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# Precautionary recapitalisation: time for a review?

Nicolas Véron

## Executive summary

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- **THE BANK RECOVERY AND RESOLUTION DIRECTIVE** (BRRD) of 2014, together with the initiation of banking union in the euro area, represent a regime change in EU banking sector policy. The BRRD replaces the prior assumption of public reimbursement of a failing bank's claimants (or bail-out) with one of mandatory burden sharing (or bail-in), thus reinforcing market discipline. The shift of preference from bail-out to bail-in represents major progress for the EU financial sector policy framework, and deserves continued support.
- **LONGSTANDING FINANCIAL CRISIS** experience suggests, however, that this shift cannot be absolute. The BRRD, accordingly, maintains the possibility of public support through government guarantees and through precautionary recapitalisation, which is the focus of this paper. Keeping open the option of precautionary recapitalisation is justified both by transitional considerations, as offering flexibility on the long and treacherous path towards a more complete banking union, and permanent considerations, as an available option for public intervention in dire crisis scenarios such as that experienced in the early autumn of 2008.
- **THE CONDITIONS** set by the BRRD for precautionary recapitalisation are fairly restrictive. They include conditions on the viability and balance sheet testing of the bank in question, the competitive impact, the economic and financial stability environment and general principles that the intervention should be precautionary, temporary and proportionate.
- **THERE HAVE BEEN** only few actual cases of precautionary recapitalisation under the BRRD so far: two Greek banks in late 2015, whose precautionary recapitalisations using ordinary shares and contingent convertible bonds can currently be viewed as broadly successful, and very recently Monte dei Paschi di Siena in Italy. It was also requested by Banca Popolare di Vicenza and Veneto Banca, also in Italy, but not granted, suggesting the conditions for access to precautionary recapitalisation are meaningfully enforced by EU authorities.
- **THERE IS** no immediate need for legislative reform of the parts of the BRRD that establish the possibility of precautionary recapitalisation, beyond making corrections to a few words in Article 32 that appear to result from hasty drafting. Implementation practice can be expected to draw lessons from early experience, including the need for an asset quality review as a prerequisite for precautionary recapitalisation in all cases except those where circumstances would make it practically infeasible. The broad review of the BRRD scheduled in 2018 should provide another opportunity to consider any need to amend the legislative basis for precautionary recapitalisation, possibly based on more lessons from practical experience in the meantime.
- **SEPARATELY FROM** any debate on the text of the BRRD itself, the auditing (and accounting) framework for EU banks should be strengthened. As part of a broader reconsideration of risk-sharing to break the bank-sovereign vicious circle, the European Stability Mechanism should be allowed to participate in precautionary recapitalisations.

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# 1 The initial motivations for precautionary recapitalisation

## The context of the BRRD

The initial episodes of the European financial crisis in 2007-08 and parallel developments in the United States exposed significant gaps in national bank crisis management frameworks in individual European Union (EU) member states, and significant differences between member states. In mid-October 2008, following the climax of financial disruption in the preceding weeks, EU member states adopted an ostensibly common approach that was largely inspired by recent actions of the United Kingdom (UK) government and included a combination of state guarantees, liquidity support and capital injections. However, while this show of common purpose had a temporary soothing impact on financial markets, it soon became apparent that the lack of common crisis management instruments, including financial resources, would lead to divergence between member states and fragmentation of the EU financial space along national lines. Member states soon adopted new legislation on bank crisis management that accentuated this divergence, with some countries opting for a US-style model conferring bank resolution authority on a national agency, similar to the Federal Deposit Insurance Corporation (FDIC) in the United States, while others maintained that court-ordered insolvency should be the only legal way to close a failing bank. (In the meantime, the FDIC's resolution authority was expanded from its earlier scope of deposit-taking credit institutions to systemically important non-banks by the US Dodd-Frank Act of July 2010).

