

Quaderni giuridici

## The marketing of MREL securities after BRRD

Interactions between prudential and transparency requirements and the challenges which lie ahead

*S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini*



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# La distribuzione di titoli MREL dopo la BRRD

## L'interazione tra regole prudenziali e di trasparenza

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## Sintesi del lavoro

L'interazione tra gli obiettivi di stabilità finanziaria e di tutela dei consumatori alla base del quadro di risoluzione delle crisi bancarie è molto complessa e rende necessaria un'adeguata calibrazione delle salvaguardie. Per questa ragione risulta appropriata una introduzione graduale dei requisiti MREL (*Minimum Requirement for own funds and Eligible Liabilities*). Se tali requisiti devono essere specifici per ogni singola istituzione (v. art. 4 del Regolamento delegato), è questo un campo d'elezione, nel quadro della regolamentazione prudenziale, per l'uso di calibrazioni individuali e per l'applicazione dei principi generali di proporzionalità, sussidiarietà e diversità. A ciò si aggiunge che i requisiti di trasparenza sono stati negli anni progressivamente rafforzati a tal punto che è oggi difficile identificare un modo assolutamente sicuro per una banca per distribuire ai propri clienti (in particolare quelli al dettaglio) strumenti finanziari in grado di esporli ad un potenziale rischio di perdita; i rischi di azioni di annullamento o di risarcimento sono divenuti tali da aver nei fatti trasformato quello che dovrebbe essere un normale processo di *marketing* in una serie di avvertimenti minacciosi. In questa situazione diventa difficile immaginare una massiccia distribuzione al dettaglio di titoli MREL sia in Italia che in molti altri Stati Membri. L'esperienza pratica illustra i travagli che derivano dall'impatto di problemi "micro" a livello "macro" e viceversa. Sennonché il sistema giuridico non dovrebbe esacerbare bensì prevenire i potenziali conflitti

JEL Classifications: G14, G18, K20, K22.

Keywords: BRRD, MREL, securities, transparency, prudential requirements.

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nell'interazione tra obiettivi di stabilità finanziaria e protezione dei consumatori. In questa prospettiva riteniamo che un più ampio uso della proporzionalità valga a meglio conciliare i requisiti prudenziali e di trasparenza; è questo certamente un problema non facile ma che deve essere necessariamente affrontato per poter soddisfare in modo sicuro i bisogni di finanziamento MREL nel futuro prossimo. Per una volta, la proporzionalità, per il suo carattere di norma "aperta" può consentire di identificare regole chiare, ma al tempo stesso attuabili, per la commercializzazione degli strumenti MREL. In caso contrario, le banche rischiano di trovarsi al centro di un conflitto tra standards 'aperti' di risoluzione e regole per la protezione del consumatore, con il rischio di dover collocare un ingente volume di titoli senza però avere un pubblico disposto ad acquistarli. Non v'è dubbio che i comportamenti di vendita al pubblico e la formazione specifica della forza di vendita delle banche debbano e possano migliorare, ma deve esservi al contempo un'idea più chiara e praticabile, di come un corretto processo di *marketing* si traduca in specifiche e ragionevoli avvertenze che siano adeguatamente comprese dal cliente e lascino la banca e i suoi dipendenti con una la 'coscienza pienamente pulita'.

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## Abstract

The interplay between the objectives of financial stability and consumer protection underpinning the bank resolution framework is a very complex one, hence the need of an adequate calibration of safeguards. A flexible approach in phasing-in MREL requirements is, therefore, necessary. If MREL must be institution-specific (Article 4 of the Delegated Regulation), there is hardly any other field of prudential regulation where individual calibrations are more warranted, and the use of general principles of proportionality, subsidiarity and diversity more necessary. In turn, transparency requirements have been progressively strengthened to a point that it is difficult to identify a sure way in which a bank may market to its clients (in particular retail ones) a financial instrument that exposes them to a risk of loss, without being exposed to an action for annulment or for damages, and without fully denaturalising the marketing process, i.e. turning it into a series of ominous warnings. It is difficult to imagine a massive retail distribution of MREL securities in Italy and in several other Member States under these circumstances. Anecdotal evidence shows the travails that result from the impact of 'micro' issues on a 'macro' level and vice versa. If one fails to grasp this connection, the legal system itself would end up exacerbating, instead of preventing, clashes between financial stability goals and consumer protection needs. In this vein, we argue that in the determination of individual MREL requirements and in the sale of MREL securities an approach based on the extensive use of proportionality should be adopted. This, to our minds, is essential to credibly answer the question to whom may MREL securities be marketed. For sure, the answer to this question needs to reconcile prudential and transparency requirements and this is an intractable problem, but one that must be addressed if MREL funding needs must be safely met in the near future. For once, proportionality, despite its open-textured nature, may call for bright-line rules in what concerns the marketing of the instruments, when applied to MREL requirements. Otherwise, banks may be caught in the middle of open standards for resolvability, on one hand, and consumer protection, on the other, with the result that they may be required to place a massive volume of securities, but find no public to place them, or else risk public outrage if they go under. Marketing standards and employee training need to improve, but there has to be a clearer idea of what a proper, and workable, marketing process looks like, and how that translates into specific warnings that are adequately understood by the client, but also leave the bank and its employees with a clear conscience.

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Any mistake remains, of course, our sole responsibility. The opinions expressed here are those of the authors and do not necessarily reflect those of Consob.

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## 1 Outstanding banks' subordinated debt and MREL future funding needs: a snapshot of European data and selected evidence from Italy

European credit institutions offer a variety of funding structures. Bank funding is institution-specific but, to some extent, also country-specific. Subordinated debt and other bail-inable debt instruments ranking before covered deposits are no exception and their issuance varies considerably across industry participants and throughout Europe.

In the wake of the financial crisis, subordinated debt and hybrid instruments have become critical, particularly in countries with weak macroeconomic conditions which went through one or more bank crises. Losses for holders of subordinated debt associated to recovery and resolution measures suddenly exposed to sunlight the magnitude of the problem; a problem simply made more acute by a legacy of mis-selling practices.

A data analysis of the outstanding European banks' subordinated debt is useful to properly frame our legal analysis<sup>1</sup> (and is also offered in Appendix 1).

The issuance of subordinated debt almost doubled in value in 2014 and was much higher in 2015 than in the period from 2010 to 2013; in turn the issuance of senior debt almost halved from 2010 to 2015.

**Figure 1 – European banks' debt issuance**  
(mln EUR)

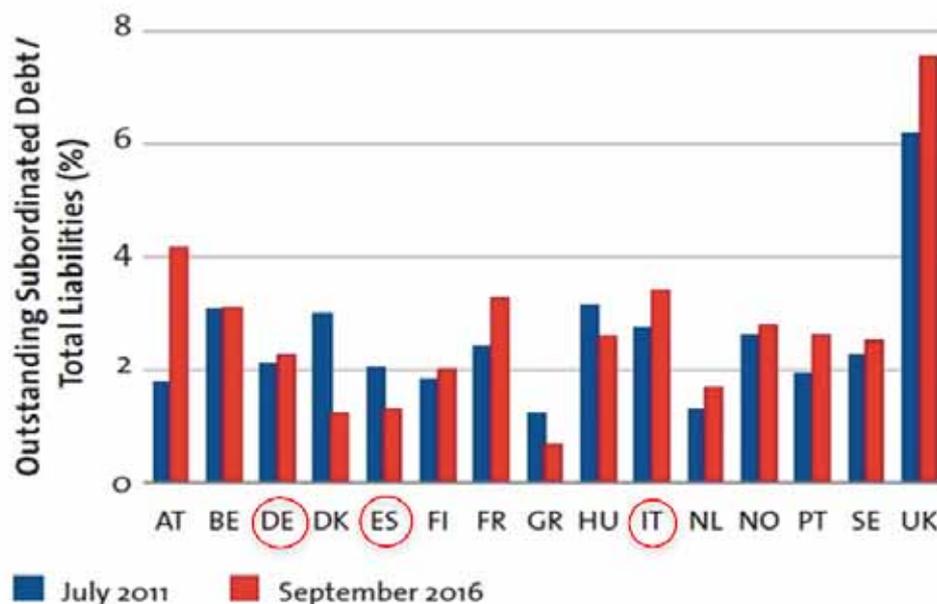
	Subordinated debt issuance		Senior debt issuance	
	Fixed duration	Perpetual	Fixed duration	Perpetual
2010	19,477	3,335	591,655	-
2011	17,350	-	582,511	-
2012	15,026	1,947	482,747	-
2013	22,516	4,497	358,038	69
2014	28,345	27,609	404,747	-
2015	24,020	9,669	302,096	846

Source: SAFE, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016, p. 12.

<sup>1</sup> We use to this informative purpose the data offered by the "Bail-In Tracker" developed by the "Sustainable Architecture for Finance in Europe" (SAFE) Research Center at the University of Frankfurt. This web tool provides information about the current outstanding subordinated debt of 36 large banks headquartered in 15 European countries, calculated for each week since July 2011. Complementary insights are offered by SAFE White Paper No. 35/2016: M. Götz, T.Tröger, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016 (the paper was also provided to the ECON Committee of the European Parliament and published in the EP website as such); further discussion in M. Götz, *The Bail-In Tracker: Does the new EU Regulation on Bank Recovery and Resolution Work?*, in *SAFE Newsletter*, 28 October 2016.

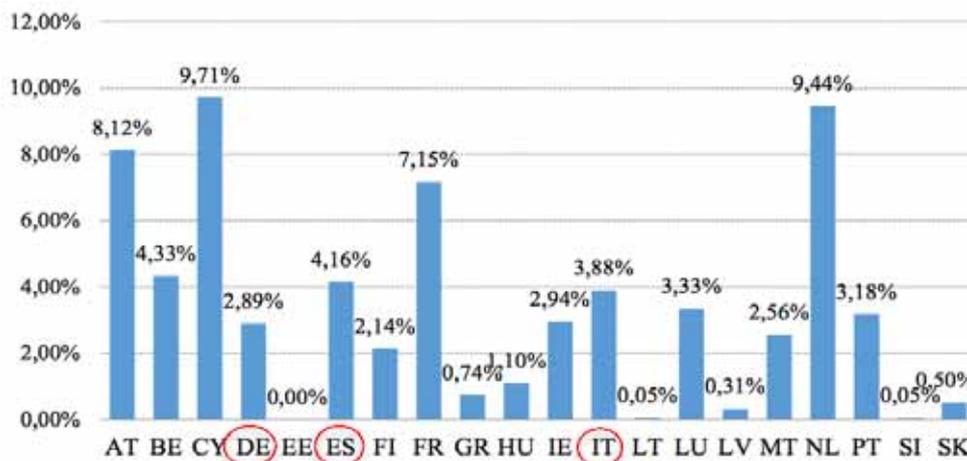
Differences among countries and institutions are, as said, large and average data hide the true story. Figures 2 and 3 below show the differences across Member States.

Figure 2 – Outstanding subordinated debt / total liabilities



Source: SAFE, Average size of outstanding subordinated debt in total liabilities across countries in July 2011 and September 2016.

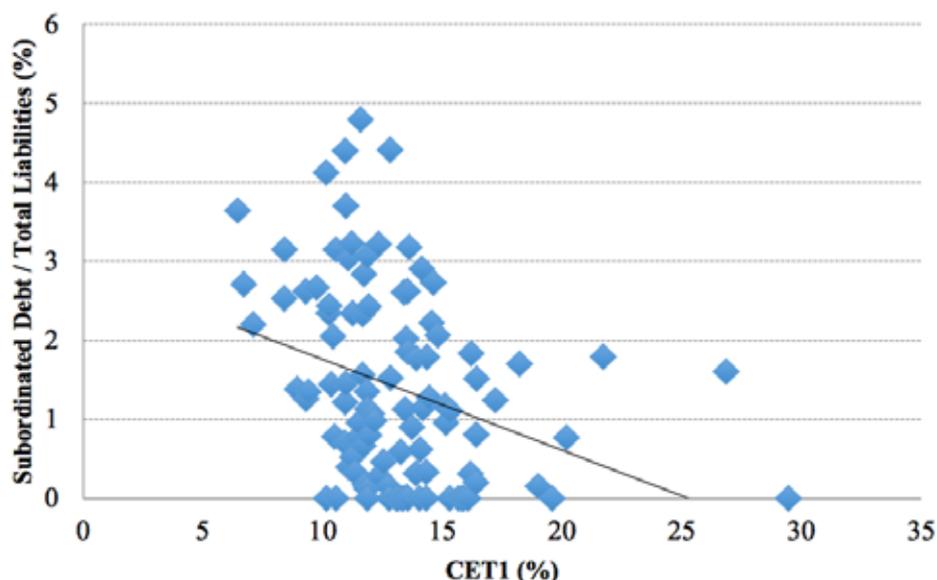
Figure 3 – European banks' aggregate subordinated debt to GDP across countries. Time period: 2014



Source: SAFE, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016, p. 10.

Figure 4, in turn, shows that financing with subordinated debt comes at the expense of, rather than in addition to, financing with equity. Banks with less equity tend to finance themselves more with subordinated debt than banks with more equity.

Figure 4 – Relationship between subordinated bank debt/total liabilities and Common Equity Tier 1 (CET1)



Source: SAFE, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016, p. 11.

These figures highlight the current holdings of subordinated debt instruments in the European banking sector. They clearly show that this must be a source of concern if banks that make recourse to subordinated debt must face loss absorbing and recapitalisation measures in the context of recovery or resolution proceedings.

The existing literature also shows that, at the European level, a broad range of differences exists as regards the relationships between capital, subordinated debt, and senior debt, too.<sup>2</sup> These differences have relevant implications for the stability of the banking system and the sustainability of bail-in processes. Some of these implications are, by way of example, briefly summarised here below.

- a) In the United Kingdom over 7,5% of bank debt is subordinated. Figures for Italy, France, Belgium, and Austria lie around the European average (below 4%), whereas in countries like Greece, Denmark and Spain the stock of subordinated debt has historically been low. The issuance of subordinated debt in Greece and Spain has even decreased between 2011 and September 2016, showing that such securities offerings are very tricky, if not impossible, to accomplish in difficult times. Moreover, anecdotal evidence shows that, if successfully placed, these securities later turn out to be as a quite intractable source of massive litigation, when the subordination clause is triggered (an issue which we will discuss in detail below). At the same time there is also evidence of a significant increase in the issuance of perpetual bonds, especially in 2014. This most likely shows that banks attempt to anticipate to some extent compliance with MREL

<sup>2</sup> M. Götz, T. Tröger, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016.

requirements (an issue which we will discuss in detail below), while limiting the roll-over risk associated with short- and medium-term debt.

- b) Nearly a 15% of the subordinated debt issued in the Euro zone is denominated in currencies other than the Euro, with a prevalence of US dollar-denominated debt.<sup>3</sup> This introduces an element of uncertainty associated to exchange-rate risk in MREL calculations, which are already complicated.
- c) More than a quarter (26%) of subordinated debt at a consolidated level is not issued by parent companies, but by their subsidiaries, which are often located in different jurisdictions. This introduces some uncertainty on the laws applicable to the bail-in of those instruments, if a strategy is adopted at a group level (an issue which we will also discuss below). It also highlights that some basic limitations in the European framework, such as the lack of harmonization of notions such as 'group interest' and its legal entitlements. In the context of restructuring and consolidation, such lack of harmonization beyond the scope of the BRRD provisions on intra-group financing agreements could prove consequential. If the intricacies of European banks' group structures, and their implications are hard to fathom even for experts, investors – especially retail ones – will most likely be unaware of bail-in risks at the consolidated level.
- d) Subordinated debt instruments issued by banks amounted to almost € 500 billion at the end 2014 of in the Euro zone. What is really striking however, as already noted, is the inverse relationship that exists between a bank's capital and its subordinated debt, with lower capital banks issuing higher volumes of subordinated debt. The paradox is that lower CET1 ratios increase the probability of bail-in, which poses a greater risk for subordinated debt instruments. It is unlikely that investors– especially retail ones– are aware of this inverse relationship. The problem is not just one of retail investors holding subordinated debt, though. According to the data provided by EBA with its End-2016 G-SII Disclosure Exercise, multiple banks (and other financial institutions) hold subordinated debt instruments issued by other banks worth roughly € 30 Billion. *Such a tangle of cross-exposures, especially in Member States with stagnant economies, could end up triggering systemic contagion with the unintended result that the use of the bail-in tool could actually endanger the soundness of the system at a 'macro' level if the crisis is not idiosyncratic in nature.*<sup>4</sup>

3 Compare also EBA, *Final Report on MREL, Report on the implementation and design of the MREL framework*, EBA-Op-2016-21, 14 December 2016, at p. 66: "Public market information on aggregate debt by currency maturing in 2018 and later (see Figure 27 and Figure 28) indicates that—besides the dominant market for issuances of instruments denominated in EUR (54%)—European banks significantly rely on funding in other currencies, predominantly in USD (19%), JPY (11%), GBP (6%) and other currencies. This indicates that banks have the potential to issue MREL-eligible instruments not only in domestic but also in international financial markets. It is important to note that global systemically important banks (G-SIBs) have better access to foreign markets, as the analysis of a subsample without including G-SIBs (Figure 28) suggests a higher proportion of non-G-SIBs' funding in EUR."

4 See O. De Bandt, P. Hartmann, *Systemic Risk in Banking: A Survey*, in C. Goodhart, G. Illing, *Financial Crisis, Contagion, and the Lender of Last Resort*, 2002, Oxford University Press, p. 249 ff.

This is an issue recently tackled also by EBA in its 2016 Report on the implementation and design of MREL, showing how tricky it is to balance all competing interests at stake in this specific domain: "The EBA recommends that exposures to MREL-eligible instruments issued by all credit institutions should be deducted from MREL on a like-for-like basis above a double threshold meant to preserve a share of market-making activity. Holdings of senior instruments should only be deducted to the extent that they are eligible for MREL (the proportionate deduction approach), unless the large exposure limit approach set out below is adopted for issuances of non-G-SIBs. While this solution departs from the Tier 2 base recommended by the Basel Committee on Banking Supervision (BCBS), the EBA considers this departure justified in the EU context where all banks are subject to an MREL requirement. Alternatively, deduction from the Tier 2 base could be retained with a view to full compliance with the BCBS recommendation. In addition, if a deduction regime was considered as hindering the development of the market for MREL instruments issued by non-G-SIBs, an ad hoc large exposure sub-limit should be introduced for holdings of MREL-eligible instruments issued by those banks within the large exposure limits set out in Article 395 of the CRR. The calibration of the sub-limits should rely on an impact analysis, taking into account the effect on non-G-SIBs, consistency with the deduction approach and consistency with the overall large exposure framework. These elements could be analysed in the context of an EBA report and eventually set out via RTS. Given that one of the objectives underpinning this option is simplification, holdings of senior instruments issued by non-G-SIBs would be fully included in the limit rather than on the proportionate basis described above".

The quantitative impact assessment of the same EBA 2016 Report largely confirms that, on aggregate and despite a significant heterogeneity across the sample, MREL requirements will impact very substantially on the funding needs of European banks.

"On an aggregated basis, an estimated EUR 58.2-208.1 billion MREL funding needs would imply between a 1.5% and 5.4% increase in the current stack of MREL-eligible instruments, all other things being equal. Under the partial subordination scenario, the total MREL funding needs increase to EUR 186.1 billion to EUR 276.2 billion or 4.9% to 7.2%. Under the partial subordination requirement, total MREL funding needs for G-SIBs and other systemically important institutions (O-SIIs) in subordinated debt of EUR 154.4 billion amount to 7.4% of total subordinated MREL instruments of all banks in the sample. The highest burden of the need to increase the amount of subordinated MREL instruments would fall on G-SIBs that—in order to obtain EUR 110 billion subordinated instruments—would have to increase the current stack of own funds and subordinated liabilities by 11%. O-SIIs would have to rollover senior debt into subordinated or issue new eligible instruments of EUR 44.4 billion equal to 5.2% of their own funds and subordinated debt.

This has market implications of unprecedented magnitude. As noted by EBA: "Public market data on European banks' debt maturity profiles reveals that the banks included in a sub-sample have more than EUR 2 202 billion of senior unsecured and subordinated debt maturing in 2018 or later. Of that amount, in 2018 and onwards, there will be a rollover of EUR 1 451 billion of senior unsecured debt. This amount compares to the EUR 1 193 billion of senior unsecured debt held by the 133 banks in the original sample used throughout this report. Based on market data, subordinated debt maturing in 2018 and later amounts to EUR 751 billion. Non-G-SIBs hold more than EUR 724 billion of senior unsecured and subordinated debt maturing in 2018 or later. Of that amount, in 2018 and later, there will be a rollover of EUR 547 billion of senior unsecured

debt. This amount compares to the EUR 613.5 billion of senior unsecured debt (MREL ex dep minus Own funds + subordinated debt) held by non-G-SIBs in the sample used for this report. Based on the market data sample, subordinated debt of non-G-SIBs maturing in 2018 and later amounts to EUR 177 billion".

In turn, the market's absorption capacity cannot be taken for granted when we deal with such a large stock of MREL securities. This is fairly acknowledged also by EBA (p. 45):

"The actual impact of MREL will depend on the capacity of markets to absorb the volumes of MREL issuances needed for the build-up of MREL and the corresponding capacity of banks (especially deposit-funded banks) to access markets, including access to deep, developed markets. At this stage, MREL market capacity is uncertain in a number of EU jurisdictions and the evolution in the coming years cannot be adequately assessed. As a result, the MREL macroeconomic impact can only be estimated by making certain assumptions regarding funding costs, steady-state MREL targets and MREL market capacity. For the purposes of this analysis, full market capacity has been assumed, potentially underestimating the actual effect on the cost of funding."

Of special concern is the impact of MREL on small and medium-sized deposit-funded institutions. EBA finds indeed (p. 65) that:

"The diversity of banking business models across the EU is beneficial to competition and enhances the overall banking system's efficiency. In addition, the diversity of business models is normally deemed an element that increases the resilience of the banking system to external shocks, thus protecting financial stability. Retail banks are often important providers of banking services for SMEs and individuals across Europe. The results demonstrated in the impact assessment section are based on a sample that does not cover all banks in Europe and, therefore, might under-represent the impact on small deposit-funded institutions—especially given their lack of experience in terms of debt market access. In addition, MREL requirements may be difficult to reach for many entities due to the domestic markets' limited capacity to absorb the planned issuances. Even if banks were able to access the markets, a spread could be significantly higher than that required for a larger institution. This, in turn, would negatively impact on their ability to provide funding to the real economy reasonable prices without increasing the risk profile of their portfolios. Small and medium-sized deposit-funded institutions are usually financed by deposits and covered bonds, and seldom issue debt instruments in the markets. For those entities, no reference exists to assess the expectation of investors' pricing of MREL-eligible instruments. It does not seem unreasonable to predict that the requested spreads would be well above those applied to G-SIBs and O-SIBs and could be close to the cost of new equity issuance. This is partly addressed in the impact assessment by assuming that the costs of senior MREL instruments for non-G-SIBs and non-O-SIBs will be equal to the cost of equity (8%). The precise impact of higher spreads over such entities' performances is impossible to assess, but it is likely to be material. However, it cannot be excluded that the short-term cost of debt increase will be counterbalanced by an overall reduction in bank risk in the long term".

A helicopter view of the Italian situation is also a breeding ground for concern. The tables hereunder are taken from a study of the CFA society<sup>5</sup> and show the funding structure of the most significant Italian banks as of 31 December 2015 (they do not reflect, therefore, the effects of the restructuring of Monte dei Paschi di Siena (MPS) of the wind-up of Banca Popolare di Vicenza and Veneto Banca).

**Figure 5 – Italian SSM-supervised banks' funding sources at 31 December 2015**  
(data as % of liabilities)

	Intesa	Unicredit	UBI	B. Pop.	MPS	Mediobanca	BPM	BPV	BPER	Credem	Iccrea	Veneto Banca	Total
Deposits	35%	52%	42%	38%	46%	19%	49%	41%	56%	47%	19%	43%	43%
Short-term Liabilities	9%	8%	4%	7%	18%	24%	9%	29%	9%	16%	66%	21%	11%
Obligations	28%	21%	42%	37%	23%	38%	27%	16%	20%	19%	11%	19%	25%
<1year	5%	5%	11%	13%	6%	6%	9%	3%	3%	1%	3%	4%	6%
Other Liabilities	22%	13%	4%	11%	7%	3%	6%	8%	6%	12%	1%	11%	14%
Equity	7%	6%	9%	7%	6%	16%	9%	6%	9%	7%	3%	6%	7%

Source: AIAF, CFA Society Italy, *BRRD e Bail-in. Implicazioni per l'analisi del settore finanziario e la tutela dell'investitore*, 2017, p. 63.

In turn, bond issuances of the same banks at 30 April 2016 appeared as follows:

**Figure 6 – Bond-based funding of Italian SSM-supervised banks**  
(data in mld EUR)

	Intesa	Unicredit	UBI	B. Pop.	MPS	Mediobanca	BPM	BPV	BPER	Credem	Iccrea	Veneto Banca	Total
<b>GUARANTEED</b>	37.7	45.5	13.9	7.6	14.9	2.8	5.4		3.7	2.7			134.2
Covered	37.7	45.5	13.9	7.6	14.9	2.8	5.4		3.7	2.7			134.2
<b>INSTITUTIONAL</b>	78.3	56.8	6.7	6.6	10.7	9.3	2.4	6.0	0.5	0.2	1.8	2.6	181.9
Junior*	5.2	5.3		0.2	0.7		0.2					0.2	11.7
Subordinated*	15.8	9.8	0.8	1.7	2.9	0.1	1.2	0.6	0.4	0.2	0.1	0.9	34.5
Senior	57.3	41.7	5.9	4.7	7.1	9.3	1.0	5.4	0.1		1.7	1.5	135.7
<b>RETAIL</b>	39.0	51.6	23.4	23.7	11.4	16.1	1.6	2.1	4.5	2.8	3.1	2.3	181.7
Junior		0.2			2.6								2.8
Subordinated	1.0	6.0	2.5	1.3		2.8		0.4	0.6	0.3	0.3		15.3
Senior	38.0	45.4	20.9	22.4	8.8	13.3	1.6	1.7	3.9	2.5	2.8	2.3	163.6
<b>TOTAL</b>	154.9	153.9	44.1	37.9	36.9	28.3	9.4	8.1	8.6	5.8	4.9	4.9	497.8

Source: AIAF, CFA Society Italy, *BRRD e Bail-in. Implicazioni per l'analisi del settore finanziario e la tutela dell'investitore*, 2017, p. 58.

\* As per the definitions used in this table, both "subordinated" and "junior" bonds fall under the umbrella of those debentures that benefit from a level of protection that is lower than the one for "senior" holdings (being generically referred to as "subordinated" instruments when taken together). For the purposes of data reporting herein, the "subordinated" category includes those subordinated instruments having a predefined maturity that- bar insolvency or bail-in- do not contribute to the absorption of losses of the issuing bank. "Junior" obligations, instead, encompass hybrid instruments (at the margin between obligations and shares), as well as debentures without a defined maturity, having a level of protection lower than the securities included in the previous category, as they can contribute to loss-absorption and the issuing bank can discretionally decide to suspend the payment of their coupons.

5 AIAF, CFA Society Italy, *BRRD e Bail-in. Implicazioni per l'analisi del settore finanziario e la tutela dell'investitore*, 2017.

We will come back to these figures in the last section of this paper, where we will measure our conclusions against this factual backdrop.

