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Rescuing failing banks for financial stability: The unintended outcomes of bail-in rules

By Andrea Miglionico*

Abstract

The regulatory architecture of the EU Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) introduced rules necessary to prevent financial instability and systemic risk contagion. However the restructuring tools for failing banks, namely bail-in, precautionary recapitalisation and resolving plans are largely flexible to allow Member States to adopt domestic policy measures to rescue distressed institutions. This leaves broad discretion to national competent authorities to provide public financial support, a legacy of the bail-out programmes that can undermine the new EU bank insolvency regime.

1. *Introduction*

The EU Banking Union with its articulated system of supervisory powers to the European Central Bank (ECB) and the innovative tools given by regulators to Single Resolution Mechanism (SRM) and Bank Recovery and Resolution directive (BRRD)[1] constitutes the new regulatory framework of bank insolvency regime.[2] The SRM is structured into a centralized resolution authority (Single Resolution Board) and a Single Bank Resolution Fund which provides mutualized private financing of bank resolution tools. In terms of supervision, the 'Single Supervisory Mechanism' (SSM) put the ECB directly in charge as the supervisor for the largest Eurozone banking institutions.[3] The ECB also has the right to oversight smaller Eurozone banks that it does not supervise directly: in substance, the ECB is the direct supervisor of the large cross-border banks

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[1] EU Bank Recovery and Resolution Directive (BRRD), Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014. These resolution tools require the 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 L 173 of 12 June 2014, p. 190.

[2] The Single Supervisory Mechanism (SSM) has been established by Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287 of 29 October 2013, p. 63. The Single Resolution Mechanism (SRM) has been introduced by 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 L 225 of 30 July 2014, p. 1.

[3] The SSM is composed of the ECB and the national competent authorities, with the ECB in charge of its effective and consistent functioning (Article 6.1). The scope of application of the SSM Regulation comprises all Euro area Member States on a compulsory basis and also non-euro area Member States that voluntarily enter into a 'close cooperation' with the ECB (Article 7). The SSM Regulation confers 'specific tasks' related to the prudential supervision of credit institutions to the ECB. See Commission release Statement/14/77, 20 March 2014.

for the entire Eurozone banking system.[4]

Bail-in is a key resolution instrument in the BRRD and in the SRM: the rationale is to provide a mechanism to return an insufficiently solvent bank to 'balance sheet stability' at the expense of some of its creditors without the necessity for external capital injection. Along the bail-in mechanism, the BRRD provides the precautionary recapitalisation for 'non-insolvent banks' that experience distressed scenario. Recapitalisation could preserve financial stability—as a remedy to cover losses for failing banks—in the case of a rescue plan with strict conditionally guaranteed by a pool of investment banks. Recapitalisation aims to give the bank a new positive outlook for profitability with the injection of new capital although it can be interpreted as a sort of temporary public financial assistance.[5] If the equity capital increase fails, the failing bank could need to resort to State aid, which in turn would likely result in the write-down or conversion of the bank's subordinated debt. The recent episodes of bank failures (Venetian banks, Banco Popular Español S.A., Banco Espírito Santo and Pireus Bank) are cases in point to demonstrate the applicability of bail-in rules to protect national interests. On this view, Avgouleas and Goodhart argue that the 'bail-in regimes will fail to eradicate the need for an injection of public funds where there is a threat of systemic collapse, because a number of banks have simultaneously entered into difficulties, or in the event of the failure of a large complex cross-border bank, except in those cases where failure was clearly idiosyncratic'.[6] Since the BRRD leaves broad discretion to national authorities to adopt domestic policy measures to rescue failing banks, it is difficult to clear up the legacy of bail-out intervention.

This article argues that the new regulatory architecture for failing banks raises doubt about the effectiveness of restructuring tools introduced in the EU bank insolvency regime. The provisions on bail-in and precautionary recapitalisation show how credit institutions rely on national supervision and public financial support. As Donnelly noted, 'Banking Union still relies significantly on national rather than European administrative and financial resources to ensure local financial stability, so that resilience remains asymmetric'.[7] It can be observed that an international insolvency regime should address fruitfully these issues establishing a common regulatory toolkit resulting

[4] Eilís Ferran and Valia Babis, 'The European Single Supervisory Mechanism' (2013) 13(2) *Journal of Corporate Law Studies*, 255. The authors note that 'designing the SSM has been an exercise in sophisticated legal gymnastics to fit within the existing Treaty framework, as well as high stakes political manoeuvring and pragmatic decision-making'.

