systemic risks. However, recent experience of crisis management cases[230] has proven that the boundary between significant and less significant banks is not exactly clear cut. As a matter of fact, what is identified as significant at the resolution planning stage could become less so at the point of non-viability (PONV), depending on whether the public interest test for resolution is met or not. It may be the case that the categorisation distinguishing between systemically important and less significant institutions as applied within the framework of the SSM and SRM could be accurate at the extremes, but less straightforward for the in-between middle-sized institutions, blurring the lines between large and small banks.[231]

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[227] Resolution entities part of a resolution group the total assets of which exceed €100 billion, pursuant to Art. 45c(5) BRRD.
[228] Resolution entities part of a resolution group the total assets of which are below €100 billion, but assessed by the resolution authority as reasonably likely to pose a systemic risk in an event of failure, pursuant to Art. 45c(6) BRRD.
[229] The EBA (2020) observed that until now subordination requirements have differed depending on the policies of the relevant resolution authorities and on their aversion to the risk of breaching the NCWO principle, finding a variation in subordination levels ranging between 68.2% and 100% of total MREL.
[230] See Chapter 5 for an in-depth analysis of recent cases.
[231] See Joosen et al. (2018), who also argue in favour of a more proportionate approach to banking regulation in Europe.

A further example of proportionate MREL calibration accounts for the application of different resolution tools and is identifiable in the fact that the recapitalisation amount (RCA) of the MREL can be calibrated and scaled down where transfer strategies are chosen, so as to reflect the lower recapitalisation needs brought about by the transfer and/or liquidation of some bank assets.[232]

#### 2.3.2.2 Institutions' ability to issue MREL

Differences are not identifiable exclusively in target calibrations but also in institutions' ability to issue and successfully place MREL-eligible liabilities. On the basis of observations on the build-up of MREL liabilities in practice, MREL shortfalls vary depending on the type and size of the banks and their resolution groups, with larger banks registering a lesser disadvantage.[233] Another issue to consider relates to the fact that the capacity of the market to absorb the issuances of instruments required to meet MREL targets is country-specific and is also dependent on the ability and appetite of local investors.[234] Hence, existing home biases could further hinder the capacity of markets to absorb MREL-eligible securities issued by banks established in countries such as the Southern European ones.

As a consequence, it may be the case that minimum bail-in conditions, and the requirements on MREL and TLAC associated with them, could become a binding constraint on the sustainability of banks' business models and affect the competitive structure of the banking markets to some extent.[235] In particular, those banks whose business models do not easily allow them to access capital markets to issue subordinated and other convertible liabilities to meet the requirements for a

[232] See SRB's 2018 MREL Policy, available at: https://srb.europa.eu/sites/srbsite/files/public_mrel_policy_2018_-_second_wave_of_plans.pdf.

[233] EBA MREL Quantitative Report, available at: https://eba.europa.eu/eba-shows-banks%E2%80%99-progress-planning-failure-encourages-them-issue-eligible-debt-instruments.

[234] On the point of investors' perspective on MREL, Tröger (2019) argues that it is unlikely that the pricing of MREL instruments can reflect an accurate risk assessment by investors due to the many discretionary choices that different constituencies are supposed to make and revisit to abide by the new regime, and this might lead to inadequate market discipline in relation to bail-inable instruments.

[235] See also the decision of 16 October 2018 of the SRB Appeal Panel in case 8/18, acknowledging that "*[t]he MREL determination may have far-reaching implications on the return on capital, the business model and the competitive level playing field for all involved institutions and cannot be considered in isolation from the actual and prospective responsiveness of capital markets to the issue of large amounts of MREL-securities*" (para. 30).

sufficient amount of bail-inable debt would probably experience more significant challenges.

In view of these considerations, it seems that there is a possibility that some of the requirements embedded in the resolution framework allow for an effective application of the rules to those institutions both meeting the public interest test for the use of resolution powers and having a size and business model enabling a sufficient issuances of subordinated liabilities eligible to be bailed-in in resolution without undue risk of negative impacts.[236] In this perspective, the resolution framework can be seen as potentially favouring consolidation in the banking sector, insofar as institutions unable to meet the necessary requirements could be (i) liquidated in case of failure, (ii) (partly) absorbed by another competitor in resolution or liquidation, or even (iii) aim to merge ex ante with other institutions that are better positioned to access capital markets to place bail-inable instruments and, thus, be more likely to be kept in the market through the application of resolution in case of failure.

## 3. Resolution tools

Resolution authorities enjoy flexibility with respect to the specific tools they can use to resolve a failing bank, ranging from the sale of the business to a private buyer, to the transfer of the business to a publicly managed bridge bank, to the separation of troubled assets from other assets through the creation of a "bad bank", to bail-in. These resolution tools are not mutually exclusive, and are most likely to be combined in practice.

### *3.1 Bail-in*

Bail-in can be used as a standalone tool or in combination with others, as part of a more articulated resolution scheme. The BRRD takes a comprehensive approach according to which all liabilities are in principle subject to bail-in; both statutory and *ad hoc* exemptions to this baseline rule can then be granted by the resolution authorities.[237]

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[236] Restoy (2018).

[237] Art. 44(3) BRRD provides for discretionary exclusions from bail-in. Exemptions may also be granted on the basis of Commission Delegated Regulation 2016/860, if there are reasons to conclude that a bail-in of specific liabilities would: (i) not be possible within a reasonable timeframe; (ii)

As for the order of priority with which the write-down and conversion should be executed, equity instruments must be affected first- starting with Common Equity Tier 1, then Additional Tier 1, and Tier 2- followed, in order, by: (i) subordinated liabilities; (ii) uncovered senior liabilities; (iii) uncovered deposits; and (iv) the deposit guarantee scheme (DGS) to which the bank concerned is affiliated for covered deposits. Each class of investors has to contribute before the following one can be impacted, and creditors within each class must be impacted pari passu, being subject to pro-rata contributions.

This approach mimics the effects of normal insolvency procedures, in compliance with the "no-creditor-worse-off" (NCWO) principle, according to which no creditor should be worse affected in resolution than what would be the case in liquidation proceedings.[238] The counterfactual scenario considered for the purposes of applying the NCWO safeguard is the national insolvency regime that would have applied to the bank or group entity in question.[239] Such safeguard constitutes an ex post liability mechanism granting a right to financial compensation to any creditor suffering a greater loss in resolution than would have been the case under national insolvency proceedings. The subordination of bail-in eligible instruments, especially in terms of MREL targets built by banks, is crucial to address the issue of potential NCWO claims in the event of the application of a bail-in of creditors.

Differently from the American Orderly Liquidation Authority (OLA), which provides for the liquidation of the bank holding company using bail-in to leave operating subsidiaries unaffected, the EU has an 'open' bank resolution process. The latter is reliant on the successful bail-in of the ailing bank. The bail-in tool can be used to keep the bank as a going concern and avoid disruptive liquidation or dis-membering of the financial institution in distress.

As for how shareholders are addressed by the application of bail-in, existing shares will need to be cancelled or transferred to bailed-in creditors. Where the

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cause contagion; (iii) impair the continuity of the institution's critical functions; or (iv) cause a disproportionate value destruction.

[238] See Binder (2016) on how the resolution framework has reduced the position of creditors to ex post compensation through the NCWO principle, differently from traditional insolvency proceedings.

[239] On the point of the continued relevance of national insolvency law under the BRRD especially in this perspective, see Haentjens (2014).

institution has a positive net asset value pursuant to the resolution valuation, existing shareholders are diluted by means of a conversion of existing capital instruments or other eligible liabilities. In such a case, the existing shareholdings must be severely diluted by the conversions. Therefore, by way of its write-down mechanism, bail-in entails a change in the ownership and control structure of the bank concerned. In this sense, who holds bail-inable securities is also relevant insofar as cross-holdings among financial institutions can have implications for market power when ownership changes as a result of bail-in application.[240] Any qualifying holdings or acquisition of control in the entities emerging from resolution, after the application of bail-in or other resolution tools, would need to be approved by the relevant supervisory authority.

### *3.2 (Partial) transfer strategies*

The other resolution tools available pursuant to the BRRD include sale of business, bridge institution and asset separation, which entail, albeit to different extents, transfer strategies to deal with the restructuring of a bank that is failing or likely to fail. In order:

1. **Sale of business** entails the sale of shares or assets, rights and liabilities of the failing bank to a private sector purchaser.[241] Only the consent of the acquirer is required to execute the sale. The transfer must be made on commercial terms in an open, transparent and non-discriminatory process, while also maximising the sale price. If this is not possible for reasons of urgency, authorities must take measures to redress competition distortions.

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[240] On the point of the relevance of bail-in holdings, Ringe and Patel (2019) found that bail-in powers may be increasing the risk arising from banking interconnections, contrary to the regulators' intention, as a consequence of a regulatory gap in the resolution framework, which fails to address concerns relating to the counterparties of bank capital. This results in a distortion of incentives for investors making investment in interconnected banks more attractive, hence producing more systemic risk than socially preferable. In this sense, the BRRD2 has brought forth some improvement, by requiring a deduction in the MREL of G-SIBs for own eligible liabilities instruments and holdings of eligible liabilities of other G-SIBs. On the counterparty risk related to bail-in, see also Bernard, Capponi and Stiglitz (2017).

[241] A share deal would be more suitable for those institutions with a high degree of operational interconnectedness, significant asset encumbrance, and for which a carve out of assets would lead to a significant value destruction. It would require sufficient market capacity and investor appetite for the whole bank at stake. On the other hand, an asset deal would potentially be more suitable for institutions holding large portfolios of specific types of assets that could also be marketed to non-financial institutions. Separability is one of the core pre-requisites necessary for an asset deal to be viable. On separability, see Section 2.2 of this chapter.

2. **Bridge institution** is similar to the previous resolution tool in terms of sale of assets, rights and liabilities. However, instead of a private purchaser, the acquirer is a temporary bridge institution wholly or partially sponsored by the government and controlled by the resolution authority.
3. **Asset separation**, allowing for the transfer of assets, rights and liabilities from a failing bank to a separated asset management company (AMC). The AMC has the purpose of managing and liquidating the assets with a view to maximising their value. However, this tool can only be applied in combination with others in order to avoid undue competitions distortions favouring the institution involved.

*3.2.1 Sale of business and bridge institution*

The application of resolution tools such as a bridge bank or a sale of business, albeit intended at limiting the recourse to public funds, still might become potentially problematic under an antitrust perspective relating to mergers and acquisitions of control. This stems from the fact that the business or portfolio of assets and liabilities transferred from the failing bank will generally be destined to be acquired by another sound entity operating within the same sector as the former, thus completing an operation which can be relevant in the context of merger control. Such considerations were evidenced in the resolutions of Spanish Banco Popular (Section 3.2.1.1), as well as of four small Italian banks (Section 3.2.1.2). In particular, the resolution of Banco Popular marked a milestone in the development of the Banking Union as concerns the recourse to European tools for bank restructuring. Indeed, the bail-in of its creditors and the consequent sale to Santander represented the first time in which the SRB used its powers under the SRMR to write down and restructure a bank's liabilities.[242]

**3.2.1.1 Lessons from the resolution of Banco Popular**

Banco Popular started to show signs of distress in 2016.[243] In the course of the following year it became clear that the bank needed a capital increase and the

[242] Dombret A., 'Failing or likely to fail? Putting the European banking union to the test'. Speech at the Deutsche Bundesbank's University of Applied Sciences, Hachenburg, 21 August 2017.

[243] These were compounded by a sentence obligating the institution to compensate its clients for a violation of consumer protection laws in relation to floor clauses set on home loans. See Europa

possibility of a sale to a competitor was advanced. As a consequence of concerns over sizable NPLs related to real estate assets ratings plunged and outflows of deposits started materializing as increasing alarming announcements on the Banco Popular's health spread. The bank's share price dropped to 32 euro cents, with capital approaching the trigger level at which AT1 instruments would convert into bail-inable bonds, even though minimum capital levels were not breached before the bank was deemed to be non-viable, thus not activating the CoCo's triggers.[244]

On 6 June 2017, the ECB determined that Banco Popular was 'failing or likely to fail', as "the significant deterioration of the liquidity situation of the bank […] led to a determination that the entity would have, in the near future, been unable to pay its debts or other liabilities as they fell due", thus meeting the first condition for resolution to be triggered. On the next day, with the SRB's determination that no alternative private solution would have been available and it was in the public interest to restructure the bank[245], Banco Popular effectively entered into resolution. This triggered the write-down and conversion of capital instruments prior to the transfer of the bank, to address the shortfall in the value of Banco Popular. In particular, all existing shares (CET1), and Additional Tier 1 instruments were written down, while Tier 2 instruments were converted into new shares, which were then transferred to Banco Santander for the symbolic price of 1 euro. The sale of the ailing bank enabled its continued operation under normal business conditions as part of the Santander group, with renewed solvency and liquidity.

In the context of the resolution of Banco Popular, no State aid was found, and no recourse was made to the SRF, but rather the SRB made use of the sale of business tool, in combination with the bail-in tool. Thus, the sale underwent a

Press, 'Banco Popular, condenado a devolver todos los intereses cobrados de más de una hipoteca con cláusula suelo', El Economista, 21 December 2016.

[244] Below 5.125% or 7% of the CET1 ratio of the bank. The fact that bonds were not converted into equity left CoCo investors with worthless securities while resolution was implemented. Such interference with the use of CoCos in resolution was a result of the blurred lines between liquidity and solvency issues triggering the bank failure. On the latter point, see Schillig M., 'Resolution and Insolvency of Banks and Financial Institutions' (Oxford University Press, 2016).

[245] These two are the remaining conditions, which, together with FOLTF, build towards a cumulative determination that resolution should be triggered. See Ventoruzzo and Sandrelli (2019) for an in-depth analysis of how the determination relating to the three conditions for resolution was carried out by the SRB.

regular merger and regulatory review.[246] More specifically, the merger was cleared on the basis of the fact that (i) the combined market shares stemming from the transaction would have remained below 30% both in Spain and Portugal in the relevant market segments where the activities of the two parties overlapped; (ii) where an overlap existed between the activities of the merging parties, either the two were not each other's closest competitor, or other important competitors would still remain present, exercising strong competitive pressure post-transaction and ensuring substitutability of products and services offered, and (iii) possible concerns due to the creation of a vertical link between banking services and the market for ATM services were curbed by the low combined market share of the parties, making any foreclosure unlikely to materialise.

Even though Banco Popular was Spain's six largest lender, with subsidiaries in Spain and Portugal and operations in the United States[247], it did not qualify as a globally significant institution and it had a relatively simple corporate structure and business model. If future resolutions cases ever came to concern larger banks, properly and fully active at global level, comprising many different legal entities, as well as complex relationships with customers and other financial institutions and infrastructures, the process might be significantly more complex to complete than it already was for Banco Popular.[248] Another relevant aspect to consider is that the effectiveness of resolution tools entailing a transfer of (part of) a failing entity also relies on the availability of a willing competitor to take on the failing bank.[249] As a result, on the basis of the market positioning of the acquirer, transfer tools in resolution will potentially generate competition concerns through an acquisition of control, which will need to be scrutinised by the relevant antitrust authorities to

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[246] *Banco Santander/Banco Popular Group*, Case M.8553, decision of 8 August 2017, available at: https://ec.europa.eu/competition/mergers/cases/decisions/m8553_573_3.pdf

[247] 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.

[248] Binder (2017).

[249] This was verified in the case of Banco Popular, through Santander, but it might not always be assumed with confidence to be reliably available, which is the reason why a "variant strategy" such as bail-in is usually required by the resolution authority to be specified in the resolution plan as a fallback option. See Restoy, Vrbaski and Walters (2020) on this point, addressing how this could imply that, in such instances, there would be little scope to reduce the MREL requirements of the institution concerned, also in view of the policy developed by the SRB. The relevance of the presence of a willing buyer was also evidenced by the rescue of Italian Monte dei Paschi di Siena, in which the limits to reliance on the market to sustain an ailing bank led to a need for a public bailout (see Chapter 5 for an in-depth analysis of the case).

ensure that no dominant position is created or strengthened, or, otherwise, to impose remedies to preserve undistorted competition.

Another cautionary tale evidenced by the Banco Popular case is linked to the fact that the application of the bail-in tool can exacerbate pro-cyclical effects due to loss of confidence at the prospect of bail-in being triggered and through potential contagion.[250] This raises an issue for regulators to calibrate the timing of their intervention with an eye to limiting behavioural risk in the market. However, this exercise is complicated by the (current) lack of a quantitative theoretical model laying down clear cut intervention thresholds and criteria on which to rely. Yet, liquidity issues might be worsened by rising funding costs at a time of distress, leading to resolution becoming increasingly inevitable. Therefore, a crucial role is also played by the way in which information is handled in the decision-making process, which is another one of the aspects that sparked a controversy in relation to the resolution of Banco Popular. Indeed, the preservation of confidentiality in the communications among all stakeholders involved in resolution proceedings is identified also by the BRRD[251] as a key element to ensure a successful resolution, while preventing market panic. This calls for an additional balancing exercise between the need for confidentiality to avoid leaks of bank-related market sensitive information and the protection of creditors' interests.[252]

#### 3.2.1.2 Resolution of four small Italian banks

As for the effects of bank restructurings on the structure and number of market operators, similar considerations arose in the case of the resolution of Italian banks Banca Etruria, Banca delle Marche, Cassa di Risparmio di Chieti and Cassa di Risparmio di Ferrara in 2015. In that instance, four bridge banks were created to take over the good parts of the four failing banks, including rights, assets and

[250] See Schillig (2016) at p. 311. Procyclicality was highlighted by Banco Popular's investors as a contributing cause for the sale to Santander for a merely symbolic amount.
[251] Art. 84 BRRD.
[252] The compatibility of the confidentiality policies of the ECB and SRB with the protection of creditors' interests has been brought into question by the Banco Popular. As a matter of fact, a number of investors filed appeals before the SRB Appeal Panel regarding access to SRB documents used in the decision-making process finally leading to the resolution of the Spanish bank. The SRB Appeal Panel confirmed that full disclosure of the Provisional Valuation Report would raise financial stability concerns, which could have had "an impact on other market participants and/or resolution actions in the future". See cases 38/17 to 43/17 brought before the SRB Appeal Panel. On this point, see also de Charette (2018).

liabilities, while the shareholders and subordinated creditors saw their claims annulled due to burden-sharing requirements. Simultaneously, the asset separation tool was used in transferring the non-performing loans of the four banks to a State-controlled AMC, aiming for recovery and improving the chances of finding candidate buyers for the bridge banks. After a failed attempt at an open sale procedure where no operator advanced an offer, BPER finally acquired the new Cassa di Risparmio di Ferrara, while UBI acquired the other three bridge banks.

The Italian antitrust authority did not oppose the acquisitions of full control of the bridge institutions on the basis of some core considerations. Firstly, where an increase was registered in the market shares of the parties it was not particularly significant, as the post-merger shares were mostly attributable to the bridge banks, which had also shown a decreasing trend in the years preceding intervention. Additionally, in the same relevant market segments at the level of province, a number of other qualified competitors were also active, and thus able to exert a disciplining effect on the new combined institutions. Then, a variation of the "failing firm defense"[253] was also advanced to approve the operations, by highlighting that, absent the two acquisitions, the assets of the bridge banks would have been forced to exit the market, thus causing a reduction in the supply of banking products and services to the detriment of customers and in any event redistributing the market shares of the exiting banks among other existing operators. Thus, the operations also had to be considered in light of their stabilisation role, allowing to solve the crisis situation of the four institutions.[254]

### *3.2.2 Asset separation*

The asset separation tool under the BRRD is an example of an impaired assets measure. While recapitalisations create a buffer of capital against future losses, impaired asset relief measures protect the recipient bank from the risk of losses materialising in the first place. Asset relief measures generally take one of two forms:

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[253] According to competition policy, there is the assumption that without a merger the failing firm would disappear from the market, implying that even a domestic merger would not result in concentration. See, as an example, Malinauskaite (2012) for a review of the development of the failing firm defense in the European merger control practice.
[254] See cases C12087 (Provvedimento n. 26552) and C12094 (Provvedimento n. 26621).

1. asset purchases, whereby the impaired assets are transferred from the balance sheet of the beneficiary to that of another entity, which is often a special purpose vehicle owned or supported by the State[255]; or
2. asset guarantees, through which the State insures the beneficiary bank against losses incurred from the impaired assets, which remain on the balance sheet of the bank.[256]

After the implementation of the BRRD, asset relief measures should only be possible in the context of resolution, as they are not mentioned as permissible among the precautionary aid measures listed in Art. 32(4)(d) BRRD. As impaired asset measures are structural in nature, they are subject to the same ex ante conditions and restrictions that the 2013 Banking Communication requires for recapitalisation aid. More specifically:

- the aid beneficiary should bear the losses associated with the impaired assets to the maximum extent possible. Generally, this is considered to be achieved when the transfer price[257] of the assets is below their real economic value (REV).[258] In accordance with the definition of the Impaired Assets Communication[259], the REV of the assets is their underlying long-term value, as estimated on the basis of underlying cash flows and broader time horizons.
- The State must receive an appropriate remuneration for the risk it takes on that the assets will suffer further impairments below their REV. If the transfer price is set at or below market value or the remuneration is calibrated taking into account market benchmarks, the European Commission may conclude that the measure itself does not entail any aid.[260]

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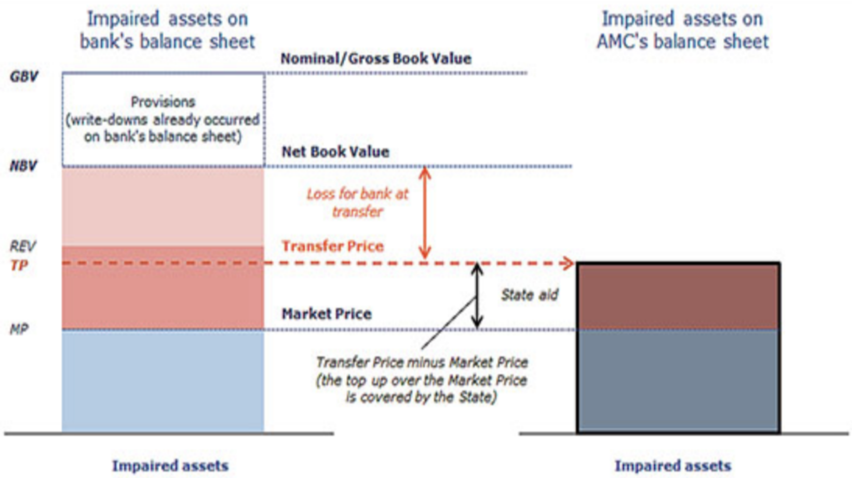
[255] This had been the case for *NAMA: Impaired asset relief scheme for banks in Ireland*, N 275/2009, 26 February 2010.
[256] What happened in the recapitalisation and asset relief for HSH Nordbank, N 264/2009, 29 may 2009.
[257] Transfer price is taken to mean the purchase price, in case of an asset purchase, or the amount insured, in case asset guarantees are used. In the case of asset guarantees, the insured amount is the book value of the assets after the deduction of a "first loss" that must be borne by the bank before the State makes any payment.
[258] As per para. 41 of the Impaired Assets Communication.
[259] At para. 40.
[260] Such was the case, for instance, for the Italian securitisation scheme (known as "GACS"), SA.43390, 10 February 2016.

– The beneficiary of the impaired asset measure must submit a restructuring plan to the European Commission.[261]

When an impaired asset relief measure qualifies as State aid, its amount must be capped at REV and the measure must respect a number of conditions in order to be declared compatible with the internal market by the Commission. The value of aid in these cases is calculated as the difference between the transfer price and the market price, as shown by Figure 4.1 below. More specifically, the market price reflects the value of the assets under the prevailing market conditions at the time of intervention.

*Figure 4.1 - State aid in impaired asset measures*




*Source*: European Commission

One of the reasons justifying the application of such measures in order to restructure ailing banks relates to the fact that impaired assets may be subject to higher risk weights, thus consuming more capital in a situation in which an institution's capital position may already be bearing some pressure.[262]

[261] Paras. 23, 34, 49 and 50 of the 2013 Banking Communication.
[262] Galand C., Dutillieux W. and Vallyon E., "Non-performing loans and state aid rules", 2017, European Economy. Banks, regulation and the real sector, p. 141.

The choice of assets to be targeted for separation will contribute to define the new bank's business model, franchise value, and potential future profit drivers. Too wide a scope for asset separation might erode the business rationale of the bank, while a narrow one incurs the risk that the bank is not fully lifted of its problem assets. As for the pricing of the transfer assets, the State aid framework requires banks to provide valuations undertaken by an independent expert, which have to be then certified by the relevant supervisory authority.[263] Therefore, the resolution authority should be able to rely on a comprehensive valuation of assets, distinguishing those that will remain within the core bank from those that will undergo a workout or foreclosure by a separate AMC, in accordance with the resolution plan. Due to time constraints and potential market upheaval while implementing the measures, valuations will most likely be uncertain, particularly where non-traded assets are concerned. The other crucial point to take into account is whether a receptive market exists to which the assets can be sold or an AMC is in place and available to value and take over such assets speedily in a crisis situation. Both potential sources of demand will mostly probably be strained once bank distress is more widespread.

It is challenging to find unquestionable criteria to assess which assets will pose significant issues in case of a remote and unpredictable situation in which resolution would need to be enacted. Instead, authorities have the flexibility to choose the most suitable resolution tool to apply, including, if needed, the asset separation tool which ensures that problematic assets can be isolated and liquidated smoothly in a given crisis context. It is debatable whether any existing difficulty to evaluate an asset for resolution purposes should be a reason for imposing the divestment of the asset concerned. If the asset structure implies that certain resolution strategies are inapplicable, then other resolution strategies could be chosen, rather than requiring an institution to divest assets in a going concern situation in order to address possible concerns in a hypothetical resolution situation. On the other hand, divestments would certainly be called for if an institution has an asset structure that makes resolution impossible. The approach chosen by resolution authorities in this respect will have implications for banks' asset structures which

[263] The Commission may challenge the valuation, in which case it can appoint its own experts (see SNS REAAL case, SA.36598, 19 December 2013) or make use of its own estimates of 'safe harbour values' (see Banif case, SA.43977, 21 December 2015).

will be more or less significant depending on the judgment of which assets constitute a significant impediment to resolvability.

**4. Implications of resolution/bail-in introduction for banks' funding**

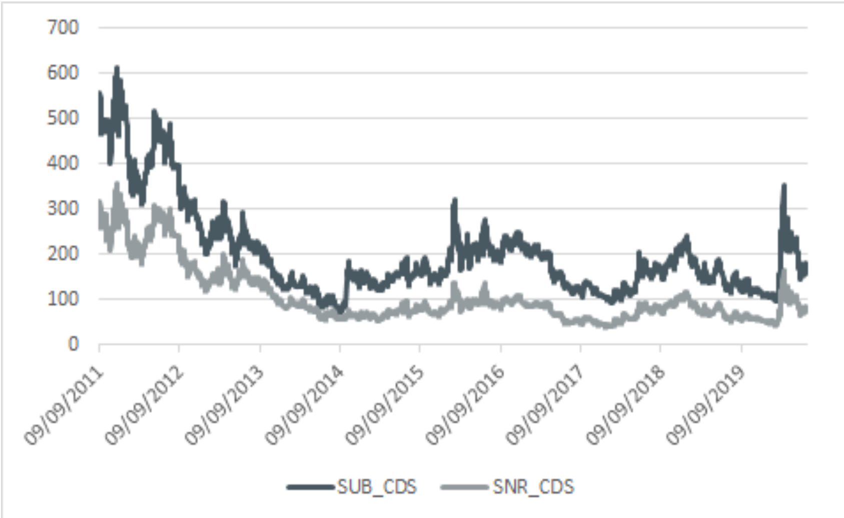
After having discussed the different resolution tools, it is worthwhile to address another competition-relevant effect that the BRRD might have brought about, in terms of how banks' funding costs might have been altered in reaction to the introduction of resolution rules, and bail-in in particular. The introduction of the BRRD has a twofold implication for the market pricing of subordinated debt, since (i) it sets an explicit hierarchy of subordination to absorb losses in case of bail-in, which could increase investors' perception of the riskiness of subordinated bonds and thus possibly lead to demand higher returns for their investment; and (ii) it requires some entities to issue subordinated debt to comply with their MREL targets.

The European Banking Authority has highlighted how banks' size and country of origin also play a role in affecting funding costs, predicting that subordinated debt would cost the same as equity for mid-sized banks not large enough to be systemically important, as well as for all banks incorporated in those countries that required international bailouts during the global financial crisis, i.e. Cyprus, Greece, Ireland and Portugal.

Banks' funding costs have been proxied by CDS spreads in a strand of economic literature.[264] Looking at the evolution of the subordinated and senior financial iTraxx indices, which are based on CDS spreads and refer to a sample of European banks, allows to have a picture of how the perception of banks' solidity or potential default has varied along the past years, both before and after the BRRD came into force.[265]

[264] See Arnould, Pancaro and Żochowski (2020) for a review.
[265] No direct causal relationship is herewith implied. This exercise has a merely illustrative purpose.

*Figure 4.2 - Subordinated and senior financial iTraxx indices (September 2011-June 2020)*




*Source:* Bloomberg

Both senior and subordinated iTraxx indices were at their peak during the global financial crisis, slowly decreasing in the years of the recovery, as shown by Figure 4.2 above. This is consistent with the situation of market turmoil and the consequent bailouts necessary to rescue financial institutions. The beginning of 2016, time at which the BRRD entered into force, registered a spike in both subordinated and senior CDS spreads, even though the former experienced a more marked variation, possibly in line with the expectation that the perceived probability of bail-in was altered, affecting funding markets as a result.[266] A slight increase in both indices is also observable around the time of both the Council agreement on the so-called "banking package" reached in May 2018 and its

[266] This is corroborated by empirical studies in the literature. See, inter alia, Schäfer et al. (2017), finding that bailout expectations have been reduced since the introduction of the restructuring regime of the BRRD, mandating bail-in. A similar conclusion was also reached by Bellia and Maccaferri (2020). Further, the FSB (2020) found evidence that credit spreads of holding companies (holdcos) of significant institutions have increased relative to their operating subsidiaries (opcos), suggesting that resolution reforms have become increasingly credible, which is also reflected in holdcos being rated less highly than their principal opcos after the implementation of the reforms. Rocamora, Suárez and Monjas (2020) also found higher levels of risk sensitiveness related to MREL-eligible debt after entry into force of the BRRD.

implementation in 2019, which further tightened the applicable prudential and resolution rules.[267]

Lastly, the outbreak of the Covid-19 pandemic and the imposition of the first lockdowns to curb its spread in a number of European countries in the month of March 2020 also triggered a sharp increase in both CDS spreads. Many banks will need to roll over debt redemptions for the remainder of 2020, also driven by requirements to have enough eligible instruments to reach their MREL targets. In case the pricing of eligible instruments remained at the heightened levels observed with the outbreak of the pandemic for a prolonged period of time, this might entail substantially higher costs for the banks concerned, constituting a significant challenge towards meeting their required targets.[268]

### *4.1 Requirement to build up MREL*

In principle, bail-in rules should have a greater impact on those banks that would have benefited most from an implicit guarantee before the introduction of the resolution framework, as they relegate the recourse to public funds to assist banks' restructuring only to exceptional or last-resort circumstances. This should mean that systemically important financial institutions (SIFIs), and in particular the riskiest ones among them, should be more significantly affected.[269]

As a consequence of the fact that banks now need to have sufficient liabilities eligible to be bailed-in in case of distress, those banks that fall short of bail-inable debt requirements will be required to increase their unsecured liabilities. This could result in an increase in overall funding costs, as banks would need to adapt their liability structure, with a more predominant reliance on costlier debt. Yet, a higher share of senior unsecured liabilities could have a positive impact in

[267] The banking package encompassed extensive amendments to the Capital Requirements Regulation (CRR), the Fourth Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).
[268] See EBA's Note on the first impacts of the Covid-19 in the EU banking sector, available at: https://eba.europa.eu. This has led some resolution authorities, such as the SRB and the Swedish National Debt Office, to assess the potential impact of market conditions on MREL transition periods.
[269] Cœuré (2013). Speech available at: https://www.ecb.europa.eu/. The FSB's evaluation of the reforms to address the too-big-fail phenomenon highlights that funding cost advantages peaked during the global financial crisis, remained high for a number of years afterwards, and then dropped. Funding cost advantages appear to have fallen substantially since the crisis peak, but still remained at least as high as those seen before the crisis. See FSB (2020), available at: https://www.fsb.org/wp-content/uploads/P280620-1.pdf.

reducing the level of encumbered assets, therefore possibly lowering the overall cost of funding instead. Indeed, asset encumbrance makes it challenging for investors to assess banks' riskiness, which may result in higher risk premia for unsecured debt.[270] It is also possible that a higher cost of senior unsecured long-term debt could lead banks to raise more short-term debt, resulting in a higher maturity mismatch and greater liquidity and interest rate risks. This could happen in particular for those banks that have already a high level of encumbered assets and so are unable to issue long-term secured liabilities.[271]

### *4.2 Possible adjustments to banks' liability structure*

Moreover, strengthened depositor protection, which is recognised by the BRRD as one of the core objectives that resolution should pursue, could potentially reduce deposit interest rates compared to the rates related to unsecured debt. Deposits typically represent a large share of the overall bank debt. As a result, even small reductions in the remuneration of deposits could produce a significant impact on the overall cost of funding.[272] On top of this, banks that already meet the minimum bail-inable debt requirement may adjust their liability structure to incorporate a larger fraction of deposits. Additionally, the removal of an implicit bail-out guarantee should imply that bank debt-holders would be incentivized to exert more efforts in monitoring banks, thus mitigating moral hazard phenomena, as part of the desiderata of regulators justifying the introduction of the resolution framework.[273] Such market discipline may mean that the expected rise in the cost of bank funding could be counterbalanced by an overall reduction in bank risk, hence not increasing the cost of funding as a result.[274]

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[270] *Ibid.* This is consistent with the findings by the FSB (2020) related to the existence of a bail-in premium for subordinated and senior non-preferred bonds, which are bail-inable.
[271] Such an issue should be curbed by the implementation of the requirements on the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) introduced by Basel III.
[272] Generally, depositors have a low sensitivity to risk, at least in normal times.
[273] For an analysis of the bail-in risk premium and associated market discipline, see, among others, Lewrick, Serena and Turner (2019). The authors find a considerable variability of bail-in premia across banks and jurisdictions, depending on the effectiveness of the applicable resolution regimes, the approaches to subordination and the differences in banks' risk-taking, implying that riskier banks indeed pay a higher premium. Crespi, Giacomini and Mascia (2018) also looked at the same mechanism in relation to Italian banks and found that large institutions and institutions with lower ratings, profitability, capitalisation, or higher liquidity faced a higher cost of issuing bail-inable bonds, seemingly finding additional support for the hypothesised improvement of market discipline in the primary market for bank bonds.
[274] Cœuré (2013).

The potential effects on banks' funding costs described above should be taken into account when addressing how the European and national banking sectors might be affected by the regulatory framework as currently in place. It may be the case that the competitive structure of banking markets will be altered by institutions' capacity to adapt to the requirements embedded in the resolution rules, determining which banks will remain operative, whether they will need to merge to better cope with regulatory requirements, and which will be the strategy or tool more suitable to deal with their failure, on the basis of their resolvability.

