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Bail-in Provisions in State Aid and Resolution Procedures: Are they consistent with systemic stability?

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Key points

This paper examines the provisions for bail-in – that is, the principle whereby any public measure to recapitalise a bank with insufficient prudential capital must be preceded by a write-down or conversion into equity of creditors' claims – in EU state aid policies and the new resolution framework for failing banks, with two aims:

i) to assess whether and how they are coordinated and

ii) more importantly, whether they address satisfactorily the question of systemic stability that may arise when investors fear that creditor claims are likely to be bailed-in in a bank crisis.

The issue is especially relevant in the present context, as the comprehensive assessment exercise underway for EU banks falling under the direct supervision of the European Central Bank may lead supervisors to require substantial capital injections simultaneously for many of the banks involved, possibly shaking investors' confidence across EU banking markets.

Recommendations

The authors conclude that the two sets of rules are, broadly speaking, mutually consistent and that they already contain sufficient safeguards to address systemic stability concerns. However, the balance of the elements underpinning the European Commission's decisions in individual cases may not be clear to bank creditors and potential investors in financial markets. The impression of unneeded rigidity on this very sensitive issue has been heightened by official statements over-emphasising that each case will be assessed individually under competition rules, thus feeding the concern that the systemic dimension of the issue may have been underestimated. Therefore, further clarification by the Commission may be needed on how the various criteria will be applied during the ongoing transition to banking union – perhaps through a new communication completing the state aid framework for banks in view of the adoption of the new resolution rules.

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1. Introduction

In July 2013, the European Commission adopted a new Banking Communication – the seventh since the start of the financial crisis – updating its criteria for the evaluation of state aid in the banking sector in response to the evolving economic and institutional environment.[1] Under this Communication, any credit institution in need of recapitalisation or 'impaired asset' measures will be required, prior to any further action, to submit a plan for restructuring or the orderly winding down the bank. Moreover, whenever there is a capital shortfall, the Commission will require that, prior to any injection of public funds, not only shareholders – as has been the case so far – but also junior creditors write down or convert into equity their claims on the bank, regardless of whether the bank is under resolution, in order to minimise the need for state aid.

Subsequently, the Council and the European Parliament have adopted a directive (BRRD)[2] and a regulation (SRR)[3] establishing uniform rules for the resolution of banks. For member states participating in the Single Supervisory Mechanism (SSM), these rules will be applied within the SRM, which will be supported by a Single Resolution Fund (SRF). Both the BRRD and the SRR contain rules for the bail-in of shareholders and creditors, either on a stand-alone basis or as a part of the resolution procedure. The adoption under the BRRD or the SRR of a resolution scheme entailing state aid or resort to the SRF is made conditional on the approval of the public support by the European Commission, under state aid rules.

The pre-conditions and the scope of burden-sharing by creditors under state aid control and resolution procedures do not coincide. Therefore, there is a need to ascertain whether the coordination of the two sets of rules is adequate. In addition, questions have been raised as to whether the guidelines on state aid to banks take sufficient account of systemic stability considerations when imposing the conversion or write-down of creditor claims.

The issue has assumed special relevance in connection with the ongoing comprehensive assessment of the quality of banks' balance sheets and business models by the European Central Bank (ECB), in preparation for the start of the SSM, which may require substantial capital injections to meet the enhanced prudential requirements, and possibly public support in certain cases. As may be recalled, the publication of the new Banking Communication in July 2013 led to a lively exchange of letters between Commissioner Joaquin Almunia and ECB President Mario Draghi (the letters were leaked to the press but never officially published). Mr Draghi reportedly feared that the Commission Communication could be read as the announcement that all banks in need of public support would be preventively subject to a bail-in of junior creditors, regardless of circumstances, potentially aggravating the funding difficulties of individual banks and the banking system as a whole. A similar issue of systemic stability may also arise in connection with the new resolution framework when bail-in is applied before the start of resolution, as will be described.