[5] Communication on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (Recapitalization Communication) OJ C 10, 15.1.2009.

[6] E. Avgouleas and C. A Goodhart, 'A Critical Evaluation of Bail-in as a Bank Recapitalisation Mechanism', Centre for Economic Policy Research, Discussion Paper No. 10065, July 2014, 19-21.

[7] Shawn Donnelly, 'Liberal economic nationalism, financial stability, and Commission leniency in Banking Union' (2017) 21(2) *Journal of Economic Policy Reform*, 170.

from the different models.[8] The next section discusses the BRRD regime and the role of the SRM for distressed banks: the resolution tools, i.e. bail-in and precautionary recapitalisation are addressed in light of the recourse to public financial support. Section three considers the case of Banca Monte dei Paschi di Siena (MPS) in relation to the recapitalisation issue. Section four examines the impact of non-performing loans (NPLs) on bank restructuring and provides an analysis of the regulatory developments on non-performing exposures (NPEs). On this view, section five underlines the quest for public interest in rescuing distressed credit institutions as the EU regulators allow Member States to adopt taxpayers funded bailout and State aid measures. This undermines the effectiveness of banking union framework and it can be seen as a circumvention of bail-in rules. The last section concludes.

2. *The BRRD and the SRM regime for distressed banks*

The BRRD and the SRM introduced a considerable set of resolution tools for application in all Member States and significantly reinforced the regime for cross-border cooperation within the EU.[9] The ECB is the competent authority responsible for supervising failing banks and works in relationship with other authorities, namely the European Commission and national central banks. The BRRD and SRM for Eurozone banks provide a regulatory framework for the resolution of banks that requires senior creditors to participate in losses, if necessary, instead of or ahead of a bank receiving sovereign support.[10] As a rule, group resolution efforts are to be coordinated by the consolidated group-level resolution authority, with only limited scope for independent resolution action by national resolution authorities for individual group companies.[11]

The BRRD contains legal provisions on loss absorbency in the form of bail-in of shareholders, creditors and, if necessary, depositors not protected by law (deposits more than €100,000) up to a maximum of eight percent of the institution's total assets, which in the past would have covered all eventualities.[12] The resolution authorities can decide to sell the bank as a going concern, create a bridge institution, hive off assets, bail-in creditors and adopt precautionary recapitalisation in a form

[8] Matthias Lehmann, 'Bail-In and Private International Law: How to Make Bank Resolution Measures Effective Across Borders' (2017) 66(1) *International & Comparative Law Quarterly* 108.

[9] See BRRD, Titles V (on "Cross-border Group Resolution" within the EU) and VI (on "Relations with Third Countries").

[10] It is important to note that covered bonds are exempt from bail-in under BRRD and may benefit from resolution tools.

[11] Jens-Hinrich Binder, 'To Ring-Fence or Not, and How? Strategic Questions for Post-Crisis Banking Reform in Europe' (December 2014) available at: http://ssrn.com/abstract=2543860. See generally BRRD, articles 87 (general principles), 88 (resolution colleges), 91 and 92 (procedural and substantive requirements for resolution action in relation to groups). On the conditions for independent action by host authorities in this context, see articles 91(8) and 92(4).

[12] Ioannis Kokkoris and Rodrigo Olivares-Caminal, 'Resolution of Banks and the State Aid Regime' in Jens-Hinrich Binder and Dalvinder Singh (eds.), *Bank Resolution: The European Regime* (OUP: Oxford University Press 2016) 304-305.

of private bail-in or recourse to public support in a form of State aid. In addition, all member States must set up national resolution funds with resources which after ten years must amount to one percent of insured deposits.[13] The BRRD regulates recovery and resolution plans: institutions need to draw up and update recovery plans to (1) assess potential vulnerabilities; and (2) prepare measures to restore their financial position in case of "significant deterioration" of financial position. Recovery plans are based on various scenario including both idiosyncratic problems and market-wide stress (e.g. normal and adverse stress scenario), and they are assessed by competent supervisory authorities, which may require amendments to remedy "material deficiencies". The BRRD and the SRM Regulation set the resolution planning: competent resolution authorities need to draft and update "resolution plans" to prepare swift and effective resolution action in case "conditions for resolution" under BRRD are met.

