

THE (IL-)LEGITIMACY OF THE EU POST-CRISIS BAILOUT SYSTEM

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ABSTRACT

Despite the strong political rhetoric against taxpayer-funded bailouts, in reality the government will always intervene when the distributional effects of a pre-determined loss allocation regime are deemed to be unacceptable. A number of commentators have argued for the development of a structured bailout framework that ensures the political legitimacy and efficiency of bailouts whilst minimizing their potentially harmful effects. The Treasury Report to the President on Orderly Liquidation Authority (OLA) and Bankruptcy Reform embraces a similar approach. Unlike OLA, the EU post-crisis bailout system has already been tested. This system consists of three elements: the BRRD/SRM resolution framework reflecting the post-crisis reform effort; national corporate insolvency law as the default option; and the overarching and non-sectorial EU State aid regime. Combining system analysis and the concept of regulatory legitimacy, this article examines the complex trifurcated EU post-crisis bailout system. Its central claim is that the current system calibration invites bailout decisions that are lacking in legitimacy because the system is unlikely to produce outputs that match the system's goal of limiting bailouts to those that are likely to be 'pie-increasing' and desirable. These shortcomings should be addressed primarily through recalibrating interconnections in a way that would elevate the BRRD/SRM resolution framework's status and transform it into the EU's Bank Resolution and Insolvency Code with national corporate insolvency law and the EU State aid regime resigned to supporting roles within the resolution framework. The modification of system elements, notably through the appropriate setting of MREL, could further enhance overall output legitimacy.

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INTRODUCTION: THE TRIFURCATED EU BAILOUT SYSTEM

At the height of the Global Financial Crisis, an unprecedented amount of resources was mobilized in order to stabilize financial institutions and markets.¹ Politically, these bank bailouts were extremely unpopular and lawmakers reacted by introducing regulatory frameworks with a view to making future bank bailouts less likely. At the international level, efforts have been coordinated through the G20 and the Financial Stability Board (FSB), culminating in the FSB's *Key Attributes of Effective Resolution Regimes*.² One of the clearest expressions of the underlying anti-bailout philosophy can be found in the Preamble to the Dodd-Frank Act, which presents itself as an "Act . . . to end 'too big to fail' [and] to protect the American taxpayer by ending bailouts."³ When he signed Dodd-Frank into law, President Obama remarked: "There will be no more tax-funded bailouts."⁴ And more recently, President Trump's "Core Principles" to guide reform of the U.S. financial regulatory system include the prevention of taxpayer-funded bailouts and moral hazard.⁵ Despite this strong political rhetoric, it is generally accepted that future bailouts are inevitable. The government can and will intervene where the distributional effects of a pre-determined loss allocation regime are deemed to be politically and/or socio-economically unacceptable.⁶ A number of U.S. commentators have therefore argued for the development of a structured bailout framework that ensures the political legitimacy and efficiency of bailouts whilst minimizing their potentially harmful effects.⁷ The Treasury Report to the President

¹ See *infra* Part III.

² See FINANCIAL STABILITY BOARD [FSB], *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 15, 2014), http://www.financialstabilityboard.org/2014/10/r_141015/.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010).

⁴ Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010, DAILY COMP. PRES. DOC. 617 (July 21, 2010).

⁵ Exec. Order No. 13772, 82 Fed. Reg. 9965 (Feb. 3, 2017).

⁶ See Christos Hadjiemmanuil, *Bank Stakeholders' Mandatory Contribution to Resolution Financing: Principle and Ambiguities of Bail-In*, in ECB LEGAL CONFERENCE 2015: FROM MONETARY UNION TO BANKING UNION, ON THE WAY TO CAPITAL MARKETS UNION, NEW OPPORTUNITIES FOR EUROPEAN INTEGRATION 225, 245 (Eur. Cent. Bank ed., 2015) [hereinafter *Bank Stakeholders*] ("Bailouts may become more rare than in the past, but there will still be concrete situations when they will appear to constitute the best available solution.").

⁷ See Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 514 (2011) ("Bailouts . . . are the proper response to systemic crises, but they must be conducted in transparent, politically accountable ways to ensure public legitimacy, which is essential for their ultimate efficacy."); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349, 1349 (2011) ("[T]he key to legitimizing future bailouts and limiting moral hazard is to institutionalize a long-term investment-oriented approach that delineates clear contours and conditions for aid."); Eric A. Posner & Anthony Casey, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 485 (2015) (arguing bailouts should "be efficient in a broad sense," and it can be assumed bailouts "will be politically legitimate if they are consistent with principles that tend to ensure efficiency or good public policy"); Robert K. Rasmussen & David A. Skeel, Jr., *Governmental Intervention in an Economic Crisis*, 19 U. PA. J. BUS. L. 7, 24, 30 (2016) (advocating for a bailout framework that increases "transparency" and articulates "a reason for the intervention" in order to achieve political accountability and legitimacy). For an early systematic analysis of bailouts, see Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951 (1992) [hereinafter Block (1992)]; and later Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149 (2010) [hereinafter Block (2010)].

on *Orderly Liquidation Authority and Bankruptcy Reform*⁸ follows a similar trajectory. It advocates for the introduction of a new chapter to the Bankruptcy Code, chapter 14, which would be geared specifically to the resolution of financial companies. In accordance with research proposals from the Hoover Institution⁹ and a number of legislative proposals,¹⁰ this reformed bankruptcy process would be the resolution method of first resort without "a single dollar of taxpayer support" required.¹¹ Dodd-Frank's Orderly Resolution Authority (OLA) should be retained as "an emergency tool for use under extraordinary circumstances"¹² and subject to significant limitations and reform. Notably, the protections against taxpayer loss exposure from uncovered Orderly Resolution Fund (OLF) loans should be enhanced so as to reduce any remaining risk to the greatest possible extent and to incentivize institutions to swiftly return to private funding. Whether any of these measures will eventually be implemented remains to be seen. However, they certainly highlight the need for a discussion about a bailout framework that goes beyond a mere *ad hoc* injection of funds into ailing firms and markets, and which is at the same time flexible enough to withstand a major systemic crisis.

Unlike OLA in the U.S., the EU post-crisis bailout system has already been tested. The EU's non-sectorial structured bailout framework predates the Global Financial Crisis by many decades.¹³ Under the EU State aid regime, "aid" is forbidden to the extent that it restricts competition and has an effect on trade between Member States. The Commission may, however, authorize certain types of aid if they fall within specified exemptions provided for under the Treaty on the Functioning of the European Union (TFEU). Member States must notify the Commission of any envisaged aid measures, and, following notification, the Commission must assess the respective measures in terms of their compatibility with the Treaty.¹⁴ The Treaty provisions on State aid are very rudimentary, conferring on the Commission a broad discretion for developing substantive State aid policy through formal rule-making or informal guidelines. The EU State aid rules apply, in principle, to all industries and sectors, and were not developed for

⁸ See U.S. DEP'T OF TREASURY, REPORT TO THE PRESIDENT OF THE UNITED STATES PURSUANT TO THE PRESIDENTIAL MEMORANDUM ISSUED APRIL 21, 2017: ORDERLY LIQUIDATION AUTHORITY AND BANKRUPTCY REFORM (2018) [hereinafter REPORT].

⁹ See Emily Kapur, *The Next Lehman Bankruptcy*, in MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL," 175, 241 (Kenneth E. Scott, Thomas H. Jackson & John B. Taylor eds., 2015) (stating chapter 14 reinstitutes bankruptcy as the primary legal procedure for failing corporations).

¹⁰ See Taxpayer Protection and Responsible Resolution Act, S.1861, 113th Cong. (2013); Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014) (as passed by the House Dec. 1, 2014); Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017) (as passed by the House Apr. 5, 2017); Financial CHOICE Act of 2017, H.R. 10, 115th Congress (2017) (as passed by the House June 8, 2017).

¹¹ See REPORT, *supra* note 8, at 3.

¹² *Id.* at 2. An outright repeal of OLA seems to be no longer on the agenda. See Jens-Hinrich Binder, Michael Krimminger, Matia J. Nieto and Dalvinder Singh, *The Choice Between Judicial and Administrative Sanctioned Procedures to Manage Liquidation of Banks: A Transatlantic Perspective*, 8–9 (Sept. 5, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244334.

¹³ See Alberto Heimler & Frédéric Jenny, *The limitations of European Union control of state aid*, 28 OXFORD REV. ECON. POL. 347, 351–52 (2012).

¹⁴ Consolidated Version of the Treaty on the Functioning of the European Union arts. 107–08, Mar. 25, 1957, 2012 O.J. (C 326) 91–92 [hereinafter TFEU].

handling EU-wide financial crisis scenarios.¹⁵ During the Crisis, it was even briefly considered to suspend the application of State aid rules altogether.¹⁶ However, with a very flexible and pragmatic approach, initially provisionally approving virtually all proposed aid measures, the Commission was able to play a critical role not only in facilitating the cross-border coordination of bailout interventions, but also in designing individual rescue measures envisaged by Member States.¹⁷ As Commissioner Almunia stated, on the basis of the State aid rules, the Commission had become the "de facto crisis-management and resolution authority at EU level."¹⁸

Since the heydays of the global financial crisis, the regulatory landscape has changed significantly. In accordance with the FSB's *Key Attributes*, the Bank Recovery and Resolution Directive (BRRD)¹⁹ has established a framework for the recovery and resolution of credit institutions and investment firms²⁰ ("institutions" or "financial institutions") that provides national resolution authorities with an arsenal of extensive resolution tools and powers, as well as funding resources through national resolution financing arrangements.²¹ As part of the Euro-zone

¹⁵ See Damien M.B. Gerard, *Managing The Financial Crisis In Europe: The Role Of EU State Aid Law Enforcement*, in COMPETITION LAW AT TIMES OF ECONOMIC CRISIS – IN NEED FOR ADJUSTMENT? 231, 234 (Massimo Merola, Jacques Derenne & José Rivas eds., 2013).

¹⁶ See JUAN JORGE PIERNAS LÓPEZ, THE CONCEPT OF STATE AID UNDER EU LAW: FROM INTERNAL MARKET TO COMPETITION AND BEYOND 221–22 (2015); Heimler & Jenny, *supra* note 13, at 362.

¹⁷ See Gerard, *supra* note 15.

¹⁸ Joaquín Almunia, Vice President, European Comm'n responsible for Competition Policy, Speech: Banking Crisis, financial stability and State aid: The experience so far (Mar. 8, 2013) (transcript available at http://europa.eu/rapid/press-release_SPEECH-13-223_en.htm).

¹⁹ See Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. (L 173) 190 [hereinafter BRRD].

²⁰ Art. 1(1) of the BRRD delineates its subject matter and scope which is identical to that of the CRD IV Regime (Regulation (EU) No 575/2013 and Directive 2013/36/EU). Accordingly, the recovery and resolution regime applies to credit institutions and investment firms established in the Union. Credit institutions are essentially deposit taking institutions, including commercial banks and universal banks. Investment firms are firms whose regular business consists of the provision of investment services to third parties and/or the performance of investment activities on a professional basis, provided they are subject to an initial minimum capital requirement of EUR 730,000 (so called 730k investment firms). Thus, the regime is applicable to individual deposit taking institutions and (730k) securities firms within a holding company structure, as well as to the credit institution or investment firm parent and its individual deposit taking and (730k) securities subsidiaries. The BRRD applies further to:

[F]inancial holding companies, mixed financial holding companies and mixed-activity holding companies that are established in the Union; parent financial holding companies in a Member State, Union parent financial holding companies, parent mixed financial holding companies in a Member State, Union parent mixed financial holding companies; branches of institutions [and investment firms] that are established outside the Union in accordance with the specific conditions laid down in this Directive.

Id. art. 1(1), at 211. The scope of the Directive is not limited to systemically important institutions; in principle, its regime applies to all covered institutions regardless of their size. *See id.*

²¹ The provisions of the BRRD have been effective since January 1, 2015, with the exception of the bail-in tool which had to be implemented by, and applied from, January 1, 2016 the latest. *See BRRD, supra* note 19, art. 130.

Banking Union, the Single Resolution Mechanism (SRM)²² adopts the BRRD resolution regime, but concentrates decision-making power in a Single Resolution Board,²³ as the Euro-zone's integrated resolution authority. Whereas the BRRD applies across the EU (and EEA) and requires implementation based on minimum harmonization, the SRM is based on a directly applicable maximum harmonization measure in the form of an EU regulation, but applies to Euro-zone countries only.²⁴ Under BRRD and SRM, the application of resolution tools and powers is conceptualized as an alternative and exception to resolving a failing institution through "normal insolvency proceedings."²⁵ Similar to the relationship between OLA and the Bankruptcy Code, where the conditions for resolution are not satisfied, "normal insolvency proceedings" apply as the default option for dealing with distressed financial firms. However, regardless of whether a failing institution is resolved through the BRRD/SRM resolution regime or under national standard insolvency law, any mobilization of financial resources that meets the definition of "aid" will be subject to the EU State aid framework.

Thus, what emerges is a complex trifurcated system of bailout regimes at the EU level.²⁶ A financial institution that does not meet the conditions for resolution

²² Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010, 2014 O.J. (L 225) 1, 1 [hereinafter SRMR].

²³ The SRB has been operational since January 1, 2015, the substantive provisions of the SRM have been applicable from January 1, 2016, and the operational provisions have been effective from earlier dates. See *id.* art. 99.

²⁴ The remit of the SRB's responsibility within the SRM is linked to the scope of the ECB's competencies under the Single Supervisory Mechanism. Accordingly, the SRB is responsible for the resolution of credit institutions subject to direct ECB supervision established in a participating Member State, that is, either a Member State whose currency is the Euro or a Member State whose currency is not the Euro which has established a close cooperation in accordance with Art. 7 of Regulation (EU) No 1024/2013. It further applies to parent undertakings, including financial holding companies and mixed financial holding companies, established in a participating Member State, provided they are subject to consolidated supervision carried out by the ECB, as well as investment firms and financial institutions established in a participating Member State, where they are covered by the consolidated supervision of the parent undertaking carried out by the ECB. National resolution authorities are responsible for the resolution of other financial institutions within the scope of the SRM.

²⁵ See BRRD, *supra* note 19, art. 32(1)(c), (5); SRMR, *supra* note 22, art 18(1)(c), (5).

"Normal insolvency proceedings" means collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person.

BRRD, *supra* note 19, art 2(1)(47).

²⁶ This is, of course, a simplification. There are currently at least twenty-eight (including the UK, which is due to leave the EU in 2020; or thirty-one within the EEA) different national corporate insolvency laws that apply in accordance with the "home Member State" principle. Under the latter, where an institution has obtained authorization (its "banking license") determines the applicable resolution and insolvency law. Each national corporate insolvency law may provide a number of different procedures, which may be judicial, administrative or of a hybrid nature. For example, an institution that has obtained its banking license in Germany may be resolved through the following procedures: (i) German corporate insolvency law which consists of the standard insolvency procedure pursuant to the *Insolvenzordnung* (InsO), modified for financial institutions by the *Kreditwesengesetz* (KWG); in addition to liquidation, the standard insolvency procedure allows for modifications in the form of the insolvency plan procedure and the process of self-administration, which may be combined. Further, a special act, the *KredReorgG*, provides specifically for financial institutions a separate "restoration procedure" and a "reorganization procedure;" (ii) If the

under BRRD/SRM may be resolved under the applicable national corporate insolvency law, which may entail the granting of State aid in which case notification to and approval of the aid by the Commission will be required. The resolution of an institution under BRRD/SRM may require the granting and approval of State aid at various stages: fund aid through the resolution financing arrangements, State aid that goes beyond the fund aid limit, aid granted through government financial stabilization tools, and Direct Bank Recapitalization through the European Stability Mechanism (ESM). Finally, in certain scenarios the possibility of granting State aid outside the BRRD/SRM resolution framework or national corporate insolvency law remains. Thus, corporate insolvency law, the BRRD/SRM resolution framework and the EU State aid regime form a complex law-related system²⁷ for dealing with failing financial firms. These elements do not coexist as isolated silos, but are more akin to a system of communicating vessels, with a multitude of interactions and interdependencies.²⁸

Combining system analysis²⁹ and the concept of regulatory legitimacy, this article comprehensively examines the EU post-crisis bank bailout system. Its central claim is that the current system calibration invites bailout decisions that are lacking in legitimacy because the system is unlikely to produce outputs that match the system's purpose of limiting bailouts to those that are likely to be "pie-increasing" and desirable. These shortcomings should be addressed primarily through re-calibrating interconnections in a way that would transform the

institution is a credit institution it will be subject to the SRM, so that its resolution will be governed by the directly applicable SRM Regulation as well as the German law implementing the BRRD, that is the *Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen* (SAG), provided resolution is in the public interest (as defined). To further complicate matters, the BRRD gives Member States a wide range of transposition options resulting in significant national divergences. See IMF, *Euro Area Policies Financial Sector Assessment Program Technical Note – Bank Resolution and Crisis Management*, IMF Country Report 18/232, ¶ 23 at 20, 44 (July 2018) [hereinafter IMF]. If the institution is under direct ECB supervision, it will be within the remit of the SRB as resolution authority; (iii) Finally, there is the EU State aid regime which may apply in combination with (i) or (ii), and in certain limited circumstances may apply on its own. A further dimension is added, in Member States like Italy and Germany, by the presence of private (non-statutory) deposit insurance funds with a mandate that goes beyond the harmonized "pay-box" function pursuant to Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, 2016 O.J. (L 173) 149. Such funds, perhaps in the form of Institutional Protection Schemes, may rescue failing institutions through capital injections, guarantees or other measure, thereby providing a credible alternative to resolution and avoiding grounds for opening insolvency proceedings. See ANNA GELPERN AND NICOLAS VÉRON, AN EFFECTIVE REGIME FOR NON-VIABLE BANKS: US EXPERIENCE AND CONSIDERATIONS FOR EU REFORM STUDY REQUESTED BY THE ECON COMMITTEE 39–42 (2019). Any financial assistance granted by such funds may or may not be subject to the EU State aid regime, depending on the level of interference and input of public authorities in a rescue attempt. See Joined Cases T-98/16, T-196/16 & T-198/16, Italian Republic et al. v. European Commission, E.C.R. 167.

²⁷ In system analysis, a system may be defined as "an interconnected set of elements that is coherently organized in a way that achieves something." DONELLA H. MEADOWS, THINKING IN SYSTEMS – A PRIMER 11 (Diana Wright ed., 2009). Thus, a system consists of "*elements, interconnections and a function or purpose*." *Id.* (emphasis in original). The EU bailout system constitutes a concrete "law-related" system: It exists in physical space-time with real people and physical objects the interactions of which are to no small extent determined by formal law. See Lynn LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 488 (1997) (explaining the notion of a concrete law-related system).

²⁸ In a set of interlinked vessels, a homogenous fluid will always settle at the same level in each vessel, regardless of the shape or volume of individual vessels. This is because gravity and pressure are constant in each vessel.

