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Bank Stakeholders' Mandatory Contribution to Resolution Financing: Principle and Ambiguities of Bail-In

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1. Bank resolution policy in the wake of the Global Financial Crisis

The establishment of special resolution regimes ('SRRs') for banking institutions constitutes a central plank of the post-crisis regulatory agenda.² In sharp contrast to the past, when most countries lacked specialized legal frameworks, or even clearly defined principles, for handling the failure of banking institutions, current regulatory thinking is premised on the belief that a state's ability to respond to failures of large and/or systemically important banks in an effective and orderly manner depends on the availability of special legal tools and procedures. These must be able to ensure continuity in the performance of failed banks' critical financial intermediation functions, that is, to preserve those operations and transactions whose interruption could have negative repercussions for the wider financial system or the real economy ('open bank' resolution).

Up till now, this objective was typically attained by means of state-financed bailouts, which prevented the collapse of troubled banks, thus preserving operating continuity and avoiding contagion and systemic crises. Bailouts, however, transfer the costs of failure from the failed banks' immediate stakeholders (and more specifically, its liability holders, including depositors, and possibly equity holders too) to the taxpayer. This has major implications for the banking market's incentive structure. In particular, if, based on past experience or governmental declarations of intent, banks' liability holders are convinced that, in the event of bank failure, the state will come to the rescue, they will tend to discount the risk of default on their claims and will, accordingly, relax their monitoring efforts. For the same reason, the wider market for loanable funds will fail to properly and fully incorporate in interest rates and bond prices perceived differences in individual banks' risk profiles.

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² See Christos Hadjiemmanuil, 'Special Resolution Regimes for Banking Institutions: Objectives and Limitations', in Wolf-Georg Ringe and Peter M Huber (eds), *Legal Challenges in the Global Financial Crisis: Bail-Outs, the Euro and Regulation* (Oxford & Portland, Oregon: Hart Publishing, 2014), at 214–217; Thomas F Huertas, *Safe to Fail: How Resolution Will Revolutionise Banking* (Basingstoke & New York: Palgrave Macmillan, 2014).

Instead, a bank's relative funding costs will tend to depend on the likelihood that it will be bailed out if in trouble. This leads to the well-known 'too-big-to-fail' ('TBTF') problem, whereby large banks (which due to their size and systemic importance are almost certain to be supported by the state) gain a significant competitive advantage in terms of financing costs in comparison to smaller banks (as to which the extension of support is not assured).³ In the manner described above, traditional bank crisis-management practices, which relied implicitly on discretionary bailouts of failed banks, resulted in inappropriate incentives, implicit subsidies to risk-taking by banks and distortions to competition. They also generated major fiscal risks, since bailouts often require enormous amounts of funding. Indeed, the recent crises in a number of euro area crises, including Ireland, Spain and Cyprus, have shown that the fiscal costs of bailouts may be prohibitive, with deleterious consequences, both for the state (whose own fiscal sustainability can be undermined by its implicit commitment to stand behind the domestic banking sector) and for the banks themselves (whose survival in times of systemic crisis may come to depend precisely on the existence of a credible state guarantee).

The need to restore market discipline, avoid moral hazard in the banking field and protect the state's fiscal position points to the second facet of recent SRRs, namely, their insistence that the financial burden of resolution actions should fall to the maximum extent possible on the private sector, that is on the failed banks' own stakeholders or, if this not possible, on the banking industry as a whole, in the form of contributions by industry-funded deposit insurance schemes and/or resolution funds. In contrast, the state's contribution to resolution financing, and the attendant exposure of taxpayers to the risk of loss, should be kept at a strict minimum, with fiscal resources being available only as an ultimate 'backstop', or last resort, in totally exceptional cases.

Thus, the SRRs that various countries have enacted following the Global Financial Crisis⁴ are characterized by this dual concern: how to organize resolution in an orderly and predictable way so as to avoid systemic disruption, without, however, shifting the costs of failure to taxpayers. Sharing common understandings on the ways in which these objectives can be pursued, the national SRRs display many technical similarities.⁵ To a large extent, they build on global standards, developed by the Basel Committee on Banking Supervision ('BCBS')⁶

³ For a review of the literature on TBTF, see Philip E Strahan, 'Too Big to Fail: Causes, Consequences, and Policy Responses', (2013) 5 *Annual Review of Financial Economics* 43–61.

⁴ Starting in the UK, with the Banking Act 2009; and Germany, with Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz) vom 9. Dezember 2010, BGBl. 2010, I, 1900. For a brief description of the German statute in English, see Barbara Jeanne Attinger, 'Crisis Management and Bank Resolution: Quo Vadis, Europe?', *ECB Legal Working Paper* No 13 (December 2011), 28–34.

⁵ Many technical aspects of post-crisis SRRs have their origins in earlier American resolution policy; Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), PL 102-242, 105 Stat 2236. But this does not apply to the financing aspects of resolution and, more specifically, to bail-in, which constitute drastic policy innovations.

⁶ The BCBS had developed common resolution concepts and principles as early as 2002; BCBS, 'Supervisory Guidance on Dealing with Weak Banks: Report of the Task Force on Dealing with Weak Banks' (March 2002), www.bis.org/publ/bcbs88.pdf, esp. section 6. See now BCBS, 'Guidelines for

and, primarily, by the Financial Stability Board ('FSB').⁷

2. Europe's new bank resolution regime: the BRRD

In the European Union, a harmonized framework for the recovery and resolution of weak or failed banks was proposed in 2012 and finally adopted in 2014 in the form of the Bank Recovery and Resolution Directive ('BRRD').⁸ The BRRD is already in force, although the full effect of Europe's new SRR will only be sensed from 1 January 2016 onwards.⁹

In so far as credit institutions, investment firms and entities belonging to banking groups are concerned,¹⁰ the BRRD pre-empts the application of general corporate insolvency law or replaces pre-existing national systems of special bank insolvency law. Based on a purely administrative approach, it largely excludes courts from the resolution process, which is instead entrusted to administrative resolution authorities. These are vested with a wide array of powers¹¹ and a set of very potent resolution 'tools',¹² or statutorily defined resolution techniques, hitherto unknown in most European countries.

Identifying and Dealing with Weak Banks' (July 2015), www.bis.org/bcbs/publ/d330.pdf, esp. section 7. Following the crisis, it took up additional work on the coordinated treatment of bank insolvencies with cross-border implications. This led to the publication of a list of ten recommendations, which, beyond the need for cross-national cooperation, also call for convergence of the underlying national resolution regimes and approaches; BCBS, 'Report and Recommendations of the Cross-Border Bank Resolution Group' (March 2010), www.bis.org/publ/bcbs169.pdf; and BCBS, 'Resolution Policies and Frameworks – Progress So Far' (July 2011), www.bis.org/publ/bcbs200.pdf.

⁷ FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2011), www.financialstabilityboard.org/publications/r_111104cc.pdf; revised version (15 October 2014) www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf. These were part of a set of policy measures intended to ensure the resolvability of the world's largest financial institutions, the so-called 'global systemically important financial institutions' ('G-SIFIs'), in a manner that puts an end to bailouts and the TBTF problem. Beyond their immediate concern with G-SIFIs, however, they serve as a global standard for regional and national SRRs. The 'Key Attributes' have been endorsed by political leaders at the G20 level; G20, 'Cannes Summit Final Declaration: Building Our Common Future: Renewed Collective Action for the Benefit of All' (4 November 2011), www.g20.org/English/Documents/PastPresidency/201512/P020151225635490988746.pdf, paras 28–29.

⁸ 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, OJ 2014 L173/190.

⁹ The period for national transposition of the BRRD expired at the end of 2014 (although many Member States failed to meet the deadline). However, Member States were given a discretion to postpone the entry into force of provisions implementing the BRRD's norms on the bail-in tool, which will be the focus of the present discussion, until 1 January 2016 at the latest. BRRD, Art 130(1).

