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IN-DEPTH ANALYSIS

Precautionary recapitalisations: time for a review

External authors:
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Queen Mary University of London

Provided at the request of the
Economic and Monetary Affairs Committee

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Abstract

The paper conducts an analysis of the precautionary recapitalisation tool of article 32.4(d)(iii) of the BRRD, which gives Member States the ability to provide support to solvent banks with a capital shortfall highlighted by stress tests and asset quality reviews, in case of a serious disturbance in the economy. In doing so, the paper examines the relationship between precautionary recapitalisation, financial stability and a serious disturbance in the economy underlying how the absence of a clear definition of 'serious disturbance' and 'financial stability' gives sufficient room for manoeuvre to determine when to provide aid. It also reviews the applicable rules on State aid and burden sharing, which allow for sufficient flexibility in case of financial stability concerns, balancing the needs of preserving financial stability but at the same time taking competition policy interests into account. Overall, precautionary recapitalisation is a necessary measure, especially given the current economic climate and its potential to facilitate the restoration of necessary capital levels.

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LIST OF ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive
CET	Core Equity Tier
CoCos	Contingent Convertible Instruments
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
LME	Liability Management Exercise
NBG	National Bank of Greece
SSM	Single Supervisory Mechanism
SRB	Single Resolution Board
SRM	Single Resolution Mechanism

EXECUTIVE SUMMARY

The paper conducts an in depth analysis of article 32.4(d) (iii) of the BRRD which gives Member States the ability to support those banks with a capital shortfall highlighted by the national, Union or SSM-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.

The paper first discusses the apparent flexibility granted by the three different options included in article 32.4(d) to argue that these serve two different purposes (liquidity and recapitalisation), therefore in case of a capital shortfall the only option available to competent authorities is precautionary recapitalisation under article 32.4(d) (iii) of the BRRD. It is also argued that it would make more sense to place these tools outside of article 32 of the BRRD (conditions for resolution), which is an unfortunate location in the text of the Directive.

It then explores the relationship between precautionary recapitalisation, financial stability and a serious disturbance in the economy highlighting how the absence of a clear definition of 'serious disturbance' and 'financial stability' gives room for manoeuvre to determine when to provide aid. Whilst this allows for flexibility, it may also come at the expenses of legal certainty. Certainty is also at stake due to different language versions of the provisions included in article 32.4(d)(iii) of the BRRD. It is suggested that consistency should be ensured within the language versions.

Financial stability may be used as a political tool, however the safety net provided by the institutional system of check and balances at EU level as well as by the legislative framework on State aid may prevent political opportunism.

The applicable rules on State aid, with particular reference to burden sharing, are examined to ascertain the extent to which they may limit the effectiveness of precautionary recapitalisation. It is argued that, whereas in principle the strings attached to the granting of the aid may hamper its swift provisioning and impact financial stability, the overall State aid framework actually allows for enough flexibility to waive some of its requirements in case of financial stability concerns.

The last part of the paper considers whether precautionary recapitalisation is indeed able to achieve its aims, namely the need to (avoid or) remedy a serious disturbance in the economy and preserve financial stability. Whereas overall it seems a necessary measure, especially given the current economic climate and recommendations are made to keep the measure after the Commission review of art 32.4(d)(iii) of the BRRD, examples are given of cases where its impact may indeed be very limited. Finally, the paper investigates whether alternative *ex-ante* measures may act as a viable substitute to precautionary recapitalisation and the use of public funds.

Throughout the paper, reference is made to the most recent cases in which precautionary recapitalisation has been used or is relevant.

1. INTRODUCTION[1]

This paper was requested by the European Parliament under the supervision of its Economic Governance Support Unit.

It is well known how the need to introduce bank recovery and resolution measures in EU law arose from the lack of a common framework on the insolvency of cross border banking institutions. At the time of crisis the Commission and Member States had few or no instruments at their disposal to tackle the financial distress that was unfolding at banking level and had to resort to the provision of State aid, *de facto* bailing out banks (mostly with taxpayers' money).

EU institutions promptly acted to create a regulatory and supervisory framework aimed at dealing with future crisis or at limiting their adverse consequences. The main guiding principles were the need to avoid moral hazard, to share the burden of insolvency, to preserve financial stability and to protect taxpayers' money from future bailouts. This resulted in: (1) more stringent capital requirements with the Capital Requirements Directive (CRD)[2] and the Capital Requirements Regulation (CRR)[3]; (2) the introduction of a directive on Bank Recovery and Resolution[4] focussing on both *ex ante* and *ex post* measures; and, (3) a new Euro area supervisory architecture with a single supervisor for significant banks (ECB) as well as a single resolution board (SRB) in case of insolvency. Greater attention has also been paid to macro prudential supervision by setting up the European Systemic Risk Board and enhancing existing macro prudential tools.

These changes are important to understand the context of article 32.4(d), which provides the legal basis for precautionary recapitalisation measures, and assess whether it is necessary to preserve financial stability and remedy a serious disturbance in the economy. To put article 32.4(d) of the BRRD in context it is needed to: (1) ascertain the meaning of serious disturbance in the economy and of financial stability; (2) analyse the extent to which the Commission communications on State aid in the banking sector (collectively known as the Crisis Communications) may limit or enhance the effectiveness of precautionary recapitalisation of article 32.4(d)(iii) of the BRRD; and, (3) assess the extent to which the newly created legal framework includes other measures that may be equally apt to remedy a serious disturbance in the economy and/or whether they can be fungible with each other.

