Bail-in Tool and Bank Insolvency: Theoretical and Empirical Discourses around a New Legal (or Illegal) Concept

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Abstract

In 2014, half a decennium after the eruption of the financial crises, the bail-in mechanism was introduced as a new pan-European legal tool in order to avoid the financial inefficiencies of the public bail-out of banks and financial institutions. Yet the system is still not immune from criticism. The dilemma that the new EU legislation has left unsolved relates to the excessive level of discretion still left to the resolution authority regarding the way in which the rights of stakeholders of the bailed-in bank (shareholders and bondholders) can be sacrificed.

Against this background, the paper attempts to discuss and analyse, via a methodology which is both theoretical and empirical, the legal provisions encompassed by the Bank Recovery and Resolution Directive and its applications to credit institutions within the context of recent crises. From a more epistemological point of view, the contribution aims to shed light on whether the new resolution tools still lie within the macro-area of the insolvency or, by contrast, they represent a new *genus* of crisis. More philosophically and intriguingly, the research examines whether, in light of the extensive powers granted to the resolution authority by the recent EU legislation, banking activity may still be regarded in Europe as business of a private nature.

Bail-in, Bank insolvency, bank resolution, MREL, no-creditor-worse-off, uncertainties, resolvability, priority of creditors, scope of bail-in, bail-in tools

1. Resolution and Resolution Tools: Their Nature

1.1. The Concept of Resolvability

In the BRRD architecture,[1] resolution plans and early intervention measures should suffice for purposes of preventing a bank crisis. Yet, should these measures prove ineffective, the powers

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[1] The first draft of the BRRD was published by the European Commission (EC) on 6 June 2012, with the full title: Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, 2012/0150 (COD). An initial commentary on the BRRD proposal can be read in: Matthias Haentjens, *Bank Recovery and Resolution: An Overview of International Initiatives* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution. A Conference Book*, 3,22 (The Hague; Eleven Publishers, 2014); Tim Verdoes, Jan Adriaanse and Anthon Verweij, *Bank Recovery Plans: Strengths and Weaknesses – How to Make a Boiling Banker Frog Jump* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution. A Conference Book,* 25,47 (The Hague; Eleven Publishers, 2014); Stephen Madaus, *Bank Failure and Pre-emptive Planning* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution. A Conference Book,* 49, 76 (Eleven Publishers, The Hague 2014); Simone Mezzacapo, *Towards a New Regulatory Framework for Banking Recovery and Resolution in the EU* , Law and Economics Yearly Review 213,241 (2013) See also European Commission, EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, MEMO/14/297 (2014) in http://europa.eu/rapid/press-release_MEMO-14-297_en.htm (accessed on 3 July 2014).

vested in the resolution authority extend to the consideration of even more extreme measures, represented as a group under the third pillar of the BRRD and termed 'resolution'.[2] Interestingly, 'resolution' is not a term specifically defined by the EU legislature. In an almost circular way, Art. 2 of the BRRD merely stipulates that 'resolution' means the application of a resolution tool[3] in order to achieve one or more of the resolution objectives[4] to ensure the continuity of an institution's critical functions, to avoid a significant adverse effect on the financial system as a whole, and to protect public funds, depositors and investors.

However, a definition of resolvability is indeed provided in the BRRD. According to Art. 15(1), part 1, BRRD, the resolution authority assesses 'the extent to which an institution which is not part of a group is resolvable'. The legal provision goes on to stipulate that the institution shall be resolvable 'if it is feasible and credible for the resolution authority to either liquidate it under normal insolvency proceedings or to resolve it by applying the different resolution tools and powers to the institution while avoiding to the maximum extent possible any significant adverse effect on the financial system …'.[5] The norm, apparently transparent, confirms in reality that the area between resolution tools and ordinary insolvency proceedings is extremely blurred, and perhaps manipulated by the EU legislator. Upon closer scrutiny, the credit institution should be resolvable exclusively in cases where the application of resolution tools can avoid any significant adverse effect on the financial system. Therefore, the first limb of the definition seems to be unnecessary and perhaps contradictory, in comparing the nature of the resolution tools with one of the traditional insolvency proceedings.
The actual assessment of the resolvability, according to Art. 16, BRRD, shall be carried out by the group-level resolution authority. This authority, 'together with the resolution authorities of subsidiaries, after consulting the consolidating supervisor and the competent authorities of such subsidiaries, …, will assess the extent to which groups are resolvable…'. In assessing this, the authorities will disregard certain assumptions that may be defined as biased and causing market distortions. In more detail, as inferable from Art. 16(1), BRRD, in the assessment of the resolvability, the 'extraordinary public financial support' should not influence the choice of the authority. Similarly, 'any central bank emergency liquidity assistance' should not be included in the evaluation by the resolution authority; nor, finally, should any central bank liquidity assistance provided under non-standard collateralization, tenor and interest rate terms.'[6]

1.2. The Conditions of Resolution

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[2] Artt. 31 ff BRRD. An exhaustive overview and commentary of the final and official text of the BRRD can be read in Jens-Hinrich Binder and Dalvinder Singh (eds), *Bank Resolution: the European Regime* (Oxford University Press, Oxford 2016); Karl-Philipp Wojcik, *Bail-in in the Banking Union* 53 Common Market Law Review 91,138 (2016); Matthias Haentjens and Bob Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar Publishing, Cheltenham 2015).

[3] See art. 37 headed 'General principles of resolution tools' and art. 58 'Temporary public ownership tool' of the BRRD.

[4] See art. 31(2) of the BRRD. In detail, the objectives 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.

[5] Art. 15(1)(let. b), para 1, BRRD.

[6] Art. 15(1)(let. c), para 1, BRRD.

Conditions for the resolution or, better, for the adoption of one of the ‘resolution tools’ are threefold. First, the relevant authority must assess that ‘the institution [is] failing or [is] likely to fail’.[7] Second, it must judge that ‘there is no reasonable prospect that any alternative private sector measures [..] would prevent the failure of the institution’ within a reasonable timeframe;[8] and third, it must conclude that ‘a resolution action is necessary in the public interest’.[9] Equally important is the circumstance that the resolution goal is to avoid disruption in the provision of essential banking services - in essence, deposits and payment services - and to restore the institution’s economic viability.[10] In this respect the lesson learnt during the financial crisis is still echoing in the financial markets. The collapse of banks, in the manner experienced during the 2007 financial crisis, may affect their main and fundamental function as paymasters: a consequence that the BRRD aims to completely prevent.