¹⁰ The resolution regime's scope of application *ratione personae* is defined in BRRD, Art 1(1).

¹¹ BRRD, Arts 59–72.

¹² BRRD, Arts 37–55.

It is worth noting the BRRD also incorporates formally in the resolution regime the recapitalization of failed banks with public funds. In particular, it authorizes, in limited cases (to use the directive's wording, in the 'very extraordinary situation' of a systemic crisis¹³) and under strict conditions, the extension by national governments of two forms of public financial assistance¹⁴: the public equity support tool, whereby the state injects capital in the failed bank¹⁵; and the temporary public ownership tool, whereby the state nationalizes the failed bank.¹⁶ In this manner, the BRRD brings within the picture and regulates through binding legal provisions the conditions for bank bailouts – a type of governmental action which up till now took place on a fully *ad hoc* basis, subject only to the need to respect European state-aid norms.¹⁷

The BRRD's tools and procedures will be applied in a decentralized manner, with individual countries retaining responsibility for the resolution of their domestic banks, in accordance with the well-established principle of home-country control. For this purpose, each Member State must appoint a resolution authority to carry on resolution actions in accordance with the domestic implementing legislation implementing. This means that the 'common' SRR is subject to important national discretions (including in relation to the critical issue of the precise order of priority of claimants in a credit institution's insolvency). Within the narrower geographical confines of the euro area and its Banking Union, however, the resolution process will be unified to a much greater extent as a result of the establishment of a Single Resolution Mechanism (SRM),¹⁸ which entails a common decision-making framework for the main resolution actions, with a supranational body, the Single Resolution Board (SRB) serving as the central resolution authority.¹⁹

¹³ BRRD, Art 37(10).

¹⁴ Arts 37(10) and 56–58. In addition to these 'government stabilization tools', which may be employed in support of failed banks, the BRRD also authorizes the extension of 'extraordinary public financial support' in various forms (including by way of recapitalization with public funds) to solvent banks, if this appears necessary in order to prevent or contain a wider financial crisis; but in this case the support may only be extended to solvent banks and should be of a 'precautionary and temporary' nature. BRRD, Art 32(4).

¹⁵ BRRD, Art 57.

¹⁶ BRRD, Art 58.

¹⁷ The applicability of the Union's state-aid framework to bank bailouts was recognized unambiguously in Commission Decision 95/547/EC of 26 July 1995 giving conditional approval to the aid granted by France to the bank *Crédit Lyonnais*, OJ 1995 L308/92.

¹⁸ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ 2014 L225/1 ('SRM Regulation').

¹⁹ The SRM is supported by common financial arrangements in the form of a Single Resolution Fund (SRF) (but not by common deposit guarantee arrangements, since the system of separate national deposit-guarantee schemes continues). However, the SRM does not lead to full unification of the resolution process, since the euro area's national resolution authorities retain certain responsibilities within the system, while the implementation of resolution action continues to be conducted in accordance to the national legal provisions applicable to each bank by reason of its nationality.

The BRRD enumerates four resolution tools, which the resolution authorities must be able to utilize separately or in combination: the sale of business tool, the bridge institution tool, the asset separation tool and, last but not least, the so-called 'bail-in' tool.²⁰ The sale of business tool permits the forcible transfer to a third-party acquirer, by way of a sale conducted on commercial terms, either of the ownership of the failing bank's legal person or of its ongoing business in whole or in part (including assets and rights as well as liabilities).²¹ The transfer is decided by the resolution authority without obtaining the consent of the failing bank's existing shareholders or any other stakeholder, and without complying with any procedural requirements under company or securities law,²² thus avoiding delays and, most importantly, strategic behaviour on the part of the old stakeholders, who might otherwise withhold their consent as a means of exerting pressure for an alternative offer that would be more advantageous to themselves. Where an appropriate acquirer cannot be found immediately, the bridge institution tool²³ enables the resolution authority to transfer ownership either over the failing bank itself or of the whole or part of its business to a special institution operating under the resolution authority's own control, so as to ensure continuity of operation and maintain critical functions pending a final retransfer of the bank or its assets to the private sector. Whenever either of these tools is used to transfer only part of the failed bank's business (as will often be the case), the old legal person with its residual estate must be wound up by way of normal insolvency proceedings.²⁴ As for the asset separation tool,²⁵ this can be used only jointly with (and effectively, in support of) another resolution tool. The asset separation tool is designed to avoid an immediate forced sale of the failed bank's portfolio of impaired assets, which may cause grave further losses; instead, the substandard portfolio is transferred to an asset management vehicle, which will seek to maximize its overall liquidation value through an orderly realization or collection process (which may include the runoff of the portfolio).

The BRRD's fourth and final resolution tool, the bail-in tool,²⁶ empowers the resolution authorities to force a failing or failed bank's immediate stakeholders (specifically, its

²⁰ BRRD, Art 37(3)–(5).

²¹ BRRD, Arts 38–39.

²² BRRD, Art 38(1), second subpara.

²³ BRRD, Arts 40–41.

²⁴ BRRD, Art 37(6).

²⁵ BRRD, Art 42.

²⁶ BRRD, Arts 43–55. For early legal commentary on bail-in (including the provisions of the draft and final BRRD), see: Simon Gleeson, 'Legal Aspects of Bank Bail-Ins', *LSE Financial Markets Group Special Paper* No. 205 (January 2012); Seraina Neva Grünewald, *The Resolution of Cross-Border Banking Crises in the European Union: A Legal Study from the Perspective of Burden Sharing* (Alphen aan den Rijn: Wolters Kluwer, 2014), at 42–45; Dirk H Bliesener, 'Legal Problems of Bail-ins under the EU's Proposed Recovery and Resolution Directive', Andreas Dombret and Patrick S. Kenadjian (eds), *The Bank Recovery and Resolution Directive: Europe's Solution for 'Too Big To Fail'?* (Berlin & Boston: De Gruyter, 2013), 189–227; Patrick S Kenadjian, 'CoCos and Bail-Ins', in Dombret and Kenadjian, op. cit., 229–257; and Bart PM Joosen, 'Bail In Mechanisms in the Bank Recovery and Resolution Directive', paper presented at the Netherlands Association for Comparative and International Insolvency Law Annual Conference (6 November 2014), ssrn.com/abstract=2511886.

shareholders and certain, but not all, creditors) to contribute to the financial cost of resolution through a write down or conversion of their claims against the bank. Bail-in is thus designed to provide an innovative and drastic response to the problem of resolution financing. At the same time, it is meant to strengthen market discipline by abolishing the public subsidy that banks' stakeholders enjoyed in the past as a result of bailouts.²⁷

Beyond the BRRD, a full appreciation of bail-in and its precise role in European resolution policy would require an examination of three other European legal instruments, namely, the Commission's communication of 2013 on state-aid measures in support of banks,²⁸ and, in so far as the Banking Union is concerned, the SRM Regulation²⁹ and the ESM's DRI Guideline.³⁰ These instruments set relevant parameters, in particular with regard to the interrelationship between bail-in and the potential financing contributions of industry-funded resolution funds, on the one hand, and of states in the form of the government financial stabilisation tools envisaged by the BRRD, on the other hand. They are of little relevance, however, for the topics of the present discussion, which is not intended to provide a detailed presentation of the provisions of European law affecting bail-in.³¹

For the same reason, the discussion will also eschew, among other things, any analysis of the formidable technical difficulties that the application of bail-in in relation to domestic and, especially, cross-border banking groups might involve – a particularly significant issue, since almost all systemically important banks are organized as groups of companies rather than as single-entity credit institutions.³² It will, instead, be restricted to highlighting certain general aspects of the new tool, namely:

²⁷ Other provisions of the BRRD seek to restore discipline by expelling the key decision-makers of the failed bank from its surviving part or successor entity. Thus, the commencement of resolution actions triggers the removal of the old board of directors and senior managers, unless their retention is considered necessary for the achievement of the resolution objectives; and the resolution authorities can exercise control over the institution under resolution with all the powers of its shareholders and management body. BRRD, Arts 34(1)(c) and 63(1)(b).