²⁹ According to LoPucki, "[t]o 'analyze' a system is to break it down into its constituent parts, to determine the nature and identity of its subsystems, and to explain the relationships among them." LoPucki, *supra* note 27, at 482–83.

BRRD/SRM resolution framework into the EU's Bank Resolution and Insolvency Code, similar to the legal framework of FDIC receiverships for deposit taking institutions in the U.S. The BRRD/SRM resolution framework would no longer be (just) an alternative to national insolvency law as the default option; it would be the only show in town with national corporate insolvency laws and the EU State aid regime resigned to supporting roles within the resolution framework. The modification of system elements, notably through the setting of appropriate levels of MREL, may facilitate overall goal attainment capacity. Part I seeks to elucidate the notion of "bailout" as a non-technical term of limited precision, in contradistinction to the legal concept of "State aid" in EU law, which has been fleshed out on the basis of extensive case law. In Part II the complex notion of regulatory "legitimacy" is introduced as a suitable standard of assessment for a law-related system. The twin aspects of "input legitimacy" and "output legitimacy" are here multidimensional: input legitimacy can be assessed in respect of both "system setup" and "system design;" output legitimacy relates to both the individual system elements as well as the system overall. The output legitimacy of the system overall will be the focus of the analysis. It is determined by the effective and efficient attainment of the overall system purpose, which is mandated by international standard setters: to limit bailouts to those that are welfare enhancing and desirable (pie-increasing). A bailout system is likely to facilitate pie-increasing bailouts if the eligibility criteria and intra-system interactions are calibrated in such a way that the social benefits of a bailout are likely to exceed its social costs. The social costs of bailouts may be kept in check through appropriate cost reduction mechanisms, in particular, in the form of loss allocation and burden sharing rules. Part III maps the different bailout cost reduction mechanism under standard corporate insolvency law, the BRRD/SRM resolution framework and the State aid regime. Whereas standard corporate insolvency law provides the most stringent burden sharing mechanism, the State aid framework is the most lenient, with BRRD/SRM as a compromise arrangement in-between. Part IV critically evaluates the eligibility criteria for each system element and the intra-system interactions. On the basis of the first cases resolved under the new system, it demonstrates that the overall framework appears to be flawed. It invites bailouts that are unlikely to be pie-increasing and may even be used to defeat the entire purpose of the post-crisis resolution framework. The Conclusion provides suggestions for improving the system's goal attainment capacity.

I. TERMINOLOGY: BAILOUT *VERSUS* STATE AID

"Bailout" is not a technical term and is often used in a somewhat fuzzy way. The elaboration of a commonly accepted definition is impaired by the great variety that government interventions in the financial sector (and beyond) may take. As a first general categorization, these measures may be divided into liquidity assistance and solvency assistance.³⁰ The former is ideally aimed at institutions with healthy

³⁰ See Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 483–84 (2010); Posner & Casey, *supra* note 7, at 522–23; Christos Hadjiemmanuil, *Limits on State-Funded Bailouts in the EU Bank Resolution Regime*, 2 EUROPEAN ECONOMY 91, 95 (2016) [hereinafter *State-Funded Bailouts*].

balance sheets that suffer a temporary liquidity shortage.³¹ Liquidity assistance may take the form of (short term) lending by central banks to institutions by way of monetary operations or on an individual basis through emergency liquidity assistance, or governments may provide state guarantees to central banks for their refinancing exposures, and/or may guarantee newly issued debt of institutions so as to facilitate access to credit markets, and/or may lend to institutions directly on a temporary basis.³² By contrast, solvency assistance seeks to restore the balance sheet of an institution that has sustained a capital shortfall. This may require a recapitalization through the purchase by the government of capital instruments in the form of equity, hybrid instruments, or subordinated debt. In addition, or alternatively, governments may directly or indirectly assume the risk associated with impaired (non-performing) assets.³³ These may be removed from a bank's balance sheet in exchange for consideration and parked in a government sponsored asset management vehicle, a so-called "bad bank," to be wound down as markets improve. Alternatively, the government may "guarantee" asset values by entering into loss sharing arrangements under which losses incurred by the institution on an asset portfolio exceeding a certain threshold would be covered by the State. As a last resort, an institution may be nationalized, which involves the expropriation of its owners/shareholders and the assumption by the government of operating losses.³⁴ Although conceptually clearly differentiated, in practical terms, illiquidity and insolvency are linked and closely interdependent; given that assessment will often be a matter of subjective judgment, both concepts will often be indistinguishable, particularly in a crisis scenario.³⁵

As a second categorization, State interventions may be distinguished in accordance with the sources of funding. These may be the central bank, general

³¹ The classic exposition is WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 53 (Kegan Paul, Trench, Trübner & Co. 1904) (1873) ("A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it. The holders of the cash reserve must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. They must lend to merchants, to minor bankers, to 'this man and that man,' whenever the security is good. In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them."). See also PAUL TUCKER, *The Lender of Last Resort: Regimes for Stability and Legitimacy*, in RESEARCH HANDBOOK ON CENTRAL BANKING 535, 536–37 (Peter Conti-Brown & Rosa Maria Lastra eds., 2018).

³² See *State-Funded Bailouts*, *supra* note 30, at 96.

³³ See *id.*

³⁴ See Gerard Hertig, *Governments as Investors of Last Resort: Comparative Credit Crisis Case-Studies*, 13 THEORETICAL INQUIRIES IN LAW 385, 388–90 (2012); Ana Petrovic & Ralf Tutsch, *National Rescue Measures in Response to the Current Financial Crisis*, (Eur. Cent. Bank. Legal Working Paper Series No. 8, July 2009), <https://www.ecb.europa.eu/pub/pdf/scplps/ecblwp8.pdf?23b81a456ecb550cfd1b693d4f10685>.

³⁵ See Wolf-Georg Ringe, *Bail-in between Liquidity and Solvency*, 22–23 (Univ. of Oxford Legal Research Paper No. 33/2016, Jan. 2017); Martin Hellwig, *Precautionary Recapitalization: Time for Review*, ¶ 3.3, EUR. PARL. IN-DEPTH ANALYSIS (July 2017), [http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602089/IPOL_IDA\(2017\)602089_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602089/IPOL_IDA(2017)602089_EN.pdf) ("Greek banks passed the comprehensive assessment in 2014 without problems, were considered to be solvent until June 2015, were considered to be insolvent in early July 2015, and were considered solvent again a few month later . . . Banca Popolare di Vicenza and Veneto Banca were treated as solvent, merely in need of a precautionary recapitalization in one week and then as likely to fail and due to be wound down the next week."); TUCKER, *supra* note 31, at 545 ("The future is uncertain. Economic and financial conditions can turn out better or worse than expected. For that reason alone, a firm might reasonably be judged solvent at the point at which a loan is granted but later become insolvent . . . [A] solvency judgment is inherently probabilistic.").

government revenue, or standing bailout funds. Acting as the lender of last resort, central banks extend (emergency) liquidity facilities to member banks in exchange for high quality collateral and a penal interest rate.³⁶ The central bank can freely create liquidity by lending to its member banks.³⁷ This increases the money supply and carries the risk of inflation, which may be addressed through offsetting measures, such as the simultaneous sale of securities or the supply of highly liquid government bonds instead of reserves.³⁸ Where the recipient is solvent, the loan will be repaid and there will be no cost for the government or the taxpayer.³⁹ Should the recipient default, however, the government accounts will be affected indirectly: Central banks distribute part of their profits to the government and reduced profits may result in a larger government deficit.⁴⁰ The latter ensues where spending outflows exceed the inflow of collected taxes into the government's general account. The difference will be made up through government borrowing in the form of government bonds issued through the money markets.⁴¹ Bank bailouts drawing on general government revenue frequently result in a significant increase in public debt and higher interest payments. In the course of the implementation of the BRRD and the SRM, bailout funds have been established in the form of national financing arrangements and the Euro-zone Single Resolution Fund (SRF). Financed, in principle, through risk-calibrated *ex ante* contributions of financial institutions, these funds may be used to ensure the effective application of resolution tools and powers and to absorb losses to a limited extent.⁴² In the end, however, bailout funds are always backed by an implicit State guarantee and the government will step in, drawing on its general revenue, should the funds turn out to be insufficient. This will remain true even under current plans according to which the European Stability Mechanism (ESM)⁴³ will provide a common backstop

³⁶ JOSH RYAN-COLLINS, TONY GREENHAM, RICHARD WERNER & ANDREW JACKSON, WHERE DOES MONEY COME FROM? 79–80 (2012).

³⁷ *Id.* at 67, 103.

³⁸ See Block (2010), *supra* note 7, at 181.

³⁹ See Posner & Casey, *supra* note 7, at 522.

⁴⁰ See Block (2010), *supra* note 7, at 183–85. Under the European System of Central Banks (ESCB), the provision of Emergency Liquidity Assistance (ELA) is the responsibility of the relevant national central bank who will incur the costs and risk associated with the granting of ELA, unless the relevant government acts as guarantor. See European Central Bank [ECB], *Agreement on Emergency Liquidity Assistance*, ¶ 2 (May 17, 2017), https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf?23bb6a68e85e0715839088d0a23011db; European Central Bank [ECB], *Convergence Report*, 27 (May 2018) ("Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created."); TUCKER, *supra* note 31, at 539 ("A central bank will cover its losses by writing down its capital or by paying less seigniorage over to the government. Either way, that simply transfers the costs to government. Ultimately, losses are a fiscal issue. They must be covered by higher taxation (or lower public spending) or by higher seigniorage, ie, resorting to inflation as a tax.").

⁴¹ See RYAN-COLLINS ET AL., *supra* note 36, at 122.

⁴² See *infra* Part II(C) and III(B).

⁴³ The ESM is an international institution under public international law, established for the purpose of providing funding and stability support for the benefit of ESM members, currently all Euro-zone countries, experiencing severe financing problems. See MICHAEL SCHILLIG, RESOLUTION AND INSOLVENCY OF BANKS AND FINANCIAL INSTITUTIONS, ¶ 12.68, at 347–48 (2016).

to the SRF in the form of a revolving credit line.⁴⁴ The ESM is ultimately funded by its members, currently all Euro-zone Member States.⁴⁵

The various bailout definitions that have been suggested in the literature cover these measures more or less comprehensively (and are not necessarily limited to financial sector bailouts). In an early attempt at developing a systematic bailout policy, Cheryl Block has defined "bailout" as "a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure."⁴⁶ The focus on firm failure and its prevention distinguishes a bailout from general subsidies, which are geared towards the achievement of broader policy or regulatory rationales through incentivizing a certain desired behavior or activity.⁴⁷ A stimulus, by contrast, is a form of subsidy that "tends to be forward looking, designed to spark economic growth or redevelopment."⁴⁸ Subsequent definitions can be divided into two groups. First, there are those that focus on the assumption by the government of the losses or risks of private enterprise. According to Anabtawi and Schwarcz, a bailout entails the allocation by the government of the losses of an illiquid or insolvent firm to itself;⁴⁹ for Levitin, a bailout is the government's allocation of a failed firm's losses to itself;⁵⁰ and Manns views bailouts as investments in private companies to provide liquidity and stability during financial crisis, which entails the government's assumption of risk.⁵¹ On the other hand, there are those who focus on the protection from losses of private enterprise through government intervention. According to Posner and Casey, a "bailout occurs when the government makes payments (including loans, loan guarantees, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors and counterparties, when the agent is not entitled to those payments under a statutory scheme."⁵² For Rasmussen and Skeel, a bailout is government funding that "protects creditors or shareholders from losses that they would otherwise suffer . . . regardless of whether the government actually loses any money in the effort."⁵³ This second category is more inclusive, as it covers interventions regardless of whether the government suffers any losses or assumes any risks itself. It seems preferable because moral hazard may ensue and market discipline may be impaired as soon as market participants can expect to be protected from losses; whether any of these losses will end up with the State and taxpayer is immaterial. All these definitions are merely descriptive and carry no normative force.

⁴⁴ As agreed by the heads of state and government of the Euro-zone countries at the Euro Summit on December 4, 2018. See *Term Sheet on the European Stability Mechanism reform* (Dec. 4, 2018), https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf.

⁴⁵ SCHILLIG, *supra* note 43, ¶ 12.70 at 348 (explaining the ESM receives funding through issuance of stock to the Member states, and the ESM is also able to issue other financial instruments and enter into financial arrangements).

⁴⁶ Block (1992), *supra* note 7, at 960.

⁴⁷ See *id.* at 956.

⁴⁸ Block (2010), *supra* note 7, at 160.

⁴⁹ See Iman Anabtawi & Steven L. Schwarcz, *Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure*, 92 TEXAS L. REV. 75, 103 (2013).

⁵⁰ See Levitin, *supra* note 7, at 439.

⁵¹ See Manns, *supra* note 7, at 1358.

⁵² Posner & Casey, *supra* note 7, at 481.

⁵³ Rasmussen & Skeel, Jr., *supra* note 7, at 10.

By contrast, the EU law notion of "State aid" is a technical term with a defined legal meaning. A national measure amounts to "State aid" if it cumulatively meets four conditions: "First, there must be an intervention by the State or through State resources. Second, the intervention must be liable to affect trade between Member States. Third, it must confer an advantage on the recipient. Fourth, it must distort or threaten to distort competition."⁵⁴ The advantage conferred must be "such as to favour 'certain undertakings or the production of certain goods' over others which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question."⁵⁵ These elements are complex and all of them are highly contested.⁵⁶ The notions of "State aid" and "bailout" do not perfectly overlap. State guarantees and loans granted to ailing financial institutions, impaired asset measures and recapitalizations are typical bailouts and also amount to (possibly Treaty-conform) State aid. However, according to Commission practice, central bank liquidate facilities that are collateralized and charge a penal interest rate do not amount to State aid, provided the beneficiary is solvent.⁵⁷ The Commission justifies this analysis with a lack of selectivity "where a central bank reacts to a banking crisis with general measures open to all comparable market players . . . rather than with selective measures in favour of individual banks."⁵⁸ Although this does not seem to be in line with established case law pursuant to which measures to an entire sector can be selective,⁵⁹ it may perhaps be justified on the basis that only banks maintain reserve accounts with central banks and are therefore factually in a special situation.⁶⁰ It may also be argued that the creation of central bank reserves cost nothing⁶¹ and does not amount to an effective burden on the State (and is therefore not "granted by the State or through State resources"). However, central bank facilities clearly shield the recipient's counterparties from losses that they would otherwise have to bear and therefore would presumably amount to bailouts under those definitions that focus on the neutralization of investors' losses.⁶² On the other hand, general subsidies—measures that pursue certain industrial⁶³ or environmental⁶⁴ policy goals regardless of any losses incurred

⁵⁴ Case C-280/00, *Altmark Trans GmbH v. Nahverkehrsgesellschaft Altmark GmbH*, 2003 E.C.R. I-7810, ¶ 75.

⁵⁵ Case C-409/00, *Spain v. Commission*, E.C.R. I-1521, ¶ 47.

⁵⁶ See Andrea Biondi, *State Aid is Falling Down, Falling Down: An Analysis of the Case Law on the Notion of Aid*, 50 C.M.L. REV. 1719, 1719 (2013) (discussing the notion of State aid).

⁵⁷ See Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), 2013 O.J. (C 216) 1, 11–12 [hereinafter *Banking Communication*] (discussing what falls within the scope of state aid rules and listing certain conditions, that if met, would not constitute aid).

⁵⁸ Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, 2016 O.J. (C 262) 1, 11 n.71.

⁵⁹ See generally *Joined Cases 6 & 11/69, Comm'n v. France*, 1969 E.C.R. 68; *Case 173/73, Italy v. Comm'n*, 1974 E.C.R. 71; *Case 241/94, France v. Comm'n*, 1996 E.C.R. 353; *Case 75/97, Belgium v. Comm'n*, 1888 E.C.R. 311.

⁶⁰ See Szymon Gebski, *Competition First? Application of State Aid Rules in the Banking Sector*, 6 COMPETITION L. REV. 89, 93 (2009).

⁶¹ RYAN-COLLINS ET AL., *supra* note 36, at 67.

⁶² Only Block is explicit about this. See *Block* (2010), *supra* note 7, at 174.

⁶³ See, e.g., *Case 88/03, Portugal v. Comm'n*, 2006 E.C.R. 511.

⁶⁴ See, e.g., *Case 487/06P, British Aggregates v. Comm'n*, 2008 E.C.R. 757, 88–91; *Case 379/98, Preussen Elektra AG v. Schleswig AG*, 2001 E.C.R. 160, 71–76.

by the beneficiaries—would not generally be regarded as bailouts, but are likely to amount to State aid.

II. REGULATORY LEGITIMACY AND LAW-RELATED SYSTEM ANALYSIS

To analyze the EU bailout system means breaking it down into its component parts as subsystems: national corporate insolvency law, the BRRD/SRM resolution framework, and the EU State aid regime; and to examine how these system elements relate to one another and contribute to the functioning of the system as a whole. The emphasis in system analysis is on interactions rather than on the system elements themselves, with a view to improving the system's functioning.⁶⁵ This requires a standard of assessment as to whether the system overall performs well and produces on average "good" results, even though individual outcomes may be questionable. In this respect, a law-related system may be assessed on the basis of its "legitimacy." In political science, "legitimacy" is a difficult concept and may, for present purposes, be defined as the acceptance by the public of "authoritative" decisions without having to be coerced even if in individual cases outcomes may violate (some) community members' normative preferences.⁶⁶ Democratic legitimacy almost exclusively rests on two types of normative arguments: "input legitimacy" and "output legitimacy."⁶⁷ The former relates to institutional arrangements that seek to ensure that governing processes are generally responsive to the normative preferences of the governed—its focus is essentially procedural. The latter is concerned with the adoption of effective solutions to common problems of the governed, focusing primarily on the substance of decision-making.⁶⁸ In democratic political systems, input legitimacy generally requires the direct or indirect participation of the governed in policy choices. However, financial regulation and supervision may require complex and sensitive decisions that can result in immediate and highly visible short term pain—e.g. the imposition of early intervention measures on a seemingly highly profitable institution; with any potential long term benefits only accruing over time.⁶⁹ In order to address the potential for political opportunism under these circumstances, in a regulatory context, direct political accountability will usually be substituted for independent regulatory bodies that have the necessary expertise and professional integrity, and can act with fairness, accountability, transparency and

⁶⁵ See LoPucki, *supra* note 27, at 487.

⁶⁶ See Fritz W. Scharpf, *Problem-Solving Effectiveness and Democratic Accountability in the EU*, 1–2 (MPIfG Working Paper, No. 03/1, 2003); TANJA A. BÖRZEL & DIANA PANKE, *Network Governance: Effective and Legitimate?*, in THEORIES OF DEMOCRATIC NETWORK GOVERNANCE 160 (Eva Sørensen & Jacob Torfing eds., 2008). See also MAX WEBER, *ECONOMY AND SOCIETY* I 31–38 (Guenther Roth & Claus Wittich eds., 1978).