Furthermore, the resolution measures are expected to apply exclusively in acute bank crises.[11] Ultimately, resolution tools are extreme measures that the supervisory authority uses in cases where no other weaponry is available.[12] As a result of this brief description, it is inferable from the reading of the new legal framework that the only alternative to the resolution is the winding up of the institution. This winding-up will not ward off a crisis; rather it simply marks the end of the bank as a business entity doing business. Art. 32, BRRD, stipulates that a resolution action can be taken only when the resolution authority considers that all of the three conditions provided by Art. 32 itself are met.
In this scenario, and if the relevant conditions are met, the resolution authorities shall be entitled to use the following five resolution tools:[13] 1) the appointment of a ‘special manager’ taking

[7] According to Article 32 of the BRRD, an institution is ‘failing or likely to fail’ when i) the assets of the company are, or will likely to be in the near future, less than its liabilities, or ii) the institution infringes, or will likely infringe in the near future, the requirements for continuing the authorisation (capital requirements, in general) in a way that justifies its withdrawal by the competent authority, or iii) the institution is, or will likely be in the near future, unable to pay its debts or other liabilities as they fall due, or, finally, iv) the institution requires an extraordinary level of financial support. As for the last condition, it is worth noting that not any degree of extraordinary financial support makes the institution a failing or likely-to-fail entity. In this respect, Art. 32(4)(d) of the BRRD refers to a number of exceptions, such as certain cases of public financial assistance, provided that this assistance meets various conditions, such as its precautionary and temporary nature, as well as its proportionate character.
[8] The implementation of an early intervention measure and/or the write-down or the conversion of contractual instruments.
[9] Art. 32 BRRD. More specifically, according to Art. 32(5) a resolution action is in the public interest when i) it is necessary for the achievement of one or more resolution objectives, ii) it is proportionate to these aims, and iii) the winding up of the institution under normal insolvency proceedings would not meet resolution objectives to the same extent. In summary, this third condition shows that this kind of public intervention in the crisis of an institution is first justified if it ensures the continuation of the institution’s critical functions or to provide security for depositors; in short, only if it achieves the “resolution objectives” listed in Article 31 BRRD. Public intervention, then, is only justified if, compared with normal insolvency proceedings, it offers a way of better achieving those objectives. Otherwise, the insolvent institution should not be saved but liquidated. De Poli Matteo, *European Banking Law,* 217 (Wolters Kluwer Italia, Assago 2017).
[10] This is spelled out by Art. 34 of the BRRD, heading ‘General principles governing resolution’.
[11] In fact, Article 32(1) (let. a) BRRD asks whether the institution has failed or is likely to fail.
[12] De Poli Matteo, *European Banking Law,* 229 (Wolters Kluwer Italia, Assago 2017). De Poli correctly highlights that, in a scenario of extreme urgency, national resolution authorities may take resolution actions without waiting until early intervention measures have been applied.
[13] The ‘resolution tools’ are detailed under Art. 37 ff BRRD.

over the failing institution's management;[14] 2) the sale of the business or the shares of the institution concerned, without the prior approval of the board of directors or the shareholders, to a private sector purchaser;[15] 3) a measure whereby the assets and/or liabilities of the institution at stake are transferred to an alternate entity owned, wholly or partly, by the resolution authority (such an entity is referred to as a 'bridge institution');[16] 4) a similar transfer may be effectuated with non-viable assets to a vehicle that is commonly denoted as a 'bad bank' (in a process defined as 'asset separation');[17] and 5) the final measure – and probably the most controversial[18] contemplated within the BRRD – is the 'bail-in tool'.[19]

2. Bail-in Tool

2.1. *The Essence of the 'Bail-In'*

It is difficult to say whether philosophically the bail-in mechanism is more effective and therefore better than the bail-out counterpart. Discussions on this subject have been rather heated for some time.[20] The bail-in tool is theoretically 'salubrious' as it makes the public subsidy entailed in the bail-out unnecessary. However, the bail-in converts this into a 'private penalty' for the creditors,[21] with modalities that, as critically assessed in this paper, are still shrouded in uncertainty and to a certain extent contradictory.[22] Although it is correctly emphasised that the bail-in is a method which allows the creditors to intensify bank monitoring,[23] the increased prospective risk may raise the cost of funding[24] or even alienate the classes of investors on which the banking system traditionally relies, namely depositors. On the positive side, it is emphasised that the way creditors are treated in a bail-in should be geared towards removing the psychological cover of the too-big-to-fail attitude which certain banks usually possess, as well as the governance costs associated with excessive leverage.[25] Further, and by no means least important, the bail-in prevents bankers' 'moral hazard implied

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[14] Some scholars (e.g. De Poli Matteo, *European Banking Law* 214(Wolters Kluwer Italia, Assago 2017)) are reluctant to regard the appointment of a special manager as a special tool. As a result of this epistemological approach, the number of resolution tools would be four.

[15] Art. 37(3)(a) BRRD. The specific modalities of this tool are detailed under Art. 38 and Art. 39 BRRD.

[16] Art. 37(1)(b). Art. 40 and art. 41 BRRD contain the details of this procedure.
See, commenting on the draft directive rather than the final statute, Stephen Madaus, *Bank Failure and Pre-emptive Planning* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution,* 61,62 (Eleven Publishers, The Hague 2004).

[17] Art. 37(1)(c) BRRD. For the details of this resolution tool, see Art. 42 BRRD.

[18] The definition is utilised by Stephen Madaus, *Bank Failure and Pre-emptive Planning* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution,* 63 (Eleven Publishers, The Hague 2004).

[19] The terminology is reminiscent of the opposite mechanism of the bail-out, which conversely implies the use of tax-payers' money to bail-out a credit institution.

[20] John C. Coffee Jr, *Bail-ins versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk*, The Centre for Law and Economic Studies, Columbia University School of Law, Working Paper No. 380, 35 (2010).

[21] Emilios Avgouleas and Charles Goodhart, *An Anatomy of Bank Bail-ins. Why the European Needs a Fiscal Backdrop for the Banking Sector,* European Economy 76 (2016).

[22] See this paper.

[23] Emilios Avgouleas, *Bank Leverage Ratios and Financial Stability: A Micro- and Macroprudential Perspective*, University of Edinburgh, Working Paper (2014).

[24] Emilios Avgouleas and Charles Goodhart, *An Anatomy of Bank Bail-ins. Why the European Needs a Fiscal Backdrop for the Banking Sector,* European Economy 76 (2016).

[25] Emilios Avgouleas and Jay Cullen, *Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries* 42 Journal of Law and Society 28, 50 (2014).

by the public bailout',[26] as 'any kind of recourse to extraordinary public financial support will now normally entail at least some burden-sharing (and loss absorption) by shareholders and creditors …'.[27]

Nevertheless, bail-ins are not a panacea.[28] Usually, bail-ins allocate a part of the losses of the bank to senior creditors. However, theoretically, unless some exemptions are embedded into the regulation, the bail-ins may even spread the risk, in cases where these creditors were other banks.[29]

Astutely, it can be affirmed that the current regulation in the area of the bail-in is still the outcome of the traumatic events of the 2007-2008 financial crises. Given the fact that the bail-out is by definition a form of moral hazard and that it undermines market discipline,[30] as well as destabilising public finances and public debt,[31] the easiest way - and probably the most simplistic one – in the immediate post-crisis years was to move to the opposite regime: the bail-in. In a more Machiavellian way, it cannot be denied that in the shift, or more realistically the sea-change, from the bail-out to the bail-in there is also an inkling of the nemesis of politicians against bankers. The former needed to pay the costly bills of the 2007-2008 financial crises, with the latter returning the bill few years later by firing the weapons of a legal mechanism that does not seem to dispense any kind of mercy to the avid banker.

Beyond doubt, the purpose of the BRRD is to avoid public bail-outs of private institutions.[32] In this respect, Recital 67 of the BRRD is clear when it stipulates:

'An effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers. It should ensure that systemic institutions can be resolved without jeopardising financial stability. The bail-in tool achieves that objective by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution. The bail-in tool will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during the normal circumstances and meets the Financial Stability Board recommendations that statutory debt-write down and conversion powers be included in a framework for resolution, as an additional option in conjunction with other resolution tools.'