²⁸ During the Global Financial Crisis, the requirement for prior approval of the state-aid element inherent in any bailout turned the Commission's Directorate-General for Competition into the key arbiter of national bank-rescue programmes. It also led to the adoption by the Commission of a series of communications, setting out its general policy for the evaluation of proposed state-aid measures relating to the banking sector. The matter is currently governed by the seventh such communication, which was issued in July 2013. '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), OJ 2013 C216/1.

²⁹ In particular, SRM Regulation, Arts 12, 17, 18(6), 20, 22(2), 27 and 76(1).

³⁰ ESM, 'Guideline on Financial Assistance for the Direct Recapitalisation of Institutions' (8 December 2014).

³¹ On the relationship between the BRRD and the other three instruments, see René Smits, 'Is My Money Safe at European Banks? Reflections on the "Bail-In" Provisions in Recent EU Legal Texts', (2014) 9 *Capital Markets Law Journal* 137–156; and Stefano Micossi, Ginevra Bruzzone and Miriam Cassella, 'Bail-in Provisions in State Aid and Resolution Procedures: Are They Consistent with Systemic Stability?', *CEPS Policy Brief* No 318 (21 May 2014).

³² See Federico Lupo-Pasini and Ross P. Buckle, 'International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects', (2015) 16 *European Business Organization Law Review* 203–226.

- the underlying philosophy of bail-in and its relation to standard theories of insolvency law (section 3);
- the limited and potentially discretionary scope of bail-in as operationalized in the BRRD (section 4);
- the tension between the bail-in tool and the protection of stakeholders' rights in accordance with general principles of insolvency law (section 5); and
- the implausibility of the claim that bail-in will relegate discretionary bank bailouts to the ash heap of history, as some people seem to think (section 6).

3. Bail-in from an insolvency-law perspective

Up to a certain point, the introduction of special norms of bank insolvency law can be justified on merely technical grounds. In other words, even if one assumes that bank insolvency shares the same objectives and principles with the general system of corporate insolvency, the unique characteristics of banking institutions arguably necessitate different procedural solutions.³³ Thus, the collective proceedings of general corporate insolvency may be unsuitable for the handling of bank failures due to their exceedingly long time frame and procedural strictures. Moreover, being court-based, they do not provide opportunities for cross-border coordination, as necessary for handling effectively the failure of an international bank. And they certainly render redundant the prior planning of recovery and resolution actions on the part of regulators, since there can be no certainty that, following failure, the insolvency court will give effect to their plans.³⁴ From this angle, an SRR can be seen a superior means of achieving in the banking field usual objectives of insolvency law, such as ensuring an orderly approach and and/or maximizing the value of the insolvent estate for the benefit of existing creditors.

According to the dominant theory of insolvency law, the creditors' bargain theory,³⁵ the institutions of insolvency provide a solution to collective action problems, which are inherent in the creditors' attempts to realize the common pool of assets of the insolvent estate. The collective proceedings seek, in particular, to prevent a value-destroying race for

³³ See, eg, Eva Hüpkes, 'Insolvency: Why a Special Regime for Banks?', in *IMF Legal Department, Current Developments in Monetary and Financial Law*, Vol 3 (Washington, DC: International Monetary Fund, 2005); Tobias MC Asser, *Legal Aspects of Regulatory Treatment of Banks in Distress* (Washington, DC: IMF, 2001), 94–118, 155–166; and IMF and World Bank, 'An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency' (17 April 2009), 18–19.

³⁴ Paul Tucker, 'The Resolution of Financial Institutions without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations', paper presented at the European Summer Symposium in Economic Theory, Gerzensee, Switzerland (3 July 2014), www.cepr.org/sites/default/files/events/papers/6708_TUCKER%20Essay.pdf, at 4–5.

³⁵ Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain', (1982) 91 *Yale Law Journal* 857; Douglas G Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy', (1984) 51 *University of Chicago Law Review* 97–130; Thomas H Jackson, *Logic and Limits of Bankruptcy* (Cambridge, Mass.: Harvard University Press, 1986). See also the contributions in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge: Cambridge University Press, 1996), esp. Pt II.

the assets between the individual creditors. The same logic applies to certain closely related pre-insolvency procedures for the reorganization of distressed enterprises through the restructuring of their obligations (such as voluntary schemes of arrangement) when these can achieve restructuring on the basis of (super)majority voting, thus overriding opportunistic holding out by particular creditors.

Of course, SRRs do not abandon the objective of estate-value maximization, which in many cases is achieved more effectively through going-concern reorganization of the existing legal person and, when this does not work, through its orderly liquidation, which may the separation and sale of its viable parts as operating units. This, indeed, is one purpose of 'open bank' resolution. Techniques of open-bank resolution essentially identical to those set out in the BRRD –that is, 'purchase and assumption' ('P&A') transactions analogous to the sale of business tool, bridge banks and 'bad banks', which in in the BRRD go under the 'asset separation' moniker– have been used for some time in the US and to a lesser extent elsewhere, including with a view to maximize value by avoiding piecemeal liquidation and preserving the failed banks' franchise value. The maximization of the failed bank's estate value may also serve to contain the losses of the relevant deposit insurer, who may thus choose to support financially the open-bank solution as the 'least costly' alternative. But these considerations are still compatible with the basic understandings of general corporate insolvency and its orientation towards the protection of private rights and interests.

This, however, is not the whole story. SRRs –at least those of recent vintage, such as the BRRD– are not confined to offering technically superior solutions to the problems of insolvency law. They have much wider, public objectives, which shift drastically the focus from the balancing of stakeholders' interests to the systemic implications of bank failure (that is, on an externality). Thus, as we have seen, their primary objectives are the protection of financial stability and the uninterrupted provision of critical credit and payment services to the economy.³⁶ Significantly, to achieve these objectives, SRRs are willing to bypass or disregard basic assumptions and limitations of the general insolvency system. This tendency is more pronounced in the case of the bail-in tool than of the BRRD's other resolution tools. The latter take for granted the funding structure of the failed bank and respect the form of the various stakeholders' claims. In contrast, the way in which bail-in operates marks a rather decisive departure from the private law's common assumptions regarding the respective roles of shareholders and debtholders in a distressed business enterprise. In this sense, bail-in has unusual, and very interesting, implications from the viewpoint of private rights and their articulation in insolvency law.

Keeping a loss-making bank, with potentially negative net worth, going will typically require an injection of new funds. As already discussed (section 1), traditionally this could be achieved only voluntarily or by means of a publicly financed bailout; but the Global Financial Crisis has proven conclusively that bank bailouts, in addition to their other defects, can have disastrous fiscal consequences. As a result, the search for alternative solutions to the problem of resolution financing has become a top policy concern.

The bail-in tool responds to this concern in a novel and ambitious way.³⁷ It seeks to return

³⁶ cf BRRD, Art 31(2).

³⁷ On the general case for bail-in and the specification of preconditions for its successful application, see Jianping Zhou, Virginia Rutledge, Wouter Bossu, Marc Dobler, Nadege Jassaud and Michael

the failed bank, or its surviving part, to full solvency and financial viability³⁸ without recourse to outside funding. For this purpose, it combines in a distinctive mix three distinct ideas: the internalization of the costs of failure by stakeholders; the mandatory aspect of liquidation; and the drastic financial restructuring of the distressed enterprise. All of these can be found in general corporate insolvency law and/or pre-insolvency reorganization proceedings, but the second and the third do not normally coalesce.

The mandatory write down or conversion of claims could be interpreted as a method for allocating to the failed bank's existing stakeholders past losses, despite the fact that the bank has escaped liquidation. From this perspective, bail-in would signify banking's renewed subjection to normal budgetary constraints and market discipline.