⁶⁷ Recently, a third normative criterion has been added: "throughput legitimacy." Vivian Schmidt, *Democracy and Legitimacy in the European Union Revisited: Input, Output and 'Throughput'*, 61 POL. STUD. 2, 5–6 (2013). It focuses on the quality of interaction among the actors involved in the decision-making process. This procedural focus puts throughput legitimacy in close proximity to input legitimacy concerns, in particular in a regulatory context where both criteria would seem to be almost indistinguishable.

⁶⁸ See Scharpf, *supra* note 66, at 3.

⁶⁹ See Anat Keller, *Independence, Accountability and Transparency: Are the Conventional Accountability Mechanisms Suitable for the European Systemic Risk Board?*, 28 ICCLR 176, 181 (2017).

policy coherence.⁷⁰ Output legitimacy ensues when a policy decision serves the common good of the respective constituency. It derives from the capacity of a regulatory system to effectively solve common problems that cannot be sufficiently addressed through individual action, market exchanges, or voluntary cooperation in civil society.⁷¹ A regulatory system is effective in this sense if it produces results that solve problems and satisfy the demands it was designed to cope with ("goal attainment; problem-solving capacity") without delays or deadlocks and at reasonable cost ("efficiency").⁷² An assessment on this basis presupposes the identification of a common problem that the regulatory system is designed to solve and the definition of a system goal, the attainment of which benefits the relevant constituency as a whole; rather than merely certain narrow private interests.⁷³ An indication of a public interest serving policy choice is its "pie-enlarging" effect, as opposed to a merely zero-sum re-distribution of resources from one group to another. However, even an overall Kaldor-Hicks efficient decision may be suspect where the benefits disproportionately accrue to one societal group at the expense of another.⁷⁴

Generally, both input and output legitimacy arguments are relevant for sustaining the legitimacy of a regulatory system; although one cannot fully substitute the complete lack of the other, trade-offs are possible—reduced input legitimacy may be compensated for by enhanced output legitimacy and *vice versa*.⁷⁵ In particular, a regulatory system that is likely to produce results that increase overall welfare in society, i.e. is a positive-sum game, may be able to tolerate less than optimal input legitimacy parameters without compromising overall legitimacy.⁷⁶

Assessing the legitimacy of the EU bailout system on this basis is a multidimensional exercise. Input legitimacy is relevant, first, at the macro-level in respect of the system setup. The question here is whether the system itself as a policy choice can be justified on the basis of input legitimacy considerations. It is relevant, second, in respect of system design. The question here is whether input legitimacy arguments can be relied on to justify system outcomes. Output legitimacy may be assessed, first, at the level of the various system elements; and, second, at the level of the system overall.

⁷⁰ See GIANDOMENICO MAJONE, *Regulatory Legitimacy*, in REGULATING EUROPE 284, 285–86 (1996); Schmidt, *supra* note 67, at 14–15. It is not always clear, whether these considerations should be part of input or output legitimacy or form the separate category of throughout legitimacy. See *id.* at 14. Because of their procedural focus, input legitimacy seems to be the appropriate category.

⁷¹ See Scharpf, *supra* note 66, at 3–4; FRITZ W. SCHARPF, GOVERNING IN EUROPE: EFFECTIVE AND DEMOCRATIC? 11 (1999).

⁷² BÖRZEL & PANKE, *supra* note 66, at 157.

⁷³ See Jerry L. Marshaw, *Constitutional Deregulation: Notes Toward a Public, Public Law*, 54 TUL. L. REV. 849, 867 (1980).

⁷⁴ See Block (1992), *supra* note 7, at 1002 (explaining the Kaldor-Hicks analysis as the "maximize-net-benefits approach to social policy. Gains and losses in welfare are added up for all of society and whichever policy produces the largest net increase in total effective income is chosen").

⁷⁵ See Scharpf, *supra* note 66, at 4–6.

⁷⁶ See MAJONE, *supra* note 70, at 294 (defining "positive-sum game" as a solution to efficiency issues where everybody involved can gain).

A. Input Legitimacy I: System Setup

The input legitimacy of the system setup concerns the issue of whether the installation of the system through its constituting elements meets the normative requirements of participation and responsiveness, or, in the regulatory context, of independence, expertise, accountability, and transparency. A detailed analysis is rendered exceedingly complex by the emanation of the system elements from various constitutional orders and regulatory spheres.

At the EU level, (corporate) insolvency law regulation for financial institutions is limited to a conflict of laws instrument containing mainly rules on jurisdiction, the applicable law and the recognition and enforcement of foreign decisions. Directive 2001/24/EC on the reorganization and winding up of credit institutions and investment firms (DRWCI)⁷⁷ adopts a "universalist" approach: measures concerning the reorganization or winding up of an institution taken by the administrative or judicial authorities of its home Member States on the basis of the law of that Member State are automatically recognized by, and effective in, all other Member States.⁷⁸ Under the DRWCI, jurisdiction and applicable law are not based on the Centre of Main Interests (COMI) concept;⁷⁹ in accordance with the principle of home Member State supervision, the connecting factor is the authorization of the institution in its home Member State.⁸⁰ By contrast, substantive corporate insolvency law is a matter for individual Member States and remains fragmented.⁸¹ In its initial plan for establishing a legal framework for dealing with ailing financial institutions, the Commission also considered examining the need for further harmonization of bank insolvency regimes, with the aim of resolving and liquidating them under the same substantive and procedural rules.⁸² Thus far, the BRRD has only harmonized to a limited extent the order of priority under national law in both resolution and standard insolvency proceedings.⁸³

⁷⁷ Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions, 2001 O.J. (L 125) 15 [hereinafter DRWCI].

⁷⁸ See *id.* at 16.

⁷⁹ The recast European Insolvency Regulation, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), 2015 O.J. EU (L 141) 19, does not apply to credit institutions, investment firms, and other firms to the extent that they are covered by the DRWCI; EU IR art. 1(2). The DRWCI has been amended to bring its scope fully in line with the BRRD. See BRRD, *supra* note 19, art. 117.

⁸⁰ See DRWCI, *supra* note 77, arts. 3(1), 9(1).

⁸¹ Drawing on the experience with an earlier non-binding Recommendation and on national regimes that work well, Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), 2019 O.J. (L 172) 67, has recently been issued. The Directive does not apply to credit institutions and investment firms. As part of its Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral, the Commission has proposed an accelerated collateral enforcement procedure as an efficient out-of-court mechanism with a view to allowing mainly banks as secured creditors to more swiftly recover the collateral securing the repayment of non-performing loans. *Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral*, COM (2018) 135 final (Mar. 14, 2018).

⁸² *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank: An EU Framework for Crisis Management in the Financial Sector*, at 16, COM (2010) 579 final (Oct. 20, 2010).

⁸³ See *infra* Part III(A).

Consequently, Member States are currently free to apply their standard corporate insolvency law to financial institutions, or may devise a corporate insolvency law that is specific to financial institutions, which may be a court-centered judicial system, an administrative system, or a hybrid system combining elements of both.⁸⁴ A number of commentators and policy makers have recently highlighted the urgent need for harmonizing and perhaps unifying bank insolvency law in the banking union.⁸⁵

The BRRD provides the rulebook for bank resolution across the EU internal market. As a directive,⁸⁶ it is binding on the Member States, but in principle not within the Member States, which must implement it into national law with a view to achieving the intended result.⁸⁷ The BRRD is supported, and its provisions specified, by a range of "regulatory technical standards" and "implementing technical standards,"⁸⁸ as well as soft-law guidelines issued by the European Banking Authority (EBA). The SRM establishes, by way of a directly applicable regulation,⁸⁹ a framework that relies on a division of responsibilities between a central decision-making level, through the Single Resolution Board (SRB) in conjunction with the ECB, the Commission and the Council, and local

⁸⁴ See Binder et al., *supra* note 12, at 9–12; Patrizia Baudino et al., *How to manage failures of non-systemic banks? A review of country practices*, in FSI INSIGHTS ON POLICY IMPLEMENTATION NO 10 (2018).

⁸⁵ See Binder et al., *supra* note 12, at 3; Gelper & Véron, *supra* note 26, at 49; Agnès Bénassy-Quéré et al., *Reconciling risk sharing with market discipline: A constructive approach to euro area reform*, CENTRE FOR ECON. POL'Y RES. POL'Y INSIGHT NO. 91 at 6 (Jan. 2018); Fernando Restoy, *Bail-in in the new bank resolution framework: is there an issue with the middle class?*, Speech at the IADI-ERC Int'l Conference, 6 (Mar. 23, 2018) [hereinafter *Resolution Framework*] (transcript available at <https://www.bis.org/speeches/sp180323.htm>); Fernando Restoy, *How to improve crisis management in the banking union: a European FDIC?*, Speech at CIRS Annual Int'l Conference 5-8 (July 4, 2019); IMF, *supra* note 26, ¶ 26, 27; *Report from the European Commission to the European Parliament and the Council on the application and review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation)*, at 8–9, COM (2019) 213 final (2019); Maria J. Nieto, *Bank Resolution and Mutualization in the Euro Area*, EUR. ECON. 131, 152 (2016); Elke König, *Why we need an EU liquidation regime for banks*, EUROFI ARTICLE (2018), <https://srb.europa.eu/en/node/622>; Elke König, *Speech: Hearing at the ECON committee of the European Parliament – SRB Chair* (July 2, 2019) (transcript available at <https://srb.europa.eu/en/node/807>).

⁸⁶ See TFEU, *supra* note 14, art. 288.

⁸⁷ The BRRD is a minimum harmonization measure only and leaves some room for national deviations and adaptations. See also IMF, *supra* note 26, ¶ 23.

⁸⁸ The former are *delegated* acts that are technical in nature and do not imply any strategic decisions or policy choices; the latter are *implementing* acts that are also technical in nature and merely determine the conditions for the application of the directive. Generally, *delegated* acts are adopted by the Commission on the basis of a power delegated to it in a legislative act that specifies the objectives, content, scope and duration of the delegation of power. See TFEU, *supra* note 14, art. 290. *Delegated* acts are of general application, supplementing or amending certain non-essential elements of the legislative act; the essential elements of an area are reserved for the legislative act and are not subject to a delegation of power. *Implementing* acts are adopted by the Commission, on the basis of implementing powers conferred on it by either legislative or delegated acts, where uniform conditions for implementing legally binding Union acts are needed. See *id.* art. 291. *Implementing* acts execute legislative or delegated acts without amending or supplementing them, although in practice it may be difficult to determine whether this is the case or not. Any of these acts may take the form of a regulation, a directive or a decision. Regulatory technical standards and implementing technical standards are drafted by the relevant European Supervisory Authority (ESA) following public consultation and a cost-benefit analysis. The standards are then subject to endorsement by the Commission. See CARSTEN GERNER-BEUERLE & MICHAEL SCHILLIG, *COMPARATIVE COMPANY LAW* 91, 90–97 (Oxford Univ. Press 2019).

⁸⁹ See TFEU, *supra* note 14, art. 288.

implementation by national resolution authorities.⁹⁰ For the substantive resolution rules, the SRM either specifically refers to the rules of the BRRD or repeats certain provisions so as to provide the SRB with directly applicable EU law as the legal basis for its decisions.⁹¹ The resolution schemes devised by the SRB are to be implemented by national resolution authorities on the basis of national law transposing the BRRD.⁹²

The EU State Aid regime is sparsely regulated in TFEU, arts. 107–109, with a general prohibition of State aid,⁹³ mandatory⁹⁴ and discretionary exemptions,⁹⁵ procedural rules,⁹⁶ and a basis for secondary legislation.⁹⁷ The latter has been used to codify Commission practice and case law on procedural matters.⁹⁸ An enabling regulation allows the Commission to exempt certain forms of horizontal aid from notification,⁹⁹ which in turn formed the basis for the Commission's regulation on block exemptions.¹⁰⁰ However, the Commission predominantly relies on soft law instruments in which it specifies its intended approach to the compatibility assessment of aid measures under the various exemptions. Since the collapse of Lehman Brothers in September 2008, the Commission assesses the compatibility of State aid in the financial sector on the basis of art. 107(3)(b): the exemption with a view "to remedy a serious disturbance in the economy of a Member State." Following the first Banking Communication of October 2008,¹⁰¹ the Commission has issued three further soft law measures: the Recapitalization Communication¹⁰² focusing on the pricing of recapitalizations, the Impaired Assets Communication¹⁰³ addressing in particular the valuation of impaired assets, and the Restructuring Communication¹⁰⁴ setting out restructuring demands as *quid pro quo* for having

⁹⁰ See SRMR, *supra* note 22, Recital (11).

⁹¹ See *id.* ¶ 18.

⁹² See *id.* arts. 18(9), 29.

⁹³ TFEU, *supra* note 14, art. 107(1).

⁹⁴ *Id.* art. 107(2).

⁹⁵ *Id.* art. 107(3).

⁹⁶ *Id.* art. 108.

⁹⁷ *Id.* art. 109.

⁹⁸ See Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EC 27.3.1999 L83/1; amended by Council Regulation (EU) No 734/2013 of 22 July 2013 amending Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, 2016 O.J. (L 204) 16.

⁹⁹ Council Regulation (EC) No 994/98 of 7 May 1998 on the application of Articles 92 and 93 of the Treaty establishing the European Community to certain categories of horizontal State aid, OJ EC 14.5.98 L142/1; amended by Council Regulation (EU) No 733/2013 of 22 July 2013 amending Regulation (EC) No 994/98 on the application of Articles 92 and 93 of the Treaty establishing the European Community to certain categories of horizontal aid, 2013 O.J. (L 204) 11.

¹⁰⁰ Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, 2014 O.J. (L 187) 1, replacing the earlier Commission Regulation (EU) No 800/2008.

¹⁰¹ See Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, 2008 O.J. (C 270) 8 (EU).

¹⁰² See Communication from the Commission – The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, 2009 O.J. (C 10) 2, 3–5 (EU).

¹⁰³ See Communication from the Commission on the treatment of impaired assets in the Community banking sector, 2009 O.J. (C 72) 1, 2, 8–9 (EU).

¹⁰⁴ See Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, 2009 O.J. (C 195) 9, 12–13

received government assistance. Going through several phases, the Commission's standard of assessment gradually moved from a very lenient towards a more rigorous approach making aid compatibility dependent on increasingly stricter conditions.¹⁰⁵ This approach was codified in the 2013 Banking Communication,¹⁰⁶ which has replaced the earlier 2008 Banking Communication, and adapts and complements the Recapitalization and Impaired Assets Communications, and supplements the Restructuring Communication.¹⁰⁷ The legal nature of the Banking Communication has been clarified by the Court of Justice in *Kotnik*.¹⁰⁸ By issuing this soft law measure the Commission imposed a limit on the exercise of its discretion. Any departure puts the Commission at risk of being in breach of the principle of equal treatment and the protection of legitimate expectations. However, the adoption of guidelines does not relieve the Commission of its obligation to examine the specific exceptional circumstances relied on by a Member State. In other words, the Commission must, in principle, authorize a proposed aid measure that complies with the guidelines; on the other hand, a Member State may still notify the Commission of aid that does not comply with the guidelines and the Commission may authorize the proposed aid in exceptional circumstances.

Given this diversity of regulatory spheres and instruments, assessing the input legitimacy of the system setup requires an investigation of both (i) the constitutional orders of the Member States and their law making powers in the realm of corporate insolvency law; and (ii) the EU law making process in all its facets, including Treaty making by the Member States (TFEU, art. 107–109), the ordinary legislative procedure (DRWCI, BRRD and SRM), as well as delegated law making and the Comitology process (regulatory and implementing technical standard, Commission communications). Some general observations must suffice. The European Union is committed to the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights.¹⁰⁹ Under the so-called Copenhagen criteria for accession, any country wishing to become an EU member must have stable institutions guaranteeing democracy and the rule of law.¹¹⁰ Of course, despite these Treaty commitments the reality may be very different. The World Bank's Worldwide Governance Indicators¹¹¹ show great diversity across EU Member States, some are amongst the most highly ranked in

(EU) [hereinafter Restructuring Communication] (emphasizing the need for burden sharing by beneficiary before they can receive state aid).

¹⁰⁵ See generally Thomas Doleys, *Managing State Aid in a Time of Crisis: Commission Crisis Communications and the Financial Sector Bailout*, 34 J. EUR. INTEGR. 549 (2012).

¹⁰⁶ See Banking Communication, *supra* note 57, ¶ 62.

¹⁰⁷ *Id.* ¶ 24.

¹⁰⁸ See Case C-526/14, *Kotnik & Others*, ECLI:EU:C:2016:570 ¶¶ 38–44.

¹⁰⁹ See Consolidated Version of the Treaty on European Union art. 2, July 7, 2016, 2016 O.J. (C 202) 13, 17 [hereinafter TEU].

¹¹⁰ See *id.* art. 49.

¹¹¹ The process by which governments are selected, monitored and replaced is measured by "Voice and Accountability" and "Political Stability and Absence of Violence/Terrorism;" the capacity of a government to effectively formulate and implement sound policy is assessed on the basis of "Government Effectiveness" and "Regulatory Quality." Daniel Kaufmann, Aart Kraay & Massimo Mastruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues*, 3 HAGUE J. ON THE RULE OF LAW 220, 223 (2011).

the world reaching almost 100% on some indicators,¹¹² others are lagging behind.¹¹³ As for the EU law making process, the EU's "democratic deficit," primarily on the basis of "unresponsiveness to democratic pressures" and "executive dominance," is a well-rehearsed theme in the academic literature, although given the counterfactual nature of decision-making in the absence of EU institutions it is perhaps somewhat overstated.¹¹⁴ More worrying are the findings of Transparency International EU: the opacity in EU law-making, the undue influence of lobbyists with a significant "revolving door phenomenon" and the resulting unequal access to decision-makers,¹¹⁵ as well as badly managed conflicts of interest, pose a significant risk for the integrity of decision-making by EU institutions.¹¹⁶ On that basis, we can tentatively conclude that the input legitimacy of the system setup is not without deficiencies.

B. Input Legitimacy II: System Design

Here the question is whether the institutional architecture of the system and its components is structured in a way that ensures the input legitimacy of system results.

Corporate insolvency law as applied to financial institutions shows great diversity, ranging from standard court-centered judicial proceedings at one end of the spectrum to purely administrative procedures with regulators in the driving seat at the other, and various hybrid systems in between.¹¹⁷ Where financial institutions are subject to general insolvency law, certain modifications are usually in place, conferring a major role on the competent supervisory authority. For example, under German law, only the Federal Authority for Financial Market Supervision (BaFin) can petition the court for the opening of insolvency proceedings. The management's duty to file for insolvency is transformed into a duty to give notice to BaFin.¹¹⁸ The court is not bound by the BaFin's petition and will order the opening of proceedings only if the court is satisfied that there is a ground for opening proceedings.¹¹⁹ With the opening of proceedings, the office holder replaces

¹¹² In 2017: Sweden, 99.51%, Finland 97.54%, The Netherlands 99.1%. See Worldwide Governance Indicators: Voice & Accountability, <http://info.worldbank.org/governance/wgi/> (follow "Download full dataset (Excel)" hyperlink; then follow "Voice and Accountability" tab).