The European Commission belatedly embarked on the project of establishing an at least partly harmonised legislative framework for bank crisis management and resolution. This effort initially took the form of Communications, namely COM(2009) 561 'An EU Framework for Cross-Border Crisis Management in the Banking Sector' on 20 October 2009, and exactly a year later COM(2010) 579 'An EU Framework for Crisis Management in the Financial Sector' on 20 October 2010. On this basis, the Commission conducted consultations that led to its legislative proposal for the BRRD on 6 June 2012 and the protracted legislative discussion that ensued, leading to the BRRD's eventual enactment on 15 May 2014 with a deadline of 31 December 2014 for its transposition by member states<sup>1</sup>. The legislative debate was powerfully reframed by the euro-area leaders' decision on 29 June 2012 to create a banking union, starting with the establishment of a Single Supervisory Mechanism (SSM) led by the European Central Bank (ECB), complemented in late 2012 by the decision to establish a Single Resolution Mechanism (SRM) with a new Brussels-based agency, the Single Resolution Board (SRB), as its hub. The timelines of legislative debates about the BRRD, SSM Regulation and SRM Regulation largely overlapped. In practice, the adoption of the BRRD and of the SSM and SRM Regulations (often referred to as 'banking union' even though that union remains very incomplete in its present form) can be viewed as a single comprehensive policy endeavour, while keeping in mind that the BRRD applies to the entire European Union while the banking union's scope of application, at least for the time being, is only the euro area<sup>2</sup>.

The BRRD, anticipated in some member states by national legislation (such as in the UK in 2009 and Germany in 2010), and complemented in the euro area by the SSM and SRM Regulations, represents a regime change for bank crisis management in the European Union. Until 2007, the stances of most national authorities were predicated on the belief that the high quality of national prudential supervision would avert the possibility of bank failures. When such failures nevertheless occurred, eg in France and Sweden in the early 1990s, the govern-

1 BRRD Article 130. Many member states missed that deadline, but most had completed the process of national transposition by the end of 2015.

2 Non-euro-area EU countries may voluntarily join the banking union through a "close cooperation" process defined in the SSM Regulation, but no member state has made that choice so far.

ment would nationalise the failing bank(s) and reimburse all their claimants, occasionally at a high cost in terms of public money and reputational damage, such as with France's Credit Lyonnais. By contrast, the BRRD stipulated that failing banks should go either through “*resolution*”, a process (possibly involving the sale of significant operations to a third party) managed by an administrative “*resolution authority*,” or a court-ordered insolvency process, with the principle that no creditor should be worse off as a consequence of the former than it would have been in the latter. While limitations on the use of public money to rescue failing banks had been gradually introduced by the European Commission in its control of state aid since 2008, the BRRD represented a comprehensive shift towards limiting the use of public financial resources in bank crisis management. Not surprisingly, it was widely heralded, at the European level and in at least some member states, as bringing a definitive end to ‘taxpayer bailouts’, which were seen as having been the misguided practice of the past<sup>3</sup>.

### Precautionary recapitalisation in the BRRD and the reasons for it

The BRRD legislation, however, did not entirely rule out publicly-funded intervention in banks outside of resolution or insolvency processes. Its article 32(4)(d), which was among the most heavily debated of the entire legislation, lays out three possibilities for “*extraordinary financial support (...) in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability*”, of which the third (article 32(4)(d)(iii)) is precautionary recapitalisation. The other two are (i) state guarantees to back central bank liquidity, and (ii) state guarantees on the bank's newly issued liabilities. While (i) and (ii) were in the initial proposal published by the European Commission in early June 2012, (iii) was added in the course of the legislative process<sup>4</sup>.