Seen as a form of reorganization proceedings, however, the mandatory character of bail-in has another function. It is designed to resolve the problem arising from the strategic behavior of stakeholders of failed banks (the shareholders, debtholders and, less directly, the directors, who can control corporate actions) as against the state, representing the taxpayers and the economy at large. When the stakeholders can reasonably expect that the state will be forced, or simply inclined, to provide support for reasons of systemic stability (or even for other reasons, e.g. political), they have an incentive to hold out, vetoing (or obstructing procedurally, if in control of the proceedings) the proposed reorganization plans, up to the point where they receive some benefit which improves their position substantially. The stakeholders become effective veto players who seek to gain a rent from the public in return for their consent; they thus manage to externalize their losses, occasionally in full, through a complete bailout.³⁹ Bail-in, being administration-based and mandatory, removes the veto power of stakeholders. Holding out is no longer possible – at least, not in a direct, procedural sense. There is no possibility for strategic behavior. Thus, bail-in allocates losses authoritatively to the stakeholders and impedes the externalization of burdens to taxpayers. In this way, it simultaneously serves two purposes: the protection of fiscal interests; and the restoration of market discipline.

Less commonly discussed is the fact that bail-in seeks to provide a solution to a problem unconnected to the bailout debate, namely, the sufficiency of reorganization exercise. For a failed bank to survive as a viable entity, the absorption of past losses is not sufficient. To

Moore, 'From Bail-out to Bail-in: Mandatory Debt and Restructuring of Systemic Financial Institutions', *IMF Staff Discussion Note* No SDN/12/03 (24 April 2012). For a rather sceptical approach, see Emiliios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins', (2015) 1 *Journal of Financial Regulation* 3–29.

³⁸ Evidently, in order to survive as an operating entity, in addition to its financial restructuring, the failed bank will also need to take steps to correct flaws in its organization and business practices, so as to avoid a repetition of past mistakes and a reversion to its previous loss-making condition. Accordingly, the BRRD provides that, when bail-in leads to the old legal person's recapitalization, this must draw (within one month) and, following official approval, implement a suitable business reorganization plan. The resolution authority may appoint one or more persons for this purpose. The reorganization plan must be compatible with the restructuring plan submitted by the institution to the Commission for state-aid purposes. BRRD, Arts 51–52.

³⁹ See Rolf de Weijs, 'Too Big to Fail as a Game of Chicken with the State: What Insolvency Law Theory Has to Say About TBTF and Vice Versa', (2013) 14 *European Business Organization Law Review* 201–224.

retain the confidence of the market and be able to resume normal business activity, it must further display a relatively high level of capitalization. This will also be necessary in order to meet its regulatory requirements. For this reason, bail-in is not limited to the absorption of past losses, but is also applied to recapitalize forcibly the institution, marshalling for this purpose liability holders' resources which are converted into equity. Note that such conversion may provide the only means of rebalancing the books and raising new private capital in the adverse environment of a systemic crisis, when external demand for new issues of capital instruments may be exceptionally weak. Bail-in is thus functionally equivalent to a US-style prepackaged bankruptcy, through which the lawful continuation of the banking business becomes possible following financial restructuring, thus avoiding a value-destructing piecemeal liquidation. The difference is that bail-in is externally mandated and does not require the majority consent of the classes of liability holders affected thereby. It is an effective method for avoiding the technical constraints of the general company and insolvency law; but to the extent that it ignores the normal principles of insolvency law, it is bound issues regarding the protection of private rights (a point discussed in section 5).

The contribution of shareholders and eligible liability holders can be achieved either through a write-down of their claims or through the conversion of claims or debt instruments into equity either in the existing legal entity or in a bridge bank. Technically, in the BRRD's scheme the authorities' power to write down or convert capital instruments (meaning equity and any other instruments included in the definition of own funds,⁴⁰ some of which may be issued in the form of debt claims, e.g. perpetual and subordinated bonds) is treated separately⁴¹ from the bail-in tool, that is, the power to write down or convert into equity the bank's liabilities.⁴² But this is only due to the fact that the former power, but not the latter, can also be exercised by the resolution authorities without formally placing the ailing bank in resolution⁴³ – effectively, as an alternative, pre-insolvency intervention. Otherwise, however, it is almost impossible to treat the power to write down or convert capital instruments separately from bail-in, and 'bail-in' will be used in the present discussion as a short form for the exercise of either power.

It is envisaged that the bail-in tool will play a prominent role in future resolution actions. Any external contribution to the financing of resolution actions, whether this is ultimately borne by the private sector or by the state, should follow bail-in, in accordance with a prescriptive financing cascade. Specifically, under the BRRD's resolution regime:

- Whenever a bank fails, the possibility of liquidation (a procedure which does not raise external financing issue) must first be considered. The BRRD emphasizes the 'exceptional' character of resolution actions: an insolvent bank should normally be wound up by way of normal insolvency proceedings; it should be maintained as a going concern through the exercise of resolution powers and the application of resolution

⁴⁰ 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, OJ 2013 L176/1 ('CRR'), Arts 25–91.

⁴¹ BRRD, Arts 59–62.

⁴² BRRD, Arts 43–55.

⁴³ BRRD, Art 59(1).

tools only if this appears advisable for financial stability purposes.⁴⁴

- If winding up is inadvisable for reasons of systemic stability, the failed bank's resolution (involving its continuation as a going-concern, whether as a whole or in part, and whether by retaining the old legal entity, through a merger with another entity or through a bridge bank) must be financed to the extent possible from private sources, both internal (existing stakeholders of the bank) and external (willing acquirers and/or investors of new capital).
- In particular, existing stakeholders – namely, shareholders, junior creditors and, depending on the circumstances, even senior creditors and depositors with deposits in excess of the guaranteed amount of € 100,000 – are required to contribute to the absorption of past losses, as well as to the recapitalization of the open bank to a level sufficient to satisfy its minimum conditions for authorization, through the write down of their equity and debt claims and/or the conversion of debt claims into equity (application of the bail-in tool).⁴⁵ The extent of write-down or conversion of claims will depend on the circumstances, but for each category of creditor included in the bail-in an upper limit is set by the principle that 'no creditor shall incur greater losses than would have been incurred if the [bank ...] had been wound up under normal insolvency proceedings' ('no creditor worse off' or 'NCWO' principle).⁴⁶
- In this context, the relevant national deposit-guarantee scheme ('DGS') (a mechanism funded through levies on the banking industry, thus also a 'private' source in a restricted sense) may be required to contribute to the financing of a member bank's resolution. However, its participation to open-bank resolution financing is limited to the amounts that it would be required to pay out to covered depositors, if the bank in question had been wound up under normal insolvency proceedings.⁴⁷ Thus, the NCWO principle applies to the DGS's participation in similar manner as to creditors whose claims are included in the bail-in.
- If the contributions of private parties are not enough, the appropriate national resolution fund or, for the countries of the Banking Union, the SRM's Single Resolution Fund (once more, a mechanism which is funded by the banking industry, therefore from a financing perspective as 'private' as the DGS) can make a contribution, subject to strict conditions and up to a specific limit. Thus, the relevant resolution fund can only step in after a contribution amounting to no less than 8% of total liabilities (that is, liabilities including own funds) has been made by stakeholders other than covered depositors by way of bail-in.⁴⁸ In addition, the intervention is limited to medium-term

⁴⁴ BRRD, rec (45)–(46).

⁴⁵ BRRD, Arts 43(2)–(3), 44(1)–(3), 46–50.

⁴⁶ BRRD, Arts 34(1)(g) and 74–75.

⁴⁷ BRRD, Art 109.

⁴⁸ BRRD, Arts 37(10)(a), 44(5)(a) and 44(8)(a); SRM Regulation, Art 27(7)(a). The 8% minimum ratio cannot include reductions in own funds reflecting historical losses, if these had been made prior to the bank's valuation for the purposes of the resolution process; ????.

financing of no more than 5% of total liabilities.⁴⁹

- If a bank remains undercapitalized even after all the aforementioned sources of resolution financing have been exhausted (either because they were depleted, or because the limits on their contribution were reached), but its continuation as a going concern appears imperative for reasons of systemic stability, recapitalization with public funds (whether national or pan-European) may be considered.