The SSM and the SRM, within their respective mandates should be able to efficiently deal with the proliferation of cross-border banking and any possible negative implications. However, the EU mechanism for resolving failing banks is still work in progress and needs to be fully tested. State level deposit insurers are not viable inside a monetary union because the liquidation of small banks could overwhelm the capacity of national deposit insurance. Mutualisation of deposit insurance requires full harmonisation of insolvency laws because the effectiveness of the bank liquidation process will have an impact on the financial situation of the deposit insurance over which insured depositors have a legal claim. Nieto and Wall observed that 'given that the barriers to cross-border banking are likely to fall, the EU should consider what sort of banking structure would provide the best combination of an integrated financial system and a financial system in which the banks are neither too large to supervise nor too large to safely fail'.[14] On this view, rules will have impact on where banks shed operations due to cost factors of maintaining operations and risk will likely migrate to less regulated local entities in a risk race to bottom.

Since the key objective of the BRRD is to favour private sector loss absorbency for failing banks through a mechanism of eligible liabilities (MREL system)[15], resolution authorities maintain discretion to adopt alternative measures for recapitalising banks in crisis. Recently, the BRRD has been under criticism for lack of harmonised regimes in the application of bail-in tools: a proposal to amend the existing rules has been advanced to strengthen the harmonisation process of national bank insolvency procedures in order to facilitate orderly intervention and uniformity of regulatory

[13] John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh, 'The EU bank recovery and resolution directive—Some observations on the financing arrangements' (2014) 15(3/4) *Journal of Banking Regulation*, 218-226.
[14] Maria Nieto and Larry D. Wall, 'Cross-Border Banking on the Two Sides of the Atlantic: Does it Have an Impact on Bank Crisis Management?', FRB Atlanta Working Paper No. 2015-11, 21.
[15] According to the BRRD all banks are required to meet a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) to ensure that sufficient financial resources are available for write-down or conversion into equity.

treatment.[16] The proposal aims to create a minimum level playing field for banks and to foster prudential treatment of NPLs: the banks should be incentivised to deal with NPLs at an early stage to avoid the origination of high volume of non-performing assets.

3. *The precautionary recapitalisation of failing banks*

The controversial rescue plan of MPS highlighted the deficiencies of the Italian banking sector in preventing failures and intervening timely to address the disruptions of distressed credit institution.[17] MPS started to deal with the non-performing exposures (NPE) after the results of the European Banking Authority (EBA) EU-wide stress test of 2016[18] that showed for MPS a strong reduction of its CET1.[19] However the difficulties of the Italian bank are legacy of the past as the first aids and relative restructuring plan evidenced the weaknesses in the corporate governance structure and showed the limits to restore a long-term profitability.[20]

The precautionary recapitalisation of MPS through a special insolvency procedure under Italian law raised concerns on the credibility of bail-in rules.[21] The provision of a guarantee by the Italian government technically amounts to a preferential treatment granted to MPS senior bondholders, despite that it is contingent and might never materialise (contingent State aid as there is a contingent burden on state resources).[22] The fact that the provision of the guarantee by the government is required for the transaction to occur will be carried under commercial markets conditions (i.e. a fee in exchange of a service that rather than being provided by a market participant will be provided by

[16] Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy, Brussels, 23 November 2016, COM(2016) 853 final; Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC, Brussels, 23 November 2016, COM(2016) 852 final.

[17] Benoit Mesnard, Marcel Magnus and Alienor Anne Claire Duvillet-Margerit, 'The precautionary recapitalisation of Monte dei Paschi di Siena', European Parliament Briefing, 6 July 2017, 3.

[18] The stress test does not have a threshold for success/failure, but is designed as an informative element relevant for the supervision process. The results will then be used by the competent authorities to assess the capacity of the bank to meet the regulatory requirements in stressed scenarios on the basis of common methodologies and assumptions.

[19] It indicates the bank's core equity capital compared with its total risk-weighted assets that are used to quantify a bank's financial strength.

[20] Following the acquisition of Banca Antonveneta for €9 billion from Banco Santander, BMPS reported €5.5 billion of impairments in the balance sheet of 2011 and 2012. See European Commission, 'State aid n° SA. 36175 (2013/N) – Italy MPS – Restructuring', C(2013) 8427 final, available at: http://ec.europa.eu/competition/state_aid/cases/249091/249091_1518538_162_2.pdf.