## 2 Burden sharing under the 2013 Banking Communication and bail-inable instruments and MREL requirements under BRRD

### 2.1 Burden sharing under the 2013 Banking Communication

With its 2013 Communication on the application of Article 107(3)(b) of the TFEU to the banking sector,<sup>6</sup> the European Commission clarified that, whenever a bank incurs in a capital shortfall, it will demand that any potential grant of state aid follow the recourse to all possible measures to minimise the cost of coping with such shortfall: these may include capital raising activities by the bank, burden-sharing by shareholders *and subordinated creditors*, as well as measures aimed at avoiding fund outflows from the bank.

Even though burden sharing was already embedded in the 2009 Banking Communication,<sup>7</sup> the 2013 update<sup>8</sup> strengthens such requirement.<sup>9</sup> Indeed, in the

6 Communication from the Commission on the application from 1 August 2013 of State aid rules to support measures in favor of banks in the context of the financial crisis ("Banking Communication") (2013/C 216/01), 30 July 2013.

7 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), 19 August 2009. Very generally, point 22 laid down the following: "Aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary. The bank and its capital holders should contribute to the restructuring as much as possible with their own resources."

8 It replaces the 2008 Banking Communication in full and supplements the remaining crisis rules laid down in the Recapitalisation Communication, the Impaired Assets Communication and the Restructuring Communication. *Article 107 TFEU itself gives leeway to the Commission to adapt the state aid policy regime in trying times*, so that, when it is necessary and proportionate in order to address market failures, aid measures can be considered compatible with the common market (compare Article 107(3), letter (b) according to which aid to "remedy a serious disturbance in the economy of a Member State" "may be considered to be compatible with the internal market"). The European Commission has wide discretion in such compatibility assessment, but its decisions remain subject to review by the CJEU. Such assessment must involve "the appreciation and weighting of different elements of an economic and social nature within a pan-European context" (Opinion of Advocate General Wahl in case C-526/14, *Kotnik*, 18 February 2016). The framework developed with the interpretation of Art. 107(3)(b) was explicitly designed as a temporary response to the crisis. Still, it continues to apply in revised form, on the grounds that "stress in financial markets and the risk of wider negative spill-over effects persist" (EC's 2013 Banking Communication, para. 4 and 6) and state interventions may still be needed to stabilise the banking sector, despite having passed the worst of the crisis. Thus, the Commission appears willing to approve national support measures for reasons of financial stability. The objective of financial stability may justify a financial institution's access to state aid, but it also requires that such aid is granted only after appropriate contributions by the banks' internal stakeholders and limited to the necessary minimum. A somewhat flexible interpretation of the Commission's discretion may however justify extensive precautionary recapitalisations of weak banks without making use of bail-in if the banking system of a specific Member State is extensively undercapitalised and there are no private capital sources that can remedy the situation. On these points see, among others: S. Micossi, G. Bruzzone, M. Cassella, *Fine-Tuning the Use of Bail-in to Promote a Stronger EU Financial System*, CEPS Special Report No 136, April 2016; C. Hadjiemmanuil, *Limits on State-funded Bailouts in the EU Bank Resolution Regime*, EBI Working Paper Series 2017, No. 2.

9 Point 13 of the 2013 Banking Communication: "The adapted Crisis Communications can also ensure more decisive restructuring and stronger burden-sharing for all banks in receipt of State aid in the entire single market"; and again point 41 more specifically recites that "adequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent. Such contributions can take the form of either a conversion into Common Equity Tier 1 or a write-down of the principal of the instruments." For

first stages of the crisis, Member States generally limited themselves to just abiding by the minimum requirements set by state aid rules with regards to *ex ante* burden-sharing, *and creditors were not required to contribute to the rescue of credit institutions*. Some Member States had to go beyond minimum requirements under state-aid rules and introduced new legal frameworks for the enforcement of more stringent burden-sharing requirements to be applied *ex ante*,<sup>10</sup> but this development brought about diverging approaches in the setting of such requirements across borders in Europe, thus prompting differences in banks' funding costs depending on how likely bail-in was perceived to be in relation to the fiscal position of one State or another.<sup>11</sup> Once these inconsistencies became noticeable, it was thought necessary to address them in order to ensure a level playing field in the single market in a way that could also preserve the system's financial stability more effectively. With the more extensive burden-sharing requirements introduced by the new Communication, shareholders *as well as subordinated debt-holders of banks experiencing a capital shortfall* will now need to pitch in with their own contributions before resorting to public recapitalisation.

More specifically, burden-sharing implies that losses shall be absorbed by equity first, *followed by hybrid capital and subordinated debt instruments* - with no contribution required of senior debt-holders - by way of a conversion of their claims into equity or the write-down of their principal. Such measures are designed to ensure that distressed banks take all necessary steps, together with their investors, to reduce their shortfall, by raising equity capital and obtaining a contribution from subordinated creditors. Indeed, measures of this kind are likely to limit the amount of state aid that would eventually need to be granted.

Recapitalisations and other measures for impaired assets subject to the Communication will be deemed compatible with it only if the Member State involved is able to demonstrate that all attempts to minimise the need for state aid have indeed been undertaken. Burden-sharing of losses is one of the primary means to ensure that the efforts are considered valid.

a discussion see C. Hadjiemmanuil, *Limits on state-funded bailouts in the EU bank resolution regime*, cit.; S. Micossi, G. Bruzzone, M. Cassella, *Bail-in Provisions in State Aid and Resolution Procedures: Are they consistent with systemic stability?*, cit.

10 The bail-in of (at least some categories of) creditors was executed in a number of instances. Cyprus applied it as part of the package to deal with the distress of the Bank of Cyprus and Laiki: this included the bail-in of uninsured depositors after the *ad hoc* adoption of a resolution rule in 2013 modelled after the BRRD, which was still in the negotiation phase at the time; several Greek banks offered the conversion of Additional Tier 1 and Tier 2 instruments held by their investors into newly issued CET1 instruments in the period between 2010 and 2015; the Netherlands went beyond state aid minimum requirements in the nationalization and bail-in of all shareholders and subordinated bondholders of SNS Real in 2013; in Spain, the national legal framework developed between 2012 and 2013 prescribed mandatory burden-sharing and the reduction of public support for failing financial institutions, implying the bail-in of subordinated debt holders, as was the case under the Spanish financial sector assistance program carried out between 2009 and 2013.

11 As per the wording of point 18 of the 2013 Banking Communication, such differences "pose a threat to the integrity of the single market and risk undermining the level playing field which State aid control aims to protect."

It is acknowledged within the Banking Communication that the applicability of burden sharing may be limited by some core principles. Fundamental rights must be respected, and some safeguards and carve-outs are needed, i.e. instances where specific derogations may be introduced to protect against unintended consequences. *A particular safeguard for the rights of subordinated creditors is provided for in the state-aid rules in point 46 of the Communication, which reads that they "should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted."*

The Communication requirement that shareholders should contribute to loss absorption, to the same extent as if no state aid were allowed, does not, however, impinge (as we will discuss below) upon holders' property rights<sup>12</sup> on the securities they possess, to the extent that they are affected only in so far as they would have been in a normal insolvency procedure. *If we focus specifically on the claims of debt-holders, this remains true as long as they are not worse off than in a normal insolvency procedure and an equal treatment is guaranteed to investors belonging to the same class in the application of conversion and write-down of debentures for the purposes of bail-in.* In such instances the write-off of the value of investors' securities would not appear to necessarily call for a positive compensation to counterbalance the alleged waiving of their right to property, since the value itself of the instruments at stake will have diminished, possibly even become null due to the bank's distress.<sup>13</sup> Still, as we will see below, this assumption entails a counterfactual exercise about the road not taken, which presents important difficulties. Some relevant considerations to be made in this respect in the corresponding section.

The Banking Communication also provides for an exception, whereby statutory burden sharing can be derogated from whenever the implementation of such measures would endanger financial stability or lead to disproportionate results (point 45).

## 2.2 Bail-inable instruments under BRRD

The Bank Recovery and Resolution Directive (BRRD),<sup>14</sup> like the 2013 Communication, responds to a need to prevent bankers' moral hazard implied by public bailouts: to this aim, any recourse to extraordinary public financial support will now normally entail at least some burden-sharing (and loss-absorption) by shareholders and creditors, as per the pecking order of their priority claims under regular insolvency proceedings. The Directive currently provides EU resolution authorities with significant powers to write-down or convert into equity, in whole or in part, but also to suspend, amend, transfer or otherwise modify a range of eligible liabilities of an

12 Enshrined in Article 17(1) of the Charter.

13 For a detailed discussion on this point, see G. Guizzi, *Il bail-in nel nuovo sistema di risoluzione delle crisi bancarie. Quale lezione da Vienna?*, *Il Corriere Giuridico*, 2015, 32(12), p. 1485-1494.

14 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014. For a first official comment (academic literature is now immense) see World Bank Group, *Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD*, April 2017.

institution when recovery or resolution measures are adopted. This is meant to ensure that losses are borne first by shareholders and creditors, instead of the taxpayers.

Within the euro zone, under Regulation No. 806/2014, the Single Resolution Board (SRB)<sup>15</sup> can order the write down or conversion into equity for the principal amount of a wide range of unsecured liabilities of banks undergoing resolution. The bail-in tool serves the purpose of recapitalising a bank in resolution or obtaining capital that can be made readily available for sustaining a new bridge institution, in case liquidation is not possible or desirable, due to the negative effects for the financial system that would arise from a default.

In principle, all liabilities of a bank are bail-inable, unless expressly excluded by the Single Resolution Mechanism (SRM) Regulation or the BRRD, so as to ensure that the scope of the bail-in tool is as wide-reaching as possible in guaranteeing an adequate level of loss absorption capacity, while making creditors subject to market discipline.

Article 48 of the BRRD stipulates the sequence in which the power to write down or convert liabilities should be applied within a resolution procedure. Such order provides that capital instruments, as defined in Regulation 575/2013/EU (CRR), should be the first to bear losses, before any other liabilities can be called upon. Article 60 of the BRRD, instead, lays down a similar provision regarding the power to write down or convert capital instruments when the so-called 'point of non-viability' is reached (*PONV conversion power*). More specifically, the BRRD requires capital and debt instruments of an institution entering resolution to be written down or converted in accordance with a loss-absorption waterfall, whose steps are ordered as follows: (1) Common Equity Tier 1 items; (2) Additional Tier 1 instruments; (3) Tier 2 instruments; (4) other forms of subordinated debt that constitute neither Tier 1 nor Tier 2 capital, in accordance with the pecking order of claims in insolvency under the relevant national law; (5) eligible liabilities, in accordance with the pecking order of claims in insolvency under the relevant national law; (6) deposits from natural persons, as well as micro, small and medium-sized enterprises in excess of the amount of covered deposits.

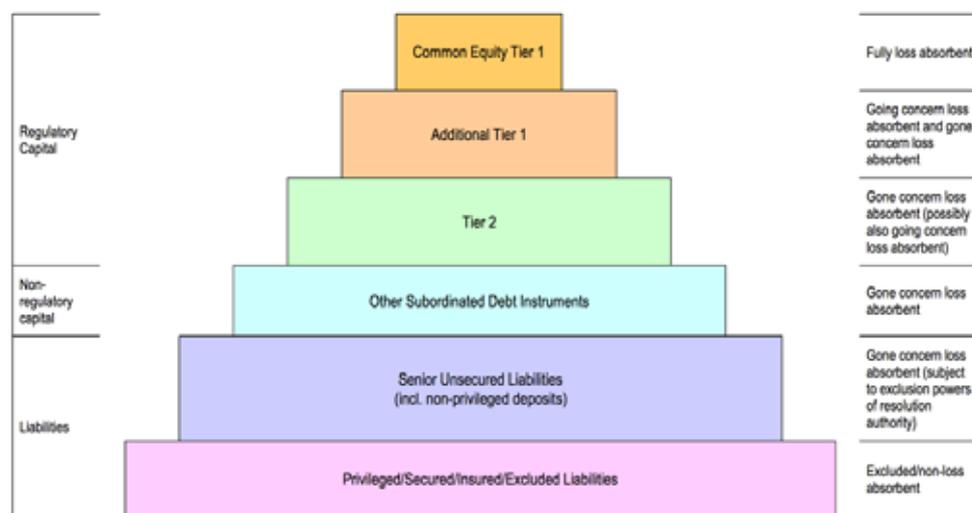
As for covered deposits in particular, i.e. those up to an amount of 100,000€, the Deposit Guarantee Scheme will pitch in in their stead.

In general, claims within the same rank must be reduced *pari passu* among themselves, and the "no creditor worse off" principle<sup>16</sup> must apply. *Creditors shall not incur losses greater than what would have come to be, had the institution entered normal insolvency proceedings, such that they are also entitled to compensation for the difference.*

15 Established in accordance with Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014. Within the SRM framework, the SRB is entrusted with a centralised power of resolution, together with national resolution authorities.

16 Enshrined in Article 34(1)(g) BRRD.

Figure 8 – Resolution Strategies and Counterparty Impacts



Source: Morrison & Foerster, *Ending Too Big To Fail: Resolution Strategies and Counterparty Impacts*, IFLR webinar, June 8, 2016.

When a financial institution is placed in resolution, its own funds and eligible liabilities constitute the primary form of financing. Their contribution must amount to no less than 8% of the bank's total liabilities. Only then the Single Resolution Fund can be tapped into, so as to cover capital needs not exceeding 5% of the total liabilities of the bank undergoing resolution.<sup>17</sup>

Note however that the actual determination of the private resources that will bear a bank's losses will result from the choices of both EU institutions' and national legislators. What EU law achieves through the definition of eligible liabilities is a reasonable levelling of the playing field, so as to counter regulatory arbitrage and opportunistic behaviours in drafting security contracts, but not full uniformity.

For a number of specific securities, the European Banking Authority has drafted guidelines<sup>18</sup> whose aim is to assist resolution authorities, as well as banks, investors, and other stakeholders in determining what is the appropriate treatment of specific categories of obligations in difficult cases. These guidelines should apply in the cases where an ambiguity arises as to the category of bail-inable instruments to which a specific instrument belongs, in order to better ascertain how they fit into the write-down sequence or conversion, with special focus on how the instrument's ranking under BRRD matches its prudential treatment under CRR/CRD IV.<sup>19</sup> The guidelines are composed by some general rules that may be applied in any case, and a

17 Differently from the BRRD, the SRM Regulation does not envisage the possibility to apply directly for alternative funding measures after the absorption of 8% of the total losses is complete.

18 See EBA, Final Guidelines concerning the interrelationship between the BRRD sequence of write down and conversion and CRR/CRD, 5 April 2017.

19 The EBA is mandated to issue such clarifying guidelines under Article 48(6) of the BRRD.

discussion of their application to specific instances concerning particular types of instruments. The two general rules are that:

- a) in applying the bail in tool or the PONV conversion power – save for those cases in which the exceptions listed in Article 38 BRRD apply – the resolution authority should treat equally the capital instruments which are ranked equally in insolvency, no matter the other characteristics and qualities they may differ in; and
- b) it should apply to instruments that are partially included in the calculation of own funds the same treatment as to those that are fully included in such computations.

Moreover, Additional Tier 1 instruments that benefit from grandfathering under Article 52 CRR<sup>20</sup> should be treated in the same way as Additional Tier 1 instruments that meet all the conditions laid down in the CRR. Likewise, those Tier 2 instruments that are only partially included in the calculation of own funds because they are subject to the amortisation regime of Article 64 CRR should be treated in the same way as Tier 2 instruments fully included in the calculation of own funds.

The rules described in these guidelines have their foundation in the resolution principles set out in Article 34 of BRRD. Such principles require that, in addition to the specific provisions of Article 48, resolution authorities should also ensure that shareholders bear losses first and *that creditors are treated fairly, and thus bear losses in accordance with their order of priority in insolvency*,<sup>21</sup> abiding by the “no creditor worse off” (NCWO) principle. A fundamental limit to the harmonisation exercise lies precisely in the definition of the pecking order in insolvency: a matter which is not set uniformly. This is compounded by the fact that article 43 BRRD provides a long list of liabilities excluded from bail-in, which immediately creates the incentive for creditors to plead that their liabilities are ‘out’ of bail-in, instead of ‘up’ in the pecking order.

Another important exception to the mandatory nature of bail-in provisions for all claimants, apart from the specific exclusion of covered depositors, is the possibility of resolution authorities to exercise their discretion to shield some categories of creditors from bail-in.<sup>22</sup> Such discretion, like the statutory exclusions

20 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013. Grandfathering conditions for instruments issued prior to the introduction of the CRR are laid down in Article 483 of the Regulation itself. Those instruments benefit from such safeguards for a transitional period going from 1 January 2014 until 31 December 2017 “in order to ensure the appropriate continuity in the level of own funds”, as per recital 78 of the CRR.

21 Unless otherwise provided in the BRRD.

22 Discretion accorded by BRRD, rec. (72), and SRM Regulation, rec. (77). Two countries that took action in this sense were Germany and Italy. In Germany, the legislature proposed to subordinate bank bonds in insolvency. A draft bill of the “Resolution Mechanism Act” (*Abwicklungsmechanismengesetz*) provides for statutory subordination of specific senior unsecured debt instruments issued by German CRR credit institutions and CRR investment firms. The proposed modifications affect sections 46f(5) through (8) of the German Banking Act (*Kreditwesengesetz*), by laying down that such debt instruments become subordinated to other unsecured bank debt in insolvency by operation of law, but they would still rank senior to any debt that is otherwise statutorily or contractually subordinated. Instead, a proposal has been advanced to make deposits that are not covered by the statutory deposit protection “super senior” in Italy. Rather than taking the German approach and providing for the statutory subordination of senior

mentioned above, may have an impact on the haircut imposed on other creditors, worsening their position, as well as potentially impinging upon the principle of non-discrimination.<sup>23</sup> This is why, in setting the MREL requirements, resolution authorities shall ensure that "when significant amounts of any insolvency class of liabilities are excluded from bail-in on either a mandatory or discretionary basis, that exclusion would not result in liabilities of the same or a more senior class bearing greater losses than they would in insolvency, as this would be an impediment to resolvability" (recital 4, Delegated Regulation 2016/1450, discussed below).

Another exception to the *pari passu* treatment is possible without prejudicing the NCWO principle, with the categories of eligible liabilities excluded from the resolution waterfall, pursuant to Article 44(3) BRRD, provided that certain conditions are met. These include instances where some particular liability cannot be bailed-in within a reasonable timeframe, when it is necessary to ensure critical functions, or if the bail-in of such liability would result in extensive contagion or a significant destruction of value.

Member States<sup>24</sup> or third countries' laws<sup>25</sup> govern the statutory exceptions to bail-in, which include liabilities owned by specific creditor categories, as per

unsecured bank debt, the Italian rules modify the creditors' hierarchy in bank insolvency proceedings (liquidazione coatta amministrativa) making those deposits that are not covered by article 108 BRRD senior to other unsecured debt of the bank. In case of insolvency, such "other deposits"- those held by corporate clients included- shall rank senior to other unsecured debt, right after covered deposits, deposit guarantee schemes, and the part of individuals' and SME's eligible deposits exceeding EUR 100,000, which all benefit from the preferential treatment under article 108 BRRD.

- 23 The decision offered by the Austrian Constitutional Court on the case of *Hypo Alpe Adria* (and creation of bad bank 'HETA') clearly highlights how an equal treatment of creditors belonging to the same investment category is one of the required points to satisfy for a positive assessment of the legitimacy of resolution proceedings. Once again, for a comprehensive analysis see G. Guizzi, *Il bail-in nel nuovo sistema di risoluzione delle crisi bancarie. Quale lezione da Vienna?*, cit., p. 1485-1494.
- 24 Some EU Member States have amended their national insolvency laws so as to ensure that senior bonds rank junior to other ordinary unsecured liabilities. For instance, Article L613-30-3-I-4 of the French Monetary and Financial Code creates a new "senior non preferred" rank in the national insolvency hierarchy - ranking senior to regulatory capital and subordinated debt, but junior to ordinary unsecured liabilities - whose introduction appears to have been favorably received by the ECB (Opinion of 23 February 2016, CON/2016/7). Such change is quite close to the requirements laid down in the proposal for amendment of the BRRD put forth by the Commission on 23 November 2016. In Italy, instead, the national Banking Association (ABI) advocated for banks to be allowed for a transitory period to calculate senior bank bonds already issued (until 2016) among the liabilities that may count for the purposes of MREL, while excluding from bail-in those senior bonds that are held by retail investors (see declarations made by ABI's Giovanni Sabatini in *ISole24Ore*, 6 August 2017). Otherwise, claims within the same rank must be written down or converted *pari passu*, as confirmed by the *Hypo Alpe Adria (Heta)* judgment establishing the unlawfulness of the different treatment granted to subordinated investors on the basis of the different maturities of their holdings.
- 25 Where securities contracts are governed by the laws of a third-country, there is a risk that the effectiveness of a resolution tool may be challenged under the law of that contract. To counter such risk, the BRRD only includes a requirement for the parties to a contract governed by a third-country law to agree to bail-in clauses. The Financial Stability Board (FSB) has highlighted the importance of setting contractual clauses that recognise the effectiveness of resolution actions taken in the jurisdiction in which the company is established, so that counterparties are less likely to successfully challenge the effectiveness of resolution actions if they contractually agreed to them in the first place. For a reconsideration, compare however the BRRD revision for what concerns art. 55 in particular, as proposed by the EC on 23 November 2016 [COM(2016)852]. According to such proposal, the resolution authority can grant a waiver on the obligation of institutions to include bail-in recognition clauses in agreements or instruments governed by third country laws, if it determines that this would not impede the resolvability of the bank, and for reasons of legal, contractual or economical impracticability of recognition clauses inclusion for certain liabilities.

Article 44(2) BRRD.<sup>26</sup> These encompass: (a) secured creditors;<sup>27</sup> (b) "protected creditors", such as covered depositors, liabilities to employees, liabilities from holdings of clients' assets or money, in the measure of their protection under the relevant national insolvency law; (c) liabilities to institutions with original maturity of less than seven days, save for intra-group liabilities. Even if each exception may find a clear justification from an insolvency, or financial stability perspective, the resulting long list will likely give rise to strategic behaviour by creditors, who have a strong incentive to position their liabilities within the 'out' list; and may also create interpretative issues in limit cases, as it will be difficult to know which principles should be used to fill the gaps.

The only exception to the rule establishing that any extraordinary financial support requires the write-down or conversion of the relevant capital instruments is the case of a precautionary recapitalisation, subject to the conditions set forth in Article 32(4)(d) BRRD. In particular, it is applicable when the institution concerned is solvent and any injection of capital or purchase of instruments involved for the purposes of its rescue is completed at prices and on terms that do not confer an advantage upon the institution.<sup>28</sup>

In accordance with the goals of the new regulatory framework for bank resolution, state aid is designed as a last resort option to be tapped into in very exceptional circumstances. One such example is the recourse to the tools of public equity support and public ownership, which fall in the category of government financial stabilisation tools being specifically addressed in Article 56 of the BRRD. On this ground, resolution authorities have the option of seeking alternative funding through those tools in the event of a systemic crisis, which qualifies as a very extraordinary situation, provided that the usual 8% contribution has been made and the financial stabilisation tool itself is cleared under state aid rules. In this sense, it is clear that this is not a resolution tool in itself, but rather an alternative to the recourse to resolution financing arrangements. *One inconsistency on this point is created by the lack of reference to the availability of government financial stabilisation tools in the SRM Regulation.*<sup>29</sup> Note that this particular option is different from the exceptions detailed in Article 32(4)(d) of the Directive, for which the provision of state aid is external and independent from the resolution procedure.

In these cases, those liabilities should not count for the MREL and should rank senior to liabilities eligible for the MREL.

26 Corresponding to Article 27(3), letters (a) through (g), of the SRMR.

27 Art. 44(2) BRRD mandates that the part of the liability that exceeds the security coverage remains subject to bail-in.

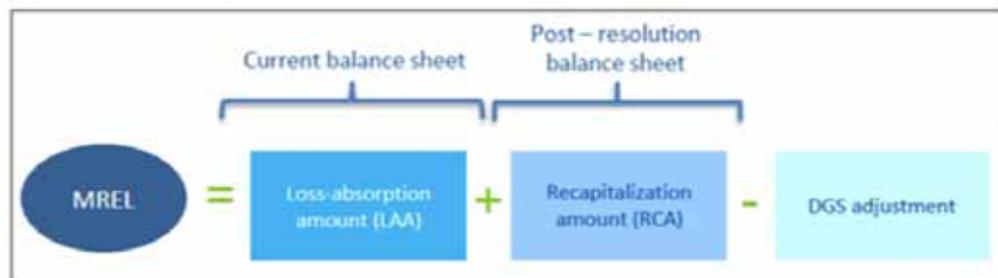
28 For concerns on a lax implementation of this requirement in the MPS case, compare M.Götz, J.P. Krahen, T. Tröger, *The Looming Risks for Banking Policy in the Rescue of Monte Paschi di Siena*, SAFE Policy Letter No. 54, also published in *Frankfurter Allgemeine Zeitung*, 3 February 2017.

29 Article 6(6) of the SRM Regulation asserts that the Commission and the Council should neither —provide extraordinary public financial support nor impinge on the budget sovereignty and fiscal responsibilities of the Member State." On this point, see A. Gardella, *Bail-in and the Two Dimensions of Burden-Sharing*, ECB Legal Conference 2015, in particular pp. 211-213.

### 2.3 MREL (minimum requirement for own funds and eligible liabilities) under BRRD and TLAC (total loss absorption capacity) under the FSB Term-Sheet.

In order to ensure the effectiveness of bail-in and other resolution tools, the undue structuring of institutions must be prevented, so as to limit the risk of contagion or bank runs, when it comes to conversions and write-downs. To this end, the BRRD calls for institutions to meet a robust "minimum requirement for own funds and eligible liabilities" (MREL) at all times. Such requirement is expressed as a percentage of an institution's total liabilities and own funds (TLOF). Its amount is institution-specific and it is thus not determined by the BRRD directly, but rather the EBA is mandated to specify the criteria for its determination by competent resolution authorities by way of regulatory technical standards.<sup>30</sup>

Figure 9 – MREL composition



MREL requirements ideally aim at ensuring that, in a resolution scenario, the write-down and conversion of the firm's internal resources - comprehensive of capital and eligible debt - will be enough to make up for the losses accrued, as well as to recapitalise the entity until it complies with mandatory capital levels once again (Art. 43, 45-49 BRRD).

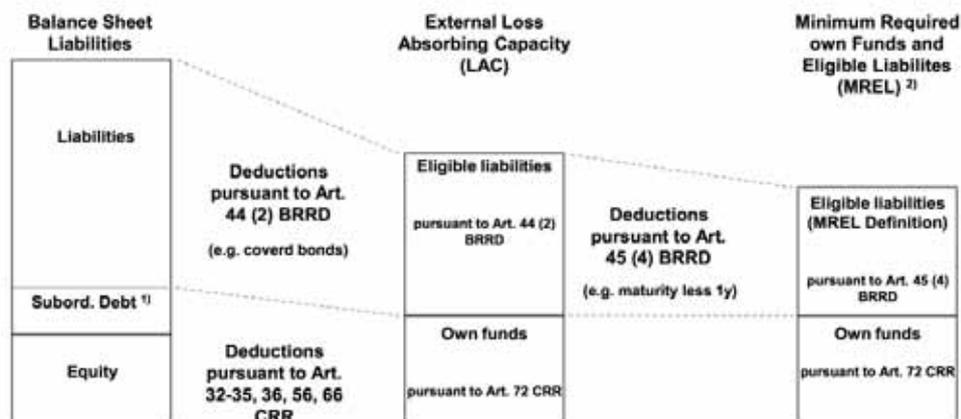
Such prerequisites should guarantee that shareholders and creditors bear losses regardless of which of the resolution tools available is applied, be it bail-in or a bridge bank. In this way, MREL ensures a sufficient capacity for both loss-absorption and recapitalisation, so as to allow for orderly resolution that can facilitate the continuity of the bank's critical functions without recourse to public funds. MREL-eligible liabilities are defined by Article 45(4) BRRD as: (a) being issued and fully paid-up; (b) not being owed to, secured or guaranteed by the institution itself; (c) not being funded directly or indirectly by the institution; (d) having a remaining maturity of at least one year; (e) not arising from a derivative; (f) not arising from preferred deposits that are preferential in the insolvency hierarchy.