While the resolution authorities have discretion to select the most appropriate method of resolution and to apply any of the resolution tools set out, the BRRD does not afford discretion as to the application of the burden-sharing cascade.⁵⁰ Accordingly, assuming that the legal prescriptions will be applied faithfully *ex post*, especially at a time of crisis, the cascade shifts the bulk of the burden from the taxpayer to the banks themselves, along with their investors and creditors.

4. Ambiguities and discretionary elements of bail-in in the BRRD

The principle of bail-in in the BRRD –just like the overall burden-sharing cascade– appears to be highly prescriptive, but the reality may prove to be more nuanced. Much may come to depend on the specific circumstances of each case. This is a typical characteristic of the BRRD and other recent SRRs, whose very detailed legal frameworks are not necessarily intended to establish hard rules or prescribe with precision the final outcomes of resolution actions, but to structure discretion and standardize the procedural framework by establishing the decision-making order and relevant considerations for official actions, while leaving substantial room to the relevant official decision-makers for *ex post* variation of the substantive choices.

Thus, the modalities of the bail-in tool in the BRRD set significant limits to its scope. They also introduce significant discretionary elements, which place in question its automaticity and uniformity of application. Of special interest in this context are: the order of priority of claims in bail-in (that is, the sequence of write-down and conversion of various instruments); the exclusion from bail-in of certain liabilities, sometimes in general terms, but on other occasions on a discretionary, *ex post* basis; and the method of protection of the economic rights of a failed bank's existing stakeholders.

To start with, the sequence of write down and/or conversion of claims in bail-in⁵¹ largely respects the order of priority in insolvency (that is, follows the reverse order, moving from more junior to more senior instruments). Thus, capital instruments and eligible liabilities may be written down or converted in the following order:

- write down of Common Equity Tier 1 items (including shares which have been issued as a result of the conversion of contingent convertible bonds, or 'CoCos', in accordance with their contractual terms, with such conversion taking place prior to the write down);
- reduction through write down or conversion of the principal amount of Additional Tier 1 instruments 'to the extent required and to the extent of their capacity';

⁴⁹ BRRD, Arts 44(5)(b) and 44(7).

⁵⁰ This also applies to the resolution actions of the Banking Union's SRM.

⁵¹ BRRD, Art 48(1).

- reduction of the principal amount of Tier 2 instruments ‘to the extent required and to the extent of their capacity’;
- reduction to the extent required of principal amount of subordinated debt that does not count as Additional Tier 1 or Tier 2 capital; and finally,
- reduction to the extent required of the principal amount of, or outstanding amount payable in respect of, the rest of eligible liabilities, in accordance with the hierarchy of claims in normal insolvency proceedings, including the new preferred rankings⁵² of DGS-covered and non-covered retail deposits.

Within each class, losses must be allocated equally, by reducing the principal amount *pro rata*.⁵³ Resolution authorities may apply different rates of conversion of debt to equity to different classes of capital instruments and liabilities. However, the conversion rates must be set so as to provide appropriate compensation to the affected creditor; and in any event, the conversion rate applicable to senior liabilities must be higher than that applicable to subordinated liabilities.⁵⁴ The provisions also require that one class of liabilities may not be converted as long as another class that is subordinated to it remains substantially unconverted into equity or not written down.⁵⁵ Interestingly, however, the relevant qualification is ‘substantially’, rather than ‘completely’, as one should expect in accordance with the absolute priority rule of insolvency law. To increase certainty and uniformity of application, the European Banking Authority (EBA) is empowered to issue guidelines on certain aspects of the process, including the treatment of capital instruments and the setting of rates of conversion of debt instruments into equity.⁵⁶

Importantly, of a failed bank’s liabilities, not all are bail-inable. Certain critical provisions of the BRRD⁵⁷ exclude for bail-in, and thus protect from the normal course of loss-absorption in accordance to the insolvency rankings, broad classes of liabilities. The BRRD mandates the exclusion of particular types of liability categorically. Other liabilities, whose contractual or transactional nature is not specified in the directive, may be exempted from bail-in on a discretionary basis *ex post*, that is, at the time of resolution, by the relevant resolution authority.

The BRRD-mandated exclusions⁵⁸ of Art 44(2) include:

⁵² BRRD, Art 108.

⁵³ BRRD, Art 48(2).

⁵⁴ BRRD, Art 50.

⁵⁵ BRRD, Art 48(5).

⁵⁶ BRRD, Arts 47(6), 48(6), 50(4). See currently the following EBA documents: ‘Consultation Paper: Draft Guidelines on the Treatment of Shareholders in Bail-in or the Write-Down and Conversion of Capital Instruments’ (EBA/CP/2014/40), 11 November 2014); ‘Consultation Paper: Draft Guidelines on the Rate of Conversion of Debt to Equity in Bail-in’ (EBA/CP/2014/39, 11 November 2014); and ‘Consultation Paper: Draft Guidelines Concerning the Interrelationship between the BRRD Sequence of Writedown and Conversion and CRR/CRD IV’ (EBA/CP/2014/29, 1 October 2014), clarifying the interrelationship between the sequence in which liabilities should be written down or converted and the structure of own fund instruments in the CRR.

⁵⁷ BRRD, Art 44(2)–(3).

⁵⁸ BRRD, Art 44(2).

- DGS-covered deposits;
- all secured liabilities, including covered bonds;
- client assets or client money, including assets or money held on behalf of undertakings for collective investments in transferable securities (UCITS) or alternative investment funds (AIFs), but only if these clients are protected under national insolvency law;
- liabilities arising by virtue of a fiduciary relationship, but only if the beneficiary is protected under national insolvency or civil law;
- interbank liabilities, excluding claims of entities within the same group, with an original maturity of less than seven days;
- claims to trading systems and their operators arising from the participation in such systems with a remaining maturity of less than seven days;
- claims of employees in relation to accrued salary, pension benefits or other fixed remuneration;
- claims of commercial or trade creditors arising from the provision to the bank of goods or services that are critical to the daily functioning of its operations;
- tax and social security liabilities, if these are preferred under national law; and
- liabilities resulting from contributions to deposit guarantee schemes.

To these mandatory exclusions may be added certain discretionary ones. Thus, in so-called ‘exceptional circumstances’, the national resolution authorities may decide to exclude totally or partially certain liabilities from bail-in if:

- it is not possible to bail-in such liabilities within a reasonable time notwithstanding the good faith efforts of the resolution authority,
- the exclusion is strictly necessary and proportionate to achieve the continuity of the bank’s critical functions and core business lines,
- ‘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’, or
- bail-in such liabilities would be value-destroying, thus imposing even higher losses on other creditors.⁵⁹

In the event of a discretionary exclusion on such grounds, the level of write down or conversion applied to other eligible liabilities may be increased, subject to the NCWO safeguard.⁶⁰

It should be noted that it is precisely because of exclusions (whether mandatory or discretionary) that a need for external resolution financing may arise. The exclusions deplete the pool of resources available for loss absorption and recapitalization, while leaving an increased volume of liabilities behind. If all capital instruments and liabilities were fully subject to bail-in in accordance to their ranking, there would never be need for external financing, because the pool of liabilities would be allowed to disappear to the degree necessary for ensuring a full absorption and internalization of losses. Liability holders would be treated in roughly the same way as in a normal liquidation. At the limit, old

⁵⁹ BRRD, Art 44(3).

⁶⁰ BRRD, Art 44(3), second subpara.

shareholders would be totally eliminated, while the former liability holders would be left, in strict accordance to their order of priority, with claims over a residual pool of assets – the equivalent of the dividend that they would receive in insolvency, albeit in non-monetized form. Of course, so robust an approach would be inconsistent with the public objectives of resolution. In a sufficiently deep insolvency, the old deposit-taking intermediary would have effectively disappeared. And resolution might have taken place in an orderly manner, but it could not achieve its stabilization and financial continuity objectives. In this sense, the protection of a large volume of claims is both a limit to bail-in and a condition for the successful completion of the resolution process.