[21] European Commission, 'State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena', Press Release, Brussels, 4 July 2017, 2. See also Monte dei Paschi di Siena, 'BMPS: European commission approves the 2017-20121 restructuring plan', Press Release, available at: http://english.mps.it/media-and-news/press-releases/2017/Pages/press_release_20170705.aspx.

[22] Bank of Italy, 'The 'precautionary recapitalization' of Banca Monte dei Paschi di Siena', available at: https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/index.html?com.dotmarketing.htmlpage.language=1.

the State acting in its commercial capacity) is something that the European Commission did not qualify as State aid.[23] Moreover, in the aftermath of the overhaul of the EU resolution regime, it is expected to favour bail-in. Therefore, the case of MPS can be seen as one where there is an attempt to avoid the unavoidable and might constitute an abuse of State aid framework. As a result, it is difficult to understand the policy of the Commission as the main objective of the BRRD is to ensure that insolvent banks can be resolved in an orderly and uniform manner without generating financial instability (and minimising the use of State aid).[24]

The recourse to financial assistance increased the reliance to aids and undermined the BRRD rules. This means that precautionary recapitalisation under the BRRD deliberately has been left as loopholes for cases where bail-ins cannot work. The liquidation of Venetian banks (Veneto Banca and Banca Popolare di Vicenza) demonstrates the willingness to avoid bail-in and seek public support.[25] These two banks were considered by the ECB 'failing or likely to fail' a condition to access the resolution or liquidation tools in which State aid was the restructuring option. The winding-up of Veneto banks seems an exception to the aid regime and constitutes a precedent for manoeuvre from Member States. However the decision on the bank's critical functions and potential adverse effects into the market is a matter of the Single Resolution Board. In the case of Venetian banks the justification for the state aid originated from the government's own assessment of local effects of liquidation. On this point, it has been noted that 'in the absence of clarity on what constitutes a serious impact on the regional economy, the rules on liquidation aid leave room for governments to effectively re-instate at the local level the public interest that the SRB has denied at national (or, in the Italian case, even at the regional) level'.[26] The SRB is the authority in charge of the assessment of public interest although the criteria for assessing a failing bank through resolution actions or national insolvency proceedings are still far from clear. In addition, the assessment whether a bank is non-insolvent and 'failing or likely to fail' leaves discretion to the EU regulators (i.e. ECB and SRB) as inconsistent decisions have been taken for distressed credit institutions. In this context, Tröger argued that 'the bail-in tool under the BRRD and the SRM-Reg provides for a highly complicated and detailed regulatory framework that gives a multitude of authorities ample

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[23] Gert Jan Koopman, 'Market based solutions to bank restructuring and the role of State Aid Control: the case of NPLs', speech delivered at the ECMI Annual Conference, Brussels, 9 November 2016, available at: http://www.eurocapitalmarkets.org/system/files/Gert%20Jan%20Koopman_Speech.pdf. (at 11-12).

[24] Karel Lannoo, 'Bank State Aid under BRRD and SRM' (2014) 13(4) *European State Aid Law Quarterly*, 630-632. It is noted that 'Member States can also provide extraordinary public financial support through additional financial stabilisation tools, such as equity support and temporary public ownership, but again as a last resort, after all other measures have been exploited, and following State aid rules'.

[25] Benoit Mesnard, Alienor Margerit and Marcel Magnus, 'The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza', European Parliament, 25 July 2017, available at http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602094/IPOL_BRI%282017%29602094_EN.pdf.

[26] Silvia Merler, 'Bank liquidation in the European Union: clarification needed', Bruegel Policy Contribution, Issue No 1, January 2018, 11, available at http://bruegel.org/wp-content/uploads/2018/01/PC-01_2018.pdf.

discretion in compelling private sector involvement and requires significant inter-agency cooperation and information sharing'.[27]

In the case of Banco Popular, the SRB considered the institution 'failing or likely to fail' subject to resolution scheme for the public interest.[28] Banco Popular was resolved by transferring all shares and capital instruments to Banco Santander S.A with no involvement of State aid. In substance, Banco Popular was resolved through the sale of assets and the bail-in tools.[29] Since the BRRD does not provide a definition of "public interest" there is risk of lack of consistency and different regulatory treatment in resolving banks in crisis.[30] This raises concerns on the effectiveness of EU rules since wide powers are granted to supervisory authorities in evaluating the financial conditions of failing banks. The question lies in the divergent assessment of investors in terms of equity and subordinated debt as it is undefined the trigger for haircuts.[31] In the same vein, 'it is really up to the SRB to decide whether the risks and the resolvability are acceptable'.[32] This approach confirms that the bank insolvency regime remains subordinated to the State aid: a scenario that incentivises domestic biases in favor of protecting national champions or other banks whose failure would cause political problems domestically.