The definition itself of the bail-in tool, encompassed within the BRRD, in Art. 2(1), point 57, reveals the invasive purpose entailed in this instrument: 'the mechanism of effecting the exercise by a resolution authority of the write-down and conversion powers in relation to the

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[26] Simone Alvaro, Marco Lamandini, David Ramos Muñoz, Elena Ghibellini, Francesca Pellegrini, *MREL Securities after BRRD: The Interplay between Prudential, Resolution and Transparency Requirements and the Challenges which Lie Ahead*, CONSOB, Commissione Nazionale per le Societa' e la Borsa, Quaderni Giuridici,21 (2017).
[27] Ibid.
[28] Chris Bates and Simon Gleeson, *Legal Aspects of Bank Bail-ins* 5 Law and Financial Markets Review 265 (2011).
[29] Ibid.
[30] Emilios Avgouleas and Charles Goodhart, *An Anatomy of Bank Bail-ins. Why the Eurozone Needs a Fiscal Backstop for the Banking Sector,* European Economy 7 (2016).
[31] Ibid.
[32] For an example of bail-out, see Pierre de Gioia Carabellese, *Corporate Governance of British Banks and Duties of Directors: Practical Implications of the Royal Bank of Scotland's Demise* 2 Law and Economics Yearly Review 134-165 (2014).

liabilities of an institution under resolution ...' Ultimately, in the words of the best literature,[33] the bail-in consists of 'powers conferred on resolution authorities to provide for restoring the capital of the failing or likely to fail institution through alternative actions of i) a debt write-down, ii) conversion of liabilities into ordinary shares and other instruments of ownership or other capital instruments, or iii) a cancellation or dilution of shares or other instruments of ownership.'[34] *Rebus sic stantibus*, the bail-in, as the stereotypical resolution proceeding, is not 'an insolvency procedure within the strict sense of the term.'[35] Given the full or partial write-down of a bank's liabilities which may engender 'the cancellation of certain parties' credit positions with the consequence that they cannot, even in theory, participate in the distribution of any remaining assets',[36] this may drive a coach and horses through the *par condicio creditorum* principles, where a joint participation of all the creditors encapsulates the very nature of the phenomenon.

2.2. The Bail-In: A Historical View

The bail-in mechanism has not made its debut from scratch in the BRRD. Historically, although this tool is the offspring of the 2007-2008 financial crises, it was the Basel Committee on Banking Supervision (BCBS) that in its Consultative Paper of August 2010[37] introduced for the first time, globally, the concept of so-called 'contingent capital instruments'. In the document, as highlighted by scholars,[38] both private investors and creditors of banks are required to 'contribute to the rescue of banks that are facing difficulties.'[39] The first proposal of the BCBS was to deny the right of the providers of the regulatory capital of the bank to reclaim the principal sums invested. The providers of regulatory capital instruments are not all the creditors of the bank, but rather, exclusively those participating in the core equity instruments, the Core Equity Tier 1, or in hybrid instruments or in Tier 2 instruments.[40] These regulatory capital instruments are subordinated should the bank get through a liquidation or insolvency. According to the BCBS, this purpose would have been achieved either via a write-off of the principal or the conversion of debt obligations into equity, relating to these 'providers'.

Nevertheless, from an empirical point of view, it is undeniable that, by briefly comparing the initial proposals of bail-in regulation with the new legislative framework that was eventually passed, there has been a significant last-minute shift. In the early stages the intention was to put in place a real burden-sharing of the losses of the bank. In particular, in cases where the authorities had decided to rescue a bank, 'then the proposal would give the regulatory authorities the option to require regulatory capital instruments (other than common shares) to

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[33] De Poli Matteo, *European Banking Law,* 224 (Wolters Kluwer Italia, Assago 2017).
[34] On this aspect, see later Chapter 4.4.
[35] Raffaele Lener and Edoardo Rulli, *Liabilities Excluded from Bail-in: Implications under Italian and EU Law* 32 Journal of International Banking Law and Regulation 428,429 (2017).
[36] Ibid.
[37] BCBS, *Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-viability*, August (2010), www.bis.org (accessed 5 November 2017).
[38] Bart PM. Joosen, *Bail-in Mechanism in the Bank Recovery and Resolution Directive* in Saskia MC. Nuijten, Bart PM. Joosen and Patrick Clancy (eds), *The Bank Recovery and Resolution Directive and the Single Resolution Mechanism,* 41(Eleven International Publishing, The Hague 2017).
[39] Ibid. at 24.
[40] Bart PM. Joosen, *Bail-in Mechanism in the Bank Recovery and Resolution Directive* in Saskia MC. Nuijten, Bart PM. Joosen and Patrick Clancy (eds), *The Bank Recovery and Resolution Directive and the Single Resolution Mechanism*, 41(Eleven International Publishing, The Hague 2017).

be written-off or converted into common shares.'[41] Conversely, in the BRRD, the bail-in has been conceived in a way that is at a first glance a penalisation of both creditors and shareholders,[42] as both the latter (first and foremost) and the former (in cases where the sacrifice of the first is not enough) are required to bear the losses of the failing bank.

Domestically, a primordial form of bail-in tool is the British legislation passed in 2009, in the aftermath of the 2007-2008 financial crises: the Banking Act 2009. The Bank of England exercised the powers conferred according to that legislation in March 2009, when the assets of the Dunfermline Building Society were sold at auction. The successful bidder was Nationwide, and they acquired both the liabilities (retail and wholesale deposits) and the assets, with the exclusion of the social housing loans.[43] As the value of the assets was lower than the liabilities that the Dunfermline assumed, the British Treasury paid to the purchaser a bonus of £1.6 billion.

3. The Scope of the Bail-in Tool

In essence, the bail-in tool aims to recapitalise the failing bank, via the writing-off of the debt, either wholly or in part, and the conversion of debt into equity. In this respect, it is correctly highlighted[44] that the consequences of this process are, first and foremost, financial: the liabilities of the bank will be proportionally reduced and this should ultimately restore the balance sheet of the credit institution.[45] In this conversion, the resolution authority will operate according to discretion. In fact, it will also be able to apply different conversion rates to different classes of liability.[46] Second, the use of the bail-in tool may also engender corporate governance consequences:[47] the debt-holders, in becoming equity-holders, will become owners or at least co-owners of the credit institution and this may mean that this category of 'trans' stake-holders will become in charge of the strategic decision of the bank.

The deviation from the initial proposals on bail-in becomes obvious if attention is paid to the scope of the bail-in tool according to the legislature. Its general scope, which each Member State should pursue, is to ensure that 'the bail-in may be applied to all liabilities of an institution …. that are not excluded from the scope of that tool …'.[48] Although the initial intention was to apply the bail-in to specific liabilities (the providers of regulatory capital), the final solution, perhaps as a result of political pressures,[49] has been somewhat different: in a slightly invasive

[41] *Basel III: A Global Regulatory Framework for more Resilient Bank and Banking Systems*, www.bis.org (2010).
[42] Bart PM. Joosen, *Bail-in Mechanism in the Bank Recovery and Resolution Directive* in Saskia MC. Nuijten, Bart PM. Joosen and Patrick Clancy (eds), *The Bank Recovery and Resolution Directive and the Single Resolution Mechanism*, 41(Eleven International Publishing, The Hague 2017)
[43] John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffery N. Gordon, Colin Mayer, and Jennifer Payne, *Principles of Financial Regulation,* 352 (Oxford University Press, Oxford 2016).
[44] Ibid at 359.
[45] Ibid.
[46] Ibid at 362. It is also correctly affirmed that creditors may receive unfair treatment in resolution.' (ibid, at 355). Particularly in major banks where there are difficult classes of creditors, the discretionary power left to the resolution authority means that the future of each class will be difficult to predict (ibid. at 355).
[47] Ibid. at 359, 360.
[48] Art. 44(1), BRRD.
[49] Bart PM. Joosen, *Bail-in Mechanism in the Bank Recovery and Resolution Directive* in Saskia MC. Nuijten, Bart PM. Joosen and Patrick Clancy (eds), *The Bank Recovery and Resolution Directive and the Single Resolution Mechanism,* 41(Eleven International Publishing, The Hague 2017).

way, to extend the scope of the bail-in tool to all the creditors, the ordinary creditors, with the exception of the ones specifically protected, such as covered depositors.