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[1] 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), 30 July 2013.

[2] Directive of the European Parliament and the Council 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 PE-CONS, 24 April 2014.

[3] Proposal for a regulation of the European Parliament and of the Council 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 Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council (COM(2013)0520 – C7-0223/2013 – 2013/0253(COD)), 15 April 2014.

The ensuing analysis concentrates on the mutual consistency of the two sets of rules, how they are coordinated and how they address the question of systemic stability when creditor claims are bailed in. It does not address the broader issue of the potential impact of bail-in on investors' confidence under distressed market conditions, which is a feature of the current transition to full banking union; on this issue, readers may usefully refer to Avgouleas & Goodhart (2014). Our conclusion is that by and large the two sets of rules are mutually consistent and that they already contain sufficient safeguards to address systemic stability concerns when confronted with a single bank's crisis (i.e. barring systemic banking crises). However, the sensitivity of investors to policy announcements in today's still-fragile financial conditions may require further efforts to clarify state aid policy regarding prudential bank recapitalisations in the transition to the SSM.

2. The role of state aid control in governing bank restructuring at EU level

Since 2008, the European Commission has adopted a number of decisions under Articles 107-109 TFEU on the compatibility of state aid measures in favour of banks. Article 107 leaves the Commission sufficient flexibility to adapt the state aid policy in trying times, by permitting it to be considered compatible with common market aid measures that appear necessary and proportionate in order to address market failures. In identifying the market failures specific to the financial crisis since 2008, the Commission had to proceed by trial and error. As it came to recognise the systemic nature of the crisis, it resorted, as a legal basis for the temporary adoption of exceptional measures, to Article 107, paragraph 3, letter b, of the Treaty, which allows the authorities to consider measures needed to "remedy a serious disturbance in the economy of a Member State" as compatible with the common market. It was understood that the standard criteria for the control of state aid would again be applicable once the financial system returned to normal conditions.

Since 2008, the Commission has adopted seven Communications setting out the special criteria to be used in the assessment of the compatibility of state aid in the financial sector (the first Banking Communication of 2008 has been entirely replaced by the Communication of July 2013; the others have been partially updated).[4] Initially, the emphasis was on state guarantees; it later shifted to recapitalization measures and the treatment of impaired assets. The three 2009 Communications, predicated on the belief that the peak of the crisis was past, focussed on restructuring aid, based on three principles:

i) The aid recipient must be viable in the long term, with no need for further aid.

ii) Bank owners must contribute to restructuring costs (burden sharing).

iii) The potential distortions of competition resulting from state aid must be kept to a minimum through adequate remedies (divestitures and behavioural measures, such as the prohibition of aggressive commercial conduct). In 2010, as funding

[4] Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (2008/C 270/02); Communication from the Commission – The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (2009/C 10/03); Communication from the Commission on the treatment of impaired assets in the Community banking sector (2009/C 72/01); Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules (2009/C 195/04); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis (2010/C 329/07); Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis (2011/C 356/02); and, finally, the "Banking Communication" of July 2013.

conditions normalised, the Commission tightened its requirements, notably by considering state aid for recapitalisation and impaired assets as compatible with the internal market conditional on the recipient submitting a restructuring plan.

In general, the criteria set out in the Guidelines were applied flexibly, always with due consideration of each case-specific features. For example, whereas in HypoBank the Commission required a substantial dismissal of assets, in ABN Amro it only required the bank to abstain from aggressive commercial conduct, as the need for state aid was seen as unrelated to a need for restructuring.

