The new bank resolution scheme: The end of bail-out?

State aid rules remain one of the decisive factors in dealing with distressed bank situations. But uncertainty remains over whether governments should be able to intervene and rescue banks in danger of failing.
State aid under the new EU bank resolution regime

The spectre of state aid resurfaced again this summer as the Italian banking crisis and results of the EU’s bank stress tests raised the question of whether Europe’s banking sector is robust enough to survive another financial crisis, as Dr. Andreas Wieland, Christoph Arhold, Kai Struckmann, Michael Immordino of global law firm White & Case and Dr. Luis Correia da Silva, Peter Hope, Nicole Robins of Oxera Consulting LLP explain.

Despite new rules coming into effect designed to avoid taxpayer funded bail-outs, uncertainty remains over whether governments should be able to intervene and rescue banks in danger of failing.

The European Banking Authority (EBA) released its latest stress test results on 29 July 2016. In the run-up to the publication, there had been widespread speculation as to whether state support may be needed for some of the region’s banks. This culminated in the Italian government requesting that EU rules on bank resolution and state aid should be amended or suspended to deal with some of its distressed lenders and their high levels of non-performing loans. The European Commission and many Member States rebuffed these ideas, and with most of the European banks receiving a reasonably clean bill of health (even under adverse scenarios, the EBA stress test results temporarily muted the discussion. For Monte dei Paschi di Siena, one of Italy’s embattled lenders, which looked particularly vulnerable in terms of its considerable recapitalisation needs, a private sector solution was announced just shortly before the publication of the stress test results.

However, these results were not able to dispel entirely concerns about capitalisation in the EU banking sector. A combination of high levels of non-performing loans, faltering economic growth, zero to low interest rates across the EU, low profitability and increasing regulatory capital requirements mean that Europe’s banking sector still faces challenges almost eight years on from the collapse of Lehman Brothers.

In particular, there are questions as to whether Italy can push through a much-needed restructuring of its financial sector purely by relying on the limited firepower of the private sector. This leaves one issue on the table: should governments be able to support banks in distress, and if yes, under what conditions? The EU resolution framework is designed to ensure an orderly wind-down of failing financial institutions. Yet, surprisingly, the interaction between the EU resolution framework and the EU state aid rules is still unexplored in many respects and raises a multitude of unresolved questions. The recent experience of the Italian banking sector shines a light on some of these questions.

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The new European resolution framework for banks took full effect on 1 January 2016. The cornerstone of the legislation is the Bank Recovery and Resolution Directive (BRRD), which harmonises the rules for the recovery and resolution of banks throughout the 28 Member States of the European Union. In the Eurozone, the BRRD is implemented through the Single Resolution Mechanism, which includes the establishment of the Single Resolution Board, a single authority to deal with bank resolutions, and of the Single Resolution Fund, a fund dedicated to facilitate bank resolution.

The aim of the new bank resolution framework is to avoid the bail-out of banks by taxpayers through creating a framework for the rescue of systemically important bank functions and the orderly wind-down of the remaining parts of a bank without using taxpayers’ money. Thus, the new resolution framework tries to shift the major burden of a bank failure to the bank’s shareholders and creditors. The new rules are designed to ensure that use of public money will be limited to extraordinary situations and only allowed after shareholders and creditors have substantially contributed to the bank rescue through burden sharing.

Bail-in instead of bail-out

The default solution under the European bank resolution framework is to put a failing bank into resolution prior to any public recapitalisation. Under the BRRD, this requires prior burden sharing by shareholders and creditors of at least 8 per cent of the bank’s liabilities through bail-in or otherwise, before resolution authorities can look to access other forms of stabilisation funding such as recapitalisation with public funds. Equity and subordinated debt holders must be bailed-in first. Senior creditors and non-covered depositors must participate in the burden sharing if this is required to reach the 8 per cent threshold. Only depositors with deposits of up to €100,000 that are covered by mandatory Deposit Guarantee Schemes (DGS) are automatically exempted. The BRRD leaves open the possibility of taxpayer intervention, but this is on a limited basis, and any such intervention would be subject to the EU’s rules governing state aid.