Therefore, the following are excluded from MREL computations: in the first place, liabilities subject to bail-in exemption, as per Article 44(2) BRRD; in the second place, *ad hoc* exemptions under Article 44(3) BRRD, if predetermined in the resolution

<sup>30</sup> Article 45(2) BRRD.

plan.<sup>31</sup> It is worthwhile to note that this discretionary element in excluding some securities from bail-in could potentially overthrow MREL calculations, as the BRRD is not straightforward in casting the difference between those that are always bail-inable and those that are not. This could also prompt an unforeseen reliance on some specific instruments rather than others for the purposes of resolution.

Figure 10 – MREL and loss-absorbing capacity



Source: C. Schiele, *Forms of external MREL/TLAC and sequencing of write down*, World Bank Conference (Vienna, 19 April 2017).

As for systemically relevant banks, the Financial Stability Board has introduced an additional prerequisite, which applies to G-SIBs that are deemed to be 'too-big-to-fail'. It aims at bolstering their capital and leverage ratios, so as to guarantee that their critical functions can be preserved without threatening systemic financial stability or requiring recourse to further taxpayer support. The minimum TLAC requirement must be met, to a large extent, with resources that are either regulatory capital or long-term unsecured liabilities<sup>32</sup> – subordinated and senior debt – particularly suited to absorbing losses. This implies that certain excluded liabilities, such as covered and short-term deposits, derivatives, structured notes, preferred or secured liabilities, cannot be bailed-in without incurring a material risk of successful indemnity claims or other legal challenges, and thus cannot count towards meeting the required minimum. For the same reason, TLAC-eligible liabilities shall be subordinated to such excluded liabilities, with their inclusion in a junior rank under the relevant national insolvency law.

Liabilities excluded from TLAC computations are: (a) insured deposits; (b) sight deposits or short-term deposits; (c) liabilities arising from derivatives; (d) non-contractual liabilities; (e) liabilities preferred to senior unsecured debt under insolvency law; (f) liabilities that benefit from statutory exemption from bail-in, or that

31 Article 45(6)(c) BRRD.

32 With a remaining maturity of at least one year.

cannot be bail-in without giving rise to a material risk of successful legal challenge or indemnity claims.

Similarly to what has been recommended for the FSB TLAC standard, the EBA has advocated for the exclusion of equity from those securities that count towards MREL and capital buffers building at the same time, in order to ensure that capital buffers can fulfil their intended purpose.<sup>33</sup> Two are the hypotheses advanced to achieve this, namely, either by stacking the buffers above MREL requirements, or by treating the two frameworks as parallel. Obviously, this has consequential implications for the determination of the sheer amount of additional funding required under MREL and TLAC for most European banks.

There are differences and overlaps between TLAC and MREL. This point has been very clearly addressed by Andrew Gracie :

"Starting with MREL and TLAC, much has been made of the differences between them. Let me set these out in turn: (1) TLAC sets a global standard for G-SIBs while MREL is for all EU banks and investment firms. (2) TLAC describes a Pillar 1 minimum requirement, while MREL is set by the resolution authority, bank by bank on the basis of a resolution plan. (3) The TLAC requirement is set in terms of risk weighted assets (RWAs) and leverage while MREL is formally set in relation to total liabilities and own funds. (4) The FSB consultation specifies the quantum and quality of TLAC a G-SIB requires and sets out how TLAC should be distributed within groups. While BRRD provides for more flexibility, certainly on whether liabilities need to be subordinated to count as MREL.

So much for the differences. But both are founded on the same principles and in the Key Attributes have the same DNA. Both are designed to achieve the twin objectives of: (i) Maintaining critical economic functions in the event of failure; and (ii) Doing so, without recourse to public funds. What this implies for the size of MREL and TLAC is the same. Resources should be sufficient to support the continuation of critical economic functions at the point of resolution. Based on an assumption that going concern capital is eroded on the way in to resolution, this implies that there is sufficient loss absorbency to convert to equity capital to stabilise the firm. Stabilisation for this purpose means having resources available to allow the firm to be reauthorised by all relevant home and host supervisors and to maintain market access. All of these factors are set out in the EBA's technical standard. The same considerations are described in the principles that cover the FSB Term Sheet.

It is worth pausing to unpack what this is likely to mean for different sorts of firm and different group structures. Certainly for G-SIBs, the assumption lying behind the calibration of TLAC is that given the size and complexity of their operations and their activities cross-border it is hard to conceive of a significant restructuring at the point of resolution. Rather the accent is on stabilising the firm via bail-in to restore solvency to buy time for an orderly restructuring and/or a solvent wind-down afterwards. This should be good for the system and, by preserving value, for creditors of the firm. By contrast, a very small bank may need no MREL beyond its current capital requirements. If, at failure, there is no obstacle to putting the firm into insolvency and paying out

<sup>33</sup> In its Final Report on MREL (Report on the Implementation and Design of the MREL Framework) of 14 December 2016.

covered deposits using the relevant deposit guarantee scheme (DGS) then no MREL is required beyond capital requirements as a going concern. This goes too to the location of TLAC or MREL in groups. There needs to be externally issued MREL wherever, under the preferred resolution strategy, bail-in of external liabilities is likely to occur or where other resolution tools are to be applied. The plan under a single point of entry (SPE) strategy is that only the entity at the top of group is put into resolution on the basis that the interdependencies within a group are so extensive that resolving the different operating companies within a group separately is either impossible or not credible. By contrast where a group is organised in a more modular fashion with limited or no interlinkages between the parts, then the resolution can have multiple points of entry (MPE). It has been convenient for exposition to set up this dichotomy between SPE and MPE. But in practice, many SPE firms will have around the periphery subsidiaries that could be resolved separately or allowed to enter an insolvency without adverse consequences for the resolution of the firm. And many MPE banks are, in practice, collections of SPE strategies. They may be set up to be resolved jurisdiction by jurisdiction. But within jurisdictions the resolution is likely to involve keeping together in resolution the legal entities within that jurisdiction. All of this can be summed up with two observations and one implication. The first observation is that the resolution strategy will govern decisions on MREL. The second is that TLAC can and will be applied for G-SIBs through the setting of MREL requirements. In other words TLAC is just one particular expression of how we will set MREL for firms where, as authorities, we are likely to face no choice other than bail-in in order to continue the firm's economic functions.[emphasis added]. The implication is that there needs to be some level of disclosure about resolution strategies and liability structures at the legal entity level. Otherwise investors will not be able to price the risks they are exposed to. The Basel Committee intends to consult on new Pillar 3 standards for this purpose by the end of this year. This is welcome. But it is welcome too that banks are starting to do more to provide this kind of information to investors.

It is also worth noting that TLAC/MREL criteria may overlap with Basel III capital requirements, due to the fact that, of the two functions they are devised to execute, namely loss-absorption and recapitalization, the former is achieved through instruments that will also qualify as Basel III capital requirements (regulatory capital, plus combined buffer, plus any Pillar 2 requirements introduced by the supervisor), and in principle it should be equivalent to the supervisory amount.<sup>34</sup>

#### 2.4 Setting MREL: Delegated Regulation 2016/1450 of 23 May 2016, EBA Final report 2016 and SRB 2017 initiatives.

On 23 May 2016 the European Commission adopted Delegated Regulation 2016/1450, which supplements the BRRD with regulatory technical standards (RTS) specifying the criteria relating to the methodology for setting the MREL. The Delegated Regulation clearly acknowledges that MREL is not only institution-specific *but also a function of the likely resolution strategy* envisaged for the specific credit

<sup>34</sup> M. Lamandini, D. Ramos Muñoz, *EU Financial Law. An Introduction*, 2016, Milano, p. 542.

institution or financial group. Recital (3) posits indeed that “the assessment of the necessary capacity to absorb losses should be closely linked to the institution's current capital requirements, and the assessment of the necessary capacity to restore capital should be closely linked to likely capital requirements after the application of the resolution strategy, unless there are clear reasons why losses in resolution should be assessed differently than in going concern.

A similar assessment is necessary to ensure the MREL is sufficient to ensure resolvability of an institution when resolution tools other than bail-in are to be applied”. This is right but also highly consequential for the proper determination of the scope of MREL requirements. Indeed, when resolution is not the envisaged strategy, because normal insolvency will be applied, MREL requirements will in principle be limited to the loss absorption amount component, which is equal to existing own funds requirements, without any additional recapitalisation amount. In this event, MREL shall not stack over capital requirements.

Article 2(1) and (2) sets out this principle where it states that: “1. Resolution authorities shall determine an amount of recapitalisation which would be necessary to implement the preferred resolution strategy, as identified in the resolution planning process. 2. Where the resolvability assessment concludes that liquidation of the institution under normal insolvency proceedings is feasible and credible, the recapitalisation amount shall be zero, unless the resolution authority determines that a positive amount is necessary on the grounds that liquidation would not achieve the resolution objectives to the same extent as an alternative resolution strategy”.

The Delegated Regulation confirms that there is a strict relationship between MREL and own funds prudential requirements on an individual basis. This idea is also supported by the requirement that “[i]n order to ensure consistency with prudential supervision, the resolution authority's assessment of the size, business model, funding model, and risk profile of the institution should take into account outcomes of the supervisory review and evaluation process (SREP) carried out by the competent authority pursuant to Article 97 of Directive 2013/36/EU”.

Two additional points raised by the Delegated Regulation are worth mentioning here for the purposes of our discussion below.

First, according to the Delegated Regulation, a consolidated MREL approach for cross-border financial groups is warranted only under special conditions and provided that the contribution to loss absorption and recapitalisation from sources in other group entities can be “credible and feasible”: *something that is highly dependent, within the EU, on quite diverging national company provisions on the laws of groups*<sup>35</sup> and, in relation with third countries parent companies or subsidiaries, also on diverging resolution regulatory frameworks. Not surprisingly, this issue is still a breeding ground for concern in its implementation. Suffice to say that, according to Article 2(10) of the Delegated Regulation, resolution authorities can “take account of

35 The Informal Company Law Expert Group (ICLEG), *Report on the recognition of the interest of the group*, October 2016, available at [http://ec.europa.eu/justice/civil/files/company-law/icleg\\_recommendations\\_interest\\_group\\_final\\_en.pdf](http://ec.europa.eu/justice/civil/files/company-law/icleg_recommendations_interest_group_final_en.pdf)

capital resources in other group entities which would credibly and feasibly be available to support market confidence in the entity following resolution, in the case of entities which: (a) are subsidiaries of a group subject to a consolidated MREL; (b) would continue to fulfil the conditions referred to in point (a) following implementation of the preferred resolution strategy; and (c) would not be expected to maintain market confidence and access to funding on an individual basis following implementation of the preferred resolution strategy". In turn, under Article 4 (3) of the Delegated Regulation: "In the case of an entity or group which is subject to capital and prudential requirements pursuant to Regulation (EU) No 648/2012 of the European Parliament and of the Council or Regulation (EU) No 909/2014 of the European Parliament and of the Council, only capital requirements pursuant to Regulation (EU) No 575/2013 and Directive 2013/36/EU should be taken into account for assessing the default loss absorption and recapitalisation requirements pursuant to Articles 1 and 2 of this Regulation. The resolution authority may adjust the loss absorption amount to take account of feasible and credible contributions to loss absorption or recapitalisation envisaged by specific sources required by Regulation (EU) No 648/2012 or Regulation (EU) No 909/2014". According to Article 4(4), finally, "In the case of entities which are subsidiaries of a group subject to a consolidated MREL, the resolution authority may exclude from its assessment of the loss absorption amount and recapitalisation amount any buffer which is set only on a consolidated basis".

Second, transitional periods to phase-in MREL requirements must be taken into account. The Delegated Regulation – departing, despite EBA's negative opinion,<sup>36</sup> from the draft RTS proposed by EBA itself, which originally envisaged a 48 months phasing-in period – adopted a somewhat more flexible approach, in Article 8, granting to resolution authorities the power to "determine an appropriate transitional period to reach the final MREL" "which is as short as possible". We will discuss the challenges that lie beneath such requirements in a following section.

After the adoption of the Delegated Regulation, as already noted, on 14 December 2016 EBA published its Report on the implementation and design of MREL framework.<sup>37</sup> Despite the fact that EBA fairly acknowledged that in the absence of MREL decisions from resolution authorities, it is hard to say whether there will be divergences in the levels set for comparable institutions across Member States, the Report is insightful in several respects. For the purpose of our discussion on the interplay between prudential/resolution requirements and transparency, it is worth noting that EBA stressed several aspects of the current framework that would call for amendments and improvements. It also made proposals that, if adopted, would clearly impact on the rights attached to the MREL securities and should be duly disclosed and understood by their holders.

36 EBA/Op/2016/02, 9 February 2016.

37 EBA, Final Report on MREL, Report on the implementation and design of the MREL framework, cit.

In EBA's words:

"(...) it is crucial that a breach of MREL is treated as seriously as a breach of capital requirements (...). The EBA also recognises that, in the current regulatory set-up, adopting an approach under which the buffers stack above MREL could lead to a mechanical acceleration of automatic restrictions on voluntary distributions. In order to address this issue, the EBA proposes that, where a breach of regulatory buffers results from a failure to roll over MREL-eligible debt, there should be the possibility of a suspension of distribution restrictions for a defined period of time, either automatically or on a discretionary basis. During this 'grace period', the institution would have time to repair its MREL capacity by issuing eligible debt.

MREL is an essential factor of a bank's resolvability. It must be met at all times and any breach should trigger an appropriate and proportionate response (...). The EBA therefore recommends that resolution authorities be given strengthened powers to respond to a breach of MREL, including an expedited impediment removal process and the power to require an institution to draw up an MREL restoration plan. The report also suggests that the toolbox of the resolution authority should be further improved through the introduction of powers to proactively monitor and manage the maturity of an institution's MREL stack. A redemption approval regime should also be implemented to ensure that there is an approval requirement for any redemption by an institution of an MREL-eligible instrument where that redemption would bring the institution into breach of its MREL requirement (or combined buffer requirement (CBR) if this stacks on top of MREL) or where the institution is already in breach of its MREL requirement. (...).

Loss-absorbing capacity should be distributed within groups with a view to best support the resolution strategy for the group by passing losses from the entities where they originate to the entities where resolution action is implemented. In the EBA's view, EU material subgroups of third-country G-SIBs should be required to collectively meet a level of MREL in line with the TLAC term sheet. For the broader population of banks, subsidiaries should meet an internal MREL requirement governed by an updated intra-group framework, with instruments that are internally issued subordinated and subject to extended write-down clauses. In addition, with a view to addressing the costs arising from pre-positioning MREL instruments at the level of every entity, the EBA recommends that resolution authorities should be able to authorise banks to count collateralised guarantees towards meeting their MREL requirement under certain conditions. At this stage, it was deemed premature to recommend the admissibility of non-collateralised guarantees; instead, a BRRD review clause could provide for further proposals based on a future EBA report.

The EBA further makes a recommendation for harmonised reporting and disclosure requirements in the area of MREL. Disclosing the MREL requirements and capacity of banks, at least in the steady-phase, would carry some important benefits. It would provide transparency to investors and thus support market discipline, decrease speculations about banks' health and facilitate appropriate pricing. At a minimum, during the transition period investors should be aware of information on the creditor hierarchy applicable to the instrument and the overall MREL quantum and composition for each institution.

It is also worth noting that EBA adopted a tripartite approach to MREL requirements for EU banks, when considering the subordination requirements for MREL-eligible liabilities. Indeed, EBA has identified three clusters of banks: non systemically relevant, for which no subordination requirement is envisaged; globally systemically important banks (G-SIBs); and other systemically important institutions (O-SIIs).

Subordination is proposed by EBA for the latter two on different terms:

The subordination of MREL-eligible instruments is important both for the signal it sends to investors about the loss absorbency of the instruments and to avoid 'no creditor worse off' (NCWO) issues. The report recommends requiring that globally systemically important banks (G-SIBs) meet their MREL with subordinated instruments at least to a level of 14.5% of RWAs (+ CBR) in line with the TLAC term sheet. In addition, considering the systemic importance of other systemically important institutions (O-SIIs) but also the level playing field and cost considerations, it is recommended to also require O-SIIs to meet a subordination requirement of 13.5% of RWAs (+ CBR). However, taking into account the heterogeneity in the O-SII population, authorities should be given some flexibility in applying this subordination requirement.

The more flexible approach adopted with regard to O-SIIs is meant to respond to concerns that only the largest European financial institutions (e.g. G-SIBs) have full access to international markets, whereas such access is a challenge for O-SIIs. In addition, limited or no access to international financial markets is the norm for many deposit-funded banks. O-SIIs are identified in accordance with the EBA Guidelines on the criteria for the assessment of Other Systemically Important Institutions (O-SIIs) pursuant to Article 131(3) of Directive 2013/36/EU and the ensuing list. In our view, this differentiation by classes is, however, relevant beyond the specific issue of formal subordination of MREL eligible liabilities. In its quantitative analysis, the EBA Report offers a revealing picture of the European population of significant (albeit not necessarily systemically important) institutions

This report draws on data on external MREL issuance collected through the EBA's regular CRD –CRR/Basel III monitoring exercise as of December 2015. The sample comprises 133 banks from 18 EU Member States and covers approximately two thirds of the total EU banking sector's assets. The sample includes almost all EU G-SIBs and a fair proportion of EU O-SIIs. The sample also includes banks that are neither G-SIBs nor O-SIIs, referred to as 'other banks'. For the present analysis, the sample of O-SIIs excludes G-SIBs. For analytical purposes, banks in the sample are broken down into two groups based on size and cross-border activity: Group 1 banks that have Tier 1 capital in excess of EUR 3 billion and are internationally active, and Group 2 banks (the remaining banks). Banks are further split into large (with Tier 1 capital in excess of or equal to EUR 3 billion), medium (with Tier 1 capital below EUR 3 billion and above or equal to EUR 1.5

billion), and small (with Tier 1 capital below EUR 1.5 billion). More than two thirds of the banks in the sample have Tier 1 capital below EUR 3 billion or are active only domestically. Of those, almost half are small banks with Tier 1 capital below EUR 1.5 billion. Beyond the classification of banks into Group 1 and Group 2, the sub-samples remain very diverse in terms of banks' TLOF, with Group 1 banks' TLOF ranging between EUR 24 billion and EUR 2 181 billion and Group 2 banks' TLOF ranging between EUR 0.7 billion and EUR 305 billion.

What is important, in our view, from this classification, is the clear view that no one-size-fits-all approach is warranted in determining either the boundaries of MREL requirements or the resolution perimeter. Both depend on a discretionary assessment that is, to some extent, reflective of supervisory preferences.

*This is well illustrated by the approach taken by the Bank of England in determining the scope of resolution.* In its November 2016 Statement of Policy<sup>38</sup> the Bank of England clarified, in the first place (p. 5-6), that

«The Bank will set MREL for individual institutions by reference to three broad resolution strategies. These strategies reflect our legal obligations, judgement of risk over the potential disruption to critical economic functions and need to apply a proportionate approach.

**Modified insolvency process** – for small institutions, which we assess do not provide services of a scale considered critical and for which it is considered that a pay-out by the FSCS of covered depositors would meet the Bank's resolution objectives. These institutions will have MREL set at the same level as regulatory capital requirements and so will meet their MREL simply by meeting their existing regulatory capital requirements.

**Partial transfer** – where institutions are considered to be too large for a modified insolvency process but where there is a realistic prospect that critical parts of the business could be transferred to a purchaser, MREL will be set at a level which permits such a transfer to take place.

**Bail-in** – the largest and most complex institutions will be required to maintain sufficient MREL resources to absorb losses and, in the event of their failure, be re-capitalised so that they continue to meet the PRA's conditions for authorisation. Bail-in is designed to stabilise the institution, providing time to enable it to be re-structured in order to address the underlying causes of its failure. The aim is that the institution, or its successor, is able to operate without public support».

38 Bank of England, *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL). Responses to Consultation and Statement of Policy*, November 2016, available at <http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelpolicy2016.pdf>

Therefore, the Bank concluded that, since the institution's resolution strategy is key to determine its MREL, it is also important to determine thresholds providing a guide to assess which resolution strategy is likely to be preferred in the Bank's likely judgement. So far the Bank established the boundary between a modified insolvency process and the use of resolution powers, on an indicative threshold in the range between 40,000 to 80,000 transactional accounts and an indicative threshold of £15 billion–£25 billion assets for the use of bail-in resolution strategies.

The SRB's approach taken to MREL in 2016<sup>39</sup> was still interlocutory, also in the face of the November 2016 proposal for BRRD amendment, which will be discussed in the next paragraph. However the SRB clarified some principles that are going to guide its future decisions. Also in the SRM context, due calibration of MREL requirements is considered key.

«The SRB is committed to developing MREL at material entity level within major banking groups and to start addressing the quality and location of MREL. As a first step, the SRB intends to set binding MREL targets at consolidated level (or appropriate sub-consolidated level according to the resolution strategy) for major banking groups under its remit in 2017, followed by determining targets at solo level for legal entities subject to BRRD late 2017/2018.

Future MREL targets will consider bank-specific features, departing from the default targets used in 2016. In this context, the SRB envisages further work in respect of the impact of resolution strategies developed during the 2016 resolution planning exercise, resulting in the tailoring of MREL to bank-specific characteristics, including risk profile and business models, before and after resolution. Similarly, the SRB will analyse the impact of recovery actions, *ex ante* exclusions from bail-in and impediments to resolvability on the MREL needs of each banking group. The SRB does not currently pre-empt any decision as to the direction nor the magnitude of adjustments which may be made. Furthermore, building on experience gained during the resolution planning phase, the SRB will conduct peer group analyses, with a particular focus on the amounts needed to ensure market confidence after resolution».<sup>40</sup>

It is also worth noting that the SRB addressed the question whether retail investors holding MREL securities should be exempted from resolution, only to conclude that they cannot (p. 22):

«The SRB will be required to bail-in retail investors in line with their ranking in the applicable creditor hierarchy, other than in exceptional circumstances. The SRB cannot exclude instruments from MREL for the sole reason that they are held by retail investors should they otherwise meet the requirements for MREL. There is no

39 SRB, *MREL: Approach taken in 2016 and next steps*, [https://srb.europa.eu/sites/srbsite/files/srb\\_mrel\\_approach\\_2016\\_post\\_final.pdf](https://srb.europa.eu/sites/srbsite/files/srb_mrel_approach_2016_post_final.pdf)

40 SRB, *MREL: Approach taken in 2016 and next steps*, p. 24.

legal basis for resolution authorities to exclude *ex ante* and uniformly eligible liabilities held by natural persons or SMEs from MREL or from bail-in. European legislation includes many safeguards to ensure financial products are sold to suitable investors only. The implementation and the supervision of such rules is under the responsibility of Member States' market authorities; therefore any possible failure to comply with investor protection rules is not an argument to exclude these liabilities from the computation of informative MREL targets or finally bail-in.

However, holdings of subordinated or senior instruments by retail customers could prove to be an impediment to resolution due to the consequences arising from the application of the bail-in tool. The SRB is of the view that large holdings of liabilities sold to retail investors make banks difficult to resolve for various reasons, including: i) the potential loss of a bank's customer base and the risk of withdrawals, as well as ii) potential litigation brought by retail investors upon or after resolution, which might endanger the bank's future viability). In this context, the difficulties associated with the issuance of MREL-eligible instruments to retail investors is connected to the broader issue of the quality of MREL instruments. The SRB will further assess significance of retail investors in different Member States and develop potential measures to address the issue, for instance, by means of higher MREL, subordination requirements or requesting adjustments to banks' funding strategies, should the situation be considered an impediment to a bank's resolution».

## 2.5 November 2016 proposal for BRRD amendment

After the introduction of the new rules governing bank resolutions, EU Member States have started to amend their national insolvency laws, to ensure that senior bonds would rank junior to other unsecured, mainly operational, liabilities, but their approaches have been different. To understand why, these reforms need to be considered within the following logical sequence: resolution rules include provisions on MREL, which are intertwined with provisions on bail-in, which are in turn inextricably linked to domestic law provisions on private law and insolvency law. Thus, a pertinent question is: what kind of relationship do these provisions have? If we consider, first, the relationship between insolvency rules and domestic law, bail-in provisions under BRRD formally respect the ranking of claims under domestic insolvency laws in the provisions regulating the bail-in sequence, i.e. the order in which the different instruments need to be written down or converted into capital.<sup>41</sup>

However, in order to have the whole picture, (i) the provisions regulating the bail-in sequence need to be read together with: (ii) the BRRD provisions that *exclude* some liabilities from bail-in, such as those protected by property or security rights,

41 Article 48 BRRD.

those arising from employment relationships, and, more crucially, those arising from covered deposits, those arising from clearing and settlement systems, and those arising from short-term debt contracts;<sup>42</sup> (iii) the provision that grants resolution authorities the ability to *exclude* certain liabilities *other than* those already excluded by BRRD on an individual basis, when justified by the difficulty to bail-in those liabilities, the need to ensure the continuity of critical functions, to avoid contagion, or prevent a destruction in value;<sup>43</sup> and (iv) the provisions that grant *insolvency* priority to some non-covered deposits over the remaining 'ordinary' liabilities, subject to bail-in.<sup>44</sup>

When the whole ensemble of rules is considered, the source of the problem becomes more evident. Resolution rules rely on insolvency priorities, but they do so with many *caveats*. Each *caveat* is susceptible to generate gaps, and each gap will be generally filled by reference to general principles, which begs the question of *which principles* should be used to fill the gaps. Put in this way, the relationship between resolution rules and insolvency law looks much more complex, because the principles and policies inspiring resolution rules, and listed in the corresponding provisions, include 'macro' considerations of financial stability, operational continuity, or market discipline.<sup>45</sup> *In this sense, they are quite different from the principles that one may associate with insolvency law, which are more associated with creditor satisfaction.* Thus, even if some of these principles are coincident, e.g. fairness towards creditors,<sup>46</sup> the presence in resolution rules of other competing considerations makes it likely that the solutions resulting from an interpretation of resolution rules could differ from those arising from an interpretation of insolvency rules.

42 Article 44 (2) BRRD.

43 Article 44 (3) BRRD.

44 Article 108 BRRD.

45 Article 31 BRRD lists resolution objectives, which are '(a) to ensure the continuity of critical functions; (b) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (e) to protect client funds and client assets'. Article 34 (1) BRRD lists resolution principles, which are: (a) the shareholders of the institution under resolution bear first losses; (b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in this Directive; (c) management body and senior management of the institution under resolution are replaced, except in those cases when the retention of the management body and senior management, in whole or in part, as appropriate to the circumstances, is considered to be necessary for the achievement of the resolution objectives; (d) management body and senior management of the institution under resolution shall provide all necessary assistance for the achievement of the resolution objectives; (e) natural and legal persons are made liable, subject to Member State law, under civil or criminal law for their responsibility for the failure of the institution; (f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner; (g) no creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75; (h) covered deposits are fully protected; and (i) resolution action is taken in accordance with the safeguards in this Directive.