The exclusions to which this legal provision refers are those under the following paragraphs 2 and 3 of the same Art. 44(1). In more general terms, the bail-in is defined by the BRRD Art. 2, which refers to the bail-in tool as follows:

'the mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to the liabilities of an institution under resolution…'.

On these premises, among academic commentators it is highlighted that the bail-in tool is 'a going-concern tool since it should enable resolution authorities to recapitalise the institution by charging shareholders and creditors of the institution an appropriate part of the costs arising from the failure of the institution …'.[50] On the other hand, it is counter-claimed that the bail-in tool is both a going-concern and a gone-concern instrument.[51] The latter conclusion can be supported by the tenor of Recital 68 of the BRRD:

'In order to ensure that resolution authorities have the necessary flexibility to allocate losses to creditors in a range of circumstances, it is appropriate that those authorities be able to apply the bail-in tool where the objective is to resolve the failing institution as a going concern if there is a realistic prospect that the institution's viability may be restored, and where systemically important services are transferred to a bridge institution and the residual part of the institution ceases to operate and is wound up'.

However, it is recognised that, in the way the BRRD was originally envisaged (an instrument of contingent capital mechanism), the only circumstance of application of the bail-in was a point of non-viability.

Ultimately, irrespective of these two contrasting stances, the bail-in mechanism applies to several hypotheses of bank crisis: shareholders and creditors of a bank that are involved with a rescue operation which otherwise would require public money, are expected to participate in the loss absorption to a full extent. Thanks to the suppression, in whole or in part, of these rights the bank should return to being a viable business.[52]

4. Bail-in Tool and Priorities

4.1. *Priorities within the Resolution Tools*

In the literature, it is correctly emphasised that 'all liabilities of a bank are bail-inable, unless expressly excluded by the Single Resolution Mechanism (SRM) Regulation or the BRRD'.[53]

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[50] De Poli Matteo, *European Banking Law* (Wolters Kluwer Italia, Assago 2017).

[51] Bart PM. Joosen, *Bail-in Mechanism in the Bank Recovery and Resolution Directive* in Saskia MC Nuijten, Bart PM Joosen and Patrick Clancy (eds), *The Bank Recovery and Resolution Directive and the Single Resolution Mechanism,* 29 (Eleven International Publishing, The Hague 2017).

[52] Ibid at 29.

[53] CONSOB, Simone Alvaro, Marco Lamandini, David Ramos Muñoz, Elena Ghibellini, Francesca Pellegrini, *MREL Securities after BRRD: The Interplay between Prudential, Resolution and Transparency Requirements and the Challenges which Lie Ahead*, CONSOB, Commissione Nazionale per le Societa' e la Borsa, Quaderni Giuridici, 22. (2017)

Art. 34 of the BRRD, which relates to all the resolution tools, stipulates that any resolution action, including the bail-in, is taken in accordance, amongst many, with one fundamental principle: the losses are borne first by shareholders of the institution and then by creditors, the latter in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in the BRRD. More specifically, Art. 34(1) BRRD, headed 'General principles governing resolution', stipulates as follows:

'Member States shall ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

(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;
(i) resolution action is taken in accordance with the safeguards in this Directive.'

It can be inferred that the norm under discussion imposes an order of priority, as it is stipulated, under letter (b) of Art. 34(1) that the creditors of the institution under resolution bear losses 'after the shareholders'. Therefore, the first category to be sacrificed, in case of application of the bail-in tool, are those who invested in the equity of the bank. In more detail, if the bail-in to the detriment of the equity holders fails to be successful, based on the combined reading of Art. 34 (General principles of the resolution tools), Art. 31 (Resolution objectives),[54] and Art. 43, addressed exclusively to the bail-in tool,[55] the mechanism under discussion shall be applied

[54] See previous Section 2.1 above.
[55] Article 43, headed 'The bail-in tool' stipulates, in its first paragraph:
'In order to give effect to the bail-in tool, Member States shall ensure that resolution authorities have the resolution powers specified in Article 63(1).'
The second paragraph continues as follows:
'2. Member States shall ensure that resolution authorities may apply the bail-in tool to meet the resolution objectives specified in Article 31, in accordance with the resolution principles specified in Article 34 for any of the following purposes:
(a) to recapitalise an institution or an entity referred to in point (b), (c) or (d) of Article 1(1) of this Directive that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation (to the extent that those conditions apply to the entity) and to continue to carry out the activities for

to the debt-holders, in addition to the equity-holders. This translates into the whole or partial conversion of the unsecured claims against the financial institution (i.e., debt instruments) into shares, and the write-off, in whole or in part, of existing unsecured claims.[56]

Admittedly, commentators' views on this are not totally uniform. Some suggest that the two main aspects of the bail-in (the conversion of equity of the distressed bank and the write-down-write-off of debt instruments) are not alternatives, and are not considered according to an order of legal priority.[57] *Ergo*, the resolution authority may use them according to its administrative discretion. Yet, it is undisputed that, as far as the conversion of debt into equity is concerned, there will be both financial and governance consequences for the bank affected by this measure.[58]

Beyond these subtle interpretations, it must be affirmed that the norm is neither perspicuous nor technically precise. In a legal provision concerned with priorities, a commentator and interpreter would expect a perspicuous focus of the legislature on the classes. By contrast, the legal provision under discussion interconnects each of the priorities, on the one hand (letters (a) and (b)), and on the other hand general principles (letters (c) and (d)). Furthermore, letters (e), (f), (g), (h), and (i), seem to belong to a different *genus*. The same applies to the following Art. 48, which, instead of elucidating the matter, increases the uncertainty: with regard to the sequence in which the power to write down or convert liabilities should be applied within a resolution procedure, there is no precise harmonisation exercise.[59] This 'pathology' of the system is also made more serious, given the fact that Art. 42, BRRD, 'provides a long list of liabilities excluded from the bail-in'.[60] In turn, this immediately creates 'the incentive for creditors to plead that their liabilities are "out" of bail-in,'[61] instead of "up" in the pecking order.

Apart from this observation of an interpretative nature, it is not incorrect to advocate the view that the bank will result in being recapitalised, courtesy of the write-off, in whole or in part, of the shares, in order 'to restore its ability to comply with the conditions for authorisation [..] and

which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU, where the entity is authorised under those Directives, and to sustain sufficient market confidence in the institution or entity;

(b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
(i) to a bridge institution with a view to providing capital for that bridge institution; or
(ii) under the sale of business tool or the asset separation tool.'

[56] On possible friction between the Directive under discussion and the European Convention on Human Rights, particularly its Art. 1, the right to peaceful enjoyment of possessions, see Alexander Schild, *Does the Directive on the Recovery and Resolution of Credit Institutions provide Sufficient Fundamental Rights Protection?* in Matthias Haentjens and Bob Wessels (eds), *Bank Recovery and Resolution,* 77, 85 (Eleven Publishers, The Hague 2004). The conclusion seems to be as follows (A Schild, Ibid. at 85): 'As long as the member states will dutifully implement the safeguards as set forth in the relevant provisions of the RRD, it is difficult to envisage a situation in which either Article 1 Protocol No. 1 or Article 13 of the Convention will be violated.'.

[57] Matthias Haentjens and Pierre de Gioia-Carabellese, *European Banking and Financial Law,* Chapter 7 (Routledge, London and New York 2015).