**5. Access to Single Resolution Fund**

The previous sections highlighted how the resolution framework emphasises the use of bail-in to shift the burden of banks' failures on shareholders and creditors, and the related build-up of MREL to provide an ex ante guarantee that bail-in- possibly in combination with other tools- will effectively function in resolution. However, it might be the case that the liabilities which are bailed in are not enough to cover losses and recapitalise a failing bank. In such an instance, having the Single Resolution Fund (SRF) make a contribution before any additional State aid is granted in the form of government financial stabilisation tools would possibly further sever the link between bank debt and sovereign debt. Alternatively, deposit guarantee funds could be used to contribute, also in support of transfer strategies within resolution schemes. Both options might bring about State aid- or other competition-related considerations. The conditions and potential critical aspects of the latter option are delved into in Section 5 of this chapter, while this section focuses on the former.

The SRF comprises resolution funding arrangements within the banking union as well as national resolution funds at Member State level. The Single Resolution Mechanism Regulation (SRMR) requires that a failing bank's losses are covered through the bail-in of its shareholders and creditors before the SRF can be accessed. This may also require bailing-in senior debt and, where necessary, uncovered deposits. Indeed, the SRF can only intervene after a bail-in of 8% of liabilities has been completed. This requirement provides a first protection to the SRF against immediate depletion, which is complemented by the limit of 5% of liabilities including own funds which the SRF is authorised to extend as funding at maximum.

If the SRF is used, the Commission will also have to make an assessment to authorise its use under EU State aid rules. The same would need to happen for interventions of national resolution funds of Member States not part of the Banking Union. This mostly relies on the fact that the use of the SRF could constitute a measure imputable to the State, depending on which authority administers the resolution funds, as otherwise the resources are supplied by the industry.[275] There has been no example yet of a resolution scheme implemented with support from the SRF and no specific indications are offered within the legal framework as regards which aspects the Commission will focus on in particular in making an assessment of the existence and consequent compatibility of any aid with the internal market when recourse to the SRF is advanced as necessary to resolve a bank.

### *5.1 Approval of aid granted through the SRF*

In line with the Commission's practice developed for other recent cases of bank rescues involving State aid, it is reasonable to presume that the approval of any existing aid would hinge on the assessment of (i) measures to ensure the long-term viability of the bank, (ii) appropriate burden-sharing in order to minimise the recourse to public funds, and (iii) measures aimed at limiting distortions of competition. This expectation is also supported by the requirements relating to the restructuring post-resolution, which should be achieved through the implementation of a business reorganisation plan. As a matter of fact, such a plan must be compatible with the restructuring plan that the institution concerned would be required to submit to the Commission under the State aid framework, when

[275] This stems from the definition of "extraordinary public financial support" (EPFS), which is another term for State aid, as laid down by Art. 2(28) BRRD. More specifically, the BRRD definition of EPFS encompasses assistance granted by national resolution funds, assistance granted by the SRF and assistance from other national sources such as taxpayers. As a result, resolution resources contributed by banks and State resources that primarily come from taxpayers are put on equal footing. This, in turn, might cause on overreliance on public finances in instances such as the granting of precautionary recapitalisations, instead of tapping into industry resources from resolution funds and the SRF, which are relegated to resolution scenarios (see also Nicolaides and O'Connor (2016) along these lines). While the automatic equation of SRF usage to existance of State aid might appear counterintuitive from a policy perspective, even the most 'optimistic' reading of the latest judgment of the General Court in the Tercas case (see Section 7 of this chapter) would still imply that the public control over the management of private funds can be enough to determine that there is a recourse to public resources.

applicable. In particular, in addition to measures aiming at restoring the long-term viability of the bank, the plan should include burden-sharing measures in order to limit any necessary aid to the minimum, as well as measures limiting distortions of competition.[276] This would likely entail a number of efficiency enhancing measures, possibly also including the divestment of assets and portfolios and a rationalisation of the geographical presence of the bank. Additionally, due to the requirement for a minimum amount of bail-in to be completed before the SRF can be accessed, it is possible that the prerequisite of burden-sharing would automatically be satisfied.

On the other hand, the requirement of a minimum write-down before access to resolution funds can be granted also implies that, where there are insufficient viable assets in the bank in distress that can back a transfer of deposits and other liabilities, if necessary for the implementation of a transfer strategy in resolution, it might be difficult to secure the funding needed to find a suitable buyer willing to take on the deposits and liabilities that authorities may wish to preserve for the benefit of the customers and the system.[277]

The degree to which funding needs from the SRF will be necessary after bail-in is applied hinges on the ratio of risk-weighted assets to total liabilities, due to the fact that a bank's recapitalisation needs are measured as a percentage of the risk-weighted assets, while bail-in is based on total assets, which equal total liabilities. For banks whose model relies on lending wholly extended to the corporate sector, risk weighted assets would be equal to total assets. In such an instance, losses might be absorbed by a bail-in, but the bank would still need to be additionally recapitalised to an 8% of risk-weighted assets. Differently, for banks with a different business model which implies a lower risk weight and a lower ratio of risk-weighted assets to total assets, a bail-in up to 8% of total assets would likely be sufficient to cover recapitalisation needs without additional support from the SRF. Thus, bail-in would be more likely to reduce the funding needs from the SRF for large banks rather than smaller ones. Then, a further consequence of the interplay between risk weighted assets and total assets in combination with the

[276] Art. 52(12) and (13) BRRD.
[277] Restoy, Vrbaski and Walters (2020).

ceiling of 5% of liabilities for the SRF contribution is that the link between losses and funding needs might not be as tight as expected.[278]

Even though studies have estimated that the SRF would have had enough funding to deal with the banking failures observed during the great financial crisis[279], it is well-acknowledged that no resolution fund can be expected to deal with a major systemic crisis on its own. If another large-scale systemic crisis at the Eurozone level were to erupt, a fiscal backstop to the SRF will be necessary to operate as an additional line of defense in protecting financial stability against systemic crises.[280]

### 6. Deposit Guarantee Schemes

Deposit guarantee schemes (DGS) are governed by the EU Deposit Guarantee Scheme Directive (DGSD). Under the BRRD, DGS must contribute cash to fund resolution actions with the aim to preserve deposit access for covered depositors, with this contribution being mandatory. Individual annual contributions are calibrated so that aggregate annual contributions do not exceed 12.5% of the fund's target level. The role of DGS in Europe is primarily that of paying out deposits, even though the DGS Directive also envisages other alternative uses, such as early intervention[281] or the protection of deposits in insolvency or resolution through means other than pay-out.[282] The role of DGSs in financing affiliated institutions in resolution is disciplined by Art. 109 BRRD, with recital 55 of the same directive specifying that the use DGSs to assist the resolution of failing institutions should comply with the framework on State aid, as is the case when recourse is made to extraordinary public financial support or resolution funds.

[278] De Groen and Gros (2015).
[279] *Id.* The authors estimate that about €72 billion would have been sufficient in a central case, while, under more stringent assumptions about capital requirements for the resolved banks, the sum might go up to €102 billion, or down to €54 billion under more optimistic assumptions. They also find that the current rules on bail-in would have ensured that a large part of the losses would have been borne by the banks' investors. In particular, for those affected in the first leg of the crisis, the 8% bail-in would have covered most of the losses, leaving little need for SRF funding. Instead during the second leg of the crisis, the 8% bail-in usually would not have been sufficient, but the 5% ceiling for SRF intervention would have implied that only in a few cases it would have covered more than half of the losses.
[280] Schoenmaker (2014). For a more detailed analysis on this point, see Chapter 6.
[281] This is the case for Inter-institutional Protection Schemes (IPS).
[282] For a comprehensive view of the different functions of DGSs, see Gortsos (2019).

DGS contributions are capped at the lower between (i) the loss the DGS would have incurred by paying out covered deposits in the bank's liquidation, at the net of recoveries that would have arisen from its subrogated claims in the insolvency; and (ii) 50% of its target level under the Deposit Guarantee Scheme Directive. This cap has the protective aim of ensuring that, on the one hand, the DGS is not depleted beyond the losses it would have incurred through the pay-out of covered deposits and, on the other hand, its capacity is not exhausted as a result of a single bank failure. This cap also entails an additional limitation of the extent to which DGS funding can be used to support liabilities other than covered deposits, which might be affected by the use of any combination of resolution tools applied. This should also have the effect of playing a disciplining role from the point of view of the incentives of holders of banks' financial instruments, as they could not rely on the expectation of DGS support if a bank's losses were limited at a level low enough that covered depositors would not be affected. Therefore, their expectations as regards the bank potentially receiving DGS support should not differ between resolution and insolvency in this perspective.

When the bail-in tool is applied, the DGS is liable to pay the amount by which covered deposits would have contributed to the absorption of the losses of the credit institution[283], if such deposits had been within the scope of bail-in and written down to the same extent to which creditors with the same level of priority under national insolvency laws would have. The DGS subrogates protected depositors which are excluded from bail-in. In such an instance, the DGS may not be required to contribute to the recapitalisation of the bank or bridge institution established.

### *6.1 DGS funds in resolution*

When other resolution tools (or a combination of them) are applied, the DGS is liable to pay the amount of losses that covered depositors would have incurred, if their losses in insolvency were in proportion to the losses faced by creditors with the same level of priority under applicable national insolvency laws. In the particular case in which eligible deposits are transferred from a bank in resolution to another entity through the sale of business tool or the bridge institution

[283] Art. 46(1)(a) BRRD.

tool, depositors have no claim against the DGS in relation to any (part) of their deposits left at the institution under resolution. Yet, this is applicable only insofar as the amount of funds transferred is equal or higher than the aggregate coverage level pursuant to Art. 6 DGSD.

Differently from the requirements relating to the use of the SRF, access to DGS funding does not depend on a minimum write-down or conversion of liabilities or other similar conditions. Therefore, there would not be a regulatory impediment to the use of DGS contributions in support of a sale of business transaction in resolution, as long as it would also include covered deposits.[284] In this sense, it may be the case the regulatory framework for bank crisis management is moving towards a FDIC-like approach to the use of DGS money in resolution in Europe, comprehensive of both cash pay-outs to covered depositors and support to the transfer of a failing bank's deposit book to an acquirer.[285]

### *6.2 DGS funds in liquidation*

As for the degree of availability of DGS funds to provide financing in insolvency proceedings instead, differences exist across Member States. Pursuant to the DGSD, Member States can allow the use of DGS funds for purposes other than pay-out of covered deposits, but they are not required to do so. Alternative purposes can entail (i) the prevention of a bank's failure ("preventative measures")[286], or (ii) the financing of measures preserving the access to covered deposits in the context of insolvency proceedings.[287] The latter measures can comprise transfers of liabilities- including deposit books- from a bank in insolvency to another bank, for which DGS funding may be provided to back the transfer in case a shortfall in assets is identified. For these types of measures, the costs for the DGS must not

[284] Restoy, Vrbaski and Walters (2020). For a discussion on who should benefit from DGS payments in the different instances where banks' critical functions are transferred to other institutions or where they are retained within recapitalised banks, see Hofmann (2020).

[285] Majnoni D'Intigano, Dal Santo and Maltese (2020) analyse the US regulatory framework and the FDIC experience highlighting some factors explaining its superior performance in comparison to that of the European Banking Union, including: (i) different functions being centered into one authority; (ii) the presence of a single framework for banking resolution applicable to all banks in a flexible manner, regardless of institutions' size; (c) the possibility to use the deposit insurance fund to protect also uninsured deposits, under the least cost principle, when it allows for a reduction of fund disbursements in purchase and assumption transactions; and (d) the absence of antitrust constraints.

[286] Art. 11(3) DGSD.

[287] Art. 11(6) DGSD.

exceed those that would have been incurred by paying out covered deposits, at the net of the recoveries stemming from the subrogation to depositors' claims in insolvency. Similarly to the cap set to DGS contributions in resolution, this cap- combined with the super-preference for covered deposits- implies that the amount of DGS funds that can be pledged for such alternative measures in insolvency is limited.

If DGS funds are only used to pay out covered depositors in the event of liquidation, after which the bank exits the market, then there are no State aid implications. On the other hand, State aid implications might materialise if a DGS offers financial support to a deposit book transfer during resolution or insolvency, with the aim of aiding the restructuring of a bank in distress. The issue lies on whether a DGS intervention is used to prevent the failure of an institution which would have otherwise exited the market, thus having a public policy purpose, or as a means through which to reduce the costs that would have otherwise been incurred in liquidation, provided that there are reasonable prospects of recovery. Crucially, a finding of existence of State aid hinges on the State having control or influence over the resources of the DGS or the decisional process that leads to the approval of intervention. This will be delved into in detail in the next section, addressing the Tercas case intervention.

One other relevant point to consider is linked to the fact that, if the industry were called to fund the DGS to then enable its use to repeatedly rescue smaller failing banks without the requirement for any form of burden-sharing from the banks' shareholders and creditors, competition concerns might materialise again through the mutualisation of losses, insofar as banks in distress would be favoured, at the expense of their sound peers.

**7. The *Tercas* case**

The relevant case highlighting the State aid issues underlying the recourse to DGS funds in resolution is the one of Tercas, in which a decision by the Commission establishing the presence of aid and its incompatibility with the internal market[288] was later overturned by the General Court of the European Union. Tercas was a relatively small Italian bank put under special administration by the Italian Ministry of Finance on 30 April 2012. The special administrator started discussions with Banca Popolare di Bari (BPB) for a potential acquisition deal, the failure of which would have led to Tercas being liquidated under national insolvency proceedings. In such a case, the competent Italian DGS, the Interbank Deposit Protection Fund (FITD), which constitutes a private banking consortium, would have needed to reimburse covered depositors pursuant to the DGSD. However, BPB agreed to buy Tercas under the condition that the FITD would cover Tercas' losses, thus affecting shareholders, but sparing creditors. Following a request by the special administrator, the FITD voluntarily agreed to intervene and the Bank of Italy authorised the intervention plan.

### *7.1 The stance of the Commission*

The Commission determined[289] that the FITD's intervention plan constituted unlawful State aid, arguing that the intervention made use of State resources, was imputable to the State and could not be cleared on the basis of the 2013 Banking Communication. The decision was challenged before the General Court by Italy, Banca Popolare di Bari and the FITD. The General Court annulled the Commission's decision by concluding that the finding of State aid in relation to the measures granted to Tercas was incorrect. Such a judgment was reached by assessing the fulfilment of the criterion of State origin of aid, as well as the imputability to the State and use of State resources, without considering other potential grounds for annulment of the decision.[290]

The crucial aspects of the case concerned the degree of intervention by public authorities in devising and executing the intervention plan. In this sense, the public mandate of the DGS in reimbursing covered deposits up to €100,000 in an

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[288] See case SA.39451. The Commission's decision of 23 December 2015 identified the potential for distortions of competition, due to the fact that "*the support interventions implemented by the FITD provided a selective advantage to Tercas and […] were not carried out by the FITD acting in the capacity of a market economy operator*" (para. 149) and "*the advantages conferred on Tercas by the interventions of the FITD distort competition by avoiding bankruptcy and market exit of Tercas*". Additionally, as Tercas was *"in competition with foreign undertakings [...] trade between Member States is affected*" (para. 159).
[289] *Ibid.*
[290] An example of other grounds could have concerned the compatibility of the aid with the internal market, for instance, see Asimakopoulos (2019).

event of liquidation and the influence exerted by public authorities upon the DGS in the design and implementation of the rescue scheme were taken into account. As to the first point, the private nature of the consortium of banks contributing to the DGS was not deemed relevant by the Commission. As to the second point instead, having a special administrator appointed by a Ministry of the Italian government sitting as an observer in the FITD board meetings and coordinating the contested intervention, coupled with the existing requirement on DGS participation for banks' licences to be authorised by the Bank of Italy- which made exiting the scheme impossible in practice- was found to indicate the existence of State influence.

### *7.2 The findings of the Court*

Building upon the landmark *Stardust Marine* case[291], imputability of aid can be inferred from a number of indicators, none of which may be decisive if considered singularly. However, the judgment has seemingly raised the standard of proof by requiring the Commission to provide decisive proof of imputability, instead of merely looking at a number of indicators which might point to its existence.

In the case of Tercas, if no buyer had been found, national authorities would have been forced to liquidate the bank, triggering a statutory obligation for the DGS to reimburse all depositors up to €100,000. As was the case, instead, the DGS intervened at an earlier stage with a facilitating role for the sale of Tercas through its agreement to cover its losses. This option was chosen as the least costly, as the DGS would still have been legally obliged to contribute to liquidation. Indeed, lacking a requirement to reimburse depositors, it is questionable whether the DGS would have voluntarily paid for the rescue of Tercas. Therefore, the Court focused on the form of intervention, rather than on its need. The fact that this voluntary intervention cost less than the full reimbursement required in liquidation justifies the form of intervention, not the intervention itself.

As regards the State influence on the DGS, the Court found no evidence that the special administrator influenced the actions of the FITD. On the other hand, the authorisation requirement by the Bank of Italy was only relevant insofar as the

[291] Case C-482/99, judgment of 16 May 2002, ECLI:EU:C:2002:294.

intervention could have produced an impact the national banking system and financial stability, but it did not imply that the intervention itself was mandatory. However, the DGS would have had a legal obligation to act in any event and regardless of any State influence.

As regards the State control over the DGS funds, the Court argued that the rescue measure hinged upon a common decision of all DGS members to allow voluntary interventions, enabled by the articles of association of the DGS, as well as on an additional specific decision of the members to intervene in this particular case. Thus, the Court concluded that the intervention was not attributable to its legal obligation to reimburse depositors.

### *7.3 The implications of the case*

Provided the judgment will not be overturned in appeal, its implications are twofold. In the context of the State aid framework, the CJEU is departing from the landmark *Stardust Marine* case on the matter of the imputability of State aid deriving from private resources, imposing a stricter standard of proof for aids granted by private entities, which requires decisive proof for imputability, rather than simple indications.[292] From the perspective of the regulatory framework for crisis management instead, the credibility of the rules on resolution is challenged. This is due to the fact that DGS funds could be used either in recovery or resolution as a voluntary means of intervention to rescue banks, without requiring creditors to shoulder any losses. Such an exception to the rules on bail-in and burden-sharing would create fertile ground for moral hazard and threaten financial stability, thus going against the same objectives that the bank resolution framework was introduced to achieve.

In conclusion, this case raises an issue of lack of coherence both with the State aid framework and with the role that the BRRD and the DGSD have apparently designed for DGSs, reinforcing their function of crisis prevention at the expense of the usual one of deposit insurance. The reading of the judgment goes in

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[292] Vitale (2019) argues that it is appropriate for the Commission to be bound by a more onerous standard of proof when the contested measure is adopted by a State-owned or private entity, since in those circumstances "merely circumstantial evidence is not enough to prove the existence of a decisive influence by the State on the decision-making process culminating in the adoption of the contested measure and on the use of the resources through which the measure is financed".

support of the use of deposit guarantee funds at an earlier stage and even in resolution with the role to assist sales or transfers of liabilities from one failing bank or entity to another, whenever not enough quality-assets are available on the balance sheet of the former to support the transfer.[293] The problem, however, lies in the absence of any concomitant requirements on burden-sharing, which would enable the use of (semi-)public funds without any curbing of potential competitive distortions or limitation of the need for external funds to a minimum.

**8. Concluding remarks**

This chapter has analysed the means of preparation for resolution, in the form of resolution planning and setting of MREL, and the execution of resolution through the different tools made available by the BRRD to highlight State aid and other competition-relevant issues arising from the regulatory framework and its implementation.

On the basis of the analysis, it would seem that stricter prudential and resolution rules could contribute to the growing trend of bank consolidation in the EU. Indeed, bail-in rules in particular, and the related MREL requirements, if putting smaller banks at a disadvantage, may prompt banking mergers and acquisitions in order to be able to tap into capital markets and prepare for resolution rather than liquidation. In this sense, the resolution framework does not necessarily drive the consolidation trend on its own, but it might reinforce it.

Resolution tools other than bail-in, which entail (partial) transfer of banks' assets, liabilities and rights also have competition-related implications for the structure of banking markets, as their successful implementation hinges on the presence of a competitor willing to take over the transferred banking perimeter. Based on the market positioning of the acquirer and the potential overlap between the merging entities, competitive safeguards will be necessary to prevent the establishment or reinforcement of dominant positions in the market. On the other hand, operations entailing acquisitions of control and mergers are considered as one of the means through which credit institutions' stability and capital position can be strengthened, as well as increasing their operative efficiency through the advantages

[293] Restoy, Vrbaski and Walters (2020).

deriving from the establishment of economies of scale. In an ideal scenario, if banks could be made systematically safe, independently of their size, then it might not be as significant a problem to allow for consolidation of different entities into bigger institutions, as long as the usual competitive safeguards are applied.

As for the role of DGS in bank crisis management instead, recent cases have shown a shift in support of the use of deposit guarantee funds at an earlier stage and even in resolution with the role to assist sales or transfers of liabilities from one failing bank or entity to another. The problem, however, lies in the absence of any concomitant requirements on burden-sharing, acting to curb potential competitive distortions and to limit the need for external assistance.

In light of the discussion of this chapter, a two-tier resolution regime appears to be shaping in which the failure of bigger banks can be dealt with through the currently available resolution tools, while smaller/mid-sized banks could be rescued through the DGS and still not be liquidated, if their continued operation is necessary to preserve financial stability and their services and operations are essential to the market. For the regime to be credible and sustainable, however, this configuration should hinge on the condition that any competitive distortions are minimised, before support is granted, thus calling for a more consistent application of burden-sharing requirements, through bail-in, also when DGS intervene.

# Chapter 5: Drawing lessons from Precautionary Recapitalisation, Resolution and Liquidation practice in Europe

## 1. Introduction

Having established from a theoretical standpoint which are the possible competitive concerns stemming from the availability of the precautionary recapitalisation exception, this chapter will offer a detailed analysis of the different rescue measures entailing different degrees of burden on public finances, which were applied in the last five years, with the regulatory framework for bank resolution already in place.

The purpose of this chapter is to critically assess the practical implementation of the EU regulatory framework for crisis management in its development, particularly in terms of the provisions relating to State aid control, in order to pinpoint the specificities of the various rescue instances and to draw some speculative conclusions on the competition-related concerns that the authorities involved might need to take stock of in their choice of rescue strategy.

To this end, all cases of crisis management which were dealt with after the introduction of European rules for bank resolution and in which some form of public support was granted in support of bank restructuring will be taken into account.[294] The cases will be analysed according to the form of intervention and related public support measures applied, distinguishing: (1) direct State recapitalisations, which have enabled the beneficiary bank to continue operating in the market as a standalone entity; (2) private acquisitions of ailing banks bolstered by State support, which led to a consolidation of entities; and (3) rescues bolstered

[294] For this reason, case SA.46558 is not considered in the analysis, as it is limited to temporary liquidity support in favour of Attica Bank, without any restructuring consequences for the institution. Case SA.48920 (2017/N) in relation to LCCU is not included, instead, because "the need for aid [did] not stem from repeated losses but from regulatory changes" (para. 43 of the Commission's decision), thus not amounting to a crisis management case.

by the intervention of a deposit guarantee fund, possibly in conjunction with a private investor, for which the market outcome is yet to be determined.

This chapter can be seen as a vehicle through which to discuss the application of different tools and solutions to deal with different bank failures, which might bring about changes in the structure of banking markets and institutions, and how these should be taken into account to assess whether any resulting change in the conduct of market players could arise as a result. In this sense, it could be interpreted as considering the potential interconnections between market structure and operators' conduct in light of measures for the management of bank crises.[295]

The exercise carried out does not intend to produce an empirical estimate of the causal impact of the rescue measures on competition indicators and structure of the relevant banking markets, since part of the institutions taken into consideration, (i) are still in the implementation phase of their restructuring schemes, and thus their ownership and organisational structures are not yet "finalised", and (ii) the geographical and product markets of activity have a regional or even province-level relevance, the competitive structure of which is not fully gleaned from public data.[296] Rather, the comparative analysis of the most recent cases of support measures granted to Greek, Italian and Portuguese banks is meant to highlight any competition-relevant issues that the implementation of the available crisis management tools might raise in practice. This should offer reasoned grounds for a discussion on the potential non-neutrality of the regulatory framework as currently set, insofar as it might produce different consequences on the structure of banking markets, depending on which tools and competitive safeguards are applied to the

[295] In the economic literature, the so-called "structure-conduct-performance" (SCP) paradigm put forth by Mason (1939) and Bain (1956) would posit that the performance of the banking industry depends on the behaviour of the incumbent banks, which is influenced by the structure of the market in which they operate, as proxied by its concentration level, generally. In accordance with this, more concentrated industries would lead to higher degrees of market power for banks, having in turn a positive impact on their profits, at the expense of higher costs for customers. Differently, the "efficient structure" hypothesis (Demsetz 1973; Peltzman 1977) would posit that differences in the efficiency of banks could result in different market structures, as efficiency would enable banks to extract higher profits and market shares.

[296] In addition, for some of the institutions included in the analysis, not all funding costs and bank-level data are publicly available, as not all institutions involved were listed at the time of rescue, thus not enabling full consistency and comparability in this respect.

management of different banks' failures and how banks are left on the market (or not) after rescue.

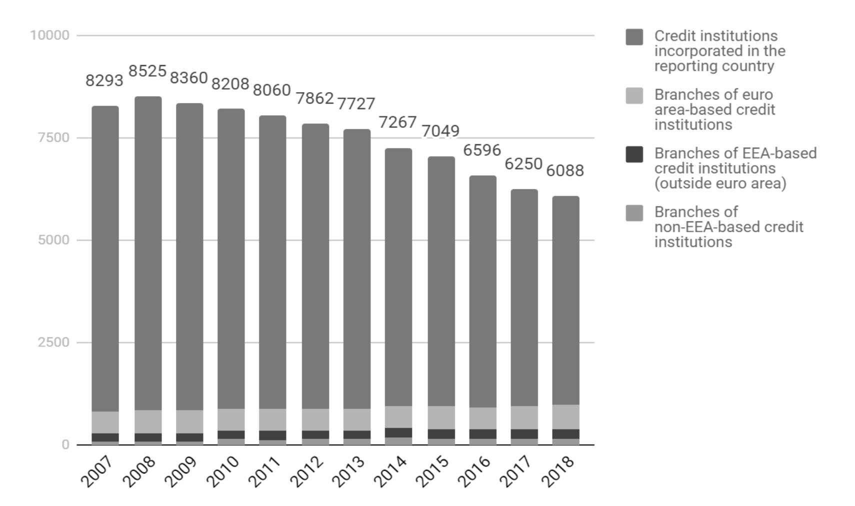
Given that different sets of rescue measures considered can entail a burden on public finances, it is worthwhile to assess whether there is any difference in the effects these measures may produce in the market from a standpoint of competition incentives for institutions. In other words, the analysis carried out in this chapter compares intervention responses, contextualising them within the national markets in which ailing banks operate, so as to discuss a number of competition-related considerations which might arise from the application of crisis management tools. The different measures applied in the rescue cases analysed in this chapter are summarised in Annex 2. Annex 3 instead provides a detailed overview of the burden-sharing requirements as well as structural and behavioural remedies applied in cases of State aid granting approved by the Commission while the BRRD was already in place.

In order to put into context the cases discussed in this chapter, it is worthwhile in the first place to have a look at data and figures relating to the structure of the European banking sector since the global financial crisis, in particular in terms of evolution of the number of institutions in the market and the shares of total assets, capital and reserves held by banks in different Member States.

## 2. Structure of the European banking sector

A consolidation trend started in the European banking sector in 2009, with the outbreak of the global financial crisis, and is still on-going, although to varying degrees throughout the past decade, as evidenced from Figure 5.1.

*Figure 5.1 - Number of EU credit institutions (2007-2018)*




*Source:* ECB Statistical Data Warehouse

More specifically, around 30% of the existing credit institutions are German banks, while Italian banks account for 8.3% of the total, with Spain accounting for 3.3% and the remaining share split by institutions in other Member States.

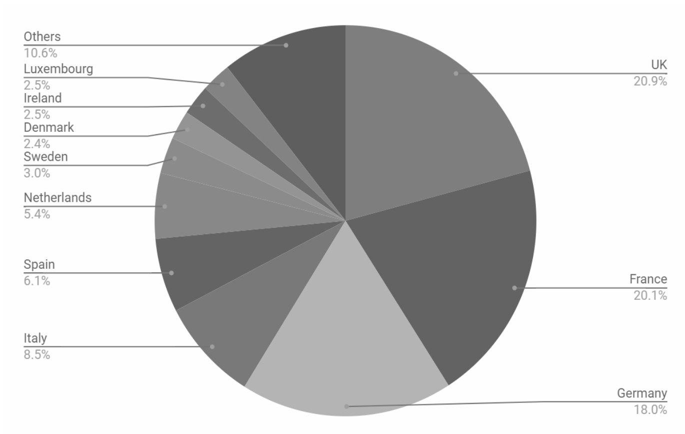
There is also a non-negligible degree of variation across national banking sectors in Europe in terms of representations of banks of different sizes. Indeed, less significant institutions (LSIs) are not equally concentrated throughout Europe, yet the LSI sector is composed of over 2,400 institutions[297] which are relatively small in size, with traditional lending-oriented business models. More specifically, in Luxembourg, Germany, Austria and Ireland, the importance of the LSI sector is relatively high, as LSIs account for over one-third of assets held in the respective domestic banking sector. Differently, the LSI sector is relatively small in countries with a more concentrated banking sector, such as in France (7.7%), Spain (4.8%) and Greece (2.6%). In absolute value, the LSI sector in Germany is the largest in Europe, with over 1,400 institutions, representing altogether approximately 55% of total LSI assets at the European level. The sector also continues to grow, with its

[297] In the first half of 2019, Italy enacted a reform of national credit cooperative banks ("*Banche di Credito Cooperativo"* – BCCs), which led to the incorporation of 228 BCCs into two significant institution groups, bringing about a major structural change in the LSI sector. Also elsewhere in Europe, a consolidation trend continued in the LSI sector in the last years, with 92 mergers and acquisitions involving 184 banks taking place during 2018 (see ECB's 2020 LSI Risk Report).

total assets increasing by 3.2% in 2018, and the average LSI size reaching €2 billion.

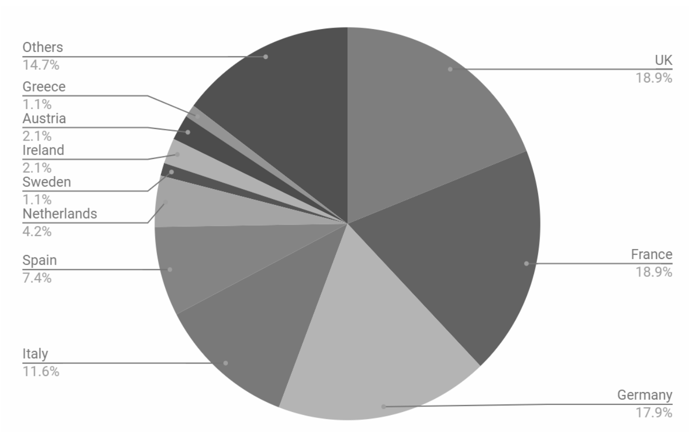
### *2.1 Shares of assets, capital and reserves*

*Figure 5.2 - Share of total assets held by EU banks*




*Source:* own computations based on data from ECB Statistical Data Warehouse

*Figure 5.3 - Share of total capital and reserves in the EU banking sector*




*Source:* own computations based on data from ECB Statistical Data Warehouse

In terms of EU banking assets, the biggest share is held by UK credit institutions (almost 21%), followed by France (20.1%), Germany (18%), Italy (8.5%) and Spain (6.1%). As regards total capital and reserves, the shares are also similarly distributed by the institutions of those same Member States, as shown by the two graphs above.

### *2.2 Concentration in national banking markets*

More information can be gleaned also from indicators relating to the concentration of some of the principal national banking sectors in Europe, including those in which the banks subject of this chapter's analysis are incorporated (Cyprus, Greece, Italy, Portugal). To this end, data on the evolution of national sectors' Herfindahl index[298] and level of concentration of total assets within the largest five credit institutions of each country give a more comprehensive picture of the structure of the national markets, thus building the background against which to consider the different rescue cases, depending on the characteristics of the institutions at stake.

[298] The Herfindahl index (HI) refers to the concentration of the banking market on the basis of total assets, obtained by summing the squares of the market shares of all credit institutions in the banking sector. Research by the Deutsche Bank (2019) finds evidence of a pattern between bank profitability (ROA) and concentration (Herfindahl index); higher levels of concentration in a national banking market are positively correlated with higher returns on assets.

***Table 5.1 - European banking sectors: Herfindahl index and share of total assets of largest 5 credit institutions***

| | Herfindahl index for credit institutions (based on total assets) | | | | | Share of total assets of largest 5 credit institutions | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Country** | **2015** | **2016** | **2017** | **2018** | **2019** | **2015** | **2016** | **2017** | **2018** | **2019** |
| **Austria** | 397 | 358 | 374 | 369 | 369 | 35.8 | 34.5 | 36.1 | 36.0 | 36.0 |
| **Cyprus** | 1,443 | 1,366 | 1,962 | 2,379 | 2,276 | 67.5 | 65.8 | 84.2 | 86.9 | 85.7 |
| **Denmark** | 1,180 | 1,224 | 1,123 | 1,069 | 1,170 | 67.8 | 68.3 | 65.7 | 64.5 | 66.2 |
| **France** | 589 | 572 | 574 | 663 | 654 | 47.2 | 46.0 | 45.4 | 47.7 | 48.7 |
| **Germany** | 273 | 277 | 250 | 245 | 277 | 30.6 | 31.4 | 29.7 | 29.1 | 31.2 |
| **Greece** | 2,254 | 2,332 | 2,307 | 2,304 | 2,382 | 95.2 | 97.3 | 97.0 | 96.8 | 97.4 |
| **Ireland** | 672 | 636 | 658 | 632 | 665 | 45.9 | 44.3 | 45.5 | 46.1 | 49.7 |
| **Italy** | 435 | 452 | 519 | 579 | 643 | 41.0 | 43.0 | 43.4 | 45.6 | 47.9 |
| **Luxembourg** | 321 | 260 | 256 | 261 | 277 | 31.3 | 27.6 | 26.2 | 26.3 | 27.7 |
| **Netherlands** | 2,104 | 2,097 | 2,087 | 2,178 | 2,039 | 84.6 | 84.7 | 83.8 | 84.7 | 84.7 |
| **Portugal** | 1,215 | 1,181 | 1,220 | 1,203 | 1,225 | 72.3 | 71.2 | 73.1 | 73.0 | 73.3 |
| **Spain** | 896 | 937 | 965 | 1,138 | 1,110 | 60.2 | 61.8 | 63.7 | 68.5 | 67.4 |
| **Sweden** | 866 | 845 | 914 | 785 | 787 | 57.8 | 56.3 | 58.2 | 54.3 | 54.9 |
| **United Kingdom** | 438 | 422 | 453 | 353 | 349 | 37.0 | 35.5 | 36.9 | 31.8 | 31.2 |

*Source:* ECB Statistical Data Warehouse

The degree of concentration of the European banking sector displays significant variability across national markets, as highlighted in the table above, with the share of assets of the five largest banks at national level also varying between 26% to over 97%. Germany and Luxembourg have more dispersed banking sectors, compared to those of other Member States, while Greece and the Netherlands have two of the most concentrated ones. Market concentration has increased in most EU countries from the turn of the century to recent years, with some exceptions including Austria and Denmark. With the outbreak of the last crisis, consolidation accelerated in those countries that suffered most from it and whose banking sectors underwent restructuring, as was the case in Greece and

Spain, for instance, where increases in HI indices were registered.[299] According to a report on financial integration in Europe by the ECB (2017), the Lerner index[300] for national banking markets suggests that banks' market power has increased in comparison with the crisis and pre-crisis periods in most Member States and in the euro area as a whole.