The limited and conditional precautionary capitalisation exception, further described in the next section, should not be viewed as a loophole but as an integral part of the BRRD package. More specifically it appears to have been motivated by two main considerations, which are distinct but partly overlap:

- First, a transitional motivation: the transition from the old ‘bail-out’ to the new ‘bail-in’ regime was correctly identified as complex and difficult, not least given the considerable heterogeneity of national situations in terms both of legal regimes and of banking sector situations. In the euro area, the need for transitional arrangements was made more acute because the banking union itself is incomplete, a situation that generates policy mismatches and provides arguments to defenders of the previous policy status quo. In this context, the possibility of precautionary recapitalisation can be viewed as an additional flexibility to handle heterogeneous national situations during a protracted period when the vision of a level playing field under common rules is bound to remain unfulfilled. This transitional motivation is presumably why the BRRD specifically signalled at the end of Article 32(4) that the possibility of precautionary recapitalisation (though not the other possibilities of public support via guarantees) may be brought to an end, by asking the European Commission to review its “*continued need*” by the end of 2015 “*and the conditions that need to be met in the case of continuation*”. In the event, however, the European Commission did not submit such a report by the 2015 deadline and has not submitted one since, ostensibly because it viewed it as too early to make an informed assessment.
- Second, a permanent motivation: the experience of the United States in October 2008 demonstrated that even in a jurisdiction with a credible and battle-tested bank resolution regime, extraordinary public financial support could be necessary in particularly

3 A timely and in-depth evaluation of the BRRD preference for bail-in and its early implementation in the European Union can be found in Philippon and Salord (2017).

4 See Council of the European Union press release, ‘Bank recovery and resolution: Council confirms agreement with EP’, Brussels, 20 December 2013, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ecofin/140277.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140277.pdf).

severe situations of financial instability. The US authorities had initially appeared to rule out such support when they allowed Lehman Brothers to go into insolvency in mid-September, but later had to establish the Troubled Asset Relief Program (TARP) to stem the escalating market disruption that ensued. Even after the Dodd-Frank Act had improved the policy framework by extending the FDIC's resolution authority to systemically important non-banks (as Lehman Brothers had been one), it appeared plausible to expect that instruments such as TARP could be necessary in some future crisis scenarios. The case for public intervention in cases of systemic crisis is abundantly recognised by the economic literature, eg Avgouleas and Goodhart (2014).

## Summary assessment

Both motivations, transitional and permanent, are still relevant now. The transition towards a viable banking sector on a level playing field defined by banking union has made considerable progress in the past few years, but remains unfinished and can be expected to remain so at least until 2018. With hindsight, the view that this transition would be over by end-2015 was too optimistic.

There are still considerable differences between member states in terms of legal frameworks (eg bank insolvency regimes and taxation of the banking sector), perceived strength of the public safety net (eg national deposit insurance schemes) and banking sector structures (eg institutional protection schemes in some member states, creating *de-facto* exemptions from the disciplines of the BRRD for individual banks in systemically important sections or 'pillars' of the national banking sector). One member state, Greece, faced an episode of major financial instability in 2015, which not coincidentally led to the first use in the euro area of precautionary recapitalisation (see section 4). In this context, the additional flexibility provided by the possibility of precautionary recapitalisation in the handling of individual cases, constrained by the restrictive conditions set in the BRRD, is useful and deserving of being kept as long as the euro-area banking sector has not been brought comprehensively back to soundness and the banking union framework remains in its current highly incomplete form.

As for the permanent motivation, it also appears justified, especially in the EU context where the nature of the legislative process makes it impractical to adopt emergency legislation even at a time of crisis. In the United States, the TARP legislation was adopted in Congress after a few days, and despite an initial negative vote. It is difficult to imagine such an effective legislative response from the EU co-legislators, even in the event of an acute crisis. As a consequence, permanently keeping on the legislative books the possibility of extraordinary public intervention in the form of precautionary recapitalisation appears sensible given the always-existing possibility of major future financial disruption.

With this in mind, whenever the transitional motivation for precautionary recapitalisation fades away (and one can be reasonably optimistic that this may happen before the end of the current decade), the most desirable policy response would not be the wholesale legislative repeal of the possibility of precautionary recapitalisation in Article 32 of BRRD, but rather an adjustment of the conditions for its use that is best achieved through changes in the framework for state aid in the banking sector. Since October 2008, successive Communications from the European Commission on the application of state aid rules to support measures in favour of banks (known as 'Banking Communications') have acknowledged that the exemptions provided by Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFUE) regarding the possibility of state aid "*to remedy a serious disturbance in the economy of a member state*" can be applicable. This determination by the European Commission, last updated in the Banking Communication of July 2013<sup>5</sup>, still appears appropriate given the lingering existence of pockets of financial fragility in the EU financial system, but should not last

5 Communication 2013/C 216/01, published in the Official Journal of the European Union on 30 July 2013.

forever and should be re-examined with increasing frequency by the European Commission as the banking sector is gradually brought back to soundness<sup>6</sup>.