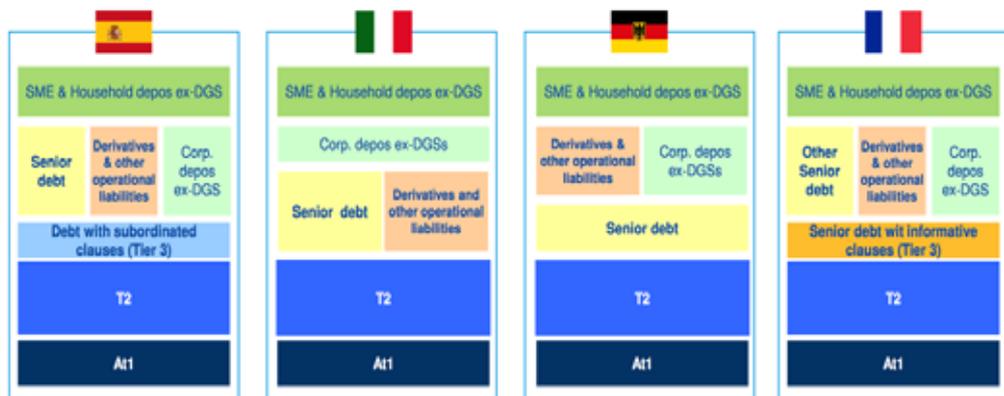
46 See article 34 (1) (f) BRRD.

With the above in mind, the role of MREL provisions becomes clear. At first glance, they look like provisions to enhance the soundness of financial institutions, which apply *ex ante*, following prudential considerations, i.e. the type of provisions that should be included as part of CRD or CRR rules. Including them among resolution rules, however, is a way to tackle the potential inconsistencies between insolvency laws, and between those laws and resolution rules. Thus, even if MREL rules are conceived for a bail-in scenario, not all liabilities subject to bail-in are MREL-eligible.<sup>47</sup> With these eligibility requirements MREL rules avoid some of the problems arising in a bail-in scenario: identifying a layer of debt that is relatively 'unproblematic', and forgetting about *caveats* and inconsistencies.

Alas, resolution rules do not go the whole way in this aim. MREL rules operate a notable simplification in the type of instruments that shall be subject to bail-in, e.g. issued and fully paid up, 1-year maturity, cannot be derivatives or deposits, etc.,<sup>48</sup> but (i) *do not expressly* require the *subordination* of MREL-eligible liabilities to non-MREL-eligible ones, and (ii) leave to each Member State the choice of the actual strategy to adopt to ensure MREL compliance. Predictably enough, Member States have chosen different strategies to fulfil this requirement.

Figure 11 visualises existing differences in 4 relevant Member States:

Figure 11 – Differences in debt subordination structures in some European countries



Source: BBVA Research, *New requirements for loss absorbing capacity: TLAC and MREL*, Capital Management Forum (London, 8 March 2016), p. 15.

This converts into different bail-in sequences in the different jurisdictions as shown in Figure 12 below.

47 See *supra* 1 (b) and (c).

48 *Supra* 1 (c).

**Figure 12 – Bail-in sequence in Italy, in the United Kingdom, in France, in Spain and in Germany**

**Bail-in sequence in Italy**  
(from 1 January 2016 to 31 December 2018)

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Other subordinated liabilities
5	Senior debt Deposits from large enterprises (above €100,000) Liabilities arising from derivative transactions
6	Deposits from natural persons, micro, small and medium-sized enterprises (above €100,000)

**Bail-in sequence in Italy**  
(from 1 January 2019)

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Other subordinated liabilities
5	Senior debt Liabilities arising from derivative transactions
6	All deposits above €100,000, except for those listed at point 7.
7	Deposits from natural persons, small and medium-sized enterprises above €100,000

**Bail-in sequence in the United Kingdom**

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Liabilities issued by the holding company
5	Senior debt issued by the operating company Deposits from large enterprises (above €100,000) Liabilities arising from derivative transactions
6	Deposits from natural persons and SMEs above €100,000

**Bail-in sequence in France**

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Senior non-preferred liabilities
5	Senior debt Deposits from large enterprises (above €100,000) Liabilities arising from derivative transactions
6	Deposits from natural persons and SMEs above €100,000

**Bail-in sequence in Spain**

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Tier 3
5	Senior liabilities Deposits from large enterprises (above €100,000) Liabilities arising from derivative transactions
6	Deposits from natural persons and SMEs above €100,000

**Bail-in sequence in Germany**

1	Common Equity Tier 1 (CET1)
2	Additional Tier 1 (AT1)
3	Tier 2
4	Senior liabilities Capital-protected structured products that are only linked to interest rates
5	Deposits from large enterprises (above €100,000) Liabilities arising from derivative transactions Structured products with no capital protection and/or whose interest payment is linked to financial variables other than interest rates
6	Deposits from natural persons and SMEs above €100,000

These variations in MREL-compliance strategies and bail-in sequences can give rise to important problems about the relative status of the different instruments. For example, in case a bank subject to German insolvency law has issued 'ordinary' liabilities subject to German law, and Tier 3 liabilities subject to French or Spanish law, should the latter be subordinated to the former in the bail-in sequence? Conversely, should a firm subject to French or Spanish insolvency law and having issued liabilities subject to German law rely on the latter to determine their insolvency

status? How should the clauses that try to ensure the non-preferred status of senior debt under the laws of one jurisdiction be interpreted under the laws of another jurisdiction? What should be the status of MREL-eligible senior debt issued by a EU bank group *vis-à-vis* several interconnected derivatives that hedge the positions of different group entities, one subject to German insolvency law (where non-secured senior debt is subordinated to derivatives), and another to Italian insolvency law (where the same debt ranks *pari passu* with derivatives)? Would this affect the netting of the derivative? How should intra-group arrangements for liquidity management and hedging be treated, considering that intra-group debt would be *subordinated* even to Tier 3 debt in some countries, e.g. Spain or Germany, whereas in other jurisdictions Tier 3 and senior unsecured debt would be subordinated to the specific arrangements, e.g. to derivatives and deposits in Germany, to deposits in Italy?

Even if some of these issues could be resolved through interpretation of the different statutory provisions, there is room for uncertainty, and uncertainty is unwelcome when it comes to the placement of debt that is supposed to fulfil mandatory regulatory requirements. In light of this, it is not surprising that EU legislators have decided to go one step further, and harmonise the type of debt that shall be used to comply with MREL. On November 23, 2016, the EU Commission publicly advanced legislative proposals for a banking reforms package,<sup>49</sup> comprehensive of amendments to the BRRD that aim, *inter alia*, to modify creditor hierarchy in insolvency.

The proposal, as noted, introduces a new "senior non-preferred" category in the insolvency pecking order for long-term debt instruments, which will rank senior to regulatory capital and subordinated debt, but junior to other unsecured liabilities. As a consequence, these debt instruments would be bailed-in before other unsecured liabilities - examples of which are operational liabilities, derivatives and deposits - in a design to improve the resolvability of EU financial institutions, while at the same time facilitating compliance with the Financial Stability Board's TLAC standard.

So as to be suitable for inclusion in this new category, liabilities shall satisfy the following characteristics: (a) being unsecured claims arising out of debt instruments; (b) having an initial contractual maturity of at least one year; (c) having no derivative features; and (d) their contractual documentation shall refer explicitly to this ranking.

This new ranking will only apply to newly issued liabilities<sup>50</sup> and Member States will be required to implement such changes into their national laws within a short timeframe. This addition will allow EU G-SIBs to issue senior debt that can count towards their minimum TLAC requirements, as well as their institution-specific MREL requirement - which is not limited to G-SIBs, but applies to all EU institutions -

49 Amendments concerning both capital requirements (CRR/CRD IV) and the resolution framework (BRRD/SRM), aimed at advancing the completion of the reforms implemented in the aftermath of the financial crisis.

50 To the benefit of existing senior debt holders, whose rank will remain senior both in insolvency and in resolution.

where MREL must be met with instruments that are subordinated to ordinary unsecured liabilities.

Finally, the BRRD amendment proposal also excludes from bail-in those liabilities with remaining maturity of less than 7 days to third country central counterparties (CCPs) recognised by ESMA by virtue of the third country equivalence (3CE) regime.<sup>51</sup>

## 2.6 Interaction between the state aid and resolution frameworks

The scope of the bail-in tool is bound by the state aid regime and the statutory exemptions accorded to some categories of creditors. *What lies between the two is in principle bail-inable, according to the pecking order of claims laid down in national insolvency laws.*

As for the interaction between the state aid framework with the resolution one, it must be noted first of all that the need for state aid in itself would constitute a trigger for resolution. In this sense, public financing cannot be considered as a resolution measure. Be it that an institution reaches its point of non-viability (PONV) with or without meeting the conditions for resolution, private resources are always the first that come into play, with a view to restoring the bank's viability<sup>52</sup> or to refinance the institution. Any use of public funds is prevented, insofar as it is in breach of the EU state aid framework.

However, there is leeway for accessing funds that are external to the bank in distress within the resolution process – primarily through the Single Resolution Fund – but only after all necessary efforts for reducing losses have been undertaken, by way of private contributions. Any use of such funds within resolution must be cleared, as already noted, under the state aid rules specified in the new Banking Communication.

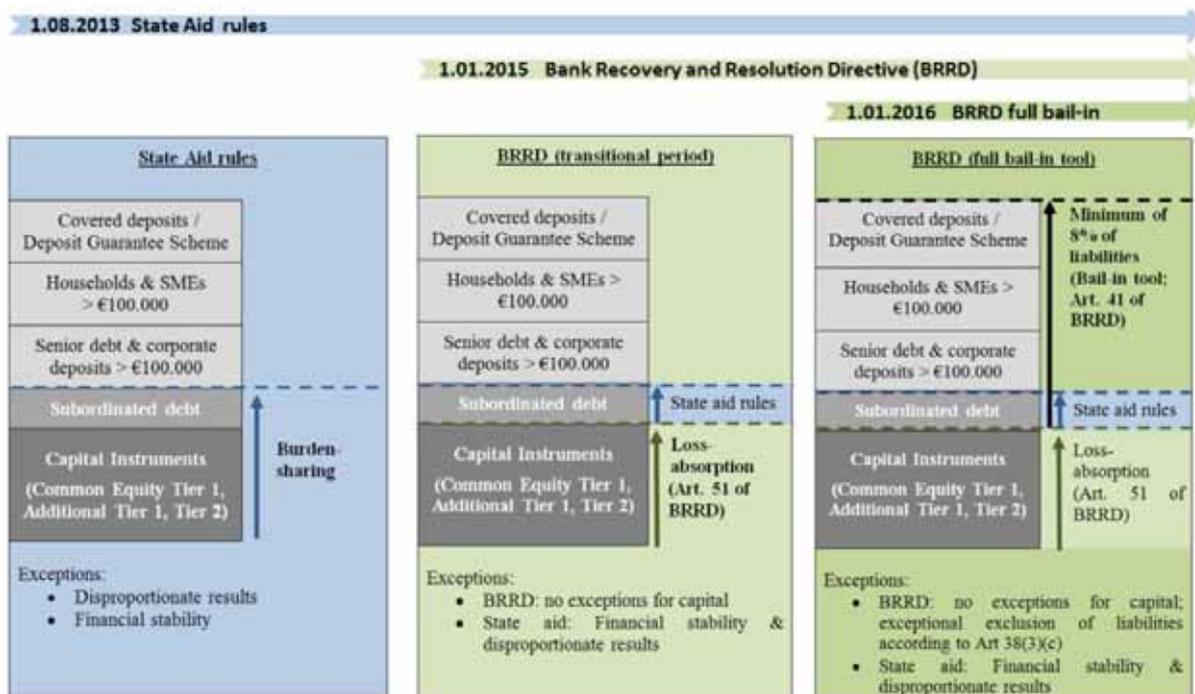
As for the order in which claims are tapped into, the two frameworks are coherent. The major difference between the two is the greater reach of the resolution requirements: the involvement of senior debt and covered deposits, which is required for the full application of bail-in, is not provided for under state aid rules.

Otherwise, the guiding principle in the evaluation of resolution cases states that, as long as adequate burden-sharing under the Banking Communication has been completed, state aid rules will be considered as respected, but then the failing institution will need to make do with the bail-in requirements of the BRRD.

51 Regulation 648/2012/EU (EMIR). The liabilities with an equal remaining maturity to EU CCPs, designated in accordance with Directive 98/26/EC, are already excluded from bail-in, as per Art. 44(2)(f) BRRD.

52 Article 59 BRRD.

Figure 13 – Interaction between the state aid and resolution frameworks



Source: European Parliament EGOV Unit, 2014.

It is also important to recall that the Commission's decisions on the granting of public aid will always be based on the resolution scheme prepared by the Single Resolution Board – for institutions under the SSM/SRM – which includes information on the exercise of bail-in powers. Therefore, its decisions, which will be taken by making all relevant state aid considerations, will not need to extend to the design of burden-sharing arrangements applicable to shareholders and creditors. Rather, the Commission will only have to assess whether the proposal made by the Board under the resolution rules also abides by the requirement of sufficient burden sharing under state aid rules. While this may leave open some room for discussion between the competition and resolution authorities, there seems to be no inherent contradiction in the exercise of the two activities.

Expectations on the use that will be made of burden sharing and of the bail-in tool by competition and resolution authorities are enough to impact directly the risk of capital instruments in the banking sector. As a consequence, if not properly governed, rather than steadying the system, they may actually become a source of instability especially in conditions of system-wide banking weakness.<sup>53</sup> As recent

53 Along these lines: C. Hadjiemmanuil, *Limits on state-funded bailouts in the EU bank resolution regime*, EBI Working Paper Series, 2017, No.2, also noting how the excessive length for the completion of the bureaucratic procedures to address a resolution (among national governments, the Commission and the ECB) may in itself become a hindrance to stability; E. Avgouleas, C. Goodhart, *Critical Reflections on Bank Bail-ins*, in *Journal of Financial Regulation*, 1, p. 3-29; A. Gardella, *Bail-in and the Two Dimensions of Burden-Sharing* (November 2, 2015), ECB Legal Conference, 2015;

Italian and Spanish recovery, resolution and winding up cases illustrate, the political implications stemming from the necessity to write down subordinated debt instruments become particularly striking, when these instruments were sold, and also mis-sold, to (at the time) unsuspecting retail or institutional investors.

This also highlights the difficulties involved in the retroactive application of the new write down and conversion rules to old debt instruments, in particular if issued before 2013.<sup>54</sup>

### 3 A brief comparative view with the US as an example of the risks of cross-border frictions and of regulatory competition. Intra-group MREL/TLAC and the problems associated to different applicable laws

After the financial crisis, the mechanism through which the bail-in and write-down of creditor claims are executed is intrinsic to the very architecture and functioning of the resolution process that is applied to systemically important institutions (SIFIs). Therefore these principles extend beyond the boundaries of the European Union. There are however significant differences in macro-regional approaches. This paves the way for frictions in dealing with cross border resolution schemes. For example, this would be the case when both the European and US framework are called into action to some extent with regard to the same ailing financial conglomerate. This justifies a pause for thought and a brief comparative digression. We draw parallels here below with only the United States, which are home of some of the most relevant financial conglomerates with material European operations via subsidiaries and where several European significant banks also operate through subsidiaries. However, the very same problems arise with China, Japan and many other third country jurisdictions. This will unfortunately be also one of the undesirable after-effects of Brexit in due course.

Title II of the Dodd-Frank Act has adopted the write down process with a different goal: that of contributing a sufficient amount of capital for the entities whose parent undergoes resolution, after the liquidation is completed. Losses at the subsidiary level will be upstreamed to the parent company, which, if excessive, will result in bank failure at the top-tier holding company, which will enter receivership and attendant losses will be borne by the holding company's shareholders and unsecured creditors. The Federal Deposit Insurance Corporation (FDIC) acts as the receiver for the distressed financial company, in that it acquires all rights and powers of the creditors of the resolved institution, in addition to terminating all rights and claims exercised by its shareholders and creditors against its assets. The only privilege that is preserved is their

A.D. Persaud, *Why Bail-In Securities are Fool's Gold*, Peterson Institute for International Economics Policy Brief, 2014, PB14-23.

54 For a critical stance on the drawbacks of the retroactivity of the resolution rules see Consob 2016 Annual Report presented at the Annual Meeting with the Financial Market on 8 May 2017.

right to receive payment as per the provisions of section 210 of the Act. The FDIC then proceeds with the establishment of a bridge holding company, referred to as "NewCo", to which any healthy operating subsidiaries would be transferred.

Section 210 of the Dodd-Frank Act also requires the FDIC to establish a "pyramid" for the priority of claims that are to be addressed in the resolution, in order to avoid any recourse to taxpayer money. A write-down process that entails an exchange of debt for securities then follows, in accordance with the specified claim priority, combined with the issuance of debt and equity in the NewCo. This discretion in choice is somewhat curbed by the introduction of a safeguard for creditors, which provides that they are entitled to receive at least what they would have received if liquidation had taken place under Chapter 7 of the Bankruptcy Code, instead of a resolution.

The introduction by the Dodd-Frank Act of the Orderly Liquidation Authority (OLA) – a fundamental reform which is currently threatened to be rolled back, following the 2017 Financial Choice Act Bill– expanded the authority of FDIC in matters of resolution, by enabling to choose which assets and liabilities are to be transferred to a third party, and potentially even to treat "similar" creditors differently. The exchange of securities for claims is based on a valuation of the new bridge company by a group of consultants appointed by the board of the NewCo itself. The FDIC has made it clear that it is required of shareholders' equity, subordinated debt and a relevant chunk of the unsecured liabilities of the distressed holding company that they remain as claims that can be tapped into.

Differently from the European resolution regime, the approach set out in the Dodd-Frank Act only allows for the treatment of the distressed financial institution as a gone concern, through a "closed bank" bail-in process for SIFIs. In accordance with the EU BRRD and the European Stability Mechanism (ESM) statute, instead, the possibility that the bank remains as a going concern is envisaged, and the bail-in can also be prompted for recapitalisation in order to restore the bank to health. In particular, the American OLA tackles resolutions with the liquidation of the bank holding company and makes use of the bail-in process to guarantee the continued operation of its subsidiaries. Both jurisdictions advance bail-in as a substitute to the outright liquidation of either the financial group as whole or of parts of it, in conjunction with the use of other resolution tools.

Against these differences in approach, several questions arise in the treatment of resolution planning of cross-border financial groups operating both in Europe and in the United States and on the ammunition at the consolidated level of MREL.

From a regulatory perspective, the framework is still under construction. On 16 December 2016, the FSB published, for instance, a consultative document on the internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC') that proposed a set of high-level guiding principles to assist the home and host authorities on group crisis management for G-SIBs. These high level guiding principles are meant to implement the FSB principles on TLAC, which require that: (i) host authorities must have confidence that there is sufficient loss-absorbing and recapitalisation capacity available to

subsidiaries in their jurisdictions with legal certainty at the point of entry into resolution; and (ii) instruments eligible for Minimum TLAC should be legally enforceable. The consultation document posited a general principle that a resolution entity should generally act as a source of loss-absorbing and recapitalisation capacity for its material subsidiaries or sub-groups, where those subsidiaries are not themselves resolution entities. To this end, internal TLAC legal mechanisms should be put in place to downstream resources to material subsidiaries or sub-groups and the consultative document proposed a set of high-level guiding principles to assist home and host authorities in the implementation of this. In this vein, it is worth noting that guiding principle 11 requires that internal TLAC should generally be subject to the governing law of the jurisdiction in which the material sub-group entity issuing the internal TLAC is incorporated. It may be issued under or be otherwise subject to the laws of another jurisdiction if, under those laws, the application of resolution tools by the relevant resolution authority, or the write-down or conversion into equity of instruments at PONV by the relevant authority, is effective and enforceable on the basis of binding statutory provisions or legally enforceable contractual provisions for the recognition of resolution actions and statutory PONV write-down powers. In turn, principle 20 requires that home and host authorities ensure that the write-down and/or conversion into equity of internal TLAC in the form of regulatory capital instruments held by third parties does not give rise to material risk of successful legal challenge. Differences in legal approaches among relevant jurisdictions could thus matter a lot.

In turn, the 2016 EBA Report found that the current intra-group approach to resolution embedded in Article 45 BRRD should be strengthened. As noted by EBA, the basic idea underpinning BRRD is that internal loss-absorbing capacity aims to ensure that, within a group, losses are passed from the entities where they originate to those entities where resolution action will be adopted. Resolution entities, to which resolution tools are expected to be applied, issue MREL-eligible liabilities to external parties (external MREL). All (or part) of the proceeds from this issuance are then down-streamed to subsidiaries, matched by equity or debt issued back to the resolution entity as 'internal' MREL resources. These internal MREL resources provide a mechanism to pass losses from the operating companies (OpCos, where losses arise and which undertake critical functions) to the resolution entity to implement the resolution strategy. As a result, the resolution entity can (and should) be placed into resolution without significant disruption to the critical economic functions located in the subsidiaries. This rationale underpins both the FSB TLAC term sheet and the BRRD. It is easier said than done, though, if only one considers the wide disparities still existing among different jurisdictions. Not surprisingly, EBA found that "when it comes to concrete provisions to deliver this objective, the FSB TLAC term sheet is more precise and concrete than the BRRD":

"The term sheet requires resolution entities to be identified and requires that material subgroups meet an internal TLAC (iTLAC) requirement. The resolution entity acts as a source of loss-absorbing and recapitalisation capacity for its material subgroups. While external TLAC is issued at the level of the resolution entity, dependent entities issue iTLAC to which the resolution entity subscribes and leaves 'prepositioned' in the material subgroups in a range of 75% to 90% of the external minimum TLAC requirement, taking into account the size and risk exposures of its material subgroups. Eligible iTLAC instruments must be issued internally and subordinated to the subsidiary's operational liabilities in order to avoid a change in control of the subsidiary and limit risks of NCWO claims. Eligible iTLAC instruments must be subject to a power of write-down and/or conversion by the host resolution authority at the PONV of the subsidiary, without the entry of the subsidiary into formal resolution. In contrast, the BRRD does not contain a

specific requirement for internally issued MREL and there is thus no distinction between the determination of internal and external MREL. (...) These provisions do not set out in detail the consequence of resolution strategies in terms of identification of resolution entities, requirements for internal issuance, subordination requirements or the conversion trigger. As a result, the BRRD provisions are underpinned by sound objectives but they are very broad and rely on implementation by—and agreement among—resolution authorities. They offer no visibility as to the correct form and calibration of internal MREL below consolidated level. This can lead to disagreement within colleges, and could make EBA mediation very difficult in a context where little guidance and no hard rules are available. In addition, implementing the TLAC term sheet for G-SIBs without changing the overall framework for the broader population of banks could exacerbate the current shortcomings and create a discrepancy in approach between G-SIBs and other banks”.

In this context, the EBA recommended that the current framework be refined in order to implement the FSB recommendation on iTLAC and, more generally, to secure alignment between internal MREL and the resolute “Under a revised framework, resolution authorities would identify resolution entities in the resolution plan, and require other entities to hold internal MREL as appropriate in relation to their treatment under the resolution strategy. Internal MREL should be subordinated to other liabilities to ensure upstreaming of losses and limit the risk of a change of control. An entity with an internal MREL requirement set in this way would not also have an external MREL requirement imposed on it. It would meet its MREL requirements through issuing internal MREL. PONV write-down of a subsidiary’s MREL should be possible for all MREL-eligible instruments, and not just capital instruments. To that effect, Article 59 of the BRRD could be extended to all subordinated internal MREL instruments (rather than only capital instruments) to allow for the write-down of internal MREL at the PONV of the entity in question. This extension could also be achieved by requiring the introduction of contractual PONV write-down clauses within internal MREL instruments”.

In sum, the EBA recommends that “the MREL framework should be amended to provide for the identification of resolution entities and the allocation of internally issued, subordinated MREL at the non-resolution-entity level. In addition, the legislative framework should include a requirement to include contractual provisions allowing the write-down or conversion of internal MREL instruments, or alternatively an extension of the scope of Article 59 (PONV write-down) to all internal MREL instruments rather than only capital. Under a revised intra-group framework, the EU should be treated as a single jurisdiction from the point of view of the iTLAC requirement. Consequently, the BRRD should implement a minimum internal requirement for material subgroups of foreign G-SIBs in the EU”.

Only time will tell if these recommendations will be enough to tame cross border frictions depending on regulatory arbitrage.

For the time being, it is quite telling that the SRB, as noted in its 2016 approach to MREL (p. 6), so far decided to set “the informative MREL targets for 2016 at consolidated level only and did not attempt to address at this stage the interplay between entities which form part of the same banking group, i.e. through internal MREL. Furthermore, informative targets have been assessed with bail-in as the main resolution tool in combination with a single-point-of-entry (SPE) strategy”.

This cautious approach by the SRB is understandable, but does not address some pressing concerns related to the status of large financial groups, with presence in the EU and third countries, which were the main reason to adopt MREL rules in the first place.

To make the issue more concrete, consider now the case of groups with presence in the US and the EU. If a bank subject to EU resolution rules issues debt subject to New York law, for example, the bail-in of that debt will not be subject to the automatic mutual recognition system under BRRD, and will pose daunting legal challenges. Absent international treaties, it is not possible to know if resolution action will be subject to recognition as such. Moreover, lacking express cooperation agreements, it is not even possible to predict which could be the attitude of US resolution authorities vis-à-vis EU resolution action. A decision would be needed on whether 'resolution' can be made subject to the system of mutual recognition espoused by the UNCITRAL Model Law on Cross-border Insolvency, incorporated as Chapter 15 of the US Bankruptcy Code. Absent this, US resolution authorities could decide in favour of cooperation, and try to give effect to acts by resolution authorities in the EU. This however would not be an EU legal act being recognised and enforced in the US, but rather an act adopted unilaterally by US authorities of their own volition. Even if such assistance were granted prima facie, it would be subject to a public policy exception, in the case of insolvency framework application, or to the full discretion of resolution authorities, if applying the resolution framework. As a consequence, complex issues would arise if US investors claimed discriminatory treatment.

This could give rise to two different, and opposite, risks. One risk would be associated to the opportunistic behaviour of a bank subject to EU rules, which would include among its MREL-eligible liabilities those subject to the law of the United States, despite knowing that they would be much more bail-in-resistant. The opposite risk, however, is the one materialising now, i.e. that EU resolution authorities may exclude for MREL purposes all liabilities subject to US law, despite the fact that some of them may be MREL-eligible. This may be in contravention of BRRD provisions, which stipulate that resolution authorities 'may require' the institution to demonstrate the effectiveness of bail-in decisions in the third country, and to refuse inclusion for MREL purposes otherwise, but do not authorise a flat and unconditional refusal every time the debt is subject to third-country laws.