[1] The authors would like to thank Dr. Marco Bodellini (University of Bologna) and Dr. Andrea Miglionico (University of Reading) for the research assistance and Dr Maria Ioannidou (Queen Mary University of London) and Prof. Ioannis Kokkoris (Queen Mary University of London) for helpful comments. Any errors or omissions are purely attributable to the authors.

[2] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC in OJ L 176 27.6.2013.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 in OJ L 176 27.6.2013.

[4] 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 and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council in OJ L173 12.6.2014.

2. THE THREE TOOLS UNDER ARTICLE 32.4(D) OF THE BRRD: FLEXIBILITY OR LIMITATION?

According to article 32.4(d), in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, financial support can be provided in one of the following forms: (1) a State guarantee to back liquidity facilities provided by central banks according to the central banks' conditions; (2) a State guarantee of newly issued liabilities; or (3) an injection of own funds or purchase of capital instruments.

The three tools available in article 32.4(d) of the BRRD are not different alternatives that the authorities have to solve the same problem, but represent different options for two different purposes: to boost liquidity and 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 and State guarantees on newly issued liabilities under article 32.4(d)(ii) of the BRRD are tools which aim at allowing the bank to solve temporary liquidity problems.[5] The precautionary recapitalisation under article 32.4(d)(iii) of the BRRD, instead, is an instrument that allows the bank to increase its capital to comply with the minimum regulatory capital rules in the event of a future significant crisis under the so-called adverse scenario. These tools seem to aim at satisfying different needs of the bank in question (liquidity v. future solvency as result of the failure of the adverse scenario stress test).

Article 32.4(d) of the BRRD provides different options to be used in a bank-restructuring context. However, it would make more sense to place them outside of article 32 of the BRRD (conditions for resolution), which is an unfortunate location in the text of the BRRD. As a precautionary measure that intervenes before the state of insolvency, article 32.4(d) can be better placed within the *ex-ante* measures that aim at avoiding insolvency.

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[5] Liquidity problems created by maturity mismatch in banks highlight one feature of banks' speciality, namely the problems in differencing between a liquidity shortage and a capital shortfall. A liquidity crisis may be of a temporary nature and could be caused by the bank funding structure or by contingent events. In addition, it may, or may not evolve into a solvency crisis. A bank experiencing liquidity problems may be fundamentally sound in the longer term, but needs a liquidity boost in the short and medium term to be able to absorb the unexpected losses (the "extraordinary […] financial support" mentioned in article 32.4(d) of the BRRD).

3. WHAT IS PRECAUTIONARY RECAPITALISATION?

There is no specific definition of the expression “precautionary recapitalisation” in EU law. The concept is derived 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*[6] *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 or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution*”.[7]

The provision also states that this measure is reserved for solvent[8] institutions and is conditional on final approval under the Union State aid framework. It also has to be of a precautionary and temporary nature and proportionate to remedy the consequences of the serious disturbance and “shall not be used to offset losses that the institution has incurred or is likely to incur in the near future”.[9] The requirements established in article 32.4(d) of the BRRD that need to be met in order to allow the precautionary recapitalization to proceed are: (1) the institution is not failing or likely to fail (confined to solvent institutions); (2) there is a need to (avoid or) remedy a serious disturbance of the economy; (3) it is used to preserve financial stability; (4) it do not confer an advantage upon the institution; (5) it must be approved under the State aid framework; (6) shall be of a temporary nature; (7) must be proportionate to remedy the serious disturbance; (8) it must not be used to absorb incurred loses or likely future losses.

As pointed out in article 32.4(d) of the BRRD, this tool is limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities, where applicable, confirmed by the competent authority. It is interesting to note, however, that in the BRRD the expression “precautionary recapitalisation” is never used. It is instead used once in one of the Commission Communications in 2008.[10]

The ECB has provided a definition of precautionary recapitalisation, according to which “[a] *precautionary recapitalisation describes the injection of own funds into a solvent bank by the state when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure that is conditional on final approval under the European Union State aid framework. It does not trigger the resolution of the bank*”.[11] Similarly, also the Bank of Italy (Banca d’Italia), in the dealing with the recent Monte dei Paschi case, has

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[6] As it will be highlighted later in the text, the wording of the Italian, Portuguese and Spanish versions of article 32(4) of the BRRD is different, as it includes also the case of avoiding a serious disturbance in the economy.

[7] See article 32(4) of the BRRD.

[8] 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 or the relevant stress test". See ECB, What is a precautionary recapitalisation and how does it work?, 27 December 2016, at www.bankingsupervision.europa.eu.
According to the EBA Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU, a bank is failing or likely to fall if there are objective elements to support a determination that in the near future it will: (1) infringe own funds requirements, including requirements relating to the continuing of the authorisation, in a way that would justify the withdrawal of its authorisation by the competent authority, including but not limited to, on grounds that it has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; or (2) have assets which are less than its liabilities. See EBA *Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail,* EBA/GL/2015/07, at p. 13, available here https://www.eba.europa.eu/documents/10180/1085517/EBA-GL-2015-07+GL+on+failing+or+likely+to+fail.pdf/02539533-27ed-4467-b442-7d2fa6fcb3d3.