## 2 Existing modalities of precautionary recapitalisation under the BRRD

### Description and categorisation

Article 32 of the BRRD sets out several conditions for a bank's precautionary recapitalisation to be possible (author's labelling):

- *Viability conditions:* the bank must not meet any of the criteria of Article 32(4)(a), (b) or (c), any of which if met would imply that the bank is “failing or likely to fail” and thus must be resolved by the competent resolution authority. In particular, a bank that “infringes or (...) will, in the near future, infringe the requirements for continued authorisation in a way that would justify the withdrawal of the authorisation by the competent authority included but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds” (Article 32(4)(a)); or whose “assets are or (...) will, in the near future, be less than its liabilities” (Article 32(4)(b)); or that “is or (...) will, in the near future, be unable to pay its debts or other liabilities as they fall due” (Article 32(4)(c)), cannot receive a precautionary recapitalisation under the BRRD. Later on, the BRRD adds that precautionary recapitalisations “shall be confined to solvent institutions” and “shall not be used to offset losses that the institution has incurred or is likely to incur in the near future.”
- *Balance sheet testing conditions:* any precautionary recapitalisation “shall be limited to injections necessary to address capital shortfall [sic] established in the national, [European] Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, EBA [European Banking Authority] or national authorities, where applicable, confirmed by the competent [supervisory] authority.” In accordance with another stipulation of Article 32(4)(d), the EBA published guidelines on 22 September 2014 on stress testing and asset quality reviews, though these are very succinct and leave ample space for discretion.
- *No-advantage condition:* The precautionary recapitalisation “does not confer an advantage upon the institution”.
- *State aid condition:* in addition to the previous condition, any precautionary recapitalisation “shall be conditional on final approval under the [European] Union State aid framework”.
- *Financial stability conditions:* The precautionary recapitalisation “is required (...) in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability”.
- *Precautionary/temporary/proportionality conditions:* the precautionary recapitalisation “shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance”.

<sup>6</sup> A critical report on the continuation of this determination under the 2013 Banking Communication is provided in Alexander Weber and Boris Groendahl, ‘Italy’s Bank Funeral Shows EU Still Using Crisis Playbook’, *Bloomberg*, 3 July 2017.



## Summary assessment

This is an altogether fairly restrictive set of conditions. The viability conditions, in particular, go well beyond a formalistic solvency assessment based on audited financial statements.

On several aspects, however, the wording is ambiguous or confusing. These instances of questionable wording presumably result from excessive haste in the drafting process.