In 2011, financial conditions worsened again in the eurozone, with the emergence of a perverse 'doom loop' between the sovereign and bank crises. The Commission reacted by extending the application of the crisis Communications. In its conclusions of 22 October 2011, the Ecofin Council acknowledged that state aid control represented the sole coordination instrument available at EU level to maintain financial stability and a level playing field in the internal market by encouraging distressed banks to restructure and return to viability.[5]

In 2012, the European Council launched the banking union project, with the purpose of breaking the vicious circle between sovereign and bank debt, overcoming the fragmentation of financial markets and eradicating moral hazard by bankers through strengthened supervision, a new banking resolution procedure at EU level[6] and beefed-up deposit insurance rules. The Commission argued that, while waiting for the banking union to be established, it was still necessary for it to play a temporary role in order to ensure the orderly restructuring of the banking sector: in this sense, its 2013 Communication can be seen as a transition, or 'bridge', communication which will have to be adapted again to intervening changes in the banking regulatory framework.

The Commission has always stressed that its overarching goal in the control of state aid in the financial sector is that of ensuring financial stability. This includes preventing spill-over effects that might result from the failure of a bank and ensuring that the banking system as a whole continues to provide adequate lending to the real economy, while minimising state aid and distortions of competition.

In order to foster financial stability and ensure that resort to taxpayers' resources for bailing out banks would in the future be minimised, the latest Guidelines require sufficiently timely and decisive restructuring plans to restore the bank to long-term viability or, as an alternative, its orderly wind-down. These restructuring plans will be assessed in close cooperation with the competent supervisory authorities; moreover, state aid will be authorised only subject to burden-sharing also involving junior creditors. Rescue aid before a restructuring plan is approved can only be admitted when the competent supervisory authority confirms that this is necessary to preserve financial stability. On the other hand, for banks not experiencing a capital shortfall, the main instrument for support should be guarantees on new liabilities.

Recapitalisation or impaired assets measures will be deemed compatible only if the member state demonstrates that all attempts to minimise the need for state aid have been undertaken, notably by:

i) submitting, before or as part of the restructuring plan, a capital raising plan (including issues of new rights, voluntary conversion of subordinated debt, asset sales, earnings retention);

ii) changing management and applying strict executive remuneration policies until the end of the restructuring period;

iii) preventing the outflow of own funds, among other things by restricting dividends, buy-backs of hybrid capital instruments, acquisitions, etc.; and

[5] See European Commission, Report on Competition Policy 2011.

[6] See Micossi et al. (2013).

iv) ensuring adequate burden-sharing: losses should be first absorbed by equity; hybrid capital and subordinated debt holders must then contribute to reducing the capital shortfall to the maximum extent, through conversion or write-down of the principal of their instruments.

The Communication envisages two scenarios for burden-sharing: i) the bank does not meet the minimum regulatory capital requirements or, ii) the minimum capital requirements are met and yet a capital shortfall is identified by a competent supervisory authority, e.g. as a result of a stress test (precautionary recapitalisations). In the first case, state aid can only be authorised after equity, hybrid capital and subordinated debt have fully contributed to covering the losses (through write-down or conversion). In the second case, the Commission indicates that if there are no alternative ways to remedy the shortfall, then in principle subordinated debt must be converted into equity before granting the state aid. The write-down of debt is not contemplated. This strengthened burden-sharing, involving junior creditors, is the main novelty of the July 2013 Communication.

During the crisis, burden-sharing involving creditors has been applied by some member states, e.g. in cases involving Irish, Dutch and Danish banks, and has been imposed by the Troika as a condition for access to financial assistance programmes in Spain and Cyprus.[7] After the adoption of the new Banking Communication, it has also been required by the Commission for approving state aid for the restructuring of the main banks in Slovenia.

In order to ensure compatibility with the protection of property rights, the Communication endorses the ‘no creditor worse off’ principle (point 46): subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no state aid had been granted.

[7] For a general background to bail-in and a description of precedents, see DG Internal Market (2011), Financial Stability Board (FSB) (2011) and Dűbel (2013).