[9] See article 32(4) of the BRRD.

[10] See Communication from the Commission ‘*The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*’.

[11] See ECB, supra 8.

provided a definition of precautionary recapitalisation as "*a measure provided under European legislation (the Bank Recovery and Resolution Directive - BRRD) in exceptional circumstances, to remedy a serious disturbance to the economy of a Member State and preserve financial stability. In these cases, in order to strengthen the capital of a bank, extraordinary State aid of a precautionary and temporary nature is permitted as long as the bank is solvent and the intervention is compliant with the rules on State aid. These rules mean that a State can only intervene after the subordinated bonds have been converted into equity (the burden sharing principle)*".[12]

[12] Banca d'Italia, *The 'precautionary recapitalisation' of Monte dei Paschi di Siena*, available at www.bancaditalia.it. As it will be discussed in the text, article 59.3(e) of the BRRD excludes the requirement to write-down or convert capital instruments in the event of a precautionary recapitalisation.

4. THE RELATIONSHIP BETWEEN PRECAUTIONARY RECAPITALISATION MEASURES, FINANCIAL STABILITY AND A SERIOUS DISTURBANCE IN THE ECONOMY

The main rationale behind precautionary recapitalisation is to allow the bank to be recapitalised in the event of a capital shortfall highlighted by a stress test in the adverse scenario in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability.

Precautionary recapitalisations do not increase moral hazard because a serious disturbance in the economy is an exogenous event beyond the banks' control and therefore, has little impact on moral hazard. This, added to the overarching need to preserve financial stability as a public good, broadly justifies the existence of the measure. Needless to say, prudent management practices should be in place to also protect banks from serious disturbances in the economy by allowing them to be better prepared to face an adversity.

It should also be noted that the existence of a serious disturbance in the economy might hint at the fragility of the sector as a whole, which would make the system more prone to a systemic crisis should the bank slip into insolvency. Because of the serious disturbance, it may also be unlikely that other national financial institutions would be able to contribute exclusively to the bank's recovery, making the public intervention even more important. Since the financial support may avoid a future insolvency of the bank being the trigger of a domino effect, a precautionary recapitalisation measure could be considered to limit negative spillover effects on financial stability.

There are no official documents from the EU, which elaborate on the definition or the main elements that need to be present to assess a serious disturbance in the economy. The use of the term can be traced back to the EU Treaty, whose art 107(1) establishes the general prohibition of State aid, unless this is justified by the existence of a serious disturbance in the economy (Art 107 (3)(b)), with no qualitative or quantitative thresholds being indicated. Whereas the exception had only rarely been used[13], the financial crisis was unanimously seen as an example of such situation and as such the provision of State aid was extraordinarily declared compatible with the Treaty, albeit subject to certain conditions.

In its subsequent acts[14] and decisions[15] detailing the strings to be attached for the aid to be declared compatible, the Commission acknowledged that the financial crisis creates the conditions for a serious

[13] Most notably in C- 301/96 Germany v Commission at para 106, available at http://curia.europa.eu/juris/liste.jsf?language=en&num=C-301/96.

[14] The so called Crisis Communications are: Banking, Recapitalisation; Impaired assets and Restructuring Communications. See: 1) Communication from the Commission of 25 Oct. 2008 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"), O.J. 2008, C 270/8; as amended by Communication from the Commission of 30 July 2013 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"), O.J. 2013, C 216/1 2) Communication from the Commission of 15 Jan. 2009 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"), O.J. 2009, C 10/2; 3) Communication from the Commission of 26 March 2009 on the treatment of impaired assets in the Community financial sector ("Impaired Assets Communication"), O.J. 2009, C 72/1.

[15] See for instance Commission decision of 18/12/2013 on State aid SA.33229 (2012/C) (ex 2011/N) – Restructuring of NLB – Slovenia which Slovenia is planning to implement for Nova Ljubljanska banka d.d. where it is said that "*The Commission has acknowledged that the global financial crisis can create a serious disturbance in the economy of a Member State and that measures supporting banks are apt to remedy that disturbance*". The 2011 Communication on the application of State aid rules to support measures in favour of banks in the context of financial crisis at point 4 affirms that "[i]n *the most acute stage of the crisis, the condition of a serious disturbance was unquestionably met across the Union in view of the extraordinary stress in financial markets, later combined with an exceptionally severe contraction in the real economy*".

disturbance. In this context, it only hinted at stress in financial markets, contraction in the real economy and wider negative spillover effects as possible components of such a disturbance[16],[17].

Absent any quantitative or qualitative indication it is difficult to assess when exactly the precautionary recapitalisation may be necessary to preserve financial stability and to remedy a serious disturbance in the economy. In this respect, it should also be highlighted that several other language versions[18] of the BRRD include the need to "avoid" such a disturbance alongside the remedial part[19], which should be favoured as it provides greater flexibility to the authorities. This need "to avoid" a disturbance provides the authorities with room for manoeuvre, as the public funding can be granted in a situation where the market is still able to share the burden, making the intervention less onerous for the State and possibly more effective for the preservation of financial stability. Precautionary recapitalisation measures seem to be better suited at preventing a serious disturbance in the economy rather than at remedying it.