- The mention of solvency after Article 32(4)(d)(iii) (*“shall be confined to solvent institutions”*) appears at odds with the conditions of not meeting any of the circumstances mentioned in Article 32(4)(a), (b) and (c), since the latter are altogether more demanding than any simple solvency test. This is even as solvency is not specifically defined in Article 2 of the BRRD<sup>7</sup>.
- The stipulation that precautionary recapitalisation *“shall not be used to offset losses that the institution has incurred or is likely to incur in the near future”* is widely open to interpretation. The intent of the co-legislators appears to be to refer to losses *“incurred”* since the end of the previous reporting period (eg last published audited or verified financial statements) and *“likely to be incurred in the near future”* before the end of the current reporting period, but this is not made explicit in the legislative text. Also, the verb *“offset”* is not specifically defined, even though its intended meaning appears to be that any such losses should be matched by capital-strengthening measures other than precautionary recapitalisation.
- In the No-advantage condition, it seems that the adjective *“undue”* (*“does not confer an undue advantage”*) was omitted and would be needed in order to be consistent with the role of state aid control.
- The mention in the Financial Stability condition of the need for precautionary recapitalisation *“to remedy a serious disturbance in the economy of a Member State”* appears, on the face of it, to mirror the text of Article 107(3)(b) TFEU as referred to in the previous section. This is the case in the English version of the BRRD but, puzzlingly, not in other language versions. For example, the German version reads *“to prevent a serious disturbance”* (the word *Abwendung* is used, instead of *Behebung* in the TFEU article); the French version reads *“to prevent or remedy”* (*empêcher ou remédier*), instead of just *remédier* in TFEU.
- The adjectives *“precautionary”* and *“temporary”* are also imprecise and subject to interpretation. An explanatory document published in late June 2017 by the European Commission, which has no legally binding value, specifies that precautionary means *“to prepare for possible capital needs of a bank that would materialise if economic conditions were to worsen significantly”* and that temporary means that *“the State should be able to recover the aid in the short to medium term”*<sup>8</sup>. A more stringent interpretation of *“temporary”* might be that any money received by the bank should be paid back within a certain timeframe.

As for the exact nature of the recapitalisation transaction, the BRRD only mentions *“an injection of own funds or purchase of capital instruments”*. Under Article 2 of the BRRD, *“own funds”* refers to definitions in the EU Capital Requirements legislation, but *“capital instruments”* appear not to be specifically defined. They are generally understood to include common equity tier one (CET1), additional tier one (AT1), and tier-two instruments.

A recent report of a subgroup of the EU Financial Services Committee (FSC, 2017, Annex 4) argues that *“it seems conceivable (...) to provide a credit institution with aid in the form of*

7 The EBA published on its website an interpretation from the European Commission’s DG FISMA, according to which the solvency test is identical to not meeting the conditions in Article 32(4)(a)(b)(c), but adds that this interpretation may change and has no legally binding value. See: [https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015\\_1777](https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2015_1777).

8 European Commission fact sheet, ‘State aid: How the EU rules apply to banks with a capital shortfall’, Brussels, 25 June 2017 (not coincidentally, the day when Banca Popolare di Vicenza and Veneto Banca were liquidated). See: [http://europa.eu/rapid/press-release\\_MEMO-17-1792\\_en.htm](http://europa.eu/rapid/press-release_MEMO-17-1792_en.htm).

*precautionary recapitalisation so as to finance an impaired asset measure”, the latter being a form of state aid that involves a purchase of non-performing assets by a publicly sponsored asset management company. The (plausible) implication is that the corresponding losses (the difference between the price paid by the AMC and the assets’ book value on the bank’s balance sheet) would not be viewed as “incurred or likely to be incurred in the near future”.*

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## 3 Actual use of precautionary recapitalisation

### Case studies

At the time of writing, precautionary recapitalisation has been requested and implemented in the cases of two Greek banks, Piraeus Bank and National Bank of Greece (NBG), in 2015, and for Italy’s Banca Monte dei Paschi di Siena (MPS) in 2017. It was also requested in March 2017 by two smaller Italian banks, Banca Popolare di Vicenza (BPV) and Veneto Banca (VB), but eventually not granted, following which the two banks were liquidated in late June 2017.

The four largest Greek banks, which in addition to Piraeus and NBG include Alpha Bank and Eurobank Ergasias, were all recapitalised at the end of 2015. In all cases, state aid was involved, with accompanying burden-sharing as set out in the 2013 Banking Communication, complemented by an aggressive “*liability management exercise*” that practically forced losses on senior unsecured bondholders<sup>9</sup>. As detailed in Mesnard *et al* (2017), the precautionary recapitalisation involved a public injection of €2.7 billion into each of the two banks, in the form of contingent convertible bonds for three-quarters of the amount and of ordinary shares for the remaining quarter, made through the Hellenic Financial Stability Fund.