[58] John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffery N. Gordon, Colin Mayer, and Jennifer Payne, *Principles of Financial Regulation,* 359 (Oxford University Press, Oxford 2016). It is highlighted that, as regards the first aspect (financial), 'the bank's liabilities are reduced by the amount of the write-off or conversion and the demands on the bank's cash flows are reduced by the removal of the requirement to pay interest on the debt written off or converted.' As far as the corporate governance is concerned, 'where the former debt-holders become equity holders, control of the bank may pass into new hands.' (Ibid. at 359)

[59] This has recently been emphasised by CONSOB, at 25.

[60] CONSOB, at 25.

[61] CONSOB, at 25.

to continue to carry out the activities for which it is authorised [..].'[62] The write-off process should be the first attempt of bail-in, as the equity holders are by definition exposed to the risk of the enterprise.

Nevertheless, the sacrifice that the shareholders are required to make may be, upon closer scrutiny, just symbolic and even unnecessary. If a bank is failing or is close to failure, it is highly likely that this has already reverberated on the value of the shares, particularly if listed. In this scenario, it appears unclear why the shareholders, in addition to the stress of seeing their shares plunge, are expected to be deprived of their ownership. In this respect, the norm appears a futile exercise in sadism, exercised by the supervisory authority against a specific category of stakeholders of the bank.

4.2. *Priorities and Insolvency Proceedings*

Art. 108, BRRD, stipulates, as regards deposits, a form of hierarchy that should be implemented in each jurisdiction, in the case of insolvency proceedings. The norm, explicitly applicable to cases of insolvency, is not necessarily concerned with the resolution tool, which by contrast is aimed at avoiding the insolvency. At the same level of hierarchy, there are both 'part of eligible deposits from natural persons and micro, small and medium-sized enterprises which exceeds the coverage level provided for in Article 6 of Directive 2014/49/EU' (let. a(i), art. 108, BRRD) and 'deposits that would be eligible deposits from natural persons, micro, small and medium-sized enterprises were they not made through branches located outside the Union of institutions established within the Union.' (let. a(ii), art. 108, BRRD). The separate category, which will be ranked higher than that just referred to above, is represented by the 'covered deposits' (lett. b(i)) and the 'deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency' (lett. b(ii)).

This scenario will soon change, once the new amendments to Art. 108, BRRD, have been implemented. In greater detail, given the inclusion of a new category of debt instruments, courtesy of an amendment to Art. 2(1), point 48, BRRD, these new debt instruments will be ranked after those listed in the previous paragraph. These claims resulting from unsecured debt instruments shall comply with a number of criteria. They will have an original contractual maturity of at least one year, they do not contain embedded derivatives, and they are not derivatives themselves. Finally, the prospectus shall explicitly refer to their lower ranking under normal insolvency proceedings. This non-preferred senior class of debt instruments shall meet the eligibility criteria of the Total Loss-Absorbing Capacity (TLAC), which the G-20, in November 2015, identified in order to ensure that global systemically important banks 'have the loss-absorbing and recapitalization capacity necessary to help ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk'.

5. Bail-in Tool and 'No-creditor-worse-off' Principle

[62] Art. 43(2)(a) BRRD. Pursuant to Art. 43(2)(b) BRRD, such recapitalisation can also be used in the bridge institution tool and asset management vehicle.

In this paper, emphasis has already been placed on the fact that no creditor is expected to suffer greater losses than they would have suffered if the institution had been liquidated under ordinary insolvency proceedings (the 'no-creditor-worse-off' principle). This principle is quintessential as it potentially aims to protect shareholders and creditors who may realise that potentially they have been affected by the application of any - and not just the bail-in - resolution tool.[63] Merely implied by the principle, albeit made explicit in the literature,[64] is the idea that claims within the same rank 'must be reduced *pari passu* among themselves'.

Upon closer scrutiny, the legal provision hides a couple of insidious and tricky conundrums. The first one is that the supervisory authority needs to ascertain in advance, with a prognosis of both a financial and an accounting nature, how the position of the shareholders and creditors would have evolved without the intervention of the resolution tool.[65] The answer would probably be positive, by definition, although the hypotheses are multifarious. The second issue is more technical. Assuming that the tool has been applied incorrectly, as the shareholders and creditors in reality would not have been worse off had the tool been avoided, it is not obvious whether the resolution authority can be sued for damages by one of the representatives of these categories. Given the fact that the matter is left to the laws and jurisdictions of each bank involved, and given the lack of precedents, it is possible to suggest that a duty of care is owed by the supervisor to the protected categories at stake (shareholders and creditors), *ergo* leading to the possibility of using the general principles of tort law in order to protect the victim against the tortious conduct of the supervisor.

Admittedly, the liability of the resolution authority for tortious conduct can be potentially lessened by the application of the legal provision under Art. 36 of the BRRD. The norm requires the supervisor to use an independent valuer, as the first step of the process. The rationale behind this is that the purpose of the BRRD is to keep the bank operating as a going concern. In reality, as the use of the bail-in tool may materialise in the dramatic circumstances of an emergency, where every moment is precious, the BRRD allows the authority to carry out an *ex post* valuation.[66]

Needless to say, covered deposits, under the third pillar of the Banking Union, are required to be protected in full.[67] The rationale behind this is obvious: by allowing the covered depositors to be bumped off the protection, there would be an internal conflict between two of the three pillars of the banking European Union.

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[63] De Poli Matteo, *European Banking Law,* 228 (Wolters Kluwer Italia, Assago 2017).

[64] Simone Alvaro, Marco Lamandini, David Ramos Muñoz, Elena Ghibellini, Francesca Pellegrini, *MREL Securities after BRRD: The Interplay between Prudential, Resolution and Transparency Requirements and the Challenges which Lie Ahead*, CONSOB, Commissione Nazionale per le Societa' e la Borsa, Quaderni Giuridici, 23 (2017).

[65] In the literature and well before the body of law of the BRRD entered into force, commentators (Karl-Philipp Kojcik, *Bail-in in the Banking Union* 53 Common Market Law Review 124 (2016)) had already highlighted that the comparison would be based on a number of assumptions, 'since insolvency proceedings usually take time, depend on the application of specific rules by courts or administrative authorities which decide depending on specific motions or situations of creditors.'

[66] John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffery N. Gordon, Colin Mayer, and Jennifer Payne, *Principles of Financial Regulation,* 361(Oxford University Press, Oxford 2016).

[67] As far as depositors are concerned, the protection is afforded to 'covered deposits,' i.e., all deposits up to €100,000. This protection includes deposits in a current account, savings deposits, and funds invested in a certificate of deposit, whereas bonds issued by the insolvent bank are not covered.

Nonetheless, the rights of the creditors protected under the DGS Directive shall remain unaffected. Ultimately, the underpinning philosophy of the resolution tools is that ‘no financial institution shall be unconditionally protected from an orderly market exit [..]’.[68] As regards the groups of banks, in the general principles governing the resolution (art. 34, BRRD), it is stipulated that resolution authorities will apply ‘resolution tools and exercise powers in a way that minimises the impact of other group entities and on the group as a whole and minimises the adverse effect on financial stability in the Union and its Member States, in particular, in the countries where the group operates.’