If the picture looks daunting for liabilities such as debt securities, try imagining more complex scenarios, e.g. those involving other types of liabilities, such as derivatives, or notes embedding a derivative. Even if these are excluded from MREL, a bail-in may take place in a situation where full MREL compliance has not been achieved, or MREL-eligible liabilities are insufficient to achieve full recapitalization, so that other, non-MREL-eligible liabilities need to be bailed-in. EU authorities may consider that, in such scenario, a bail-in of credit-linked notes, or similar derivatives is an adequate solution, if they fulfil other MREL-eligibility requirements, and are not 'operational' liabilities. However, US authorities and courts might not look favourably upon a decision to bail-in 'their' derivatives notes, while 'EU' operational liabilities are excluded.

This is just one example of how bail-in and MREL rules may stiffen capital movement and promote the balkanization of banking. Now consider that these rules are inserted into the broader context of resolution planning, i.e. MREL-eligible instruments have to be placed consistently with the resolution strategy. EU rules do not predetermine which strategy should be followed, but a preference for SPE strategies has developed among US resolution authorities, as well as those in the United Kingdom, or France. If such strategy were adopted only at the top of the groups, the picture would be clear. The problem is that some large banking groups may have subsidiaries in other jurisdictions which are themselves systemically important. If, say, an EU-domiciled banking group has assets in the US that qualify it as systemically important, or a US-domiciled

banking group has assets in the EU that qualify it as systemically important, resolution authorities in the home jurisdiction of the parent company may impose an SPE strategy, which means that subsidiaries should issue 'internal MREL' to be subscribed by the parent company, which shall be the only 'resolution authority'. If, however, the resolution authorities in the subsidiary's country are also opting for an SPE strategy and consider the presence of the foreign group as systemically important, the group may have to create a US-domiciled (for EU groups) or EU-domiciled (for US groups) intermediate parent company, which may issue 'external MREL'. Even if the goal is to bail-in that debt, would the holders of the debt of the intermediate holding company be aware of the fact that the group does not stand behind that debt? What would happen if some of the intermediate holding company's debt is held by the parent company, and some held by third parties, such as investors?

These considerations illustrate how, even at the least complex level, i.e. assuming that all jurisdictions have specific resolution rules, recognise bail-in, have a requirement similar to MREL, and promote a SPE strategy, problems may arise, and the types of risks assumed may be unclear.

## 4 A “new normal” without a transitory period: the relevance of the protection of property and of retail investor protection

The previous sections have shown how 'burden-sharing' has evolved from a requirement of state-aid rules in the banking sector into the main instrumental policy of bank resolution, and then of bank supervision. Burden sharing is meant to strike a balance between keeping the entities safe and avoiding moral hazard. The question is whether this new policy can find some sort of limit in the pre-existing fundamental rights and principles, which may act as a kind of check, or balance, on its potential excesses. This is of particular relevance in our context, because at least some of Italian banks' subordinated debentures written down or converted in recent bank crises had been issued before 2013. In this section we examine whether (a) the right to property can pose a direct threat to the policy of burden sharing; and, then, (b) which may still be the hidden traps for this policy. *Furthermore we examine whether (c) in assessing the ability to apply the bail-in tool to retail debt liabilities, the Resolution Authorities should consider the supervisory assessment of the proper implementation of the degree of compliance of banks to the rules on retail investors' protection (in particular to MiFID).*

### 4.1 Whether the right to property poses a direct threat to the exercise of burden sharing

An investor who had gone to sleep in 2009 (with the crisis in full swing, mind you) and woke up today could be surprised by the emphasis in law and policy

on investors' 'suffering'.<sup>55</sup> She could thus be forgiven for finding the prospect of investing in products which are instrumental to the financial health of the bank, rather than hers, rather unappealing. Worse still, she could find that the bank where she had invested in is in financial distress, and that public authorities, far from being concerned about her losses, gloat about making an example of her. On some level, one could understand that investors claim that 'the rules have changed', or that 'her property is being interfered upon'. The question is whether that claim would receive any response beyond sympathy.

The short answer is 'no', at least if one examines the European Court of Justice's (CJEU) and European Court of Human Rights' (ECtHR) case law on the right to property. The main precedents in this regard are *Grainger*, by the ECtHR,<sup>56</sup> and *Kotnik*,<sup>57</sup> *Dowling*,<sup>58</sup> and *Ledra Advertising*,<sup>59</sup> by the CJEU. *Grainger* was the first of the post-crisis decisions, and is also known as the 'Northern Rock' case, as it concerned the homonymous entity's nationalisation, and posterior decision to award compensation to its shareholders. In effecting such valuation, however, the independent valuer was expressly instructed to assume that no financial assistance would be extended to the bank.<sup>60</sup> The Court found that (i) the government had to be granted a wide margin of appreciation;<sup>61</sup> (ii) the zero compensation was not due to the government's instructions, but to the fact that the company's assets did not offset its liabilities;<sup>62</sup> (iii) the plaintiffs could not establish that Northern Rock's state was due to a regulatory failure of state authorities;<sup>63</sup> (iv) nothing compelled public authorities to cover the debts of a private institution;<sup>64</sup> and (v) the government's decision, far from being "manifestly without reasonable foundation" (the standard of review when State authorities enjoy a wide margin of appreciation), was properly founded on the policy of avoiding moral hazard.<sup>65</sup>

Before going into some of the decision's arguments in detail, it is worth completing the picture with *Kotnik*,<sup>66</sup> the other case that, together with *Dowling*,<sup>67</sup> which repeats much of its reasoning, sets the framework for public intervention in

55 The English version of BRRD uses the more neutral verb 'bear' in article 34, but 'suffer' is used in recitals (55), (67) or (71), or articles 107 (3) or 109 (1) (b).

56 Application 34940/10 *Dennis Grainger and others v. the United Kingdom*, 10 July 2012 (hereafter: *Grainger*).

57 *Tadej Kotnik and Others v. Državni zbor Republike Slovenije*, C-526/14 of 19 July 2016 ECLI:EU:C:2016:570 (hereafter: *Kotnik*).

58 *Gerard Dowling and Others v. Minister for Finance*, C-41/15 of 8 November 2016, ECLI:EU:C:2016:836 (hereafter: *Dowling*).

59 *Ledra Advertising Ltd and Others v. European Commission and European Central Bank*, C-8/15 P of 20 September 2016, ECLI:EU:C:2016:701, (hereafter: *Ledra*).

60 *Grainger* at 11, 21, 23. The financial assistance extended by the government was in terms of Lender of Last Resort (LoLR).

61 *Grainger* at 39.

62 *Grainger* at 40.

63 *Grainger* at 41.

64 *Grainger* at 42.

65 *Grainger* at 42.

66 *Kotnik*.

67 *Dowling*.

ailing banks and burden-sharing. In that decision what was challenged was not a single intervention measure, but the European Commission's Communication on state-aid in the banking sector.<sup>68</sup> Thus, this was no longer an isolated decision where the authorities decided to withdraw public support; rather, the Commission was stating in advance that any form of public support extended to banks in distress would be considered a form of state aid, and thereby illegal, unless it fulfilled specific requirements, the most important of which, or the most controversial, was the need for burden-sharing, by the entity's shareholders and debtholders.<sup>69</sup> The CJEU held (i) that shareholders or debtholders of a bank cannot harbour the 'legitimate expectation' that the bank would receive financial assistance;<sup>70</sup> (ii) that a transitional period for the States to adjust to this regime was not justified, since no legitimate expectation had been created, and, even if it had been created, *the objective of ensuring the stability of the financial system while avoiding excessive public spending and minimising distortions of competition* would qualify as the type of overriding policy interest that would justify excluding any transitional period; and (iii) the burden-sharing measures indicated in the Banking Communication did not constitute an illegal interference with property rights, because they did not impose losses on shareholders, and because debtholders would only suffer losses after the first had been absorbed by shareholders, and with the maximum suffered in insolvency proceedings.<sup>71</sup>

68 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') OJ C 216, 30.7.2013, p. 1–15.

69 Banking Communication paras. 40 – 46.

70 "[T]he shareholders and subordinated creditors of banks who are subject to burden-sharing measures, laid down in points 40 to 46 of the Banking Communication, such as those at issue in the main proceedings, cannot rely on the principle of protection of legitimate expectations as a ground of objection to implementation of the contested measures. 64 The reason is that, on the one hand, the shareholders and the subordinated creditors of the banks concerned were given no guarantee from the Commission to the effect that it would approve State aid designed to overcome the capital shortfall of those banks. On the other hand, those investors received no assurance that, with respect to measures designed to deal with the capital shortfalls of banks who were the recipients of the State aid authorised by the Commission, some of those measures would not be liable to be prejudicial to their investments. 65 Further, the fact that, in the first phases of the international financial crisis, the subordinated creditors were not called upon to contribute to the rescue of credit institutions, as noted by the Commission in point 17 of the Banking Communication, does not put the creditors concerned in the main proceedings in a position to rely on the principle of protection of legitimate expectations. 66 Indeed, such a circumstance cannot be regarded as a precise, unconditional and consistent assurance capable of engendering a legitimate expectation on the part of the shareholders and the subordinated creditors that they would not be subject to burden-sharing measures in the future. As the Court has previously held, while the principle of protection of legitimate expectations is one of the fundamental principles of the European Union, economic operators are not justified in having a legitimate expectation that an existing situation which is capable of being altered by the EU institutions in the exercise of their discretion will be maintained, particularly in a field such as State aid in the banking sector, whose subject matter involves constant adjustment to reflect changes in the economic situation". *Kotnik* 63-66.

71 Those creditors are to contribute to reducing the capital shortfall (i) only after losses are first absorbed by equity and (ii) only 'if there are no other possibilities' available to overcome any capital shortfall in the bank concerned or where that bank no longer meets the minimum regulatory capital requirements. Further, point 46 of that communication provides that 'the "no creditor worse off principle" should be adhered to. Thus, subordinated creditors should therefore not receive less, in economic terms, than what their instrument would have been worth if no State aid were to be granted. 78 It follows from point 46 that the burden-sharing measures on which the grant of State aid in favour of a bank showing a shortfall is dependent cannot cause any detriment to the right to property of subordinated creditors that those creditors would not have suffered within insolvency proceedings that followed such aid being granted'.

Even if the final conclusion can be shared, several details stand out. First, it is interesting to note that the CJEU, by separating the analysis of the protection of legitimate expectations from the analysis of the right to property, weakens the parties' rights. One can comfortably say that, absent plain expropriation measures, when it comes to financial instruments, the right to property itself consists in a series of expectations over the future returns of the asset. *These expectations can be significantly altered through the variation of the institutional framework.* It is a matter of determining whether the variation constitutes an 'interference', and whether a certain expectation over the *status quo* was legitimate. In this regard, the Court chose the more restrictive interpretation of what constitutes a legitimate expectation, which needs to be grounded on "*precise, unconditional and consistent assurances, originating from authorised, reliable sources*".<sup>72</sup> If that is the benchmark, there is little investors may rely upon, which means that their property rights amount to little.

This is not to say that, conversely, investors should have a right to be bailed-out, but by failing to introduce any distinction or nuance the Court's rulings is clearly overshooting. In the first place, this could be read as applying as well to public authorities' (including central banks') *regular* liquidity supply, via open market operations and liquidity facilities.<sup>73</sup> The rulings fail to acknowledge that banking is characterised by liquidity management (supply or withdrawal) and price setting by public authorities. In this setting, the features that make a specific type of financial assistance 'special', e.g. lender of last resort (LoLR) or recapitalisation, should be acknowledged first, in order to characterise the measure as 'state aid';<sup>74</sup> otherwise public authorities would be entitled to pull back normal liquidity supply channels without giving any explanation. In the second place, banks are supervised on an ongoing basis but, if at the end of a favorable Asset Quality Review (AQR) or Supervisory Review and Evaluation Process (SREP), or other supervisory controls, they were not granted formal "*precise, unconditional and consistent assurances*", would a subsequent, sudden change in the supervisor's approach on the bank's asset quality and on its viability (and likelihood to fail), reneging the previous findings, be warranted under this very generous standard of review?

A second controversial aspect of the CJEU opinions, as well as of the ECtHR opinion, is that they seem to take for granted that the zero valuation is a consequence of the entities' actual insolvency, i.e. the fact that they accumulated more liabilities than assets,<sup>75</sup> which justifies the change of control over decision-making.<sup>76</sup>

72 Kotnik at 62.

73 Guideline (EU) 2015/510 of the ECB of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60), OJ L 91, 2.4.2015, p. 3.

74 Unlike Kotnik and Dowling, the narrative in Grainger distinguishes the measure analysed as a LoLR measure, while clarifying that the entities continued to have access to 'regular' liquidity facilities. See *Grainger* at 7 – 11.

75 In *Grainger* the ECtHR held that: "The assumptions required the Valuer to allow for the realities of the situation, namely that Northern Rock had survived only because of the provision of LOLR support and that the Government now sought to bring an end to that support. There was nothing in the statutory assumptions to prevent the Valuer from taking into account the company's assets when deciding its total net worth. The fact that he found the former shareholders to be entitled to no compensation indicated that, in the light of the events of the preceding few

This seems to rule out the possibility of 'false positives', i.e. of entities that are merely in a situation of illiquidity, and are nonetheless treated like insolvent or entities that are solvent but are nonetheless considered insolvent because their assets are valued by supervisory authorities less than their real value due to different methodologies and predictions. Some authors, however, dispute the ability of the market, or public authorities, to distinguish between illiquid and insolvent entities, especially in a situation of crisis or when the actual value of assets is reflective of very complex future predictions.<sup>77</sup> Yet the CJEU seems readier than economic literature to trust the judgment of the market that pushes the entity over the brink, and of the authorities (or courts) that put it into resolution (or insolvency), or otherwise force-feed funds to the entity and mandate burden-sharing. *This however neglects that hard cases are the rule, and not just the exception; and hard cases come about precisely when banks have not accumulated more liabilities than assets, when there are divergent views between banks' insiders and supervisors on the evaluation of assets and the adequacy of the provisions.* A capital shortfall with respect to one or more of the prudential capital requirements only arises if all of the supervisor's assumptions prove correct. Something that is cannot be taken as the invariable rule and, in any case, only time could tell. If nonetheless burden sharing is immediately imposed, no counterfactual would be easily available for affected shareholders and creditors to show whether the shortfall was actually there or their expropriation was just a self-fulfilling prophecy from the side of the authority. Is this really a situation where legitimate expectations should be ruled out?

An alternative reading of the CJEU case law could also be possible. Namely, forced recapitalisation and burden-sharing are admissible only to the extent that there is a serious disturbance in the economy of a Member State, and in order to prevent systemic risk.<sup>78</sup> This would be in line with the prevailing view that the public interest test that justifies resolution is met only when such economic disturbance or systemic risk is clearly demonstrated. Yet in that case the question is what happens whenever an entity is wound up and subject to burden sharing in the absence of an economic disturbance, or systemic risk. In this context the risks of false positives described above cannot be ruled out either.

The picture is completed by Mallis<sup>79</sup> and Ledra.<sup>80</sup> In the former the Court ruled out that the restructuring and resolution measures introduced by Cyprus within

months, the company's assets did not offset its losses". Grainger at 40. In Kotnik the CJEU held in paragraphs 74 and 75 that burden-sharing measures in a state-aid procedure would not be different from a court insolvency order.

76 This was even more evident in Dowling, where the shareholders' meeting of Irish Life had rejected the recapitalisation proposal made by the Minister for Finance, and instructed the managers to examine other possible avenues to achieve the same end. Nonetheless the Court ruled that the subscription of new shares by the State could be completed without any consideration of shareholders' pre-emption rights.

77 C. Goodhart, *Liquidity risk management, Financial Stability Review – Special Issue: Liquidity*, 2008, p. 35.

78 The CJEU ruled that: "The provisions of the Second Directive do not therefore preclude an exceptional measure affecting the share capital of a public limited liability company, such as the Direction Order, taken by the national authorities where there is a serious disturbance of the economy and financial system of a Member State, without the approval of the general meeting of that company, with the objective of preventing a systemic risk and ensuring the financial stability of the European Union". See *Dowling* at 50.

79 Mallis and Malli v. *Commission and ECB*, C-105/15 of 20 September 2016, EU:C:2016:702.

the framework of a conditional program backed by the ESM could be deemed as being *imposed by* the European Commission and the ECB themselves, by virtue of their alleged control over the ESM. In the latter the Court held that the write-down and conversion of debt instruments or obligations required of Cyprus on the basis of the Memorandum of Understanding that disciplined the ESM intervention did not amount to "a disproportionate and intolerable interference impairing the very substance of the appellants' right of property". Mallis did not offer any interesting angle on property rights, as it was focused on the imputation of certain measures to EU authorities, ruling in a negative sense. In *Ledra* the Court sidestepped that objection by finding that EU authorities could nonetheless be hypothetically liable for their involvement in acts contrary to EU Law.<sup>81</sup> However, it found that the conversion of a 37,5% of Cyprus Popular Bank's uninsured deposits into shares, with the promise of a buy-back of shares if the bank became overcapitalised did not constitute "a disproportionate and intolerable interference impairing the very substance of the appellants' right to property", in light of the imminent risk of financial losses if the banks had failed.<sup>82</sup> Again, the conclusion may be sound, but the Court did not explain how it had reached it, i.e. whether 37,5% is a reasonable figure in general, what was the impact of the buy-back promise, or how probable, or threatening, the risk of loss needs to be.

#### 4.2 Bail-inable instruments and property rights: open issues

The general conclusion one can reach from the cases decided by the CJEU and Grainger, decided by the ECtHR, is that investors have no legitimate right to expect emergency liquidity measures, that burden-sharing measures are not generally contrary to property rights, and that insolvency proceedings are generally accepted by the courts as a good benchmark to measure investors' necessary losses, in line with what the no-creditor-worse-off principle postulates.<sup>83</sup> Rightly so. Beyond that, however, the courts do not offer much in terms of guidance. Then, it is easy to conclude that past burden-sharing actions were valid, but it is much harder to determine which were the decisive elements in the courts' finding. *Thus, it is also difficult to ascertain how to use these cases as guidance for future instances of bail-in subject to different conditions, and undertaken in different circumstances.*

The insight that looks more promising as a venue to scrutinise bail-in decisions is one that was not explored by the decisions: the existence of a difference in treatment of some banks (and investors in those banks instruments) with respect to others. In Grainger Northern Rock's shareholders alleged that the bank had been

80 *Ledra Advertising v. Commission and ECB*, C-9/5, 20 September 2016.

81 One could see the case as an attempt by the Court to set some boundaries on the action by EU institutions in an environment that had been considered outside EU Law in *Pringle*. See the decision *Pringle v. Government of Ireland*, C-370/12 of 27 November 2012, ECLI:EU:C:2012:756. On the other hand, one could also argue that the Court cleverly maneuvered to put the action of EU institutions nominally under the scrutiny of EU Law, while, by merely subjecting it to the action in damages, it set such a high threshold that it would seldom be met.

82 *Ledra* at 73-74.

83 Articles 73-75 BRRD.

granted a different treatment from other major institutions, like Royal Bank of Scotland and HBOS, and that this was proof of the lack of proportionality of the measure.<sup>84</sup> *Surprisingly, neither the parties nor the Court pursued this argument.* Had the difference in treatment been established, it would have certainly helped to present a more credible case, and would have put public authorities into a more defensive position. They would have been forced to argue either (i) that LoLR was only extended as long as there was a risk for the system as a whole, which would reinforce the assumption that 'too-big-to-fail' banks would get financial aid almost as a matter of principle; or (ii) that part of the discretion associated to LoLR measures includes the ability to 'be arbitrary', i.e. refuse LoLR assistance only to some cases, to prevent financial institutions from counting on it. This would make sense from a moral hazard perspective, but could sit badly with the equality principle, which demands that differences in treatment be justified to not be disproportionate.

The existence of unreasonable differences in treatment constituted the basis for the successful challenge of the Austrian Federal Act on Restructuring Measures for Hypo-Alpe-Adria-Bank International AG (HaaSanG) before the Austrian Constitutional Court. The HaaSanG provided that the supplementary capital and subordinate debt emissions held by third parties and covered by guarantees of the State of Carinthia would expire if they matured before June 30, 2019, together with all their associated security, including statutory guarantees. The Austrian Constitutional Court, in line with the ECtHR and the CJEU, found that the expiry of claims was not per se an expropriation, since claims were chosen for their worth, which was zero or low, using insolvency as the adequate benchmark, and the State had to be granted a wide margin of discretion. The distinction between 'normal' and 'subordinated' creditors was also legitimate, again using insolvency as a benchmark. The Court nonetheless found that there was an unlawful interference with the right to property, because subordinated creditors with claims maturing before June 30, 2019 were discriminated further, as the security and guarantees expired with the claim, while other creditors with equivalent claims were not affected and kept their entitlement to interests.

A second set of considerations that may provide the background for future developments are those pertaining to the procedural angle of the adoption of intervention measures, a field where financial supervision and resolution authorities can expectedly rely less on their 'special' status vis-à-vis the usual procedural safeguards applicable to every decision adopted by a public authority with an impact in a natural or legal person's basic rights, including the one to property.

Existing precedents seem to support this preliminary assessment, although with two important caveats: the precedents are not abundant, and the cases were decided in the absence of a statutory framework like the one currently in place. Still, in cases like *Credit and Industrial Bank v Czech Republic*, and *Capital Bank v Bulgaria*, the ECtHR, which was the deciding court, adopted a less deferential attitude.

84 "Two other major United Kingdom institutions, the Royal Bank of Scotland and HBOS, were treated entirely differently by the Government barely a year after the nationalisation of Northern Rock. These institutions were provided with over GBP 60 billion of financial support, on a secret basis, with the deal structured so as to avoid nationalisation and so as to leave shareholders with some, albeit reduced, value". Grainger at 32.

In both cases the administrative authorities were confronted with a financial crisis, in both cases extraordinary measures were taken, such as the intervention of individual banks (respectively, Credit and Industrial Bank, and Capital Bank) to mitigate the spill-over effects of insolvency. In Credit and Industrial Bank there was a removal of management, in Capital Bank the bank's license was revoked, the bank was declared insolvent and wound up. In both cases different procedural gimmicks made it impossible for the parties to challenge the intervention measures. Perhaps the more blatant case was Credit and Industrial Bank, where the unchallengeable nature of the act was grounded on the fact that the bank's board had been replaced by an insolvency administrator appointed by administrative authorities. This, in the authorities' view, deprived the former bank's board of standing to sue on behalf of the bank, since they were no longer its representatives (a situation not very dissimilar from the one recently considered by the General Court in its order 12 September 2017, *Komerčbanka*).

An interesting element is that, even though the applicants in the different cases relied on judicial protection and the right to the peaceful enjoyment of possessions (the definition of 'property rights' under article 1 of Protocol 1) the reasoning under each right was indistinguishable from the other. In Credit and Industrial Bank the coincidence of argument was such that the Court, after declaring the measures invalid under the right of access to courts and procedural rights did not consider necessary to re-examine the same arguments under article 1 of Protocol 1. In Capital Bank the Court examined the judicial review (or lack thereof) of the declaration of insolvency under article 6 ECHR's procedural rights, and the deprivation of the license under article 1 of Protocol 1, but this was arguably due more to the applicant's choice of legal ground in each case than to a distinctive approach by the Court, which, in both cases, was procedural in nature.

In the view of the ECtHR, Czech courts in Credit and Industrial Bank, and Bulgarian courts in Capital Bank had not acted as courts "with full jurisdiction". This was relatively easy to conclude in Credit and Industrial Bank, where any hypothetical right of the entity's board to lodge an appeal before they were formally divested of their representative powers was impossible to exercise in practice. This was due to the fact that the divestment decision was adopted without the presence of the bank, the entry in the register was made one day after the publication of the decision, and the decision indicated that there was no right of appeal.

In *Capital Bank v Bulgaria*, the Court's finding of a breach was based on the fact that the rules precluded review by the courts, something that had been confirmed by the courts themselves, which refused to exercise any review, and on the fact that the central bank decision had been adopted by an administrative body, which could not act as a substitute of courts for purposes of procedural rights. On grounds of property rights, the Court also concluded that the absence of judicial review did not, in itself, amount to a violation of the right (which, in our view, shows deference towards the courts) but the lack of opportunities by the applicants to present their case (they were notified once the decision was taken), and challenge the central bank decision did not stand scrutiny.

So far, so predictable, and, perhaps for this reason, it is still not a very enlightening background for future cases. Yet there was one additional consideration in *Capital Bank v Bulgaria*, which, in our view, provides the more interesting background for discussion. This is because the Court did not content itself with finding a prima facie breach of rights, but went on to analyse whether the measures were justified using a proportionality check. In this regard, this case stands as the only isolated instance where the proportionality analysis did not favour public authorities. The well-known 'Damocle-

an sword' argument was wielded before the Court, since, the authorities alleged, this was a case where financial stability was at stake, and this called for a wide margin of appreciation, the same argument that the Court willingly made its own in *Grainger*. Yet, the Court in *Capital Bank* was unimpressed: as special as the banking business may be, this could not justify a total absence of review by an independent body, and the threat of panic and contagion was not necessarily best served by a heavy-handed intervention, like the withdrawal of the license.

Still, the circumstances of the case were specific enough to command caution. According to the Court, the urgency of the situation could be mitigated by ensuring that the courts prioritised the case, and/or imposing strict time limits. Furthermore, an authority alleging that the risk that a judicial challenge of the withdrawal of the license could spread panic should offer some basis for such assertion. In this case, the facts did not side with the authorities, since the withdrawal of the license took place several months after the bank had been declared insolvent. Even then, the risk of panic could be addressed by other measures, such as a suspension of license subject to a final judicial decision, and/or proceedings not subject to publicity.

Thus, what makes the case interesting is the Court's willingness to go beyond the 'yes/no' assessment of the validity of the act, and to give guidance to national authorities. In our view, the Court hinted a willingness to be rather generous, and had the authorities not shown such a blatant disregard for any notion of due process, the outcome might well have been different. This is confirmed by the more recent case of *Adorisio v The Netherlands*, where Dutch authorities expropriated the investors in a Dutch bank. The deadlines for lodging an appeal were very short (10 days), and the time granted to the plaintiffs to examine the statement of defence by the Minister was even shorter, since they were granted access the afternoon before the hearing, and could access the report of an independent firm (on which the decision of intervention was based) in redacted form. Still, the ECtHR did not see that judicial protection rights had been impaired: the access to the reports in redacted form was (in the Court's view) compensated by the fact that the Administrative Jurisdiction Division had had access to the report, and nothing suggested it could be subject to challenge in light of the fact that the arguments put forward by the applicants had, apparently, been well-constructed, and that they had not established that, had they had access to the statement of defence, they would have changed their arguments or position.

If we accept that premise, the ECtHR's view was not good news for judicial review, not because of its acceptance of short timeframes, which look like a necessity in this context, but rather because the Court's conclusion begs the question whether the standard of judicial protection can be examined on the sole basis of after-the-fact considerations. The above is, of course, a simplification of a case where the ECtHR, of its own motion, carefully looked at the substance of the case and its details, to see if there was evidence of defencelessness and vulnerability. The Court's assessment was tough, but fair, and ready to engage with the facts.

One further consideration that needs to be made is that the ECtHR had to decide these cases in a field barren of useful legal sources. Yes, article 6 of the ECHR is a legal basis, which, like the proverbial acorn, has given rise to an oak tree of precedent. Yet the Court had to make decisions with little to hold on to in terms of what is 'fair' and 'reasonable' in the context of financial crises or bank interventions, where, even though judicial review is needed, there is normally a previous administrative procedure that provides a greater opportunity for the arguments on substance to unfold.