Still, the fact of the matter is that exclusions reduce the potency of bail-in as a solution to the problem of resolution financing. They can leave a funding gap, which necessitates the intervention, first of the relevant resolution fund, and then of the state. The BRRD seek to constrain reliance on these external, public sources of financing by insisting on bail-in of 8% of total liabilities, including own funds, before these other sources of funding can be called upon to contribute.

Even worse, discretionary exclusions of a potentially wide range of liabilities can turn bail-in into a largely optional tool, whose use and scope depends on the *ex post* evaluation of prevailing conditions in the financial and real economy. To constrain the discretion of national resolution authorities in this regard, the Commission is empowered to adopt delegated acts specifying the circumstances when exclusion is necessary on such grounds.⁶¹ Moreover, a discretionary exclusion requires prior notification to the Commission and, if it leads to a funding gap that will need to be filled by the relevant resolution fund, may be opposed by the latter.⁶² And the state-aid framework provides additional safeguards. However, the main issue is not one of national abuse of the system of discretionary exclusions, but the time-inconsistency of resolution policies. This affects the Commission as much as the national resolution authorities. Accordingly, the existence of discretions takes away the automaticity of bail-in and turns its applicability into an open question (to which we will return in section 6).

As for the mandatory exclusions of specified classes of liabilities, this is bound to lead to strategic behaviour on the part of credit institutions and their liability holders, thus opening an important new chapter in the history of bank funding and regulatory dynamics. In particular, banks could seek to alleviate the burden by financing themselves to a much greater extent with non-bail-inable instruments. The mandatory presence of a sufficient volume of bail-inable liabilities in banks' balance sheets is thus a prerequisite for the successful operation of bail-in.⁶³ For this purpose, the BRRD introduces a minimum requirement for own funds and eligible liabilities ('MREL').⁶⁴ The MREL obliges credit

⁶¹ BRRD, Art 44(11). See currently EBA, 'Technical Advice on the Delegated Acts on the Circumstances When Exclusions from the Bail-in Tool Are Necessary' (1 EBA/Op/2015/07, 6 March 2015).

⁶² BRRD, Art 44(12).

⁶³ At the global level, the problem is addressed by the FSB's proposal for a 'total loss-absorbing capacity', or 'TLAC', requirement. FSB, 'Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution: Consultative Document' (10 November 2014).

⁶⁴ BRRD, Art 45.

institutions to meet, at all times, a minimum amount of own funds and eligible liabilities expressed as a percentage of their total liabilities and own funds. The MREL will be set separately for each credit institution, always in view of certain general criteria, which do not include, however, a numerical minimum level or default indicator.⁶⁵ In combination, the exclusion of certain types of liabilities and the MREL may lead to a bifurcated liability structure, with banks seeking to confine the issuance of bail-inable liabilities to the level necessary for meeting their specific MREL, while for the rest they prefer to finance their activities with non-bailinable instruments.

A converse problem concerns the possibility that a high concentration of bail-inable instruments issued by a particular bank in the hands of another entity (such as a bank, financial institution, shadow bank or institutional investor) might lead to the collapse of that entity due to losses from holding the instruments, should the issuing bank fail, thus providing a channel of contagion. In order to ensure resolvability by way of bail-in without thereby engendering contagion, resolution authorities are authorized to limit the extent to which other institutions within the scope of the resolution regime, which do not belong to the same group, can hold the bail-inable liabilities of a particular institution or group.⁶⁶

5. Bail-in and stakeholders' rights

In SSRs generally, and the BRRD specifically, the public interest (including in the stabilization of the financial system and the minimization of taxpayers' exposure to direct loss or mere financial risk) can trump the stakeholders' interests, especially by overriding their legitimate expectation to receive individually the maximum possible recovery rate. The bail-in tool, in particular, raises issues of equal treatment and protection of property rights, which go to the heart of private law and, in particular, the general principles of insolvency. At a limit, the tension between discretionary but mandatory bail-in and the private rights of stakeholders may raise questions relating to the violation by the state of fundamental rights of the stakeholders.⁶⁷ At a more prosaic level, however, the application of bail-in entails unavoidably substantive conflicts with legitimate private interests of the stakeholders affected thereby, as the latter are reflected in the principles and objectives of general insolvency law, including the absolute priority rule, which requires strict respect for the order of priorities, the principle of *pari passu* satisfaction within the same class, and the expectation that insolvency proceedings must ensure the maximization of payouts to

⁶⁵ BRRD, Art 45(2) and (6). The criteria are operationalized with the help of a regulatory technical standard ('RTS'), whose final draft has already been issued by the EBA: 'EBA Final Draft Regulatory Technical Standards on Criteria for Determining the Minimum Requirement for Own Funds and Eligible Liabilities under Directive 2014/59/EU' (EBA/RTS/2015/05, 3 July 2015).

⁶⁶ BRRD, Art 44(2), fifth subpara.

⁶⁷ On potential tensions between bail-in and the right to property as enshrined in the ECHR, see Anna Gardella, Anna Gardella, 'Bail-in and the Financing of Resolution within the SRM Framework', in Danny Busch and Guido Ferrarini (eds), *European Banking Union* (Oxford: Oxford University Press, 2015), paras 11.24–11.32.

stakeholders, always according to their rank.⁶⁸

Of course, the general principles of resolution emphasize that shareholders bear first losses, adding that creditors bear losses after the shareholders in accordance with their order of priority, but recognize that this principle is bent in various cases where the Directive provides otherwise.⁶⁹ Moreover, the directive requires the 'equitable', not equal, treatment of creditors of the same class; even this is subject to exceptions.⁷⁰

The exclusion of many categories of liabilities is a significant source of tension between bail-in and private rights. In particular, the exclusions result in more lenient treatment of the liabilities covered thereby in comparison to the non-excluded ('eligible') liabilities of the same insolvency rank! This consideration applies with particular force to the *ex post* discretionary exclusion of certain liabilities. By nature, the exclusion of certain claims worsens the position of those left behind in a reduced pool of bail-inable liabilities. This violates both the *pari passu* principle and the recovery maximization objective of insolvency law. This consideration applies with lesser force to the mandatory exclusions. These may be seen as a prepublicised modification of the order of priorities, which, having been promulgated in the form of legal provisions of general applicability, determines the private investors' decision-making horizon and defines in a stable way the content of their contractual rights.⁷¹ In the special case of deposits, the BRRD re-prioritizes the relevant claims in a direct and legally unexceptionable way, by introducing new mandatory preferences in favour of DGS-covered deposits, followed by non-covered deposits from natural persons and micro, small and medium-sized enterprises.⁷²

Another tension relates to the ambiguity of the provisions governing the extent of inclusion in bail-in and relative treatment of various classes of claims.⁷³ The whole tenor of the provisions suggests that more senior claims can be written down or converted before junior ones have been extinguished completely, as the absolute priority rule would require. (Conversely, the provisions require a severe dilution of existing shareholders when bail-in is applied to a bank with positive net worth.⁷⁴ Since this may not be necessary on financial grounds, the relevant provision introduces a punitive element in an otherwise technical

⁶⁸ Such conflicts are a general trait of SRRs, due to their departure from normal insolvency norms and purely mandatory and administration-based character. See Eva Hüpkes, 'Special Bank Resolution and Shareholders' Rights: Balancing Competing Interests', (2009) 17 *Journal of Financial Regulation and Compliance* 277–301. But they acquire a particularly virulent form in the case of bail-in.

⁶⁹ BRRD, Art 34(1)(a)–(b).

⁷⁰ BRRD, Art 34(1)(f).