### *2.3 Focus on Italy, Greece, Cyprus and Portugal*

Already from 1999 the number of banks operating in the Italian market started decreasing, with the total number of credit institutions dropping from 890 to slightly above 500 at the end of 2019. This consolidation trend is also reflected in an increase of the HI for the national sector, which has risen from 435 to 643 in the past five years, and in a higher concentration of total assets in the hands of the biggest five Italian institutions. Studies have found that the consolidation process of the Italian banking sector in the past years has created no apparent conflict between concentration and competition[301], excluding any evidence of collusive behaviour among Italian banks, with efficiency gains being the main drivers for institutions' profitability.[302]

Compared to other national banking sectors, the Greek banking sector is among the most concentrated ones in Europe, with its assets being almost fully owned by the biggest five national credit institutions. Also before the financial crisis, Greece had been maintaining a higher concentration ratio in its banking sector than other Eurozone countries, rendering its national banking market a *de facto* oligopoly, which has enabled the maintenance of high loan-deposit interest spreads.[303]

As for Cyprus, 30 authorised credit institutions are operative in the country, of which seven are local authorised credit institutions, while the rest either either subsidiaries of foreign banks from EU and non-EU countries or branches of foreign

[299] Maudos and Vives (2019).
[300] The Lerner index is an indicator of firms' market power, based on the difference between price mark-ups and marginal costs. It has the benefit of overcoming criticisms of concentration measures as proxies for competition concerning the fact that banks do not necessarily exercise more market power after their market share increases.
[301] Coccorese (2005, 2009).
[302] Coccorese and Cardone (2020).
[303] Alexiou and Sofoklis (2009).

banks. The three primary banks are Bank of Cyprus, Hellenic Bank and RCB Bank. Between 2018 and 2020, the national banking sector underwent consolidation due to acquisitions as well as a reduction in branches, which decreased from 458 in 2016 to 326 at the end of 2019. This consolidation trend is also reflected by the increases in HI index, which is among the highest in Europe, and in the share of assets concentrated among the five largest credit institutions in the country.

The concentration of the Portuguese banking sector instead, as proxied by its HI index and the share of total assets held by the biggest institutions in the country, has remained quite stable in the past five years. At the end of 2018, the Portuguese banking system comprised 150 institutions, out of which 60 of were banks- half of these being branches of foreign banks. The HI index had been relatively stable in the previous years as well, going from 1207 in 2010 to 1164 in 2014. Yet, the higher increase in market concentration observed in Portugal compared to other EU countries seemingly did not weaken competitive conditions in the national banking sector, with banks' returns on equity and spreads between loan and deposit rates remaining stable or even shrinking, at least in the early 2000s.[304]

**3. Direct State recapitalisations**

A number of recapitalisations have been completed in the last years to the benefit of institutions exhibiting capital shortfalls, due to increased regulatory requirements or in the adverse scenario of supervisory exercises, such as stress tests or asset quality reviews. These schemes involved injections of capital through the subscription by the State of either ordinary shares or hybrid instruments, such as contingent convertible bonds (CoCos). As these measures fall outside of the scope of BRRD resolution, they can generally entail a lower degree of burden-sharing by the creditors of the beneficiary institutions and are accompanied by remedies to curb competition concerns, as per State aid requirements.

Such rescue measures can enable the survival of the institution concerned as a standalone entity in the market, or possibly facilitate its consolidation into another

[304] See IMF (2005), available at www.elibrary.imf.org.

institution at a later stage, depending on the outcome in terms of ownership structure following the exit from the State.

### *3.1 Caixa General de Depositos (CGD)*

One particular example of direct recapitalisation of an ailing bank from the part of the State can be observed in the case of Portuguese Caixa General de Depositos (CGD), which is the largest banking group in Portugal. At the end of 2011, the bank had total assets amounting to €120.6 billion and a leading market position in most of the business areas of its activity in Portugal, and particularly in deposits and retail loans. Its presence has remained significant along the years also internationally, especially in Spain and Portuguese-speaking African countries. CGD's only shareholder is the Portuguese State.

#### *3.1.1 The 2013 recapitalisation*

In 2012, additional capital needs amounting to €1.65 billion were identified for the bank, as linked to increased capital requirements. On 28 June 2012, two recapitalisation measures in favour of the bank were approved by the Portuguese government, namely encompassing the subscription of ordinary shares for €750 million and CDG-issued CoCos amounting to €900 million. As the EU Treaties are neutral on the type of property ownership, the Commission is bound to give equal treatment to publicly and privately owned banks. Therefore, alike to the option for privately owned banks to seek capital on the market to increase their capitalisation, a State-owned bank can seek capital from the State, in its role of shareholder.[305]

In this case, the Commission assessed that the support measures extended by Portugal to CGD constituted State aid within the meaning of Art. 107(1) TFEU, on the basis of three main points:

1. a lacking analysis on the return of the return on the State's investment prior to the government's announcement of the decision to implement the capital increase, which would have been required by a private investor on the market to substantiate the choice whether or not to invest;

[305] https://ec.europa.eu/commission/presscorner/detail/en/MEMO_17_557.

2. an expected return on the investment below the cost of equity, which a private investor would not accept[306];
3. the capital injection was decided within the same context and at the same time as the subscription not only of CGD's CoCos, but also of those by BPI and BCP, thus giving rise to a so-called 'pollution effect' on the nature of the aid measure.[307]

The approval of the State support also hinged on a restructuring plan, which aimed at reducing the bank's labour costs and non-performing loans. Moreover, behavioural restrictions were imposed on CGD, including: (i) an acquisition ban, (ii) a ban on aggressive commercial practices, (iii) a ban on advertising State support, and (iv) a restriction on the remuneration of the bank's managers.

At the time of the approval of the first rescue measures for CGD in 2013, the 2013 Banking Communication had yet to come into force. In accordance with the earlier State aid rules[308], banks only needed to be prevented from using public support as a remuneration of their own funds when profits generated from their activities were not sufficient. Thus, the only restriction imposed at the time consisted of behavioural remedies including the prohibition to distribute dividends, to hand out bonuses to the bank's managers, and to pay coupons to bondholders.

The restructuring concluded in 2013 provided for burden-sharing in the form of no payment of dividends and interest to preferred shareholders and subordinated debt holders. Yet, this restructuring did not achieve its prefixed objectives and a new recapitalisation by the Portuguese State became necessary in 2016.

*3.1.2 The 2016 recapitalisation*

The Commission assessed three measures implemented by Portugal to strengthen CGD's capital position by €3.9 billion, and in particular:

[306] Even if losses or low profitability could be accepted in the first years after rescue, they would need to be compensated by returns above average at a later stage, in order for a private investor in the market to accept. See Botelho Moniz, de Gouveia e Melo and do Nascimento Ferreira in Laprévote, Gray, de Cecco (2017), p. 414.
[307] Recapitalisation of Caixa Geral de Depósitos, SA.35062, 18 July 2012, para. 38.
[308] 2009 Restructuring Communication, 2009/C 195/04.

1. the internal reorganisation of Portugal's 49% shareholding in Parcaixa, which was transferred to CDG and increased its core capital by around €0.5 billion was not found to generate new cost for Portugal;
2. the conversion of existing State-held hybrid debt into shares, which was worth approximately €0.9 billion, was deemed to have been completed on terms that a private debt investor would have accepted as well, thanks to a sufficient return; and
3. the injection of €2.5 billion of new equity into CGD by Portugal was similarly found to have been completed at market terms that an investor would have accepted.

In addition, CGD raised internal capital and issued €930 million of additional Tier 1 capital to investors unrelated to the Portuguese State.

Differently from other recapitalisations, the Commission found this injection of public money not to amount to State aid, as the recapitalisation was expected to generate a return that would be sufficient to satisfy a private investor, thus conforming to the market economy investor principle (MEIP).[309] Somewhat surprisingly, the main justification for not finding State aid did not revolve around the application of burden-sharing or the deal being concluded at market terms, but rather on the prospect of the institution repaying the aid in the future, by virtue of an appropriate remuneration being set for the State. However, the likelihood of repayment of public funds is not one of the criteria to assess whether a measure constitutes State aid under European law.

*3.1.3 CGD's market position and balance sheet indicators*

As of September 2015, before the second recapitalisation, CGD had a national market share of 24.2% relating to total assets. As of June 2016, its market share on total credit stood at 21.9%, whereas the one on total deposits stood at 28.5%. The bank had developed a strong franchise as a universal bank, with a leading position in the domestic retail banking market, counting with 4 million customers in Portugal and €99.3 billion in assets.

[309] See P. Nicolaides, Bank Recapitalisation that Conforms to the Market Economy Investor Principle, 29 August 2017, stateaidhub.eu.

In 2017, CGD preserved its leading position in the domestic banking market, with a market share of customer deposits of 26.4% and a market share in the individual customers' segment of 29.9% registered at year-end. Its market share in loans and advances to customers was 20.8%, with corporate credit and mortgage market shares of 17.1% and 25.4%, respectively, as of 31 December 2017. Compared to the previous year, the market shares in loans and advances to customers and in the individual customers' segment decreased by 1%, while the market share of customers' deposits dropped by 1.3%. Its share of the mortgage market instead just saw a slight inflection from the 26.1% observed in 2016.

CGD's asset quality evolved positively as well, with NPE and NPL ratios reduced to 9.3% and 12.0% (from 12.1% and 15.8% in December 2016), respectively. The amount of NPL decreased to €2.7 billion in 2017, down 25% from the previous year, with the coverage by impairments reaching 56.7% at year-end. The phased-in and fully implemented CET 1 ratios in December both stood at 14.0%, with phased-in Tier 1 and Total ratios of 15.0% and 15.6%, respectively, thus is full compliance with the regulatory requirements. After net losses of €171 million and €1.86 billion registered in 2015 and 2016 respectively, the bank also reverted to profit-making, with a net income of €52 million in 2017. This was also reflected in the bank's ROE, which stood at 1.1%, after it had been at -1.3% in 2015 and -32.0% in 2016.

The recapitalisation effectively enabled CGD to remain operative as a standalone entity in the market, while also keeping its domestic market share broadly unaltered compared to the pre-rescue situation, with very slight decreases only. This is not surprising, given that CGD was State-controlled and the first banking group in Portugal, thus not likely to be split up or acquired in full by another financial entity, despite lagging behind competitors in terms of insufficient re-pricing and slower cost reduction prior to the recapitalisation.[310] The rescue package and the restructuring plan as approved enabled the bank to recover profitability and improve its efficiency, which were good signals in view of attaining a future return for the State's additional investment in the bank.

[310] Recapitalisation measures for Caixa Geral de Depósitos, SA.47178, 10 March 2017, para. 39.

*3.1.4 Considerations on recapitalisations of State-owned banks*

Having established that no State aid was found in the 2016 recapitalisation, it is still worth considering how burden-sharing requirements would have been applied in the counterfactual case in which the recapitalisation had not conformed to the MEIP. This would have entailed a conversion of write-down of instruments, leading to a loss of all or part of the capital of the State, as the sole shareholder of the institution, but the twofold aim of burden-sharing of preventing moral hazard and reducing costs to the taxpayers would have been defeated.[311]

While private shareholders would be resistant to bail-in due to the prospect of dilution or wipe-out[312], the situation would be different for the State, as it would be called to contribute in any case, be it through bail-in exclusively or with additional State aid, in case bail-in were not sufficient to cover losses and recapitalise the bank involved. Therefore, a paradox might arise within the new resolution framework for those banks that are already State-owned, where the purpose of severing the link between banks and their sovereign through the private intervention of shareholders and debtholders might be impossible to achieve in practice. Indeed, for those institutions, the burden-sharing requirement would not reduce the burden of a bank's failure for taxpayers.[313]

This case offers particular insights into the competition-related intricacies that may arise within the new regulatory framework for bank resolution, as a result of the specificities of the ownership structure of financial institutions, in case their distress requires the application of crisis management measures, independent of whether State support is necessary.

State-owned banks might pose a particular sort of challenge to the management of crises, since State involvement will be included by definition, be it through burden-sharing, or through potential additional public funds. It is in this light that the reasoning of the Commission in its approval of the aid to CGD being based on an appropriate remuneration in line with the conditions that a private market investor would accept might be read. Indeed, if burden-sharing still implies

[311] Nicolaides (2017), *supra* note 310, arguing that the loss for the State would not have amounted to State aid.
[312] As shown also by recent cases, as discussed in this chapter.
[313] Nicolaides (2017), *supra* note 310.

a disbursement of public resources, another possible channel through which to verify that aid is minimised is to check that the State's approach to evaluate its investment does not significantly depart from the one private investors would be reasonably expected to apply. Still, more emphasis should be put on addressing whether rescue deals have been concluded on market terms, in order to give more relevance to the degree to which the State might have favoured the institution rescued, compared to the conditions the market would have imposed in the same period.

Considering the fact that States have increasingly come to control what is now around 18% of the assets of the European financial sector, the important role of State-owned banks further complicates reaching a straightforward and non-contradictory stance on the application of State aid within the regulatory framework for crisis management.[314]

### *3.2 National Bank of Greece and Piraeus Bank*

The first two cases of precautionary recapitalisations completed within the meaning of Art. 32(4)(d)(iii) BRRD concerned National Bank of Greece (NBG) and Piraeus Bank and date back to 2015.

#### *3.2.1 Market position and balance sheet indicators of NBG and Piraeus*

At the end of 2014, Piraeus Bank had a market share representing 29% of the total domestic deposit market in Greece, in line with the previous year. At the end of 2015, it accounted for 30.2% of all customer loans issued in Greece, for 27% of deposits, and it held a market share of 22.4% in terms of total assets at national level. The Bank also held the largest market share in Greece in terms of loans, close to 30%. As of 30 June 2015, NBG held a market share of 22% in Greece for loans, and accounted for 29.1% in terms of deposits.

Both Piraeus Bank and NBG incurred losses in the years prior to the capital injection. For the period between 2013 and 2015, Piraeus Bank posted €8,007 millions of losses, against a capital injection of €2,720 million. In the same period NBG posted accumulated losses of €5,583 million, against a capital injection of €2,706 million. For the €15.7 billion injected in Piraeus Bank and NBG in 2013, the

[314] Along these lines, see Lannoo (2017).

sum of the share capital of the two entities was €2.9 billion before the additional injections completed in December 2015, meaning that most of the capital injected by the Greek State in the two entities in 2013 was lost, even if €8.3 billion of the injections into the two banks had been recorded as financial transactions at the time. The NPL rate for the two institutions was at 40% and the return on assets at -0.82% by September 2015, with a need to rebuild the deposit base and stem the deposit outflow. On this basis, there was no clear assurance that the two institutions would become profitable and able to pay out dividends in the near future.

In the autumn of 2015, the ECB carried out an asset quality review (AQR) and a stress test. According to the results disclosed in November 2015, Alpha Bank, Eurobank, NBG and Piraeus Bank reported cumulative capital shortfalls of €4.4 billion in the baseline scenario and €14.4 billion in the adverse scenario. In response, the Greek Parliament approved a new recapitalisation law on 31 October 2015, requiring banks to raise private capital by means of share capital increases, bond swaps or asset sales. All four banks managed to raise enough capital to avoid being resolved, but NBG and Piraeus only managed to address the baseline scenario through private funds, despite having completed the conversion of both subordinated and senior debt holders. The capital ratios and shortfalls highlighted for the four banks are detailed in table 5.2.

*Table 5.2 - 2015 Comprehensive assessment results*

| | | | Alpha | Eurobank | NBG | Piraeus | Total |
|---|---|---|---|---|---|---|---|
| CET1 **(EUR)** | *at 30/06/2015* | | 6792 | 5389 | 7412 | 6189 | **25781** |
| RWA **(EUR)** | | | 53516 | 39218 | 63870 | 57113 | **213716** |
| CET1 ratio **(%)** | *at 30/06/2015* | | 12.7% | 13.7% | 11.6% | 10.8% | **12.1%** |
| | *post-AQR* | *9.5 %* | 9.6% | 8.6% | 8.1% | 5.5% | **7.9%** |
| | *baseline scenario* | *9.5 %* | 9.0% | 8.6% | 6.8% | 5.2% | **7.3%** |
| | *adverse scenario* | *8%* | 2.1% | 1.3% | - 0.2% | - 2.4% | **0.1%** |
| Capital shortfall/ Buffer **(EUR)** | *post-AQR* | *9.5 %* | 73 | - 339 | - 831 | - 2188 | **- 3285** |
| | *baseline scenario* | *9.5 %* | - 263 | - 339 | - 1576 | - 2213 | **- 4391** |
| | *adverse scenario* | *8%* | **- 2743** | **- 2122** | **- 4602** | **- 4933** | **- 14401** |

*Source:* EGOV.

All four banks accounted for more than 95% of the national market and were under restructuring following previous receipt of aid. Requiring commitments from the Greek State regarding each of the four institutions to reduce their lending to the real economy would have had adverse macroeconomic effects, which led the Commission to allow for the restructuring plan not to include a downsizing of loans.[315]

The Commission also noted that the capital needs of the Greek banks were mainly a result of their participation in the Private Sector Involvement (PSI) programme of 2012[316], rather than being caused by excessive risk-taking or mismanagement. Additionally, Piraeus Bank and NBG had a larger exposure to Greek sovereign risk than other banks in Greece did.[317]

315 Piraeus Bank, SA.34826, 23 July 2014, para. 152.

316 A significant debt restructuring programme initiated with private creditors of the country in order to reduce the debt burden of the sovereign, through which the Greek government amended the conditions of bonds under Greek law with a face value of €177 billion. Due to the bank's large exposures to government bonds, they played a key role in the programme, which, in turn, had negative effects on their solvency.

317 Piraeus Bank, SA.34826, 23 July 2014, para. 321; National Bank of Greece, SA.34824, 23 July 2014, para. 370.

*3.2.2 The rescue schemes*

Piraeus Bank and NBG resorted to a precautionary recapitalisation to cover the shortfalls identified in the adverse scenario. The Hellenic Financial Stability fund injected €2.7 billion in each of the two banks, in the form of contingent convertible bonds (CoCos) for 75% of the amount, and in ordinary shares for the remaining amount (25%). The capital injections allowed the two institutions to build up prudential capital buffers.[318] Table 5.3 below illustrates the specific structure of the capital raising exercise used to recapitalise the four major Greek banks in 2015.

***Table 5.3 - 2015 Greek banks' capital raising exercise***

| (EUR mln) | Alpha | Eurobank | NBG | Piraeus | Total |
|---|---|---|---|---|---|
| **Conversion into equity** | 1011 | 418 | 759 | 582 | **2769** |
| **Capital from private investors** | 1552 | 1621 | 757 | 1340 | **5271** |
| **Capital from HFSF** | - | - | 2706 | 2720 | **5426** |
| **(of which shares)** | - | - | (676) | (680) | **(1356)** |
| **(of which cocos)** | - | - | (2029) | (2040) | **(4069)** |
| **Other capital** | 180 | 83 | 380 | 291 | **935** |
| **TOTAL Capital shortfall** | **2743** | **2122** | **4602** | **4933** | **14401** |

*Source:* banks' websites.

An 8% interest on the CoCos was due and payable at the sole discretion of the issuer either in cash or in shares, once again, at the sole discretion of the issuer. Therefore, the CoCos injected in NBG and Piraeus Bank had a contingent annually payable rate of return, giving them the nature of equity more than of debt instruments. The conversion price of the CoCos was fixed at €0.3, equal to the nominal value of the ordinary shares. The fact that a conversion takes place at the nominal value instead of at market price is a non-market feature indicating *prima facie* that the CoCos entail a gift component, which would materialise at the time of the conversion in case the market value is inferior to the nominal value.

[318] Piraeus Bank, SA.34826, 23 July 2014, para. 168; National Bank of Greece, SA.34824, 23 July 2014, para. 177.

While private investors participated in the capital increase in Piraeus Bank and NBG simultaneously with the Greek State, it is arguable whether the same conditions were applied compared to the two classes of investors. In particular, Law 4340/2015, approved by the government on 1 November 2015 for the two recapitalisations, ensured that any capital shortfall in the adverse scenario not covered by private investors would be addressed by the Greek State through the HFSF instead. As a consequence, private investors could already be absolutely certain that any potential capital shortfall would be covered by the government, in accordance with the law approved, before any specific measures for the two institutions were even agreed upon. Moreover, the subscription by the government was significantly higher than that of private investors in both cases. The instruments used for the capital injections were also different, as the CoCos were only subscribed by the HFSF, their design may also have entailed a gift component, and they were not freely tradable, requiring the consent of the bank and the supervisor for any transfer.[319]

For these reasons, it is reasonable to conclude that the capital injections by the Greek government in the two systemic banks did not have as the main objective earning a sufficient or attractive rate of return, but rather they were undertaken for a public policy purpose, due to the fact that private capital was not available to cover the shortfall identified in the adverse scenario of the AQR.[320]

The Commission listed a number of conditions that would have to be met for the State aid to be considered as falling under the exception of precautionary recapitalisation pursuant to Art. 32 (4)(d)(iii) BRRD and be declared compatible with the internal market. These included the solvency of the beneficiary institution and the measure's temporary and precautionary use in covering the institution's capital shortfall. In light of this, some particularly salient aspects of the precautionary recapitalisations granted to the two banks comprise the following points:

[319] https://ec.europa.eu/eurostat/documents/1015035/7142247/Advice-2016-EL-Statistical-treatment-2015-bank-recapitalisations.pdf/01f5a9df-a8be-4d69-b8bc-621b1acc062e
[320] *Ibid*.

1. Burden-sharing was completed by the banks' shareholders, subordinated creditors and even senior bondholders, going beyond the mandatory requirements of State aid rules.
2. Preponderant reliance was made on CoCos compared to ordinary shares to inject capital into the two institutions, facilitating the exit from State due to the repayable nature of the hybrid instruments. The exit of the State from the bank in the short-medium period is necessary for the recapitalisation to be deemed "temporary", as per the wording of the requirements of Art. 32(4)(d) BRRD.
3. The capital injection was declared to be used to bolster prudential capital buffers, thus seemingly aligning with the "precautionary" sentiment of the exception provided for in the BRRD in recapitalising with a forward-looking perspective, to prepare for potential future losses that the bank could incur with the materialisation of the adverse scenario envisaged in the stress test.

Additionally, restrictions on remuneration were imposed with a corporate governance-related aim[321] and within the context of a cost-cutting programme.[322] In this sense, these measures were not imposed strictly to diminish competitive concerns. Apart from the divestment of foreign assets, no other downsizing was imposed on the institutions as a remedy to possible distortionary effects on competition, but rather additional sales of branches were imposed, in part with a cost-cutting and efficiency-enhancing purpose.[323] Behavioural requirements included an acquisition ban and an advertising ban.[324]

*3.2.3 Post-rescue situation of the institutions*

At the end of 2015, NBG's CET1 ratio had increased to 14.6%, thus fully complying with regulatory requirements. Following approval by the SSM and in accordance with the applicable regulatory framework, on 15 December 2016, NBG fully repaid the CoCos issued in December 2015 and held by the HFSF for an

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[321] See, for instance, Piraeus Bank, case SA.34826, 23 July 2014, para. 140.
[322] *Id*, para. 346.
[323] The Commission argued that requiring significant downsizing and reduction of lending in a situation in which all four big banks in Greece were under restructuring would have had "adverse macro-economic effects" (see case SA.43365, para. 161; case SA.43364, para. 152).
[324] Case SA.43365, Annex C paras. 28-29; case SA.43364, Annex C paras. 28-29.

amount of €2,029 million, in accordance with the commitments contained in its revised restructuring plan approved by the Commission on 4 December 2015. After the repayment of the CoCos, the group's CET1 ratio as of 31 December 2016 stood at 16.3%, thus confirming the solidity of the bank's capital base.[325] Piraeus Bank, on the other hand, has yet to repay the CoCos issued to the HSFS as part of the precautionary recapitalisation measure of 2015, after having skipped their coupon payments in 2018 in order to focus on strengthening its capital base. On 2 December 2019, it paid €165.466 million in cash to the HSFS, thus resuming the payment of the coupon of the CoCos for 2019.

As of December 2016, Piraeus Bank maintained the first position in the Greek banking sector, with a 30% market share in terms of loans, while its deposit market share stood at 29%, up again to the level reached in the year prior to the recapitalisation. Its shares relating to housing loans and consumer loans instead were posted at 26% and 21% respectively. The NPL ratio for the group decreased from the 40.1% registered in 2015 to 37.5%. NBG also kept its market share in 2016, accounting for one fourth of the Greek retail banking market. Its NPL ratio contracted by 15% to reach 12.5% in 2016. Therefore, the recapitalisation measures applied in 2016 do not seem to have significantly altered the positioning of the two institutions in the market. The recapitalisations achieved their aim of strengthening the capital position of the banks concerned, while credit risk also decreased to some extent, as evidenced by the improvements in NPL ratios.

As for the rescue schemes resulting in the preservation of the two standalone banks without their merger or incorporation into other existing financial institutions, it would have been unlikely to foresee otherwise, due to the structure of the Greek banking sector, which is concentrated across four main banking groups.

### *3.3 Monte dei Paschi di Siena (MPS)*

The only other case of precautionary recapitalisation authorised so far involves Italian Monte dei Paschi di Siena (MPS).

Following the merger of Banco Popolare and Banca Popolare di Milano, MPS became the fourth largest Italian bank with a total balance sheet of €153

325 As reported in the bank's 2016 financial statements.

billion, €65.5 billion of RWAs, 25,566 employees and 2,032 branches at the end of 2016, with its main activities related to the SME segment. In 2009, MPS had participated in a bank recapitalisation scheme, in which Italy subscribed €1.9 billion in hybrid bonds (the so-called "Tremonti bonds"). The bank also received liquidity support in the form of State guarantees. After the implementation of the scheme, which had the purpose of bolstering the financing of the real economy, the bank was deemed to be financially sound.

### *3.3.1 MPS's market position and balance sheet indicators*

***Table 5.4 - MPS's financial indicators (2008-2016)***

| | | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total assets** | EUR mn | 213796 | 224815 | 244279 | 240794 | 218886 | 199106 | 183444 | 169012 | 153.178 |
| **Net income** | EUR mn | 931 | 225 | 987 | **-4698** | **-3190** | **-1439** | **-5347** | 390 | **-3231** |
| **Tier 1 ratio** | % | 5.13 | 7.52 | 8.37 | 10.30 | 9.52 | 10.62 | 8.67 | 12.85 | 8.17 |
| **NPL ratio** | % | 7.68 | 9.53 | 10.63 | 12.90 | 16.36 | 21.50 | 29.81 | 33.84 | 33.619 |
| **Capital impairment ratio** | % | 33.40 | 43.02 | 49.08 | 97.35 | 187.91 | 247.83 | 304.54 | 214.13 | 285.87 |
| **Employees** | | 33973 | 32475 | 31880 | 31550 | 30382 | 28013 | 26548 | 25731 | 24560 |
| **Branches** | | N/A | N/A | 3069 | 2793 | 2671 | 2793 | 2344 | 2133 | 2032 |

*Source:* EGOV

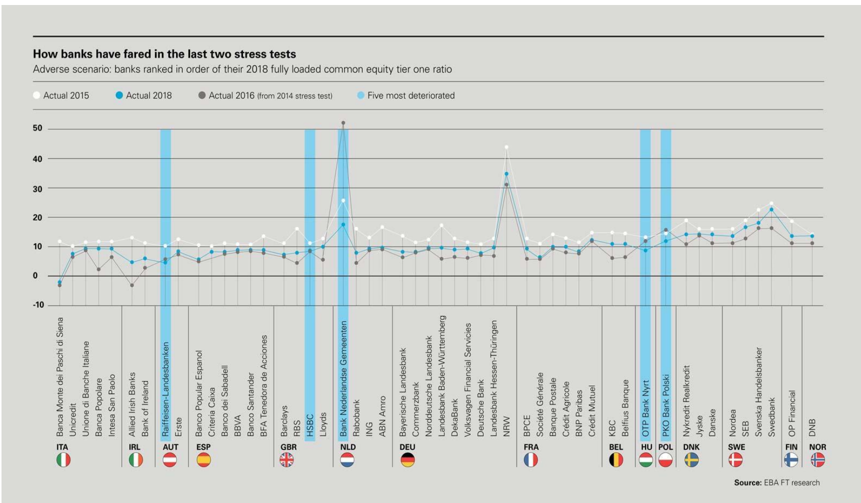
Most of the losses that MPS started incurring in 2011 and 2012 were for the main part related to the acquisition of Banca Antonveneta concluded for €9 billion in 2008, for which impairments were booked by the bank for around €5.5 billion in those two years. Additionally, unclear accounting practices on two structured transactions[326] led the bank to book further losses for a total of €1.2 billion. This called for a second recapitalisation in 2013, approved by the European Commission as restructuring aid, through which the Italian government replaced the Tremonti bonds with new hybrid bonds- referred to as "Monti bonds"- for an overall amount of €4.1 billion.[327]

[326] With Deutsche Bank and Nomura.
[327] Thus creating a net increase of €2.2 billion from the previous recapitalisation.

In its financial accounts for 2016, the bank disclosed a net loss of €3,241 million, mostly due to extraordinary loan loss provisions, and also reported significant deposit outflows for €15 billion. As of 31 December 2016, its CET1 ratio stood at 8.2% and the total capital ratio was 10.4%. The bank's results for the first quarter of 2017 showed a net loss of €169 million, a CET1 ratio of 6.5% and a total capital ratio of 8.9%. As of 31 March 2017, its total assets amounted to €148.8 billion and its RWAs were €64.5 billion, with €5 billion in deposits also recovered in the first quarter of 2017. At the end of 2016 the bank's market share on direct funding was 3.55%[328], whereas the one related to customer loans stood at 6.64%.

*3.3.2 The rescue scheme*

On 29 July 2016, the EBA's EU-wide stress test exercise were made public (see the graph below).




In the exercise, MPS showed a gap of around 14.27 percentage points between its capital position under the baseline and adverse scenarios, compared to an overall average of 4.5 for tested institutions.[329] A relevant impact of the stress scenario (7.5 pp) had also been registered in the 2015 stress test carried out on

328 Including deposits and repurchase agreements (apart from repurchase agreements with central counterparties) from resident consumer clients and bonds net of repurchases placed with ordinary resident customers as first-instance borrowers.

329 The latter was in line with previous exercises: 3.2 pp in the 2014 SSM stress test and 4.67 pp in a 2015 SSM stress test conducted on 9 institutions.

Greek banks. The gap for MPS seemed to stem from the idiosyncratic problems relating to the lack of robustness of its balance sheet due to loan loss provisions, capital allowances and a decrease in interest margin, rather than from the stress test methodology applied.[330] After a failed attempt at a capital raise from private investors for €5 billion, the Italian government announced it would ask for the Commission's approval of a precautionary recapitalisation.

Before State aid could be granted, burden-sharing was implemented by means of a conversion of subordinated debt instruments into ordinary shares at pre-defined conversion rates and a dilution of existing shareholders. To this end, any provisions related to patrimonial rights on the bank's shares or other capital instruments subject to burden-sharing that hindered the full recognition of the shares or of the capital instruments as CET 1 instruments were rendered void.[331] The total capital injected into MPS amounted to €8.1 billion, encompassing (i) the conversion of junior bondholders for €4.3 billion, and (ii) a capital injection of €3.9 billion by the State. In addition, the Italian State also pledged an additional €1.5 billion to compensate the retail investors to whom MPS's financial instruments had been mis-sold. The difference between the capital shortfall of €8.8 billion calculated by the ECB and the final capital injection €8.1 billion was the result of asset sales through which MPS disposed of several businesses and stakes in the months of February and July 2017 and enabling the bank to raise additional capital.

The Commission considered that the losses recorded by MPS in its accounts after the stress test were losses 'already incurred', which were covered by private means through their charge against the bank's equity. On the other hand, 'likely losses' were taken to include:

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[330] In its note commenting the results of the 2016 stress test for Italian banks, the Bank of Italy specified that: "*[a]bout half of the overall reduction in Monte dei Paschi's capital can be put down to a decrease in the interest margin; the other half is due to an increase in capital allowances and loan loss provisions and to write-downs on the AFS government securities portfolio. Two thirds of the P&L account loss comes from a decrease in net interest income. The idiosyncratic shock (equal to 220 basis points), which is proportionate to the bank's initial rating (B-), is much greater than the shock assumed for higher rated banks (25 basis points for banks rated AAA), particularly since its effects continue for three consecutive years*". Note available at: https://www.bancaditalia.it/media/approfondimenti/2016/stress-test-2016/index.html?com.dotmarketing.htmlpage.language=1

[331] Article 22 para. 4 of Law-Decree 237/2016 (Decreto-Legge 23 dicembre 2016, n. 237. Disposizioni urgenti per la tutela del risparmio nel settore creditizio. (16G00252) (GU n.299 del 23-12-2016). Decreto-Legge convertito con modificazioni dalla L. 17 febbraio 2017, n. 15 (in G.U. 21/02/2017, n.43)).

1. losses arising from the disposal of bad loans, as a result of the haircut applied on their book value; and
2. additional losses which the supervisor asked the bank to book in the future, following an on-site inspection, insofar as its results did not overlap with losses already incurred or losses according to point 1 above.

The private resources of the bank, which contributed to cover its losses encompassed: (i) proceeds from the sale of the merchant acquiring business; (ii) capital generated from the conversion of subordinated debt instruments into equity, at the exclusion of those for which compensation was offered due to mis-selling; and (iii) other private resources internally available. The Commission also indicated that the balance sheet reduction envisaged in MPS's restructuring plan would contribute to the reduction of its funding needs.[332]

Additionally, the Italian authorities pledged to sell their investment in MPS before an agreed point in time, thereby ensuring that the recapitalisation will only be a temporary measure, in compliance with the second subparagraph of Art. 32(4) BRRD. Yet, the Italian State[333] only received equity in exchange for the injection into the bank, making no recourse to hybrid instruments, differently from the approach taken in the recapitalisation of the two Greek banks, which relied predominantly on the issuance of CoCos to the State. Structural remedies imposed to remedy competition distortions included downsizing of the bank in terms of total assets, RWAs, geographic footprint, branches and staff.[334] Behavioural commitments imposed encompassed an acquisition ban, a ban on advertising the State aid and a ban to implement aggressive commercial practices.[335] Thus, the aim was to contain the size of the bank, limiting the advantage received through the aid, in view of its continued operation in the market.

[332] *Ibid*, para. 71.
[333] Through the Ministry of Economy and Finance (MEF).
[334] Case SA.47677, paras. 66-69.
[335] *Ibid*., para. 70.

*3.3.3 Post-rescue situation of the institution*

At the end of 2017, the bank's market share on direct funding stood at 3.78%, up 23 bps compared to the previous year[336], while the market share on customer loans remained stable from 2016. In 2018, MPS's market share on direct funding was 3.66%, slightly below the one observed at the end of 2017. The one related to loans to customers instead stood at 5.30%, decreasing by 120 bps compared to the previous year, due to transfers. The bank's profitability largely improved, as shown by its positive ROE of 2.9%, compared to the negative -41.6%. The gross NPL ratio also showed improvements, lowering to 17.3% from the 35.8% of 2017, favoured by the transfer of an NPL portfolio, for a deconsolidation of approximately €24 billion.

At the end of 2019, the bank's market share of customer loans stood at 5.08%, while its share of direct funding remained stable at 3.78% at national level. Instead, its ROE was negative at -12%, having decreased almost 15% from the previous year. One the Italian territory, the bank had 1,422 branches, which was a reduction of 107 operating units compared to 31 December 2018, as part of the implementation of the initiatives included in the Restructuring Plan.