4. *The impact of NPLs on bank restructuring*

The case of MPS underlines the problem to get rid of NPLs from bank balance sheet.[33] High percentages of NPLs reduce profitability, increase funding costs and tie up bank capital, which negatively impact credit supply and ultimately growth.[34] Addressing the rise of NPLs has become a key challenge for the EU banking system and the resolution of NPLs requires comprehensive action to deal with these types of bad loans sitting on banks' books.[35] The main problem is the lack of a harmonised framework to estimate the obligors' ability to repay and whether it has deteriorated.

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[27] Tobias H. Tröger, 'Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime' (2018) 4(1) *Journal of Financial Regulation*, 38.
[28] Commission Decision (EU) 2017/1246 of 7 June 2017 endorsing the resolution scheme for Banco Popular Español S.A., C(2017) 4038. The resolution of Spanish bank can be regarded as private bail-in capital without intervention of the state.
[29] Benoit Mesnard, Alienor Margerit and Marcel Magnus, 'The resolution of Banco Popular', European Parliament, 28 August 2017, 3.
[30] David Mayes, 'Banking union: the problem of untried systems' (2017) 20 *Journal of Economic Policy Reform*, 9.
[31] Robert Smith, 'Banco Popular serves as a harsh lesson for coco debt holders' *Financial Times*, 8 June 2018.
[32] David Mayes, 'Banking union: the disadvantages of opportunism' (2017) 21(2) *Journal of Economic Policy Reform*, 139.
[33] Christopher Gandrud and Mark Hallerberg, 'How not to create zombie banks: lessons for Italy from Japan' (2017) 6 *Bruegel Policy Contribution*, 7, available at: http://bruegel.org/wp-content/uploads/2017/03/PC-06-2017-030317.pdf.
[34] Ibid., 10.
[35] David Bholat et al., 'Non-performing loans: regulatory and accounting treatment of assets', Bank of England Staff Working Paper No. 594, April 2016, 3.

In March 2017 the ECB produced a qualitative guidance on NPLs, including consideration of how the 'unlikely to pay' criterion should be applied in practice, and how banks should manage and monitor forbearance, write offs and collateral valuation.[36] This supervisory toolkit aims to address the issue of identification and allocation of deteriorated loans in the EU banking sector.[37] As indicated in the guidance, 'the key objective of granting forbearance measures is to pave the way for nonperforming borrowers to exit their non-performing status, or to prevent performing borrowers from reaching a non-performing status'.[38] The guidance aims to harmonise private mechanisms to resolve troubled banks through the mandatory implementation of the NPL guidance into the complex system of banking resolution.[39] The NPL guidance has been further developed in the prudential treatment for distressed loans through supervisory expectations on the classification of NPEs.[40] The ECB's supervisory expectations supplement the NPL guidance by specifying the regulatory actions when assessing a bank's levels of prudential provisions for NPEs.[41] The ECB guidance should facilitate private restructuring mechanisms of NPLs – i.e. private workouts – and should enhance out-of-court collateral enforcement. On this view, the Commission's proposal aims to introduce minimum loss coverage for nonperforming exposures and establish secondary market to sell NPLs can be considered a welcome approach.[42]

However the issue of regulating NPLs raises the question of identifying viable tools to restructure NPLs: in this context various proposals have been suggested, namely individual bank restructurings, bank-internal bad-bank units and bank-specific asset management companies (AMCs).[43] Enria argued to establish an AMC with government support to resolve NPLs selling the assets at their economic