In this regard, the CJEU is the court best suited to step up, and fill the void of principles that still haunts bank intervention cases, for several reasons. First, as stressed by some of its judges in public lectures, it is “not a fundamental rights court”. This admission is often (and justifiably) read as “not a primarily-worried-about fundamental rights court”, which captures the risk that fundamental rights considerations may be sidelined in favour of more definite concerns about specific EU rules that constitute the statutory material on which the Court has to decide more frequently, even to curtail fundamental rights under national constitutions.

In practice, if we take a negative view, this can mean that the current framework on resolution and supervision, which was not present when the courts had to decide on the above cases, may constitute the preponderant, when not the only, source for the CJEU to adjudicate cases where there is a decision that allegedly interferes with individual rights, adopted without procedural guarantees. As long as the safeguards contemplated in the specific EU rules are respected, the CJEU would give the authorities its blessing. The ECtHR, for its part, has no competence to adjudicate on decisions adopted by EU institutions and bodies, and it has been almost ready to grant national authorities much leeway when they limit themselves to execute acts required under EU law.

Yet the above statement could also be read in the sense that the CJEU is “not under the limited mandate of a fundamental rights court”, in which case the evolution could be different. Instead of prioritising the policy considerations behind the statutes, the CJEU could use fundamental rights as the pinnacle of the EU legal order, not only from the perspective of bulwarks against interference, but as ‘affirmative’ principles, which must be used to interpret the specific statutes, and thereby to guide the action by EU institutions and bodies, and national authorities applying EU law. The seemingly dry and technical law of bank resolution or supervision is filled with open-textured references, which could be interpreted under the aegis of procedural guarantees, and not just financial stability.

Admittedly, the Court has done nothing so far to confirm this second possibility. Yet this could change due to the broader array of rights present in the Charter of Fundamental Rights, and thus available to the CJEU to be used as a check on action by public authorities. This is another reason why the CJEU is better placed to construe a better system of procedural safeguards. As opposed to the ECHR, where the safeguards are restricted to the judicial review of acts by public authorities, the Charter provisions can be used to scrutinize in more detail the administrative that resulted in the administrative decision subject to challenge. The safeguards applicable are summarised under the right to a good administration, and include: the right of the person to be heard before any adverse measure is adopted against him/her/it; the right of access to the file; and the duty of the administration to give reasons for its decisions. These are echoed in the specific rules on supervision, and, to some extent, resolution. The fact that such safeguards are also included in the specific supervision and resolution norms could give rise to a self-referenced interpretation of those safeguards, based on the statutory texts, which appeals to their primary policies (financial stability, protection of taxpayers, etc.) However, it could also result in a more robust one, where the safeguards are instilled with fundamental rights, understood as broader principles, which must also inform the interpretation of the specific statutory texts.

In this sense, our more founded expectation (or hope) should be with the duty to state reasons. If the Court’s concern when adjudicating on resolution or supervision issues is the asymmetry of expertise in that specific area, and the potentially fatal

consequences if decisive action is delayed, it should at least be unyielding with the authorities' duty to explain how such action is justified in the specific case. This is what would help the Court to learn about the actual framework of decision-making by the authorities, and anticipate future action, to the point of developing a reasonable rule-of-thumb on the basis of the authorities' own justification. Thus, even if public authorities should enjoy discretion, and the courts should respect considerations of financial stability, boilerplate references to "the perils of financial contagion, and the risk of systemic collapse" should leave the CJEU unfazed because this administrative duty to state reasons is what constitutes the real basis of judicial protection. Otherwise, the stage of judicial review becomes a "would you rather trust..." game, with a foregone conclusion.

After a series of decisions where the CJEU has limited itself to grant bail-in tools a solid legal basis, it should not delay too much the adoption of a less accommodating approach with respect to procedural safeguards, both administrative and judicial, which is the final reason why the CJEU is better placed to be the 'reference court' on these issues. The third reason why the Court can, and should, be the one to construe the resolution measures with the background of fundamental rights is because it is *only one of the courts* with competence to apply EU Law, including resolution rules and fundamental rights. National courts must also apply these provisions, together with their national constitutions, giving rise to a relationship that is as complex as it is risky.

It is risky because the whole system of EU bank resolution is grounded on the automatic mutual recognition of decisions by resolution authorities on a cross-border basis. This was already the foundation of the EU Insolvency Regulation,<sup>85</sup> and the Banks' Winding Up Directive.<sup>86</sup> If anything, it has been expanded by the BRRD,<sup>87</sup> which also regulates the powers that resolution authorities must be vested with, and their effectiveness. Yet recent experience shows that domestic courts are often ready

85 See articles 19 *et seq* of Regulation 2015/848 of the European Parliament and Council of 20 May 2015 on insolvency proceedings (recast) formerly Regulation 1346/2000.

86 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions. Article 3 (1) of the Winding Up Directive states that: "The administrative or judicial authorities of the home Member State shall alone be empowered to decide on the implementation of one or more reorganisation measures in a credit institution, including branches established in other Member States." Then, No. (2) of the same provision, in its three paragraphs, clarifies that: "The reorganisation measures shall be applied in accordance with the laws, regulations and procedures applicable in the home Member State, unless otherwise provided in this Directive. They shall be fully effective in accordance with the legislation of that Member State throughout the Community without any further formalities, including as against third parties in other Member States, even where the rules of the host Member State applicable to them do not provide for such measures or make their implementation subject to conditions which are not fulfilled. The reorganisation measures shall be effective throughout the Community once they become effective in the Member State where they have been taken." Article 9 (1) of the Winding Up Directive provides that: "The administrative or judicial authorities of the home Member State which are responsible for winding up shall alone be empowered to decide on the opening of winding-up proceedings concerning a credit institution, including branches established in other Member States. A decision to open winding-up proceedings taken by the administrative or judicial authority of the home Member State shall be recognised, without further formality, within the territory of all other Member States and shall be effective there when the decision is effective in the Member State in which the proceedings are opened".

87 See, e.g. Article 66 BRRD.

to cling to weak arguments to refuse recognition of acts that interfere with the “their” creditors’ rights, as shown by the decision of first instance of the English commercial court in the case *Goldman Sachs v Novo Banco*,<sup>88</sup> even if the decision was later corrected by the Court of Appeal,<sup>89</sup> and the decision of the München court in the Hypo Alpe Adria case.<sup>90</sup> The latter decision enjoys particular importance, because it concerned an Austrian law, which made it possible to apply resolution measures to Heta, the entity created to nationalise the Hypo Alpe Adria bank, even though the entity was not itself a bank. The Austrian decision was challenged by a German investor (the public bank Bayern LB) and the court refused to grant cross-border recognition to the Austrian measures because they were not directed to the recapitalisation of the entity, but, rather, its liquidation.

None of these cases strictly concern bail-in decisions, and there is still paucity of evidence to conclude whether the path towards a seamless system of mutual recognition of resolution decisions will be rough or smooth. However, as the decision of the Austrian Constitutional Court referred above illustrates, some courts are growing restless with the apparent unassailability of resolution decisions, and are relying on principles that constitute familiar terrain, such as non-discrimination and due process. EU resolution rules provide no roadmap for cases where a decision on bail-in by resolution authority in State A, having effects in State B, where some investors are located, is adopted in contravention of the non-discrimination principle, or due process rights under the Constitution of State B, or in a way that, according to State B’s courts, violates the non – discrimination principle of article 21 of the EU Charter of Fundamental Rights, or the rights to a good administration and judicial protection under articles 41 and 47 of the Charter.

In the past the CJEU has been adamant in concluding that EU rules that leave no choice to Member States cannot be circumvented by referring to national constitutions.<sup>91</sup> However, in this scenario the Court might face a PR storm if it tells a national court that it is ‘too protective’ in terms of non – discrimination, or that it is ‘asking too much’ of resolution authorities, in terms of an explanation. Since bail-in decisions normally affect a myriad of investors, potentially located in different countries, the CJEU might be confronting not one, but several, domestic constitutional courts.

Despite what the previous paragraph may suggest, we are not fond of apocalyptic scenarios, in fact the opposite. We are merely trying to illustrate that, if

88 *Goldman Sachs v. Novo Banco* [2015] EWHC 2371 (Comm). Portuguese authorities stated that the decision in the context of the resolution of Banco Espírito Santo (BES) to transfer assets to Novo Banco (‘NB’, the bank where the ‘good assets’ were transferred) did not include a loan facility subscribed by BES with Oak Finance Luxembourg. Since the loan facility included a jurisdiction clause in favour of English courts, the Commercial Court declared itself competent to decide on whether NB had succeeded, or not, BES in the loan facility, despite the previous decision by resolution authorities.

89 See *Goldman Sachs v. Novo Banco* [2016] EWCA Civ 1092, paras 24-34. The UK Court of Appeals relied on the broader interpretation of “reorganisation measures” under art 2 of Directive 2001/24 laid out in the decision of the Court of Justice of the European Union of *Kotnik*.

90 *Bayern LB v. Hypo Alpe Adria* (HETA case) Regional Court (LG) Munich I, judgment of 8 May 2015. See A. Gardella *ibid.* p. 218-219.

91 See, e.g. Melloni.

scrutinising bail-in decisions too much can pose important risks of contagion and endanger financial stability, scrutinising them too little can create a schism between EU courts and domestic courts, with unpredictable consequences. This would be dangerous, considering that the solution is not a hard one. It suffices for the CJEU to delve deeper on whether bail-in decisions discriminate between holders of different instruments in a way that is unjustified, and to be less keen to accept the pre-packaged threat of systemic risk.

#### 4.3 Whether the Resolution Authorities, in assessing the ability to apply bail-in tool to retail debt liabilities, should consider the supervisory assessment of proper implementation of the degree of compliance of banks with rules on retail investors' protection (in particular MiFID ones)

Recent cases of banks in distress or entering resolution suggest that in several instances retail investors were approached aggressively by banks in order to sell them banks' debt liabilities subject to loss sharing, giving them the wrong impression that a recommended product was as safe as a deposit. Particularly significant were cases of 'self-placement', where banks placed debt instruments issued by them with their own client base or cases of financial instruments offered by entities having close links or other legal or economic relationships with the issuer. In those cases the bail-in would affect retail investors who are at the same time also clients of the bank.

In such cases the application of bail in to retail debt liabilities is a source of financial instability with contagion effects that may trigger a run on deposits and social unrest. For this reason in applying BRRD resolution authorities should explicitly *consider* and address this element *in their resolution planning* giving also due consideration to the implementation by the financial institutions of the relevant aspects of the consumer protection framework contained in the Markets in Financial Instruments Directive (MiFID).<sup>92</sup>

## 5 Daunting challenges in the marketing of bail-inable instruments

### A) Transparency requirements and lessons from Italy

After the adoption of the Banking Communication and of the BRRD and in the wake of recent banks' restructurings and resolutions under both national and European rules, it is clear that the risk profile of bank debentures reflects their actual exposure to burden-sharing. This is something that, in the placement of these

<sup>92</sup> This is also the reason why even recently ESMA underlined that – in accordance with MiFID I – institutions must provide existing clients who already holds debt liabilities subject to the BRRD with complete and updated information on the potential treatment [*Esma statement on MiFID practices for firm selling financial instruments subject to the BRRD resolution regime* (ESMA/2016/902)].

instruments and on an ongoing basis, should be fairly and carefully disclosed to, and considered by, the investors.

This turned public attention from the financial stability side to the transparency side of the coin and even the Basel Committee set to work on recommendations on this.<sup>93</sup> In turn, EBA, in its 2016 Report, included a recommendation on transparency (No. 12), calling in particular for the introduction of new EU requirements, whereby:

«in the steady state, credit institutions in the EU should be required to disclose the quantum and composition of their MREL-eligible liabilities, as well as the MREL required from them by the resolution authority. The BCBS recommendations, once finalised, should serve as a starting point and should be extended to cover all of the MREL-eligible liabilities of G-SIBs and non-G-SIBs. They should also be extended to include information on other financial instruments subject to bail-in as well as information on the creditor hierarchy. In the transitional period, and pending finalisation of the BCBS recommendation in this area credit institutions in the EU should be required to disclose to investors the quantum and composition of their stack of MREL-eligible liabilities, as well as information on the creditor hierarchy (at a minimum). In addition, disclosure should be required or actively encouraged if a failure to roll over MREL debt could lead to automatic restrictions on distributions.»

Since the new resolution framework was designed without any grandfathering provision for instruments issued before the 2013 Communication and the BRRD and since the CJEU ruled out, as noted above, that it could be constructively derived from the general principle of legitimate expectations, this opened new ways to look at this quite significant legacy problem.

Attention was soon shifted on how and to whom these bailed-in financial instruments had been sold in the past and should be sold in the future. Indeed, once losses were first allocated to the holders of these securities in some Member States, public rage rapidly mounted because allegedly many investors had been misled, one way or the other, by the issuer. The case was allegedly strong with many retail investors found unable to understand the risk of burden-sharing and to have sufficient loss-bearing capacity to incur losses when their debt securities were written down.<sup>94</sup> Italian and Spanish experiences were exemplary and worth being briefly recalled. We deal in this paragraph with the lessons learnt from the Italian experience and in the next paragraph with those that can be drawn from Spain.

93 Basel Committee on Banking Supervision, *Guidelines for identifying and dealing with weak banks*, July 2015.

94 A recent study argues that debt holders of bail-in able debt shall be (a) sophisticated investors, which are (b) active outside the banking sector and are (c) not subject to an asset-liability mismatch due to their investment strategy. See SAFE, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, White Paper No. 35, 2016, p. 7 ff..

## 5.1 The starting point in Italy: perceived equivalence between deposits and bank's bonds, in the face of a long tradition of bail-outs and banks' exemptions

Up to the recent 2015-2017 bank restructurings, resolutions and wind-downs, holders of Italian banks' debentures, herein included subordinated debt-holders, unlike shareholders, had never been affected by a bank's failure and had always been bailed out, one way or the other.

This is why these bank debentures were widely considered safe, essentially risk-free and very different from securities placed by a corporate issuer. They were perceived as a different way for the bank to raise funds from families and others in surplus of capital and to cope, in parallel, with the time inconsistency problem: bank bonds are mid- to long-term, and hybrids carry a very long maturity date, sometimes even perpetual. Thus, in principle – except for the need to be either repaid or rolled over at maturity, something that does not apply to on sight-demand deposits, albeit factually dormant, and to perpetual hybrids – they enable a better matching of the liability side of the bank's balance sheet with the asset side.

This perception was to some extent supported, at the very outset, by national and European legislation, which in a way treated similarly savings flowing into banks in the form of deposits and those consisting of bank bonds subscriptions (differently from those invested into other financial activities): prudential supervision was in itself deemed sufficient to ensure the needed protection.

At national level, Article 12 paragraph 3, letter c) of Law n. 77/83 expressly excluded the application of the rules concerning public offerings to "securities, different from shares and to other comparable transferable securities, or giving the right to buy shares or other comparable securities, issued by credit institutions".

At European level, Article 5 letter a) of Directive 89/289/EEC set out that "Member States may provide for partial or complete exemption from the obligation to publish a prospectus where the transferable securities being offered to the public are: a) debt securities or other transferable securities equivalent to debt securities issued in a continuous or repeated manner by credit institutions (...) which regularly publish their annual accounts and which, within the Community, are set up or governed by a special law or pursuant to such a law, or are subject to public supervision intended to protect savings; (...)".

The same approach was confirmed by Article 100(1)(f) of the Italian Legislative Decree No. 58/1998 ("TUF"). A prospectus was deemed unnecessary. To be true, such conclusion was questioned in the literature and, to some extent, also by Consob during the preparatory works. Tommaso Padoa Schioppa rightly prophesized that "having obtained an exemption [from prospectus requirements] gives the banks the illusion of having an advantage but, as the market culture progresses, it could result in a damage to credibility". Nonetheless, this was the approach followed and Italian case law has been very scant on mis-selling of banks' securities for quite a long time, but for an handful of exceptional cases. For its part, Consob interpreted Article 100, paragraph 1, letter f), TUF as mandating a prospectus for banks' "reverse convertible securities" but deemed it non-mandatory both for securities (different from shares or financial

instruments that allow to purchase or subscribe shares) that did not guarantee a 100% reimbursement of the paid-up investment at maturity, and in case of bonds issued by foreign banks.

In turn, although Article 21 of Legislative Decree No. 58/199 already laid down general criteria to be complied with in the provision of investment services (namely: a) to act diligently, fairly and transparently in the interests of customers and the integrity of the market; b) to acquire the necessary information from customers and operate in such a way that they are always adequately informed; c) to use publicity and promotional communications which are correct, clear and not misleading; and d) to have resources and procedures, including internal control mechanisms, suitable for ensuring the efficient provision of services and activities), these requirements originally did not apply to the direct sale by a bank of its debentures to its clients.

## 5.2 From the repeal of the bank exemption to current transparency requirements in the sale of newly issued bail-inable instruments

With Directive 2003/71/EC of 4 November 2003 (on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC) the European approach changed. Instead of leaving the choice whether or not to impose a prospectus for banks securities to each Member State, such exemption was harmonized and anchored to special conditions.<sup>95</sup>

This, together with the corporate failures of the time, led to important changes in the transparency regime applicable to bank bonds in Italy at the end of 2005. Article 11 of Law no. 262 of 28 December 2005 ("Legge sul Risparmio")<sup>96</sup> repealed Article 100(1)(f) TUF and extended the application of Articles 21 and 23 TUF also to banks, putting forward a new Article 25-bis devoted to fairness and transparency in the placement of financial products issued by banks. Consob then identified two exemptions: one based on the economic value of the offerings and the other

95 Among the securities to which the same directive "does not apply" ex Art. 1, para 2, were: "(f) non-equity securities issued in a continuous or repeated manner by credit institutions provided that these securities: i. are not subordinated, convertible or exchangeable; ii. do not give a right to subscribe to or acquire other types of securities and that they are not linked to a derivative instrument; iii. materialise reception of repayable deposits; iv. are covered by a deposit guarantee scheme under Directive 94/19/EC of the European Parliament and of the Council on deposit-guarantee; (j) non-equity securities issued in a continuous or repeated manner by credit institutions where the total consideration of the offer is less than EUR 50 000 000, which limit shall be calculated over a period of 12 months, provided that these securities: i. are not subordinated, convertible or exchangeable; ii. do not give a right to subscribe to or acquire other types of securities and that they are not linked to a derivative instrument". Furthermore, according to transitional provision (Art. 30.2), "by way of derogation from Article 3, Member States which have used the exemption in Article 5(a) of Directive 89/298/EEC may continue to allow credit institutions or other financial institutions equivalent to credit institutions which are not covered by Article 1(2)(j) of this Directive to offer debt securities or other transferable securities equivalent to debt securities issued in a continuous or repeated manner within their territory for five years following the date of entry into force of this Directive".

96 As modified in first instance by art. 3 of the Legislative Decree. n. 303 of 29 December 2006 and later by art. 3 of the Legislative Decree n. 51 of 28 March 2007.

centred on the special features of some banking (and insurance) products.<sup>97</sup> Out of these exceptions, the prospectus required for bank bonds<sup>98</sup> was essentially the one mandated by Regulation n. 809/2004/EC.

This was however just the beginning of a convoluted and intense story, which we briefly illustrate in this paragraph and the following.

Relevant developments were first introduced by the Market in Financial Instruments Directive (2004/39/CE, "MiFID", into effect from 1 November 2007, replacing the "ISD" -Investment Services Directive) and by its transposition in Italy through Legislative Decree n. 164/2007. Consob, in the exercise of its powers of regulatory supervision under Article 6, paragraphs 2 and 2-bis TUF, issued in 2007 a new Regulation on Intermediaries (No. 16190/2007), which extended the application of MiFID rules also to the subscription and placement of financial products issued by banks (in particular the principles "know your customer" and "know your products"). It also made clear that the execution only regime could be followed only where orders for non-complex products were placed (and genuinely originated) by the client, whereas the rules on suitability and appropriateness were to apply whenever complex products were involved.

After the Commission Communication on state aids in the banking sector of 2013, Consob requested from banks that they included in the first pages of their prospectuses (also for bonds) a new risk factor linked to this. In turn, in December 2014, a new Communication was adopted aimed at precluding intermediaries from selling complex financial products – subordinated bonds being therein included (as we will see below) – to retail investors. In a climax, during the most recent banks' capital increases, Consob also required that, instead of signing the usual pre-printed form, investors willing to subscribe the shares had to draw up by themselves a handwritten statement confirming their full awareness of the risks connected to the investment. Partly as a result of this, between 2015 and 2016 savings previously invested into bank bonds were partly shifted to other forms of use, such as mutual funds and bank deposits, contributing to the acceleration of an already-developing trend. The weight of bank bonds in clients' portfolios dropped by about 28% in that two-year period.

Several measures were also adopted to address banks' self-placement, such as a) implementing supervisory and enforcement actions (including on-site inspections); b) imposing pecuniary sanctions; c) publishing several guidelines and clarifications on banks' self-placement. And an ad hoc arbitration for the rapid out of court settlement of disputes with retail investors was set up in January 2016.

Directive 2014/65/EU of 15 May 2014 ("MiFID II") updated and broadened the reach of transparency requirements related to investment products, with applicability from 2018 onwards. The main change will be that investment firms will need to ensure and prove that those providing advice and information have the necessary knowledge and expertise to abide by the requirements of the directive (Article 25 (1), MiFID II).

97 Article 34-ter, paragraph 4 Regolamento Emittenti sets out that: "In the event of public offerings concerning instruments other than capital securities issued continuously or repeatedly by banks, a simplified prospectus is published that contains at least the information pursuant to Attachment 1M, as long as said instruments have the following characteristics: 1) the total price of the offer, within the European Union, calculated for a period of 12 months, is less than 75,000,000 euro; 2) are not subordinate, convertible or able to be traded; 3) do not grant the right to subscribe or purchase other types of financial instruments and are not connected with a derivative instrument".

98 Compare Consob Communication n. DEM/6031543 of 7 April 2006.

Product governance under Regulation No. 600/2014 (MiFIR) will be part of this and investment firms shall ensure that the substantive content of the financial products offered to their clients, and the information related thereto, best serve their interests. In this way, authorities will be able to carry out a "proactive" enforcement activity, up to "product intervention" under Articles 39 to 42 MiFIR. This intervention can range from a simple request to modify advertising materials, to the temporary suspension of a product's marketing, to the imposition of restrictions in the sale or distribution of a product or service (for example a limitation to its distribution to non-retail clients only), to the permanent ban on the marketing, sale or distribution of a specific financial instruments, or on a particular activity or financial practice. As to self-placement, then, Article 41 of MiFID II Delegated Regulation requires now that financial institutions which offer financial instruments issued by themselves or other group entities to their clients and that are included in the calculation of prudential requirements specified in CRR, CRD or BRRD, shall provide those clients with additional information explaining the differences between the financial instrument and bank deposit in terms of yield, risk, liquidity and any protection provided in accordance with the Deposit Guarantee Schemes Directive.

In turn, MiFID II expanded the pre-existing requirements of suitability and appropriateness that financial intermediaries must abide by when assisting clients in their choice of investment. As for suitability, firms providing investment advice or portfolio management services must obtain the following information from a (potential) client: (i) knowledge and experience of the investment field in which the investment advice or portfolio management is to be offered; (ii) financial situation including ability to bear losses; and (iii) investment objectives including risk tolerance.

Intermediaries are also obliged to take reasonable steps to ensure that investment advice and decisions to trade- buy or hold- are suitable in virtue of the collected client information, and otherwise abstain from the recommendation of products or instruments. The suitability assessment applies to all recommendations, so that firms must implement all policies and procedures needed to understand the nature and features of the instruments - costs and risks included - and to assess whether equivalent financial instruments could meet the client's profile, while taking into account costs and complexity. As for the assessment of appropriateness, firms must obtain information regarding their clients' knowledge and experience in order to enable the firm to determine if the products and services envisaged are appropriate: (i) the types of financial service, transaction and regulated financial instruments the client is familiar with; (ii) the nature, volume and frequency of the client's transactions in regulated financial instruments; and (iii) the level of education, profession or former profession of the client. ESMA acknowledged that, due to the increased scope of instruments covered by MiFID II with respect to MiFID I, an increased number of instruments will be now considered "complex". Among them also subordinated debt instruments are listed as instruments incorporating "a structure making it difficult for the client to understand the risk". The result is an extension of the scope for the appropriateness assessment.

The ESMA action in this domain preceded MiFID II.

On 7 February 2014, ESMA issued an opinion on MiFID practices for firms selling complex products that was eventually implemented by the above mentioned Consob Communication of 22 December 2014 on the distribution of complex financial products to retail clients. In this opinion perpetual bonds, subordinated bonds and other product whose "capital protection may be conditional or partial, or can be withdrawn on the occurrence of certain events are considered as examples of complex products". For

products of this kind ESMA warned that "the more complex a product, the harder it is to demonstrate that retail clients have sufficient financial knowledge and experience to understand the key features, benefits and risks involved in an investment" (point 12). The opinion focussed thus on how organizational requirements, suitability and appropriateness should be implemented in practise in the conduct of business.

In turn, on 31 July 2014 ESMA issued a statement on contingent convertible capital issued by banks to meet their prudential requirements. ESMA clarified the hybrid nature of these instruments and their heterogeneity in the existing practice and concluded:

"In a crisis CoCos have the potential to play an important role to inhibit risk transfer from debt holders to taxpayers. They along with other standards to improve the quality and quantity of bank capital reflect a considerate response to the former regulatory capital framework. There exists a tension between (i) the prudential needs of an issuer to optimize its capital structure with affordable loss absorption funding that maintains the entity as a going concern, and (ii) the needs of investors to properly price the risk of loss of coupon or capital, which are particular challenges for CoCos. Similarly, given the varying trigger levels of issuance across a given banking group it is difficult to envision exactly how the contractual provisions relating to the conversion or write-down of CoCos will play out. There exists uncertainty in the context of a supervisory decision establishing when the point of non-viability has been reached as well as in the context of a statutory bail-in set up under the new Bank Recovery and Resolution Directive. Investors should fully understand and consider the risks of CoCos and correctly factor those risks into their valuation".

This statement coincided with the ESMA publication of a Public Statement on Self-Placement, which was a reminder to firms of their obligations when providing their investment services or products to their clients (we will consider it in the next paragraph).

ESMA also tackled the order-handling service exemption when complex products, such as bail-inable instruments, are concerned. To this purpose, it provided more specifications in its Final Report of 26 November 2015. Indeed, article 25(4) of MiFID II allows investment firms to provide order-handling services (reception and transmission of orders, as well as execution of orders on behalf of clients) without performing the appropriateness test described in Article 25(3). In addition to some other conditions, Article 25(4) requires that such services relate to specific types of products – usually termed "non-complex" – including certain debt instruments as well as some structured deposits. In order to fall under an "execution only" regime, financial instruments should not belong to the category of instruments embedding a derivative or presenting a structure that makes it difficult for the client to understand the risk related to the investment made. Regarding subordinated bonds, ESMA confirmed that holders of a subordinated debt instrument are in a less favourable position than those holding an ordinary debt instrument, as a consequence of the subordination clause. Furthermore, this less favourable position is deemed difficult to grasp for the average retail investor, and for this reason these instruments are considered as complex.