After the recapitalisation was concluded, MPS experienced a period of depressed profits, with profitability recovering in the year immediately after the measures, but dropping once again in 2019. At the same time, no significant changes were registered in MPS's national market shares related to its principal activities and segments after the precautionary recapitalisation was applied. As the MEF was not operative directly or through shareholdings of in-house companies in the same markets where MPS was, the operation entailed a mere substitution of one operator with another, thus not determining any modification of the pre-existing competitive structure of the market. Additionally, in the geographical areas where MPS was active, a number of other qualified competitors were also present[337], thus guaranteeing a disciplining effect on MPS, also in reputational terms. For these reasons, the acquisition of control by the MEF did not build or reinforce a dominant

[336] The value of direct funding did not include the effects of the recovery of the subordinated bonds subject to burden-sharing.
[337] Including, among others, Unicredit and Intesa SanPaolo.

position in the markets concerned, which might have been liable to eliminate or substantially and lastingly reduce competition.[338]

At the time of writing, the Italian State has yet to sell its stake in MPS, which amounts to more than 68% of share capital, with the rest being held through subsidiaries by BMPS[339] and Assicurazioni Generali. This means that, even though the bank has been preserved as a standalone entity, the final ownership structure of the bank is still to be determined. Depending on who will acquire new stakes in the bank after the State will exit, competitive implications might be different based on whether a simple privatisation will be carried out or consolidation into another national competitor will be necessary in order to preserve critical functions, clients and business lines, and to ensure the institution's sustained viability in the long term. In addition, only at the time of the State's exit, it will be possible to fully observe the effective disbursement of public funds to rescue MPS, depending on the difference between the expenses incurred and the realisation from the sale of the bank to new acquirers.

### *3.4 Preliminary policy proposals to improve the application of precautionary recapitalisations*

All banks on the receiving end of precautionary recapitalisations in the last years have histories of needing State support in multiple instances, albeit to different extents and for different reasons. The different financial conditions which the different institutions found themselves in while waiting for the implementation of the recapitalisations and shortly afterwards, as well as the different mix of instruments subscribed by the Greek and Italian States respectively to complete their capital injections offer a number of cues to discuss possible issues related with the perception of how the measures are applied in practice and potential policy

[338] In the deposit-taking segment, MPS's market share was generally below 30%, with the only exception of the Siena area, where the bank's share is approaching 50%. As for the market of loans to customers in the Siena and Grosseto areas, MPS held a share above 30%, but still below 50%. Instead, in the markets related to consumer finance, asset management, leasing, insurance, and card issuing, MPS's share remained below 5% and even decreased since 2015. Therefore, the decreasing market shares were seen as positive elements corroborating a lack of dominant position. This, combined with a lack of overlap in activities between MPS and the MEF, led to a non-opposition of the measure by the Italian antitrust authority (AGCM). See case C12107, decision of 18 October 2017 (Provvedimento n. 26808) available at: https://www.agcm.it/

[339] 3.18% own shares held by MPS Group following the capital strengthening operations pursuant to Italian Law Decree Law no. 237/2016 (as subsequently amended and converted) and Italian Ministerial Decree of 27 July 2017.

options to improve the precautionary recapitalisation tool, to ensure it is effectively used as an exception.

*3.4.1 Precautionary recapitalisations and CoCos*

Comparing the approaches taken by Greece and Italy to precautionary recapitalisations, it is clear that the timing at which the measure is decided and implemented plays an important role. As shown by the MPS case, in which the bank breached capital requirements while waiting for a rescue solution to be agreed upon[340], the longer it takes for the measure to be implemented and the more uncertain its outcome is, the more likely it may be that the bank's capital starts being depleted while waiting for some intervention to be enacted, possibly breaching regulatory requirements as well. In such an instance, it is likely that also the trigger point for the conversion of any existing CoCos might be breached already.

There is currently no reference in the regulatory framework to any requirement concerning the most efficient point in time at which a precautionary recapitalisation should be enacted. Yet, a precautionary recapitalisation applied to a bank closer to breaching its capital requirements could trigger a faster capital depletion and possibly runs on liquidity due to uncertainty, which would increase the likelihood that (additional) solvency or liquidity support through public finances will be necessary, which is precisely what the resolution framework is meant to avoid to the maximum extent possible. It is therefore worthwhile to consider whether precautionary recapitalisation, built within the resolution regulatory framework as an exception under specific conditions and constraints, could be improved by setting complementary requirements on how it should be applied by national governments. In this sense, consideration could be given to the instruments used by the State to complete the capital injection, insofar as there might be some disciplining effect they could exert on their new holders once they are sold by the State, with a view to increasing the ability of the bank to rely on its internal resources to cover losses and recapitalise in the future, if needed. The practical applications of precautionary recapitalisations by Greece and Italy differ on this

[340] MPS breached minimum capital requirements under Art. 92 CRR in the first semester of 2017, as a consequence of the wait for the precautionary recapitalisation to be approved and completed and the related protracted uncertainty.

particular point. Greece relied for the most part on CoCos in the recapitalisations of NBG and Piraeus Bank, which has been noted by the Commission as a positive aspect towards increasing the probability of repayment of the State's investment. Italy instead made exclusive use of ordinary shares to complete its capital injection into MPS.

#### 3.4.1.1 Use of CoCos

If, indeed, CoCos could be helpful in ensuring the temporary nature of recapitalisation measures due their being repayable instruments, it is worth considering whether a requirement to complete capital injections pursuant to Art. 32(4)(d)(iii) BRRD with a mixed subscription of ordinary shares and CoCos by the State could be introduced. CoCos[341], especially with a high trigger, would create the conditions for recapitalisations in going concern without delaying them to the event of bank failure, in which capital would be already depleted below minimum regulatory requirements. This might have the positive effect of reducing the probability of public support in the form of State recapitalisations outside of the BRRD framework, by involving private CoCo holders in the recapitalisation process relatively early, while also diluting risk-taking incentives of the existing shareholders.[342] However, the possible CoCo-induced debt overhang problems might have negative consequences in a situation of broader financial distress, resulting from banks with outstanding CoCos possibly having lower incentives to recapitalise.[343] The exceptional nature of precautionary recapitalisations, whose application usually concerns a single institution or two at a time, based on practical experience, could lessen this risk of a broader distortion of CoCo holders' recapitalisation incentives, as debt overhang issues should not have as strong an impact on the single entity issuing the CoCos.[344]

[341] Perotti and Flannery (2011).
[342] See Avdjiev et al. (2017), who find empirical evidence that CoCo issuance results in a statistically significant lowering of CDS spreads for the issuer, pointing to the existence of benefits in terms of risk reduction and decrease in the cost of debt. The authors also find a stronger impact on CDS spreads of the issuance of CoCos for which the loss-absorption mechanism is the conversion into equity, compared to those which entail the write-down of the principal.
[343] Goncharenko, Ongena, Rauf (2019).
[344] *Ibid.* Other critics (see, for instance, Schwarcz (2018)) of the usefulness and viability of CoCos as a resolution option highlight their unsuitability as a macroprudential regulatory tool, which, however, is not the intended focus for this chapter's proposal.

### 3.4.1.2 Trigger and conversion mechanism

On the other hand, a high trigger set for a CoCo held by the State could prove to be problematic if the financial standing of the bank is particularly precarious in the period following the recapitalisation preceding the exit of the State. Thus, as an alternative approach, a mechanism reminiscent of the one proposed- albeit with a different inspiration and purpose- by Gordon (2010) could be devised, according to which, once the bank is again stabilised after the recapitalisation, the equity stakes of the State will, in whole or in part, be converted into CoCos, making them available on the market through an open and non-discriminatory procedure. These CoCos should then exert a disciplining effect on the bank's shareholders, while also diminishing the likelihood that State involvement will be needed again at a later point in time. Such an effect, however, hinges on the condition that their conversion is set with a high trigger point. One other requirement for this option to work is that a relatively liquid market for CoCos exists, so as to be able to position the needed instruments.

Depending on the process through which the State involved in the recapitalisation sells its stake in the bank concerned and effectively exits it[345], the potential effects on the new ownership structure of the bank should also be taken into account. In this context, it is also worth highlighting that the complexity of CoCos as financial products will likely imply that their holders will not be retail investors, thus shifting the ownership towards professional investors instead. As a result, it will also be crucial to consistently verify institutions' compliance with the regulatory requirements on product governance, in order to avoid other issues of mis-selling of financial instruments. If this is effective, then State support would be limited even more, by nipping in the bud instances in which retail investors would need to be compensated in case they were mis-sold instruments subject to future burden-sharing or bail-in.

### *3.4.2 Precautionary recapitalisations applied as regular recapitalisations*

Another point to be made is still linked to the issue of timing of the State interventions. Since a 'wait-and-see' approach, or difficulties in accessing private

[345] See point (50) at p.12 of the *New aid and amended restructuring plan of Banca Monte dei Paschi di Siena,* SA.47677, 4 July 2017, referring to the State exit happening with the sale of its entire stake in the bank in an "open, unconditional and non-discriminatory sales process and on market terms".

funding, could imply that precautionary recapitalisation is applied in "limit" situations where the bank at stake might already be close to insolvency, then another problem might materialise in relation to which losses the public funds end up covering and, as a result, whether the recapitalisation is for all effects a "precautionary" measure within the meaning of Art. 32(4)(d)(iii) BRRD.

#### 3.4.2.1 Timing of intervention

In this sense, the timing of the application of the rescue measures also has relevant implications for the sustainability and credibility of the options made available by the regulation. Indeed, it could happen that the implementation of the rescue measure generates a sort of self-fulfilling mechanism, by which an institution that is solvent when the recapitalisation is approved still ends up in breach of capital requirements, which would have been a pre-condition to trigger resolution proceedings instead. If this is the case, then what should be used as an exception to rescue a bank which might come under distress in very specific circumstances, could in effect convert into the reinstatement of recapitalisations outside of the BRRD framework, as if the rules on resolution had not been introduced or did not apply. In fact, the recapitalisation might not be offsetting losses likely to be incurred in the future, but actually needing to cover losses that have already started to materialise in the meantime after the identification of the capital shortfall, which would seem to go against the nature of the exception as a precautionary, forward-looking measure. This issue could be further exacerbated by the fact that the estimation of a bank's capital shortfall and the extent to which it is attributable to past losses is not straightforward, and it would benefit from harmonised procedures to deal with NPLs.[346] Still, for all intents and purposes, precautionary recapitalisations are granted to institutions which do not manage to raise capital on the market. This in itself creates a selective application of the measure, which entails a preferential advantage for the institution at stake, which is why appropriate countervailing measures need to be imposed on the beneficiary, with a view to diminishing anticompetitive effects.

On the matter of the timing of intervention, some scholars have also argued that the MPS case has highlighted the European Commission's rigidity in requiring

[346] Along these lines, see Lannoo (2017).

burden-sharing by subordinated debtholders, which has caused the protraction of the rescue process, with the Italian government seeking a solution agreeable to both the Commission and the ECB.[347] One consequence of this is that the implementation of private solutions for bank rescues might be made harder by the supervisors' insistence on an immediate and comprehensive recovery of capital positions. Indeed, investors considering to participate in a capital-raising plan might think twice, knowing that if the bank's private funding is ever less than fully sufficient, bail-in will ensue or public funds may still be used if financial stability is at stake.

#### 3.4.2.2 Political considerations

On another note, considerations of a political nature also play a role in governments' decisions on how to deal with a banking crisis in some instances. The Italian situation concerning retail holdings of bail-in-eligible liabilities is illustrative of this particular point, as many creditors of Italian banks being families and small investors rather than professional investors. Evidence of mis-selling of their instruments also came to light in the last years with reference to a number of bank resolution and restructuring cases- MPS included-which largely explained why Italy sought to avoid a bail-in of these investors, favouring a solution backed by the State in order to reduce the scope of liabilities that would have been involved in sharing the bank's losses.[348]

Based on these considerations, there are grounds to argue that situations have arisen and can arise, whereby a precautionary recapitalisation becomes a "regular" recapitalisation in practice, due to the type of losses covered, as also influenced by uncertainty and hesitance in the execution of the rescue. Even if the competition concerns stemming from the immediate application of the measure are dampened by virtue of burden-sharing, other remedies and the submission of a

347 Hadjiemmanuil C., "Monte dei Paschi: A Test for the European Policy Against Bank Bailouts", 2 May 2017, Oxford Business Law Blog.

348 The public perception of the issue was very critical. National news outlets also reported the striking case of a pensioner who committed suicide after he had lost most of his savings as a result of the bail-in applied to restructure Banca Etruria in 2015. That measure involved four small Italian with a combined market share of 1% at the time. As part of the resolution, four temporary bridge banks were created, to which all assets and some liabilities were transferred. Instead, the equity and subordinated debt remained at the "original" ailing banks, as a contribution by shareholders and subordinated debt holders.

credible restructuring plan, those that may arise from the adaptation of market players' expectations of which crisis management tool will be used to deal other potential bank crises might be similarly, if not more, relevant. If some sort of implicit guarantee is reinstated for bigger banks, which might decrease their funding costs as a result, those institutions might gain a competitive advantage compared to other market players.

## 4. Interventions to support liquidation or leading to a sale and consolidation of the failing institution into another entity

Two rescue schemes adopted for smaller Italian banks in 2017 have been applied outside of the perimeter of resolution, leading to the liquidation of the ailing banks under national insolvency proceedings, with a concurrent transfer of specific liabilities to an external acquirer, backed by public funds. Then, another case involving liquidation aid was granted to a Cypriotic bank in the following year. The requirement for the Commission's approval of a sale of a bank in distress- or just part of it- to another institution hinges on the viability of the acquirer and its capability to absorb the transfer of the ailing bank. The assessment that this requirement is met is based on i) the strong financial position of the acquirer, ii) the size of the acquirer, which must be much larger than the ailing bank, iii) a good track record of the acquirer in generating synergies, and iv) the transfer to the acquirer only of the good parts of the ailing bank.

### *4.1 Banca Popolare di Vicenza and Veneto Banca*

Banca Popolare di Vicenza (BPVi) was an Italian commercial bank, located in the Veneto Region[349] and mostly operating in the north-eastern regions of Italy. The bank had around 500 branches and a national market share of approximately 1% as regards deposits and 1.5% for loans, with total assets slightly below €35 billion at end-year 2016.

Similarly, Veneto Banca was also a Veneto-located commercial bank, operating mainly in northern Italy. As of 31 December 2016, the bank had around 400 branches and a market share at national level of around 1% in terms of both

[349] Veneto accounts for a non-negligible portion of the Italian GDP, with an industrial sector mostly relying on a significant number of SMEs and individual entrepreneurs. It is also one of the richest regions of the Eurozone.

deposits and loans. At the end of 2016, it had €28 billion of total assets. Both banks had levels of non-performing loans exceeding the national average by around 20 percentage points[350] and had failed to make profits for a number of years. In the 2014 Comprehensive assessment, capital shortfalls had been identified for the two institutions, which led them to be put under ECB-monitoring.

The two banks had been rescued by the 'Atlante fund' in 2016, which had been set up to recapitalise weak Italian lenders and purchase NPL portfolios after two failed capital raising exercises, which had been fully underwritten by Intesa San Paolo and Unicredit for BPVi and Veneto Banca, respectively. Atlante had injected €2.5 billion of capital in the two banks in 2016, with an additional €0.9 billion in January 2017 in advance of a future capital increase. The two banks had also been considering a merger, combining their activities amounting to around €60 billion, with a view to operating in the same region and exploiting synergies from their consolidation in order to increase efficiency and viability of the combined entity. In a report to the Italian Parliament, the Bank of Italy held that in the absence of some form of State intervention, the liquidation of the two banks could have triggered the early repayment of loans due to them by approximately 100,000 SMEs and 200,000 households for a total worth of around €26 billion, which in turn could have triggered a spread of insolvencies and additional losses for BPVi and Veneto Banca's creditors.

In March 2017, the two banks advanced requests to the Italian State to benefit from a precautionary recapitalisation to address their capital shortfalls. The Italian deposit guarantee scheme was not in a position to reimburse the banks' insured depositors at the time without extraordinary contributions from Italian banks. Additionally, as a consequence of enforcing the State guarantees covering the senior bonds issued by BPVi and Veneto Banca, the government would also have become liable to pay €8.6 billion. On 23 June 2017, in its role of competent supervisory authority under the SSM Regulation,[351] the ECB found the two institutions to be "failing or likely to fail" pursuant to Art. 18(1) SRMR, due to lack

[350] 37% in the face of an Italian average of 18%.
[351] Council Regulation (EU) no. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287 of 29 October 2013, p. 63.

of capital and an inability to offer credible solutions to address its shortfall.[352] However, the SRB determined that, despite concurring with such an assessment, resolution was “not warranted in the public interest”, since “neither of the two banks provided critical functions and their failure was not expected to have a significant adverse impact on financial stability”.[353]

The Single Resolution Board came to the conclusion that resolution would not have been warranted in the public interest for either bank, implying that a wind-down for the two institutions had to be completed under Italian national insolvency procedures. In this context, Italy determined that their liquidation would have had a serious impact on the real economy in the northern regions where the institutions were most active.

*4.1.1 The rescue scheme*

The aid granted by the Italian State in order to smoothen the liquidation and market exit of the two banks hinged on two measures, namely:

1. an injection of about €4.785 billion in cash; and
2. State guarantees for a maximum of approximately €12 billion to bolster the acquirer's financing of the liquidation mass, to be called upon if the liquidation mass is insufficient to repay Intesa for its financing.

Both support tools were backed by the Italian State's senior claims on the assets in the liquidation mass. As a consequence, the net costs for the sovereign were found to be much lower than the nominal amounts of the measures provided.

After a public tender, the best offerer to which the acquisition was adjudicated was Intesa Sanpaolo, a leader in Italy in business areas spanning retail, corporate, and wealth management, servicing 11.8 million customers through a network of approximately 3,700 branches located throughout the country, with market shares beyond 12% in most Italian regions.[354] The "good" assets of the two banks, including performing loans and tax assets, were transferred to Intesa,

[352] See ECB press release.
[353] See SRB, press release: “The SRB will not take resolution action in relation to Banca Popolare di Vicenza and Veneto Banca”, 23 June 2017, available at https://srb.europa.eu/en/node/341.
[354] Intesa’s 2019 annual report, available on the group’s website.

together with senior liabilities, such as deposits, State-guaranteed bonds and other senior bonds, as well as shareholdings in other financial institutions, branches and employees. On the other hand, the claims of the shareholders and subordinated bondholders were kept within the banks undergoing liquidation. Non-performing loans instead were transferred to Società per la Gestione delle Attività (SGA), which is an Italian "bad bank" established in 1997 in the context of the restructuring of Banco di Napoli.

The guarantees enabled the transfer of risks to their acquirer, by way of a transfer of assets from BPVi and Veneto Banca, within the operation of orderly wind-down of the two ailing institutions. The operation entailed the transfer of a portfolio of assets and liabilities, the perimeter of which excluded ordinary shares, capital instruments, subordinated debt holdings and non-performing loans. Guarantees do not constitute a direct expenditure commitment from the part of the State and, where granted, the relative disbursement can be at least partially recovered, for instance in case revenues are accrued from the non-performing or high risk loans sold or disposed of. As a matter of fact, the proceeds from the recovery of any such loans, net of costs of the recovery operation, would be returned to the banks in liquidation for the purpose of paying their creditors, among which is the State, in accordance with the order of priority provided by national insolvency law.

As for the direct cash injection, instead, it went to support the corporate restructuring within Intesa SanPaolo deriving from the acquisition of the two banks and the capital need generated by the operation. Yet, this injection did not entail the subscription of an equivalent stake in the share capital of the bank by the State. Rather, it constituted a purely operative liquidity support that implied cash disbursements of public money in effect. Differently, the public guarantees entailed potential liabilities, the amount of which identified the maximum potential exposure to risk the State could come to face.

On the one hand, the measures decided by the State as a guarantee of the fulfilment of the obligations of the two banks in liquidation in relation to the sale contract and the cash injection in support of the restructuring and capital needed for Intesa's acquisition of assets and liabilities were to all effects direct disbursements of public money in favour of the acquirer. On the other hand, the guarantees pledged in relation to (i) the coverage of the asset imbalance resulting from the due diligence performed, (ii) the buyback of high risk loans not classified as non-performing, which were returned to the banks in liquidation for transfer to SGA, and (iii) the non-performing loans transferred SGA for recovery, can all be categorised as risk transfer measures. Retail investors and others who had purchased subordinated bonds issued by the two banks were compensated through the special fund created by the government to compensate the subordinated bondholders of the four lenders resolved in November 2015.[355]

The measures adopted by the Italian government could be considered as being equivalent to an application of the bail-in tool in combination with the sale of business and asset separation tools in the context of a resolution within the BRRD framework, if it were not for two major differences: (i) the senior liabilities of the two banks were not subject to burden-sharing, differently from what could have happened in case resolution had been the chosen strategy; and (ii) the measures applied to the two banks were financed with public funds, rather than via a full-fledged bail-in, which would have made possible the inclusion of senior liabilities as well, possibly in conjunction with resolution funds or deposit guarantee schemes.

*4.1.2 The evaluation by the Commission and the Italian antitrust authority*

The Commission confirmed that the measures did not constitute aid to Intesa, because the acquirer was selected through an open, fair and transparent sales process, fully managed by Italian authorities to ensure that the best available offer would be chosen for the sale, with a view to reinstating the viability of the activities transferred from the two ailing banks.[356] In addition, Intesa seems to meet the conditions usually assessed by the Commission to authorise the acquisition of an ailing bank. These encompass, in particular: (i) the bigger size of Intesa, both by comparison with the acquired entities and in terms of national relevance; (ii) its reputation of being able to extract synergies and generating economies of scale and scope; and (iii) its sound financial position, as verified by its capital, liquidity,

[355] Banca delle Marche, Banca Etruria, CariFerrara and CariChieti.

[356] Law-Decree No. 99 of 25 June 2017, which disciplined the operation, also highlighted that the choice of the acquirer through the sales process took into account the obligations that the bank would have to abide by under the European State aid framework (Art.3(3)). See case SA. 45664, 25 June 2017, paras. 90-93.

credit risk, and profitability indicators.[357] In addition, the small size of the two entities, combined with their disappearance from the market through liquidation, led the Commission to conclude that no undue distortions of competition would arise, despite the large amount of aid in relation to the size of the two banks and the absence of remuneration.[358] Therefore, the positive evaluation of the safeguards instated to alleviate potential concerns on the conferral of a competitive advantage upon Intesa, as the beneficiary of State guarantees, was sufficient to conclude that risks of undue distortions of competition had been curbed to the extent possible. As a result, the European Commission looked favourably upon the concurrent consolidation and orderly market exit of the ailing institutions, with the rescue having the additional benefits for Italy of also sparing the national deposit guarantee scheme and retail investors.

In this particular instance, the consolidation achieved by the rescue measures put in place by the State was relatively contained, as a result of the liquidation of BPVi and Veneto Banca, which brought about a limited transfer of activities to be restructured and downsized by Intesa, compared to a counterfactual scenario in which the two banks could have withstood their distress through a merger between themselves, thus remaining in the market.[359] The Italian antitrust authority AGCM cleared the acquisition also in view of a risk of supply contraction in the absence of the operation, due to the lack of alternative market operators interested in acquiring the parts of the ailing banks. From a competition stance, the market shares of the post-merger remained below 30%, with small increases generally below 5%. Where the market share of Intesa combined with those of the two banks was more significant, the presence of numerous and qualified competitors in the same market segments, acting as a disciplining force, contributed to the operation not altering significantly the competitive structure of the market.[360]

### *4.2 Liquidation aid for Cyprus Cooperative Bank Ltd*

Another case of liquidation aid granted after in recent years concerns Cyprus Cooperative Bank Ltd. Similarly to the aid granted to support the liquidation of

[357] At the end of 2016, Intesa registered a CET1 ratio of 12.7%, a ROE of 6.4%, a ratio of bad loans to total loans to customers of 4.1%.
[358] Case SA.45664, para. 116.
[359] See Provvedimento n. 26658 of 5 July 2017 in case C12103.
[360] See Provvedimento n. 26658 of 5 July 2017 in case C12103.

Veneto Banca and BPVi, the aid granted to the Cypriotic bank was meant to ensure a speedy and fully-fledged integration of certain assets and liabilities of the institution into Hellenic Bank and to enable the residual entity- renamed Cooperative Asset Management Company Ltd., “SEDIPES”- to handle the asset workout.

### *4.2.1 The rescue scheme*

Cyprus Cooperative Bank had been created by the merger of cooperative credit institutions, becoming the second largest bank of Cyprus in 2018 with a market share of 25% in terms of deposits, focusing on retail deposits and lending to local residents. Despite two consecutive State recapitalisations in 2014 and 2015, the bank did not succeed in returning to viability.

The difficulties of the Bank led to its exit from the banking market by way of (i) a sale of certain assets and liabilities on market terms to Hellenic Bank and (ii) the withdrawal of the banking licence of the residual entity, which solely focused on managing its assets before being wound down. Also in this instance, the sale was carried out by way of an open and transparent tender procedure, in order to avoid granting aid to the acquirer.

As a result of the prior recapitalisations, the State had become the 99% shareholder of the bank, having diluted and left with 1% of the shareholding the previous owners, as part of the burden-sharing requirements. The restructuring plan for the bank also included structural commitments to sell or wind-down its non-core commercial operations and participations in non-core businesses, combined with the application of other cost-cutting and other rationalisation measures. In addition, the withdrawal of the residual entity’s license after the workout of transferred assets and the fact that the buyer took over and fully integrated less than 50% of the branches and staff of the ailing bank led the Commission to identify no undue distortions of competition, despite the very large amount of aid granted.

### *4.2.2 Considerations on the consolidation achieved through the aid measures*

Hellenic Bank, the acquirer, has become one of the two major players in the Cypriotic banking sector, together with Bank of Cyprus. The two institutions hold the vast majority of deposits in their portfolios and control altogether 67% of the market share. This is due to the absorption of the assets and liabilities transferred from Cyprus Cooperative Bank, which entailed an increase in Hellenic's deposit share from 11.9% at year-end 2017 to 30.9% at the end of 2018. In the same year, its net loans share also increased to 19.5% from the 8.1% it controlled prior to the acquisition of parts of Cyprus Cooperative Bank.

Therefore, differently from the case of the two northern Italian banks, even though the Commission determined that actual and potential competitive distortions would be minimised by the market exit of Cyprus Cooperative Bank, the market share detained by the failing bank, combined with the market presence of the acquirer, led to a significant degree of consolidation in the Cypriotic banking market, through a centralisation of banking activities in the hands of a smaller set of market operators. Despite the apparent push towards concentration in the market, it is likely that the preservation of assets and liabilities of the failing bank was justified on grounds of its market relevance prior to its failure. While this is easily understandable with a view to protecting a significant number of national depositors and bank employees, for instance, it also begs the question of whether there was also an attempt to preserve critical bank functions, which would have instead justified a resolution more than a liquidation. In any event, when an acquisition of this sort leads to consolidation in a market that is already concentrated, focus should be devoted to achieving a viable structure for the entity emerging after intervention, while also limiting any undue advantage extended to it, by means of appropriate structural and behavioural commitments.

### *4.3 Competition-related considerations in the Italian case and credibility of the framework*

Some more consideration should now be given to some competition-related aspects and credibility issues raised by the application of liquidation aid for Veneto Banca and BPVi, also as a result of the different interpretations at European and national level of what can constitute a public interest for resolution. In practice, the measures enacted in the Italian case enabled the application of less stringent requirements on the burden-sharing of losses by senior classes of creditors of the failing banks, who would have otherwise been called to contribute in the event of a resolution, entailing what looked like a variation of a resolution action, allowing for public support to the highest bidder without the application of a full bail-in and with reimbursement of junior creditors.[361]

In its press release, the Commission explained that Italy had determined that the liquidation of the banks would have had a serious impact on the real economy in the regions where they were most active.[362] This consideration was in line with the regulatory approach of taking into account the effects of a bank's failure within the specific macroeconomic conditions in which the bank operates.[363] Yet, the claim that the exit of the two banks from the market via liquidation would not cause any distortion of competition in the European banking market does not seem to be fully persuasive, in consideration of the fact that a strong economic and political interest in sparing bondholders to the maximum extent possible, due to their mostly being retail investors.[364]

Additionally, while the SRB found there to be no public interest in resolving the two banks under EU rules, the Commission seems to have had a different interpretation in effect by approving the compatibility of the Italian Decree with State aid rules. There was no indication of the SRB and the Italian regulator having carried out two different public interest tests, which could have led to different outcomes. Additionally, in the view of some commentators, the legal basis to justify taking into account regional effects would have been provided by Art. 107(3)(c)

[361] See case SA.45664. The scheme was found to grant an advantage to BPVi and Veneto Banca, as without public support the activities of the two banks would not have found an alternative buyer and would therefore have left the market (para. 88). The cash injection and the guarantees were not remunerated in any way and were implicitly collateralised only by the NPLs remaining in the residual entities, which were likely to generate further losses at a later stage, implying that the scheme did not abide by the MEIP as no private investor would have undertaken the same measures (paras. 60-67). Along the same lines, the measures were found to be liable to distort or threaten to distort competition, as they allowed the activities of the two banks to be sold to the acquirer with an advantage that competitors did not receive, whereas they would have been wound down in the absence of State support (para. 69). The compatibility of the aid was confirmed on the grounds that: (i) the aid was limited to the minimum amount necessary; (ii) distortions of competition were limited; (iii) appropriate burden-sharing was completed; and (iv) there seemed to be no risks to the long-term viability of the resulting entity.

[362] The Law Decree underlined how ordinary liquidation proceedings applied in "atomistic" form would have severely prejudiced the economy, thus calling for a solution that would have allowed to manage the crisis with "additional instruments", as in the absence of public support, the liquidation would have entailed a destruction of value for the two banks, with serious consequences for non-professional investors and creditors holding non-preferred debt instruments, as well as for families and enterprises relying on credit access by those institutions.

[363] See, in this respect, Grünewald (2017).

[364] Among others, see Lannoo (2017) and Asimakopoulos (2018). The latter highlights how the reference to the exact amount of cash needed for the acquisition of the two banks present in the Italian Decree laying down the rescue measures is further proof that the scheme was "*an effort to apply resolution tools without bailing-in senior creditors*".

TFEU, which was not the one used by the Commission.[365] So, the fact that the same assessment led to different determinations of what constituted public interest is a potential threat to the credibility of a European Single Resolution Mechanism.

Therefore, the case highlighted a lack of legal certainty and credibility of the resolution rules, limiting the capacity and purpose of the recently-introduced regulatory framework. Due to the differences in amounts, types, assumptions and pre-conditions of the different measures applied, they are difficult to sum and compare uniformly, in order to provide a conclusive view of which rescue schemes had more significant consequences for the use of taxpayers' money, at least until the State involved has exited its ownership stake in the rescued institutions. However, it would seem that an application of aid in liquidation alike to the one granted to the two Venetian banks could be problematic for the sustained credibility of the regulatory framework for crisis management, insofar as it could create the premise for certain classes of creditors to be better off in liquidation than they would in resolution. This concern could be lessened by aligning the burden-sharing requirements under State aid rules with those of bail-in under resolution.

On a related note, the threshold for the public interest test is also crucial in setting a reference point against which to measure the likelihood of a bank being applied resolution measures or undergoing liquidation proceedings, thus calling for further clarification and alignment of approaches between the SRB and other national resolution authorities.

**5. Rescue measures with contribution by deposit guarantee funds**

The cases related to the rescue measures for the Italian Banca Carige and Banca Popolare di Bari (BPB) exemplify a hybrid solution for crisis management, which relies on support being granted by the national deposit guarantee fund, acting as anchor investor and facilitator with the aim to successfully complete the sale of the bank in distress or its incorporation into another private investor at a later stage. Even though the final market outcome for the two institutions has yet to materialise at the time of writing, the two cases offer the opportunity to formulate hypotheses on how different options for restructuring could be devised and what the respective

[365] *Ibid.*

outcomes could come to be, depending on the structure of the entities that would be left on the market post-rescue.

In 2017, a similar arrangement was used to complete the acquisition by Crédit Agricole Cariparma of a 95.3% equity stake in three savings banks in Cesena (Cassa di Risparmio di Cesena SpA), Rimini (Cassa di Risparmio di Rimini SpA) and San Miniato (Cassa di Risparmio di San Miniato SpA) from the voluntary arm of Italy's Interbank Deposit Insurance Fund (FITD), the national DGS. Prior to the completion of the transaction, the voluntary arm of the FITD increased the capital of the target banks to align their fully-loaded CET1 ratios with the criteria of the acquiring group. As part of that rescue scheme, a portfolio of NPLs of the three banks, for a gross total of approximately €3 billion, was securitised with the help of the Italian Recovery Fund (Atlante II) or sold to private investors and deconsolidated from the balance sheets of the institutions. Afterwards, Crédit Agricole Cariparma paid a consideration of €130 million to the FITD to acquire its stake in the three institutions.[366]

The feasibility of the contribution of the national deposit guarantee fund in the cases regarding Carige and BPB must also be read in light of the landmark judgment rendered by the General Court in what came to be known as the Tercas case[367], which set a new standard for the interpretation of the existence of State aid, in instances where deposit guarantee schemes are involved in bank rescue schemes.

### *5.1 Carige*

The recent case concerning Italian Banca Carige exemplifies rescue measures combining State support and interventions from deposit guarantee funds.

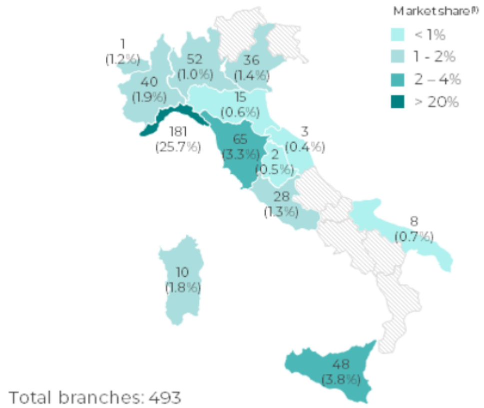
[366] The merger was not opposed on the grounds that the new combined market shares in the relevant segments of operation did not show the generation or reinforcement of a dominant position and other strong competitors could have exercised a disciplining effect on the new merged entity. See case M.8639 of 30 November 2017.

[367] Joined Cases T-98/16, Italy v Commission, T-196/16, Banca Popolare di Bari SCpA v Commission, and T-198/16 Fondo interbancario di tutela dei depositi v Commission, 19 March 2019. The judgment was extensively analysed in Chapter 4.

*5.1.1 Carige's market position and balance sheet indicators*

Banca Carige Group is a middle-sized banking group counting with approximately 4,300 employees and 500 branches, and €23,960 million in total assets at Q3 2018.

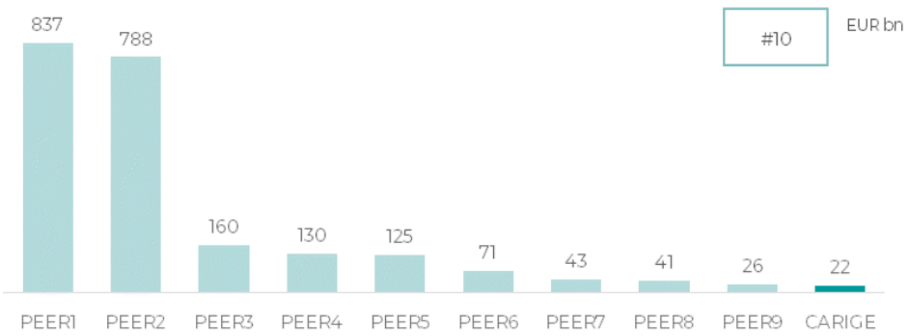
*Figure 5.4 - Carige's branches and market share by Italian region, as of 31/12/2018*




*Source:* Gruppo Carige's website, based on Bank of Italy's data.