Overall, the absence of a legal definition of serious disturbance leaves regulators and supervisors with a fair degree of flexibility in determining the need, or lack thereof, to provide extraordinary public financial support on the basis of their own assessment. In deciding whether or not to make use of article 32.4(d)(iii) of the BRRD, authorities would also consider other factors such as: (1) the size of the bank; (2) if it is more than one bank that needs financial support; (3) the actual causes of liquidity problems, whether these are mostly related to the adverse economic conditions or if these are more structural; and, (4) the pace of deterioration of banks capital. In this respect, the flexibility granted allows for a case-by-case assessment. Whereas this is in principle a positive outcome, which contributes to the limitation of moral hazard, it comes at the expense of legal certainty. It may also give the involved authorities incentives to delay the process, which may in turn exacerbate the liquidity strains of the bank, therefore blurring the boundaries between the solvency and insolvency of the bank.

In terms of financial stability, the Commission links it to the need to prevent negative spillover effects stemming from the insolvency of a credit institution and the "need to ensure that the banking system as a whole continues to provide adequate lending to the real economy"[20]. It can be argued that the determination of the effect on financial stability may be influenced by the economic and political impact that a contrition in lending may have. This component of financial stability can be addressed by public stimulus measures aimed providing lending to the economy and to sustain employment, as states actually did back in 2008[21].

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[16] The 2013 Banking Communication at point 5.

[17] In his testimony before the Italian Joint Parliamentary Commission, Mr Barbagallo, Head of Supervision at the Bank of Italy, mentions the GDP reduction of 9% from the start of the financial crisis, and the reduction of industrial production index of over a quarter, as the main economic reasons behind the need to enact the urgent decree which allows for the recapitalisation of ailing banks. These have in turn determined an increase in NPLs which had a negative impact on banks' profitability. The Head of Supervision also mentions mismanagement, slow restructuring process of the banking sector as well as its inability to keep up with technological changes, as causes of banks' losses. See Carmelo Barbagallo, *Audizione sul decreto Legge 23 Dicembre 2016 n 237 Disposizioni Urgenti per la Tutela del Risparmio nel Settore Creditizio presso le Commissioni Riunite di Camera e Senato*, available here https://www.bancaditalia.it/pubblicazioni/interventi-vari/int-var-2017/Barbagallo_audizione_20171701.pdf.

[18] Such as the Italian, French, Spanish and Portuguese versions of the BRRD text.

[19] The text of article 32.4(d) in English and other languages is different. As highlighted below, the English version does not include the use of precautionary recapitalisation to "avoid" a serious disturbance in the economy but only to "remedy" such situation. See below:

"*32.4(d) extraordinary public financial support is required except when, in order to* [avoid or] *remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms …*".

[20] 2013 Banking Communication, point 7.

[21] See Costanza A. Russo, Di Paese in Paese contro la crisi, in *Il Mondo sull'orlo di una crisi di nervi: Origini, Sviluppo, Responsabilità del Terremoto*, book edited by Pellizzon L., Castelvecchi, Roma, 2009, 125-137.

Ensuring the smooth functioning of the banks' critical functions, however, may also preserve financial stability. Unless the relevant bank has carried out a thorough internal restructuring process whereby those functions have been insulated (ring-fenced) from the spreading of financial problems, extraordinary financial support may be of vital importance to preserve those functions.

The precautionary recapitalisation tool is to be used to allow the bank to be recapitalised in the event of a capital shortfall highlighted by a stress test in the adverse scenario in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability. As indicated above, it is difficult to precisely delimit the exact extent of what constitutes a "serious disturbance" and when it can put "financial stability" at risk. This notwithstanding, this is a desired discretionary flexibility granted to the authorities to exercise—on very limited occasions—an exceptional deviation from the policy agenda of not using public funds. It is important to stress that the precautionary recapitalisation can only be performed if the strict requirements are met.[22]

As analysed below, the actual scope of the implementation of the precautionary recapitalisation results from the applicability of two separate albeit related set of norms that are applied in the realm of a banking crisis. These are the State aid rules (and the burden sharing principle specifically) and the BRRD. Therefore, the extent of the use of precautionary recapitalisation is limited by the State aid framework, as described below.

[22] These requirements are established in article 32.4 of the BRRD and they are: (1) the institution is not failing or likely to fail (confined to solvent institutions); (2) there is a need to (avoid or) remedy a serious disturbance of the economy; (3) it is used to preserve financial stability; (4) it do not confer an advantage upon the institution; (5) it must be approved under the State aid framework; (6) shall be of a temporary nature; (7) must be proportionate to remedy the serious disturbance; (8) it must not be used to absorb incurred loses or likely future losses.