6. Bail-in Tool and Exempted Liabilities

Art. 44(2), BRRD,[69] lists the liabilities that can be in no way subjected to a write-down or a conversion in equity.[70] Together with covered deposits, these liabilities will not be affected by the application of the bail-in tool. Among these, mention can be made of: i) secured liabilities, as covered bonds; ii) liabilities to employees, liabilities to commercial or trade creditors, liabilities to tax and social security authorities; and iii) liabilities to credit institutions and investment firms, excluding entities that are part of the same group, with an original maturity of fewer than seven days. Remarkably, Art. 44(3) encompasses exceptional circumstances where certain liabilities, not automatically excluded from the application of the write-down or conversion powers, may be included after a specific resolution of the resolution authority.[71]

Within the legal framework of discretionary exclusions, the EBA-issued guidelines are devoted to limiting this broad power.[72] Additionally, Regulation 2016/860, which came into force on 4

[68] Simone Mezzacapo, *Towards a New Regulatory Framework for Banking Recovery and Resolution in the EU,* Law and Economics Yearly Review (part 1) 211 (2013).
[69] Article 44(2), BRRD, headed ‘Scope of the bail-in tool’.
[70] An analysis concerned with the bail-in was orchestrated in Italy in respect of the Venetian banks, Banca Popolare di Vicenza and Veneto Banca, see Raffaele Lener and Edoardo Rulli, *Liabilities Excluded from Bail-in: Implications under Italian and EU Law* 32 Journal of International Banking Law and Regulation 428-438 (2017). For a broader discussion of empirical cases of bail-in, see Financial Sector Advisory Center (FinSAC), *Bank Resolution and “Bail-in” in the EU: selected Case Studies Pre and Post BRRD* World Bank Group, in <http://pubdocs.worldbank.org/en/120651482806846750/FinSAC-BRRD-and-Bail-In-CaseStudies.pdf> (2017).
[71] The relevant circumstances are the following: i) it is not possible to subject to bail-in a particular liability within a reasonable time, notwithstanding the efforts of the resolution authority made in good faith; or ii) the exclusion is strictly necessary to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution to continue essential operations, services, and transactions; or iii) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, which would severely disrupt the functioning of financial markets in a manner that could bring about a grave disturbance to the economy of a Member State or of the Union; or finally iv) the application of the bail-in tool to those liabilities would cause a destruction in value such that losses borne by other creditors would be higher than if those liabilities were excluded from bail-in. When a certain liability has been excluded from the application of the bail-in, the level of a write-down or conversion of other liabilities will likely be increased to take account of this exclusion. However, the additional burden on creditors affected by the bail-in shall occur in accordance with the ‘no-creditor-worse-off’ principle.
[72] EBA/Op/2015/07 of 6 March 2015, Technical advice on the delegated acts on the circumstances when exclusions from the bail-in tool are necessary. For more details, see Raffaele Lener and Edoardo Rulli, *Liabilities Excluded from Bail-in: Implications under Italian and EU Law* 32 Journal of International Banking Law and Regulation 428,438 (2017)

February 2016,[73] has further reduced the area of this discretion. In detail, as commented on by scholars,[74] the Regulation clarifies the hypotheses where the liabilities can be excluded. In that respect, it must be complied with by national resolution authorities, by the Single Resolution Board (SRB) as a resolution authority in the banking union, and by the Commission when prohibiting or requesting amendments to the exclusion proposed by a resolution authority.

Finally, resolution authorities have the power to write down and convert capital instruments of the distressed institution.[75] The implementation of the power to write down and to convert capital instruments produces effects comparable to those achieved by the application of the bail-in tool. The write-down and the conversion of capital instruments are additional instruments since they can be exerted either in conjunction with a resolution action, or independently of it, when the following conditions occur: i) the entity can be placed under resolution but no action has yet been carried out; ii) the competent authority determines that non-write-down or non-conversion would affect the viability of the entity; iii) the entity requires extraordinary public financial support.[76]

7. Uncertainties of bail-ins

This section will examine two uncertainties associating with bail-ins: the dilemmas arising from MREL; the conditions to initiate bail-ins. In this respects, some Italian and Cypriot cases provide egregious food for thought.

7.1. Uncertainties from MREL

As it has been examined in the last Section 6, since resolution authorities enjoy discretion to exempt certain categories of debts from the list of bail-inable liabilities,[77] one given bank has to maintain a minimum requirement of designated debts for a potential bail-in to work.[78] This minimum requirement is named as minimum requirements for own funds and eligible liabilities (MREL); without it, the loss incurred by a bank in a financial crisis, would be too large for that credit institution to fully absorb by either cancelling or converting the MREL to equity. [79]

The BRRD provides national resolution authorities with methods to calculate the minimum bail-inable liabilities on an institution by institution base.; also, it proposes to enhance the predictability and stability of bail-in mechanism.[80] Hence, one may affirm that MREL is an

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[73] Regulation 2016/860 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under Art. 44(3) of Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (OJ L 144).

[74] Raffaele Lener and Edoardo Rulli, *Liabilities Excluded from Bail-in: Implications under Italian and EU Law* 32 Journal of International Banking Law and Regulation 430 (2017).

[75] According to Art. 59 BRRD, headed 'Requirement to write down or convert capital instruments'.

[76] Art 59(3), BRRD, headed 'Requirement to write down or convert capital instruments'.

[77] See Art. 44(3) in BRRD and Recital 72 of BRRD. Resolution authorities may exclude or partially exclude liabilities where necessary to avoid the spreading of contagion and financial instability which may cause serious disturbance to the economy of a Member State. When carrying out those assessments, resolution authorities should give consideration to the consequences of a potential bail-in of liabilities stemming from eligible deposits held by natural persons and micro, small and medium-sized enterprises above the coverage level provided for in Directive 2014/49/EU.

[78] Michael Schillig, *Resolution and Insolvency of Banks and Financial Institutions,* 288 (OUP 2016).

[79] BRRD art. 45.

[80] Gabriel Moss and others, *EU Banking and Insurance Insolvency,* 244-245 (2nd Edition OUP 2017).

important condition to make the mechanism of bail-ins workable. However, the flip side of the coin is that, as the resolution authorities have discretion to subordinate debts in the category of MREL to other liabilities, the discretionary exclusion exerted at the time of a banking crisis may drive a coach and horses through the no-creditor-worse-off principle (NCWO) discussed in Section 5.[81] The tenet of the 'NCWO principle' is that the creditors should not suffer more losses than they would have incurred in, in cases of liquidation of the institution. Nevertheless, the case of the Cypriot Banks bail-in seems to reveal that discretion and manipulation are harmful not only for the same insolvency principles but also for those enshrined in the BRRD, which may result in being blatantly breached, particularly the NCWO concept. Even though the cases were dealt with before the BRRD, they are still telling and significant.

On 2013, the Eurogroup and Troika agreed to provide Emergency Liquidity Assistance to Cyprus on the condition that two biggest Cypriot banks, the Bank of Cyprus and Cyprus Popular Bank (Laiki) would sell their Greek branches and bail-in part of their losses.[82] Since the Cypriot Banks operated under the auspice of lender of last resort loans from the EU, this gave both the Eurogroup and the IMF a strong voice: ultimately, the best way forward for these two banks, according to these international bodies, was a significant bail-in of uninsured deposits in the Bank of Cyprus and Laiki.[83] The Cypriot government decided to bail-in these banks as it would not have been able to pay insured depositors, had the banks entered national insolvency proceedings.[84]

Empirically, the resolution plan for Laiki was as follows: its operation and business in Greece and Cyprus would be sold to Piraeus Bank and the Bank of Cyprus respectively.[85] Also, Laiki would be divided into one bad bank and one good bank: more specifically, all the interests of shareholders, bondholders and 47.5% of the uninsured deposits would be left in the bad bank and wiped out.[86] Despite the reassuring picture, so many flaws and inconsistencies were obvious in the rescue plan. Frist, the discretionary power had been exerted so that the University of Cyprus which had a large deposit in Laiki, resulted in being exempted.[87] Additionally, a significant amount of exemptions were made to Greece-based depositors. More specifically, Greek depositors in the branches of two banks sold to Piraeus were not subject to any haircut, whereas the Cypriot uninsured creditors ended up bearing the disproportionate cost of the bail-in.[88] From a hypothetic analysis done by Costas Xiouros, should Greece-based depositors have not been exempt from bail-in, Cypriot depositors of the Bank of Cyprus would only account for 17% of bail-inable liabilities rather than the more consistent 47.5% which eventually materialised. Furthermore, the number for Cypriot depositors of Laiki would have