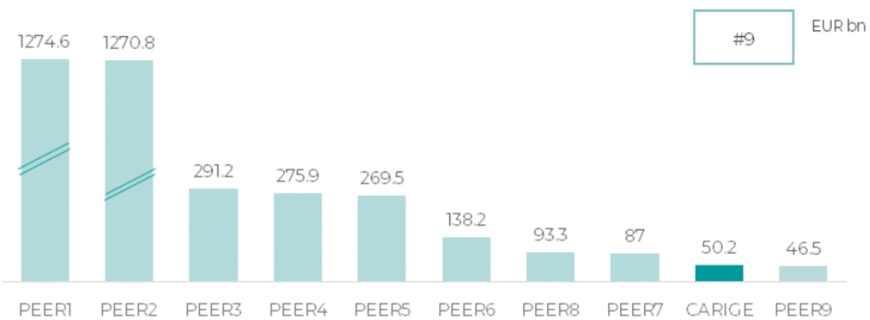
From Figure 5.4, it is clear to see that Banca Carige's market power is concentrated in the Liguria region, where it has a market share of around 35% for loans and 23% for deposits. while it remains below 4% in all other regions where the bank has a presence. Carige holds a much higher market share in the Liguria region than the two Venetian banks did in the Veneto region. However, compared to the latter two, Banca Carige is smaller in terms of balance sheet size.

*Figure 5.5 - Carige's assets (EUR bn) compared to national peers, as of 31/12/2018*




*Source:* Gruppo Carige's website, based on FY2018 reports of national peers.[368]

*Figure 5.6 - Carige's overall funding and net loans (EUR bn) compared to national peers, as of 31/12/2018*




*Source:* Gruppo Carige's website, based on FY2018 reports of national peers.

The bank's main source of funding are retail and corporate deposits, with current accounts, demand deposits, and time deposits representing approximately 54%[369] of funding in relation to the total balance sheet amount, bank funding coming for the most part[370] from central banks accounting for 18%, and bonds issued by Carige making up 14%. The latter have been placed in the market for an amount of approximately €3.5 billion, which appear to be almost entirely held by the bank's own clients.

[368] Unicredit, Intesa San Paolo, Banco BPM, Monte dei Paschi di Siena, Banca Popolare di Sondrio, Credem, BPER, Creval, Unione di Banche Italiane (UBI).
[369] Representing approximately €13.5 billion altogether.
[370] 77%, according to information available on the bank's website.

In the 2014 Comprehensive Assessment carried out by the ECB, a capital shortfall of €1.83 billion was identified for Carige, together with a CET1 ratio of 2.3% in the baseline scenario of the stress test, hence below the minimum regulatory requirement. Between December 2014 and September 2018, the bank incurred losses for around €1.6 billion, with additional losses for €189 million booked in the first nine months of 2018. Its profitability was weakened by a deterioration in asset quality and a decrease in net operating income. As of 30 September 2018, Carige had a total balance sheet of €24 billion- out of which €13 billion-, operating with 4,293 employees and 503 branches.

### *5.1.2 The rescue scheme*

The ECB stress testing exercise of 2018 highlighted no capital shortfall for Carige in the baseline scenario compared to a threshold of 8% CET1, but showed a significant capital depletion in the adverse scenario by the end of 2020. At the end of September 2018, the bank reported capital ratios below the SREP capital requirements imposed by the ECB, with a CET1 ratio of 10.8% in face of the 11.175% required, and a Total Capital ratio of 10.9%, below the required 13.125%.[371]

As part of its capital restoration plan, on 30 November 2018, Carige placed Tier 2 subordinated bonds for a total of €320 million mainly with the Voluntary Intervention Scheme (‘VIS’) of the Italian Interbank Deposit Protection Fund (FITD)[372], which underwrote an amount of €318.2 million, while a stake of €1.8 million was undersigned by Banco di Desio e della Brianza. Those subordinated bonds were placed with a fixed rate coupon of 13%[373]- considerably above the bank’s average total cost of funding of 0.86% at the end of September 2018. As the subscription of Tier 2 bonds was concluded by the voluntary arm of the FITD, which entails no use of public funds or any other form of State aid, this initiative raised no issues from a State aid perspective. The placement of the Tier 2 bonds was the first of two interconnected transactions envisaged in the plan, the second being a EUR €400 million share capital increase, to which further capital strengthening measures were also associated, including the disposal of a bad loan portfolio

[371] The difference was explained by the subordinated debt issued being merely 0.1%.
[372] An interbank consortium, to which 151 Italian banks contribute.
[373] To be increased to 16% in case the subsequent capital raise failed.

approximately amounting to gross €0.9 billion through a securitisation backed by the GACS scheme.[374] However, the capital increase failed after the abstention of the bank's main shareholder from the vote on the capital plan.

Having considered Carige's weak capital position, quality of the credit portfolio, significant losses, governance instability and fragile liquidity situation[375], on 2 January 2019, the ECB announced the appointment of three temporary administrators[376] and a surveillance committee to take charge of Banca Carige and replace its board of directors, following the resignation of a majority of board members of the bank. On 8 January 2019, a law decree was approved by the Italian government, with the aim to provide a State guarantee for future bonds issued by Carige and a guarantee targeted at enhancing collateral quality in order to enable both a potential access to Emergency Liquidity Assistance (ELA)[377] and the participation in a capital increase. On 25 January 2019, the bank issued €2 billion bonds benefitting from a State guarantee.[378] The issuance included two bond lines of €1 billion each, maturing on 25 January 2020 (with a coupon rate of 0.5%) and on 26 July 2020 (with a coupon rate of 0.75%). Those guarantees aimed at boosting the liquidity position of the bank, instead of capital, enabling the bank to refinance itself on the market at interest rates, which the bank could not have benefitted from in the absence of aid.

In order to ensure the sustainability of the bank's funding costs, the bank's temporary administrators also discussed with the managers of the VIS of the FITD a revision of the terms of the Tier 2 bonds placed in November 2018.[379] The aid was authorised as compatible with the internal market on grounds of: (i) appropriateness to remedy a serious disturbance in the economy, by strengthening the liquidity position of the bank; and a (ii) proportionate limitation of the guarantees to the amount and conditions necessary to tackle the liquidity stress of the bank. The

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[374] "Garanzia Cartolarizzazione Sofferenze", the Italian scheme for State guarantees to banks' senior tranches of NPL securitisation structures, cleared by the Commission in case SA.43390 of 10 February 2016.
[375] Liquidity support to Banca Carige, SA.52917, 18 January 2019, para. 11.
[376] One of the early intervention measures at the ECB's disposal, pursuant to Art. 29 BRRD.
[377] A detailed discussion on ELA follows in Chapter 6.
[378] Instated through the Law Decree of 8 January 2019.
[379] The rediscussion of the terms of the subordinated bonds was in line with the ECB's early intervention powers, pursuant to Art. 27(1)(e) BRRD, according to which supervisors may require the management body of a bank to "draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan, where applicable".

solvency of the bank was confirmed through a point-in-time and forward-looking assessment of compliance by the ECB, which still found a breach of the overall capital requirement on total capital level of 13.75%, including the capital conservation buffer, and a failure to comply with the Pillar 2 guidance (P2G) on the CET 1 capital level (11.80%). This was also accompanied by capital projections showing a widening of the breach of the P2G and of the capital conservation buffer going forward. Still, in the view of the Commission, the solvency would be ensured by virtue of: (i) a three-month temporary administration with the mandate to ensure that Carige could meet its capital requirements in a sustainable manner; (ii) Italy's commitment to submit any update of the capital plan submitted by the bank to the ECB; and (iii) no indication of the bank's inability to meet its liabilities.

The guarantees were found to be of a temporary nature, in compliance with the requirements of Art. 32(4)(d) BRRD, by virtue of the fact that the maturity of the new liabilities to be guaranteed was limited up to 18 months. They were also confirmed to be of a precautionary nature, since they only covered newly issued liabilities of an institution considered as solvent, but temporarily subject to liquidity stress.[380]

A restructuring or wind-down plan was also requested, lacking the reimbursement of the aid within two months.[381] As for the capital raising plan, even if the capital raise of €400 million fell through, the Commission still found compliance with the requirements of the Banking Communication[382] on grounds of urgency.[383] The safeguards put in place to prevent the outflow of funds from the bank included the suspension of dividend and coupon payments. Behavioural safeguards were also introduced to ensure that Carige would not use the aid received in order to expand its activities, encompassing a ban on advertisements referring to the State support, an acquisition ban and a ban on any aggressive commercial strategies that would not be possible without the public support.[384] Differently from the case of the two Venetian banks, for which the State guarantees

[380] Case SA.52917, 18 January 2019, para. 71.
[381] As per point 58 of the 2013 Banking Communication. The need for additional scrutiny whenever liquidity aid is granted to a bank with a capital shortfall is warranted with the aim of setting additional safeguards to limit distortions of competition.
[382] Points 32-34 of the 2013 Banking Communication.
[383] Case SA.52917, 18 January 2019, para. 59.
[384] *Ibid.*, para. 33.

were used in support of an asset transfer within an operation of orderly wind-down and exit from the market, the guarantees used for Carige served the purpose of transferring (or mitigating) credit risk, with the involvement of the market. The granting of such liquidity guarantees did not require the application of burden-sharing measures.

After multiple failed attempts at recapitalising the institution, first with BlackRock and then with private equity fund Apollo, a rescue plan worth a total of €900 million was finally approved at the end of July 2019. The scheme consisted of:

i. a €700 mln share capital increase, structured in tranches, reserved respectively for: (a) the FITD's VIS in the amount of €313.2 million, against the conversion of the subordinated bonds it had subscribed in November 2018; b) Cassa Centrale Banca (CCB) for €63 million; c) Carige's current shareholders for an amount of €85 million, in proportion to their respective shareholdings; and (d) the FITD for an amount of €238.8 million. FITD also took an underwriting commitment with respect to the tranche reserved for the bank's current shareholders, in the event of full or partial failure of their subscription;
ii. the issuance of Tier 2 subordinated bonds for a total worth of €200 million, partly subscribed by State-controlled Mediocredito Centrale (MCC) and Istituto Credito Sportivo.

*5.1.3 Post-rescue situation of the institution*

Following the capital raise, the FITD came to detain ownership for 79.992% of Carige's capital[385], CCB reached 8,34%, while Malacalza Investimenti was diluted from its previous holding of 27.555% down to 2.020%. Since the FITD cannot remain a long-term investor in Carige, CCB has an option to buy the FITD's

[385] Since the FITD was not active in any of the markets in which Carige was operating, the acquisition constituted a mere substitution of a market operator with another. See case C12269, Decision of 27 November 2019 (Provvedimento n. 28007), available at: https://www.agcm.it/

stake with a significant haircut between mid-2020 and the end of 2021.[386] According to the rescue plan, State-owned SGA purchased almost all of Carige's impaired loans for a total amount of €3.1 billion. Once CCB exercises its call option, its holding in Carige could increase to somewhere between 82% and 91%. The acquisition of a stake by unlisted cooperative banking group CCB was looked upon favourably also with a view to the acquirer's vocation as a locally-rooted bank, with a focus on households and SMEs, possibly enabling the establishment of synergies and economies of scope with Carige.

The approach taken to the rescue to Carige mirrors the one applied to the precautionary recapitalisation of MPS, insofar as a negative result following a supervisory exercise triggers a wait for the application of exceptional measures under Art. 32(4)(d) BRRD, in the form of a recapitalisation or liquidity guarantees, outside of the resolution framework. The difference in the case of Carige lies in the concomitant availability of private sector solutions to rescue the bank, including contributions from other banking institutions, through the FITD. In practice, the measures applied to the benefit of Carige became a rescue by the banking system itself. The recourse to the FITD does not in itself involve the use of public resources, since the fund relies on industry contributions. No full burden-sharing was applied, as 'voluntary funds' were involved, but rather the result was a dilution of the previous shareholders of the bank and the write-down of subordinated instruments held by the FITD as a result of a previous capital injection.

Another solution could have been devised, with the separation of Carige into a bad bank and a good bank, leaving shareholders and debt holders in the bad bank to complete the required burden-sharing. However, a bail-in would have wiped out the existing shareholders and involved other financial institutions, as the only subordinated debt instruments available were the ones already subscribed by the FITD, and possibly retail investors would have been affected as well, which might have explained why the final scheme approved was different.

[386] This might create the potential for anti-competitive concerns in the form of restrictive agreements with CCB, due to the minority shareholding of the latter in Carige, possibly leading to a merger at a later stage, if CCB exercises its option on FITD's stake.

### *5.2 Banca Popolare di Bari (BPB)*

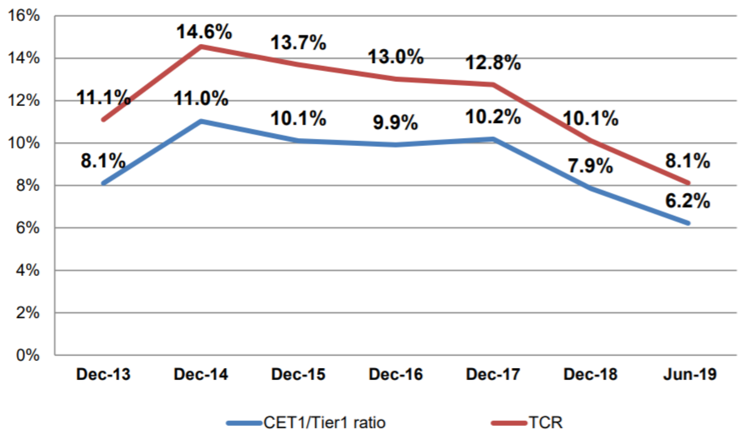
The latest case involving the use of the national deposit guarantee fund in a similar fashion concerns Banca Popolare di Bari (BPB).

#### *5.2.1 BPB's market position and balance sheet indicators*

The bank is the largest lender in southern Italy, with a customer base of just under 600,000, including more than 100,000 firms accounting for around 60% of loans, amounting approximately to €6 billion. Customer deposits amount to €8 billion, of which €4.5 billion are for stand-alone deposits of less than €100,000, thus protected by the FITD. Its share in lending and funding markets in the regions of Puglia, Basilicata and Abruzzo is around 10%. Along the years, the bank had solidified its status as a national cooperative bank, managing to issue and distribute financial instruments.[387] Private and retail investors held more than two thirds of the bank's senior and subordinated debt, for a total of €300 million.

In the course of 2019, the bank's capital base needed to be raised in order to meet regulatory requirements, as shown by the declining trend in BPB's capital ratios highlighted by Figure 5.7 below.

*Figure 5.7 - Banca Popolare di Bari's capital ratio trend*




*Source:* Bank of Italy

[387] The Bank of Italy reported around 70,000 shareholders holding 2,500 shares on average, corresponding to €5,900, based on the price recorded on the Hi-MTF market before the suspension in 2019.

The decrease in capital ratios observed from 2017 onwards was accompanied by a decline in profitability, as reflected in the return on equity (ROE) experiencing a sharp drop from 2017 to 2018, going from 0.2% to -63%, which only increased to -16% in the first half of 2019, with the cost/income ratio also showing an increase, which reached 107% as of June 2019.[388] In relation to the bank's credit risk, the NPL ratio of BPB showed an increasing trend 2011 and 2015, going from 12.6% to 27.7%, then slightly decreasing to 26.8% and 25.5% in 2016 and 2017 respectively, to finally reach 22.9% in 2018 and the first half of 2019. Problems of transparency had also come to light in the context of capital raising exercises conducted by the bank, which pointed to the value of the shares issued not being in line with the market.[389]

### *5.2.2 The rescue scheme*

According to the Bank of Italy, a liquidation involving the reimbursement of depositors, without selling BPB's assets and liabilities to another bank, would have had a considerable impact on both the local economy and on savings. This would have mainly be driven by the reduction of the value of the shares to zero, in a moment where legal disputes with shareholders were already ongoing as a result of the placement of the capital raises concluded between 2014 and 2015[390], which triggered sanctioning proceedings by Consob because of their non-compliance with the regulations on investment services.

The same problem would have materialised with reference to subordinated loans, issued for a total amount of €290 million, out of which €220 million had been placed with retail customers. The Bank of Italy had estimated that all ordinary creditors and deposits of more than €100,000 not attributable to households and small firms, and possibly also a portion of deposits above €100,000 of households and small firms, would have been affected.[391] The FITD would have had to

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388 Bank of Italy's data.

389 The prospectus related to the capital raise of 2014 contained a reference to the fact that no fairness opinion had been given by any independent expert on the determination of the offer price of the shares (€8.95, with a 6% discount applied on the issue price of €9.53). Moreover, the Price/Earnings and Price/Book Value indicators computed on the basis of the offer price were reported as 'mis-aligned' with those of a sample of peer banks listed on the market.

390 A total of €550 million almost entirely subscribed by retail customers.

391 https://www.bancaditalia.it/media/approfondimenti/2019/pop-bari/approfondimenti-PopBari-en.pdf?language_id=1

reimburse protected depositors around €4.5 billion, against a financial endowment of only €1.7 billion come December 2019, requiring the activation of funds worth €2.75 billion which had been subscribed in August 2019 by the FITD together with a number of banks, in order to equip the Fund with the resources necessary for the reimbursement of depositors. However, this could have required extraordinary contributions from the banking system, leading to losses.

On the other hand, a sale of the bank's assets would have brought about a block in operations, to the prejudice of the continuity of funding for households and firms, and with a considerable local impact, partly due to the significant share of loans extended by BPB to clients located in the regions where it was operating and possibly also undermining depositors' confidence, with a knock-on effect for other similar local institutions. The weakness of the local economy would also have probably hindered the absorption of BPB's 2,700 employees.

All of these considerations called for a liquidation with the sale of BPB's assets and liabilities, which turned out to be problematic in view of the difficult local economic conditions and the bank's own situation. The lack of interested counterparties made the sale of assets and liabilities unfeasible without the combined support of State aid to cover sale losses and, potentially, restructuring costs and capital requirements made necessary if capital were absorbed by the asset purchases, similarly to what happened in the case of the liquidation of the Venetian banks.

MCC, also known as Banca del Mezzogiorno, became the main banking institution involved in the acquisition of BPB, with the support of a capital injection by the State to be used in part for the capital raise for BPB and in part to meet future regulatory requirements. MCC was consistently smaller in size compared to BPB[392], but its intervention was deemed to be in line with the aims indicated in Italian Law Decree 142/2019.[393] The approval of the acquisition by the AGCM hinged on a number of considerations, including the following: (i) MCC and its

[392] As of July 2019, BPB had €1.2 billion in NPLs, which corresponded approximately to half the size of MCC's balance sheet and four times its tangible equity.

[393] Decreto Legge n. 142/2019 recante "Misure urgenti per il sostegno al sistema creditizio del Mezzogiorno e per la realizzazione di una banca di investimento". In this perspective, MCC would be reinforced to promote the development of financial and investment activities also to the benefit of enterprises in Southern Italy, abiding by market conditions and terms. See case C12301, AGCM's decision of 23 June 2020 (Provvedimento n. 28280), para.34. Available at: https://www.agcm.it/.

holding did not detain other controlling stakes in banks, financial institutions, insurance or investment companies; (ii) many and qualified competitors were present in the market segments where the acquirer and acquired entities both operated; and (iii) the post-merger market shares of the new entity remained below 1% for some segments or below 15% for others, thus not creating or reinforcing a dominant position in the market. On the basis of the above, the operation was deemed to leave unaltered the competitive structure of the markets concerned, only enacting a substitution of one operator for another. AGCM explicitly highlighted that the approval also took stock of the fact that operation was carried out within a crisis context involving a number of banks, with the aim of avoiding or remedying a significant disturbance in the economy that would have manifested in the absence of intervention, thus preserving the stability of the national banking system.

The FITD committed altogether €1.17 billion to rescue BPB, including the €364 million already pledged, while control was acquired by MCC, which contributed €430 million. One of the conditions of the scheme is that BPB be turned into a limited liability company. The approval of the rescue with the intervention of the FITD came on the wave of the one applied to Carige, as well as on the finding that no State aid was involved in another comparable instance involving Norddeutsche Landesbank – Girozentrale (NordLB), due to the measures being completed on market terms.[394]

Alike to the Carige case, the recourse to the FITD has been the crucial instrument employed to ensure the feasibility of the rescue measures to stabilise the institutions concerned and preserving jobs, while also facilitating their acquisition by other investors, be it through consolidation into another banking entity or not. Both for BPB and for Carige, the market outcome of the rescues, in terms of structure and ownership of the banks after the FITD will have exited its investments is still pending. Different implications might arise depending on whether the other already existing investors will acquire the stakes, by effectively consolidating the banks into their own groups and possibly relying on economies of scale and scope, or alternative third parties will acquire control.

[394] The approval of the rescue of NordLB came on 5 December 2019, based on the fact that the German State received a remuneration in line with what a private operator would have accepted in the same circumstances for its direct investment of €2.8 billion, coupled with investments to downsize the institution and bring it back to profitability.

Deposit guarantee funds' obligation to reimburse all covered depositors upon liquidation serves the public policy purpose of preserving financial stability. However, voluntary interventions prior to (and even preventing) liquidation, as was the case for Carige and BPB, are outside the scope of this public mandate. So long as these types of voluntary interventions are less costly for the DGS than a reimbursement of depositors in liquidation, they serve the private interests of the DGS members, thus only incidentally affecting public interest as a result.

If deposit guarantee schemes can be used in recovery and resolution contexts as a voluntary means of intervention without any concurrent requirement of burden-sharing of the shareholders and creditors of the bank concerned, this option has the potential to generate moral hazard, distorting risk-taking incentives, due to the assurance that other private resources will eventually cover losses and recapitalise a bank in distress.[395]

**6. Tailoring rescue measures to different types of institutions**

In the four cases in which State interventions took the form of direct recapitalisations, the aided institutions were preserved as standalone entities in the market, with conditions imposed on restructuring and divestment, aimed at curbing distortions of competition, as well as guaranteeing the long-term viability of the institution and securing a return to the sovereign for the injections made.[396]

Differently, in the Italian cases of liquidation and rescues with intervention by deposit guarantee funds, consolidation in whole or only of part of the assets and liabilities of the ailing banks within another existing entity was the option sought after, with a view to strengthening the institutions and guaranteeing their viability after re-organisation and restructuring.

[395] See also the considerations made in Chapter 4 in this respect.

[396] Also in the case of the resolution of four small Italian banks in 2015, the good parts of the institutions remained as standalone entities as a bridge solution, but later ended up being acquired by UBI (Nuova Banca Etruria, Nuova CariChieti, Nuova Banca Marche) and BPER (Nuova Cassa di Risparmio di Ferrara). The approval of the two operations involving UBI and BPER hinged on the temporary nature of the legal status of the four good banks and the lack of interest by alternative market participants in acquiring the bridge banks, which was likely to lead to the exit of the assets of the bridge banks from the market, thus reducing supply on the markets concerned. Where the activities of the acquirers and acquired institutions overlapped, the post-merger market shares were not found to be conducive to a dominant position, also by virtue of the presence of competitors with good reputation and a more attractive product offer for customers compared to the merging banks. See C12087, decision of 12 April 2017 (Provvedimento No. 26552) and C12094, decision of 18 October 2017 (Provvedimento No. 26621).

There is a relevant difference between resolution(-like measures) and liquidation or public recapitalisation in terms of which liabilities can be kept in the institution at stake after the crisis measures are applied. Indeed, resolution relies primarily on a restructuring of the liability set-up of the bank[397] to complete an internal loss-absorption and recapitalisation. On the other hand, public recapitalisations, which are not tied to equally extensive requirements on burden-sharing[398], might entail a broader carry-over of liabilities to the phase post-intervention, be it by keeping them in the institution as a standalone entity or within a new entity in case the failing bank (or part of its assets and liabilities) are consolidated into another institution.

In fact, burden-sharing was applied in all cases analysed in which capital support measures were granted, even though not to the extent that would have otherwise been required if resolution tools had been applied, with the exception of the two Greek precautionary recapitalisations, which applied it more extensively to involve senior creditors as well, in order to minimise funding needs to the maximum extent possible. Yet, the rescue schemes hinging on the participation of the voluntary arm of the national DGS did not complete burden-sharing through a full write-down, as they only entailed a dilution of the existing shareholders and a conversion of debt instruments already held by DGS. This can have additional competition-related implications, as the DGSs are funded through industry contributions, which may trigger a mechanism that pushes better performing institutions to rescue their peers, with the risk of needing to further contribute to the guarantee fund ex post.

As for the aid remedies required in the cases analysed, the divestments provided for in the different rescue schemes served the primary purpose of improving institutions' efficiency, rather than being strictly applied to limit potential competition distortions. This mainly related to closure of branches and sales of participations or business lines, which had the additional aim of freeing up capital for the banks, in order to minimise the amount of public funds needed. With a similar rationale, most schemes also included the disposal of NPL portfolios,

[397] Through the application of the resolution tools such as bail-in the first place.

[398] Differently from the BRRD provisions, State aid rules, as per the 2013 Banking Communication, do not impose the write-down and conversion of senior debt instruments. See Chapter 2 for an in-depth discussion on this point.

seeking to increase the chances of recovery while improving the credit risk of the banks concerned.

Those banks that were preserved as standalone entities did not register significant changes in the market shares relating to the segments in which they were most active even after the rescue measures were implemented, despite the structural remedies imposed. This can be partly explained by their market positioning prior to the application of the rescue measures, as, in fact, all recapitalised banks were within the top five institutions in their respective countries. For concentrated banking sectors such as the Greek one, and, to a lesser extent, the Portuguese one, in which market power is centered in the hands of a small number of big banks, it would have been unlikely to foresee an alternative solution leading to further consolidation.

### *6.1 Significant institutions*

As for MPS instead, which is still under State control, one could hypothesise a in which the bank would be absorbed into another significant institution. One of the basic requirements for an acquisition to be approved relies on an acquirer being able to successfully incorporate the ailing bank, which entails both being financially sound and having a size that is sufficient to accommodate the failing bank and integrate it into the existing business by exploiting and generating economies of scale and scope. This implies that bigger institutions, with a larger degree of market power, would be ideally placed to complete such operations. Where market power is already significant, an additional absorption of the good parts of another bank might give rise to competitive concerns, if there is a risk that a dominant position established in the market as a result of the acquisition is then abused. Indeed, the European regulatory framework does not condemn the existence of a dominant position in itself, but only its abuse.[399]

However, if the turnover of the institutions that are consolidated is sufficiently high, remedies would become necessary to curb competitive concerns potentially arising from their merger in order to guarantee sustained competition in the market. Such remedies can entail the divestment of assets or business lines, for

[399] This also has economic justifications relating to Pareto improvements stemming from the existence of a dominant firm in the market. On this point, see, for instance, Vatiero (2008).

instance. This might have an impact on the market share of the institutions concerned, depending on the magnitude and nature of the divestments and which alternative competitors would come to acquire them.

### *6.2 Mid-sized banks*

Instead, in the case of mid-sized banks, which might have a significant local relevance, even if not at national or even European level, it would seem more appropriate to envisage actions of consolidation, through mergers or sale of parts of the assets and liabilities. This could serve the purpose of improving their efficiency, through the establishment of synergies or economies of scope, in case of consolidation with other small institutions, or even economies of scale if absorbed by bigger peers. With this perspective, potential competitive concerns should be stemmed within the restructuring process, by applying an appropriate level of burden-sharing, so as to ensure that certain classes of creditors do not receive a preferential treatment compared to what would be required under BRRD resolution, in order not to distort banks' and authorities' incentives to use one crisis management strategy consistently over another. Then, whether consolidation could generate anticompetitive results in the national market where the rescued institutions operate will depend on the market power and positioning of the consolidating entities and of those banks that will be left as competitors. No definite implication exists according to which more consolidation in a banking market will automatically lead to anticompetitive conduct by the market players. Rather, it is for public authorities to take into account whether concentration and competition can co-exist in the market of reference when devising rescue schemes and potential remedies for institutions, in order to minimise competition-related concerns.[400]

### *6.3 Less significant institutions*

Lastly, as for smaller, less significant institutions, these would most likely enter liquidation upon failure, with consolidation into another entity of the 'good' parts of the bank with a view to preserve critical functions, assets and liabilities,

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[400] In this sense, see Maudos and Vives (2019), holding that "*the optimal degree of concentration in the industry, dynamic incentives for prudence of incumbents, and the ease of entry*" should be considered in reviewing mergers. The authors also recognised that a temporary increase in market power could be allowed with the aim of reducing excess capacity or rebuilding the charter values of prudent banks.

such as deposit books, to the extent possible. For these institutions, the expectation of rescue could possibly rely on contributions by deposit guarantee funds for covered depositors, but it is perhaps less likely that their incentives to compete would be distorted ex ante, if the envisaged action to rescue them in case of failure entails a loss of control post-liquidation, due to the takeover of an acquiring entity. As such, the risk of establishment of quiet life equilibria with collusive outcomes among smaller institutions might be diluted as a result of an expected consolidation into a bigger institution, which might achieve greater cost-effectiveness, through the creation of economies of scale and scope.[401] Yet, for this to be the case, the granting of public support in liquidation should not favour the senior creditors of the failing bank through a limited application of the burden-sharing requirement.

### *6.4 Differences in national banking sectors and uniformity of crisis management tools application*

Therefore, in this respect, the different characteristics of national banking markets can have different implications as far as the application of resolution and State aid measures is concerned. For instance, the varying degrees to which LSIs are present across national banking sectors in Europe and their different relevance in terms of share of assets held will influence the choice of crisis management tool and strategy in the event of failure and possibly lead to different approaches, depending on the country of incorporation of the ailing institution. Indeed, countries with more concentrated banking sectors, where the market operators are in great part significant institutions will be more likely to be faced with the application of resolution tools in case of a bank failure, as such institutions will be more likely to meet the public interest criterion, compared to situations in which a failure would interest an LSI in a banking sector where small institutions have a more significant weight in the national economy. As a matter of fact, despite not meeting the conditions for a finding of public interest that would justify resolution, it may very well be that an LSI within a very interconnected network of small banks, whose activities are important to preserve stability at local level, would need to be rescued through public resources.

[401] See Maudos and Vives (2019) for a comprehensive overview of both benefits and drawbacks of consolidation.

By means of another example, complications could also arise in the event of a failure of a saving bank or a cooperative group part of an institutional protection scheme (IPS), depending on the structure of the group itself, as well as on the type of solidarity mechanisms in place for intragroup support among the IPS members. An integrated cooperative group can amount to a significant institution and be more suited to the application of resolution tools in case of failure. By contrast, a failure of an institution which is member of a network of smaller and separated banks would not call for resolution, but might still require public intervention to stem contagion effects and preserve systemic stability at local level. In addition, different stability implications will arise where a failure involves an IPS member subject to a mutual solidarity mechanism that requires support to other members to be unlimited compared to one that is capped at a level that preserves the solvency of the single member. In this sense, different structures within national banking sectors and different group models might lead to a non-uniform application of crisis management rules within the EU.

### *6.5 A tripartite approach?*

On the basis of the considerations above, a tripartite approach could be configured, according to which (i) larger, systemic banks would be restructured through resolution and the application of a full-fledged bail-in; (ii) mid-sized banks could be resolved through sales of portfolios of assets and liabilities to other entities, possibly enabled by temporary voluntary contributions of the DGS; while (iii) smaller local banks could be liquidated in accordance with national insolvency law, with an intervention by the DGS in favour of covered depositors. With a view to limiting distortions of competition with reference to the different approaches delineated, the degrees of burden-sharing required under State aid rules and under the resolution framework should be further aligned.

The degree of concentration and contestability of the different national banking markets and the market power of the institutions involved will need to be factored into authorities' decisions on the best suitable measures to apply, as well as into their assessment by the Commission, so as to give appropriate consideration to the potential effects that the rescue and restructuring measures chosen might have on institutions and on the structure of the national banking markets, in a broader perspective.

## 7. Concluding remarks

With the BRRD framework in place in Europe, a number of rescue measures applied in the past years *have* still entailed some degree of State intervention or use of public resources. Analysing the cases enatailing the application of crisis management measures in Italy, Greece and Portugal in recent years, this chapter has provided an overview of the specificities of different crisis management measures and how they were deployed to take into account different bank-specific and national market characteristics and institutions' financial performance and perspectives. The exercise carried out in this chapter had the aim of highlighting possible attention points for authorities to take into account when choosing which crisis management strategy to deploy, on the basis of the structure and conditions of the market in which the bank in distress operates, and determining which possible remedies or countervailing measures should be applied in order to curb potential risks of distortions of competition.

Based on the practical applications of the precautionary recapitalisation option envisaged by the BRRD, some points of attention have been highlighted, with a view to proposing improvements in the implementation of the exception for recapitalisation. In particular, there might be a case in favour of using precautionary recapitalisations as soon as a capital shortfall is identified through a supervisory exercise, in order to prevent further capital deterioration of the institution to the extent possible, thus minimising at the same time the amount of public support needed. Moreover, there is leeway to revisit the requirements to grant a precautionary recapitalisation or to consider how to improve its application in practice in terms of instruments used, in order to ensure that it remains a one-time exception to resolution only applicable in very specific circumstances and within a limited timeframe, by reducing the likelihood that similar State support will be necessary again for the same bank, while possibly diluting the risk-taking incentives of the existing shareholders at the same time. To this end, the burden-sharing requirement could be accompanied by capital injections through financial instruments which should maximise the flexibility for the State to exit its investment in the short to medium term, while also creating the conditions for their future holders to cover eventual new losses and recapitalise the bank if needed, without making recourse to another public recapitalisation.

As to the potential consolidation of institutions post-rescue, it seems that larger significant institutions can expect to be left as standalone entities in the market, while mid-sized and smaller banks would more probably be merged or acquired by an external entity, in order to improve efficiency, through synergies and economies of scale and scope. Therefore, two scenarios can be envisaged, in which either the institutions maintain, build up or reinforce market power and possibly pass this through to customers via higher rates, or they can leverage their synergy-creating abilities and achieve greater levels of efficiency, which could ultimately benefit their customers. Indeed, there is no straightforward implication that larger institutions or more concentrated banking sectors will certainly and systematically exhibit signs of anticompetitive conduct in the market. Consolidation may entail a number of benefits, mostly through the establishment of economies of scale of cost efficiencies contributing to a profit boost, and in the way of fostering private risk-sharing mechanisms. However, it can also create tension with the objective of ensuring a level playing field among market players.

If, instead, any ex ante quiet life equilibria existed prior to the failure for smaller institutions, they would be difficult to count on after the rescue, as the burden-sharing and possible acquisition of portfolios of assets and liabilities by an external acquirer would not guarantee that the owners of the ailing bank would remain unaltered in whichever entity remains after rescue. As a matter of fact, some degree of contribution from shareholders and subordinated debt holders at minimum would be required under State aid rules, as applicable in cases of liquidation aid or precautionary recapitalisation. The situation might however be different, in case other rescue schemes alike to those of Carige and BPB were put forth without imposing any burden-sharing requirement on the existing shareholders and debt holders.

In general, an issue might arise in relation to the perception of the credibility of bail-in and the resolution framework at large. If exceptions to full-fledged bail-in become the regular way in which bank failures are dealt with, institutions might start adjusting their expectations relating to the possibility of a public bailout. This problem could be heightened for significant banks, which can rely on the knowledge of their essential role at national and European level and their higher degrees of interconnection, to reasonably expect that liquidation would not be a credible strategy for them. If this were the case, the market would also react and possibly re-price banks' financial instruments, by adjusting their rating as well.

The reasoning behind the continued granting of aid to struggling institutions is clear, since bank failures can have serious, long-lasting consequences for a national or regional economy. However, the position of the Commission on the instances in which to allow such aid might turn out to be self-defeating. Indeed, instead of being able to grant aid early on, in order to lessen the degree of losses that will need to be covered if the bank's situation further deteriorates in time, aid beneficiaries and national authorities run through multiple options and possible regulatory hoops, before ending up receiving some form of public support either way. In other cases, it is uncertain that rescued institutions could absolve the commitments made at the time they received the aid.