For completeness, it may be recalled that state aid policy also places some constraints on Emergency Liquidity Assistance (ELA) procedures by national central banks (under ECB control): Point 62 of the 2013 Banking Communication specifies in this regard that “dedicated support to a specific credit institution (commonly referred to as ELA) may constitute aid”, unless certain conditions are met.[8] In turn, ECB rules for ELA are fully consistent with those for state aid and, in addition, the ESCB Statute assigns the Governing Council the power to restrict such operations when they may “interfere with the objectives and tasks of the Eurosystem” (Article 14.4). Since ELA normally does not constitute state aid, the application of burden-sharing and bail-in cannot come into play.

3. Write-down and conversion in the resolution framework

The objective of the BRRD and the SRR is to manage and resolve bank crises through common administrative procedures, whose application for member states participating in the SSM will be entrusted to a new EU authority, the Single Resolution Board (SRB). The resolution objectives are: to ensure the orderly unwinding of a bank that is failing, while preserving the continuity of critical functions (e.g. the payment system), protecting financial stability and depositors, as well as minimising reliance on extraordinary public financial support (Article 12 of the Regulation). This last provision is meant to bar any future public support of failing banks – from bail-out to bail-in – thus severing one link between

[8] The credit institution, albeit temporarily illiquid, must be solvent; the liquidity provisions occur in exceptional circumstances and are not part of a larger aid package; the facility is fully secured by collateral with appropriate haircuts; the national central bank charges a penal interest rate; and the measure is taken at the central bank’s own initiative, without any counter-guarantee of the state.

banking and sovereign risks.[9] As may be seen, there is a significant overlap with the objectives of the 2013 Banking Communication.

Under the "General Principles" for bail-in in Article 13 of the SRR (and in Article 34 of the BRRD), the shareholders of the institution under resolution will bear first losses; creditors will bear losses after them, in accordance with the reverse order of their priority claims under national insolvency law; and no creditor shall incur greater losses than would have been incurred if the entity had been wound up under normal insolvency proceedings (the 'no creditor worse off' condition[10]). Thus, the list of creditor claims that may be called in is broader than that under the 2013 Banking Communication, potentially extending to senior uncovered bonds and, down the line, uninsured deposits (those above €100,000, under the Deposit Insurance Directive).

The SRB has the power to write down and convert liabilities of the credit institution both on a stand-alone basis and within a resolution procedure, by activating the bail-in tool. Article 18 states that the write-down and conversion of capital instruments shall be exercised by the Board when:

i) the entity would no longer be viable unless the capital instruments are written down or converted into equity; and

ii) public aid is required by the entity or group, with the exceptions provided for by Article 16.3.d (described below).

When the exercise of the write-down and conversion powers is sufficient to recapitalise the bank, the Board may use them without placing the bank in resolution; otherwise, the write-down and conversion of capital instruments will take place within the resolution procedure, before any other resolution action is taken.

There are conditions for initiating a resolution procedure, according to Article 16 of the Regulation:

i) the entity is failing or likely to fail;

ii) there is no reasonable prospect that an alternative action (including the write-down or conversion under Article 18) would prevent its failure within a reasonable timeframe; or

iii) a resolution action is necessary and proportionate in the public interest (as defined in Article 12) to ensure the continuity of critical functions, maintain financial stability, minimise the burden on public resources, and protect depositors and client funds and assets.

The entity is deemed to be failing or likely to fail when one or more of a set of circumstances listed in paragraph 3 of Article 16[11] are met; amongst them stands the receipt of extraordinary public financial support (i.e. state aid). The determination of the condition (i) above shall be made by the ECB, after consulting the SRB; the SRB will decide on the presence of conditions (ii) and (iii). When this is the case, the SRB will adopt a resolution scheme detailing the use of resolution tools and that of the Fund, and send it to the Commission. The resolution scheme will enter into force if no objections have been raised by the Council or the Commission (on the grounds of public interest listed in Article 16 paragraph 6) within 24 hours after transmission by the SRB of the scheme.