<table>
<thead>
<tr>
<th>Source</th>
<th>EC Bank Recovery and Resolution Directive</th>
<th>8% threshold for preliminary bail-in by the stakeholders of the bank under resolution</th>
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<tbody>
<tr>
<td>Source</td>
<td>European Commission</td>
<td>€5.38 trillion Total approved state aid to banks in EU28 (2008-2014)</td>
</tr>
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</table>
The exception: Precautionary recapitalisation
As an exception to the rule, public funds may be injected into the banks without triggering a resolution via ‘precautionary recapitalisation’ under Article 32(4)(d) BRRD. This article permits capital injection from state funds, provided that the injection is precautionary, follows a stress test and specifically addresses capital shortfalls implied by an ‘adverse scenario’. Precautionary public sector recapitalisation is not permitted for banks that are insolvent or considered likely to fail in the near future under the ‘point of non-viability test’ in the BRRD. The article also permits public sector guarantees to be given in respect of access to central bank liquidity. However, again, the use of public funds must be in compliance with state aid rules.

The current state aid framework: The 2013 Banking Communication
With respect to banks, the current EU framework for state aid is further specified in the 2013 Banking Communication of the European Commission. The 2013 Banking Communication continues to define detailed rules applied by the Commission in cases where the provision of state aid is related to banks. It is worth noting that the 2013 Banking Communication was enacted prior to the adoption of the new European resolution framework and is therefore not fully aligned with it. In practice, this can create frictions, in particular, with respect to the required level of burden sharing.

Burden sharing, but more flexibility as to senior debt
Both the BRRD and the 2013 Banking Communication stipulate mandatory burden sharing of shareholders and creditors before any state aid is granted. However, unlike the BRRD, the 2013 Banking Communication does not oblige senior debt holders to contribute to restructuring costs. Therefore, the burden sharing rules set out in the 2013 Banking Communication are of particular importance if a bail-in is not already required by the BRRD, such as in the case of precautionary recapitalisation. Otherwise, the burden sharing requirements under the BRRD are stricter.

The exception to preserve financial stability
Despite stressing the importance of burden sharing, the 2013 Banking Communication acknowledges that there may be exceptional circumstances in which burden sharing would not be proportionate or where burden sharing is considered to be counter-productive to the preservation of financial stability. Thus, no burden sharing is required if implementing such measures would endanger financial stability or lead to disproportionate results. This exception could cover cases where the aid amount to be received is small in comparison to the bank’s risk weighted assets and the capital shortfall has been reduced significantly in particular through capital raising measures, such as rights issues, a voluntary conversion of subordinated debt instruments into equity, a liability management exercise, capital-generating sales of assets and portfolios or securitisations, earnings retention and other measures reducing capital needs. While the European Commission has made clear that it is determined to interpret this provision narrowly, the exception may open a path to avoid a bail-in if at the same time resolution under the BRRD can be avoided.

Not every state intervention constitutes state aid
It goes without saying that the burden sharing requirements under the state aid regime are only triggered if the measure in question actually constitutes state aid. Yet, this is not true in all cases where state resources are used to intervene in distressed banks, in particular if a government decides to intervene in a bank in the same way as a private investor would.

Lessons from Italy
This is the course that Italy pursued in April 2016 when its government sponsored the creation of a private-backed bank rescue fund to tackle concerns over the health of its financial sector.

The problem stems from the fact Italian banks are nursing more than €360 billion of non-performing loans which are proving to be a drag on economic recovery. Due to state aid rules, Italy turned to the private sector for a solution. The result was Atlante 1, a €4.25 billion back-stop fund sponsored by Cassa Depositi e Prestiti (a state-owned institution), banks, insurers and other institutional investors, such as the Italian banking foundations. The fund aims to stabilise Italy’s financial system by purchasing (i) newly issued shares of banks which do not meet their SREP capital requirements and (ii) NPL portfolios.

In order to attract a wide range of investors for selling notes to the securitised assets it holds, Atlante 1 can benefit from a guarantee scheme introduced by the Italian state. Despite the government’s intervention, the European Commission has found the scheme free from state aid since the risk for the state is limited and, in particular, the state’s remuneration for the risk taken is on market terms. However, the amount raised from the private sector for Atlante 1 fell short of solving the sector’s problems, and resources became stretched in June 2016 when the fund bought shares worth £2.5 billion of struggling lenders Veneto Banca and Banca Popolare di Vicenza. Therefore, in August 2016, in order to tackle the immediate problems of Monte dei Paschi di Siena, a second privately backed bank support fund with similar
features was set up—Atlante 2.

The ongoing problems facing the Italian banking sector represent the first serious challenge to BRRD, and when the UK voted to leave the European Union, this triggered a sharp sell-off of Italian banking shares on 27 June amid concerns about their financial health. Italy’s Prime Minister Matteo Renzi argued that EU rules on the provision of state aid should be waived on the grounds of preserving financial stability. The European Union rejected this request. The need for a taxpayer-funded capital injection was alleviated when the country’s banks did reasonably well in the stress tests, and a plan is in place for a private sector rescue of stricken lender Monte dei Paschi di Siena.