⁷¹ This argument is reinforced by the obligation imposed, for reasons of legal certainty, on banks to incorporate in the contractual terms of bail-inable instruments issued under the law of a third country a term whereby the holder of the instruments recognizes the bindingness of a potential decision of the resolution authorities subjecting the instruments to bail-in. BRRD, Art 55; and EBA, 'Final Report: Draft Regulatory Technical Standards on the Contractual Recognition of Write-Down and Conversion Powers under Article 55(3) of Directive 2014/59/EU' (EBA/RTS/2015/06, 3 July 2015).

⁷² BRRD, Art 108.

⁷³ BRRD, Arts 48–50. See also the relevant EBA guidelines, *supra*, note 56.

⁷⁴ BRRD, Art 47(1).

approach to burden-sharing.)

The fact that resolution can take place at a point when the bank is still solvent, aggravates in a very serious way the tension between bail-in and private rights. The trigger for resolution in the BRRD is that the institution is ‘failing or likely to fail’, and the failure cannot be avoided by resorting to alternative private sector measures or supervisory action (such as early intervention measures or the pre-resolution write down or conversion of relevant capital instruments) which could prevent the failure within a reasonable timeframe.⁷⁵ When these conditions apply, resolution action may be taken if this is necessary in the public interest.⁷⁶ However, ‘failing or likely to fail’ does not mean only actual or impending balance-sheet insolvency or inability to pay debts as they fall due, in harmony with the usual criteria insolvency law. It may also include vaguely defined situations raising the need for public financial support as well as, and more critically, situations involving the actual or impending infringement by the bank of its regulatory requirements for continuing authorisation, including the depletion of a significant amount of own funds due to operating losses.⁷⁷ The criteria are rather fluid and imprecise, but they certainly mean that the trigger for resolution can be crossed at a point well before the bank has reached the financial state of negative net worth (economic insolvency). Unfortunately, the BRRD does not include a specific numerical indicator of critical undercapitalization, to serve as a clear quantitative trigger. In any event, the early trigger raises further concerns regarding the treatment of liability holders (who at this stage may legitimately expect to get what they are due under the terms of their contracts) as well as equity holders (whose interest in the bank continues to have positive value).

The power to write down capital instruments can also be exercised as a corrective action, that is, without placing the bank in resolution.⁷⁸ In this case there is an alternative test, namely, that the institution (or its group) are no longer ‘viable’.⁷⁹ This is also set out in imprecise terms, but effectively overlaps with the trigger for resolution in the proper sense. But on this occasion too, the trigger can be pulled at a point when the institution is not insolvent.

The resolution regime seeks to alleviate concerns relating to bank stakeholders’ private rights by introducing the NCWO principle,⁸⁰ according to which ‘no creditor shall incur greater losses than would have been incurred if the institution . . . had been wound up under normal insolvency proceedings’.⁸¹ Shareholders are not explicitly mentioned, but their financial interests are also at stake and should be considered. The assumption appears

⁷⁵ BRRD, Art 32(1).

⁷⁶ BRRD, Art 32(1)(c) and (5).

⁷⁷ BRRD, Art 32(4) and (6). See also EBA, ‘Final Report: 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, 26 May 2015).

⁷⁸ BRRD, Art 59(1)(a).

⁷⁹ BRRD, Art 59(3)–(4).

⁸⁰ For detailed analysis, see Karl-Philipp Wojcik, ‘Significance and Limits of the “No Creditor Worse Off” Principle for an Effective Bail-in’, in the present volume.

⁸¹ BRRD, Art 34(1)(g).

to be that resolution will tend to increase a failed bank's total value to a considerable extent, so that, even though certain stakeholders may receive less than a full share of the difference, they will still be left better off than under the alternative scenario of insolvent liquidation. Accordingly, despite the fact the principle of equal treatment among the relevant class is not honoured in full, such stakeholders cannot be said to suffer actual harm as a result of its violation!

The NCWO principle applies to partial transfers under the other resolution tools as well as to bail-in.⁸² It requires, in particular, resolution authorities to ensure, on the basis of a valuation by an independent person, not only that the conditions for resolution (or, where applicable, a pre-resolution write down of capital instruments) exist, but also that the proposed resolution actions are appropriate and that bail-in is applied only to the necessary extent.⁸³ In addition to this prior valuation, another independent valuation must take place following the implementation of the chosen resolution action, in order to establish whether the treatment of shareholders and bailed-in creditors in resolution was different from what it would have been in the counterfactual comparative scenario of the bank's liquidation.⁸⁴ If the treatment proves to have been worse than in liquidation, there is a right to compensation (or 'safeguard'), whereby the creditors' or shareholders' excess losses are covered by the relevant resolution fund.⁸⁵ It may be asked, why it should be the resolution fund which owes the compensation, but this is not the main concern.

The fundamental ambiguity of the NCWO principle relates to the basis of comparison.⁸⁶ The BRRD mandates that the treatment of stakeholders in resolution should be compared with the liquidation value of the bank at the time of the resolution decision, rather than its value following restructuring.⁸⁷ The valuation must assume that no resolution actions would take place and that no extraordinary public financial support would be extended.⁸⁸ Worse, although this is not clearly stated, the implicit operating assumption would appear to be that the valuation must be conducted on a gone-concern and forced-sale basis (rather than on a going-concern or open-bank reorganization basis, since this is explicitly excluded, or

⁸² NCWO is a general principle governing resolution and the application of resolution tools, in accordance with BRRD, Art 34(1).

⁸³ BRRD, Arts 36 and 46. See also the relevant draft RTSs issued by the EBA: 'Consultation Paper: Draft Regulatory Technical Standards on Valuation under Directive 2014/59/EU' (EBA/CP/2014/38, 7 November 2014); 'Consultation Paper: Draft Regulatory Technical Standards on the Valuation of Derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)' (EBA/CP/2015/10, 13 May 2015); and 'Final Report: Draft Regulatory Technical Standards on Independent Valuers under Article 36(14) of Directive 2014/59/EU' (EBA/RTS/2015/07, 6 July 2015).

⁸⁴ BRRD, Art 74.

⁸⁵ BRRD, Art 75.

⁸⁶ See Phoebus Athanassiou, 'Valuation in Resolution and the "No-Creditor-Worse-Off-Principle"', (2014) 29 *Butterworths Journal of International Banking and Financial Law* 16–20; and George Jacobs and David Mitchell, 'The No-Creditor-Worse-Off Principle from a Valuation Perspective: Standing in the Shoes of a Hypothetical Liquidator', (2014) 29 *Butterworths Journal of International Banking and Financial Law* 233–235.

⁸⁷ BRRD, Art 74(2).

⁸⁸ BRRD, Art 74(3).

even a longer-term orderly liquidation basis, potentially including the managed run-off of the asset portfolio)! The question is whether this is in all cases an appropriate valuation approach. Furthermore, the evaluation is bound to depend on macroeconomic assumptions and changing market conditions. The problem of the potentially inappropriate comparator is accentuated when the bank has been placed in resolution before reaching the point of balance-sheet insolvency.

6. An end to bailouts?

Regardless of the tensions discussed above, bail-in is bound to affect the banking industry's incentive structure. However, one may doubt whether bail-in and, more generally, the new, structured approach to resolution, will mark the end of TBTF and/or bank bailouts using taxpayers' money.⁸⁹ Bailouts may become more rare than in the past, but there will still be concrete situations when they will appear to constitute the best available solution. Exactly as in the past, this is likely to be the case primarily with regard to large failures and systemic crises.