On 15 December 2015, ESMA published an update to its Q&A on disclosure requirements for debt capital markets transactions under the Prospectus Directive (2003/71/EC, as later amended), providing guidance on the level of disclosure that should be included in a prospectus, when it involves securities that are subject to bail-in powers under the BRRD. In particular, EU banks need to disclose bail-in risk for any debt

securities issued after 1 January 2016. ESMA established that when the possibility of bail-in is considered to be "material" by the issuer- envisaging the probability of bail-in actually occurring and what the potential impact on investors would be - this should be properly reflected in the risk factors section and summary of the prospectus. The risk factor should also serve the purpose of making prospective investors aware of the possibility that, in the event of a write-down or conversion of debt instruments in resolution the amount outstanding may be reduced; the debt security may be converted into ordinary shares or other instruments of ownership; and contractual terms (such as the maturity of the instrument) may also be altered. In addition, such risk factor should also alert prospective investors to the fact that public support can be relied upon only as a last resort measure, after having made use of bail-in and other resolution tools.

Later, on 2 June 2016, ESMA published a new statement targeting precisely bail-inable securities, to remind firms of their responsibilities to act in their clients' best interests when selling bail-inable financial instruments, noting that BRRD rules in force since January 2016 imply that firms are likely to issue a significant amount of potentially loss-bearing instruments to fulfil their obligations. ESMA is concerned that investors- in particular retail ones- may be unaware of the risks they may face when buying these instruments. The statement emphasises the need for firms to comply with their obligations under MiFID and the importance of providing investors - existing and new - with up-to-date, complete information drafted under the supervision of the compliance function; managing potential conflicts of interest, in particular, when a firm sells its own bail-inable financial instruments directly to its customers (self-placement); and ensuring the product is suitable and appropriate for the investor which may entail collecting information about the client that is more in-depth than usual to reflect the fact that she could lose money even without the firm entering into insolvency.

Yet, the potential impact of BRRD had been previously identified, in Italy, by Consob Communication n. 0090430 of 24 November 2015, which clarified that investors need to be made aware of the fact that limitations exist to public intervention for the rescue of financial institutions in distress. In addition, a full disclosure of the potential eligibility of the chosen investment product for bail-in, as well as its positioning on the hierarchy of bail-inable instruments must be provided. As for portfolio management, clients need to be adequately informed of the potential investment in securities that are liable to write-down or conversion according to burden-sharing or the more recent bail-in requirements.

More recently, on 12 April 2016, Consob adopted ESMA's "Guidelines on complex debt instruments and structured deposits". In accordance with these guidelines, obligations, other forms of securitised debt and money market instruments (overall labelled as "debt instruments") are excluded from the reach of the new execution only regime, as they incorporate a structure that is such to make it difficult for clients to understand the risk stemming from such operations. In line with Art. 19(6) MiFID, those obligations, other forms of securitised debt and money market instruments in which a derivative element is embedded are still deemed as complex instruments. As regards structured deposits- which generally fall in the category of instruments benefiting from the execution only regime by virtue of art. 1(4) MiFID II- they are excluded from such regime whenever deemed "complex" in view of their incorporating a structure that makes it hard for the client to fully grasp their related investment risk or the cost of their divestiture before maturity.

In conclusion, drawing from all of these regulatory developments, it is clear how the original standards for transparency have been strengthened over time both at

European and national level in view both of the financial product innovations occurred in the last years- which broadened the range of potential investment choices and increased their degree of complexity- and of the introduction of the new rules on bank resolution. These developments acted at the level of both prospectus disclosure and investment services provision. This has evidently added an additional layer of policy considerations to an already difficult balance.

### 5.3 An history of past mis-selling of outstanding bank's bail-inable liabilities? The institutional response

All the measures briefly described in the previous paragraph were presented as a response to past practices of mis-selling (a term to which many meanings are attributed, including: aggressive or incompetent sales tactics; a failure to appropriately advise customers; deliberate strategies to sell financial services that customers do not need).<sup>99</sup> Mis-selling by banks in retail business can be explained by economic frictions between banks and their clients, driven by different levels of expertise, different levels of transaction costs and different access to financial markets.<sup>100</sup> Examples of mis-selling are mis-representation of information,<sup>101</sup> overly complex product design<sup>102</sup> and non-customised advice.

A particularly effective practice of mis-selling may occur when financial institutions "self place" with their clients financial instruments that they, or their group companies, have issued and that are eligible to comply with specific prudential requirements. It is no surprise, thus, that the ESAs already stressed in 2014 that these practices may breach some of the rules governing financial institutions (i.e. rules governing conflicts of interest, remuneration, provision of advice and suitability and appropriateness of products) and may result in significant consumer detriment.<sup>103</sup> In particular, the Joint Committee noted that the loss bearing features of many self-placement products expose consumers to significant risks that do not exist for most other financial instruments, such as the risk of having to share losses (risk of burden sharing). Furthermore, these products often lack fully harmonised structures, trigger points and loss absorption, making it difficult for consumers to compare them with other financial products and to fully understand (and price) what they are buying.

Mis-selling of financial products is socially undesirable and, to curb it, there is a need of *ex ante* regulation of the kind we already discussed in the previous

99 J. Black, R. Nobels, Personal pension misselling: the causes and lessons of regulatory failure, in *The modern Law Review*, 61 (6), pp. 789-820.

100 SAFE, Fair retail banking: how to prevent mis-selling by banks, White Paper No. 39, 2016.

101 Material mis-representation of information is the deliberate hiding or falsification of a material fact which, if known to the other party, could have aborted or significantly altered the basis of a contract, deal, or transaction.

102 This kind of mis-selling occurs when financial intermediaries design products which are too complex for clients to understand because they are not in a position to uncover all features of a product which are relevant for its payoff.

103 Joint Committee of the European Supervisory Authorities, Placement of financial instruments with depositors, retail investors and policy holders ("self placement"), JC 2014 62, 31 July 2014.

paragraph, as well as the setting of behavioural requirements for banks, regulating the compensation of employees, and ex post litigation. Bail-inable instruments are no exception and, in a sense, are also more prone than other financial products to the risk of mis-selling. *Indeed, even if households and other types of retail investors receive adequate information on the specific risk of a bail-in instrument, they may still lack the necessary loss-bearing capacity.* Moreover, whenever banks must issue and place additional banks' securities eligible for burden-sharing (shares and subordinated debt) to abide by reinforced prudential requirements, this could run counter the success of the placement if they openly disclose their weaknesses; there is therefore a perverse market incentive in place for them not to properly comply with transparency requirements. In other terms, a potential clash exists between prudential and transparency needs, which is exacerbated by the fact that powers to intervene in cases in which financial instruments subject to burden sharing are systematically sold to unsophisticated retail investors fall outside the competence and responsibilities of prudential supervisors and are vested exclusively with securities supervisors. However, the latter may be less aware of the real prudential situation of the issuer.<sup>104</sup>

Italy shows that if ex ante regulation and supervision proves insufficient, extraordinary ex post institutional intervention becomes then inevitable. This story is therefore worth a brief digression.

- a) Few days had passed since the implementation of BRRD, when, on 22 November 2015, Bank of Italy adopted resolution for 4 mid-sized banks under temporary administration (Banca delle Marche, Banca dell'Etruria, Cassa di Risparmio di Chieti and Cassa di Risparmio di Ferrara), totalling altogether around EUR 30 billion assets and 1% of Italian deposits. The Italian government supported the initiative with a Law Decree (No 183/2015). Under the resolution scheme: a) non-performing loans (NPLs) for EUR 8,5 billion Gross Book Value of the 4 failing banks were transferred to a bad company; b) all other assets different from NPLs, together with deposits and non subordinated bonds, were respectively transferred by each failing bank to two newly-established banks, maintaining the original company names, and having capital of 9% of their respective RWAs, wholly subscribed by the national resolution fund; c) the 4 original banks were wound up and all of their shares and subordinated debt instruments were written down. This was a true baptism of fire for the new rules on resolution, and quite an unfortunate one. Many reasons coalesced against it. To our purposes it is sufficient to note that supervisory authorities were also blamed for having authorised, when the situation of some of these banks was already significantly deteriorated, increases of capital or sale of subordinated debt to retail investors. Be it as it may, the first Italian market test for BRRD-like resolution was dreadful. It instigated a system-wide fall in investors' and depositors' confidence and even threatened to ignite contagion and bank runs. It is reported that in the days and weeks that followed the resolution, outflows from banks' retail deposits to time deposits with Italian Post amounted to several billions. Public rage mounted quickly, especially when anecdotic evidence showed that shares or subordinated debts had been unsuitably sold

<sup>104</sup> This fragmentation of competences inhibits tackling the problem adequately according to SAFE, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?, White Paper No. 35, 2016, p. 14 ff.

in the past by the same banks to retail investors unaware of any risk of bail-in. Explanations meant to clarify that, despite its effects on shares and subordinated debt, resolution had preserved value if measured against a winding up of the banks and Consob Communication of 24 November 2015 No. 0090430 on transparency requirements for the sale of bail-inable instruments were not successful in laying to rest the turmoil.

- b) A first legislative response came with the 2016 Stability Law (Law 28 December 2015, No 208), whose article 1, paragraphs 855-861, established a solidarity fund to the benefit of retail investors (natural persons) that held, at the date of the entry in force of Law decree No 183/2015, subordinated debt securities issued by the 4 banks under resolution. The fund was originally capped at EUR 100 million, to be financed (and managed) by the Fondo Interbancario (Italian DGS). The determination of the conditions to access to the fund, herein included what proceedings had to be instituted, was delegated to a Decree of the Treasury: in some case an ad hoc arbitration had to determine whether investment rules of conduct had been violated at the time of sale of such debt. This was not enough to restore market confidence.
- c) Retail investors' outrage was quickly converted into legal actions against the banks, especially the failed 4, but possibly also against the bridge banks because of alleged ambiguities in the scope of the liabilities transferred to them by order of the Bank of Italy. A risk of massive litigation emerged; and in the meantime, criminal investigations and civil litigation were undertaken against Monte dei Paschi di Siena in the face of its shares and perpetual bonds issuances of 2008 and 2011.
- d) In May 2016 a new Law Decree was adopted (No 59 of 3 May 2016), which was meant, among many other things, to improve the level of protection of retail investors and streamline the reimbursement for their subordinated debt holdings in the 4 failed banks with an automatic 80% reimbursement for those who had invested by the cut-date of 12 June 2014, provided that their financial assets did not exceed € 100.000 and their yearly revenues were below € 35.000. The Decree also significantly increased the firepower available to the fund for this purpose.
- e) A few weeks later both Banca Popolare di Vicenza and Veneto Banca failed to win support from their shareholders for their capital increases mandated by the ECB for prudential reasons. At the same time it became known (being on very vociferous press reports for weeks) that these banks, in need for capital at least since 2013, had wilfully breached investment rules of conduct and financed acquisition or subscription of their shares in their past capital increases of 2014 and 2015. The liability risks associated to mis-selling converted into a necessity for the new governance of the two banks to make huge provisions (in this way weakening an already weak capital position). In the first month of 2017 these two banks went through the first (successful) experiment of a public offer of settlement to prevent thousands of claims by their retail investors from becoming a fatal impediment to restructuring (the settlement was finally targeted by a vast majority of holders of these securities).
- f) A Law Decree was adopted at the end of December 2016 to cope with the capital shortfall of Monte dei Paschi di Siena (MPS). One cannot underestimate the symbolic effect of MPS's travails: on the wake of the fateful referendum of 4 December 2016 and the ensuing political turmoil, a market solution was beyond reach

for one of the most venerable European banks. The new Law Decree provided, among other things, a framework for the injection of new capital through public funds into banks that, despite being still solvent, showed a capital shortfall in a stress test conducted either at European or national level and based on a worst-case scenario (Article 14). The law then tried to reach a balance between the demands of state aid rules on burden-sharing and the political necessity to limit bondholders' losses, especially retail ones, by regulating the conversion of subordinated debt into shares at a given exchange ratio. Recent commentaries of the MPS case highlight some of the inconsistencies in the actions taken in this respect. The implementing Decrees for the precautionary recapitalisation of MPS were then adopted in July 2017.

- g) Finally, a few days after the momentous resolution of Banco Popular with the intervention of Banco Santander in Spain, Law Decree 25 June 2017, No. 99 was adopted to wind up Banca Popolare di Vicenza and Veneto Banca. Despite some apparent similarities (the immediate sale for a price of one Euro of the sound part of the going concern of the failed bank to the respective first national banks, Santander in Spain and Intesa San Paolo in Italy), the two transactions were quite differently designed, because the former was adopted within the frame of the first EU resolution whilst the latter was adopted within the frame of national winding up, once the SRB had found that the public interest test was not met and resolution could not be granted to the two failing Italian banks. Thus, the Decree was essentially aimed at providing sufficient public support to the acquisition of the sound part of the going concerns of the two banks and of the related retail deposits and senior debt instruments (issued with public guarantee under the December 2016 Decree). Such an endowment was quite certainly necessary to secure Intesa San Paolo intervention and in this way to prevent a systemic crisis at the national level.

## 6 Daunting challenges in the marketing of bail-inable instruments

### B) How changes at the micro level of the supervisory and judicial approach to transparency can impact the macroeconomic context. Lessons from Spain

#### 6.1 The Spanish traditional pro-bank approach and its sudden reversal

Traditionally, the courts' views in Spain were relatively formalistic and overall pro bank, and this held true also with respect to the mis-selling of financial products.<sup>105</sup> Then, all of a sudden, everything changed. What changed, and why is this important to our current purposes?

<sup>105</sup> Up until 2012, the Supreme Court rejected that the breach of conduct rules related to the transparency in the marketing of financial products, could constitute the basis for a claim of annulment, and thus restitution. See Spanish Supreme Court Decision of 21 November 2012 (RJ 2012/11052).

Several things combined in the crisis years to result in important changes. These changes are important to assess the banks' ability to place capital and debt products among their clients. First, the Spanish courts were confronted, for the first time, with cases of mis-selling of financial products *on a massive scale*. These were primarily of two kinds. One concerned the marketing of hybrid capital instruments similar to preferred shares.<sup>106</sup> The other concerned the marketing of swap instruments, which should have operated in a way similar to an insurance for clients against a rise in interest rates, but in practice gave the banks a stable interest rate.<sup>107</sup> The trickle of cases making their way up the court system, which soon turned into a tide, suggested that something could be structurally wrong with the way banks marketed financial products. This finding did, as we noted, have many commonalities with concomitant Italian experiences.

A second aspect that contributed to this was the tardy response by supervisory authorities, despite clear evidence that, at least in some cases, financial products had been sold to the wrong people for the wrong reasons. The National Securities Market Commission (Comisión Nacional del Mercado de Valores, "CNMV") and Banco de España had the tools to open proceedings, which could have resulted in large-scale solutions, like the restitution of part of the investment to clients. Yet for a long time, no such proceedings were opened. Perhaps supervisory authorities saw no evidence of mis-selling. Perhaps they had more urgent matters to attend to, such as the precarious state of the banking system. Perhaps, for this reason, they did not want to stir trouble in a sector that was already wobbly. As seen below, the government reacted later, trying to solve the problem of mis-selling through an arbitration mechanism, but by then enough *preferentes* cases were in the courts to give them some preliminary, but weighty evidence, that at least some investors had been misled. When a massive process of marketing of securities is addressed on a case-by-case basis, in civil lawsuits seeking the annulment of the individual contracts and/or damages, there are obvious limitations. Civil courts were limited by the facts of each individual case, and the evidence provided by the parties. Cases often turned into a burden of proof issue, which depended on whether the client had to prove misconduct, or the bank had to prove compliance. Thus, the public bodies deciding the first cases, i.e. courts, lacked the means to investigate the context of each sale, let alone the higher-level marketing protocols and procedures.

As the third piece of this perfect storm-puzzle, Spanish courts were scolded by the Court of Justice of the European Union for being 'too pro-bank'. The decision in the *Aziz* case was, of course, more complex than that.<sup>108</sup> Yet in essence, the CJEU held that, even the very efficient, very expedient Spanish executory proceedings had to make room for the debtor to allege the nullity of contract clauses under the 93/13

106 They were called 'preferred participations' (*participaciones preferentes*) because they were conceived not only for banks, but also for savings banks, which had a structure similar to foundations, and thus no ownership stakes. These were regulated by the 3rd Additional Provision of Act 19/2003. See D. Ramos Muñoz, *Las participaciones preferentes y su contexto: resolviendo el sudoku*, *Diario La Ley* N° 7970, Tribuna 22 (November 2012).

107 Again, the clients alleged that they were not duly informed of the risks, which included the risk of cancellation paying the price of the swap at that moment.

108 *Aziz*, C-415/11 of 14 March 2013, EU:C:2013:164.

Unfair Contract Terms Directive. The implication was that Spanish courts were leaving consumers at the mercy of banks in eviction actions.

These circumstances combined (or conspired) to result in an important change in Spanish courts' attitude towards the bank-client relationship. First, the Supreme Court decided that 'floor clauses' (*cláusulas suelo*) were unfair, pursuant to Directive 93/13/CEE.<sup>109</sup> Even if some contrition was expected after the case by the Court of Justice, the decision was strong and controversial: clauses that set the 'price' cannot generally be considered 'unfair',<sup>110</sup> but the Spanish Supreme Court creatively interpreted the meaning of the Directive's provisions, to conclude that the clauses were invalid.<sup>111</sup> Still, the Court showed that it was not ready to fall on the clients' side without regard to the consequences. In its finding, the Supreme Court chose to limit the effects of its nullity decision to the payments to be received from then onwards, i.e. banks should not charge the interest rate agreed as a 'floor', but neither should they reimburse the interest payments resulting from the floor since the time the contract was concluded.

## 6.2 The CJEU Genil case, the Supreme Court 2014 decision on mis-selling and their aftermath

As a next step, the Supreme Court began to decisively side with the clients in mis-selling cases, even leading to a new doctrine on swap cases in early 2014, holding that the breach of MiFID marketing rules would justify *prima facie* a claim of 'mistake', and thereby lead, absent other considerations, to the annulment of the contract.<sup>112</sup> This time the cause-and-effect between European and Spanish decisions is less easy to establish, but the Spanish courts found support for their change of approach in a 2013 decision by the Court of Justice.<sup>113</sup> The holding was not controversial like *Aziz*, but the Court confirmed that MiFID applied to products marketed by banks,<sup>114</sup> and that the existence of a relationship of 'advice', with its enhanced transparency duties, depended on the substance of the relationship, not the type of contract concluded by the parties.<sup>115</sup>

The CJEU decision on MiFID and swaps, however, cannot explain the tidal wave of pro-client decisions that followed, which reflected a genuine change of heart

109 Decision by the Spanish Supreme Court of 9 May 2013 (ECLI: ES:TS:2013:1916). We believe it is not random that the decision was issued with two months difference with the case by the European Court.

110 Article 4 (2) of Directive 93/13 on Unfair Contract Terms.

111 See Decision of the Spanish Supreme Court of 9 May 2013 (ECLI: ES:TS:2013:1916).

112 Spanish Supreme Court Decision of 20 January 2014 (ECLI: ES:TS:2014:354).

113 Case C-604/11 *Genil v. Bankinter*, 30 May 2013, ECLI:EU:C:2013:344 (hereafter: *Genil v Bankinter*).

114 *Ibid* at 36-48. The Banco de España and the CNMV had issued a joint note, whereby they held that swap contracts that were bound to a lending agreement would be covered by (less exacting) bank transparency rules, and only independent 'investment' swaps would be covered by MiFID. See Banco de España – CNMV Delimitación de Competencias en Relación con la Supervisión y Resolución de Reclamaciones que afectan a Instrumentos o Productos Financieros Derivados de Cobertura (2010). This division of competences was not in line with the findings of the Court.

115 *Genil v. Bankinter* at 49 – 55.

by the Spanish Supreme Court.<sup>116</sup> As it happens with tidal waves, this one was indiscriminate, and together with the swap contracts, it also swept away the sales of hybrid capital instruments, which were not equivalent (the products were less complex, the risks easier to understand). This did not matter much to the courts, and the entities faced one annulment decision after another.<sup>117</sup>

Despite the fact that supervisory authorities had lacked the expediency to prevent large-scale mis-selling, the dripping of cases at a 'micro' level in civil courts soon became a problem at a "macro" level, and, as the government realised in 2013, a political headache.<sup>118</sup> To address the problem, Spain passed a royal-decree with two measures: first, it created a high-level commission to study and monitor the problem; second, it established a system for a collective arbitration of sorts which would allow some clients to recover part of their investment,<sup>119</sup> both measures being accompanied by the enhancement of the role of the Spanish Deposit Guarantee Scheme.<sup>120</sup> This system was later used as a blueprint by the Italian government in its 2016 measures meant to hold retail investors harmless from the losses deriving by the mis-selling of shares or hybrid securities issued by the four resolved banks (MPS, Banca Popolare di Vicenza and Veneto Banca).

Yet, we say arbitration 'of sorts' because the Spanish norm was skimpy about its details, which were left to the Commission. The Commission did so in its resolution of 17 April 2013, where it set the criteria to determine which clients should be offered arbitration. Two are the salient points of the resolution. One, it mixed legal criteria associated to the marketing of the product, with more social criteria associated, for example, to the loss suffered by the investor as a percentage of his or her patrimony, or to the fact that the investment was lower than EUR 10.000. This shows that the procedure was not trying to ascertain the facts, but to compensate those citizens who had suffered the most (if we are kind) or those citizens that could make for a more damning front page in the papers (if we are cynical). Second, many of the 'legal' criteria that *gave access* to the specific procedure identified marketing conditions that should have automatically given clients a favourable court ruling, as they included, e.g. the total absence of information on

116 The decisions by the Spanish Supreme Court on the issue are countless. Suffice to cite some, such as 15 December 2014 (RJ 2015\56); 15 September 2015 (RJ 2015/3993); 15 October 2015 (RJ 2015\5030); 13 November 2015 (RoJ 4664/2015); 4 December 2015 (RJ 2015\5461); 9 December 2015 (RJ 674\2015); 10 December 2015 (RJ 2015\5777); 8 April 2016 (RJ 2016/1496); 19 May 2016 (JUR 2016\117371); 3 June 2016 (RJ 2016\3863); 13 July 2016 (RJ 2016\3194); 15 July 2016 (RJ 2016\3201); 30 September 2016 (RJ 2016\4581); 5 October 2016 (RJ 2016/225150); 23 November 2016 (no. 691/2016; JUR 2016\261556).

117 See, e.g. Decisions of the Spanish Supreme Court of 12 January 2015 (RJ 2015\608); 16 September 2015 (RoJ 4004/2015); 25 February 2016 (RoJ 610/2016); or 29 June 2016 (RoJ 3138/2016).

118 This resembles closely what happened in Italy with the mis-selling claims related first to the securities issued by the four banks resolved in 2015 and then those issued by MPS, Veneto Banca and Banca di Vicenza.

119 Royal Decree-Law 6/2013, of 23 March. Similar schemes were crafted in Italy in 2016, first for the holders of subordinated debt issued by the four banks resolved in 2015 and then for MPS subordinated debt mis-sold to retail investors.

120 The DGS (*Fondo de Garantía de Depósitos de Entidades de Crédito*) would be allowed to both acquire shares and debt from SAREB, and to acquire shares from entities that transferred NPLs to SAREB, in order to lessen the impact of the conversion mandated by the resolution authority (FROB), which shows how much the problem of NPLs was linked to the problem of hybrid capital instruments, from both, a solvency, and investor protection perspectives.

risks, the lack of classification of risk profile, the absence of a contract document, or the fact that the investor was a minor or incapacitated.

In these circumstances, some investors, especially those with larger patrimonies, who could count on a less sympathetic arbitration continued to go to the courts instead. The colourful environment resulting from this led to the rise of American-like trial lawyers, who advertised their services in billboards and TV: up to that point, a phenomenon unknown in Spain. The process has been a long, winding road, where banks have lost, and lost, and lost again, *so much so that, in light of existing precedents, it is difficult to identify a sure way in which a bank may market to its clients a financial instrument that exposes them to a risk of loss, without being exposed to an annulment action, and without fully denaturalising the marketing process, i.e. turning it into a series of ominous warnings. It is difficult to imagine a massive distribution of MREL securities in Spain or Italy under these circumstances.*

### 6.3 From Banco Popular onwards

Spain has been home not only to one of the most comprehensive restructurings of the banking sector. It has also inaugurated the Single Resolution Mechanism (SRM), with the decision by the Single Resolution Board (SRB) that Banco Popular was 'failing or likely to fail', that there was no reasonable prospect of a private sector solution, and that resolution action was necessary and in the public interest: such action consisted in a write down of CET1 and Tier 1 instruments, and the conversion of Tier 2 instruments into capital, followed by the sale to Banco Santander, for 1 euro.<sup>121</sup> The decision was followed by immediate action by Mexican investors, international bondholders, a Spanish association of consumers, and other parties, including a distressed-debt US firm, who announced legal action.<sup>122</sup> To mitigate the effects of the lawsuit Santander already announced that it would offer compensation to some of the retail customers/investors in Banco Popular,<sup>123</sup> for which it already raised specific amounts.<sup>124</sup>

121 See Notice summarising the effects of the resolution action taken in respect of Banco Popular Español pursuant to Article 29(5) SRMR. See <https://srb.europa.eu/en/node/315>. Last accessed: 30 August 2017.

122 Thomas Hale, Mexican investors ask ECJ to overturn Banco Popular sale, in Financial Times 4 August 2017 <https://www.ft.com/content/a4a7691e-7901-11e7-90c0-90a9d1bc9691>.

123 Santander announces a commercial action for retail customers affected by the resolution of Banco Popular. Santander Press Release 13 July 2017. [http://www.santander.com/csgs/Satellite/CFWCSancomQP01/en\\_GB/Corporate/Pressroom/Santander-News/2017/07/13/Santander-announces-a-commercial-action-for-retail-customers-affected-by-the-resolution-of-Banco-Popular.html](http://www.santander.com/csgs/Satellite/CFWCSancomQP01/en_GB/Corporate/Pressroom/Santander-News/2017/07/13/Santander-announces-a-commercial-action-for-retail-customers-affected-by-the-resolution-of-Banco-Popular.html)

124 Santander concludes 7.072 billion euros rights issue with investor demand amounting to more than eight times the number of new shares offered. Santander Press Release 26 July 2017. See [http://www.santander.com/csgs/Satellite?applD=santander.wc.CFWCSancomQP01&tc=GSNoticia&tcanal=CSCORP&cid=1278718425068&empr=CFWCSancomQP01&tleng=en\\_GB&tpagename=CFWCSancomQP01%2FISBPageConfig%2FCFWCSancomQP01\\_Page\\_contenedoraCabecera&twpid=1278712308030](http://www.santander.com/csgs/Satellite?applD=santander.wc.CFWCSancomQP01&tc=GSNoticia&tcanal=CSCORP&cid=1278718425068&empr=CFWCSancomQP01&tleng=en_GB&tpagename=CFWCSancomQP01%2FISBPageConfig%2FCFWCSancomQP01_Page_contenedoraCabecera&twpid=1278712308030).