5. THE 2013 BANKING COMMUNICATION AND THE INTERACTION BETWEEN STATE AID FRAMEWORK, BURDEN SHARING AND PRECAUTIONARY RECAPITALISATION

Precautionary recapitalisation needs to be considered in tandem with the framework of State aid. Within the Crisis Communications, the one that is more relevant to precautionary recapitalisation is the 2013 Banking Communication. The main features of the 2013 Banking Communication are: (1) to contain any State aid to the minimum; (2) an enhanced level of burden sharing from shareholders and subordinated creditors regardless of the solvency of the bank (as long as financial stability is not put at risk); (3) the need for a bank restructuring plan (to be approved before granting the aid); (4) evidence that alternative measures have already been exploited to the maximum extent; and, (5) if recapitalisation measures are needed to preserve financial stability, these can exceptionally be authorised on a temporary basis as rescue aid before a restructuring plan is approved.[23]

5.1 The uneasy case for burden sharing under the State aid framework

To some extent, the possible effectiveness of precautionary measures may indeed be limited by State aid rules because of the different underlying policy interests of the two sets of norms and the interests that they are trying to protect. State aid protects competition and consumer welfare whereas the bank recovery and resolution regime protects financial stability. A misalignment between the two is possible[24]. Should Member States be free to decide over the 'if' and 'how' of the precautionary recapitalisation measures, they may probably act sooner and in a more decisive manner, therefore lowering the probability of spillover effects[25]. Acting independently does not necessarily entail that the State would not include covenants to recover the aid. However, giving States an unconditional freedom to act could undermine other important goals of European policy.

Most likely, a recapitalisation using public funds will come with an imposition by the Commission of the burden sharing principle under the State aid framework. Yet, it is worth stressing that article 32.4 of the BRRD states that precautionary recapitalisation cannot be used to absorb previous losses or likely to incur losses. This results in a need to either: (1) raise private capital from existing shareholders or new investors; or, (2) bail-in existing creditors. Within this framework, successful examples of the use of the burden sharing principle in the context of a precautionary recapitalisation are the cases of Piraeus Bank and NBG. Here, private investors contributed EUR 2.21 billion and EUR 1.89 billion, respectively through the underwriting of new shares[26] and through the voluntary conversion of claims into shares (LME) by junior creditors. The involvement of the Atlante fund in the recapitalisation of Banca Popolare di Vicenza and Veneto Banca is another interesting example of private sector recapitalisation though the issuance of shares to a new investor.

However, having to require contribution from the private sector, at a moment where the market is experiencing problems, may be unrealistic, as highlighted by the unsuccessful attempt to raise capital by Monte dei Paschi[27], or by the refusal of the Atlante fund to inject additional funds in Banca

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[23] However, in this case the competent supervisory authority will have to provide an *ex ante* analysis of the severity of the capital shortfall as one that would otherwise force them to withdraw the licence. The analysis will also have to demonstrate the inefficacy of possible private measures to avert any risk to financial stability.

[24] See Costanza A. Russo, The New Course of EU State Aid Rules During the 2007-2009 Financial Crisis, in Kern Alexander (eds.) *Research Handbook of International Financial Regulation*, Elgar Publishing (2012).

[25] Coordination problems are highlighted by the Italian central bank Governor, as mentioned here www.ft.com/content/3c6e3cb8-46ae-11e7-8519-9f94ee97d996

[26] See European Commission decisions C(2015) 8626 of 29 November 2015 (State Aid SA.43364 (2015/N) – Greece) and C92015) 8930 of 4 December 2015 (State Aid SA.43365 (2015/N) – Greece).

[27] It is worth stressing that in the case of the precautionary recapitalisation of National Bank of Greece, the Commission used the expression "undue advantage" (as "an advantage incompatible with the internal market under State aid rules") to state that when a bank is unable to raise capital privately from the markets it is being favoured by receiving State aid. See Recital 173 of the EU Commission decision C(2015) 8930 dated 4 December 2015.

Popolare di Vicenza and Veneto Banca.[28] The combined wording of article 32.4(d) and of article 59.3(e) of the BRRD seems to imply that in case of a precautionary recapitalisation, the BRRD excludes the requirement to write-down or convert capital instruments. As mentioned, article 32.4 of the BRRD states that the public injection of funds shall not be used to offset losses that the institution has incurred or is likely to incur in the near future. However, future losses could be the ones resulting from the sale or devaluation of impaired assets (such as non-performing loans). Looking through the provision the interpretation can be that these future losses can be covered just with the write down of equity and debt instruments or with the conversion of liabilities into equity, which is part of the burden-sharing tool.

Recent experience shows that there could be additional complications as in some cases financial instruments used to finance the bank have been mis-sold to unsophisticated retail investors unable to properly understand the riskiness and the complexity of such financial products. In Monte dei Paschi there has been a dissemination of subordinated bonds among retail investors who were not adequately informed about potential risks when they decided to invest in the financial instruments.[29] In this case, the Italian government introduced the possibility of compensating these retail investors who were mis-sold the securities by converting them into equity and buying such equity with more secure senior instruments. The Commission understood that such compensation is an entire separate consideration to burden sharing under the State aid framework.[30]. Conversely, the resolution of four Italian banks[31] required writing down subordinated bonds since these financial instruments have been mis-sold to unsophisticated retail investors unable to properly understand the riskiness and the complexity of such financial products. In this case, the Italian Government introduced an arbitration procedure to allow them to recover the invested amount. Here one could argue that even if such a political strategy is understandable, it can be considered as a circumvention of the State aid framework.