Even general corporate insolvency law will tend vacillate between an *ex ante* insistence on strict enforcement and a more lenient *ex post* perspective.⁹⁰ *Ex ante*, the law may emphasize the principles of hard budgetary constraints and strict enforcement of claims, because these optimize debtors' incentives and reinforce market discipline. *Ex post*, however, things are seen in a different light. Due to the long time-delays, informational asymmetries and high administrative and transactional costs of the liquidation process, the termination of an insolvent enterprise will frequently appear more costly and inefficient, and thus value-destroying, when compared with the alternative of its continuation as a going concern, following some sort of debt restructuring. Thus, real insolvency actions tend to relax *ex post* the budgetary constraints and to treat debtor enterprises more leniently than what would be necessary in order to eliminate moral hazard. The same shift in perspectives applies with a vengeance to bank failures – not to mention system-wide banking crises, when the incentives for forbearance are almost insurmountable! This is due to the overriding consideration that bank closures can cause exceptionally strong negative external effects. Of course, the resulting softening of the theoretically applicable norms creates moral hazard; but, all in all, the immediate external costs of strict enforcement may be so high (especially in the context of a systemic crisis),⁹¹ that even a benevolent public decision-maker may consider it preferable to relax the supervisory standards, and even to

⁸⁹ For economic theoretical support for bail-in, see Peter Klimek, Sebastian Poledna, J. Doyne Farmer and Stefan Thurner, 'To Bail-out or to Bail-in? Answers from an Agent-Based Model', (2015) 50 *Journal of Economic Dynamics & Control* 144–154. For empirical evidence (in the form of retrospective calculation of bail-in's potential impact on the euro area's banking crises), see Thomas Conlon and John Cotter, 'Anatomy of a Bail-in', (2014) 15 *Journal of Financial Stability* 257–263; Clara Galliani and Stefano Zedda, 'Will the Bail-in Break the Vicious Circle Between Banks and their Sovereign?', (2015) 45 *Computational Economics* 597–614.

⁹⁰ cf Matej Marinč and Razvan Vlahu, *The Economics of Bank Bankruptcy Law* (Berlin and Heidelberg: Springer, 2012), ch 2.

⁹¹ See Luc Laeven, 'Banking Crises: A Review', (2011) 3 *Annual Review of Financial Economics* 17–40, at 23–28.

use public moneys for a costly bailout.

The policy trade-off between immediate stabilization and longer-term incentives is unlikely to disappear simply because of the new resolution principles. To strictly enforce the regulatory covenants, or to tolerate slippages and even provide support to failing banks, thereby fuelling moral hazard, is a perennial dilemma of banking policy, which we cannot simply wish away.

Moreover, it is not true that the interests of taxpayers are in all cases harmed by bailouts. It is notoriously difficult to evaluate the costs of bailouts. The immediate pricetag for recapitalizing the failed banks does not tell the whole story. There are indirect costs (such as the long-term cost of reduced market discipline, or the distortions resulting from the state-financed validation of substandard past financial claims and the retention of high levels of leverage in the economy), but also substantial indirect benefits (from the financial and macroeconomic stabilizing effect), which cannot be measured with accuracy. Even in terms of direct outlays, the magnitude of the subsidy to the banking sector, as well as the taxpayers' estimated losses, will depend on the macroeconomic environment. They will be higher precisely at the point when the economy is weak and system-wide difficulties are in evidence – that is, precisely at the point at which the social costs of allowing a bank to fail will also rise. It is not uncommon for the sign of the taxpayers' investment in banks to be reversed over time, as the macroeconomic environment improves, with the potential loss from the state's participation in bank recapitalization efforts eventually turning into substantial gains, as the economy improves and the value of the recapitalized banks increases.⁹²

Time inconsistency may, more specifically, affect the actual application of the BRRD's bail-in instrument. The resolution approach in the BRRD is largely premised on the assumption that banks fail individually, one at a time. In reality, bank failures (including failures of systemically important banks) tend to occur in a context of wider economic distress. In this environment, resolvability and bail-in cannot of themselves preserve systemic stability. They can certainly render more practicable the rapid recognition and write-off of bad debts, thus facilitating immediate deleveraging. But this can hardly be achieved without second-order harmful effects. In particular, it is unrealistic to believe that, in a systemic crisis, bail-in can take place at a scale sufficient to absorb the losses and/or cover the recapitalization needs of all troubled banks simultaneously and without very serious negative side-effects. In this scenario, alternative private sources of financing will also be scarce: new private money will be no more forthcoming that it was during the recent crisis. Similar considerations apply to the individual failure of any of the system's largest banks.⁹³ In such circumstances, a publicly financed bailout continues to provide a valid policy alternative, because, even if remains

⁹² See Mathias Dewatripont, 'European Banking: Bailout, Bail-in and State Aid Control', (2014) 34 *International Journal of Industrial Organization* 37–43.

⁹³ In the Banking Union, the total pre-funded resources of the relevant DGSs and the SRF may eventually suffice for the resolution of even the largest systemically important banks, but only if these fail one-by-one, at discrete points in time. But they will be clearly insufficient for a system-wide bank recapitalization exercise. This is why the need for a publicly financed bailout cannot be ruled out. See Christos Hadjiemmanuil, 'Bank Resolution Financing in the Banking Union', London School of Economics, *LSE Law, Society and Economy Working Paper No 6/2015* (2015), ssrn.com/abstract=2575372, 35–38.

technically feasible, it may appear highly undesirable.

In short, bail-in evidently improves the overall policy mix, especially if the MREL is taken into consideration: it increases banks' financial buffers in normal times and the resources available for resolution financing at the point of failure; it introduces new restructuring possibilities by achieving simultaneously some deleveraging and recapitalization; and it precludes strategic behaviour on the part of the banks' stakeholders, thus enabling resolution officials to pursue more effectively the optimal resolution actions. *Ex post*, however, full bail-in may often prove to be unsuitable. This is why in the relevant provisions the apparent automaticity of bail-in is watered down by allowing discretionary exemptions for particular classes of liabilities.⁹⁴

As for bail-in's impact on market discipline, it should be observed that the latter depends less on the internal legal articulation of the formal resolution regime and more on predictions about the state's future response to a crisis. If the assumption is that bailouts are unlikely to disappear completely, bail-in may lead to generally reduced, and possibly less linear, *ex ante* values for the bailout subsidy, that is, to higher, and more properly priced, funding costs for banks,⁹⁵ but not to a full correction.⁹⁶ Moreover, the likelihood of a bailout, and with it the estimated value of the subsidy, will be neither the same for all banks, nor immutable over time, but will be likely to increase with a bank's size and, primarily, with the deteriorating macro-environment. And in any event, market discipline will continue not to apply to the various categories of protected ('excluded') creditors.

Taken by itself, then, bail-in may have a limited practical effect, leaving the general tendency of the old incentive structure largely unaffected. It may reduce substantially the likelihood of bailouts in the case of medium and small banks, but only to a lesser extent the value of the TBTF subsidy. If so, rather than removing the comparative advantage from size, it would tend to entrench it. To cancel the TBTF subsidy, the enactment of bail-in-focused resolution policies is not enough, because such policies are neither time-consistent, nor sufficiently uniform in their application and effects. For this purpose, regulatory measures which penalize size in normal times, such as structural regulations and prudential requirements whose intensity increases with size, would be necessary.

⁹⁴ BRRD, Art 43(3).

⁹⁵ On the implication of the introduction of the bail-in tool for banks' cost of funding, see Benoît Coeuré, 'The Implications of Bail-in Rules for Bank Activity and Stability', at the conference on 'Financing the Recovery after the Crisis – The Roles of Bank Profitability, Stability and Regulation', Bocconi University, Milan (30 September 2013).

⁹⁶ Strahan, 'Too Big to Fail . . .', *supra*, note 3, at 56–57, observes that markets price the specific risk of large financial firms more now than before the Global Financial Crisis; this is an indication that market perceptions of the probability of bailouts have changed (possibly also due to the insistence of recent legislative instruments on orderly resolution and bail-in). A similar conclusion is reached by Oana Toader, 'Quantifying and Explaining Implicit Public Guarantees for European Banks', (2015) 41 *International Review of Financial Analysis* 136–147, who nonetheless also points to another partial explanation, namely, the fiscal weakness of several European governments, which reduces the value of the implicit state guarantee to the liability holders of domestic banks.