Additional emphasis in the rules on the need for aid interventions to be prompt and well-circumscribed, rather than deployed closer to a bank's insolvency[402], coupled with the imposition of credible structural and behavioural commitments on institutions with a view to reducing competition distortions, could go some way towards improving the sustainability of the crisis management framework. Solving the mismatch in burden-sharing requirements between State aid and resolution rules, as well as a clarification building towards a consistent application of the public interest assessment across different resolution authorities would offer another significant contribution to diminishing the potential for distorted incentives to materialise when choosing which tools to apply to restructure an ailing institution.

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[402] On the need to ensure prompt intervention, see Bodellini (2017), arguing that the Greek and Italian precautionary recapitalisations have highlighted how crucial it is for authorities to intervene before troubled banks cross the line of insolvency.

# Chapter 6: Liquidity and Solvency Backstops: State Involvement after Bank Resolution

## 1. Introduction

It is well-established in the economic literature that the presence of a credible ultimate safety net backed by governments is key in guaranteeing the soundness of the banking system. Indeed, banking assets are inherently risky. Rumours about the quality of a bank's assets can cause a bank run, which regulators try to prevent with the introduction of deposit insurance.[403] In turn, a privately organised deposit insurance fund, funded by premiums paid by participating banks, can run out of money, in particular during a severe financial crisis when multiple banks fail at the same time. Therefore, to be credible, a deposit insurance fund needs the backing of the government. In this sense, a government can reduce but not eliminate its role as last resort to the banking system.[404] Additionally, credit agencies recognise the presence of a sufficiently strong and credible fiscal backstop, which is a "safety net". This is directly reflected in the overall ratings given to financial institutions, which also embed the expected amount of government support.

However, when dealing with this issue, focus is usually limited to acknowledging the need for a deposit guarantee scheme (DGS), rather than considering how authorities, institutions or governments can intervene at an earlier stage to address banks' solvency and liquidity problems. In order to try filling such a gap, this chapter instead intends to address the somewhat grey area between the application of resolution, through the tools made available by the BRRD[405], and the use of a deposit guarantee scheme as a last resort option to avoid bank runs during a crisis. This in-between area can be identified with those measures enacted by central banks and other European bodies to guarantee sufficient liquidity both

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403 Diamond, D. W., Dybvig, P.-H., (1983), "Bank Runs, Deposits Insurance, and Liquidity", The Journal of Political Economy, 91, 3, p. 401-419.
404 Gros, D., Schoenmaker, D., (2014), "European Deposit Insurance and Resolution in the Banking Union", Journal of Common Market Studies, 52, 3, p. 529-546.
405 Directive 2014/59/EU.

during and after a bank's resolution, or the recourse to government financial stabilisation tools aimed at bolstering solvency.

Another aspect that is often overlooked and that should also be clarified is the link between funding in resolution and funding before resolution. In most cases, before reaching resolution, a bank already has a considerable exposure vis-à-vis central banks, be it through regular monetary operations in normal times, or through "lender of last resort" (LOLR) facilities, such as emergency liquidity assistance (ELA)[406], as market-based funding dries up. The establishment of a mechanism for funding in resolution needs to take into account this connection and must clarify the role of the central bank before, during and possibly after resolution.

Indeed, the new resolution regime enshrined in the BRRD, which requires losses to be absorbed by shareholders and creditors instead of taxpayers, is incompatible with the "ambiguity" that has traditionally characterised the LOLR framework, which is one of the crucial roles central banks have in protecting financial stability.[407] Indeed, the resolution regime revolves around the idea of recapitalising a bank by applying several tools, among which the most prominent one is bail-in. However, the need to also ensure that enough liquidity is available to guarantee a smooth and successful resolution process has been mostly neglected so far.[408]

Additionally, most banking crises lie in a grey area between liquidity and solvency problems.[409] When the authorities take a decision on whether to intervene or not they normally do not have full information about the solvency situation of the bank in question. Very often the trigger for intervention is a liquidity problem, as the bank loses access to funding when the rumors of solvency problems propagate. Moreover, the provision of liquidity is crucial for the success of a bank resolution process. Even if a bank is well recapitalised after the implementation of a resolution tool- be it bail-in or another- and can continue operating, it still needs liquidity to

[406] ELA is a framework put in place by the ECB in 1999 and subsequently revised (the last time being 2017). See Hallerberg and Lastra (2017).
[407] The concept of "lender of last resort" dates back to the XIX century (Bagehot dictum).
[408] See Eurogroup (2018). Letter from President Centeno to President Tusk. Eurogroup, 25 June 2018, Brussels.
[409] Fernandez de Lis, S., Pardo, J. C., Martin, G., (2018) "Funding in resolution: the lender of last resort function in the new resolution framework", BBVA Research, available at https://www.bbvaresearch.com

pay its debts as they come due. Indeed, the main resolution tools are aimed at restoring banks' solvency, rather than liquidity. In particular, the bail-in tool is meant to ensure loss absorption and, where needed, recapitalisation.[410]

A lack of liquidity could ultimately lead the bank into a bankruptcy process. The ensuing liquidation of assets and the discontinuation of critical services could put at risk the financial stability of a country, which is exactly what the new resolution regime intends to avoid. In a situation of bank distress that calls for restructuring through resolution, the first problem is not necessarily how to lend *ex novo* to the entity in resolution or who should do it; how to renew the existing positions to maintain market confidence during the period immediately after resolution, so as to recover market access as soon as possible is also a crucial issue. As a matter of fact, the assumption that the market would quickly provide the necessary funding after losses have been imposed on investors isn't realistic.[411] This transition is complicated by the fact that most central banks are prohibited from lending to insolvent banks. In a liquidity crisis it is crucial to have sufficient ammunition to stop a speculative attack or a bank run. The central bank is the only institution with this firing capacity. Even if the institution in charge of funding in resolution is not usually the central bank, the latter acts as a backstop.

In this regard, the eurozone is an exception due to its peculiar institutional configuration. As a matter of fact, there is currently no clarity around the provision of funding to a bank in resolution and there is no credible public sector backstop in place. As it happens, the BRRD is more focused on how to recapitalise an entity rather than on how to ensure liquidity during a resolution.[412] A clear regime of funding in resolution, including a credible public backstop mechanism, would also contribute to guaranteeing a level playing field for banks in the eurozone, also in comparison to peers in other third countries, and to providing clarity to investors in bail-inable securities, thus raising the credibility of the whole resolution framework as a result.

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[410] Demertzis et al. (2018).

[411] See the speech by SRB's Elke Koenig (2018), "Gaps in the Banking Union regarding in resolution and how to close them", Eurofi, available at https://srb.europa.eu/en/node/621.

[412] This is not the case in other jurisdictions such as the UK, USA or Canada where frameworks for the provision of liquidity are in place.

The use of the fiscal backstop and the specific type of assistance it will offer will be dependent upon the resolution strategy previously chosen. Indeed, different resolution tools might lead to different implications in terms of backstop recourse. With a view to this, it is also important to understand the distinction between liquidity and loss absorption. Indeed, the suggestion of a public sector liquidity backstop should not be confused with taxpayer-funded bail-outs, or losses being placed upon public institutions. As a matter of fact, the BRRD framework requires banks to have sufficient loss absorbing capacity to enable losses to be covered and the institution to be recapitalised. However, this is distinct from the question of liquidity funding for a bank in resolution. Provision of liquidity to banks is a well-established principle and, if done correctly, does not involve the public sector taking on losses of the institution. This is reflected in the words of Ben Bernanke in his comment piece on the Orderly Liquidation Authority (OLA), which provides a liquidity backstop facility for firms in resolution in the U.S. "*A temporary liquidity backstop is likely to be necessary to maintain critical operations as the firm is restructured […] Importantly, though, these loans are limited in size and are temporary funding, not permanent capital. They are backed by first claims on the firm's assets and—if that is not enough—by an assessment on other large financial firms. The one group that is guaranteed not to see losses in an OLA is taxpayers.*"[413]

On the basis of the above, after a distinction of the different backstop-like measures for solvency and liquidity support to banks, the analysis of this chapter will move to an assessment of what form of backstop is proposed to enact them and whether one could reasonably expect competitive distortions to come about in the banking market as a result.

**2. Solvency assistance: extraordinary public financial support**

First of all, it is worthwhile to address whether additional interventions aimed at solvency restoration might be required even after resolution has already been implemented. In principle, the new framework for crisis management establishes an automatic relationship between the "point of non-viability" (PONV)

[413] Ben Bernanke's speech available at: https://www.brookings.edu/blog/ben-bernanke/2017/02/28/why-dodd-franks-orderly-liquidation-authority- should-be-preserved/

of a bank, the moment at which the institution is failing or likely to fail (FOLTF), and its solvency and liquidity positions.

According to the BRRD, the PONV should be understood as the point at which the relevant authority determines that the institution meets the following conditions for resolution: i) it has been deemed to be failing or likely to fail; ii) there are no private alternatives to rescue it and iii) resolution is necessary in the public interest. At an earlier stage, an institution should be considered as FOLTF when: (i) it is in breach of its capital requirements, i.e. infringes or is likely to infringe the requirements of continuing authorisation or when its assets are or are likely to be less than its liabilities; (ii) it is illiquid, thus is or is likely to be unable to pay its debts as they fall due; or (iii) it requires extraordinary public financial support, with the exception of "precautionary recapitalisation" as per Art. 32(4)(d) of the BRRD.

### *2.1 Government financial stabilization tools*

The notion of State intervention is captured in the concept of 'extraordinary public financial support' (EPFS), defined in Art. 2(28) of the BRRD, stating that it is "State aid within the meaning of Article 107(1) TFEU, or any other public financial support at supranational level, which, if provided for at national level, would constitute State aid", that is granted in order to preserve or restore the viability, liquidity or solvency of a banking institution covered by the BRRD itself. As such, this notion is broader than that of State aid. Indeed, this definition of EPFS captures assistance granted by national resolution funds, by the SRF (see Chapter 4) and from other national sources such as taxpayers. It also includes support granted by supranational public organisations, which could arguably encompass the ESM, the European Investment Bank or the European Bank for Reconstruction and Development.

Nevertheless, in accordance with the goals of the new regulatory framework for bank resolution, State aid is relegated as an option to be tapped into only in exceptional circumstances. One such example is the recourse to "government financial stabilisation tools" (GFSTs). If resolution financing arrangements (e.g. recourse to resolution funds) are not sufficient, then alternative financing sources like GFSTs can be available. As means of direct financial support from national public funds, they can only be granted under strict conditions and must comply with the EU State aid framework. More specifically, they must be used as a last resort tool to avoid a systemic crisis. Member States may provide extraordinary public financial support through GFSTs in accordance with Articles 56(3) and Article 37(10) of the BRRD and with the EU State aid framework, including direct intervention to avoid the wind-up of the institution, with a view to meeting the objectives for resolution referred to in Article 31(2) of the same directive.

Financial stabilisation tools can take any of the following forms: (a) public equity support where the State participates in the recapitalisation with CET1, AT1 and T2 instruments, as referred to in Article 57 BRRD; or (b) temporary public ownership by a Member State nominee or Member State-owned company, in case such an injection is insufficient, as referred to in Article 58 BRRD. They can be used as a last resort after having assessed and exploited the other resolution tools to the maximum extent practicable whilst maintaining financial stability, as determined by the competent ministry or the government after consulting the resolution authority.

When applying the GFSTs, Member States shall ensure that their competent ministries or governments and the resolution authority apply the tools only if all the conditions laid down in Article 32(1) as well as one of the following conditions are met:

a) the competent ministry or government and the resolution authority, after consulting the central bank and the competent authority, determine that the application of the resolution tools would not suffice to avoid a significant adverse effect on the financial system;
b) the competent ministry or government and the resolution authority determine that the application of the resolution tools would not suffice to protect the public interest, where extraordinary liquidity assistance from the central bank has previously been given to the institution;
c) in respect of the temporary public ownership tool, the competent ministry or government, after consulting the competent authority and the resolution authority, determines that the application of the resolution tools would not suffice to protect the public interest, where public equity support through the equity support tool has previously been given to the institution.

On this basis, resolution authorities have the option of seeking alternative funding through those tools in the event of a systemic crisis- which qualifies as a "very extraordinary situation"[414]- provided that a minimum bail-in contribution of 8 % of a bank's liabilities and own funds has been made and that the financial stabilisation tool itself is cleared under State aid rules. In this sense, it is clear that the tools are not resolution tools in themselves, but rather an alternative to other resolution financing arrangements. Such tools must be implemented under the leadership of the competent ministry or government of the country where the failing bank is located, in close cooperation with the relevant resolution authority.[415] However, they are only available if the competent ministry or resolution authority determines *inter alia* that (i) the use of the resolution tools by themselves would not suffice to avoid a significant adverse effect on the financial system, or (ii) it would not suffice to protect the public interest.

Therefore, as seems to be the case for the use of other tools made available by the current regulatory regime, financial stability remains the overriding policy interest that justifies instances of direct government intervention. This is also reflected in the concept of public interest to be preserved.[416] Then, it remains relevant to understand how this is balanced with the competition policy concerns that may arise from the potential competitive distortions arising from State intervention. At least in principle, though, it appears that government support is not ruled out, but rather still acknowledged as the only viable option to avert systemic contagion and to preserve stability.

**3. Liquidity support measures**

Not only solvency measures must be considered within the resolution framework, though. Indeed, a number of liquidity support schemes for banks in need have been put in place in some EU Member States, including, but not limited to, Cyprus, Greece, Italy, Poland and Portugal, in recent years. Their purpose is to

[414] See Art. 37(10) BRRD.
[415] In order to give effect to the government financial stabilisation tools, Member States shall ensure that their competent ministries or governments have the relevant resolution powers specified in Articles 63 to 72, and shall ensure that Articles 66, 68, 83 and 117 apply.
[416] On the finding that financial stability is an "*overriding and inviolable public interest, which becomes a pivotal European value that may prevail over the principle of legitimate expectations and over the need to protect investors*", see Raganelli (2017).

ensure that banks have no difficulties in funding their operations and to guarantee access to deposits. Under EU State aid rules, banks with a capital shortfall cannot benefit from general liquidity support schemes, meaning that the Commission must take decisions on a case-by-case basis. In accordance with the 2013 Banking Communication, these aid measures can still be temporarily approved as rescue aid, meaning that they can be granted before the Commission has approved the restructuring plan of the bank concerned. However, this is only possible for banks that have no capital shortfall.[417] Instead, if a bank with a capital shortfall needs liquidity support, the Commission will require the relevant Member State to submit a restructuring plan.

The objective of such assistance measures is to provide safety to investors, by acting as a safety net that can ensure liquidity for the banks involved. However, they are also meant to counteract an international market failure, by which banks that are solvent still encounter difficulties in getting access to liquidity. Thus, liquidity support measures should establish the "conditions for the revival of the interbank lending market and financial markets more generally".[418] State aid implied by a liquidity measure is deemed to be compatible with the internal market if it is proportionate and commensurate with the need to ensure sufficient liquidity in the banking sector in the particular circumstances. In its 2013 Banking Communication, the Commission does not envisage a mechanism whereby the ECB would provide funding in resolution. However, liquidity assistance from a central bank could be considered as State aid if the bank is (i) not solvent, (ii) not backed by collateral and (iii) if assistance is backed by a counter-guarantee from a State. Therefore, the discussion must also turn to addressing the role of central banks in assisting institutions in distress.

### *3.1 Liquidity assistance by central banks*

Central banks may act as LOLR by providing emergency liquidity assistance (ELA) to failing banks. As acknowledged in the preamble to the BRRD, liquidity support from central banks aims to "secure access to funding under equivalent conditions for all credit institutions that are otherwise solvent". Within

[417] Point 58 of the 2013 Banking Communication.
[418] Slovenian guarantee scheme, case N531/2008, 12 December 2008, para. 33.

the eurozone, the decision to grant ELA is at the discretion of national central banks. This means that any costs and risks arising from the provision of ELA are incurred by the relevant national central banks (NCBs). Nevertheless, in order to ensure that ELA operations do not interfere with the single monetary policy, the ECB's Governing Council may object to or restrict the provision of ELA.

Then, the question is whether ELA can be considered as a national measure and whether it constitutes State aid. As to the first aspect, the provision of ELA to solvent but illiquid institutions remains national responsibility. The decentralisation of ELA assistance implies that the ultimate credit risk lies with Member States' fiscal sovereignty. Nevertheless, coordination arrangements are in place, through which national central banks of the euro area are required to inform the ECB- and to also request authorisation when the overall ELA size exceeds certain thresholds- on the financial situation of the beneficiary, the systemic implications, and the terms of the financial assistance. As for the second point, instead, the Commission has held that liquidity assistance does not constitute State aid, if the following cumulative conditions are met:[419]

i) the financial institution is solvent at the moment of the liquidity provision and the latter is not part of a larger aid package;

ii) the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value;

iii) the central bank charges a penal interest rate to the beneficiary; and

iv) the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State.

Therefore, the State aid provisions applicable to ELA are similar to those applicable to pure State guarantees. Yet, in addition, banks applying for ELA must present a restructuring plan demonstrating their capacity to recover and restore their access to market funding in the long term, when public support is no longer available. However, there are also some clear-cut situations where no liquidity can

[419] Codified in point 51 of the 2008 Banking Communication and reprised in point 62 of the 2013 Banking Communication.

be provided by a central bank, be it under the monetary policy framework or ELA: this is the case for entities put into insolvency or liquidation proceedings.

### *3.2 Liquidity assistance after the "failing or likely to fail" determination*

As already established, a precondition for a resolution action to be undertaken is that the entity needs to be determined as failing or likely to fail. At that stage though, it will still be early to know whether there is a reasonable prospect of an alternative private sector solution or supervisory intervention, as well as whether resolution is in the public interest.[420] Nonetheless, the entity's risk profile will be worsened by the very fact of the "failing or likely to fail" determination. In principle, such an entity could still have recourse to Eurosystem monetary policy liquidity provided that it complies with the counterparty eligibility criteria, in particular that it is financially sound and has sufficient eligible collateral. However, to address the uncertainty and the associated risk in the Eurosystem's counterparty framework, ECB rules provide that the entity's access to Eurosystem monetary policy credit instruments is frozen at the level prevailing at the time the institution is determined as failing or likely to fail.[421]

Ideally, the application of one of the resolution tools (sale of business, bridge institution, asset separation, or bail-in) would lead to the credit institution recovering its financial soundness. In these situations, the restored solvency of the failing counterparty will first have to be confirmed by the competent supervisory authority before the Governing Council decides to "unfreeze" its access to Eurosystem monetary policy liquidity. Such confirmation is also necessary for the provision of ELA. Thus, the entity would need to be handed back to the supervision of the relevant competent authority, which will provide information on the observation of the required ratios. Instead, if the entity is a *newly created* counterparty, such as a bridge bank, it will first have to be licensed to operate as a credit institution. It will then have to be accepted as a Eurosystem counterparty. This means it will have to fulfil all the eligibility criteria, including the requirement to comply with the relevant capital, liquidity and leverage

[420] Respectively, the second and third cumulative conditions necessary to trigger a resolution action for a failing bank.
[421] See ECB's Yves Mersch's speech "The limits of central bank financing in resolution", 30 January 2018, available at https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180130.en.html

ratios. Therefore, if applying one of the resolution tools restores the entity's financial soundness, or if combining its business with that of an absorbing entity results in the emergence of a financially sound entity or group, access to central bank liquidity could resume after the Eurosystem has made its assessment.

*3.2.1 Liquidity provision by central banks*

Still, the need remains for banks to be able to plan ahead and obtain liquidity, even if determined as failing or likely to fail or if the resolution process has already been activated. Indeed, the establishment of a new liquidity source has been debated since the Single Resolution Board handled its first big resolution case in June 2017, by forcing the sale of Spain's Banco Popular Espanol SA to Banco Santander SA.[422] The question is then whether and to what extent this liquidity should be provided by central banks. The ECB's position on the matter has been constant: the provision of central bank liquidity, be it through monetary policy credit operations or emergency liquidity assistance, should not be automatically assumed in resolution planning.[423] Resolution measures should be financed by contributions from shareholders and creditors of the bank, or by the State or at Union level, but not by central banks. More specifically, central banks can only provide liquidity in the context of pursuing their objectives and to carry out the tasks within their mandate. In addition, with regard to the monetary financing prohibition, the ECB has repeatedly stated that the financing of resolution measures is a government task. This does not necessarily mean that the Eurosystem would be prevented from providing liquidity in the context of resolution, as long as the provision of liquidity complies with the requirements of any of the two sources of central bank liquidity.[424]

Liquidity can be provided under the generally applicable monetary policy rules and respecting the limits set out in the Treaty and any Governing Council decisions. Liquidity provision by central banks in the event of resolution must not be assumed *ex ante*, even though the possibility is not excluded, provided the

[422] See Chapter 4 for a discussion of liquidity and solvency considerations raised by the Banco Popular case.
[423] This is also specified in Art. 10(b) BRRD.
[424] These requirements are stricter in the case of monetary policy liquidity than for ELA. For example, in the case of the asset separation tool, liquidity can be provided to the solvent part of the bank that is participating in monetary policy transmission, but not to finance the separation itself.

specific rules and objectives of the Eurosystem are followed. The decision on the provision of central bank liquidity will be taken independently and *ad hoc* by the Eurosystem to ensure that potential emergency lending does not interfere with monetary policy. However, central banks provide liquidity, not solvency support. This is precisely the reason why the Single Resolution Fund (SRF) was established, namely that the financing of resolution should no longer come from the taxpayers, but from the banks themselves. This is where the provision of liquidity by the SRF actually becomes crucial in the euro area. However, since this source of liquidity has yet to be fully operationalised, the question remains where to have a backstop come from. This source cannot come from the central banks, as resolution financing is a government task, complemented by the rules and procedures applied by the SRB and the national resolution authorities within the framework of the SRM. Thus, funding gaps that cannot be addressed by the industry or through the SRF should ultimately be filled by Member States.[425]

### *3.3 Liquidity assistance with the application of different resolution tools*

Different degrees and sources of liquidity will be necessary and available depending on the stage of distress of the bank involved and the consequent restructuring to be implemented, as well as on the type of entity that needs to viably operate on the market. Table 6.1 provides a structured overview of the different liquidity sources available to banks under restructuring, according to the different phases of the execution of a resolution action.

[425] Mersch (2018), *supra* note 422.

*Table 6.1 – Liquidity sources according to timing and entity involved*

| | Entity | Liquidity source |
|---|---|---|
| **Normal times** | Private bank | ● Central bank liquidity<br>● Emergency liquidity assistance (ELA) by national central banks |
| **Resolution weekend** | Private bank to which a (combination of) resolution tool(s) is applied | Not necessary, operations suspended |
| **Post-resolution (potential lingering uncertainty)** | ● Restructured bank (bail-in)<br>● Newly owned private bank (sale of business)<br>● Bridge bank<br>● Asset management vehicle | Unclear |
| **Normal times (renewed credible access to markets)** | Private bank | ● Central bank liquidity<br>● Emergency liquidity assistance (ELA) by national central banks |

*Source:* own elaboration

If a bank to which the bail-in tool is applied (i.e. open-bank bail-in strategy) found itself in need of liquidity, two potential means could be foreseen for it to access it, namely: (i) through ELA, provided that resolution has not impacted its levels of eligible collateral and bail-in has ensured compliance with minimum capital requirements; (ii) through the SRF, provided that the resolution plan explicitly provided for the possibility to ask for SRF funding, although it is unclear whether the minimum bail-in requirement of 8% would be applicable also in such an instance or that would only be required in case of recapitalisation measures[426]; or (iii) through DGS resources. The latter option, however, is not meant as a primary source of funds in resolution in the European Union,

[426] The SRMR does not explicitly mention this.

The same considerations would be valid in case transfer tools were applied. Liquidity provision in transfer strategies could also pass through DGS resources[427], in the form of cash disbursements, guarantees, or monetary grants to a bridge bank or acquirer, for instance. As highlighted in Chapter 4, interventions by DGSs in resolution could qualify as State aid under certain conditions and, thus, are subject to scrutiny under the State aid framework. This will entail an assessment aimed at verifying that contributions are made on terms that a market operator would also accept, in case there is a finding of imputability of DGS resources to the State. The 2013 Banking Communication, however, does not specify whether specific competitive safeguards would be required of the beneficiary in an instance where DGSs intervened.[428]

Differently, a bank entering liquidation under national insolvency proceedings would not need liquidity injections, as it would exit the market, without continuing its operations; however, a transfer of a portfolio of its assets and liabilities to another market operator might require some liquidity support.[429] In such a case, the situation would be comparable to that described with respect to resolution transfer strategies, and competition distortions would be redressed by ensuring the exit of the beneficiary from the market within a short timeframe.[430]

If any of the conditions for access to ELA, SRF or DGS funding were not verified, the only remaining option for a bank to access liquidity would appear to be guarantee schemes or other forms of liquidity support, as described in Section 3. In this sense, it is reasonable to expect that smaller banks would rely more heavily on such forms of public support to cover liquidity needs, especially if resolution is not the strategy envisaged to deal with their potential failure. In any case, clarification and resources would be needed to operationalise mechanisms of liquidity support

[427] The latter option, however, would only be available in some States, depending on the applicable regulatory framework and whether DGS interventions can support transfer of covered depositors only, or also other liabilities. See Baudino et al. (2019).
[428] Baudino et al. (2019) highlight that, where central bank facilities are available, liquidity provision by the DGS is likely to be possible on less onerous terms than ELA, or against collateral that would not be eligible under the central bank's framework. This could create distortive incentives to make recourse to DGS contributions whenever possible, to bypass ELA requirements.
[429] This was the case in the context of the liquidation of Banca Popolare di Vicenza and Veneto Banca, where liquidity guarantees were extended on bonds of the two banks within a scheme to transfer the good parts of the two institutions to Intesa San Paolo, the acquirer. See Commission decision C(2017) 4501 of 25 June 2017 (SA.45664 (2017/N) – Italy), discussed in depth in Chapter 5.
[430] *Ibid.*

for banks in restructuring, in order to reduce the continued recourse to State resources. A discussion of possible policy options in this respect is provided in the next Section.

**4. Funding in resolution**

One implicit assumption embedded in the BRRD is that once the institution's own funds are restored, it will be possible to access funding to refinance liabilities as they come due. Nevertheless, following any recapitalisation, a firm may experience heightened liquidity needs generated by market volatility, uncertainty surrounding asset valuations, and an asymmetry of information regarding its viability. Then, one must turn to considering the ability of resolution funds or other sources and bodies to provide such liquidity as needed.

The resolution process deals with the solvency issues of the bank concerned, through the application of bail-in and the use of the SRF, but the latter is not equipped to shoulder major liquidity needs for large, globally-systemic banks (G-SIBs), which might exceed the size of the SRF and its backstop.[431] However, the ECB and national central banks are prohibited from providing liquidity in the absence of eligible collateral or guarantees. The current resolution framework does not specify who should provide liquidity, and against which guarantees, if collateral were to be insufficient.[432] An additional limitation to the use of the SRF arises because its contribution is bound by construction by what is determined in the resolution scheme, not being adaptable following a potentially negative market response to the restructured entity.[433]

The Financial Stability Board (FSB) had also advocated for an effective public sector backstop mechanism to be made available to secure liquidity in resolution, while banks would need to maintain available non-encumbered assets.[434] In the eurozone, such a mechanism is on the way to operationalisation by virtue of

[431] The size of the resolution funds has been questioned to possibly be insufficient in case they have to provide temporary funding to financial institutions in exceptional circumstances where access to markets is difficult. On this point, see, among others, Hellwig (2014), Hadjiemmanuil (2015) and Yiatrou (2016).

[432] Resolution planning and resolvability assessments could contribute to alleviate the problem of insufficient collateral, up to a point, by requiring banks to make the necessary preparations that ensure the availability of eligible collateral in preparation for resolution and post-resolution viability.

[433] Demertzis et al. (2018).

[434] FSB, (2016) "Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB")", available at www.fsb.org.

the expected future role of the European Stability Mechanism (ESM) in committing funding to the SRF, enabled by the reform of the ESM Treaty (discussed in section 5.1). It is important to recall that public financing does not constitute State aid if certain conditions are respected[435], and must also not be perceived as equivalent to government stabilisation tools under BRRD,[436] which address solvency issues and are subject to different conditions.

As stated in the European Commission communication on Banking Union from 11 October 2017,[437] it is important that there is sufficient liquidity available and the fund could be used in combination with central bank liquidity. Along these lines, the ECB has been considering a new policy tool that would allow it to inject cash into banks that are being rescued from the threat of insolvency, tackling a gap in rules for dealing with troubled lenders.

### *4.1 A proposal for Eurosystem Resolution Liquidity Assistance*

The suggested framework for Eurosystem Resolution Liquidity Assistance (RLA) lays out conditions including a far-reaching public guarantee to safeguard against central-bank losses. The measure is potentially controversial because it is against the ECB's mandate that it finances actions that should be undertaken by public authorities, such as bank resolution. Therefore, it is suggested the RLA should be seen as a monetary-policy tool, ensuring the banking system can transmit official interest rates to the real economy.

The RLA would be earmarked for banks that meet temporary funding difficulties in resolution and its access would be strictly subject to the following conditions:

- The bank has been recapitalised through bail-in;
- The liquidity serves the purpose to sustain the credit institution in the execution of the resolution strategy;

[435] In essence, relying on whether the transaction entered by a public authority is concluded at terms that a private investor in the market would also accept (this concept is known as the "market economy investor principle"), implying that the support would not grant an undue advantage to the beneficiary.
[436] Artt. 56-58 BRRD.
[437] https://ec.europa.eu/info/publications/171011-communication-banking-union_en.

- The liquidity is provided at a penalty rate but without deteriorating the solvency capacity of credit institutions;
- The liquidity is secured, with collateral provided by the resolved entity or in other cases by the resolution fund (as envisaged by the BRRD);
- The financing is temporary and must be replaced by private funding as soon as possible.

The RLA would thus enable the stabilisation of the bank after entry into resolution by providing confidence to markets and clients. It could also lessen moral hazard concerns, given its limited duration and its penalty rate, and the fact that it is only available in resolution. Existing monitoring of asset encumbrance enables identification of available collateral. Additionally, as a complement to this tool, an explicit clarification should be provided in the current resolution framework on what precisely the functions of the resolution fund are.[438]

Funding under the Eurosystem RLA would still need public backing though, because the requirements on bank collateral would be weaker than for the ECB's regular operations. The collateral demand could even be dropped entirely and replaced by the euro-area guarantee in "exceptional circumstances". Having it be provided at the European rather than national level would also beneficially go in the direction of lessening the discretionality applied at national level and the ensuing legal uncertainty, which can also unlevel the playing field across different institutions. Still, while this condition is aimed at bolstering the euro area's attempts to break the interdependence of governments and the respective national banks, it could run into opposition from countries that are not in favour of debt mutualisation.

### *4.2 A mechanism for liquidity assistance: State aid considerations*

The latest ECB policy on ELA[439] provides some level of clarity regarding funding in resolution. Its principal novelty, compared to its previous policy, is that ELA can be provided only to solvent banks (i.e. those that comply with Pillar 1

[438] European Banking Federation, (2018) "Discussion paper on funding in resolution under BRRD", available at https://www.ebf.eu

[439] Agreement on emergency liquidity assistance of 17 May 2017. Available at: https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf

minimum capital requirements). Yet, an exception can be made for banks that do not comply with Pillar 1 requirements, but still have a credible prospect of recapitalisation during the 6 months following the determination of non-compliance. Therefore, once the entity is declared failing or likely to and a plan to apply a resolution tool in order to recapitalise it is approved, the central bank could continue providing ELA to the bank, provided sufficient collateral is available to be pledged.

However, a mechanism could be designed through which temporary ECB liquidity support from the ECB could be taken over by the institution responsible for the implementation of resolution schemes until the entity regains access to the markets. More specifically, the central bank could continue providing the funds because it is the most appropriate institution to commit potentially high amounts of money in a timely manner. However, the risk could be assumed by the SRF by providing guarantees either i) directly to the bank, which could in turn use them as "collateral" against funds from the central bank, or ii) to the central bank for the full amount of the loan. Consequently, the central bank would not be exposed to losses and would only act as a mere provider of funds. This could also solve the problem generated by banks not being able to access ELA because they have run out of eligible ELA collateral, which is likely to happen during a resolution process. Additionally, such a mechanism would be fiscally neutral because the SRF has access to *ex post* contributions from the financial sector if the entity in resolution is unable to reimburse its funding, therefore enabling ultimate loss absorption by the private sector, without making recourse to governmental support. However, the *ex post* contributions should be calibrated in such a way to avoid excessive pro-cyclical effects and competitive distortions also driven by the financial health of the contributing institutes.

To this end, in exchange for such liquidity assistance, authorities might impose a tough restructuring plan in order to restore the bank's long-term viability. If the market considers that the business reorganisation plan is credible and realistic, this should allow funding needs to recede, and the institution could gradually recover to a normal state or 'business as usual', where access to market funding would be available once again. Such a mechanism would possibly also reduce State aid concerns, since: i) the bank could still be deemed solvent when it receives the funds, as a recapitalisation plan would be applied in the short term; and ii) no counter-guarantee from the State would be involved. Therefore, the point to be ascertained under State aid rules would be whether the guarantees from the SRF would constitute public aid, by assessing the imputability of the SRF resources. Yet, as the SRF is backed by ex-ante funds raised from the industry, and it can be re-insured ex post by other industry funds, moral hazard issues should be dampened.

Within a completed Banking Union, ELA would ideally be provided in a centralised manner, further severing the link between banks and their national sovereigns, by having a euro area-wide fiscal body with recourse to the SRF extending guarantees for liquidity provisioning.[440] This implies that a centralised treasury would guarantee centralised liquidity provisioning relying on the SRF to ensure that losses are ultimately borne by the banking sector, rather than by taxpayers. However, so long as the Banking Union is not complete and liquidity provisioning still hinges significantly on the extension of ELA by national central banks, guarantees from national treasuries, possibly in combination with a larger guarantee from the ESM, would remain necessary. As a consequence, scrutiny under State aid rules will remain a necessary component to assess the compatibility of liquidity assistance measures to banks. In addition to the requirement of setting a minimum remuneration for the State[441], mostly behavioural safeguards would be required to curb undue distortions of competition, including a ban of advertisement related to the State support received and a ban on commercial aggressive practices. This entails that no significant restructuring or burden-sharing would be imposed.[442] However, if banks were to call upon the guarantees, an individual restructuring or wind-down plan would need to be submitted within two months after the activation of the guarantee.[443]

[440] On this point, see also Demertzis et al. (2018).
[441] In line with the formula of the 2011 Prolongation Communication.
[442] Provided that the conditions at points 59 and 60 on the amounts and type of securities to be guaranteed are respected.
[443] Point 58 of the same Communication also posits that, where a bank with a capital shortfall needs urgent liquidity support, an individual notification to the Commission is required, together with a restructuring or wind-down plan, unless the aid is reimbursed within two month. In such an instance, burden-sharing would also be required as part of the support scheme, in order to reduce the capital shortfall to the maximum extent possible and, as a consequence, the need for public support.

## 5. Which form of backstop for the EU banking sector?

It is now worthwhile to delve more in depth into what a fiscal backstop for the banking sector, as the last step on the ladder of crisis management tools, could look like when it must deal with either solvency or liquidity assistance.

In the context of the Banking Union, the backstop function would be activated where, even after imposing losses on the banks' shareholders and creditors, the SRF is temporarily short of resources to facilitate the orderly resolution of the distressed banks. In this perspective, it should increase confidence in the European banking sector by acting as a last resort in case less favourable conditions materialise. At the same time, it would strengthen the resolution mechanism while recovering costs from the banking sector, thus making sure taxpayers do not have to pay for failing banks.

The guiding principles developed by the FSB[444], which are generally accepted, posit that public sector backstop funding mechanisms should be:

- credible in terms of size and sufficiently large to support the orderly resolution of potentially multiple large banks simultaneously;
- capable of delivering temporary funding with sufficient rapidity; and
- the term of funding being sufficient to allow the bank in resolution to regain access to private sources of funding.