To sum up, the use of private funds can be limited in certain situations and there may be cases where the use of bail in tool whereby debt holders are written off or converted into equity holders may not be optimal due to mis-selling activities. This again creates a tension between policy and protected interests and a case-by-case evaluation from the Commission is to be welcome.

5.2 The interplay between burden sharing and precautionary recapitalisation

The imposition of burden sharing by the Commission is at risk of defeating the purpose of precautionary recapitalisation. At least in principle the requirements of the State aid rules make the ability to provide public funds limited to few cases, which in turn can have a negative impact on financial stability. Whereas burden sharing through the involvement of shareholders and junior subordinated creditors is in principle fair and equitable, it may exacerbate market conditions therefore triggering a domino effect. However, the above considerations are mitigated by the fact that State aid rules are also perceived to limit moral hazard and, even if there is no empirical evidence of their effectiveness, the Commission may be well positioned to force the State to recover the aid and limit to the very minimum the one being granted. The appreciation of the need to act swiftly may actually lead the involved authorities and the Commission to cooperate more effectively, and to establish tailor made responses depending on the actual needs. Finally, the rigour of the Banking Communication leaves some space to flexibility where it allows waiving burden sharing requirements in case of financial stability concerns (at point 45), which is the same rationale behind article 32.4(d) of the BRRD.

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[28] www.firstonline.info/News/2017/05/30/pop-vicenza-e-veneto-banca-no-di-atlante-a-nuovi-capitali/NTFfMjAxNy0wNS0zMF9GT0w

[29] European Commission, Press Release dated 1 June 2017 titled « Statement on an Agreement in principle between Commissioner Vestager and Italian authorities on Monte Dei Paschi di Siena (MPS).

[30] Ibid.

[31] The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio della Provincia di Chieti.

Article 32.4(d)(iii) of the BRRD deals with precautionary recapitalisations carried out with the use of public funds. Therefore, the provision does not make any direct reference to the need to involve private resources in the precautionary recapitalisation of the bank. However, as mentioned in both of the Greek cases, *i.e*. Piraeus Bank and NBG, where the Commission has authorized the precautionary recapitalisation, a significant amount of private resources have been provided. In the same way, it is expected that in the likely precautionary recapitalisation of Monte dei Paschi, shareholders and subordinated creditors would be involved in the costs of restructuring.

The requirement to involve private investors in the authorization to use State aid towards the precautionary recapitalisation is the result of the application of the State aid rules (so-called burden sharing principle) and indirectly by article 32.4 of the BRRD were it states that previous losses or likely to incur losses cannot be absorbed with precautionary recapitalisation. In particular, point 15 of the 2013 Commission's Banking Communication states that "*the bank and its capital holders should contribute to the restructuring as much as possible with their own resources*". In addition, point 19 states "[b]*efore 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*". The main rationale of the burden sharing principle is to avoid or at least minimise the creation of moral hazard as well as the impact of the aid on the fair competition within the common market.[32]

In the context of a precautionary recapitalisation the choice to increase the contributions from private investors is based on the evaluation of its impact on financial stability. As long as the authorities involved in the decision assume that the write down of a greater amount of liabilities is not able to generate financial instability, then there could be room to make more use of the burden sharing principle. Differently, the involvement of new investors is always welcome even though in such situations it can be quite difficult to succeed.

It could be counterproductive to set a fixed threshold for the amount of liabilities required to be written down to provide more protection to taxpayers. Both the interests in place have to be assessed on the basis of the consideration that even financial instability affects taxpayers. A policy of discretion should be favoured having as guiding principles both, not distorting competitiveness (and ensure the protection of taxpayers' money) and preserving financial stability. This notwithstanding, upon a conflict of both, the latter should prevail which seems to be confirmed by the exception included in point 45 of the 2013 Banking Communication which allows for the disapplication of the burden sharing tool when "implementing such measures would endanger financial stability or lead to disproportionate results", highlighting that in a last resort situation the entire applicable legal framework (both, the BRRD and the State aid framework) will prioritize maintaining financial stability.[33] This has been acknowledged by the Commission stating that "financial stability remains the overarching objective in its assessment".[34]

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[32] According to point 41 of the 2013 Banking Communication, "Adequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid 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. In any case, cash outflows from the beneficiary to the holders of such securities must be prevented to the extent legally possible".

[33] It is worth stressing that according to point 52 of the 2013 Banking Communication, the Commission has the discretion to review the provision of State aid ex post and impose burden sharing measures, if needed. Also, according to point 53 of the 2013 Banking Communication, the grant of State aid will be periodically reviewed by the Commission. As noted by Kokkoris, it is expected that the Commission would approve the grant of State aid and pursue a detailed assessment of such schemes at future intervals. See Ioannis Kokkoris, State Aid Law v Single Resolution Mechanism: David v Goliath or vice versa?, International Corporate Rescue, volume 10, issue 6, 2013.

[34] See the press release by the Commission dated 10 July 2013 titled "State aid: Commission adapts crisis rules for banks", available at http://europa.eu/rapid/press-release_IP-13-672_en.htm.