MPS requested precautionary recapitalisation from the Italian government in December 2016, following the failure of protracted earlier efforts to raise external capital from arm’s-length investors including entities linked to the government of Qatar. On 1 June 2017, the European Commission published a ‘Statement on Agreement in principle between Commissioner [Margrethe] Vestager and Italian authorities on Monte dei Paschi di Siena’ that is described as having been “*reached (...) on the restructuring plan of MPS to enable the precautionary recapitalisation of the bank in line with EU rules*”<sup>10</sup>. The plan’s approval was fully confirmed on 4 July 2017. As a consequence, MPS is expected to become majority-owned by the Italian government.

BPV and VB requested precautionary recapitalisation from the Italian government in March 2017<sup>11</sup>, but their request was not approved and the European Central Bank eventually declared them on 23 June 2017 to be failing or likely to fail. That day, BPV published a statement specifying that the decision to reject its precautionary recapitalisation request was made by the European Commission<sup>12</sup>. The two banks were liquidated in the following days. This sequence suggests that the conditions for precautionary recapitalisation were assessed rigorously by the relevant EU authorities.

There have been numerous other cases of bank recapitalisation by governments since

9 See eg Helene Durand, ‘Piraeus debt holders face tough choice as recap gets underway,’ *Reuters*, 15 October 2015.

10 [http://europa.eu/rapid/press-release\\_STATEMENT-17-1502\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm).

11 European Commission press release, ‘State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo,’ Brussels, 25 June 2017, available at [http://europa.eu/rapid/press-release\\_IP-17-1791\\_en.htm](http://europa.eu/rapid/press-release_IP-17-1791_en.htm).

12 Banca Popolare di Vicenza, Comunicato Stampa, 23 June 2017. See: [https://www.popolarevicenza.it/bpvi-web/data/bpvi-comunicato/SalaStampa/Comunicati-Stampa-IR/IT/2017/Comunicato\\_stampato/allegato/23\\_06\\_2017\\_Comunicato\\_stampato.pdf](https://www.popolarevicenza.it/bpvi-web/data/bpvi-comunicato/SalaStampa/Comunicati-Stampa-IR/IT/2017/Comunicato_stampato/allegato/23_06_2017_Comunicato_stampato.pdf).



2007, but almost all happened before the full entry into force of the BRRD on 1 January 2016. The more recent recapitalisation of Portugal's Caixa Geral de Depósitos was not considered state aid and thus not a precautionary recapitalisation. In September 2016, the German government was reported to be envisaging a contingency plan under which it would take a 25-percent ownership stake in Deutsche Bank, presumably through a precautionary recapitalisation. This report, however, was officially denied<sup>13</sup>.

### Summary assessment

The few cases examined above suggest that the implementation of precautionary recapitalisation is broadly in line with the intent of the co-legislators and the conditions set out in the BRRD as reviewed in the previous section. In cases such as BPV and VB where the conditions were not met, precautionary recapitalisation did not happen even after it had been formally requested.

The two Greek cases have been criticised for unnecessarily harsh treatment of creditors, but can currently be considered broadly successful, since neither Piraeus nor NBG have needed any further recapitalisation despite the challenging Greek macroeconomic and business environment. No in-depth assessment has been done for the purpose of writing this paper though.

The MPS case is very recent and therefore more difficult to assess. It was evidently treated less harshly than NBG and Piraeus were, a fact that is not in itself surprising given the circumstances of the Greek assistance programme in 2015. On the basis of publicly available information, the proposition that MPS was not failing or likely to fail before it received precautionary recapitalisation, and met the other conditions as well, appears open to debate, but not altogether implausible. This uncertain status is linked to the fact that many of the problem loans on its balance sheet (as with other Italian banks) were made to small- and medium-sized enterprises (SMEs), and such loans are particularly difficult to value in uncertain economic times such as the current ones in Italy.

Evidently, other future cases of precautionary recapitalisation, if any, will help to inform and stabilise expectations about the future use of the instrument. Significant learning-by-doing can be expected. The first case of resolution under the BRRD in the euro area – that of Banco Popular announced on 8 June 2017 – has clarified a number of issues that had been matters for speculation. Beyond this initial ‘proof of concept’, a long learning curve can be anticipated before the current uncertainty about the practical aspects and impact of resolution and of precautionary recapitalisation can be significantly reduced.