[36] ECB, 'Guidance to banks on non-performing loans' (2017), 49-50, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.
[37] It can be noted that in the south of the European Continent, the European Bank Coordination 'Vienna Initiative'—a private-public sector forum which brings together international financial institutions, international organizations, public authorities and private banks—has launched various proposals to address NPLs in CESEE countries. The main purpose is to create a platform of coordination and cooperation for Western banks to enhance enforcement measures, improving consistency in the definition of NPLs and removing legal obstacles and execution issues in distressed transactions. Specifically, the 'Vienna Initiative' has adopted a set of principles for monitoring and preventing the deterioration of assets.
[38] ECB (note 36) 39.
[39] However, the guidelines are soft law recommendations—not binding and not enforceable—and leave discretion to national authorities to implement them at the domestic level.
[40] ECB, 'Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures' (2018), 2,
available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf.
[41] The ECB will assess banks' practices and report any divergences with the prudential provisioning expectations: banks are required to maintain their level of monitoring in line with the prudential expectations. Supervisory expectations on secured exposures – that benefit from credit risk protection – apply after seven years from the date on which they have been classified non-performing (e.g. "vintage period"). Supervisory expectations on unsecured exposures – that do not benefit from credit risk protection – apply after two years from the date on which they have been defined as "vintage".
[42] European Commission, Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for nonperforming exposures, Brussels, 14 March 2018, COM(2018) 134 final.
[43] Patrizia Baudino and Hyuncheol Yun, 'Resolution of non-performing loans – policy options', (2017), FSI Insights on policy implementation No. 3, 3-4, available at https://www.bis.org/fsi/publ/insights3.pdf.

value.[44] Avgouleas and Goodhart proposed a new structure for a Pan-European "bad bank" with virtually ringfenced country subsidiaries to ensure burden sharing without debt mutualisation.[45] This proposal has been reinforced in the 2018 Commission blueprint on national AMC[46]: the document provides non-binding principles to guide Member States in the implementation of AMCs at the domestic level. These principles highlight the role of AMC in removing troubled assets from bank balance sheet and restructuring banks with high levels of NPLs. As stated, 'AMCs can be private or (partly) publicly funded without State aid, if the State can be considered to act as any other economic agent'.[47] It can be observed that the blueprint underlines the need to complement the AMCs with the State aid rules, the BRRD and the SRM regime to create a common level playing field for banks on NPLs resolving tools.

5. *The quest for public interest in rescuing failing banks*

In the case of MPS there has been a market dissemination of subordinated bonds to retail investors who were not presented with a full disclosure of potential risks.[48] As result, the Italian government introduced a compensating scheme for affected retail investors whereby they would be able to convert the subordinated debt securities into equity.[49] Even if such a political strategy might be desirable[50], it can be considered as a circumvention to the applicability of bail-in on junior debt holders which according to the burden sharing principle applies when granting State aid. As Yadav noted, 'Monte dei Paschi offers a cautionary example of what is at stake for regulators in seeking to

[44] Andrea Enria, 'The EU banking sector - risks and recovery. A single market perspective', Luxembourg (2017), 16, available at https://www.esm.europa.eu/speeches-and-presentations/esm-seminar-andrea-enria-eba-chairperson.
[45] Emilios Avgouleas and Charles Goodhart, 'Utilizing AMCs to tackle Eurozone's legacy non performing loans', (2017) *European Economy Banks, Regulation, and the Real Sector*, 103-104, available at http://european-economy.eu/wp-content/uploads/2017/07/EE_1.2017.pdf.
[46] European Commission, 'AMC Blueprint. Accompanying the document Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank. Second Progress Report on the Reduction of Non-Performing Loans in Europe', Commission Staff Working Document, Brussels, SWD(2018) 72 final, available at http://ec.europa.eu/finance/docs/policy/180314-staff-working-document-non-performing-loans_en.pdf.
[47] Ibid, 4.
[48] 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)".
[49] The financing to buy the equity from the original retail investors will be obtained from new secure senior debt instruments. The Commission understands that such compensation scheme is an entire separate consideration to burden sharing under the State aid framework. See 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)".
[50] In this line of thinking Martin Sandbu, 'Banking union will transform Europe's politics', *Financial Times*, 26 July 2017, who observed that in the recent banking failures 'Spain offered a glimpse into the future of bank regulation, while Italy clung to the bad habits of the past. On this discrepancy, Italy demonstrated greater ability to lobby for its case, however power is not all; it matters what one uses it for'. In particular, it is argued that banks in Italy are run by politically embedded foundations a scenario that show an incestuous relation between state and credit institutions. This phenomenon can determine the following effects: 'deep confusion between the national interest and that of the banking sector; hidden subsidies from taxpayers to banks, protecting both their managers and their investors; and gross inefficiencies in an allocation of capital driven more by political and personal priorities than economic logic'.