¹¹³ In 2017: Bulgaria 60.48%; Greece 40.95%; Romania 49.05%. See World Bank, Worldwide Governance Indicator: Political Stability & Absence of Violence/Terrorism 2017, <http://info.worldbank.org/governance/wgi/#reports>.

¹¹⁴ PAUL CRAIG & GRÁINNE DE BURCA, *EU LAW: TEXT, CASES, AND MATERIALS* 150–55 (6th ed. 2017).

¹¹⁵ Senior EU decision-makers frequently move directly into positions where they seek to influence former colleagues or their staff or join organizations they have previously regulated. See TRANSPARENCY INTERNATIONAL EU: ACCESS ALL AREAS – WHEN EU POLITICIANS BECOME LOBBYISTS 7 (2017), <http://transparency.eu/wp-content/uploads/2017/01/Access-all-areas.pdf> (last accessed Nov. 6, 2019).

¹¹⁶ LOUIS HANCISSE ET AL., TRANSPARENCY INTERNATIONAL EU OFFICE: THE EUROPEAN UNION INTEGRITY SYSTEM 8 (2014), https://transparency.eu/wp-content/uploads/2016/10/EU_Integrity_System_Report.pdf (last visited Nov. 6, 2019).

¹¹⁷ See Binder et al., *supra* note 12; Baudino et al., *supra* note 84.

¹¹⁸ Gesetz über das Kreditwesen, [KWG] [Banking Act] July 15, 2014, KWG § 46b, (Ger.), https://www.gesetze-im-internet.de/kredwg/_46b.html [hereinafter KWG].

¹¹⁹ Insolvenzordnung, [InsO] [Insolvency Statute] Oct. 5, 1994, InsO § 16 (Ger.), https://www.gesetze-im-internet.de/insol/_16.html [hereinafter InsO]. A general ground for opening proceedings is the debtor's inability to pay its debts as they fall due. See *id.* § 17(1) (cash flow insolvency); KWG, *supra* note 118, § 46b(1) (same). Another general ground for opening proceedings is an excess of liabilities over assets. See

the management and obtains comprehensive powers to dispose of the assets with a view of maximizing returns for creditors. BaFin is likely to revoke the banking license.¹²⁰ Spanish insolvency law is similarly structured, albeit with a much-reduced role of the competent authority;¹²¹ whereas Italian law provides for a financial institution-specific liquidation procedure of an administrative nature firmly in the grasp of Banca d'Italia and the Ministry of Finance.¹²²

The BRRD/SRM resolution regime is an administrative procedure with initially¹²³ no court involvement. The process is dominated by competent and resolution authorities. The resolution authority determines, either upon a communication from the competent authority or on its own motion, whether the institution meets the conditions for resolution and decides whether and in what form to take resolution action.¹²⁴ Following the initiation of resolution proceedings, the resolution authority can take control of an institution, directly or indirectly,¹²⁵ so as to operate it with all the powers of the shareholders and the board of directors and to manage and dispose of its assets. Under the SRM, following a determination that an institution is failing by ECB¹²⁶ or SRB,¹²⁷ the SRB assesses whether the conditions for resolutions are met, in particular whether there is no feasible private sector alternative¹²⁸ and whether resolution is necessary in the public interest.¹²⁹ If so, the SRB adopts a resolution scheme, which places the institution under resolution, determines the application of resolution tools and

KWG, *supra* note 118 § 46b(1) (insolvency on a balance sheet basis); InsO § 19(1) (same). Prospective cash flow insolvency provides a further ground. However, BaFin may petition the court on that basis only with the consent of the debtor's management.

¹²⁰ KWG, *supra* note 118, § 35(2)(4).

¹²¹ See Single Resolution Board, *Decision of the Single Resolution Board in its Executive Session of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Espanol, S.A. (the "Institution") with a Legal Entity Identifier: 80H66LPTVDLM0P28XF25, Addressed to FROB, ¶ 9–18 (SRB/EES/2017/08) (June 7, 2017), https://srb.europa.eu/sites/srbsite/files/srb_decision_srb_ees_2017_08_non-confidential_scanned.pdf [hereinafter SRB *Banco Popular*] (explaining Spanish insolvency law briefly); see also Binder et al., *supra* note 12, at 31–35.*

¹²² See Single Resolution Board, *Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution") with a Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority, ¶ 8–18 (SRB/EES/2017/11) (June 23, 2017) [hereinafter SRB *Veneto Banca*]; Single Resolution Board, *Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A. (the "Institution") with a Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority, ¶ 8–18 (SRB/EES/2017/12) (June 23, 2017), https://srb.europa.eu/sites/srbsite/files/srb-ees-2017-12_non-confidential.pdf [hereinafter SRB *Banca Popolare di Vicenza*].**

¹²³ On judicial review, see SCHILLIG, *supra* note 43, Chapter 5.

¹²⁴ See BRRD, *supra* note 19, art. 82.

¹²⁵ Through an appointed administrator, see BRRD, *supra* note 19, art. 72, or a "special manager," see BRRD, *supra* note 19, art. 35.

¹²⁶ The ECB decides within its Supervisory Board, composed of a Chair and Vice Chair, four ECB representatives and one representative of national central banks of Euro-zone Member States, giving national representatives a majority. See Danny Busch, Mirik Rijn & Marije Louisse, *How Single is the Single Resolution Mechanism?* 13 (Eur. Banking Inst. Working Paper 2019, No. 30, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3309189.

¹²⁷ The SRB can make a determination that an institution is failing or likely to fail only after having previously informed the ECB of its intention and only if the ECB does not make such a determination within 3 calendar days following receipt of the SRB's notice of intention.

¹²⁸ This assessment is to be made by the SRB in close cooperation with the ECB.

¹²⁹ See SRMR, *supra* note 22, art. 18(1).

powers, and determines the use of the Single Resolution Fund.¹³⁰ The latter is subject to a prior decision by the Commission confirming that the use of the Fund (or the granting of State aid) is compatible with the internal market and the Treaty provisions on State aid.¹³¹ The resolution scheme will enter into force only if within 24 hours of its transmission by the SRB to the Commission neither Commission nor Council object.¹³² On the basis of the resolution scheme, the SRB ensures that national resolution authorities take the necessary action under national law transposing the BRRD in order to implement the decision of the SRB.¹³³

The State aid procedure is governed primarily by article 108 TFEU and the Procedural Regulation.¹³⁴ Responsibility for the enforcement of the State aid regime rests exclusively with the Commission, in cooperation with the aid granting Member State. Under the SRM, the procedure is replicated so as to bring the SRB to the table.¹³⁵ The procedural regime for new aid¹³⁶ consists of a preliminary examination¹³⁷ and, depending on its outcome, a formal investigation procedure.¹³⁸ The preliminary examination procedure is conceptualized as a dialogue between the Commission and the respective Member State. It begins with the notification by the Member State of a proposed aid measure to the Commission¹³⁹ and imposes on the Member State a "standstill" obligation prohibiting the granting of aid for the duration of the preliminary examination, and, where initiated, also for the duration of the formal investigation procedure, until a final decision is reached.¹⁴⁰ Following notification, the Commission considers the measure and may come to the conclusion that the measure is not "aid"; it is "aid" but compatible with the Treaty; or it is "aid" and the Commission encounters "serious difficulties" in its assessment of the aid's compatibility with the Treaty. In the latter case, the Commission launches the formal investigation procedure¹⁴¹ by giving notice to the parties concerned, essentially the Member State and the beneficiaries of the proposed aid

¹³⁰ *Id.* art. 18(6).

¹³¹ *Id.* art. 19(1), (3), at 43–44.

¹³² Within twelve hours of transmission, the Commission may propose to the Council to either object to the scheme on the basis that the public interest requirement has not been met, or to approve (or reject) a material modification of the amount to be provided by the Single Resolution Fund. Where the Council objects on public interest grounds the entity is to be wound up under national insolvency law. Where, within twenty-four hours of transmission, the Council approves the proposed modification in respect of the use of the Fund, or the Commission objects to the scheme on the basis of its remaining discretionary aspects, the SRB has to modify the resolution scheme within eight hours in accordance with the reasons expressed by Council or Commission. *See id.* art. 18(7)–(9).

¹³³ *Id.* art. 18(9), at 29.

¹³⁴ Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EC 27.3.1999 L83/1; amended by Council Regulation (EU) No 734/2013 of 22 July 2013 amending Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, 2013 O.J. (L 204) 16 [hereinafter Procedural Regulation].

¹³⁵ SRMR, *supra* note 22, art. 19. Otherwise, obligations to notify the Commission of aid measures would only apply to Member States, and not the SRB as an EU agency.

¹³⁶ In addition to aid yet to be granted, this concept includes the alteration of existing aid; Procedural Regulation, art. 1(c). Existing aid includes aid in existence when the Member State joined the Union and aid legally implemented in accordance with the Treaty. *See id.* art. 1(b) (defining "existing aid").

¹³⁷ TFEU, *supra* note 14, art. 108(3).

¹³⁸ *Id.* art. 108(2).

¹³⁹ *Id.* art. 108(3); Procedural Regulation, *supra* note 134, art. 2.

¹⁴⁰ TFEU, *supra* note 14, art. 108(3); Procedural Regulation, *supra* note 134, art. 3.

¹⁴¹ Procedural Regulation, *supra* note 134, art. 4.

measure, in order to receive their comments.¹⁴² As a result of the formal investigation, the Commission may authorize the measure,¹⁴³ possibly subject to certain conditions, or may decide that the aid may not be granted.¹⁴⁴ The Banking Communication has modified this general framework in important respects. For restructuring aid¹⁴⁵ in the form of a recapitalization or impaired asset measure, Member States are invited to enter into voluntary pre-notification contacts with the Commission. In particular, Commission and Member State may discuss a restructuring plan and once agreement has been reached, the Member State may formally notify it. Agreement on the restructuring plan is a necessary precondition for the authorization of recapitalization or impaired asset measures.¹⁴⁶ Exceptionally, the Commission may authorize these measures on a temporary basis as rescue aid¹⁴⁷ before a restructuring plan has been approved where this is necessary for preserving financial stability.¹⁴⁸ Throughout the process, the Commission has to liaise closely with supervisory authorities so as to ensure a smooth interplay between the different roles and responsibilities of all authorities involved.¹⁴⁹ Thus, for the financial sector, State aid control is essentially a four-way negotiation between the Commission, the relevant Member State's government, the relevant supervisory authorities, and the beneficiary institution. This remains relevant in particular for those situations where State aid may be granted outside the BRRD/SRM resolution framework.

The assessment of the institutional architecture of domestic standard insolvency law requires an analysis of the workings of the insolvency court systems in the various Member States, including procedural arrangements, court independence, appointment of judges and legal education. For financial institution insolvency processes, the independence, expertise and professional integrity of national competent authorities is of equal importance. The same is true for national resolution authorities under the framework of the BRRD and when implementing resolution schemes issued by the SRB. The World Bank's "Rule of Law" Worldwide Governance Indicator¹⁵⁰ paints a mixed picture with many Member

¹⁴² Third parties in the form of other Member States, competitor firms and trade associations may be invited to comment. See TFEU, *supra* note 14, art. 108(2); Procedural Regulation, *supra* note 134, art. 6.

¹⁴³ Because it is not "aid" or it is "aid" compatible with the Treaty.

¹⁴⁴ Procedural Regulation, *supra* note 134, art. 7.

¹⁴⁵ "Restructuring aid" involves "more permanent assistance and must restore the long-term viability of the beneficiary on the basis of a feasible, coherent and far-reaching restructuring plan, while at the same time allowing for adequate own contribution and burden sharing and limiting the potential distortions of competition." European Commission, *Communication from the Commission: Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty*, at 7, COM (2014) 249 final (July 31, 2014) [hereinafter *R&R Guidelines*].

¹⁴⁶ Banking Communication, *supra* note 57, ¶ 34, at 7.

¹⁴⁷ "Rescue aid" is of an urgent and temporary nature with the primary objective of keeping an undertaking afloat for the short time needed to work out a restructuring or liquidation plan. See *R&R Guidelines*, *supra* note 145, ¶ 26, at 7.

¹⁴⁸ Banking Communication, *supra* note 57, ¶ 50, at 9. The same applies to State guarantees and liquidity support (other than through central banks), although here a threat to financial stability is not a precondition for a temporary approval. See *id.* ¶ 56, at 10.

¹⁴⁹ *Id.* ¶ 14, at 3.

¹⁵⁰ This indicator seeks to capture "perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence." Kaufmann et al., *supra* note 111, at 223.

States scoring very highly,¹⁵¹ whereas others show significant shortcomings.¹⁵² The same is true for the "Control of Corruption" indicator.¹⁵³ Of the EU institutions involved in the SRM resolution framework (SRB, ECB, Commission and Council) and the State aid regime, only the SRB has not yet been subject to scrutiny by Transparency International, although its transparency policy has been found wanting by the Appeal Panel in the course of the resolution of Spanish banking group Banco Popular,¹⁵⁴ with the Appeal Panel's decision currently being subject to judicial review.¹⁵⁵ For Commission and Council, the opacity of decision-making, the susceptibility to the influence of lobbyists, inadequate mechanisms for dealing with conflicts of interest, and the "revolving door" problem have already been identified.¹⁵⁶ A recent report on the integrity of the ECB has found, in addition to a need to improve the management of conflicts of interest, that the revolving door phenomenon is particularly problematic.¹⁵⁷ Overall, the ECB's accountability framework has been found to be lacking given its far-reaching responsibilities in the economic governance of the Euro-zone.¹⁵⁸ A further concern is that EU institutions and national authorities rely on a small number of accounting firms and financial advisory firms when designing rescue packages. The involvement of the same firms as consultants and auditors of failing institutions can result in massive conflicts of interest. Moreover, even poor or inaccurate advice resulting in significant losses for the taxpayer has few, if any, consequences with new contracts being awarded despite repeated failures in the past.¹⁵⁹

¹⁵¹ For 2017: Austria 96.2%; Denmark 97.6%; Finland 100%.

¹⁵² For 2017: Bulgaria 51.9%; Greece 56.7%; Romania 63.9%.

¹⁵³ It seeks to capture "perceptions of the extent to which public power is exercised for private gain, including both petty and grand corruption, as well as 'capture' of the state by elites and private interests." Kaufmann et al., *supra* note 111, at 223. For 2017: Denmark 98.6%; Finland 99%; Luxembourg 96.2% and Bulgaria 51%; Greece 52.4%; Italy 61.5%.

¹⁵⁴ See European Union Single Resolution Board Press Release, The SRB Appeal Panel Decides on Access to SRB Documents with Respect to the Banco Popular Case (Nov. 29, 2017), <https://srb.europa.eu/en/node/442>.

¹⁵⁵ Case T-62/18, *Aeris Invest v. SRB*, 2018 EUR-Lex CELEX LEXIS 25-26 (Feb. 6, 2018), <https://eurlex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:62018TN0062&qid=1572443882527&from=EN>.

¹⁵⁶ See LOUIS HANCISSE ET AL., *supra* note 116, at 10-12.

¹⁵⁷ Members of the Executive Board have frequently moved on to posts in private finance, even though none of them had significant professional experience in the private financial sector prior to their ECB appointment.

¹⁵⁸ See BENJAMIN BRAUN & MAX PLANOK, TWO SIDES OF THE SAME COIN?: INDEPENDENCE AND ACCOUNTABILITY OF THE EUROPEAN CENTRAL BANK 5 (Leo Hoffmann-Axthelm & Transparency International EU eds., 2017), https://transparency.eu/wp-content/uploads/2017/03/TI-EU_ECB_Report_DIGITAL.pdf.

¹⁵⁹ See Sol Trumbo Vila & Matthijs Peters, *The Bail Out Business: Who profits from bank rescues in the EU?* 4 (2017), https://www.tni.org/files/publication-downloads/tni_bail_out_eng_online0317.pdf. For example, in 2011, Bankia reported profits of over EUR300m duly audited by Deloitte. When Bankia had to be nationalized less than a year later it turned out that it had actually lost EUR4.3bn. The Bank of Spain declared Deloitte's audit reports for Bankia invalid due to grave irregularities: at least 12 clear errors in Bankia's financial statements had been overlooked by Deloitte. *Id.* at 10-11.

C. Output Legitimacy I: System Elements

Normative system analysis assesses a system's results against the goals that have been attributed to the system as desirable.¹⁶⁰ The system elements are themselves subsystems with their own (normative) goals attributed to them.¹⁶¹ Thus, output legitimacy can be assessed, first, in respect of the results achieved by the system elements: corporate insolvency law, the BRRD/SRM resolution framework, and the State aid regime. For each system element, we need to identify the goal attributed to it and the problem(s) it is designed to solve, and establish whether the subsystem has the capacity of attaining the envisaged objective (at reasonable social cost).¹⁶²

In the absence of a clear statutory stipulation,¹⁶³ the identification of the goal that corporate insolvency law, when applied to financial institutions, should seek to achieve is marred with difficulties. Not only may there be significant divergence across jurisdictions, even within one and the same legal system various procedures may be geared towards the attainment of different objectives.¹⁶⁴ As a general tendency in European national insolvency legislation over the last 30 years, there has been a shift in emphasis from insolvency law being almost exclusively geared towards protecting the creditors' property rights with a view to maximizing asset values¹⁶⁵ towards the more inclusive goal of rehabilitating and continuing the debtor's business as a going concern, thus also benefitting stakeholders, other than creditors, notably employees and the wider community. This trend is neatly encapsulated in the often-invoked notion of "rescue culture."¹⁶⁶ Where corporate insolvency law is deployed, perhaps in modified form, for dealing with distressed financial institutions, the protection of depositors, and/or, more broadly, the stabilization of the financial system, are likely to be of at least equal if not overriding importance.¹⁶⁷ In order to prevent a run on the debtor's assets, with the commencement of insolvency proceedings, a more or less comprehensive moratorium will normally come into effect.¹⁶⁸ Certain qualified financial contracts of systemic importance—derivatives, repos, stock lending—may be exempt.

¹⁶⁰ LoPucki, *supra* note 27, at 486. Positive analysis equates the goals of the system with the results that the system actually produces. *Id.*

¹⁶¹ *See id.* at 487.

¹⁶² *See* BÖRZEL & PANKE, *supra* note 66, at 157; *see also* SCHARPF, *supra* note 71, at 11.

¹⁶³ Binder et al., *supra* note 12, at 12. *See, e.g.*, InsO, *supra* note 119, § 1 ("The insolvency process has the objective of collectively satisfying the creditors by realizing the debtor's assets and distributing the proceeds, or by adopting an alternative solution pursuant to a restructuring plan in particular with a view to rescuing the business as a going concern.").

¹⁶⁴ *See* Horst Eidenmüller, *Comparative Corporate Insolvency Law*, in *THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE* 1003, 1006–15 (Jeffrey Gordon & Wolf-Georg Ringe eds., 2016).