As mentioned above, an escape clause in Article 16.3.d provides that financial support to the bank by national authorities or the Fund does not imply that the institution is failing or is likely to fail, when it involves state guarantees to back liquidity facilities provided by central banks (Article 16.3.d.i), state guarantees of newly issued liabilities or recapitalisations (injections of own funds, Article 16.3.d.ii) or the purchase of capital instruments that do not

[9] There is another link that remains, stemming from banks' exposure to sovereign securities held in their balance sheet.

[10] Article 34.1.g of the BRRD.

[11] Paragraph 4 of Article 32 of the BRRD.

confer an advantage upon the entity (Article 16.3.d.iii).[12] The three exceptions only apply to solvent entities and, in any event, are conditional on approval under state aid rules. In practice, these measures shall be acceptable when they are of a precautionary and temporary nature and proportionate to remedy the consequences of a serious exogenous disturbance. The exception in Article 16.3.d.iii concerning recapitalisations is limited to capital shortfalls established following the stress tests, asset quality reviews or equivalent exercises.[13]

In summary, if the entity requires state aid (with the exception of state guarantees and aid for recapitalisation at market prices, aimed at solvent companies), it is deemed to be failing or likely to fail and the Board may use its powers to write down and convert its liabilities (bail-in) when this is deemed necessary to achieve the public-interest objectives of the new rules. If a broader resolution action is needed, these powers will be exercised within the resolution procedure and may be associated with the use of other instruments (e.g. sale of business tool, bridge institution tool, or asset separation tool) and resort to the resolution Fund, as described by the resolution scheme prepared by the Board. The resolution scheme will enter into force only if no objection has been raised by either the Council or the Commission within 24 hours from its transmission by the Board.

All of this is without prejudice to the application by the Commission of the state aid framework.[14] More specifically, the SRR provides that when public aid (either state aid or aid from the Fund) is present, the Board shall act in conformity with the decision on that public aid taken by the Commission.[15]

[12] See also Article 32.4.of the BRRD.

[13] See also Article 32.4 of the BRRD.

[14] Article 44.12 of the BRRD.

[15] Article 16.8 of the SRR.

4. Coordination of resolution procedures with state aid control

Article 16a of the regulation coordinates the action of the Board relating to the resolution procedure (Article 16) and that of the Commission in the exercise of its powers for the control of state aid. Use of the Resolution Fund is treated as state aid and therefore is subject to prior control by the Commission under Article 107 TFEU, with the same procedures. Although the resources of the SRF will be collected with fees charged on banks, they result from a compulsory contribution established by the law and therefore are treated as if they were public resources. The rationale for this provision is to ensure equal treatment of those member states participating in the SSM and those not participating when their banks are supported with public funds.

Under Article 16a, when the resolution action involves the granting of public aid, the adoption by the Board of the resolution scheme "shall not take place until such time as the Commission has adopted a positive or conditional decision concerning the compatibility of the use of public aid with the internal market" under Article 107 TFEU. The regulation recalls the principle of the BRRD (Article 3.3) whereby institutions should ensure the operational independence between their function in the resolution framework and other functions. For the Commission, this implies that the performance of the institutional tasks related to public aid control will have to be clearly separated, also from an organisational perspective, from the Commission tasks in vetting the SRB resolution proposal under Article 16 of the regulation.

When the Board considers that resolution measures could constitute public aid, it will invite member states to notify the Directorate General for Competition of the European Commission, and it will directly notify measures involving the use of the Fund. If the Commission takes a negative decision on the compatibility of public aid, the Board will be obliged to reconsider its resolution scheme and revise it. It is also envisaged that the

Commission may amend its initial decision, following a recommendation by the Board or on its own initiative, if the implementation of resolution tools and actions departs from the criteria on the basis of which it has taken its original decision. This opens the way to the exercise of some flexibility, in the case of unforeseen developments related to financial stability.