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[81] Tobias H. Tröger, *Why MREL Won't Help Much* SAFE Working Paper No. 180 8 (2017).
[82] Costas Xiouros, *Handling of the Laiki Bank ELA and the Cyprus Bail-in Package* in Alexander Michaelides and Athanasios Orphanides (eds), *The Cyprus Bail-In Policy: Lessons from the Cyprus Economic Crisis*, 33 (Imperial College Press 2016).
[83] John Theodore and Jonathan Theodore, *Cyprus and the Financial Crisis-The Controversial Bailout and What it Means for the Eurozone,* para 14.23 (Palgrave Macmillan 2015).
[84] ibid at para 14.23.
[85] It derives from the above that Bank of Cyprus have continued operating, despite its crisis, mercy of the acquisition of the 'good' assets from Laiki.
[86] Thomas Philippon and Aude Salord, *Bail-ins and Bank Resolution in Europe: A Progress Report*, Geneva Reports on the World Economy Special Report 4, 32 (2017).
[87] Pamela Lintner and Johanna Lincoln, *Bank Resolution and "Bail-In" in the EU: Selected Case Studies Pre and Post BRRD,* 21 (2016).
[88] John Theodore and Jonathan Theodore, *Cyprus and the Financial Crisis-The Controversial Bailout and What it Means for the Eurozone,* para. 14.102 (Palgrave Macmillan 2015).

been likely to be 24.5% while in fact, they resulted in bearing up to a more significant figure of 60%.[89] In other words, depositors in the bank of Cyprus and Laiki were put in a worse situation than they would have been in the liquidation scenario of these banks.[90]

7.2. Uncertainty Regarding the Conditions to Apply Bail-Ins

Given the uncertainties with regard to the institution-specific MREL,[91] the costs for creditors may outweigh that of liquidation.[92]Therefore, it is not clear whether the bail-in tool is always the most economical way for distressed medium or small size financial institutions, which may not generate significant externalities to damage the public interest. This is probably the reason why resolution tools such as bail-in can only be initiated when some conditions are met so as to avoid the possible exorbitant costs to the stakeholders.[93]

In section 1, it has been made clear that the resolution tools are designed to apply in extreme cases where a financial institution is failing or likely to fail and no alternative options are available and it is in the public interest to rescue the financial institution.[94]However, the interpretation of these three standards, without rigid and well-established practice, may subject to resolution authorities' cooperation and discretion.[95]That is to say, the BRRD does not make it clear when resolution tools should be used. What if the resolution authorities, such as the Single Resolution Board, does not agree to rescue a national bank, even though the bank is very important to the local economy? What actions should national governments take? This is what happened in Italy.

When two Italian banks Veneto Banca and Banca Popolare di Vicenza found themselves in financial difficulties, the SRB was of the opinion that the Banca Popolare di Vicenza and Veneto Banca should need not be put in resolution; the banks should be dealt with by the Italian national insolvency law as they were not large enough to cause harm to the financial stability of the system and a full-out resolution on the basis of public interest was not justified.[96]

The opinion of SRB seems to imply that liquidation for these two Italian banks was a cheaper and viable option for the Italian government. However, 80% of the junior bonds were sold to retail investors and this category would eventually bear the loss in the liquidation proceedings.[97] The Italian government decided to back up the banks by issuing guarantees of up to 12 billion euros to deal with non-performing loans; also the government facilitated Banca

[89] Costas Xiouros, *Handling of the Laiki Bank ELA and the Cyprus Bail-in Package* in Alexander Michaelides and Athanasios Orphanides (eds), *The Cyprus Bail-In Policy: Lessons from the Cyprus Economic Crisis*, 33 (Imperial College Press 2016).
[90]ibid at 84.
[91] Tobias H. Tröger, *Why MREL Won't Help Much* SAFE Working Paper No. 180 (2017).
[92] Jens-Hinrich Binder, *Proportionality at the Resolution Stage: Calibration of Resolution Measures and the Public Interest Test,* available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2990379 (accessed on 28th August 2017).
[93] Ibid at 8.
[94] See section 1.2.
[95] Tobias H. Tröger, *Too Complex to Work A Critical Assessment of the Bail -in Tool under the European Bank Recovery and Resolution Regime,* EBI Working Paper Series No.12, at 13 (2017).
[96] See the Single resolution Board press report at https://srb.europa.eu/en/node/341 (accessed on 26 Aug 2018).
[97] https://uk.reuters.com/article/uk-italy-veneto-banks-restructuring-idUKKBN17D2AL (accessed on 26 Aug 2018); Thomas Philippon and Aude Salord, *Bail-ins and Bank Resolution in Europe: A Progress Report,* Geneva Reports on the World Economy Special Report 4, at 39 (2017).

Intesa to acquire the good assets of these banks at the expense of another 5.2 billion euros.[98] From a speech of the deputy governor of the Bank of Italy, the bail-out is probably the best option for Italian banks as a potential bail-in may be very expensive and prejudicial to both the Italian market and the consumer confidence.[99] However, the actions taken by the Italian government represented a quasi-bailout, not a straightforward liquidation.

The cases may create further uncertainties as to when the bail-in can be applied. The above Cypriot case also reveals this issue. It was alleged that, since the size of economy of Cyprus was too small to trigger a knock-on effect in Europe[100], and considering that most of depositors were Russians and the origin of money nebulous,[101] the resolution authorities Troika and Cypriot government decided to let Cypriot to test the bail-in tool.

8. Conclusion

The bail-in tool was introduced at the dawn of 2016 in the aftermath of both the 2007-2008 financial crises and the 2011 Euro zone crisis, and it has been heralded as an instrument designed to preserve the essential functions of the bank, particularly its ability to remain a reliable paymaster. Beyond the intentions of the EU legislation, which are not necessarily correct (to keep afloat the bank as paymaster), the way this scope has been achieved, by simply targeting certain categories of stakeholders as sacrificial lambs, without any clear definition *ex ante* of the legal criteria, is controversial. Thus, the discretion left to the resolution authority seems to mimic a form of Russian roulette, where the dead man walking is one of the major stakeholders of the bank, with the resolution authority being the nasty and ruthless killer.

Against this background, this paper, first and foremost, attempts to provide a legal categorisation of the bail-in tool, in light of the general principles of corporate law and insolvency law. The bail-in, far from being an insolvency proceeding, as it lacks the quintessential element of the *par condicio creditorum*, is a *sui generis* instrument of an administrative nature.

In light of the fact that the magnitude of the powers - pretty unfettered - given to the supervisory bodies is egregious, the paper has highlighted further that the new EU regulation in this area may be tainted with vagueness.[102] According to Lord Bingham, one of the guiding principles of the rule of law is that the 'law must be accessible, intelligible, clear and predictable', in order that individuals know what conduct is lawful or unlawful.[103] Similarly, Raz asserts that the rule of law requires that 'laws should be relatively stable and the making of laws guided by open, stable, clear and general rules'.[104]

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[98] Mara Monti, *Italy versus Spain: Two Measures for Solving The Same Banking Problem* (2017) at http://blogs.lse.ac.uk/europpblog/2017/06/28/italy-spain-two-measures-same-banking-problem/. (accessed on 27 Aug 2018).