¹⁶⁵ On Spanish insolvency law, *see* SRB *Banco Popular*, *supra* note 121, ¶ 11.

¹⁶⁶ *See* EUROPEAN LAW INSTITUTE, INSTRUMENT OF THE EUROPEAN LAW INSTITUTE: RESCUE OF BUSINESS IN INSOLVENCY LAW 103 (2017), https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_el/Publications/Instrument_INSOLVENCY.pdf [hereinafter EUROPEAN LAW INSTITUTE].

¹⁶⁷ For the United Kingdom, Banking Act 2009, section 99(2), "[o]bjective 1 is . . . to ensure that as soon as is reasonably practicable each eligible depositor . . . has the relevant account transferred to another financial institution, or . . . receives payment" from the deposit guarantee fund. For Germany, KredReorgG, § 1(1), "[t]he rehabilitation and reorganization procedures aim to stabilize financial markets through the rehabilitation or reorganization of credit institutions . . ." Baudino et al., *supra* note 84, at 10–14.

¹⁶⁸ Creditors are no longer able to exercise their individual enforcement rights; judicial proceedings come to a hold. Even secured creditors may be prevented from enforcing their security interests.

Insolvency proceedings normally entail the appointment of an office holder to at least supervise the management of the debtor's business, whereby the court itself or an administrative authority may fulfill this role. Legal systems may differ in their general policy preference in terms of restructuring or liquidation of a failing institution, although perhaps ideally the outcome should depend on the circumstances in every individual case.¹⁶⁹ Where the business is no longer viable, liquidation will be the only option. Here, insolvency law provides a mechanism that ensures the realization of the company's assets at maximum value. The proceeds must be fairly and equitably distributed amongst the different classes of creditors in accordance with a statutory order of priority under which the ranking of various creditors is clear from an *ex ante* perspective. However, there seems to be no good reason as to why, in appropriate circumstances, national corporate insolvency law may not be utilized for preserving a failing institution as a going concern. In the past, banks such as Barings and Chancery Plc have been successfully restructured on the basis of the English law administration procedure. The application of this "rescue culture" requires, here and in general, a corporate insolvency law that enables a distressed firm to acquire a new capital structure.¹⁷⁰ This can be achieved in two principal ways. First, the business remains with the debtor company and the latter's debt load is reduced, by writing down or rescheduling liabilities and/or converting debt to equity. Here, standard corporate insolvency law provides a negotiation process facilitated by information rights, majority voting in classes and possibly cross-class cramdown provisions, although in bank-specific insolvency regimes the role of creditors will often be much reduced.¹⁷¹ Second, and perhaps more suitably for financial institutions, the business (assets and certain liabilities) may be transferred (sold) to a new entity with a more sustainable capital structure, leaving some of the existing creditors behind with an empty shell.¹⁷² This requires extensive powers of the office holder to dispose of the debtor's assets, combined with the legal recognition of arrangements that determine seniority amongst creditors and facilitate the release of security. In practice, both approaches will often be combined to a greater or lesser extent.¹⁷³ It is difficult to evaluate the goal attainment capacity of the various domestic insolvency law systems, in particular when applied to financial institutions. Resolution of financial institutions through insolvency law is a rare event, not least because deposit insurance funds and institutional protection schemes may come to the rescue,¹⁷⁴ and many of the newer procedures remain untested. Empirical material is scarce. The "distributing administration" of

¹⁶⁹ Binder et al., *supra* note 12, at 12.

¹⁷⁰ BARRY R. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, *BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS* 26 (4th ed. 2007).

¹⁷¹ Baudino et al., *supra* note 84, at 20–22.

¹⁷² On the Italian bank specific Compulsory Administrative Liquidation procedure, see SRB *Veneto Banca*, *supra* note 122, ¶ 15; SRB *Banca Popolare di Vicenza*, *supra* note 122, ¶ 15.

¹⁷³ For non-financials, see *EUROPEAN DEBT RESTRUCTURING HANDBOOK: LEADING CASE STUDIES FROM THE POST-LEHMAN CYCLE* 19, 26–27 (Kon Asimacopoulos & Justin Bickle eds., 2013).

¹⁷⁴ For example, the German Düsseldorfer Hypothekenbank was taken over by the *Einlagensicherungsfonds des Bundesverbandes deutscher Banken eV*, a private non-statutory insurance fund, with a view to protecting financial stability in Germany when the bank suffered significant portfolio losses (article available at <https://bankenverband.de/newsroom/presse-infos/verkauf-der-dusseldorfer-hypothekenbank/>).

Lehman Brothers International Europe, Lehman's main trading company in Europe, and of other Lehman entities is still ongoing 10 years after commencement. The World Bank's Doing Business report on Resolving Insolvency may only provide a rough indicator.¹⁷⁵ However, given the complexity involved in the resolution of a financial institution through insolvency, it is unlikely that a lowly ranked jurisdiction¹⁷⁶ would do significantly better in the financial institution context; and higher ranked jurisdictions¹⁷⁷ may do significantly worse.

The meta-objective of the BRRD/SRM resolution framework is spelled out in Recital (1) of the BRRD:

The financial crisis has shown that there is a significant lack of adequate tools at Union level to deal effectively with unsound or failing credit institutions and investment firms Such tools are needed, in particular to prevent insolvency or, when insolvency occurs, to minimize negative repercussions by preserving the systemically important functions of the institution concerned. During the crisis, those challenges were a major factor that forced Member States to save institutions using taxpayers' money. The objective of a credible recovery and resolution framework is to obviate the need for such action to the greatest extent possible.

Rightly or wrongly, standard insolvency law proceedings are deemed to be inadequate for dealing with systemic financial institutions in distress: they are perceived as being too slow, unable to ensure the continuity of critical functions, and resulting in the destruction of value with a negative impact on the real economy; thus, overall insufficiently geared towards the preservation of financial stability.¹⁷⁸ The BRRD/SRM resolution framework seeks to simulate the loss allocation principles of general insolvency law, thereby retaining the incentive structure for investors and management with a view to restoring market discipline; whilst at the same time providing a tailored administrative procedure aimed at avoiding the systemic implications of standard insolvency law in form of contagious knock-on effects for other market participants, financial market infrastructures and the real economy.¹⁷⁹ The general concern in corporate insolvency law for maximizing asset values and balancing stakeholder interests is partly superseded by public policy considerations in the interest of financial stability which are invoked to override certain basic assumptions and limitations of

¹⁷⁵ The assessment does not look at financial institution insolvency at all (the model is based on a small hotel business). See World Bank Group, *Resolving Insolvency*, DOING BUSINESS, <http://www.doingbusiness.org/data/exploretopics/resolving-insolvency> (last visited Nov. 4, 2019).

¹⁷⁶ Malta: 121; Luxembourg: 90; and even France only makes it to 28.

¹⁷⁷ Finland: 2; Germany: 4; Denmark: 6; Netherlands: 7; Slovenia: 9.

¹⁷⁸ See Karl-Philipp Wojcik, *Bail-In In The Banking Union*, 53 COMMON MKT. L. REV. 91, 92 (2016).

¹⁷⁹ See *id.* at 126; see also *Bank Stakeholders*, *supra* note 6, at 232–34; *State-Funded Bailouts*, *supra* note 30, at 101; Jens-Hinrich Binder, *Proportionality at the Resolution Stage: Calibration of Resolution Measures and the Public Interest Test 3* (The Principle of Proportionality and Its Applicability in EU Banking Regulation, February 2017) (July 3, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2990379 [hereinafter *Proportionality at Resolution Stage*]; Jens-Hinrich Binder, *Systemkrisenbewältigung durch Bankenabwicklung? Aktuelle Bemerkungen zu unrealistischen Erwartungen*, 2017 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT 57, 60 (2017).

standard corporate insolvency law.¹⁸⁰ Consequently, when applying resolution tools and powers, resolution authorities must seek to achieve one or more of the "resolution objectives:" (i) to ensure the continuity of critical functions; (ii) to avoid significant adverse effects on financial stability, including by preventing contagion and maintaining market discipline; (iii) to protect public funds by minimizing reliance on extraordinary public financial support; (iv) to protect depositors as well as client funds and assets; and (v) to minimize the cost of resolution and avoid the unnecessary destruction of value.¹⁸¹ These resolution objectives also inform the public interest requirement as one element of the resolution trigger. Thus, where the competent authority or the resolution authority determines that an institution is failing or likely to fail—due to a breach of minimum capital requirements, illiquidity, insolvency, or a need for extraordinary public financial support—and the resolution authority further determines that there is no other alternative for preventing failure, and that resolution is in the public interest, the institution will be subject to resolution proceedings under which the resolution authority has a range of far reaching resolution tools and powers at its disposal. The transfer tools allow the resolution authority to transfer the shares of an institution under resolution, or all or some of its assets, rights, or liabilities to a private sector purchaser,¹⁸² a bridge institution,¹⁸³ or an asset management vehicle.¹⁸⁴ Generally applicable corporate and securities law is suspended and the consent of the institution's shareholders is not required. In addition, BRRD and SRM provide for a 'bail-in' tool for eligible liabilities, on top of the power to write down or convert capital instruments. The bail-in tool entails the powers to write down eligible liabilities, to convert them into shares, and to cancel shares and debt securities. These powers may be used to either recapitalize an institution in order to restore its viability;¹⁸⁵ or to reduce the amount of debt transferred from the institution under resolution to a bridge institution with a view to capitalizing it, or in the context of the sale of business tool or asset separation tool.¹⁸⁶ In order to provide adequate funding for the application of resolution tools and powers, the BRRD establishes a European System of Financing Arrangements consisting of national financing arrangements, borrowing between national financing arrangements and the mutualization of national financing arrangements in the case of a group resolution.¹⁸⁷ Under the SRM, a Single Resolution Fund (SRF) has been established, pooling resources from all Euro-area banks and serving as a Euro-area wide insurance mechanism.¹⁸⁸

To date, the BRRD/SRM resolution framework has been used only once in the case of Spanish banking group Banco Popular. The resolution entailed the application of the power to write down and convert capital instruments, in combination with the sale of business tool.¹⁸⁹ With total assets of EUR147bn,

¹⁸⁰ See *Bank Stakeholders*, *supra* note 6, at 232; *Proportionality at Resolution Stage*, *supra* note 179, at 3.

¹⁸¹ BRRD, *supra* note 19, art. 31(2); SRMR, *supra* note 22, art. 14.

¹⁸² BRRD, *supra* note 19, art. 38(1); SRMR, *supra* note 22, art. 24.

¹⁸³ BRRD, *supra* note 19, art. 40(1); SRMR, *supra* note 22, art. 25.

¹⁸⁴ BRRD, *supra* note 19, art. 42(1); SRMR, *supra* note 22, art. 26.

¹⁸⁵ BRRD, *supra* note 19, art. 43(2)(a); SRMR, *supra* note 22, art. 27(1)(a).

¹⁸⁶ BRRD, *supra* note 19, art. 43(2)(b); SRMR, *supra* note 22, art. 27(1)(b).

¹⁸⁷ BRRD, *supra* note 19, art. 99.

¹⁸⁸ SRMR, *supra* note 22, arts. 67–79.

¹⁸⁹ See SRB *Banco Popular*, *supra* note 121, art. 5.1.

Banco Popular was classified as a significant institution directly supervised by the ECB. The EBA stress test in 2016 showed a CET1 ratio of 10.2% in the baseline scenario, and of 6.6% in the adverse scenario, so that the bank should have been able to sustain a severe shock, although competing measures of the bank's risk exposure released by NYU and the IMF showed serious shortages of capital.¹⁹⁰ The disclosure of extraordinary provisions, the appointment of a new CEO, the announcement of a capital increase without any specifics, and the resulting downgrades lead to the initiation of a private sales process, and an acceleration of deposit withdrawals from business customers. Emergency Liquidity Assistance of EUR3.6bn granted by the Bank of Spain was used up within two days, allowing sophisticated creditors to exit on time without sustaining any losses.¹⁹¹ Following consultation with the SRB, the ECB determined that the bank was failing or likely to fail.¹⁹² The SRB determined that no equally effective private sector or regulatory measures were available: the private sales process had failed; early intervention was unlikely to be successful; and a write down and conversion of capital instruments in isolation was unlikely to be sufficient. Resolution was deemed to be in the public interest in order to ensure the continuity of critical functions¹⁹³ and to protect financial stability.¹⁹⁴ Having received one binding offer as a result of the marketing process, the SRB adopted a resolution scheme on June 7, 2017, which was endorsed by the Commission. A provisional valuation carried out by Deloitte established a net asset value of EUR -2bn in the baseline, and of EUR -8.2bn in the adverse scenario. An earlier PWC audit of April 2016 had established a net asset value of EUR10.8bn,¹⁹⁵ just over a year before. The resolution scheme entailed in a first step the write down and conversion of capital instruments: 4bn ordinary shares with a par value of EUR0.50, amounting to a share capital of EUR2bn, were written down and canceled to 100%; various Additional Tier 1 instruments were first converted at par value into newly issued shares resulting in 1.35bn of EUR1 par value shares, the New Shares I, which were subsequently written down and canceled to 100%; thereafter, various Tier 2 instruments were converted at par into newly issued shares resulting in 684m of EUR1 par value shares, the New Shares II. In exercise of the sale of business tool, all New Shares II were transferred to Banco Santander for EUR1.

¹⁹⁰ See Edward J. Kane, *Europe's Zombie Megabanks and the Deferential Regulatory Arrangements that Keep them in Play* 18 (Bos. Coll. – Dep't of Fin.; Nat'l Bureau of Econ. Research, 2017), <https://ssrn.com/abstract=3038510> (questioning the credibility of the EBA stress-test results which seem to have the main purpose of giving citizens false comfort).

¹⁹¹ *Id.* Although unrelated to the Banco Popular case, see also TUCKER, *supra* note 31, at 544 ("[I]t is quite simply wrong for a politically insulated authority knowingly to lend, even on a secured basis, to a firm with negative net assets, as the lender is making others worse off; short-term unsecured creditors escape as bankruptcy is deferred, but longer-term unsecured creditors end up as claimants in bankruptcy with a call on a smaller pool of assets.").

¹⁹² Due to a significantly deteriorating liquidity situation, the bank would be unable to pay its debts or other liabilities in the near future.

¹⁹³ Deposits of households, SMEs and larger corporates; SME lending; and payment and cash services.

¹⁹⁴ Banco Popular was Spain's sixth largest banking group with total assets that rendered the group significant and of a systemic nature. Moreover, there was a risk of contagion if liquidated under normal insolvency law procedures.

¹⁹⁵ Thomas Hale et al., *Banco Popular's failure leaves questions unanswered*, FIN. TIMES (July 4, 2017), <https://www.ft.com/content/8c6fee28-608f-11e7-91a7-502f7ee26895>.

The Banco Popular resolution has been celebrated as an exemplary application of the new resolution framework, demonstrating that a systemically significant institution can be resolved with minimal market disruption and without any taxpayer contribution.¹⁹⁶ However, certain features of the process suggest that some caution may be in order. It is somewhat peculiar that the preliminary valuation established a net asset value of the firm that was almost to the cent equal to the aggregate of Additional Tier1 and Tier2 instruments. It was only because of this coincidence that the potentially much more disruptive bail-in of junior or even senior bond holders and the injection of resolution fund money could be avoided.¹⁹⁷ In this sense, Banco Popular was an "easy case."¹⁹⁸ As an interesting aside, Deloitte, who carried out the preliminary valuation, had been found guilty of malpractice and fined to the tune of EUR12m for their auditing of the accounts of another failed Spanish bank.¹⁹⁹ In the context of Deloitte's submission of the final valuation report for "no-creditor-worse-off" purposes, it has been remarked that Deloitte was allowed "to mark its own homework," putting the credibility of the final valuation in doubt.²⁰⁰ Moreover, as a result of the transaction, Spain's largest bank, Banco Santander, has become even bigger which does seem to run counter to the reform rationale of tackling the "too-big-to-fail" problem. As Kane has pointed out, it is very likely that Santander has received tacit assurances of contingent loss absorption in the form of guarantees or options to put any non-performing loans back to the Spanish government,²⁰¹ thus concealing the true nature and cost of the transaction as a (partial) bailout.²⁰² Overall, the BRRD/SRM transfer tools are time-honored resolution mechanisms that have been successfully used in other jurisdictions, notably in FDIC receiverships for depository institutions. It remains to be seen whether these tools can be equally effectively applied in respect of large

¹⁹⁶ See *Banco Popular process is a model for failing banks*, FIN. TIMES (June 8, 2017), <https://www.ft.com/content/99a2e27c-4c48-11e7-919a-1e14ce4af89b>.

¹⁹⁷ See Hale et al., *supra* note 195.

¹⁹⁸ NICOLAS VÉRON, TAKING STOCK OF THE SINGLE RESOLUTION BOARD 14 (Econ. Governance Support Unit ed. 2019), https://bruegel.org/wp-content/uploads/2019/04/IPOL_IDA2019634393_EN.pdf. The Popular case "not the most complex possible." *Id.*

¹⁹⁹ Trumbo Vila & Peters, *supra* note 159, at 15.

²⁰⁰ See Thomas Hale, *Banco Popular: New report says alternatives to rescue were worse*, FIN. TIMES (Aug. 6, 2018), <http://ftalphaville.ft.com/2018/08/06/1533560573000/Banco-Popular--new-report-says-alternatives-to-rescue-were-worse-/>.

²⁰¹ See Kane, *supra* note 190, at 18; Binder, *Systemkrisenbewältigung*, *supra* note 179, at 63 (pointing out that experience shows that private sector purchasers will normally require generous assurances that the risks of the acquired parts of the business will not end up with them, which renders doubtful the idea of cost-neutral solution on the basis of the transfer tools).