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## 4 Conclusions and policy recommendations

### General assessment

Precautionary recapitalisation is a possibility under EU law for valid reasons, which should not be viewed as contradicting the other provisions of the BRRD. The transitional motivation, to add flexibility during a complex and difficult process of bringing the EU banking sector back to soundness under an incomplete banking union framework, is still relevant at the time of writing. That transition is inherently imperfect, if only because of widespread perceptions in some member states (particularly Italy) of unfairness in the scheduling of the modalities of implementation of banking union and the BRRD. Such perceptions are partly understandable and partly misguided. For example, German savings and cooperative banks are practically

<sup>13</sup> ‘Bundesregierung bereitet Notfallplan für Deutsche Bank vor’, *Zeit Online*, 28 September 2016.

**Whenever the case for such transitional flexibility ceases to exist, the desirable policy response should be a tightening of state aid control, rather than a repeal of precautionary recapitalisation**

exempted from the application of the BRRD by the institutional protection schemes to which they belong. The treatment of Deutsche Bank by the Single Supervisory Mechanism in the 2016 exercise of stress testing gave an appearance of favouritism that the ECB has not effectively dispelled<sup>14</sup>. Conversely, the Italian authorities should have acted early on, eg in 2011, 2012 and 2013, to compel banks that had mis-sold risky financial instruments to retail clients to buy these back at par value, once it became clear that the EU would adopt a framework for burden sharing and bail-in (see section 2). That no such action was taken must be viewed as a large-scale failure of regulation and supervision in Italy, not of EU policy. The upshot is that there is justification for the flexibility offered by the possibility of precautionary recapitalisation, constrained by restrictive conditions, during this imperfect transition.

Whenever the case for such transitional flexibility ceases to exist, the desirable policy response should be a tightening of state aid control to remove the applicability of Article 107(3)(b) TFEU, rather than a repeal of precautionary recapitalisation through a revision of the BRRD. This is because the permanent motivation for precautionary recapitalisation, as an available instrument to respond to future possible cases of acute crisis, will remain relevant, especially in the absence of a practical European Union capacity to adopt emergency legislation even in dire circumstances.

The use of precautionary recapitalisation is constrained by fairly restrictive criteria, and the few cases of actual use so far do not suggest that these criteria are improperly enforced by the relevant authorities. In these circumstances, it would be inadvisable to repeal Article 32(4)(d)(iii), as long as the reasons for its drafting are still valid, and while there is no clear evidence of unintended consequences.

Conversely, the broader reform embedded in the BRRD, occasionally if simplistically referred to as “*replacing bail-out with bail-in*”, is sound and should be further pursued. Any calls to “*suspend BRRD*” should not be heeded<sup>15</sup>.

## **BRRD revision**

It is advisable to correct the instances of ambiguous or incorrect wording in the text, as identified in section 3 of this paper. Such changes can be made without altering the more substantial provisions of Article 32 and should thus be uncontroversial. At a minimum, “*an advantage*” should be replaced with “*an undue advantage*”, and the different language versions of the phrase “*to remedy a serious disturbance*” should be aligned with the English version.

Beyond these corrections, no change in Article 32(4)(d)(iii) appears imperative before the broad review of the BRRD planned to start by mid-2018 at the latest under BRRD Article 129.

Specifically, there is no urgent need to tighten the conditions for precautionary recapitalisation, let alone to impose more creditor burden-sharing than is currently requested under the state aid framework. Suggestions made in the recent Geneva report (Philippon and Salord, 2017; proposals 5 and 14) appear premature in this regard. In the light of recent experience with BPV and VB (which came after the report’s publication), their assessment that “*precautionary recapitalization [...] often means more forbearance, more denial and more time wasted before real action is taken*” appears unduly harsh. It will be useful, however, to reconsider these and other similar proposals at the time of the above mentioned BRRD review after mid-2018, in the light of any further experience with precautionary recapitalisation in the meantime.