The decision has been considered a successful example of resolution,<sup>125</sup> and thus far no major criticisms have been raised against it.<sup>126</sup> The legal challenges however will be a decisive test of the robustness of resolution tools. It is too soon to tell whether retail clients will succeed if they seek annulment of contracts for the sale of Tier 2 instruments,<sup>127</sup> or even shares. However, the fact that in such seemingly exemplary context the acquirer is preparing itself to pay billions to the bailed-in shareholders may suggest that, by law or sheer willingness, investments in bank capital or MREL are not suitable for retail investors. *Thus, any lack of nuance when approaching the issue may risk conflating the complexity associated with MREL, due to its convertible and subordinated, or non-preferred nature, and the complexity associated to the vagaries of bank activity, as a source of unsuitability for retail investors.*

## 7 The challenges which lie ahead

This leads us to the conclusive part of our reflections. The bank resolution framework presents us with an extremely complex interplay between objectives of financial stability and consumer protection, hence the need of an adequate calibration of safeguards. The flexible approach adopted so far by the European Commission, the EBA and the SRB in phasing-in MREL requirements under the BRRD is, therefore, welcome. As the SRB put it in its 2016 MREL approach, *"MREL is not a common regulatory standard but more a Pillar 2 instrument, driven by the risk and resolvability profiles of each institution"*. If it must be institution-specific (Article 4 of the Delegated Regulation), there is hardly any other field of prudential regulation where individual calibrations are more warranted, and the use of general principles of proportionality, subsidiarity and diversity more necessary. Anecdotal evidence shows *the travails that result from the impact of 'micro' issues on a 'macro' level and vice versa*. If one fails to grasp this connection, *the legal system itself will end up exacerbating, instead of preventing, clashes between financial stability goals and consumer protection needs*.

In this vein, we argue that, even though the overall policy framework developed by EBA and the European Commission on MREL is so far convincing, the gradualism embedded in the new rules should be seized as an opportunity to *adopt, in the determination of individual MREL requirements and in the sale of MREL securi-*

125 This was reportedly stated by Valdis Dombrovskis, EU Vice-President for the euro and social dialogue. Also in charge of financial stability. See Financial Times June 8, 2017, <https://www.ft.com/content/6577b696-b950-3a0b-a9bf-d0c429658cbb>.

126 Skeptical views have been limited to state that it is soon to reach conclusions on some issues, and that the Banco Popular case may be inadequate to draw lessons for larger, more complex, institutions. See, e.g. J.H. Binder, *Wunderkind is Walking? The Resolution of Banco Popular as a First Test for the Single Resolution Mechanism*, in *Oxford Law Blog*, 14 June 2017, <https://www.law.ox.ac.uk/business-law-blog/blog/2017/06/wunderkind-walking-resolution-banco-popular-first-test-single>.

127 Some courts of first instance have already ruled on the nullity of contracts for the sale of convertible bonds, such as the Juzgado no. 8 of Barcelona. See 'Popular deberá devolver a un cliente 100.000 euros invertidos en bonos convertibles', ABC 7 July 2017, [http://www.abc.es/economia/abci-popular-debera-devolver-cliente-100000-euros-invertidos-cocos-201707071703\\_noticia.html](http://www.abc.es/economia/abci-popular-debera-devolver-cliente-100000-euros-invertidos-cocos-201707071703_noticia.html) las accessed, 30 August 2017. Since the controversy predated these actions we will need to wait for future developments.

ties, an approach based on the extensive use of proportionality. We offer three questions that illustrate our view of the challenges which lie ahead, and how to tackle them.

a) First, should MREL requirements be calculated taking into account not only the resolution strategy chosen in the resolution plan, but also the *probability* with which such strategy will be the one eventually implemented, as opposed to other alternatives? In other words, MREL rules adopt a mechanistic approach, whereby a resolution strategy must be chosen, arrangements must be made to adjust to it, including the MREL level, and then, when the PONV is reached, the strategy is implemented, and the authorities stay the course no matter what. Reality, however, has a habit of imposing itself, and, in some cases, the feasible and desirable course of action when a bank reaches its PONV may turn out to be different from what was originally envisaged in the resolution plan. This can create problems with existing rules, such as Article 2(2) of Delegated Regulation no. 1450/2016, which states that:

«Where the resolvability assessment concludes that liquidation of the institution under normal insolvency proceedings is feasible and credible, the recapitalisation amount shall be zero, unless the resolution authority determines that a positive amount is necessary on the grounds that liquidation would not achieve the resolution objectives to the same extent as an alternative resolution strategy».

The problem lies in coordinating the *ex ante* resolvability assessment, under Article 2(2), at the moment of resolution planning, with the *ex post* assessment that resolution conditions are met, at the PONV. In the *ex ante* resolvability assessment the SRB should first determine whether insolvency liquidation is feasible and credible, and second, whether it would achieve resolution objectives better than any alternative resolution strategy. The *ex post* assessment of resolution conditions entails in particular a determination of whether the public interest test is satisfied. Since this can only be decided at the PONV, it gives rise to a first problem. Thus, if the *ex ante* planning held that liquidation was less feasible and credible than resolution, and the SRB then decides, in its *ex post* assessment, that resolution cannot be applied, this raises the issue of whether the SRB can, and should, do so, and, if so, how. If the SRB can do so, it should also enjoy some leeway for a dynamic adjustment of its crisis management strategy at the PONV. However, the risk is that this adjustment is one-sided, i.e. it would be possible to switch from resolution in the plan to liquidation at the PONV, but not the opposite: once the Article 2(2) assessment concludes that the recapitalisation amount should be zero, this would rule out a subsequent decision to resolve the credit institution, since it would lack recapitalisation capacity. Thus, the second problem is whether MREL determination should also proportionately reflect the probability of a change of approach by the resolution authority, e.g. by providing for a recapitalisation capacity even when liquidation is the chosen strategy.

More importantly, though, if the SRB has determined that a bank should not be subject to resolution but to national insolvency proceedings, we argue that the MREL exercise should not be considered over. Rather, a MREL-like exercise should be

undertaken at a national level. If resolution under BRRD and Regulation EU No. 806/2014 is ruled out, and national insolvency law (for banks) applies, loss-absorption and even recapitalisation capacity may be necessary. It is easy to envisage such need in cases where a write down and conversion of bail-inable liabilities is necessary as a prior step to a partial, or total, transfer, to provide the potential purchaser with an equity cushion to assuage its concerns, and to better protect depositors and avert serious disturbances at the state level. In such case, MREL-like requirements should be set by the competent resolution authority at a level that allows the transfer under national law to take place smoothly. Yet these requirements would be MREL-like, or MREL-inspired, rather than actual MREL, because they would fall outside the scope of BRRD, whose Article 45 circumscribes MREL to *resolution and in order to make possible the application of the bail-in tool*.

Likewise, MREL-like requirements would not be under the purview of the SRB. Yet they could still gain significant relevance within the Banking Union if the SRB approach to the cases of Banca Popolare di Vicenza and Veneto Banca becomes policy. There the SRB made clear that significant banks supervised by the ECB and falling within its competence according to the SRM Regulation are not to be subject to resolution because *the public interest test set out in Article 35(1) and (5) BRRD and in the SRM Regulation would justify resolution in principle only for highly interconnected banks operating at a pan-European scale*. This does not necessarily mean that primarily domestic banks will be left out of resolution in the future, and the Banco Popular resolution should warn against premature conclusions. Nonetheless, if resolution becomes but one possible outcome, rather than the preponderant one, national law and national resolution authorities will have to pick up the slack. In doing so, the main guidance will not be the BRRD, but the 2013 Banking Communication, and the goals to determine the extent to which burden sharing should apply to aid an orderly winding up, and the level of MREL-like liabilities to this aim. If MREL-like requirements are not only the rules applicable to resolutions that pass the public interest test, but also the ground principles in cases bank insolvency under domestic law, certainty will be enhanced, and the scope for regulatory arbitrage will be reduced. It will be more difficult to press domestic authorities into greater laxity if they can rely on an EU-wide standard as the blueprint for their requirements. Yet, if a movement that makes national approaches more consistent with the EU-level approach is to succeed, it should be accompanied by a parallel movement that makes the latter more flexible.

b) In second place, could/should resolution authorities consider country-specific factors, such as macroeconomic constraints, in the design of appropriate transitional periods in their determination of individual requirements?

Such transitional periods are regulated by Article 8 of Delegated Regulation no. 1450/2016. There seems to be a different reading of the expression "as soon as possible" by different competent resolution authorities. The Bank of England, for

instance, adopted in its 2016 Policy Statement<sup>128</sup> a staged approach, which in our view offers a good example of proportionate implementation:

«the Bank has determined that the transitional period to meet end-state MRELS should be extended by two years to 1 January 2022. The Bank will set interim MRELS that differ for global systemically important banks (G-SIBs), domestic systemically important banks (D-SIBs)(3) and other institutions that are subject to a bail-in or partial transfer resolution strategy».

Unlike the Bank of England, the SRB has not yet set the duration of transitional periods although there seem to be the idea that the "as soon as possible" requirement is a call for a faster implementation than in the United Kingdom. In its 2016 MREL approach, nonetheless, the SRB showed a welcome positive attitude towards a flexible approach where it noted<sup>129</sup>

«transition period is necessary to ensure the credibility of the resolution framework, allowing time for institutions to build up the necessary loss-absorption capacity. The SRB will closely assess the impact of the proposed methodology on the markets, both at BU and at participating Member State level, addressing not only issues related to market capacity but also to market access. Furthermore, the SRB will also analyse the possibility of granting transition periods in respect of the quantum of MREL instruments required but also the quality, for instance with respect to subordination».

Transitional periods should be set adopting flexible corridors and that calibration may be not only institution-specific but also country-specific. Proportionality makes it possible for harmonised requirements within the Banking Union to coexist with such a flexible approach.

Let us provide a simple example. If G-SIBs have better access than O-SIBs to international capital markets to place their MREL/TLAC instruments, G-SIBs should be called to phase-in as soon as possible and O-SIBs be granted a longer grace period, as anticipated in the 2016 SRB MREL approach. Such phase-in could be further calibrated on account of specific circumstances, up to the maximum end of the corridor. Specific circumstances could include adverse macroeconomic scenarios that stifle domestic demand for MREL instruments, and hamper access to international capital markets, even if they are country-specific, provided that competent supervisory and resolution authorities are satisfied that such circumstances are present, and that flexibility for a gradual phase-in is warranted to avoid disruption in banking and capital markets. *Otherwise, MREL compliance may be achieved at the expense of consumer protection, with dangerous feedback effects.*

Two of us already discussed the idea of an exceptional calibration of some prudential or resolution requirements under the aegis of the proportionality principle

128 Bank of England, *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)*, Responses to Consultation and Statement of Policy, November 2016, p. 7.

129 Single Resolution Board (SRB), *MREL: Approach taken in 2016 and next steps*, 2016, p. 25.

in a previous paper.<sup>130</sup> Although raising this issue could kick the hornets' nest, the insight that, from a macroeconomic perspective, capital requirements should be countercyclical, "tough during a credit boom *and more relaxed during a crisis*",<sup>131</sup> could apply in this context. MREL is a good measure, with countercyclical effects to prevent financial collapse.<sup>132</sup> Yet, if it is rushed forward without any qualms about the situation of the market where it is applied, it may have feedback effects, and prove ineffective. The CJEU already held in *Gauweiler* that differentiated treatment by Member States is admissible even when it comes to the *single* monetary policy, since differences in the monetary policy transmission channel can result in the same measure having diverging effects in different markets. Even if regulatory requirements are different, legally speaking it should be easier to justify a differentiated approach when this would be restricted to the transitional stage until MREL is achieved, subject to adequate controls, and the mechanisms to ensure flexibility are expressly contemplated in the law, leaving ample discretion to authorities.

c) In third place, to whom may MREL securities be marketed? The answer to this question needs to reconcile prudential and investor-protection requirements. Taking stock from past Spanish and Italian experiences, it is currently difficult to envisage a sure way for a bank to market to its retail clients a burden-sharing instrument without being exposed to serious liability, or, alternatively, turning the marketing process into a series of ominous warnings. *We are not fully convinced that this is proportionate and the outcome for sure is not: it is difficult indeed to imagine a massive distribution of MREL securities in Spain or Italy, not to mention Cyprus or Greece, to retail investors under these circumstances.* In turn, Article 44(2) BRRD and EBA recommendations necessarily limit cross holdings of MREL securities among credit institutions to prevent contagion. This leaves a picture with investment funds as the only likely buyers. In turn, this will increase the gap between G-SIBs, which can comfortably access international capital markets, as shown by the 2017 Unicredit and Deutsche Bank capital increases, and O-SIBs, not to mention small and mid-sized banks, which cannot. The proper placement of multiple, massive issuances of MREL instruments in a short time span will prove a daunting task.

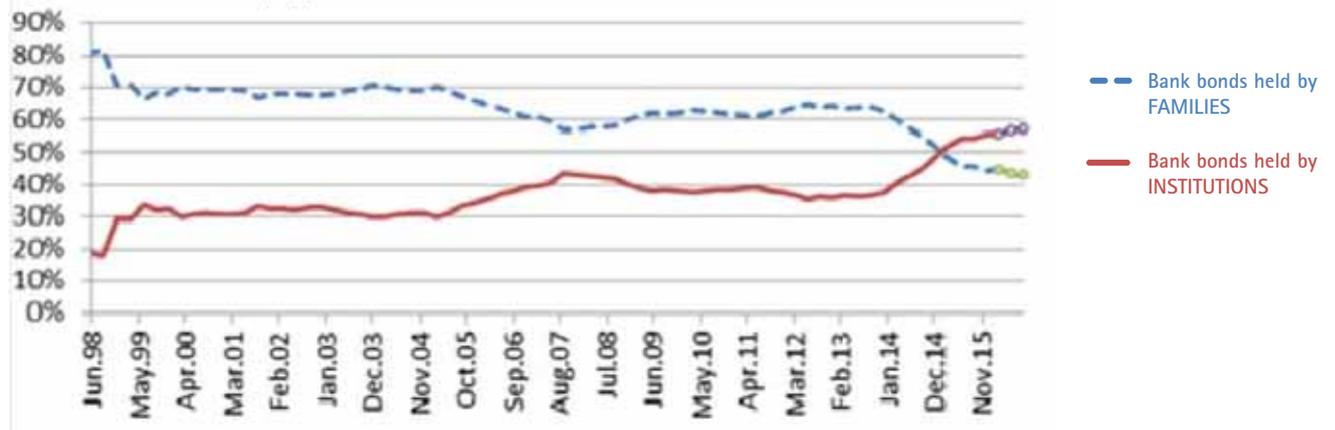
Figure 14 shows existing differences between the dynamics of retail and institutional bond holdings and illustrates in particular how the percentages of bond holdings are currently shared between families and institutions. Note that demand for bank bonds increased up to the end 2004 (with a peak of household holdings approaching 12% of total liabilities), then decreasing starting from 2005. The fall observed in the first nine months of 2016 amounted to over €35 billion.

130 M. Lamandini, D. Ramos, *Proportionality of the Single Rule Book and the Debate on Regulatory Simplification and Diversification*, International Conference on Proportionality in Banking, Central Bank of Greece, Athens, 13 February 2017 (accessible on the EBI website).

131 M. Brunnermeier, A. Crockett, C. Goodhart, A. Persaud, H. Shin, *The Fundamental Principles of Financial Regulation*, (ICMB/CEPR: London, 2009), p. 29.

132 A. Maddaloni, A. Scopelliti, *Rules and Discretion(s) in Prudential Regulation and Supervision: Evidence from EU Banks in the Run-Up of the Crisis*, Working Paper, July 2016 (finding that banks established in countries with less stringent prudential regulation were more likely to require government support during the crisis).

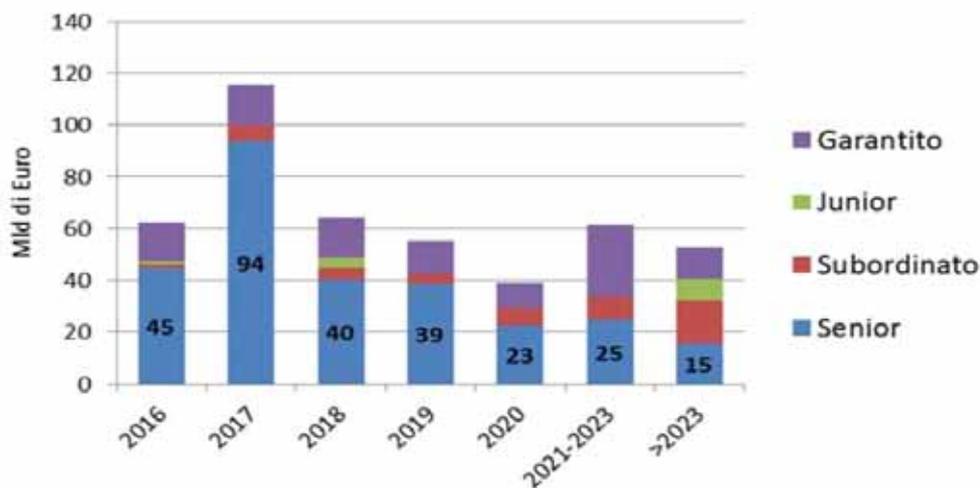
Figure 14 – Bank bonds by type of holder



Source AIAF, CFA Society Italy, BRRD e Bail-in. Implicazioni per l'analisi del settore finanziario e la tutela dell'investitore, 2017, p. 55.

Figure 15 shows, in turn, that a significant stock of existing bank bonds are approaching maturity and need to be rolled over.

Figure 15 – Debenture maturities for the largest Italian banks at 30 April 2016 (data in mld euros)



Source: AIAF, CFA Society Italy, BRRD e Bail-in. Implicazioni per l'analisi del settore finanziario e la tutela dell'investitore, 2017, p. 60.

In such a situation, it may be doubtful that investment funds could show enough appetite for a massive supply of MREL securities, unless structural regulatory adjustments are put forward in the rules governing their portfolio diversification. This market-design move, however, would be intrusive, and could have unpredictable feedback effects. Furthermore, the success of the current approach rests on assumptions that have not been tested, e.g. a massive distribution of MREL securities could still be an endogenous source of instability, by exacerbating herding effects among

institutional investors; and retail investors may still be exposed to the risks of MREL securities through their investment in Undertakings for Collective Investment in Transferable Securities (UCITs) if professional intermediaries pick MREL securities for their portfolio, and lack effective risk-shielding strategies. Absent these, the very idea of *de facto* keeping away retail investors from MREL securities will prove to be illusory and, in terms of risk dispersion and absorption, even counter-productive, if institutional investors react, as they normally do, in a swifter and more procyclical way to perceptions of the risk associated to these instruments.

This seemingly intractable problem must be addressed if MREL funding needs must be safely met in the near future. For once, proportionality, despite its open-textured nature, may call for bright-line rules in what concerns the marketing of the instruments, when applied to MREL requirements. Otherwise, banks may be caught in the middle of open standards for resolvability, on one hand, and consumer protection, on the other, with the result that they may be required to place a massive volume of securities, with no public to place them, or else distribute them among the public, and risk public outrage if the securities go under. Marketing standards and employee training need to improve, but there has to be a clearer idea of what a proper marketing process looks like, and how that translates into specific warnings that are adequately understood by the client, but also leave the bank and its employees with a clear conscience.

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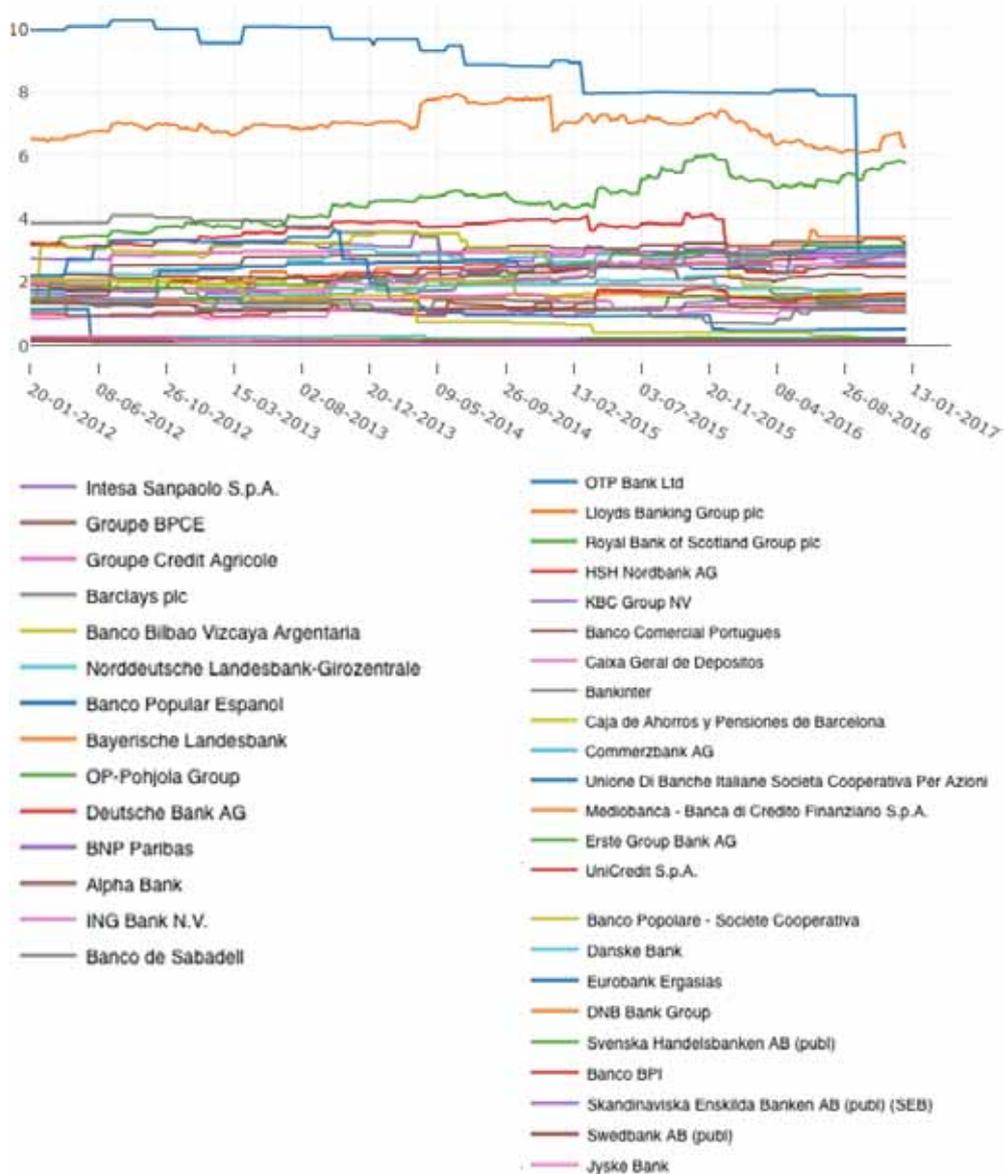
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# Appendix

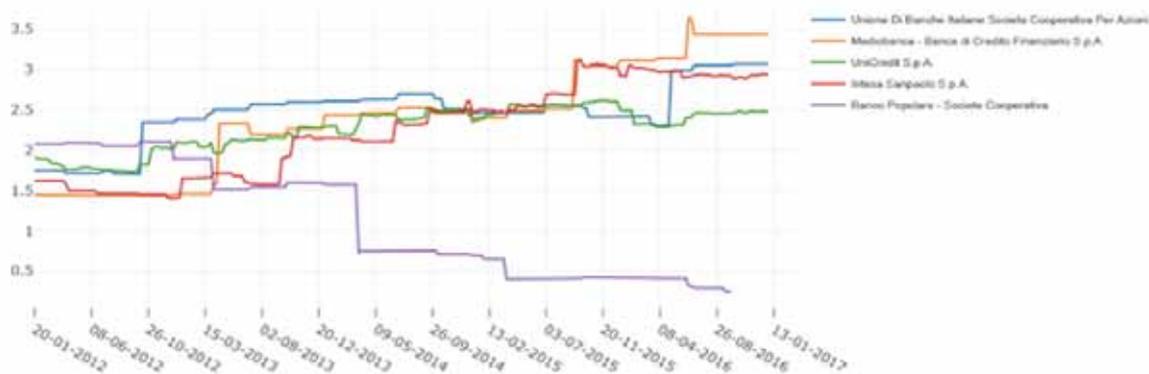
The graph here below shows the evolution of European banks' outstanding publicly issued subordinated debt:

Figure A - Outstanding subordinated debt by European banks as a percentage of total liabilities



Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.

Figure B - Outstanding subordinated debt by European banks as a percentage of total liabilities (Italy)



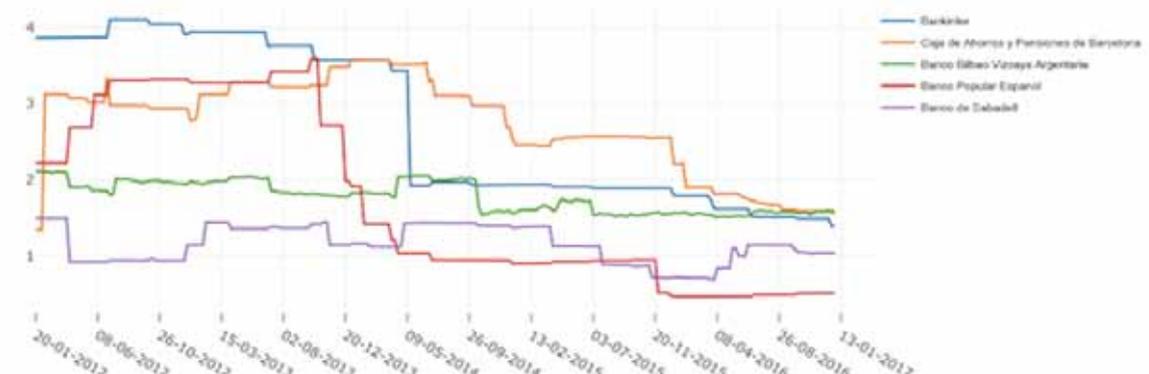
Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.

Figure C - Outstanding subordinated debt by European banks as a percentage of total liabilities (France)



Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.

Figure D - Outstanding subordinated debt by European banks as a percentage of total liabilities (Spain)



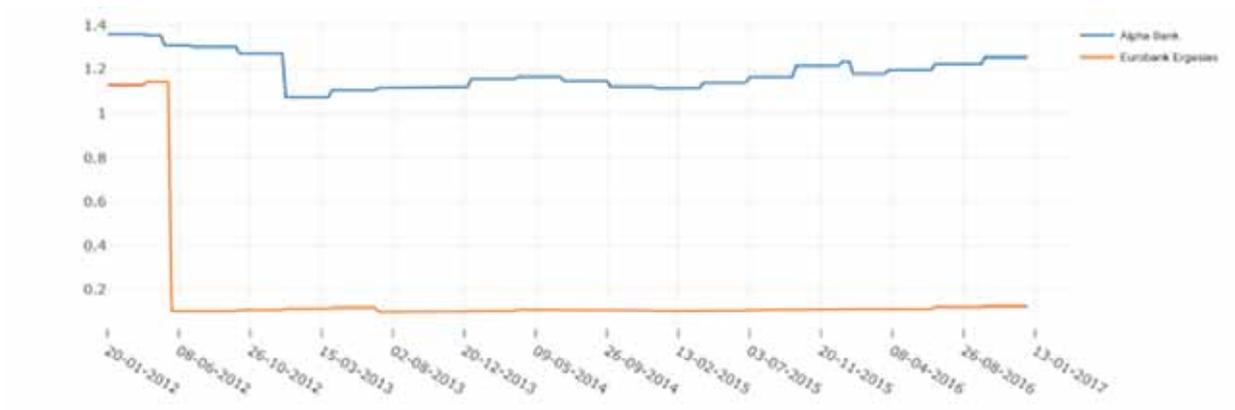
Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.

Figure E – Outstanding subordinated debt by European banks as a percentage of total liabilities (Portugal)



Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.

Figure F – Outstanding subordinated debt by European banks as a percentage of total liabilities (Greece)



Source: SAFE, Bail-In Tracker, <http://www.bail-in-tracker.eu/bail-in-tracker.html>.



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