²⁰² The resolution process is currently subject to legal challenges brought by investors against EU regulators and/or the Popular management, concentrating mainly on the issue of valuation and the decline of net asset value from EUR10.8bn to EUR-2bn within a year, as well as the burning through of EUR3.6bn in emergency liquidity within 2 days. Thomas Hale, *Banco Popular investors to press ahead with legal action*, FIN. TIMES (July 17, 2017), <https://www.ft.com/content/bdc009ca-68b1-11e7-8526-7b38dcaef614>; Tobias Buck & Jim Brunsden, *Emergency funds failed to save Banco Popular from death spiral*, FIN. TIMES (June 8, 2017) <https://www.ft.com/content/6f32eca2-4c62-11e7-a3f4-c742b9791d43>. A list of pending cases can be found at the website of the European Banking Institute. See European Banking Institute, *The Banking Union and Union Courts: overview of cases as at 16 October 2019* (2019), <https://ebi-europa.eu/publications/eu-cases-or-jurisprudence/>; see also Rosa Maria Lastra, Costanza A Russo & Marco Bodellini, STOCK TAKE OF THE SRB'S ACTIVITIES OVER THE PAST YEARS: WHAT TO IMPROVE AND FOCUS ON? Appendix (Econ. Governance Support Unit ed. 2019), [http://www.europarl.europa.eu/RegData/etudes/STUD/2019/634392/IPOL_STU\(2019\)634392_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2019/634392/IPOL_STU(2019)634392_EN.pdf).

and complex financial institutions. Effective application may be thwarted by time constraints and sheer complexity.²⁰³ Transfers may not be effective for assets, rights, and liabilities governed by foreign law. Finding an adequate buyer is much easier for a small or medium sized bank in a competitive banking market with a multitude of smaller institutions. It will be much more difficult for a large and complex banking group. Unless the failing institution is liquidated on a piecemeal basis, only other large institutions will likely be able to take on parts of the business in resolution, thus exacerbating the "too-big-to-fail" problem. The bail-in tool remains largely untested and its goal attainment capacity controversial. The bail-in of deposits at two Cypriot banks occurred prior to the taking effect of the BRRD and affected predominantly non-EU depositors. Whilst recognizing bail-in's inherent risk of contagion, believers expect that the prices of debt will more accurately reflect the risk of an investment in a bank, thereby strengthening market discipline and reducing the likelihood of a systemic crisis.²⁰⁴ Skeptics point to the complexities inherent in the bail-in process with its multiple discretionary junctures, ambiguities, and inter-agency coordination and cooperation requirements, which in combination are likely to render the adequate pricing of bail-inable debt near impossible.²⁰⁵ The emerging consensus seems to be that bail-in may be effective when it comes to the resolution of smaller non-systemic domestic banks, but counterproductive during a systemic crisis.²⁰⁶ This is somewhat ironic given that the BRRD/SRM mechanisms were devised specifically for the resolution of institutions the failure of which would likely constitute a systemic event.²⁰⁷

Initially, the goal of State aid control was deemed to be the removal of discriminatory measures between Member States. The granting of State aid to domestic firms would put undertakings from other Member States at a disadvantage similar to national regulatory restrictions to free movement. State aid control was viewed as a tool for removing these restrictions, and thus as an essential element of the internal market and its free movement rationale.²⁰⁸ Subsequently, as the internal market and free movement gradually became a reality, the State aid regime was seen as more akin to the rules on competition law with the aim of preventing distortions of competition between undertakings—foreign and domestic—rather than between Member States. The State aid rules no longer exclusively targeted obstacles to trade between Member States, but were increasingly applied to ensure the proper functioning of the internal market by preventing distortions within individual national markets.²⁰⁹ Rather than drawing a

²⁰³ BASEL COMMITTEE ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 8 (2010), <https://www.bis.org/publ/bcbs169.pdf>.

²⁰⁴ Wojcik, *supra* note 178, at 129.

²⁰⁵ See generally Tobias Tröger, *Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime* (J. FIN. REG., Vol. 4, Issue 1, SAFE Working Paper No. 179, Eur. Banking Inst. Working Paper No. 12, 2017); https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023184.

²⁰⁶ Wojcik, *supra* note 178, at 130; Emiliós Avgouleas & Charles Goodhart, *Critical Reflections on Bank Bail-ins*, 1 J. FIN. REG. 3, 28 (2015).

²⁰⁷ Binder, *Systemkrisenbewältigung*, *supra* note 179, at 67–68.

²⁰⁸ PIERNAS LÓPEZ, *supra* note 16, at 47.

²⁰⁹ *Id.* at 148 (emphasizing one or the other rationale may have an impact on the interpretation of the concept of aid and the application of aid control). The application of competition law standards to State aid

clear dividing line between both approaches, the rationale for State aid control may perhaps best be viewed as a dynamic concept that has evolved in accordance with the economic and political realities of the Union.²¹⁰ The hybrid nature of the State aid regime seems to have been implicitly endorsed in *Philip Morris* where, despite an invitation by the applicant to rule on the substance of the State aid rules, the Court remained essentially silent.²¹¹ The broad discretion that the Commission enjoys under the State aid regime allows it to pursue policy objectives other than undistorted competition and free movement. These secondary policy objectives may potentially conflict with the primary rationales of competition and free movement in which case the application of State aid control becomes a balancing exercise. Where pursuance of secondary objectives is likely to enhance undistorted competition, the State aid framework may allow the Commission to pursue a specific industrial policy under the cover of the competition and internal market rationales. Both scenarios can be observed in the context of financial institution bailouts. Under the Banking Communications, "financial stability has been the overarching objective" for the Commission.²¹² At the same time, the Commission aims at "ensuring that State aid and distortions of competition between banks and across Member States are kept to a minimum."²¹³ In an acute crisis, financial stability concerns will usually be invoked to justify comprehensive bailouts in order to prevent contagion. Accordingly, at the beginning of the global financial crisis, the balance was tilted heavily towards financial stability with the Commission approving aid measures very generously. As crisis-State aid practice moved through its various phases, the Commission increasingly insisted on the implementation of compensatory measures that would offset distortions of competition resulting from State aid.²¹⁴ Depending on the type of aid measures²¹⁵, nuanced compatibility criteria apply. State aid must be limited to the minimum amount necessary and the Member State must demonstrate that all measures to limit State aid have been exhausted.²¹⁶ Adequate burden sharing requires, in principle, a contribution to loss absorption by equity, the holders of hybrid capital instruments, and of subordinated debt; not, however, of senior (unsecured) debt

would necessitate an economic analysis that includes the identification of the relevant products and geographic markets and their structure, as well as an assessment of whether any distortions are appreciable (beyond *de minimis*). *Id.* at 7, 189. Under internal market standards, there is no room for a *de minimis* rule and the requirements for analyzing the effects on competition and trade are much reduced. *Id.*

²¹⁰ *Id.* at 260.

²¹¹ Case C-730/79, *Philip Morris Holland BV v. Comm'n*, 1980 E.C.R. 02671, ¶ 9–12.

²¹² According to the Commission, financial stability concerns "the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy." *State-Funded Bailouts*, *supra* note 30, at 97.

²¹³ Banking Communication, *supra* note 57, ¶ 7.

²¹⁴ See Doleys, *supra* note 105, at 560.

²¹⁵ The Banking Communication distinguishes: (i) recapitalization and impaired asset measures; (ii) State guarantees and liquidity support other than through central banks; (iii) liquidity provision by central banks, deposit guarantee schemes and resolution funds; and finally (iv) liquidation aid. In the view of the Commission, these categories differ in respect of their distortive effect. Banking Communication, *supra* note 57, ¶ 28–88.

²¹⁶ This is the purpose of the capital raising plan to be submitted by the Member State to the Commission in the course of voluntary "pre-notification contacts." Banking Communication, *supra* note 57, ¶ 32; *State-Funded Bailouts*, *supra* note 30, at 98.

holders.²¹⁷ If following the implementation of capital raising measures and burden sharing a capital shortfall remains, it may be covered through State aid on the basis of a restructuring plan to be assessed on the basis of the Restructuring Communication.²¹⁸ The necessary measures to limit distortions of competition vary depending on the degree of burden sharing: The greater the burden sharing and the bank's own contribution, the less need for offsetting measures.²¹⁹ Distortions of competition may be addressed, in addition to the adequate remuneration of any State intervention,²²⁰ through structural measures²²¹ and/or behavioral measures.²²² On the assumption that a financial system consisting of smaller, less complex and actively competing banks is more stable and less prone to financial crisis, the pursuit of long term financial stability seems to coincide with the undistorted competition rationale. This would seem to allow the Commission to pursue a quasi-industrial policy through State aid control, forcing structural change. As expressed by Commissioner Almunia in 2012: "we want a leaner, cleaner and healthier banking system centered on the financing of the real economy."²²³ On the basis of its State aid practice during the crisis, the Commission has been widely credited with preventing a banking meltdown whilst at the same time avoiding significant distortions of competition in the internal market.²²⁴ However, it is questionable whether the State aid control mandate was robust enough to force structural change within the banking sector.²²⁵

D. Output Legitimacy II: System Output

The system output has to be measured against the goals attributed to the system overall. Where the actual system output falls short, the system's behavior may be addressed by either modifying the behavior of the system elements or their interactions.

²¹⁷ See Banking Communication, *supra* note 57, ¶¶ 40–46; Wojcik, *supra* note 178, at 105; *State-Funded Bailouts*, *supra* note 30, at 98; Hellwig, *supra* note 35, ¶ 3.5.

²¹⁸ See Banking Communication, *supra* note 57, ¶ 31. A comprehensive and detailed restructuring plan should demonstrate how the bank will restore long term viability without State aid as soon as possible. It should identify the reasons for the bank's difficulties and outline how the proposed restructuring measures remedy the underlying problems. Information should be provided on the bank's business model, including in particular its organizational, structure, funding, corporate governance, risk management, capital adequacy and remuneration incentive structure. Whether the restructuring plan will restore the bank's long-term viability has to be demonstrated under a base line scenario as well as under stress scenarios. Long-term viability also requires that State aid is either redeemed over time or remunerated according to normal market conditions, thereby ensuring the timely termination of State aid. See Restructuring Communication, *supra* note 104, ¶ 9–14.

²¹⁹ See *id.* ¶ 31.

²²⁰ See *id.* ¶ 34.

²²¹ These include the divestiture of subsidiaries, branches, portfolios of customers or business units, and reduction of business activity through limits on the beneficiary's expansion in certain business or geographical areas. See *id.* ¶ 35–36.

²²² These may include limits on the use of State aid for acquisitions, requirements to lend to the real economy, and pricing restrictions. See *id.* ¶ 39–45.

²²³ Joaquín Almunia, Vice President of the Eur. Comm'n responsible for Competition Policy, Europe's banking sector after the crisis: Oversight, regulation and responsibility, Speech at 23rd World Savings Banks Institute Congress (May 10, 2012) (transcript available at [file:///Users/zfzz6786/Downloads/SPEECH-12-348_EN%20\(1\).pdf](file:///Users/zfzz6786/Downloads/SPEECH-12-348_EN%20(1).pdf)).

²²⁴ See PIERNAS LÓPEZ, *supra* note 16, at 222–23.

²²⁵ See Doleys, *supra* note 105, at 561.

The Group of 20 (G20) has called repeatedly for an effective system of resolution tools and powers to restructure or resolve all types of financial institutions in crisis without having to rely ultimately on taxpayers' money.²²⁶ According to the FSB's Key Attributes, "[t]he objective of an effective resolution regime is to make feasible the resolution of financial institutions . . . without exposing taxpayers to loss."²²⁷ Thus, the overall system goal, as mandated by international standard setters, is the limitation of taxpayer-funded bailouts to a minimum. Given that certain bailouts are inevitable, the system objective becomes operational when defined as limiting bailouts to those that are "good," because they are in the public interest. The "pie-enlarging" effect of a bailout is an indication that it is in the public interest, as opposed to being merely re-distributive.²²⁸

A bailout will be "pie-increasing" to the extent that its social benefits exceed its social costs. Although easily formulated, this standard is difficult to apply to a concrete bailout or bailout framework, both *ex post* and even more so *ex ante*. Still comparatively easy is the juxtaposition of government money outflows in form of loans and recapitalization, and risk exposure under guarantee schemes, and the subsequent inflows through loan repayment, the sale of capital instruments and guarantee fees. As of February 2019, the total outflows under the U.S. bailout measures amounted to \$632.4bn, the total inflows to \$739.7bn, generating a profit for the taxpayer of \$107.3bn.²²⁹ For the EU, the picture is less rosy. Between 2008 and 2016, EUR 5 trillion have been approved as State aid for the rescue of ailing banks; of which EUR2 trillion have been used up.²³⁰ As of October 2016, an amount of EUR 213bn of taxpayers' money—equal to the GDP of Finland and Luxembourg combined—has been irrecoverably lost.²³¹ Even these relatively straightforward figures are fraught with uncertainty. In the absence of universally accepted guidelines, various governments and EU institutions rely on different methodologies for estimating and calculating bailout costs, which makes cross country comparison very difficult.²³² More importantly, in the same way that the social benefits of a bailout go far beyond the revenue received by the

²²⁶ See G20 Pittsburgh Summit 2009, *Leaders' Statement: The Pittsburgh Summit*, ¶ 2 (Sept. 24–25, 2009) (transcript available at <http://www.g20.utoronto.ca/2009/2009communique0925.html>); see also G20 Toronto Summit 2010, *The G-20 Toronto Summit Declaration*, ¶ 21 (June 26–27, 2010) (transcript available at <https://www.oecd.org/g20/summits/toronto/g20-declaration.pdf>); G20 Seoul Summit 2010, *The G20 Seoul Summit Leaders' Declaration*, ¶ 2 (Nov. 12, 2010) (transcript available at <http://www.g20.utoronto.ca/2010/g20seoul.html>).

²²⁷ Financial Stability Board, *supra* note 2, at 3 (preamble).

²²⁸ Block (1992), *supra* note 7, at 1002; Giovanni Dell'Ariccia et al., *Trade-offs in Bank Resolution*, 2018 IMF STAFF DISCUSSION NOTE 6 ("Bail-outs should be the exception not the rule – their use justified as a last resort, exclusively when financial stability is gravely threatened, and structured to mitigate the associated costs.").

²²⁹ These figures include the auto bailouts as well as Fannie, Freddie and AIG. Paul Kiel & Dan Nguyen, *Bailout Tracker: Tracking Every Dollar and Every Recipient*, PRO PUBLICA, (last updated Oct. 2, 2019), <https://projects.propublica.org/bailout/main/summary> (highlighting these figures include the auto bailouts as well as Fannie, Freddie and AIG).

²³⁰ European Commission, *State Aid Scoreboard 2018*, EUROPA.EU, http://ec.europa.eu/competition/state_aid/scoreboard/ (last visited Jan. 9, 2020) (discussing how much state aid has been approved by the European Union to aid struggling banks).

²³¹ Trumbo Vila & Peters, *supra* note 159, at 5.

²³² *Id.* at 8; CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 164 (2009) (noting bailout comparisons across European Union nations are difficult due to a lack of uniformity in overall analysis).

government—as proceeds of the selling of stakes in bailed-out institutions or loan repayments with interest—the social costs reach far beyond the sums of immediate bailout money injected by the government.²³³

1. The Social Benefits of Bailouts

The (hidden) social benefits of a bailout may be thought of as equal to the costs to the government of nonintervention.²³⁴ The counterfactual nature of this assessment makes the determination of bailout benefits a highly speculative exercise.²³⁵ The statements of Timothy Geithner and Ben Bernanke before the House Committee on Financial Services on the AIG bailout²³⁶ may serve as an example of the widely accepted narrative:

AIG's failure would have caused catastrophic damage—damage in the form of sharply lower equity prices and pension values, higher interest rates, and a broader loss of confidence in the world's major financial institutions. This would have intensified an already-deepening global recession, and we did not have the ability to contain the damage through other means.²³⁷

Global banks and investment banks would have suffered losses on loans and lines of credit to AIG and on derivatives with AIG FP

....

Moreover, as the Lehman case clearly demonstrates, focusing on the direct effects of a default on AIG's counterparties understates the risk to the financial system as a whole. Once begun, a financial crisis can spread unpredictably

Moreover, it was well-known in the market that many major financial institutions had large exposures to AIG. Its failure would likely have led financial market participants to pull back even more from commercial and investment banks, and those institutions perceived as weaker would have faced escalating pressure.²³⁸

In these passages, "AIG" could be replaced with the name of any major financial institution of global significance. The narrative is plausible, at least to some extent,²³⁹ and almost impossible to disprove, although there is some empirical

²³³ See REINHART & ROGOFF, *supra* note 232.

²³⁴ See Block (1992), *supra* note 7, at 1013 ("Where the government cost of a decision not to intervene exceeds the cost of government assistance that would be necessary to rescue the troubled enterprise, bailout would appear the financially prudent."); Dell'Ariccia et al., *supra* note 228, at 28 (explaining the potential harms of non-intervention).

²³⁵ Levitin, *supra* note 7, at 452 (asserting the analyses of bailout benefits are often uncertain).

²³⁶ See *Oversight of the Federal Government's Intervention at American International Group: Hearing Before the Comm. on Fin. Servs. U.S. House of Representatives*, 11th Cong. 20 (2009).

²³⁷ *Id.* at 8 (statement of Timothy Geithner, Secretary, U.S. Dept. of the Treasury).

²³⁸ *Id.* at 11–12 (statement of Ben Bernanke, Chairman, Board of Governors, The Federal Reserve).

²³⁹ See Tröger, *supra* note 205, at 5 (explaining AIG is far from the only financial institution susceptible to requiring a bailout).

evidence suggesting that market reactions to the Lehman bankruptcy and the AIG bailout were very similar, indeed sometimes worse in the latter case.²⁴⁰

Generally speaking, the costs of nonintervention and therefore the benefits of intervention are greater where nonintervention would imperil large parts of the domestic and potentially global financial system with significant macro-economic consequences: a loss in tax revenues, increasing unemployment and higher costs for unemployment benefits and other welfare programs, a reduction of economic output and productivity, and a possible explosion of government debt.²⁴¹ This will more likely be the case where a failing institution is systemically important and occupies a central position within a domestic or the global financial system, by, for example, acting as counterparty for numerous other firms with large exposures or by supporting important sectors of the real economy.²⁴² A multitude of smaller firms may reach a critical mass with their combined failure potentially having a macro-economic impact.

2. The Social Costs of Bailouts

It is tempting to equate the social costs of bailouts with the sums of money directly injected into failing institutions and markets. However, this does not account for significant amounts of hidden costs in the form of fees paid by governments and EU institutions to the Big Four accounting firms and a small number of financial consultancies.²⁴³ Another hidden cost frequently ignored is the increase in public debt and higher interest payments.²⁴⁴

The non-pecuniary social costs of bailouts are even more difficult to quantify. Conceptually, these costs are encapsulated in the so-called "too-big-to-fail" problem. As the memory of the global financial crisis begins to fade,²⁴⁵ commentators have begun to argue that the "too-big-to-fail" problem is

²⁴⁰ See JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED, AND WORSENERED THE FINANCIAL CRISIS 25–30 (2009) (comparing the Lehman Brothers bailout to the AIG bailout); Ayotte & Skeel, Jr., *supra* note 30, at 490–91 (explaining markets did not seem to distinguish between different distress resolution mechanisms, but were concerned only with the fact of distress itself).

²⁴¹ See Block (1992), *supra* note 7, at 1013 (explaining an important factor in deciding when to intervene is cost to the government); Levitin, *supra* note 7, at 451 (describing the potential macroeconomic impact of intervention); Posner & Casey, *supra* note 7, at 522 (asserting bailouts have a macroeconomic benefit); REINHART & ROGOFF, *supra* note 232, at 163; Tröger, *supra* note 205, at 5 (describing the positive and negative elements of government intervention); Dell'Ariccia et al., *supra* note 228, at 9 (laying out a "resolution framework that allows use of public funds if and when the risks to macro-financial stability from bail-ins are exceptionally severe").

²⁴² See Binder, *Systemkrisenbewältigung*, *supra* note 179, at 61.