14 See Laura Noonan, Caroline Binham and James Shotter, ‘Deutsche Bank received special treatment in EU stress tests: German lender’s result was boosted by a special concession agreed by the European Central Bank’, *Financial Times*, 10 October 2016.

15 Wiley *et al* (2016) claim that “*the European Commission rejected the Italian government’s proposal in late June to suspend the resolution framework and State aid rules to allow a recapitalisation without bail-in*”. It might be recalled that the BRRD was adopted by unanimity decision of member states, and with an overwhelming majority in the European Parliament.

## Implementation practice

Bank crisis management is not an exact science. Legislators should aim at maximising predictability as one of their objectives, but predictability can ultimately be achieved only through consistent implementation practice. The legislation should leave sufficient discretion to the relevant authorities to adapt to the inherently unpredictable circumstances of individual cases, particularly in the above-mentioned context of an unfinished banking union in which, to mention only one example, bank insolvency frameworks remain widely divergent between member states<sup>16</sup>.

It is very important, for example, that the European Commission's Directorate-General for Competition (DGCOMP) be rigorous in its assessment of financial stability and of the scope for serious disturbance in the economy of a member state when verifying compliance with the financial-stability conditions of Article 32. Similarly, the SSM and other prudential authorities must be discriminating in their decisions on stress test scenarios (both baseline and adverse) and their running of stress testing, given the key role these play in the balance-sheet testing conditions of Article 32. The various authorities involved, including the SSM, SRB, DGCOMP and relevant national governments and authorities, should learn the right lessons from past episodes in order to improve their coordination. Last but not least, as a matter of good supervisory practice and unless circumstances make it absolutely impossible, an in-depth asset quality review should always be performed as a prerequisite for precautionary recapitalisation. The European Parliament should scrutinise such practices as appropriate, but should refrain from overly prescriptive legislation that would risk being counter-productive in concrete cases of crisis management.

## Related reform recommendations

Finally, past debates about precautionary recapitalisation suggest consideration of two reforms that are not within the scope of the BRRD itself, but are closely related.

First, the auditing framework for EU banks (and by extension, for other companies as well) should be improved. The experience of the past decade suggests that many EU banks' public financial statements, even when a bank is listed on a stock exchange, are not of sufficient quality and reliability. In the BRRD context, the consideration by public authorities of *"losses that a bank has incurred or is likely to incur in the near future"* is rendered more difficult than it would be with higher-quality audits. This concern justifies a broader reform of public auditing in the European Union, which is also advisable under the EU policy of capital markets union<sup>17</sup>. Furthermore, all EU banks that do not yet publish consolidated financial statements using International Financial Reporting Standards (IFRS) should be legally required to do so, even if they are not publicly listed and irrespective of size, as is the case in several EU member states and in most of the world's other jurisdictions that have incorporated IFRS into their accounting framework<sup>18</sup>.

Second, for banks headquartered in the euro area, the European Stability Mechanism (ESM) should modify its guidelines on the use of its direct recapitalisation instrument (finalised in December 2014) to allow for that instrument to be used for precautionary recapitalisation. Currently, only individual member states can engage in precautionary recapitalisations, a situation that prevents the fulfilment of the banking union's aim *"to break the vicious circle between banks and sovereign"*, as repeatedly emphasised by euro-area heads of state and government. Allowing the ESM to participate either alone or alongside member states would help to fulfil that promise and would also, given the ESM's professionalism and governance framework, enhance discipline in the process of precautionary recapitalisation when it is needed. This reform could be part of a broader future reconsideration of financial risk-sharing in the banking union, together with measures aimed at enhancing market discipline and sounder risk management.

<sup>16</sup> The importance of this particular aspect was highlighted by the cases of BPV and VB.

<sup>17</sup> This argument is developed in Véron and Wolff (2015).

<sup>18</sup> Similarly, all banks in the United States, even small unlisted ones, are required to use US Generally Accepted Accounting Principles for their financial statements.

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