6. IS PRECAUTIONARY RECAPITALISATION NECESSARY TO PRESERVE FINANCIAL STABILITY?

The tools provided in article 32.4(d) of the BRRD empowering the authorities to make use of public funds to recapitalise a bank which could have a capital shortfall in the event of a future severe crisis under the adverse scenario, are still necessary at the present juncture to preserve financial stability. This is mainly due to the fact that in a relevant number of Member States the present situation is still characterised by a fragile banking and financial sector. Therefore, the difficulties of banking and financial institutions can lead to crisis able to generate recession and create a disturbance in the real economy. The reasons that justified the adoption of the BRRD in 2014, including precautionary recapitalisation, are still present. In other words, as prescribed by the review clause in article 32.4 of the BRRD, there is a continuing need for allowing the support measures under point (d)(iii) of the same article.

However, assuming arguendo, there are hypothetical scenarios where it can be argued that precautionary recapitalisation may not be sufficient or indeed needed to preserve financial stability. For instance, the extent to which the banks eligible for precautionary recapitalisations do pose a real threat to financial stability per se can be debatable. Ailing banks are supposed to cover past losses with their own capital or via debt write down, and are expected to successfully raise capital from the private sector. Therefore, the situation of financial distress would not—in principle—trigger a domino effect.

The case of Monte dei Paschi showed that it was not able to raise capital and later resorted to issue debt with a government guarantee. This showcases that the most recent problems of banks' solvency result from the amount of non-performing loans, which in turn could lead to liquidity concerns if those banks ceased to benefit from a government guarantee (as also evidenced by Monte dei Paschi and Veneto Banca and Banca Popolare di Vicenza). The Northern Rock case demonstrated that if the funding model of the bank is fragile, this can pose a threat to financial stability, irrespective of bank's actual size or ability to raise funds in the short term. A precautionary recapitalisation that intervenes late in the bank crisis timeline may also be ineffective in containing the possible spread of risk to other institutions.

Because of the flexibility granted to authorities in determining the existence of a serious disturbance in the economy, they may feel inclined to resort to precautionary recapitalisation in those cases in which the use of different instruments such as bail in may have an impact on household savings. To avoid the social consequences of having to write down or convert the investment of lifetime saving of private individuals, authorities may prefer public intervention. There are safety nets to avoid political opportunism by abusing of the use of public funds, such as the Commission role in attaching conditions for approval of the State aid, and the need to respect the relevant requirements included in the crisis communications (particularly the 2013 Banking Communication). This notwithstanding, there have been instances in which these have been bypassed by national governments[35].

There have been cases in the past also were the same bank has been recapitalised more than once. Should precautionary recapitalisation be used to sustain a firm that has previously received aid, it may be interpreted as a sign that some banks are still too big to fail and in so doing increasing moral hazard rather than placing responsibility at individual bank level. It can also be seen as a failure of the bank insolvency framework to achieve its aims. Should the reasons leading to perform a precautionary recapitalisation be the result of mismanagement and/or fraudulent activities, precautionary recapitalisation may lack any punitive element broadly advocated in the Directive. If it were to be any punitive element, it should stem from a strict use of the State aid framework applied by the Commission. However, this might lead to a clash of interests (*i.e.* preserving financial stability

[35] See for instance Case C-667/13 Banco Privado Portugues and Massa Insolvente do Banco Privado Portugues, available at http://curia.europa.eu/juris/documents.jsf?num=C-667/13.

v. market protection). In this particular situation, the former prevails as the State aid regime allows to proceed with the use of public support in exceptional cases were the financial stability is at stake.

Authorities should in theory be able to better assess the impact of a recapitalisation due to the greater attention now put on macro prudential supervision. Yet market dynamics may evolve quicker than expected. This is one of the reasons why in case of a serious disturbance in the economy with potential effects on financial stability, a system-wide form of intervention by regulators may be preferable to *ad hoc* measures.

In an attempt to improve the current framework, it is suggested to: (1) adopt the precautionary recapitalisation tool as a permanent feature since it may prove to be effective whenever financial stability is in peril due to a serious disturbance in the economy; (2) place this tool (as well as the liquidity tools of article 32.4(d)(i) and (ii)) within the *ex-ante* measures that aim at avoiding insolvency as it current location is unfortunate (conditions for resolution); (3) unify the different languages of the text of the BRRD (the English version does not allow to use the precautionary recapitalisation to “avoid” a serious disturbance in the economy but just to “remedy” it, on the contrary, other versions (*e.g.* Italian, French, Spanish and Portuguese) allow both, *i.e*. to avoid and remedy a serious disturbance in the economy); and, (4) explore further the need to require a greater use of CoCos (that can be converted upon the failure of an adverse scenario stress test) targeted to professional investors.

7. PRECAUTIONARY RECAPITALISATION AND ALTERNATIVE EX ANTE MEASURES

One last consideration that needs to be made is whether alternative *ex ante* measures may effectively substitute precautionary recapitalisation (and avoid the use of aid). Among those, one should consider the provision of Emergency Liquidity Assistance (ELA) by central banks and the role-played by recovery plans, bail-inable instruments and intra-group asset transfers. The conclusion is that none of them is indeed a perfect substitute, or a viable and effective alternative. This reinforces the need to maintain the measure included in art 32.4(d)(iii).