²⁴³ See Trumbo Vila & Peters, *supra* note 159, at 6. Fees can easily reach hundreds of millions of Euros with little or no accountability for quality. The same accounting firms that assure investors of the stability and profitability of financial institutions will be awarded lucrative government contracts in the preparation of subsequent bailouts, which sometimes occur only a few months after an audit. Indeed, even established malpractice does not prevent an audit firm from being hired by the same institution again and/or by the respective government. See Hellwig, *supra* note 35, ¶ 3.3.

²⁴⁴ See REINHART & ROGOFF, *supra* note 232, at 172; Dell'Ariccia et al., *supra* note 228, at 8.

²⁴⁵ See John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1029–37 (2012) (on the concept of the "regulatory sine curve").

exaggerated.²⁴⁶ The "too-big-to-fail" problem may be broken down into three basic elements: (i) moral hazard on the part of a "too-big-to-fail" firm; (ii) moral hazard on the part of investors who buy the financial assets issued by a "too-big-to-fail" firm, usually referred to as lack of market discipline; and (iii) the exposure of taxpayers to losses on implicit and explicit government guarantees, loans and/or capital injections.²⁴⁷

The moral hazard argument (i) goes as follows: when operating under an implicit state guarantee, an institution's management and traders have an incentive to invest in highly volatile assets in order to achieve ever-higher returns for investors and ever-higher compensation for themselves²⁴⁸ without having to fear adverse consequences from the materialization of downside tail-risks. The ensuing culture of short-termism and speculation renders the financial system more fragile overall. At a conceptual level, Steven Schwarcz has challenged this argument. Rather than being caused by bailout expectations, excessive risk taking was due to the prevalent shareholder primacy rule of corporate governance. In order to maximize shareholder value, a firm's management must invest in any project with a positive net present value taking into account only the potential costs to the firm itself; any systemic harm will be externalized and born by other market participants and the general public, and should therefore not be considered by a shareholder value maximizing management.²⁴⁹ However, theoretically shareholders are deemed, and empirically they are likely, to be widely diversified.²⁵⁰ In a world of diversified investment portfolios, management can ignore systemic harm only to the extent that their firm is "too-big-to-fail" and will be bailed out. Otherwise, firm failure, if truly systemic, will hit shareholders (and other investors) directly across their entire portfolio. Consequently, a shareholder wealth maximizing management should take systemic harms into account; only the prospect of a bailout eliminates

²⁴⁶ See Posner & Casey, *supra* note 7, at 526; Steven L. Schwarcz, *Too Big To Fool: Moral Hazard, Bailouts and Corporate Responsibility*, 102 MINN. L. REV. 761, 764 (2017).

²⁴⁷ *Bank Stakeholders*, *supra* note 6, at 226; Tröger, *supra* note 205, at 6; Wojcik, *supra* note 178, at 93; Dell'Ariccia et al., *supra* note 228, at 8.

²⁴⁸ EMILIOS AVGOULEAS, *GOVERNANCE OF GLOBAL FINANCIAL MARKETS* 113–15 (Cambridge Univ. Press, 2012).

²⁴⁹ Schwarcz, *supra* note 246, at 770. Consequently, seeking to address excessive risk taking by regulating "too-big-to-fail" may be "inefficient, ineffective, and sometimes even dangerous." *Id.* at 765–84.

²⁵⁰ Henry T.C. Hu & Jay L. Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1360–62 (2007).

systemic harm from the equation and allows excessive risk taking.²⁵¹ Empirical research seems to confirm that the moral hazard problem remains valid.²⁵²

According to the second element of the "too-big-to-fail" problem, the funding costs of "too-big-to-fail" institutions are publicly subsidized. Investors will benefit from higher returns given a certain level of risk. Market discipline breaks down because any potential losses for investors will not be borne by them, but by the taxpayer.²⁵³ It has been argued that the empirical evidence merely demonstrates that large, systemically important firms can borrow at lower than average cost, which may be due to reasons other than the expectations of a bailout, notably economies of scale, better access to capital markets, larger dividend pay-out ratios, and less vulnerability to market disruptions.²⁵⁴ However, Bryan Kelly, Hanno Lustig and Stijn Van Nieuwerburger find that "[r]isk adjusted crash insurance prices for larger banks are lower than those of their smaller peers, indicating investors perceive differences in bailout likelihoods across institutions consistent with an implicit '[too-big-to-fail]' guarantee."²⁵⁵ Whereas this result can still be explained on the basis of alternative factors, this is more difficult for recent empirical analysis on the effects of the BRRD. Jannic Cutura finds that bonds exposed to a potential BRRD bail-in faced increased yield spreads as compared to the control group of otherwise identical bonds issued by the same institution. For G-SIBs this effect was less pronounced.²⁵⁶ Moreover, Lea Steinbruecke shows that whereas agreement on BRRD and SRM and the associated decline in bail-out expectations initially reduced the relative funding advantage for large banks, the

²⁵¹ This can be demonstrated by modifying Schwarcz's example for "calculating the expected value disparity." Schwarcz, *supra* note 246, at 797–99. With an 80% chance of a project succeeding and, in that case, a value accruing to investors of 50m, plus a loss of 20m should the project fail, the expected value of the project to investors is 36m ($.8 \times 50m + .2 \times -20m$). If at the same time the value of the project's success to society is negligible, and the project's failure has a 10% chance of triggering the institution's failure in which case it has to be bailed out with 500m, the expected value of the project to the public is -10m ($0.8 \times 0 + .2 \times -1 \times 500m$). However, this calculation only works if the institution's bailout is priced in. Without it, expected value to investors would have to take into account their portfolio losses. Of course, everything depends on the assumed values. Schwarcz assumes that a firm's bailout will cost 500m. However, if the firm is systemic, its failure without bailout will trigger the failure of other similarly situated firms in which diversified investors hold financial assets. If we assume that firm failure would trigger the failure of only three other firms at the same cost, the expected value to diversified investors is unlikely to remain positive ($.8 \times 50m + .2 \times -20m + .02 \times -1 \times 2bn = -4m$).

²⁵² See Lammertjan Dam & Michael Koetter, *Bank Bailouts and Moral Hazard: Evidence from Germany*, 25 REV. FIN. STUD. 2343, 2344–45 (2012). These authors point out, rightly, that the moral hazard problem consist (only) in the additional risk taking due to higher bailout expectations, which is usually not directly observable and cannot be inferred from the riskiness of bailed out banks; rather, what is required are variables that explain the likelihood of a bailout, but are uncorrelated with a bank's risk taking. *Id.* at 2344. Dam and Koetter's main contribution is the development of precisely such variables on the basis of regional political differences. They find an increase of bailout expectations increases risk taking, measured as the likelihood of distress. According to the authors, an "economically significant increase in risk taking thus provides evidence for moral hazard due to bailout expectations." *Id.* at 2345.

²⁵³ See AVGOULEAS, *supra* note 248, at 119.

²⁵⁴ See Schwarcz, *supra* note 246, at 767.

²⁵⁵ Bryan Kelly, Hanno Lustig & Stijn Van Nieuwerburgh, *Too-Systemic-To-Fail: What Option Markets Imply About Sector-wide Government Guarantees*, 106 AM. ECON. REV. 1278, 1281 (2016).

²⁵⁶ See Jannic Cutura, *Debt holder monitoring and implicit guarantees: Did the BRRD improve market discipline?* 2–3 (SAFE Working Paper No. 232, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3263375. ("[B]ank bonds which suffer from unexpected BRRD bail-in exposure face increased yield spreads of about 10–15 basis points compared to the control group—a pattern that cannot be observed for non-bank corporate bonds.").

loss of credibility resulting from the Deutsche Bank bail-out speculations shortly after the new framework had become operational soon reinstated the "too-big-to-fail" funding advantage.²⁵⁷

The third element of the "too-big-to-fail" problem is the taxpayers' exposure to losses. Even where loans have been repaid with interest and capital investments sold at a profit, because of the hidden direct costs of bailouts the net impact on government deficits may be negative. This means that resources need to be held back and are not available for a Keynesian stimulus package or investment in infrastructure, health care, or education.²⁵⁸ However, the issue goes deeper. The implicit or explicit "too-big-to-fail" government guarantee consists of a put option that allows creditors to assign any losses in excess of shareholders' net worth to the taxpayer; and a stop-loss call option on the firm's assets that allows the government as guarantor to take over the firm's assets when the shareholders' net worth approaches or becomes zero. This is the economic equivalent of holding an equity position.²⁵⁹ Where the government refuses to exercise the call option—because an institution is "too-big-to-fail"—and continues to support the firm through liquidity assistance and explicit guarantees, it actually assumes a subordinated equity position with the taxpayer as residual risk bearer. Moral hazard induced risk taking with a view to increasing the return on equity directly transfers value from taxpayers through the put to shareholders and through stock options to the managers of "too-big-to-fail" firms.²⁶⁰ The public seems to be at least subconsciously aware of these re-distributional effects, which accounts for the unpopularity of bailouts in the financial sector. When public resources are scarce and safety nets are being slashed, a blatant transfer from "poor to rich" is difficult to justify.²⁶¹

²⁵⁷ Lea Steinbruecke, *Are European Banks Still Too-Big-to-Fail? The Impact of Government Interventions and Regulatory Reform on Bailout Expectations in the EU* 3–4 (Dec. 31, 2017) (unpublished manuscript), <https://ssrn.com/abstract=3098296>. The study demonstrates that paying higher prices for large European bank stocks is rational for investors because of the implicit state guarantee, as demonstrated by the loss in portfolio value immediately following the Lehman bankruptcy which signalled that even a large bank may fail. Portfolio losses were soon reversed when it became clear that no large European bank would be allowed to fail.

²⁵⁸ Kane, *supra* note 190, at 4.

²⁵⁹ Edward J. Kane, *A Theory of How and Why Central-Bank Culture Supports Predatory Risk-Taking at Megabanks* 22 (Inst. For New Econ. Thinking, Working Paper No. 34, 2015), <https://ssrn.com/abstract=2718733>.

²⁶⁰ Kane, *supra* note 190, at 21; Dell'Ariccia et al., *supra* note 228, at 8. The lack of proper loss compensation, despite government funds being fully repaid, can be seen by the difference in the rate of return on government and private investment. For example, in the case of Goldman Sachs, the rate of return on private investment was more than double the rate of return on the government bailout despite assuming the same level of risk. As Manns writes, "[t]he reward for helping Goldman Sachs bridge the depths of the crisis was a premature payout that left Goldman Sachs executives to reap the returns from the Treasury Department's risk taking." Manns, *supra* note 7, at 1373–77.

²⁶¹ This notion was already present in a famous letter that Anne Robert Jacques Turgot, Louis XVI's controller-general of finances wrote to his king in 1774, warning him about the dangers of generous subsidies:

Your Majesty knows that one of the largest obstacles to the economy is the multiple requests He is continuously assailed with . . .

It is necessary, Sire . . . to consider those from whom this money comes you can distribute to your courtiers, and compare the misery of those from whom it is sometimes required to tear off it by the most rigorous executions, with the situation of those who have more titles to obtain your liberalities.

3. Cost-Benefit Analysis

A bailout framework will likely facilitate pie-increasing bailouts if the availability of bailouts is limited to scenarios where bailout benefits are (likely to be) relatively large, whilst at the same time reducing the social costs to the greatest possible extent. The former may be ensured through the calibration of the bailout eligibility criteria and the interactions between the various system elements. Moral hazard, lack of market discipline, and taxpayer loss exposure may be reduced by letting an appropriate amount of losses lie where they fall, with a failing institution and its investors.²⁶² The larger the (likely) benefits the more lenient cost reduction measures can be; or, *vice versa*, the more limited and uncertain the benefits of a bailout the stricter should be the measures applied with a view to reducing the social costs of bailouts.

III. COST REDUCTION MECHANISMS

Moral hazard, lack of market discipline, and taxpayer loss exposure can be addressed through "loss sharing mechanisms": an appropriate, that is, socially acceptable, amount of losses is allocated to the failing firm and its investors.²⁶³ Corporate insolvency law provides the ground rules of the game. Losses will be allocated in accordance with a predetermined order of priorities. Equity and debt investors know in advance their place within that order and can price their investments accordingly. A bailout by necessity deviates from the pre-established order of priority. The main purpose of a government intervention is usually that the default loss allocation framework is deemed to be inappropriate. At least some investors will receive more than they would have received under the default regime, at the expense of other classes of investors and/or the taxpayers in general. There will be winners and losers.²⁶⁴ The government decision as to who benefits and who loses out is inherently distributive and political.²⁶⁵ To the extent that critical counterparties are spared from losses, non-critical counterparties and the taxpayer have to pick up the bill. Loss allocation may thus appear as a pure subsidy for certain "too-big-to-fail" counterparties.²⁶⁶ Non-critical counterparties

Letter from Anne Robert Jacques Turgot, King Louis XVI's Controller of General Finances, to King Louis XVI, King of France (Oct. 24, 1774) (available at <http://desguin.net/spip/spip.php?article55>).

²⁶² See Aygoules & Goodhart, *supra* note 206, at 5; Dell'Ariccia et al, *supra* note 228, at 9 ("[W]hen spillovers are relatively small, it is preferable to suffer their consequences than generate moral hazard by providing bail-outs . . . [W]hen spillovers are particularly severe, for example, when an aggregate shock triggers a systemic banking crisis, it is preferable to tolerate the consequences of moral hazard than suffer the destabilizing effects associated with bail-ins.").

²⁶³ See Levitin, *supra* note 7, at 508 (explaining the public expects loss sharing mechanisms to be a part of bailouts and that deviations from that norm increase the moral hazard of "too-big-to-fail" firm bailouts).

²⁶⁴ See Rasmussen & Skeel, Jr., *supra* note 7, at 24 (suggesting because bailouts are drastic remedies that inherently result in seemingly unfair outcomes for some).

²⁶⁵ See Levitin, *supra* note 7, at 481 (explaining there are no preset rules for a bailout when the government steps in).

²⁶⁶ See *id.* at 510 ("If critical counterparties do not take haircuts, what about other noncritical counterparties that are too-small-to-matter? Imposing a haircut on them reduces the cost of a bailout and might help mitigate moral hazard. Applying haircuts only to noncritical counterparties violates a core principal of resolutions, namely that equity is equality—similarly situated creditors are to be treated alike—and losses should be shared pro rata, except when provided otherwise by statute. Violating this principal

may be compensated for their additional loss absorption. However, this does not address the moral hazard issue, nor does it reduce taxpayers' loss exposure, as the government will ultimately underwrite any compensation paid to non-critical counterparties.

A. Corporate Insolvency Law

Under corporate insolvency law, the allocation of losses is based on a predetermined statutory order of priority for the distribution of proceeds in liquidation. In restructuring proceedings, the order of priority influences a creditor's bargaining power in plan negotiations and may have a bearing on plan confirmation. Losses are allocated in accordance with the reverse order of priority; in principle, there is no room for government intervention. Losses are borne by a failing firm's investors; and the taxpayer is off the hook.²⁶⁷ At least theoretically, this reduces the social costs associated with taxpayer loss exposure and lack of market discipline to zero. Moral hazard is kept in check by the insolvency process. In liquidation, management and risk takers will lose their jobs and their reputation may be severely tarnished. In a restructuring, senior management is likely to be replaced, either upon the appointment of an office holder or, in debtor-in-possession type proceedings, by a restructuring specialist. Lower level risk takers, however, may remain in place and may even be incentivized with higher remuneration packages to stay with the firm.

The statutory order of priority is currently a matter for national law. However, to some extent, the BRRD has harmonized the order of priority in resolution and normal insolvency proceedings. In particular,²⁶⁸ according to BRRD, art. 108(1) eligible deposits from natural persons and micro, small and medium-sized enterprises have a priority higher than claims of ordinary, unsecured creditors. To the extent that deposits are covered by deposit insurance, they have an even higher ranking than non-covered eligible deposits. A deposit guarantee scheme subrogating to the rights of covered depositors has the same (higher) ranking as covered depositors.²⁶⁹ Other than ranking ahead of general unsecured creditors, the BRRD does not determine how this limited (tiered) depositor preference relates to other classes of preferred creditors (if any) and to the holders of floating or fixed security interests. These are matters to be determined by national law.²⁷⁰ In order to

undermines the public legitimacy of bailouts because the loss allocations appear as naked interest group subsidies with public funds. Moreover, imposing haircuts only on the too-small-to-matter rewards counterparties that are themselves TBTF, exacerbating moral hazard problems.").

²⁶⁷ This is subject to the granting of State aid within the framework of national corporate insolvency law. See *infra* Part IV(C).

²⁶⁸ The BRRD also affords resolution authorities and financing arrangements preferred creditor status as regards their reasonable expenses incurred in connection with the resolution vis-à-vis the institution as well as a bridge institution or AMC. See BRRD, *supra* note 19, art. 37(7). This essentially establishes an administrative expense priority for these claims.

²⁶⁹ See *id.* art. 108.

²⁷⁰ This is also true for the question as to how BRRD, art. 108(1) relates to BRRD, art. 109(1) dealing with the liability of deposit guarantee schemes. The amount of liability is based on the extent that covered depositors would have suffered losses if they had been treated similarly to the "creditors with the same level of priority under the national law governing normal insolvency proceedings." Given that pursuant to BRRD, art. 108(1), covered depositors have a ranking higher than ordinary, unsecured creditors, it is a question of national law whether there are any other creditors with a similar preferential status.

enhance the effectiveness of the bail-in tool, the new art. 108(2) has introduced the asset class of non-preferred senior debt, which has a ranking below ordinary unsecured claims and above capital instruments.²⁷¹ The introduction of this new asset class is complementary to the TLAC and MREL standards, as it facilitates meeting the subordination requirement as a prerequisite for TLAC eligibility.

Outside this area of harmonization,²⁷² the statutory orders of priority under national law vary significantly. The ranking of creditors can have important (re-) distributive effects. For example, a high ranking of employee wage claims benefits labor at the expense of investors; carve-outs from a security interest for the benefit of unsecured creditors²⁷³ may work to the advantage of customers and suppliers at the expense of financial institutions. A statutory subordination of shareholder loans²⁷⁴ benefits outside lenders at the cost of intra-group debt. Despite all the differences, it is possible to discern a basic common structure: secured credit normally takes priority over administrative expenses, which rank ahead of general unsecured creditors, and equity. Depending on the legal system, further classes may be added: creditors with a super-priority, preferential creditors, and subordinated creditors.²⁷⁵

For example, under French law, certain employee claims²⁷⁶ enjoy a first-ranking so-called super-priority.²⁷⁷ These claims take priority over administrative expenses and secured credit (as well as general unsecured creditors). In other legal systems, it is normally secured credit, which takes the top spot in the creditor

²⁷¹ Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy, 2017 O.J. (L 345) 96. In order to qualify as non-preferred senior, a debt instrument must have an original maturity of at least one year, must not contain an embedded derivative or be a derivative itself, and the relevant documentation and prospectus must explicitly refer to the lower ranking.