Concept of state aid can be wider than expected

Not all forms of public intervention fall within the definition of state aid but it might be surprising that the use of resources stemming from banks themselves, i.e., private resources, can also be subject to state aid scrutiny. The road to setting up Atlante 1 began in December 2015 when the European Commission declared that Italy’s decision to provide regional lender Banca Tercas with a €300 million injection from its deposit guarantee fund was incompatible with the European Union’s state aid rules.

Contrary to those rules, Banca Tercas’ subordinated creditors weren’t forced to take losses on their holdings, the Commission said. Italy has challenged the recovery decision before the General Court of the EU (GC).

Likewise, support by resolution funds, even if sponsored by private banks, generally falls under EU state aid control, since they are regularly created by the state and run by the resolution authorities. State aid control remains applicable even in case of resolution.

Even if a bank is under resolution, this does not mean that state aid control ceases to apply. On the contrary, state aid rules will retain their importance alongside the BRRD. As an example, the sale of a bridge bank to which assets of a bank under resolution have been transferred will have to comply with state aid provisions.

This has implications for the sale procedures and can limit the support for the bridge bank or its buyer in connection with or following re-privatisation. The same is true for any form of public financial support used during resolution. As a consequence, measures implying the use of the resolution fund cannot be granted without the Commission’s prior approval.

Conclusions

State aid rules remain one of the decisive factors in dealing with distressed bank situations. While the new bank resolution framework limits the ability of governments to recapitalise distressed banks without triggering resolution, both the BRRD and the state aid framework provide exceptions to avoid resolution and the bail-in of creditors. However, the European Commission and the Single Resolution Board made it clear that they interpret these exceptions narrowly. This puts the emphasis on how to avoid resolution and the burden sharing requirements under state aid rules. Some recent cases demonstrate that these efforts can be successful even if it involves some sort of state involvement. As Italy continues to reform its banking sector by forcing weaker players to merge or raise capital and looks to find means of support, the framework of the BRRD and its interaction with the EU’s state aid rules will continue to be a subject for debate.

Short overview on DG Comp procedure

State aid needs to be notified to and approved by the European Commission before it can be implemented. If this is not respected, the Commission may also investigate aid ex officio. The steps in a state aid investigation are as follows:

1. The Member State wishing to grant a state aid will enter into pre-notification talks with the European Commission. They are especially important in banking restructuring cases. Here, the Commission and the Member State concerned try to reach an agreement on the restructuring plan even before the aid is officially notified.

2. Then the Member State notifies the aid or the Commission starts an ex officio investigation. If an agreement had been already reached during the pre-notification talks, the Commission will immediately publish a press release, in order to ease the financial markets.

3. At the end of the preliminary phase, the Commission will either decide (i) that the plans do not involve aid, (ii) involve aid that is compatible with the internal market, or (iii) that it has serious doubts as to the compatibility of the plans with the state aid rules and will therefore open a formal investigation. A non-confidential version of this ‘Opening Decision’ will be published in the Official Journal of the European Union, where it invites all interested third parties to submit observations.

4. Once the Commission has concluded its in-depth investigation it will take a decision determining whether or not the plans amount to state aid, and if so, whether that aid is compatible with the internal market (the Commission may also reach a conditional decision stating that the aid would be compatible if certain conditions are respected).

5. Key issues for the assessment:
   a. the bank has to demonstrate through the capital raising plan that it has undertaken all possible capital raising measures to minimise the public intervention;
   b. the bank has to demonstrate through the capital raising plan that it has undertaken all possible capital raising measures to minimise the public intervention;
   c. if the capital raising measures are not sufficient to meet the capital shortfall, bail-in is imposed on shareholders and subordinated creditors; contributions from senior debt holders or depositors are not required as a mandatory component of burden sharing, although Member States are free to do so;
   d. the bank has to prevent all outflows of capital and junior debt from the moment it becomes aware of the possibility that it may need to resort to state aid.
State aid and stress tests: A snapshot

State aid approved to banks in all EU28 countries, cumulative (in €bn)

- Recapitalisations
- Impaired assets measures
- Guarantees
- Other liquidity measures

How banks have fared in the last two stress tests
Adverse scenario: banks ranked in order of their 2018 fully loaded common equity tier one ratio

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Actual 2015</th>
<th>Actual 2018</th>
<th>Actual 2016 (from 2014 stress test)</th>
<th>Five most deteriorated</th>
</tr>
</thead>
</table>

Source: European Commission

Source: EBA FT research

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