Liquidity assistance is usually granted by central banks within the course of their normal open markets operations and standing facilities. However when this takes the form of an ELA, *i.e*. the provision of dedicated support to an institution, point 62 of the 2013 Banking Communication subjects it to the State aid framework unless some specific conditions are cumulatively met. Among those, "*the credit institution is temporarily illiquid but solvent at the moment of the liquidity provision which occurs in exceptional circumstances and is not part of a larger aid package*"[36] and "*the measure is taken at the central bank's own initiative, and in particular is not backed by any counter-guarantee of the State*"[37], which entails that ELA may also be considered as alternative measures to article 32.4(d)(i) and (ii) of the BRRD directive. However, unlike precautionary recapitalisations under article 32.4(d)(iii) of the BRRD, ELAs do not intervene on banking capital as these operations serve different purposes and the impact on financial stability may be different. Therefore, ELA cannot be seen as a substitute for precautionary recapitalisation.

Recovery plans are regulated by article 5 of the BRRD, and should be drawn up by the institution based on realistic assumptions "*applicable in a range of robust and severe scenarios*" (BRRD paragraph 21) and should be activated whenever the relevant conditions are met. As they are aimed at restoring a situation of financial distress of the bank by raising private funds to cater for losses and they do consider severe stress scenario, these are in principle a substitute for precautionary recapitalisations. However, it could be argued that recovery plans are not intended to cover the case where a bank is unable to raise funds because of a serious disturbance in the economy. In this sense, they are not a substitute to precautionary recapitalisation, and the provision of public funds will be of vital importance.

Contractual bail in differs from the statutory bail in to be activated in a resolution scenario due to its voluntary nature agreed on a contractual basis. It can represent the first step of the contribution from the private sector that a bank needs to exhaust before resorting to public funds. However contractual bail in can only be activated whenever the relevant triggering event materialises. Since the adverse stress scenario which is considered in precautionary recapitalisation is only a possible future event, which may or may not be caught by the applicable contractual conditions, the contractual trigger may actually not have materialised and therefore the bail in may not be activated.

Intragroup asset transfer is allowed under the BRRD, however it presents a number of limitations and conditions, which may not make it suitable to the bank's need. Depending on market and group conditions it can also be restricted or prohibited by the competent authority. The ability of the bank to raise funds internally is also contingent upon the group being large and diversified. Therefore the possibility of recurring to internal funding does not rule out the need of a precautionary recapitalisation as a tool to preserve financial stability upon a serious disturbance in the economy.

[36] See point 62(a) of the 2013 Banking Communication.

[37] See point 62(d) of the 2013 Banking Communication.

8. CONCLUDING REMARKS

Article 32.4(d) of the BRRD draws an important distinction on how to address a possible bank's liquidity or capital shortage in case of a serious disturbance in the economy: in the former case States can make use of the tools included in article 32.4(d)(i) and (ii) of the BRRD; in the latter, *i.e.* article 32.4(d)(iii) of the BRRD, States can inject funds and purchase capital instruments to recapitalize a bank. The latter is what is known as precautionary recapitalisation, which is subject to strict conditions including the solvency of the institution and the compatibility with the EU State aid framework.

Yet, the analysis of article 32.4(d) of the BRRD and of the Banking Communication revealed possible tensions between the two set of norms, mainly due to the different policy objectives and interests they try to protect.

Whereas the approval by the Commission of precautionary recapitalisation is conditional upon the respect of the EU framework on State aid (with particular reference to the burden sharing principle included in the 2013 Banking Communication), it appears that a strict interpretation of the latter may diminish the positive effect that a recapitalisation can have on financial stability. This initial conclusion is further reinforced by the lack of clarity as to the actual meaning of serious disturbance in the economy. These tensions are mitigated by a certain degree of flexibility granted by the 2013 Banking Communication in avoiding attaching conditions to the recapitalisation of solvent banks when financial stability is genuinely at stake, but so far the extent to which the Commission is willing to use this ability is unclear (protection of competition and consumer welfare v. bank recovery and resolution preserving financial stability).

Financial stability may be used as a political tool, however the safety net provided by the institutional system of check and balances at EU level as well as by the legislative framework on State aid may prevent political opportunism.

It should be noted that the absence of a clear definition of 'serious disturbance' and 'financial stability' gives room for manoeuvre to determine when to provide aid. Whilst this too allows for flexibility, it may also come at the expenses of legal certainty (also—to a certain extent—due the differences in the wording of article 32.4(d)(iii) of the BRRD in the different language versions we might see additional confusion as to the actual aim of the measure *i.e.* whether it is to only remedy or to *avoid* or remedy a serious disturbance in the economy, if the former, it entails an additional requirement).

Despite the examined caveats and cases, given the present economic juncture, it is still a needed tool with a potential to (avoid or) remedy a serious disturbance in the economy and preserve financial stability. This conclusion seems to be reinforced by the lack of alternative viable measures. In other words, as prescribed by the review clause in article 32.4 of the BRRD, there is a continuing need for allowing the support measures under point (d)(iii) of the same article.

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