### *5.1 The role of the SRF and ESM*

In the Banking Union, the SRF has been established for the purpose of both (i) absorbing losses and compensating creditors and (ii) providing liquidity in resolution.[445] In the latter case, the SRF may make loans to and guarantee the assets or the liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle. Yet, the SRM regulation does not specify whether and under which conditions liquidity support needs to be backed by collateral.[446] It also still does not have access to a credit line and does not have the

[444] *Supra* note 435.
[445] Art. 76 SRMR: "to guarantee assets or liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle".
[446] On collateral conditions, recital 33 of the SRMR notes that "Where liquidity support involves no or significantly less risk than other forms of support, in particular in the case of a short-term, one-off

resources to deploy the significant amounts of liquidity that may be required. For this reason, together with the current lack of a fiscal backstop, the interaction between central bank liquidity in resolution and the role of the SRF should be considered as part of the resolution funding framework in the Banking Union. While the SRF itself may not be sufficient for the provision of liquidity, it could potentially play a role in supporting the provision of private or central bank funding, for example through a potential role of guarantor to private or central bank funding, ensuring that any losses would be borne by the industry.[447]

Mario Draghi, former President of the ECB, commented the following: "*resolution needs financing, and the Resolution Fund, which is funded by banks, will ensure that it is paid for by the private sector. But in a very deep crisis, the resources of such funds can be depleted. That is why in all the other large jurisdictions, such as the US, the UK and Japan, resolution funds are backstopped by the fiscal authority. The aim of such backstops is not to bail banks out: any funds borrowed are repaid by the private sector over time. Rather, the aim is to create confidence that bank resolution can always be enacted efficiently, which has a stabilising effect in a crisis and prevents more banks from being dragged into difficulties.*"[448]

As for the provision of a backstop for solvency purposes, the SRM Regulation explicitly states the possibility for the European resolution fund to seek "alternative funding means" be it from "financial institutions", "institutions" or "other third parties".[449] Also, "public financial arrangements" providing financial means to the fund are a possibility.[450] Admittedly, it remains unclear today which of these bodies (if any) would be willing to provide such financial means to the resolution fund in extraordinary circumstances. The two most likely sponsors to the resolution fund would be the ESM and (one or more) Member States.

extension of credit to solvent institutions against adequate collateral of high quality, it is justified to give such a form of support a lower weight of only 0,5 [to determine the threshold governing decision making procedures to avoid first-mover advantages]".

[447] Association for Financial Markets in Europe (AFME), June 2018, "Liquidity in resolution", Discussion Paper, available at https://www.afme.eu

[448] Speech available at: https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180511.en.html

[449] Art. 73 SRMR.

[450] Art. 74 SRMR.

Obviously, whether or not the resolution fund will need “extraordinary financial assistance” to cover any resolution or recapitalisation costs in the run up to the completion of national contributions will heavily depend both upon the size of any future bail-in as well as upon the size of any assistance by affected Member States, whether it will be to banks or to the resolution fund. Both variables are subject to moral hazardous behaviour, but still remain unknown as of today, making it hard to appropriately judge the adequacy of the fund’s financial capability. The means for ESM-assistance to the resolution fund have been introduced through the reform of the ESM Treaty of end-2019.[451]

### *5.2 The ESM reform*

On 4 December 2019, the Eurogroup agreed in principle, subject to national procedures, on a reform to the ESM touching upon a number of aspects, including a development of the ESM’s financial assistance instruments and an enhancement of the ESM’s role as a common backstop for the SRF.

In the event that the SRF is depleted, the ESM can act as a backstop and lend the funds necessary to finance a resolution, through the provision of a revolving credit line. A nominal cap for loans to the SRF is set at €68 billion.[452] If the credit line is used, the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended so that the total maturity is up to five years. As a result, it will be fiscally neutral over the medium term. If non-euro area Member States join the Banking Union, the ESM and non-euro area Member States would provide parallel credit lines to act as a common backstop to the SRF. At the latest, the common backstop is meant to be in place by 1 January 2024.

As a consequence, the ESM will be enabled to be involved in the financing of recapitalisations through either of the following mechanisms:

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[451] Prior to its reform, the ESM-Treaty would have only allowed for loans being awarded to ESM-Members. An intervention to backstop the SRF would not have been possible. Following Article 19 ESM-Treaty, ESM-Governors could have allowed for the ESM financing the resolution mechanism. Such a decision would have required unanimity and the consent of some national parliaments.

[452] This figure is expected to be above the target level of the SRF in 2024, for an alignment between the size of the SRF, which is 1% of covered deposits in the Banking Union (estimated at around €55 billion), and that of the backstop.

(1) ESM-financial assistance to the SRF, which in turn recapitalises the bank, or

(2) ESM-financial assistance to a Member State by an ESM-loan to recapitalise the bank.[453]

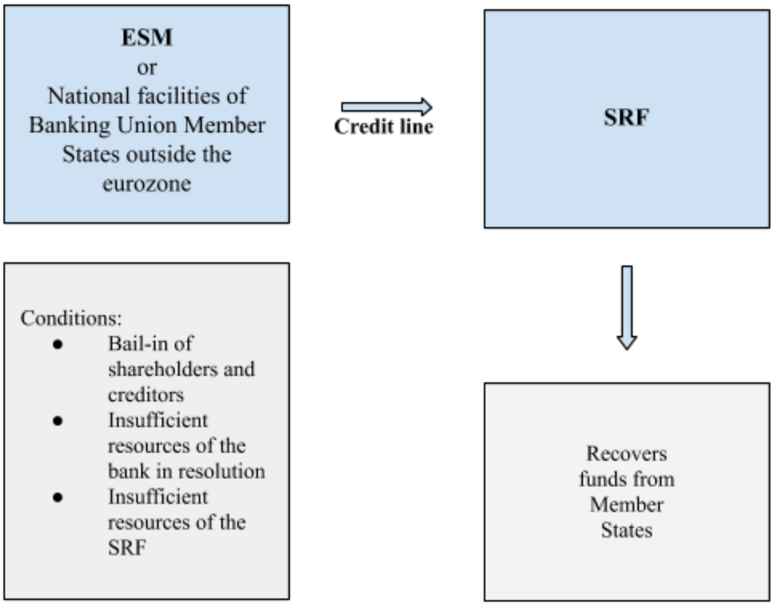
ESM-financial assistance to the resolution fund for recapitalisation purposes should be possible only given the following conditions being fulfilled simultaneously:

- it is only applied to major recapitalisations above 5% of the bank's liabilities, which means that an 8% bail-in and a full write-down of eligible liabilities would have already taken place; and
- the Single Resolution Board (SRB) has made all possible efforts to raise contributions or borrow funds from other sources at acceptable rates.

Figure 6.1 exemplifies how the backstop system would work.

[453] Currently, the financial assistance toolkit of the ESM also includes a Direct Recapitalisation Instrument (DRI) for banks, which, however, will be removed after the establishment of the ESM common backstop. Such an instrument was available for financial institutions: (i) in (likely) breach of the relevant capital requirements and unable to attract sufficient capital from private sector sources to resolve their capital problems; (ii) for which burden-sharing arrangements, such as bail-in under the BRRD, are insufficient to fully address the capital shortfall; (iii) with a systemic relevance or posing a serious threat to the financial stability of the euro area as a whole or the requesting ESM Member; (iv) supervised by the ECB; and (v) to which the beneficiary Member State cannot provide financial assistance without very adverse effects on its own fiscal sustainability, thus making the use of the indirect recapitalisation instrument unfeasible.

*Figure 6.1 - ESM backstop functioning*




*Source*: own elaboration

Given the conditions described, the ESM serving as a backstop for the resolution fund would serve a number of purposes. Among them, it could diminish risks for the taxpayers, since the fund- differently from a single financial institution- is backed by a large number of banks. ESM-assistance to the fund would better activate national backstops compared to ESM-loans to Member States for recapitalisation, thus increasing national responsibility in coping with moral hazard. On the downside, however, this would ultimately be at the cost of a higher default risk for the ESM, and hence taxpayers. As a possible solution for the latter problem, the volume made available for this instrument might be confined.

It is also important that the ESM should not be the first recourse in case the resolution fund encounters any financial problem. In this sense, an ESM backstop for the resolution fund could be earmarked for major recapitalisations (above 5%), but only after all possible efforts are made by the SRB to tap into other capital sources, either by raising contributions or borrowing the necessary funds at reasonable rates. This has a twofold implication of (i) increasing the responsibility of the banking sector in shouldering losses and recapitalisations of institutions, thus ensuring the fiscal neutrality of support and (ii) further diminishing the expectation of institutions to receive public financial support.

**6. Economic considerations on fiscal backstops**

The economic literature has widely acknowledged how fiscal backstops act to preserve the stability of financial markets. Some studies have looked at the interaction between fragility and market structure and found that panic runs could occur in all competitive conditions. Panic runs result from coordination problems among depositors and network externalities, and these features need not depend on the degree of competition for deposits.[454] On the other hand, there might be another mechanism at play, too. More competition may worsen bank fragility: by raising interest rates on deposits, more competition may exacerbate the coordination problem among depositors, leading to a panic run[455], and also increase the probability of fundamental runs.[456]

Competition also affects the functioning of the interbank market. Banks with surplus liquidity and market power in the interbank market might face two choices, which lead to opposite effects. More specifically, they might deny funds to deficit banks, forcing inefficient asset liquidation and increasing the probability of bank failures.[457] Alternatively they might help troubled banks in need of liquidity in order to prevent contagion. However, this can only occur when competition is imperfect, as otherwise banks are price takers on the interbank market and cannot influence the price level with their action.[458]

However, in addition to its stabilisation purposes, the existence of a fiscal backstop is crucial for the credibility of the ECB as banking supervisor. Indeed, if fiscal funds are not available for resolution, the supervisor may hesitate to initiate

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[454] Matutes, C., Vives, X., (1996) "Competition for Deposits, Fragility, and Insurance", Journal of Financial Intermediation, 5, 184-216.
[455] *Ibid.*
[456] Goldstein, I., Pauzner, A., (2005) "Demand deposit contracts and the probability of bank runs", Journal of Finance, 60, 1293-1328.
[457] Acharya, V.V., Gromb, D., Yorulmazer, T., (2012) "Imperfect Competition in the Interbank Market for Liquidity as a Rationale for Central Banking".
[458] OECD, (2010) "Competition, Concentration and Stability in the Banking Sector", Policy Roundtable.

the wind-down or restructuring of a bank in distress.[459] However, the provision of a credible fiscal backstop to international banks is challenging. The countries involved do not take into account any foreign externalities of a potential bank failure, and are only prepared to backstop their respective domestic part. More formally, the financial trilemma states that the objectives of (1) financial stability, (2) international banking, and (3) national financial policies for supervision and resolution are incompatible.[460] Any two of the three policy objectives can be combined but not all three. Freixas et al. (2003) also modelled how *ex post* negotiations on burden-sharing lead to an underprovision of recapitalisations. Countries have an incentive to understate their share of the problem in order to have a smaller share in the costs.[461]

As a matter of fact, the establishment of a fiscal backstop notoriously incurs into a free-riding problem. Countries that do not sign up for burden-sharing nevertheless profit from it, as the stability of the European financial system is a public good. In particular, "stronger" countries would be discouraged from *ex ante* contributions to the backstop, for fear of needing to systematically assist weaker countries and their financial institutions. If the benefits of membership to the Banking Union are greater than the costs deriving from backstop contributions and the necessity for a unified safety net that reflects the uniformity already present in supervision and resolution is acknowledged, this problem might be alleviated.

In this sense, if access to such a backstop is perceived as a limit option that is sufficiently "far up" on the ladder of crisis management strategies, combined with the assurance that the single banks will need to contribute by themselves first through burden-sharing (bail-in) and then the SRF would pitch in, could make it even more palatable. The fact that SRF involvement entails contributions by the banking sector itself should at the same time dampen concerns on banks' moral hazard generated by the expectation that public assistance will automatically be granted. This effect could be further strengthened by the requirement that one national compartment of resolution funds contribute to the one of another country if

[459] Vives, X., (2016) "Competition and Stability in Banking: The Role of Regulation and Competition Policy", Princeton University Press, p. 240.
[460] Schoenmaker, D., "The financial trilemma", 2011, Economics Letters, 111, 57-59.
[461] Freixas, X., Parigi, B. M., Rochet, J.-C., "The lender of last resort: a 21st century approach", 2003, ECB Working Paper No. 298.

the funding of the latter turns out to be insufficient. Yet, such a condition can generate a mechanism of "losers of last resort", where the banks that are not assisted and need to pitch in to cover for others cannot do not even get reimbursed for their contribution. This could bring about competitive distortions if the additional *ex post* contributions are always asked of one category of banks: either the relatively smaller ones, because only the biggest ones are rescued, or the stronger ones because only the weaker will end up needing assistance.

***6.1 Expectations regarding liquidity assistance***

Having established the economic rationale for establishing a fiscal backstop and acknowledged some of the reasons for which some countries may be reluctant to contribute to it, it is now also necessary to turn to the economic effect that the legal rules on last resort assistance by central banks and resolution funds, as extensively presented in previous sections, can produce. More specifically, as to the provision of ELA, it amounts to a crisis prevention tool that falls within the remit of national central banks as part of their mandate to ensure financial stability. This 'crisis prevention' role is fully recognised in the SRM Regulation which explains that the "*need for emergency liquidity assistance is not a condition that sufficiently demonstrates that a [bank] is, or is likely in the near future to be, unable to pay its liabilities as they fall due*"[462]; and therefore does not need to be placed under resolution.

The exemption of ELA from State aid rules is based in particular on the assumption that a bank is only temporarily illiquid but otherwise solvent at the moment of the liquidity provision. It seems up for debate how to square that understanding of solvency (under a 'point-in-time' assessment) with that of the ECB (under a 'forward looking' assessment), as the ECB's 2017 Agreement[463] considers undercapitalised banks with a "credible prospect of recapitalisation" to be solvent as well. Nevertheless, resolution planning should not assume that central-bank liquidity will fill the gaps. Yet, since ELA decisions are taken at national level by national central banks, expectations about the likelihood of receiving such

[462] Recital 57 SRMR.

[463] https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf

liquidity assistance may vary from country to country.  This particular concern could be lessened if the ECB provided ELA directly to the banks, rather than their NCBs. Indeed, ELA centralisation would involve a sharing of these future risks and would correct the disparities in its application observed in several recent cases of resolution in Spain, Italy, Latvia.[464] It would also be consistent with the centralisation of supervision, monetary policy and bank resolution.

For what concerns the degree to which the possibility of liquidity assistance could be expected in resolution planning and execution, some guidance is offered by Art. 10 BRRD and Art. 8 SRMR, which posit that: "the resolution plan shall not assume any of the following: any central bank emergency assistance; any central bank liquidity assistance under non-standard collateralisation, tenor and interest rate terms". Thus, private sector sources of liquidity are the only ones that institutions can consider in their resolution planning. Nevertheless, while limited and circumscribed, the provision of ELA seems possible under the 2017 Agreement, not only before resolution as a crisis prevention tool, but also during a resolution under specific circumstances, namely: i) there has to be a "credible prospect of recapitaalisation", which is the very objective of resolution; ii) banks need to have 'sufficient' collateral; iii) insolvency proceeding must not have been initiated according to national laws. Those conditions are restrictive and only met in specific resolution scenarios.

A "credible prospect of recapitalisation" seems plausible if a bank can either count on a recapitalisation from private sources, or if its capitalisation levels can be restored via bail-in; the latter option, however, is only available if the SRB finds that there is public interest in taking action. Conversely, if an undercapitalised bank has no access to private capital, and if its resolution (bail-in) is not necessary in the public interest, it would not have access to ELA. Even banks whose resolution is in the public interest may be blocked from using ELA in the event that the resolution tool chosen (e.g. in the case of asset transfers) entails the opening of insolvency procedures. This all adds to an interpretation of ELA according to which it cannot be considered as a 'generally available' source of resolution financing that the SRB may avail of or count on when resolving a bank. Therefore, risk-taking incentives

[464] Concerning Banco Popular, four small Italian banks, and ABLV, respectively.

for banks should not be affected in this respect, as no reasonable expectation could be formed that central bank liquidity assistance would be automatically available.

### *6.2 Implications of the credibility of the backstop*

Then, other considerations should be made as to the role of the ESM in safety net provision, instead. On this point, the conditionality set for its support measures for recapitalisation requires contributions both by the failing bank (through bail-in of minimum 8% of a bank's liabilities) and by the resolution fund or through other arrangements (with an additional 5%). This leads to the hypothesis that any potential distortionary effects caused by a solvency backstop by the ESM would mostly be a carry-over of the effects produced by the resolution strategy previously chosen to cover the losses of the failing bank and to recapitalise it.[465] However, it must also be noted that the involvement of backstops would only concern very significant banks whose failure would have a relevant impact on the economy also by way of contagion. In fact, failures of smaller institutions should have been dealt with through other crisis management strategies at an earlier point in the crisis "ladder", either through liquidation or through a combination of resolution tools that can cover lower loss absorption and recapitalisation needs without needing additional support.

In any case, the fact that the use of public funds might be an exception to be accessed only in extraordinary circumstances and under strict conditionality does not change the fact that the perception of the inadequacy of funds of the SRF and the ESM not being fully operational yet limits the credibility of the regime.[466] The limited credibility of the regime has important implications on the cost of funding of banks, which might influence bank competitiveness, as well as on the sovereign's willingness to initiate a bank resolution rather than providing public support. Increasing the firepower of a resolution fund until its target level is high enough to accommodate any given bank's resolution, so that the credibility of the regime can be ensured also entails opportunity costs in terms of the funds set aside

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[465] See the discussion in Chapter 4 on the competition-related implications produced by the use of different resolution tools.

[466] On this aspect, see, for example, Yiatrou (2016) and Hellwig (2014), highlighting that the fiscal backstop would be limited in a major systemic crisis because its target level is set too low. That fact that the ESM Treaty reform eliminates the DRI, which had a funding limitation, and goes beyond it in providing a backstop to the SRF can be read as positive in light of these considerations.

for resolution purposes. In this sense, the regime as it is currently set could arguably be considered as being credible for small banks, thus affecting their funding costs, but it would also affect the funding costs of bigger banks[467], insofar as its limited credibility makes resolving bigger banks without any recourse to public support potentially more destabilising and dangerous.

### *6.3 Severing the doom loop between sovereigns and banks*

Lastly, one other relevant point to consider is whether the eventual existence of a fiscal backstop, providing assistance in face of solvency and liquidity issues, would further sever the doom loop between sovereigns and banks. However, even if the central bank as monetary authority can in principle print as much liquidity as needed to act as LOLR, ultimately there has to be a fiscal authority behind the central bank to compensate for potential losses incurred by the former. This is particularly true also in view of the fact that ECB has a very limited mandate for discharging LOLR powers, given the absence of fiscal union and centralised fiscal powers within the eurozone.[468] As such, losses related to LOLR functions are a fiscal matter because they have to be borne by taxpayers.[469]

On the other hand, the provision of liquidity during a crisis in many cases requires the central bank to design and implement operations jointly with the fiscal authority, involving some risk-sharing. Additionally, the LOLR operations can have distributive consequences stemming from the decisions to provide liquidity to some financial institutions but not others.[470] This framework also needs to address the problem of moral hazard because banks might engage in risky behaviour if they know that the LOLR would step in in case of problems.[471]

[467] Among others, see Bongini et al. (2015), finding that the reallocation of losses of bank failure on debt-holders (through bail-in in resolution or depositor preference in liquidation) can alter banks' funding costs, especially when combined with the regulatory changes to capital adequacy standards (i.e. higher equity). For a review of the literature on this point, see also FSB (2020), as also referenced in Chapter 4.
[468] Goodhart C., "The Political Economy of Financial Harmonisation in Europe", 2003, in J. Kremer, D. Schoenmaker, P. Wierts (Eds), Financial Supervision in Europe (Cheltenham Edward Elgar).
[469] Tucker, P., "The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction", 2014, BIS Paper No. 79b.
[470] Howarth, D., Quaglia, L., "The Political Economy of European Banking Union", 2016, Oxford Scholarship Publishing.
[471] For instance, this has traditionally been a concern of the Bundesbank, which never openly admitted its willingness to act as LOLR prior to the establishment of the European Monetary Union. See Goodhart, C., "The Political Economy of Monetary Union", 1995, The Central Bank and the Financial System, p. 156-202.

Therefore, Member States can limit their involvement into banks' rescues only up to a point. Then, the recourse to national fiscal backstops or the application of national precautionary recapitalisations will raise some of the well-known questions about the sufficiency of funding and the creation of distortions through political choices, namely by maintaining national champions, safeguarding preferred classes of creditors and generally "kicking the can down the road" for what concerns State intervention in bank rescues. This is where State aid control will still be necessary. However, this will also imply that the "too-big-to-fail" problem will not be completely eliminated.

**7. Concluding remarks**

It is well-established that a credible ultimate safety net backed by governments is key in guaranteeing the soundness of the banking system. Even though economic studies tend to focus on deposit guarantee schemes in this respect, there are a number of backstop-like measures that European authorities, government and central banks can take to ensure banks' liquidity and solvency.

In the context of the Banking Union, the backstop function would be activated where, even after imposing losses on the banks' shareholders and creditors, the SRF is temporarily short of resources to facilitate the orderly resolution of the distressed banks. In this perspective, it should increase confidence in the European banking sector by acting as a last resort in case less favourable conditions materialise. At the same time, it would strengthen the resolution mechanism while recovering costs from the banking sector, thus making sure taxpayers do not have to pay for failing banks.

A common fiscal backstop is currently not operational yet. In this context, the monetary financing prohibition would prevent such fiscal mutualisation through the backdoor of the Eurosystem. Yet, there might still be situations where a gap in funding could arise. How to fill that funding gap will have to be assessed on a case-by-case basis, also looking at the responsibilities of governments, which are the other source of financial support through State aid. With the prospect of the ESM becoming the official backstop to the SRF, conditionality for access to assistance and limitations to amounts pledged to recapitalisations should dampen moral hazard concerns and potential competitive distortions would mainly be a by-product of the resolution strategy previously chosen.

Moreover, on the matter of liquidity needs, assistance by central banks must not be assumed in resolution planning, but it is an option if the bank is solvent or has a reasonable expectation of being recapitalised back to solvency in a short time. Therefore, this availability leaves open a window for expectations on liquidity assistance to form, thus possibly creating competitive distortions, albeit limited by the approach of constructive ambiguity taken by central banks.

In any case, more clarity should be provided in the current framework on the resolution fund functions and what are the accepted means for liquidity provision in the resolution process. One could argue that additional clarity in specifying that liquidity can be provided could lead stakeholders to rely on and anticipate the receipt of State aid, thus raising an issue of moral hazard. However, the fact that banks could be called to contribute ex post to replenishing resolution funds used to extend support, combined with the condition that no EPFS can be assumed at the resolution planning stage, should dampen such moral hazard concerns, as banks should take all necessary measures ex ante to ensure that liquidity sources are available internally to the maximum extent possible. Generally, a mechanism of funding in resolution in the eurozone should hinge on the following considerations: i) it is crucial to acknowledge that ELA funding will in most cases be involved at a stage prior to resolution; ii) as a further step towards the completion of the Banking Union the ECB should centralise the provision of ELA; iii) once the PONV is reached, and as soon as there is a clear path to future solvency of the bank, ELA should still be available for the bank. However, due to a probable lack of eligible ELA collateral, a funding in resolution mechanism should be in place where the SRF could provide guarantees either to the bank directly or to the ECB, thus shifting the risk onto the private sector; iv) the ESM is well-placed to act as the public backstop to the SRF when the latter runs out of funds.

Even in the case of liquidity support, despite the central bank's activity as LOLR, ultimately there has to be a fiscal authority behind the central bank itself to compensate for potential losses incurred by the former. This implies that the link between sovereigns and banks will not be fully severed, despite the significant improvements introduced with the post-crisis regulatory framework to manage bank failures. As a consequence, the check for any potentially resulting competitive distortions will remain within the scope of State aid control carried out by the European Commission.

# Chapter 7: Conclusions

## 1. Aim of the study

As explained in the introductory chapter of this book, the Bank Recovery and Resolution Directive (BRRD) has introduced new rules and tools to manage bank crises in Europe. Yet, recent cases of bank rescues in Europe have shown that (i) some degree of public intervention is still possible in managing bank failures, despite the intended shift from bailout to bail-in introduced by the BRRD[472]; and (ii) different combinations of resolution tools and public support measures entail different restructurings of institutions, which need to be scrutinised by competition authorities under State aid rules. This suggests that measures enacted with a view to preserving financial stability do not completely rule out the possibility that competition concerns could still arise, even though the regulatory framework should have decreased reliance on public support.

Therefore, this study has focused on addressing to which extent the interaction between resolution rules (BRRD) and State aid rules allows to minimise (potential) distortions of competition when dealing with bank failures. To this end, after looking at the approach to bank rescues taken by the Commission during the global financial crisis (Chapter 2), the analysis has moved to identifying the avenues still available to grant public funds to failing banks, both outside (Chapter 3) and within the perimeter of resolution rules (Chapters 4 and 6), to highlight the competitive concerns that may arise as a result.

Another aspect which was analysed to address the research question concerns the fact that crisis management tools and strategies entail different restructuring requirements for ailing institutions, which can alter institutions' ownership and operational structures. In this respect, Chapter 4 has provided an analysis of the specificities of different crisis management measures and how they

[472] In the desiderata of the regulators, such a shift was meant to shift the burden of banks' losses and failures from the shoulders of taxpayers upon bank shareholders and creditors. Chapter 5 has provided a detailed analysis of the most relevant cases in this respect.

are deployed to take into account different bank-specific and national market characteristics, as evidenced by recent cases of bank rescues in Italy, Greece, Cyprus and Portugal.

**2. Main findings**

The analysis has produced a number of findings relating to the emergence and minimisation of (potential) competition concerns through the application of stabilisation measures aimed at rescuing and restructuring financial institutions. All in all, while the new rules on resolution have improved the approach to bank crisis management compared to that in place during the financial crisis, by reducing reliance on public finances, the shift from bailout to bail-in has not been absolute. Both the rules and their application have competition-related implications which may have not been fully accounted for. In this respect, the core findings of this dissertation should be highlighted.

In the first place, it appears that the regulatory framework for crisis management, meant as the combined application of resolution and State aid control rules, gives prevalence to financial stability considerations over competition ones, even though each bank rescue case entails a balancing of the two objectives, whenever recourse is made to public support or there is a change in banks' ownership and control structures. More specifically, burden-sharing requirements (also through the application of bail-in) constitute the first check against the emergence of competitive distortions while rescuing banks.

In addition, structural and behavioural remedies are combined with the aim of preserving the competitive structure of the relevant banking markets to the greatest extent possible, by limiting alterations in beneficiaries' size and acquisition of market power after rescue. More substantial structural remedies are generally imposed through balance sheet reductions and divestments upon those beneficiaries that emerge as standalone entities after rescue, compared to cases in which entities are split, or leave the market through liquidation. This is consistent with the approach kept with respect to bank bailouts approved during the global financial crisis.

As burden-sharing has direct implications for the funding costs of institutions, different approaches in this respect might exacerbate differences in banks' funding costs among institutions and countries, depending on the scope and means of burden-sharing applied in individual bank rescues, possibly distorting institutions' competitive standing in the relevant markets.[473] This concern has been lessened through the formalisation of uniform burden-sharing requirements introduced with the 2013 Banking Communication. However, the difference in the scope of contributions required from banks' creditors under resolution rules and State aid rules creates the potential for distorted incentives to materialise when choosing which tools to apply to restructure an ailing institution, since specific classes of creditors would be better off with the adoption of crisis management strategies other than bail-in. This is true for cases of liquidation aid[474], but also in relation to the use of DGS funds in support of sales or transfers of liabilities from a failing bank to another entity, due to a lack of concomitant requirements on burden-sharing, which would act to curb potential competitive distortions and limit the need for external assistance.[475]

As a consequence of the above, if exceptions to full-fledged bail-in[476] become the regular way in which bank failures are dealt with, institutions might start adjusting their expectations relating to the possibility of a public bailout. This problem could be heightened for significant banks, which can rely on the knowledge of their essential role at national and European level and their higher degrees of interconnection, to reasonably expect that liquidation would not be a credible strategy for them. If this were the case, the market would also react and possibly re-price banks' financial instruments and adjust their rating. Insofar as this could re-integrate "implicit guarantees" for systematically significant institutions, it would undermine the competitive level playing field in European banking markets and go against the very purpose of the resolution regime.

Another critical issue from a competition perspective stems from the lack of clarity around the acceptable sources of liquidity support available to banks

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[473] The different types of burden-sharing applied to cases of bank bailouts approved before the introduction of the 2013 Banking Communication have been detailed in Chapter 2.
[474] Such as in the case of Veneto Banca and Banca Popolare di Vicenza (Chapter 5).
[475] On this point, see the discussion prompted by the Tercas case (Chapter 4).
[476] Either by way of precautionary recapitalisations or through voluntary support by DGS funds.

undergoing restructuring. This creates the conditions for increased recourse to public support- be it in the form of guarantees or other liquidity measures- which, in turn, increases the risk of competition distortions.

Other relevant findings of the study relate to the fact that the regulatory framework for crisis management, as currently shaped by resolution and State aid rules, has the potential to affect the competitive structure of banking markets in Europe. This comes about mainly through two channels: (i) regulatory requirements which might favour specific categories of institutions, while entailing more significant costs for others; and (ii) restructuring requirements for institutions, stemming from the application of different crisis management tools.

Indeed, to the extent that bail-in rules, and the related MREL requirements, may put smaller banks at a disadvantage compared to larger institutions with easier access to capital markets[477], they may prompt banking mergers and acquisitions in order to be able to tap into capital markets and prepare for resolution rather than liquidation. In this sense, the resolution framework could contribute to reinforcing a growing trend of bank consolidation in the EU.

For what concerns resolution tools other than bail-in, which entail a (partial) transfer of banks' assets, liabilities and rights, these also have competition-related implications for the structure of banking markets, as their successful implementation hinges on the presence of a competitor willing to take over the transferred banking perimeter. Based on the market positioning of the acquirer and the potential overlap between the merging entities, competitive safeguards are necessary to prevent the creation or reinforcement of dominant positions in the market, which might restrict competition.

On the basis of the above and an analysis of recent cases of bank restructurings (Chapter 5), it would appear that the regulatory framework could also lead to different crisis management measures being applied to adapt to the size, interconnection and systemic relevance of the institutions concerned. More specifically, (i) larger, systemic banks could be restructured through resolution and the application of a full-fledged bail-in- or a precautionary recapitalisation, under

[477] See the discussion in Chapter 4.

exceptional and very specific circumstances- preserving them as standalone entities; (ii) mid-sized banks could be resolved through sales of portfolios of assets and liabilities to other entities, possibly enabled by temporary voluntary contributions of the DGS, which would lead to mergers and consolidation; while (iii) smaller local banks could be liquidated in accordance with national insolvency laws and leave the market, with an intervention by the DGS in favour of covered depositors.[478]

Therefore, the State aid control framework will remain a relevant and integral part of the regulatory framework for crisis management, with the purpose of scrutinising bank restructuring schemes to ensure that competition distortions are avoided or limited to the maximum extent possible, through a combination of burden-sharing, and structural and behavioural safeguards. It is with this perspective that a number of policy proposals can be advanced starting from this study, as laid down in the next section.

## 3. Policy implications and proposals

### *3.1 Burden-sharing alignment and use of remedies*

In order to limit potential distortions of competition in reference to different approaches taken towards bank restructurings, the degrees of burden-sharing required under State aid rules and under the resolution framework should be further aligned. This should decrease to a large extent the potential for distorted incentives to materialise when choosing which tools to apply to restructure an ailing institution, which is currently discernible in the application of restructuring strategies outside of BRRD resolution.

Moreover, in view of a short- to mid-term scenario in which public funds could be necessary to support banks in distress as a direct consequence of the Covid-pandemic, and considering that burden-sharing requirements might be waived[479], increasing relevance should also be given to the imposition of structural

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[478] Once the restructuring schemes for the banks taken into account in Chapter 5 are completed and the ownership structure of the restructured entities becomes known, it would be worthwhile to reassess those cases to verify the final impact on the competitive structure of the banking market in which the institutions operate.

[479] See Chapter 3 on the provisions of the Temporary Framework for State aid allowing for the applicability of point 45 of the 2013 Banking Communication, providing an exception to forgo burden-sharing requirements for reasons of financial stability.

and behavioural remedies upon rescued banks, so as to stem competitive distortions in European banking markets.

In any case, the degree of concentration and contestability of the different national banking markets and the market power of the institutions involved will need to be factored into authorities' decisions on the best suitable measures and competitive safeguards to apply, as well as into their assessment by the Commission, so as to give appropriate consideration to the potential effects that the rescue and restructuring measures chosen might have on institutions and on the competitive structure of national banking markets.

***3.2 Precautionary recapitalisation implementation***

Precautionary recapitalisations can be an effective crisis management tool in ensuring financial stability when there is a threat of a serious disturbance in the economy. However, this beneficial effect must be weighed against the drawbacks arising from the potential creation of an expectation of public assistance for the banks.

To this end, some improvements in the implementation of precautionary recapitalisations would be necessary in order to increase the credibility of the regulatory framework and maximise the moral hazard-reducing effects of the resolution rules, as a result. In particular, it is crucial that the authorities intervene before the bank in trouble 'crosses the line' of insolvency, in order to prevent further capital deterioration of the institution to the extent possible, thus minimising at the same time the amount of public support needed. To this end, burden-sharing requirements could be supported by injections of capital through financial instruments which should maximise the flexibility for the State to exit its investment in the short to medium term, while also creating incentives and conditions for their future holders to cover eventual new losses and recapitalise the bank, if needed, without making recourse to another public recapitalisation.[480]

With this in mind, European regulators could consider clarifying the rules to establish the circumstances and conditions at which circumscribed aid could be

[480] See Chapter 5 for a proposal on increased use of either (i) CoCo instruments or (ii) equity convertible into hybrid instruments.

granted as early intervention, rather than closer to a bank's insolvency. Prompt intervention, coupled with credible structural and behavioural commitments imposed on restructured institutions with a view to reducing competition distortions, could go some way towards improving the sustainability of the crisis management framework.

### *3.3 Public interest assessment*

As observed in the conclusions to Chapter 3, the "public interest principle" set out in Article 32(5) BRRD and Article 18(5) SRMR leaves national governments and European authorities some discretion in choosing which instances and institutions warrant the granting of a precautionary recapitalisation. In this sense, the concept of public interest is likely to remain tightly interwoven with national politics and biases[481], which might lead in turn to economically inefficient outcomes.

A more uniform approach is needed among the SRB and national resolution authorities for performing the "public interest assessment", which determines the choice of crisis management strategy to apply, i.e. resolution or liquidation. If the public interest assessment keeps a high threshold to determine the relevance of an institution to justify its resolution, small banks will always be caught by national insolvency laws disciplining their liquidation, which might not account for the local significance of a bank's operations. This becomes even more relevant in light of the lack of harmonisation among national insolvency frameworks in Europe, which does not ensure a playing field in the management of liquidations and failures, thus possibly creating regulatory arbitrage incentives.[482] Ultimately, the challenge lies in striking an effective balance between allowing inefficient banks to exit the market in an orderly manner and accounting for the fact that the local relevance of an institution might fall through the cracks in the assessment of public interest as it currently appears to be structured.

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[481] See, for instance, the different conclusions reached by the SRB and Italian authorities on the existence of a public interest in relation to Veneto Banca and Banca Popolare di Vicenza (Chapter 5).
[482] See the speech by SRB Chair Elke König before the ECON Committee of the European Parliament in this respect: https://srb.europa.eu/en/node/508.