It is important also to recall that the Commission's decisions on public aid will always be based on the resolution scheme prepared by the Board (which includes information on the exercise of bail-in powers). Therefore, its decisions, which will be taken under the state aid perspective, will not need to extend to the design of burden-sharing arrangements to be applied to shareholders and creditors. The Commission will only have to assess whether the proposal made by the Board under resolution rules satisfies the requirement of sufficient burden-sharing under state aid rules. While this may entail some room for discussion between the competition and resolution authorities, there seems to be no inherent contradiction.

5. In conclusion: how to improve the public communication of competition policy goals

Our analysis shows in the first place that the new resolution framework is fully consistent with state aid policy. Indeed, coordination of the two sets of provisions is explicitly provided for by the SRR, since all decisions entailing resort to public aid will be preliminarily vetted by the Commission under state aid rules, and the interaction between the two procedures is well designed. Once the SSM and the SRM are fully in force, the task of limiting moral hazard and the use of public funds through appropriate bail-in measures will plainly fall to the SRB, although the Commission may express its view in the exercise of its competences in the control of state aid.

As to the relationship between bail-in under the two procedures and concerns of financial stability – meaning that the expectation or fear of a bail-in may trigger a run on a bank or the banking system by (uncovered) depositors and investors – the following conclusions apply. First, when a bank is failing or likely to fail and therefore likely to be placed under resolution, the essential requirement to preserve financial stability is speed of the decision, which under normal circumstances should take place within a weekend following the ECB communication that the relevant circumstances are met. Here, bail-in is just a particular component of the general process and does not seem to entail specific consequences or raise special concerns. As has been described, it is also possible for the resolution authorities to write down and convert unsecured liabilities into equity on a stand-alone basis; but again, this may only happen when the bank is no longer viable and therefore already is under special care by the resolution authorities. Therefore, a separate adverse impact of bail-in on investors' expectations is not likely. Moreover, under the BRRD and SRR, bail-in is excluded for viable entities when public support is of a temporary and precautionary nature and is proportionate to remedy the consequences of a serious exogenous disturbance.

Thus, the possibility of destabilising effects from fears of bail-in seems mainly to arise for solvent institutions in need of public support to raise capital, hence from the application of state aid rules. In this regard, the Banking Communication already contains a number of safeguards and exceptions that may help dispel these fears. These notably include the following:

i) the provision that an exception can be made in cases where implementing the Communication would endanger financial stability or lead to disproportionate results (point 45);

ii) the provisions specifying that when applying state aid rules to individual cases, the Commission shall take account of the macroeconomic environment; the specificities of each credit institution and each Member State; the circumstance that the need for state aid has not been the result

of excessive risk-taking; the need of a coordinated approach when recapitalisation measures involve a wide share of the financial system, taking into consideration the aggregate effects of restructuring of individual institutions at the level of the sector and on the economy as a whole; and the feasibility of burden-sharing measures and their impact on market structure (points 9-11); and

iii) the 'no creditor worse off' principle, whereby subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no state aid were to be granted (point 46).

On the basis of these criteria, it is reasonable to expect that the prudential recapitalisation of a solvent bank, following a stress test, would not entail the risk of losses for junior creditors even where, due to general market conditions, there is a need for some temporary public support.

However, this reassuring balance of the elements underpinning the Commission's decisions in individual cases may not be clear to bank creditors and potential investors out there in financial markets. The impression that there is an unneeded rigidity on this very sensitive issue has been heightened by official statements over-emphasising that each case under competition rules will be assessed individually, thus feeding the concern that the systemic dimension of the issue may have been underestimated.

Therefore, some further clarification by the Commission may be needed on how the various criteria will be applied during the ongoing transition to banking union – perhaps through a new communication completing the state aid framework for banks in view of the adoption of the new resolution rules – without of course calling into question the principle that public aid has to be kept to a minimum, both for distressed banks and for banks that are fundamentally sound, and that the availability of public aid should not give rise to moral hazard and distortions of competition.

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