[99] https://www.ft.com/content/03a1c7d0-5a61-11e7-b553-e2df1b0c3220. (accessed on 26 Aug 2018).

[100] John Theodore and Jonathan Theodore, *Cyprus and the Financial Crisis-The Controversial Bailout and What it Means for the Eurozone,* para 14.5 (Palgrave Macmillan 2015).

[101] Thomas Philippon and Aude Salord, *Bail-ins and Bank Resolution in Europe: A Progress Report,* Geneva Reports on the World Economy Special Report 4, at 36 (2017).

[102] In this paper the overlap between bail-in and property rights, which is also an obvious area of doctrinal analysis, has been deliberately left outside the perimeter of the investigation. For a commentary on this specific matter, see Karl-Philipp Wojcik, *Bail-in in the Banking Union* 53 Common Market Law Review 116, 118 (2016).

[103] Tom Bingham, *The Rule of Law* (Penguin, London 2011).

[104] Joseph Raz, *The Authority of Law,* 214, 218 (Oxford University Press, Oxford 1979).

By contrast, apart from a quite generic principle of priorities hinted at by the BRRD (shareholders to pay first, and senior creditors to pay later),[105] in reality the supervisory authority has been made, courtesy of the new rules, the *supremo* entitled to artificially alter the basic ownership structure of the bank. This paper echoes a concern that these powers may modify the same principle of hierarchy that in every jurisdiction usually governs the claims of creditors. The resolution board, and the multifarious administrative bodies behind it, resembles a reincarnation of the mythological figure of Charon. It is he who will decide, among the different moribund souls approaching the banks of Hades, the ones who deserve salvation - and therefore can be safely navigated across the Styx - and the ones who by contrast need to loiter on the shore. The double standards in the recent case of the Venetian banks, designated major banks according to the Single Supervisory Mechanism rules, but all of a sudden reclassified as regional banks according to the SRM rules, is further evidence corroborating this assumption.

Furthermore, the resolution tools and particularly the bail-in tool, after more than two years in existence, still lie in a nebulous area as regards their trigger. In preserving the continuation of the main activities of the bank, it is still debatable, from a doctrinal point of view, whether the tool is a going-concern tool or a gone-concern one. As regards this, better identification and/or wording of the concept of 'failing or likely to fail' appears necessary, in so much as to limit the trigger to the 'likely to fail'. Ultimately, the failing bank should no longer be allowed the resolution tool, as at that point the bank is already insolvent, and therefore orthodox insolvency proceedings should apply.

Additionally, the BRRD seems to be an all-inclusive, but quite confusing, piece of legislation where different *sedes materiae* are interwoven, whereas separate pieces of legislation would have been a better *modus operandi*. The order of priorities that, in the case of the resolution tool, can be applied by the resolution authority, the tenor of which is far from clear, could have been kept separate from the usual order of priorities, applicable to the insolvency proceedings of banks, concerned with the proper bank insolvency.

Upon close scrutiny, it might be suggested that the recent piece of legislation may have preserved the principle of continuation of the fundamental activities of the bank. Yet, the same legislation may have given the last rites to the bank as a business entity. In the new scenario, the credit institution hardly fits into the concept of entrepreneurial activity, given that the rights of the main stakeholders – shareholders and all ordinary creditors - are sacrificed, *ad libitum*, by an overarching and overwhelming public authority, the decisions of which will hang over the functioning of the bank like the proverbial sword of Damocles.

Possible corrections to the BRRD in the area of the bail-in tool are few but certainly urgent. A more perspicuous definition, within the legislation, of the major creditors who are going to be sacrificed in cases where the bank is likely to fail, is recommended. The initial proposal adumbrated in 2012 to identify this category exclusively in those who provide regulatory capital to the bank, despite the time and the legislation passed in the meantime, is not illogical.[106] In a scenario where banks, in the last decennium, have been profoundly dissected like corpses at the mercy of fearless doctors in their post-mortem investigations, the new rules

[105] See in this Section 4 above.

[106] More recently, when this paper was already complete, an Author (Tobias H. Troeger, *Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime* 4 Journal of Financial Regulation 35,72 (2018)) points out that a concentration of private sector involvement falling under the minimum requirements for own funds and eligible liabilities is to be preferred.

of recapitalisation of banks should protect *per se* financial institutions. In the state-of-the-art current legislation, there is an uncertainty which ultimately may affect the decision of any investor to put money into a bank.

A decennium has now passed since the explosion of the first financial crisis, conventionally seen as coinciding with the Northern Rock illiquidity. In celebrating this tragic-comic anniversary, a plethora of regulations has been promulgated. These rules may already be obsolete, as they were envisaged in a scenario (the 'big bank' of the 2000) which in the meantime has been superseded by a more fragmented market of small-medium institutions. The example of the Venetian banks, major players in the market and also regarded as major banks according to the SRM rules, yet exempt from the bail-in, may be a paradigm.

In this regulatory furore, the administrative tool of the resolution of the bank, instead of clarifying the exit rules applicable to the bank, may have simply created a proliferation of norms, in some cases in contradiction with one another. Ultimately, it can be legitimately questioned whether the BRRD and its underpinning philosophy, in preserving the concept of the bank as paymaster, in reality signs the death warrant of the bank as it has been organised and has survived until recently since its mediaeval ancestors. The BRRD may have achieved the internalisation of the losses of the bank and one of the main pillars of the Banking Union,[107] but at the same time it may have caused an irremediable disentanglement of the legal discipline of the bank from the law of corporations and the insolvency law. In a contribution published when the BRRD and the bail-in had just entered into force, it was authoritative observed that bail-in is 'a game changer and a cornerstone of the Banking Union' and that this any new regulatory tool 'will prove its utility only in real life and in the course of time'.[108] More than two years on it is possible to already affirm that the bail-in has been a disappointing experience and the empirical cases examine may confirm the assumption.

A final and provocative idea is to close one's eyes and to imagine, for a few minutes, what would have happened if, during the dramatic nights of October 2008, the Royal Bank of Scotland had not been rescued by the British Government. Perhaps an astute novelist, such as Frederick Forsyth, would have narrated that major banks would suffer from the contagion and a widespread chain reaction of bank insolvency proceedings would ensue. Nonetheless, the market would have restarted according to its usual dynamics, even stronger than before and with a new mission, something that after 10 years is still difficult to see in Europe. In other words, in the rhetoric of the post-financial crisis, it is suggested that bail-outs have saved the world. However, this probably ignores the fact that not only has the economy failed to get better, but that also it is now even worse, given the lack of clarity of the new caliginous, contradictory, 'non-legal' and technocratic rules of the BRRD, particularly those in the area of the bail-in tool. In Florence and Venice, during the Renaissance, and even prior to that during the Middle Ages, bankers used to fail quite frequently, and failure was symbolised by the act of the court officer breaking the desk. This conduct was defined in the Italian spoken in these cities as '*rompere il banco*', or '*banco rotto*', from where we get the English term 'bankruptcy'. Florence and Venice were opulent cities, the wealthiest at that time, and yet even along their streets bankers used to be subject to insolvency from time to time. Perhaps, six centuries on, that same spirit needs be rekindled along the streets of contemporary Europe.

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[107] This aspect is emphasised by Karl-Philipp Wojcik, *Bail-in in the Banking Union* 53 Common Market Law Review 138 (2016).

[108] Karl-Philipp Wojcik, *Bail-in in the Banking Union* 53 Common Market Law Review 138 (2016).

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