solve the problem of too-big-to-fail banks. Post-crisis regulation requires banks to maintain thicker capital buffers-reserves of assets available to better ensure that banks can pay off depositors and other short-term creditors to prevent a crisis at one bad firm from spreading to others within the financial system'[51]. The ECB promoted the precautionary recapitalisation for MPS while it clearly stated in the guidelines on NPLs that the priority is to develop workout units and private debt restructuring agreements to write-off bad loans from the bank balance sheet.[52] It seems that the ECB proposals to establish private mechanisms to resolve troubled banks ended up in forms of domestic bailout, reasonably the mandatory implementation of the NPL guidance into the complex system of banking resolution would have been desirable.

As mentioned, the rules contained in the BRRD are largely flexible to allow Member States to adopt the policy measures necessary to protect the public interest, even if the directive does not define the boundaries of 'public interest' when to provide public support.[53] The precautionary recapitalisation of MPS leaves doubts on the suitability of the public measure to restore the equity of the bank since it is not clear the interpretation of Article 32(4)(d) of the BRRD about the necessary aid. Specifically, the BRRD does not provide a clear definition of the 'interest to preserve financial stability and remedy a serious disturbance in the economy'.[54] In addition, it is not clear the distinction between precautionary recapitalisation and extraordinary public support since Article 32 of the BRRD consider interchangeable these concepts, which in theory they should be regulated as different tools.[55] Article 32(4) of the BRRD provides criteria for the failing or likely to fail (FOLTF) credit institutions and the concept of solvency should refer to these provisions.[56] However the concepts of solvency and FOLFT do not coincide, raising doubts in the application of preventive measures to resolve distressed banks.[57] It can be argued that the BRRD rules open room for interpretation of the applicable regime in a way that it could not be consistent with the public interest.

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[51] Yesha Yadav, 'We Need to Know Who Invests in Bank Equity' (2017) 70 *Vanderbilt Law Review En Banc*, 284.

[52] ECB (note 36) 19-20.

[53] Stefano Micossi, Ginevra Bruzzone and Miriam Cassella, 'Fine-tuning the use of bail-in to promote a stronger EU financial system', CEPS Special Report No. 136, April 2016, 16-17.

[54] Rodrigo Olivares-Caminal and Costanza Russo, 'Precautionary recapitalization: time for a review', European Parliament, Note provided in advance of the public hearing with the Chair of the Single Resolution Board in ECON on 11 July 2017, 10.

[55] Christos V. Gortsos, 'Last resort lending to solvent credit institutions in the euro area before and after the establishment of the Single Supervisory Mechanism (SSM)', paper presented at the European Central Bank (ECB) Legal Conference: "From Monetary Union to Banking Union, on the way to Capital Markets Union: new opportunities for European integration" held in Frankfurt on 1-2 September 2015, 6, available at https://ssrn.com/abstract=2688953.

[56] EBA Single Rulebook Q&A (2015_1777), available at http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_1777.

[57] World Bank-FinSAC, 'Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD', April 2017, 106, available at http://pubdocs.worldbank.org/en/609571482207234996/FinSAC-BRRD-Guidebook.pdf. It is pointed out that 'the FOLTF definition used under the BRRD is rather vague (and it will be difficult in practice to define the point of non-viability) but gives the required discretion to intervene early enough'.

6. *Concluding remarks*

In the aftermath of the 2007-09 global financial crisis, the introduction of new resolving mechanisms for distressed banks has been lauded as a significant step forward in the EU bank insolvency regime. In this context, the rapid rise of NPLs and the recent failures of fragile credit institutions have demonstrated the need to strengthen the harmonisation process of restructuring measures to avoid inconsistency in the application of rules and discretion of supervisory authorities. The EU Banking Union represents a welcome approach in the regulatory framework of ailing banks: the BRRD and the SRM establish innovative tools to avoid the involvement of depositors into the rescue programmes and to contain the disruptions of collapses. However the EU regulators leave wide discretion to national governments to adopt taxpayer funded bail-out which is a legacy of the past to protect financial stability under the public interest.