### *3.4 Liquidity in resolution*

In order to reduce to the greatest extent possible banks' recourse to public resources to obtain liquidity, e.g. in the form of guarantees, more clarity should be provided in the current framework on the functions of resolution funds and the accepted means for liquidity provision in the resolution process, explicitly laying down the sources and conditions for liquidity access. One argument against the need for additional regulatory clarification in this respect could be that a more precise application of the rules to grant liquidity assistance could lead stakeholders to rely on and anticipate the receipt of State aid, thus exacerbating a problem of moral hazard that the regulatory framework on bank resolution meant to counter. Yet, on the other hand, one could argue that moral hazard issues would be limited by the fact that banks could be called to contribute to replenishing resolution funds on an ex-post basis, thus repaying to some extent the support received and, since EPFS cannot be assumed at the resolution planning stage, they should have taken all necessary measures ex ante to ensure that liquidity sources are available internally to the maximum extent possible.

Generally, a mechanism of funding in resolution should take into account the following considerations: i) a centralisation of emergency liquidity assistance (ELA) provision by the ECB would contribute to the completion of the Banking Union; ii) as soon as there is a clear path to future solvency of a bank in resolution, ELA should be available. However, due to a probable lack of eligible ELA collateral, a clear funding in resolution mechanism should enable the SRF to provide guarantees either to the bank directly or to the ECB, thus shifting the risk onto the private sector. Bearing this in mind, the ESM is well-placed to act as the public backstop to the SRF when the latter runs out of funds (Chapter 6).

# Annex 1 - Data on national banking sectors (Chapter 5)

| Country | Number of credit institutions | Assets (€ million) | Loans (€ million) | Deposits (€ million) | Capital and reserves (€ million) |
|---|---|---|---|---|---|
| **Austria** | 544 | 845,380 | 565,048 | 543,275 | 78,008 |
| **Belgium** | 88 | 1,001,881 | 601,842 | 664,939 | 72,797 |
| **Bulgaria** | 26 | 57,133 | 38,367 | 41,776 | 9,266 |
| **Croatia** | 22 | 60,202 | 44,320 | 43,117 | 10,973 |
| **Cyprus** | 32 | 69,861 | 48,538 | 42,784 | 13,560 |
| **Czech Republic** | 52 | 286,090 | 209,579 | 166,485 | 28,729 |
| **Denmark** | 98 | 1,056,444 | 668,793 | 320,447 | 64,300 |
| **Estonia** | 37 | 26,207 | 24,608 | 18,020 | 3,588 |
| **Finland** | 257 | 628,492 | 374,908 | 234,683 | 52,803 |
| **France** | 409 | 8,810,390 | 5,412,610 | 4,701,364 | 619,746 |
| **Germany** | 1,584 | 7,775,993 | 4,981,050 | 4,856,395 | 599,066 |
| **Greece** | 37 | 292,595 | 190,919 | 178,114 | 59,444 |
| **Hungary** | 60 | 126,053 | 65,236 | 82,234 | 13,660 |
| **Ireland** | 327 | 1,101,935 | 332,900 | 302,891 | 92,430 |
| **Italy** | 508 | 3,669,283 | 2,388,626 | 2,623,710 | 380,251 |
| **Latvia** | 54 | 22,792 | 18,128 | 15,318 | 3,408 |
| **Lithuania** | 85 | 30,064 | 26,672 | 24,235 | 3,144 |
| **Luxembourg** | 135 | 1,077,297 | 470,964 | 455,247 | 60,136 |
| **Malta** | 24 | 44,435 | 19,805 | 23,291 | 4,297 |
| **Netherlands** | 93 | 2,320,609 | 1,384,483 | 1,181,180 | 143,667 |
| **Poland** | 647 | 461,749 | 321,283 | 316,511 | 68,786 |
| **Portugal** | 141 | 390,771 | 239,657 | 283,121 | 54,456 |
| **Romania** | 34 | 104,334 | 65,301 | 74,686 | 15,047 |
| **Slovakia** | 27 | 82,005 | 61,155 | 61,934 | 10,466 |
| **Slovenia** | 17 | 40,630 | 28,130 | 31,942 | 4,804 |
| **Sweden** | 153 | 1,284,115 | 831,558 | 509,420 | 65,685 |
| **United Kingdom** | 390 | 9,035,347 | 4,078,704 | 3,886,742 | 37,083 |
| **TOTAL** | **4,599** | **38,875,794** | **18,792,622** | **18,086,933** | **2,525,501** |

*Source:* ECB Statistical Data Warehouse

# Annex 2 - Summary of measures applied in rescue cases (Chapter 5)

| | Private sector solutions | Early intervention measures | Guarantees (State aid framework) | Other measures |
|---|---|---|---|---|
| **CGD** | Issuance of additional Tier1 instruments | | | State recapitalisation |
| **NBG** | Capital raise | | | Precautionary recapitalisation |
| **Piraeus Bank** | Capital raise | | | Precautionary recapitalisation |
| **MPS** | Sale of NPLs | | Guarantees on impaired assets/NPL securitisation ('GACS') | Precautionary recapitalisation |
| **Carige** | Capital raise: deposit guarantee fund and other private investors<br><br>Sale of NPLs | Temporary administrators<br><br>Plan for negotiation of debt restructuring | Liquidity guarantees | |
| **Banca Popolare di Bari** | Capital raise: deposit guarantee fund and other private investors<br><br>Sale of NPLs | Temporary administrators | | |
| **Banca Popolare di Vicenza and Veneto Banca** | Sale of NPLs | | Impaired asset measures (guarantees)<br><br>Liquidity guarantees | Liquidation aid (cash injection) |

*Source:* own elaboration

# Annex 3 – State aid compatibility and remedies – post-BRRD rescue cases

| Case | Burden-sharing/ State remuneration | Remedies | |
|---|---|---|---|
| | | **Structural** | **Behavioural** |
| **Liquidity support to Attica Bank**[483] | - State remuneration based on market data and in line with Prolongation Communication | | - Advertising ban<br>- Ban on aggressive commercial practices |
| **Liquidity support to Banca Popolare di Vicenza**[484] **and liquidity support to Veneto Banca**[485] | - State remuneration based on market data and in line with Prolongation Communication | | - Advertising ban<br>- Ban on aggressive commercial practices |
| **Sale of bridge banks Nuova Marche, Nuova Etruria, Nuova Carichieti to UBI Banca**[486] | - Full write-down of equity and capital instruments<br>- Remaining subordinated debt not transferred to new entities<br>- Senior claim by resolution fund on residual entities | - Withdrawal of residual entities' license and exit from market<br>- Limited lifespan of bridge banks | - No new activity by residual entities<br>- Deposit and loan pricing policy on bridge banks |
| **Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid**[487] | - Senior claim of buyer and State exceeding value of residual assets | - Exit from the market of the two entities after sale<br>- Staff and branch reduction by buyer | |

[483] Case SA.46558 (2016/N) – Greece. Commission decision C(2016) 6573 of 7 October 2016.
[484] Case SA.47149 (2016/N) – Italy. Commission decision C(2017) 331 of 18 January 2017.
[485] Case SA.47150 (2016/N) – Italy. Commission decision C(2017) 328 of 18 January 2017.
[486] Cases SA.39543 (2017/N-2), SA.41134 (2017/N-2), SA.43547 (2017/N-2) – Italy. Commission decision C(2017) 3000 of 30 April 2017.
[487] Case SA. 45664 (2017/N) – Italy. Commission decision C(2017) 4501 of 25 June 2017.

| Case | Burden-sharing/ State remuneration | Remedies | |
|---|---|---|---|
| | | **Structural** | **Behavioural** |
| **Sale of bridge bank Nuova Carife to BPER**[488] | - Full write-down of equity and capital instruments<br>- Remaining subordinated debt not transferred to new entity<br>- Senior claim by resolution fund on residual entity | - Withdrawal of residual entity's license and exit from market<br>- Limited lifespan of bridge bank<br>- Reduction in headcount and branch closure | - No new activity by residual entity<br>- Deposit and loan pricing policy on bridge banks |
| **New aid and amended restructuring plan of Banca Monte dei Paschi di Siena**[489] | - Deep shareholder dilution (to 2.5%) through capital increase<br>- Conversion of AT1, T2 and all other subordinated debt into equity | - Branch reduction in Italy and abroad<br>- Balance sheet reduction<br>- Deleveraging of leasing activities | - Acquisition ban<br>- Advertising ban<br>- Ban on aggressive commercial practices |
| **Recapitalisation of the Lithuanian Central Credit Union**[490] | - Transformation of non-loss absorbing additional shares into loss absorbing shares<br>- Disqualification of additional shares as regulatory capital | | |
| **Liquidation aid for the orderly market exit of Cyprus Cooperative Bank Ltd**[491] | - Significant senior claim of State | - Withdrawal of residual entities' license and exit from market<br>- Buyer taking over less than 50% of branches and staff of CCB | |

[488] Case SA.41925 (2017/N-2) – Italy. Commission decision C(2017) 4564 of 29 June 2017.
[489] Case SA.47677 (2017/N) – Italy. Commission decision C(2017) 4690 of 4 July 2017.
[490] Case SA. 48920 (2017/N) – Lithuania. Commission decision C(2017) 8848 of 18 December 2017. No additional measures imposed to limit distortions of competition due to small market share and size of LCCU group, as well as low absolute value of aid amount.
[491] Case SA.35334 (2018/N-2) – Cyprus. Commission decision C(2018) 3961 of 19 June 2018.

| Case | Burden-sharing/ State remuneration | Remedies | |
|---|---|---|---|
| | | Structural | Behavioural |
| **Liquidity support to Banca Carige**[492] | - State remuneration based on market data and in line with Prolongation Communication | | - Dividend and coupon ban<br>- Advertising ban<br>- Ban on aggressive commercial practices |

*Source:* own elaboration

[492] Case SA.52917 (2019/N) – Italy. Commission decision C(2019) 554 of 18 January 2019.

# Cases

**European Commission**

***State aid***

*Banesto*
M 455/1994

*Banco di Sicilia*
C 16/1998

*Restructuring aid to SachsenLB*
Commission decision C(2008) 2269 of 4 June 2008 (C 9/2008 (ex NN 8/2008, CP 244/2007) – Germany)

*Financial Support Measures to the Banking Industry in the UK*
Commission decision C(2008) 6058 of 13 October 2008 (N 507 /2008 – United Kingdom)

*Restructuring aid to IKB*
Commission decision C(2008) 6022 of 21 October 2008 (C 10/2008 (ex NN 7/2008) – Germany)

*Support measures for the banking industry in Sweden*
Commission decision C(2008) 6538 of 29 October 2008 (N 533/2008 – Sweden)

*Dutch credit guarantee scheme*
Commission decision C(2008) 6616 of 30 October 2008 (N 524/2008 – The Netherlands)

*Support Measures for the Credit Institutions in Greece*
Commission decision C(2008) 7382 of 19 November 2008 (N 560 /2008 – Greece)

*Restructuring aid to Fortis Bank and Fortis Bank Luxembourg*
Commission decision C(2008) 8085 of 3 December 2008 (NN 42/2008 - Belgium, NN 46/2008 - Luxembourg NN 53/A/2008 – Netherlands)

*Slovénie - Public support measures to the financial sector*
Commission decision C(2008) 8574 of 12 December 2008 (N531/2008)

*Rescue package for financial institutions in Germany*
Commission decision C(2008) 8629 of 12 December 2008 (N 625/2008 – Germany)

*Commerzbank*
Commission decision C(2009) 3708 of 7 May 2009 (N 244/2009 – Germany)

*Restructuring of WestLB*
Commission decision C(2009) 3900 of 12 May 2009 (C 43/2008 (ex N 390/2008) – Germany)

*Recapitalisation and asset relief for LBBW (Landesbank Baden Württemberg)*
Commission decision C(2009) 188 of 30 June 2009 (C 17/2009)

*Restructuring aid for Kaupthing Bank Luxembourg SA*
Commission decision C(2009) 5640 of 9 July 2009 (N 344/2009 – Luxembourg, N 380/2009 – Belgium)

*HSH Nordbank*
Commission decision C(2009) 8271 of 22 October 2009 (C 29/2009 ex N 503/2009 - Germany)

*Restructuring aid to Northern Rock*
Commission decision C(2009) 8102 of 28 October 2009 (C 14/2008 (ex NN 1/2008) – United Kingdom)

*Sparkasse KölnBonn*
Commission decision C(2009) 8558 of 4 November 2009 (C 32/2009 (ex NN 50/2009) – Germany)

*Asset relief and second recapitalisation for KBC*
Commission decision C (2009) 8980 of 18 November 2009 (C 18/2009 (ex N 360/2009) – Belgium)

*ING's Illiquid Assets Back-Up Facility and Restructuring Plan*
Commission decision C(2009) 9000 of 18 November 2009 (C 10/2009 (ex N 138/2009) – The Netherlands)

*Restructuring of Lloyds Banking Group*
Commission decision C(2009) 9087 of 18 November 2009 (N 428/2009 – United Kingdom)

*Slovak recapitalisation and guarantee scheme ("the Slovak scheme")*
Commission decision C(2009) 9889 of 8 December 2009 (N 392/2009 – Slovakia)

*Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme*
Commission decision C(2009) 10112 of 14 December 2009 (N 422/2009 and N 621/2009 – United Kingdom)

*Recapitalisation of certain financial institutions*
Commission decision C(2009) 10490 of 21 December 2009 (N 302/2009 – Poland)

*Rescue aid (capital injection and asset guarantee) to BAWAG P.S.K.*
Commission decision C(2009) 10521 of 22 December 2009 (N 640/2009 (ex-PN 119/2009) – Austria)

*Restructuring aid to Dunfermline Building Society*
Commission decision C(2009) 340 of 25 January 2010 (NN 19/2009 – United Kingdom)

*Viability plan SNS REAAL*
Commission decision C(2010) 498 of 28 January 2010 (N 371/2009 – The Netherlands)

*Recapitalisation measures in favour of the banking sector in Spain*
Commission decision C(2010) 504 of 28 January 2010 (N 28/2010 – Spain)

*Restructuring of Dexia*
Commission decision C(2010) 1180 of 26 February 2010 (C 9/2009 (ex NN 45/2008, NN 49/2008 and NN 50/2008) - Belgium, France and Luxembourg)

*Rescue and restructuring of Caja Castilla-La Mancha*
Commission decision C(2010) 4453 of 29 June 2010 (NN 61/2009 – Spain)

*Restructuring of Bank of Ireland*
Commission decision C(2010) 4963 of 15 July 2010 (N 546/2009 – Ireland)

*Lithuanian bank support scheme*
Commission decision C(2010) 5472 of 5 August 2010 (N 200/2009 and N 47/2010 – Lithuania)

*Restructuring Aid to AEGON*
Commission decision C(2010) 5740 of 17 August 2010 (N 372/2009 – The Netherlands)

*Restructuring aid for Parex Banka*
Commission decision C(2010) 6202 of 15 September 2010 (C 26/2009 (ex N 289/2009) – Latvia)

*Danish winding-up scheme*
Commission decision C(2010) 6788 of 30 September 2010 (N 407/2010 – Denmark)

*ABN AMRO Group NV*
Commission decision C(2011) 2114 of 5 April 2011 (C 11/2009 (ex NN 53b/2008, NN 2/2010 and N 19/2010 – The Netherlands)

*Joint restructuring plan for Anglo Irish Bank and Irish Nationwide Building Society*
Commission decision C(2011) 4432 of 29 June 2011 (SA.32504 (2011/N) and C 11/2010 (ex N 667/2009) – Ireland)

*Hypo Real Estate*
Commission decision C(2011) 5157 of 18 July 2011 (C 15/2009 (ex N 196/2009) – Germany)

*Increase of the ceiling amount of a second-loss guarantee for HSH Nordbank AG*

Commission decision C(2011) 6483 of 20 September 2011 (SA.29338 (C 29/2009 ex N 503/2009) – Germany)

*Restructuring of Quinn Insurance Ltd through the contribution of the Insurance Compensation Fund*
Commission decision C(2011) 7266 of 12 October 2011 (SA.33023 (2011/NN) – Ireland)

*Second restructuring of Bank of Ireland*
Commission decision C(2011) 9755 of 20 December 2011 (SA.33443 (2011/N) – Ireland)

*Restructuring plan of Amagerbanken*
Commission decision C(2012) 148 of 25 January 2012 (SA.33485 (2011/N) – Denmark)

*Recapitalisation of FHB Jelzálogbank Nyrt*
Commission decision C(2012) 1021 of 22 February 2012 (SA.29608 (C37/2010) – Hungary)

*Restructuring of Banco Português de Negócios (BPN)*
Commission decision C(2012) 2043 of 27 March 2012 (SA. 26909 (2011/C) – Portugal)

*Resolution of T Bank*
Commission decision C (2012) 3256 of 16 May 2012 (SA.34115 (2012/NN) – Greece)

*New recapitalisation scheme for credit institutions in Portugal*
Commission decision C(2012) 3525 of 30 May 2012 (SA.34055 (2011/N) – Portugal)

*Restructuring of UNNIM Banc SAU*
Commission decision C(2012) 5014 of 25 July 2012 (SA.33733 (2012/N) – Spain)

*Restructuring aid for Bayern LB*
Commission decision of 25 July 2012 (SA.28487) and decision C(2013) 507 of 5 February 2013 (SA.28487 (C 16/2009 ex N 254/2009) – Germany and Austria)

*Restructuring of Österreichische Volksbanken AG*
C(2012) 6307 of 12 September 2012 (SA.31883 (2011/C) (ex N516/10) – Austria)

*Monitoring - Kapitalzuführung zugunsten der Hypo Tirol Bank AG*
Commission decision C(2012) 7047 of 4 October 2012 (SA.34716 (2012/N) – Austria)

*State Guarantee Scheme for Cypriot Banks*
Commission decision C(2012) 7962 of 6 November 2012 (SA.35499 (2012/N) – Cyprus)

*Restructuring of Catalunya Banc S.A.*
Commission decision C(2012) 8759 of 28 November 2012 (SA. 33735 (2012/N) – Spain)

*State aid to TT Hellenic Postbank S.A. through the creation and the capitalisation of the bridge bank "New TT Hellenic Postbank S.A."*
Commission decision C(2013) 2689 of 6 May 2013 (SA.31155 (2013/C) (2013/NN) (ex 2010/N) – Greece)

*Liquidation aid for the resolution of AB Ukio Bankas*
Commission decision C(2013) 5258 of 14 August 2013 (SA.36248 (2013/NN) – Lithuania)

*Restructuring of NLB*
Commission decision C(2013) 9632 of 18 December 2013 (SA.33229 (2012/C) (ex 2011/N) – Slovenia)

*Restructuring Plan SNS REAAL 2013*
Commission decision C(2013) 9592 of 19 December 2013 (SA.36598 (2013/N) – The Netherlands)

*Transfer of property-related assets from FIH to the FSC*
Commission decision C(2014) 1280 of 11 March 2014 (SA.34445 (2012/C) – Denmark)

*Amendment of the Restructuring of CEISS through integration with Unicaja Banco*
Commission decision C(2014) 1658 of 12 March 2014 (SA.36249 (2014/N-3) – Spain)

*Restructuring of Abanka Vipa Group*
Commission decision C(2014) 5857 of 13 August 2014 (SA.38228 (2014/N) – Slovenia)

*Restructuring aid for Banka Celje/Abanka*
Commission decision C(2014) 9858 of 16 December 2014 (SA.38522 (2014/N) – Slovenia)

*Resolution (via liquidation) of Banca Romagna Cooperativa – Credito Cooperativo Romagna Centro e Macerone - Società Cooperativa*
Commission decision C(2015) 4599 of 2 July 2015 (SA.41924 (2015/N) (ex 2015/PN) – Italy)

*Amendment of the restructuring plan approved in 2014 and granting of new aid to Alpha Bank*
Commission decision C(2015) 8488 of 26 November 2015 (SA.43366 (2015/N) – Greece)

*2015 additional restructuring aid to Piraeus Bank*
Commission decision C(2015) 8626 of 29 November 2015 (SA.43364 (2015/N)-Greece)

*Amendment of the restructuring plan of National Bank of Greece approved in 2015*
Commission decision C(2015) 8930 of 4 December 2015 (SA.43365 (2015/N)-Greece)

*Restructuring of Magyar Kereskedelmi Bank Zrt.*
Commission decision C(2015) 9349 of 16 December 2015 (SA.40441 (2015/N) – Hungary)

*Resolution of Banif – Banco Internacional do Funchal S.A.*
Commission decision C(2015) 9763 of 21 December 2015 (SA.43977 (2015/N) – Portugal)

*Aid to Banca Tercas*
Commission decision C(2015) 9526 of 23 December 2015 (SA.39451 (2015/C) (ex 2015/NN) - Italy)

*Italian securitisation scheme*
Commission decision C(2016) 873 of 10 February 2016 (SA.43390 (2016/N) – Italy)

*Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca - Liquidation aid*
Commission decision C(2017) 4501 of 25 June 2017 (SA.45664 (2017/N) – Italy)

*New aid and amended restructuring plan of Banca Monte dei Paschi di Siena*
Commission decision C(2017) 4690 of 4 July 2017 (SA.47677 (2017/N) – Italy)

*Liquidity support to Banca Carige – Cassa di Risparmio di Genova e Imperia*
Commission decision C(2019) 554 of 19 January 2019 (SA.52917 (2019/N) – Italy)

*Market-conform measures for strengthening capital and restructuring of Norddeutsche Landesbank*
Commission decision C(2019) 8821 of 5 December 2019 (SA.49094 (2019/N) – Germany)

***Merger***

*Banco Santander/Banco Popular Group*
Commission decision C(2017) 5659 of 8 August 2017 (M.8553)

*CARIPARMA/CARICESENA/CARIM/CARISMI*
Commission decision C(2017) 8224 of 30 November 2017 (M.8639)

**Court of Justice of the European Union**

*Tadej Kotnik and Others v. Državni zbor Republike Slovenije*, C-526/14 of 19 July 2016 ECLI:EU:C:2016:570

*Gerard Dowling and Others v. Minister for Finance*, C-41/15 of 8 November 2016, ECLI:EU:C:2016:836

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Joined Cases T-98/16, *Italy v Commission*, T-196/16, *Banca Popolare di Bari SCpA v Commission*, and T-198/16 *Fondo interbancario di tutela dei depositi v Commission*, 19 March 2019, ECLI:EU:T:2019:167

**European Court of Human Rights**

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**Italian Antitrust Authority (AGCM)**

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Case C12087, decision of 12 April 2017 (Provvedimento No. 26552), available at: https://agcm.it/

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# Summary (English)


This dissertation analyses the EU regulatory framework for the management of bank crises, with a focus on the interconnections between bank resolution and State aid rules and their implications for banking competition and market structures.

To this end, the primary step involves an assessment of the EU State aid rules as applied to the banking sector, to establish which are the conditions for granting public funds to institutions in distress and how these conditions have evolved from the latest financial crisis until the recent years. The establishment of the Banking Union provides an important backdrop against which to evaluate how a greater degree of sectoral integration at EU level has influenced the implementation of State aid rules and how bank crisis resolution strategies have been updated. In particular, focus is devoted to the balance struck between financial stability and competition policy objectives whenever governmental measures are deployed with a stabilisation purpose in instances of bank distress. In this respect, this study is grounded on the interaction between the 2013 Banking Communication of the European Commission and the newer prescriptions introduced by the Bank Recovery and Resolution Directive (BRRD), so as to assess the efficiency of the existing regulatory framework and evaluate how the apparent trade-off between financial stability and competition is addressed.

As a number of bank crisis resolution strategies and tools have been made available by the composite framework of resolution and State aid rules, this dissertation aims to assess how the use of different combinations of such strategies and tools can affect bankers' incentives and banking market structures in different ways. To this end, this study provides a detailed comparative analysis of the most recent cases of application of bank resolution, precautionary recapitalisations and bank liquidation, respectively, in order to offer an updated and comprehensive view of the different tools available and suitable to deal with different sorts of bank failures.

This exercise is relevant both from a positive and from a normative perspective. From the former point of view, this study endeavours to shed light on the complexity of the interactions between alternative crisis management tools and forms of State aid, highlighting the enduring role of public fund granting in affecting institutions' market conduct depending on the choice of bank restructuring tool, as well as public authorities' incentives in choosing which rescue strategies and tools to apply to different instances of bank distress. From the latter point of view instead, it highlights how the regulatory framework, as designed and/or applied, can actively shape institutions' and markets' conduct and structure, with the aim of assessing whether the intended regulatory goals of the BRRD are met in practice and advancing policy proposals for possible improvements in this respect.

# Summary (Dutch)

Deze dissertatie analyseert het EU-regelgevingskader voor crisisbeheersing in de banksector, met een nadruk op de onderlinge verbindingen tussen de regels voor afwikkeling van banken en overheidssteun en de gevolgen daarvan voor concurrentie tussen banken en marktstructuren.

De eerste stap daartoe is een beoordeling van de EU-regels voor overheidssteun, toegepast op de banksector, om te bepalen wat de voorwaarden zijn voor het verstrekken van gemeenschapsgeld aan noodlijdende instellingen en hoe deze voorwaarden zich hebben ontwikkeld vanaf de laatste financiële crisis tot recente jaren. De instelling van de bankenunie biedt een belangrijke achtergrond waartegen kan worden geëvalueerd hoe een grotere mate van sectorale integratie op EU-niveau de invoering van de regels voor overheidssteun heeft beïnvloed en hoe de strategieën voor afwikkeling van de bankencrisis zijn geactualiseerd. De focus is met name gericht op het bereikte evenwicht tussen financiële stabiliteit en de concurrentiebeleidsdoelstellingen wanneer overheidsmaatregelen worden toegepast met het oog op stabilisering in het geval van in nood verkerende banken. Wat dit betreft is dit onderzoek gebaseerd op de interactie tussen de bankenmededeling van de Europese Commissie uit 2013 en de recentere voorschriften geïntroduceerd door de EU-richtlijn voor het herstel en de afwikkeling van banken [Bank Recovery and Resolution Directive (BRRD)], om de efficiëntie van het bestaande regelgevingskader te beoordelen en te evalueren hoe de kennelijke wisselwerking tussen financiële stabiliteit en concurrentie wordt aangepakt.

Nu een aantal bankencrisis afwikkelingsstrategieën en instrumenten ter beschikking staan via het samengestelde kader van regels inzake afwikkeling en overheidssteun, is deze dissertatie erop gericht om te beoordelen hoe het gebruik van verschillende combinaties van deze strategieën en instrumenten de prikkels van bankiers en de bancaire marktstructuren op verschillende manieren kan beïnvloeden. Dit onderzoek biedt hiertoe een gedetailleerde vergelijkende analyse van de meest recente gevallen van toepassing van respectievelijk bankafwikkeling,

herkapitalisatie uit voorzorg en bankliquidatie, om een geactualiseerd en uitvoerig overzicht te verschaffen van de verschillende beschikbare en geschikte instrumenten ten behoeve van de verschillende soorten van bankfaillissementen.

Dit onderzoek is relevant, zowel vanuit een positief als vanuit een normatief perspectief. Vanuit het eerstgenoemde oogpunt tracht dit onderzoek een licht te doen schijnen op de complexiteit van de interactie tussen alternatieve crisisbeheersingsinstrumenten en vormen van overheidssteun, waarbij de voortdurende rol wordt benadrukt van het verstrekken van gemeenschapsgelden bij het beïnvloeden van het marktgedrag van instellingen afhankelijk van de keuze van het bankherstructureringsinstrument evenals de prikkels van overheidsinstanties bij de keuze welke reddingstrategieën en instrumenten toe te passen op verschillende gevallen van in nood verkerende banken. Vanuit het laatstgenoemde oogpunt wordt echter benadrukt hoe het regelgevingskader, zoals dat is ontworpen en/of toegepast, het gedrag en de structuur van instellingen en markten actief kan vormen, met als doel om te beoordelen of in de praktijk wordt voldaan aan de beoogde regelgevingsdoelen van de BRRD en het bevorderen van beleidsvoorstellen voor mogelijke verbeteringen in dit verband.

# Curriculum vitae

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| **Short bio** |
| --- |
| **Elena Ghibellini (Cento, 1992) is a PhD candidate in the European Doctorate in Law and Economics, a joint doctoral programme by the University of Bologna, the University of Hamburg and Erasmus University Rotterdam.**<br><br>**Elena's research interests encompass banking and financial regulation, competition policy and law and finance. During her PhD, Elena was a visiting researcher at the University of Hamburg, Erasmus University Rotterdam and the University of Amsterdam. She has also presented her research in a number of seminars and conferences, both at Italian and international level.**<br><br>**After a year at the European Banking Authority, Elena is currently a PhD trainee at the European Central Bank, where she deals with crisis management issues, especially in relation to resolution planning and bank resolvability.** |

| **Education** | |
| --- | --- |
| European Doctorate in Law and Economics – Joint degree from the University of Bologna, Erasmus University Rotterdam and the University of Hamburg | 2016-2020 |
| Master's degree in Economics (*cum laude*) – University of Bologna | 2014-2016 |
| Bachelor's degree in Business and Economics (*cum laude*) – University of Bologna | 2011-2014 |
| **Work experience** | |
| PhD Trainee – Crisis Management Division (Directorate General Microprudential Supervision IV) of the European Central Bank | September 2020 - present |
| Trainee – Supervisory Review, Recovery and Resolution Unit (Prudential Regulation and Supervisory Policy Department) of the European Banking Authority | October 2019 – August 2020 |
| Degree Programme Tutor – Bachelor in Business and Economics, University of Bologna | 2014-2016 |
| Audit Intern (curricular internship) – Professional accountants' firm, Bologna | June – November 2013 |
| **Prizes and awards** | |
| Full PhD scholarship – Department of Economics, University of Bologna | 2016-2019 |
| Youth Merit Award – Rotary Club Bologna Valle del Samoggia | 2011 |

| Publications | |
|---|---|
| ‘*Corporate Governance and Stewardship’* (Conference Report) ECGI-ICGN Academic Day, Amsterdam, 11 February 2019 (with Martino E.) | 2019 |
| *‘The Marketing of MREL Securities after BRRD: Interactions between Prudential and Transparency Requirements and the Challenges which Lie Ahead’* CONSOB Legal Papers No. 15, December 2017 (with Alvaro S., Lamandini M., Ramos Muñoz D., Pellegrini F.) | 2017 |
| **Others** | |
| Member of the Young Researchers Group of the European Banking Institute (EBI) | 2018 - present |

# EDLE PhD Portfolio

| | |
|---|---|
| Name PhD student: | Elena Ghibellini |
| PhD-period: | 2016-2020 |
| Promoters: | Prof. Dr. Marco Lamandini and Prof. Dr. Alessio M. Pacces |

**PhD training**

| ***Bologna courses*** | ***year*** |
|---|---|
| Introduction to Statistics (Prof. Alessandra Giovagnoli) | 2016 |
| Introduction to European Competition Law (Prof. Alberto De Pra) | 2016 |
| Experimental Law and Economics (Prof. Marco Casari) | 2016 |
| Modelling Private Law (Prof. Francesco Parisi) | 2016 |
| Behavioural Law and Economics and Enforcement (Prof. Paolo Vanin) | 2017 |
| Game Theory and the Law (Prof. Emanuela Carbonara) | 2017 |
| ***Specific courses*** | ***year*** |
| Seminar 'How to write a PhD' | 2017 |
| Academic Writing Skills for PhD students (Rotterdam) | 2017 |
| Seminar Series 'Empirical Legal Studies' | 2017 |
| Introduction to German Law (Prof. Hannes Rosler) | 2017 |
| Modelling Contract and Tort Law (Prof. Barbara Luppi) | 2017 |
| Topics in International Law and International Relations (Prof. Cosette Kramer) | 2017 |
| Empirical Methods for the Law/Advanced Statistical Analysis (Prof. Christoph Engel) | 2017 |
| ***Seminars and workshops*** | ***year*** |
| Bologna November seminar (attendance) | 2016 |
| Seminar on 'Multinational Banks and Supranational Supervision', Bologna (attendance) | 2016 |
| Seminar on 'Bank Restructuring Process in Spain', Bologna (attendance) | 2017 |
| Seminar on 'Asymmetric Information and the Securitization of SME Loans', Bologna (attendance) | 2017 |
| EURO-CEFG lecture on the European Banking Union (Prof. Dirk Schoenmaker), Rotterdam (attendance) | 2017 |
| BACT seminar series (attendance) | 2017-2018 |
| EGSL lunch seminars (attendance) | 2017-2018 |
| Joint Seminar 'The Future of Law and Economics' (attendance) | 2018 |
| Rotterdam Fall seminar series (peer feedback) | 2017 |
| Workshop on Experiments at the Crossroads between Law and Economics | 2017 |
| Rotterdam Winter seminar series (peer feedback) | 2018 |

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|---|---|
| EBI Young Researchers' Annual Workshop on Banking and Financial Regulation (organiser and session chair) | 2019 |
| 'Disclosure Obligations: Individual and Welfare Effects' (Prof. Cass Sunstein), ACLE Lecture, Amsterdam (attendance) | 2019 |
| 'Liquidity and Resolution', Webinar, Florence School of Banking and Finance (attendance) | 2019 |
| 'State Aid in the Context of Covid-19', Webinar, Florence School of Banking and Finance (attendance) | 2020 |
| ***Presentations*** | ***year*** |
| Bologna March seminar | 2017 |
| Hamburg June seminar | 2017 |
| Rotterdam Fall seminar series | 2017 |
| Annual Conference, Italian Society of Law and Economics (SIDE-ISLE), Rome | 2017 |
| Rotterdam Winter seminar series | 2018 |
| Bologna November seminar | 2018 |
| Annual Conference, Italian Society of Law and Economics (SIDE-ISLE), Lecce | 2018 |
| Joint Seminar 'The Future of Law and Economics', Rotterdam | 2019 |
| ***Attendance (international) conferences*** | ***year*** |
| 'Reflections on design and implementation of the Banking Union', EBI Conference, Bologna | 2016 |
| Annual Conference, Italian Society of Law and Economics (SIDE-ISLE), Turin | 2016 |
| Annual Conference, Single Resolution Board (SRB), Brussels | 2017 |
| Financial Stability Conference, Financial Risk and Stability Network (FRSN), Berlin | 2017 |
| 'Regulating Finance: Levelling the Cross-Sectoral Playing Field?', EBI Conference, Nijmegen | 2018 |
| 'Toward an integrated enforcement of banking regulation: the case of the Single Supervisory Mechanism', EBI Conference, Luxembourg | 2018 |
| Global Annual Conference on Banking Regulation, European Banking Institute (EBI), Frankfurt | 2019 |
| Conference on Prospectus Regulation and Liability, Amsterdam | 2019 |
| ECGI-ICGN Academic Day, Amsterdam | 2019 |
| ***Teaching*** | ***year*** |
| Instructor at the in-house course on "EU Bank Resolution Law" at the Central Bank of San Marino (organised by EUI Florence School of Banking and Finance) | 2018 |
| ***Others*** | ***year*** |
| Teaching assistant – 'European Banking and Capital Markets Law' (Prof. Marco Lamandini, Master of Law and Economics of Insurance and Finance, University of Bologna) | 2018 - present |
| Teaching assistant – 'The Law and Economics of State Aids' (Prof. Federico Ferretti, Master of Law and Economics of Insurance and Finance, University of Bologna) | 2019 - 2020 |

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|---|---|
| Teaching assistant – 'Law and Economics of Financial Transactions' (Prof. Alessandro Pomelli, Master of Law and Economics of Insurance and Finance, University of Bologna) | 2019 - 2020 |
| Supervision of Master theses – LLM Law & Finance, University of Amsterdam | 2019 |