²⁷² A further area of harmonization is the long-standing "super-priority" of certain contracts between financial market participants involving the large-scale transfer of financial instruments or cash as collateral to cover exposures subject to (close-out) netting arrangements, usually under a master agreement: essentially, derivatives transactions, stock lending, and short-term repo financing. The European regime consists of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems OJ EC 11.6.1998 L166/45 and Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, 2002 O.J. (L 168) 43 (both amended by Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims, 2009 O.J. (L 146) 37. The covered financial contracts are exempt from key insolvency law provisions—the moratorium, certain avoidance powers, and possibly restrictions on the amendment or termination of rights and *ipso facto* clauses, thus, creating a de facto "super-priority" for these contracts and their creditors.

²⁷³ For example, under English law, for floating charges created on or after 15 September 2003, the liquidator, administrator or receiver, as the case may be, has to make available for the satisfaction of unsecured debts a "prescribed part" of the company's net property. Insolvency Act 1986 § 176A(2) (Eng.). "Net property" is the property that would be available for the satisfaction of floating charge holders in the absence of the provisions on the prescribed part. Currently, the prescribed part is for a net property of up to £10,000: 50%; for £10,000 and above: 50% of the first £10,000 and 20% of the excess; but not more than £600,000 overall. Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097 (Eng.).

²⁷⁴ For Germany, see InsO, *supra* note 119, § 39(1)(5).

²⁷⁵ See EUROPEAN LAW INSTITUTE, *supra* note 166, at 240–50.

²⁷⁶ For wages and reimbursement for accrued holidays incurred within 60 days prior to the commencement of proceedings.

²⁷⁷ See CODE DU TRAVAIL [C. TRAV.] [LABOR CODE] arts. L3253-3, L3253-4. It is capped, however, at an amount equal to twice the maximum base for the calculation of contributions to the French national insurance system. *Id.*

hierarchy. However, there is great variation. German law distinguishes between secured creditors with a right to separation and secured creditors with a right to preferential satisfaction. The former can reclaim an asset that does not belong to the debtor's estate,²⁷⁸ unaffected by insolvency proceedings. The latter merely have a right to preferential satisfaction out of the proceeds of the sale of collateral,²⁷⁹ with the realization of collateral being largely integrated into the insolvency process. Under French law, the claims of secured creditors with either a security interest on immovable property (hypothec) or with a fixed security interest in movable property take priority over all other claims, except the employee super-priority, the costs of the proceeding, and the 'new money' priority.²⁸⁰

In accordance with BRRD, art. 108(1), under both German²⁸¹ and French law,²⁸² eligible deposits take priority over general (unsecured) creditors (only). Within the new class of eligible depositors, covered deposits (up to the maximum amount of EUR100,000) and, following compensation of depositors, any claims to which the deposit insurance scheme has been subrogated, rank ahead of eligible deposits of natural persons as well as micro, small and medium sized enterprises that exceed the maximum amount of coverage.²⁸³ Within each sub-class, depositors share on a pro rata basis. Following the payment of the classes that take priority, any remaining proceeds will be distributed to the general (unsecured) pre-commencement creditors in proportion to their admitted claims.²⁸⁴ Under German law, the payment of unsecured bonds and similar debt securities issued by credit institutions is contingent on the prior payment of all other general unsecured creditors.²⁸⁵ Consequently, senior unsecured bonds are to be paid in priority after the operational liabilities have been paid in full, but before the payment of any contractually subordinated (junior) instruments.²⁸⁶ This statutory subordination was introduced in anticipation of the new BRRD, art. 108(2) with a view to facilitating the effective application of bail-in as envisaged by the FSB's TLAC requirements.²⁸⁷ French legislation has followed suit.²⁸⁸ Statutorily and contractually subordinated creditors will receive a dividend only after the general creditors have been satisfied in full. As residual claimants, shareholders, in the order of preference shares and ordinary shares, form the end of the line.

On that basis, the loss allocation cascade in standard corporate insolvency proceedings looks as follows: equity takes first losses, followed by hybrid

²⁷⁸ See *InsO*, *supra* note 119, § 47.

²⁷⁹ *Id.* §§ 49, 50.

²⁸⁰ Those who under a court approved conciliation agreement have made a contribution of fresh funds to the debtor or have supplied new assets or services to the debtor in order to ensure the continuation and long-term future of the debtor's business activity enjoy the new money priority if subsequently safeguard or judicial reorganization or liquidation proceedings have been opened. CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L611-11.

²⁸¹ See *KWG*, *supra* note 118, § 46f(4).

²⁸² See CODE MONÉTAIRE ET FINANCIER [C. MON.] [MONETARY AND FINANCIAL CODE] art. L613-30-3.

²⁸³ On Spanish law, see *SRB Banco Popula*, *supra* note 121, ¶¶ 17, 18; see also Baudino et al., *supra* note 84, at 12–15.

²⁸⁴ See CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L643-8.

²⁸⁵ See *KWG*, *supra* note 118, § 46f(5).

²⁸⁶ See *id.* § 46f(6), (7).

²⁸⁷ Gesetzentwurf der Bundesregierung – Abwicklungsmechanismusgesetz, Deutscher Bundestag, Drucksache 18/5009, 76 (May 25, 2015).

²⁸⁸ See CODE MONÉTAIRE ET FINANCIER [C. MON.] [MONETARY AND FINANCIAL CODE] art. 613-30-3.

instruments and subordinated debt;²⁸⁹ any losses remaining thereafter are borne by general unsecured creditors and, depending on the legal system, by preferential creditors. Even secured creditors and creditors with a super-priority may sustain losses: for example, where collateral value has declined below the nominal amount of the secured debt, or where the settlement of terminated derivative contracts is delayed with adverse consequences for the counterparty. The only constituency that is shielded²⁹⁰ from losses is the covered depositors, which will be compensated by the relevant deposit guarantee schemes, with the latter then taking their place within the loss allocation cascade.

The impact of a statutory order of priority on the social costs associated with a lack of market discipline depends on whether and to what extent there is room for priority deviations. To the extent that certain creditors or classes of creditors may receive a treatment in insolvency that is more beneficial than under the statutory loss allocation regime, market discipline may be compromised. A deviation from the statutory order of priority may occur under an administrative regime and within court-centered frameworks. Pre-commencement and post-commencement contractual modifications of the loss allocation framework may be imposed on dissenting creditors, possibly on the basis of a plan of reorganization, subject to affirmation by the court. Irrespective of a creditor agreement, under both types of insolvency regimes, the court or the relevant administrative authority may have the power to rewrite the statutory order of priority to a greater or lesser extent. In any case, the feasibility of a deviation/rewriting depends on the rigor and stringency with which the *pari passu* principle and the absolute priority rule, both part of national insolvency laws to varying degrees, are applied and enforced. The former seeks to ensure that all creditors within the same class (if there are any) are treated equally and proportionately on the basis of their pre-insolvency entitlements and that no creditor obtains preferential treatment.²⁹¹ It may prevent a contractual arrangement from taking effect that would allow certain (unsecured) creditors to opt out of *pari passu* distribution to their advantage,²⁹² or the affirmation by the court of a plan of reorganization that violates the *pari passu* principle.²⁹³ The

²⁸⁹ Under the new BRRD, art. 48(7), Member States are required to ensure that in their applicable national insolvency laws claims resulting from own funds items (common equity tier 1, additional tier 1 and tier 2) rank below any claims not resulting from own funds items; inserted by Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalization capacity of credit institutions and investment firms and amending Directive 98/26/EC, 2019 O.J. (L 150) 62.

²⁹⁰ Shielded only to the extent that the relevant deposit guarantee scheme has the necessary funds. The proposed European Deposit Insurance Scheme (EDIS) that would progressively mutualize deposit insurance within the Euro-zone remains on the agenda but faces significant political opposition. SCHILLIG, *supra* note 43, at 319, ¶ 12.15.

²⁹¹ See EUROPEAN LAW INSTITUTE, *supra* note 166, at 240; see also *British Eagle Int'l Airlines Ltd v. Compagnie Air France* [1975] 1 WLR 758, 780G-H (per Lord Cross).

²⁹² See *British Eagle Int'l Airlines Ltd v. Compagnie Air France* [1975] 1 WLR 758; see also *Nat'l Westminster Bank Ltd v. Halesowen Presswork & Assemblies Ltd* [1972] AC 785.

²⁹³ Because they have no (adverse) effect on the rights of the remaining creditors, contractual subordination agreements remain valid. See EUROPEAN LAW INSTITUTE, *supra* note 166, at 246; *Re Maxwell Commc'ns Corp.* (No 2) [1993] BCC 369, 377 (per Vinolett J); *Re SSSL Realisations (2002) Ltd* (in liquidation) and another company [2004] EWHC 1760 (Ch) ¶ 45 (per Lloyd J); *In re Kaupthing Singer & Friedlander Ltd* (in administration) [2010] EWCH 316 (Ch) ¶ 10 (per Blair J).

absolute priority rule²⁹⁴ seeks to ensure that a plan of reorganization respects the order of priority established outside of insolvency proceedings under non-insolvency law; a plan cannot be imposed on dissenting creditor classes if their pre-insolvency priority would thereby be compromised.²⁹⁵ Both mechanisms realize their effect *ex ante*: if strictly applied, the court will not confirm a plan of reorganization, and neither court nor administrative authority will be able to rewrite the statutory order of priority with the result that an envisaged restructuring or liquidation cannot take effect. The strength of these principles varies greatly between jurisdictions. Sometimes a rewriting of priorities is merely subject to the adequate protection of creditors' interests, a test which may be satisfied where a creditor is not worse off than they would have been in a hypothetical liquidation.²⁹⁶ Arguably this test would not prevent other similarly situated creditors, and even junior classes, from receiving a more favorable treatment under the plan than they would under the statutory regime.

B. BRRD/SRM Resolution Framework

Under the BRRD/SRM resolution framework, the application of resolution tools and powers is reserved for circumstances where resolution is necessary in the public interest and other options are not readily available.²⁹⁷ Consequently, financial institutions should be resolved primarily through the normal corporate insolvency process. This means that shareholders and creditors absorb losses; to the extent that covered depositors are present, the relevant deposit guarantee scheme is required to contribute. Private sources of funding—existing shareholders and creditors, willing purchasers and providers of new finance—are the preferred means of resolution funding.

Where resolution is justified on systemic grounds,²⁹⁸ the general resolution principles apply. These require that the management body and senior management of a failing institution are replaced, except where their retention is necessary in order to achieve the resolution objectives.²⁹⁹ Thus, moral hazard is addressed in a way not dissimilar to standard corporate insolvency law; and again, the requirement to replace management does usually not affect risk-takers below management level. In respect of market discipline, the general resolution principles establish a schedule for the allocation of losses amongst the different stakeholder constituencies: Shareholders bear first losses; creditors bear losses after the shareholders in accordance with the order of priority of their claims under national law, unless provided otherwise under the BRRD/SRM framework; creditors of the same class must be treated in an equitable manner; covered deposits are fully

²⁹⁴ See *Case et al. v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 117 (1939) (applying the "rule of full or absolute priority").

²⁹⁵ Accordingly, and possibly subject to a "new value" exception, under a plan proposal, no creditor may receive more than the nominal value of their claim and no creditor junior to the class opposing the proposal, including shareholders, may receive any value; further no creditor of equal ranking with the opposing class may obtain better treatment than that class. For German law, see *InsO*, *supra* note 119, § 245(2). Similar principles apply for the shareholders as an opposing class. See *id.* § 245(3).

²⁹⁶ EUROPEAN LAW INSTITUTE, *supra* note 166, at 322–24.

²⁹⁷ BRRD, *supra* note 19, art. 32(1); SRMR, *supra* note 22, art. 18(1).

²⁹⁸ Binder, *Systemkrisenbewältigung*, *supra* note 179, at 61.

²⁹⁹ BRRD, *supra* note 19, art. 34(1)(c); SRMR, *supra* note 22, art. 15(1)(c).

protected; and resolution action must be taken in accordance with the safeguards provided for under BRRD and SRM. Moreover, no creditor shall incur greater losses in resolution than they would have incurred if the institution had been wound up under normal insolvency proceedings, installing the "no-creditor-worse-off" principle.³⁰⁰ BRRD and SRM take the national orders of priority of claims as a base line, subject to the modifications introduced by BRRD and SRM in form of a limited depositor preference and the non-preferred senior asset class.³⁰¹ The *ex ante* protections of *pari passu* and absolute priority are replaced with the vague, and essentially *ex post*, standard of the "no-creditor-worse-off" principle.³⁰² This is reflective of the resolution authority's discretion to derogate from national creditor rankings, the extent of which depends on the resolution tools and powers to be applied, subject to the principle of proportionality.³⁰³

In accordance with the principle that shareholders should bear first losses,³⁰⁴ relevant capital instruments must be written down or converted where the resolution authority decides to apply a resolution action that would result in losses being borne by creditors.³⁰⁵ A write down of capital instruments is not actually a resolution tool³⁰⁶ and may occur either independently of, or within resolution and as a prerequisite for the application of resolution tools and powers.³⁰⁷ In applying the write down power, CET1 instruments³⁰⁸ are written down first in proportion to the losses and up to their capacity by either cancelling them or severely diluting them through conversion of existing debt into equity.³⁰⁹ Thus, depending on the amount of losses, common shares may be cancelled and the existing shareholders wiped out. Thereafter, the principal amount of, first, Additional Tier 1 instruments,³¹⁰ and following that, Tier 2 instruments is to be written down or converted to CET1 instruments, permanently, and, in principle, without

³⁰⁰ BRRD, *supra* note 19, art. 34(1); SRMR, *supra* note 22, art. 15(1).

³⁰¹ BRRD, *supra* note 19, art. 108; SRMR, *supra* note 22, art. 17. BRRD, art. 48(7) mandates the ranking of claims emanating from own funds items below claims arising from instruments that do not qualify as own funds. See *supra* note 289.

³⁰² Jens-Hinrich Binder, *The Position of Creditors Under the BRRD*, in COMMEMORATIVE VOLUME IN MEMORY OF PROFESSOR DR. LEONIDAS GEORGAKOPOULOS, BANK OF GREECE'S CENTER FOR CULTURE, RESEARCH AND DOCUMENTATION 37, 47–50 (2016).

³⁰³ See *Proportionality at Resolution Stage*, *supra* note 179, at 11.

³⁰⁴ See BRRD, *supra* note 19, art. 34(1)(a); SRMR, *supra* note 22, art. 15(1)(a).

³⁰⁵ See BRRD, *supra* note 19, art. 37(2); SRMR, *supra* note 22, art. 21(1)(a).

³⁰⁶ See Wojcik, *supra* note 178, at 99.

³⁰⁷ See BRRD, *supra* note 19, art. 59(1). Irrespective of whether resolution tools and powers are exercised or not, where either the "appropriate authority" determines that the institution meets the conditions for resolution; or the appropriate authority determines that in the absence of a write down the institution will no longer be viable; which is essentially the conditions for resolution minus the public interest requirement. See *id.* art. 59(3), (4); SRMR, *supra* note 22, art. 21(1)(b)-(d), (3). Capital instruments must further be written down where the institution or group requires extraordinary public financial support. See BRRD, *supra* note 19, art. 59(3)(e); SRMR, *supra* note 22, art. 21(1)(e).

³⁰⁸ See BRRD, *supra* note 19, art. 2(68); Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. (L 176) 1, 37.

³⁰⁹ See BRRD, *supra* note 19, art. 60(1)(a); SRMR, *supra* note 22, art. 21(10)(a).

³¹⁰ These may have been written down or converted already on the basis of their terms providing for a trigger event at the point of the CET1 capital ratio falling below 5.125%. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. (176) art. 54.

compensation,³¹¹ to the extent necessary to achieve the resolution objectives or up to the respective loss absorbing capacity, whatever is the lower. The power to write down and convert capital instruments has been applied in the resolution of Spanish banking group Banco Popular.³¹²

Following a write down of capital instruments, the BRRD/SRM loss allocation principles differ depending on whether the resolution authority applies the transfer tools (sale of business, bridge institution, and asset management company) or the bail-in tool. Loss allocation under the transfer tools is determined exclusively by the general resolution principles, affording the resolution authority a wide margin of discretion, subject to the principle of proportionality.³¹³ In deciding which liabilities are to be transferred to a private sector purchaser or bridge institution, and will thus be fully protected and insulated from losses, the resolution authority must take the order of priority of claims under applicable national insolvency law as a baseline.³¹⁴ However, the resolution authority may deviate from this national order of priority, subject only to the principle that creditors of the same class are to be treated equitably, not equally. For example, Portuguese bank Banco Espírito Santo was resolved by creating a bridge bank (Novo Banco) and transferring all liabilities to it except certain "excluded liabilities" in accordance with statutory transfer restrictions. In *Goldman Sachs International v. Novo Banco*, it was contested among the parties whether the facility agreement at issue had in fact been transferred or fell into the category of excluded liabilities.³¹⁵ Special safeguards are in place for secured creditors, regardless of whether the security arises from a security interest proper, title-based funding, or set-off and netting provisions. A partial transfer of rights and liabilities to another entity must not result in a disturbance of these arrangements.³¹⁶ The discrimination between various groups of creditors equally ranked under national insolvency law is likely to be the rule, rather than the exception. The application of resolution tools and powers, with a view of ensuring the continuity of critical functions and to preserving financial stability by necessity, entails the selection and transfer of certain systemically important contractual relationships that are essential for achieving the resolution objectives, and the leaving behind and eventual liquidation of the remaining non-systemic arrangements.³¹⁷ In these scenarios, the "no-creditor-worse-off" principle requires the *ex post* compensation of left behind shareholders and creditors to the

³¹¹ Where it subsequently transpires, in the course of the final valuation, that the amount of the write down exceeded what was necessary, a write up mechanism applies to reimburse affected creditors and shareholders. See BRRD, *supra* note 19, art. 46(3).

³¹² See *supra* Part II(C).

³¹³ See *Proportionality at Resolution Stage*, *supra* note 179, at 11.

³¹⁴ See BRRD, *supra* note 19, art. 34(1)(b), (f), (g) (containing resolution principles); SRMR, *supra* note 22, art. 15(1)(b), (f), (g) (same).

³¹⁵ See *Goldman Sachs Int'l v. Novo Banco SA* [2018] UKSC 34. The Supreme Court had to decide, in the context of a dispute concerning jurisdiction of the English courts pursuant to a jurisdiction clause in a facility agreement, whether certain measures taken by the Bank of Portugal as resolution authority overseeing the resolution had to be recognised in England. *Id.* It was held that an English court had to treat the liability at issue as never having been transferred to the bridge bank, Novo Banco. *Id.* As a consequence, the bridge bank was never party to the jurisdiction clause. *Id.*

³¹⁶ See BRRD, *supra* note 19, arts. 76–78.

³¹⁷ See Binder, *supra* note 302, at 49.

extent that they incurred greater losses in resolution than they would have incurred if the institution had been wound up under normal insolvency proceedings.³¹⁸

The loss allocation principles for the bail-in tool are much more prescriptive and the resolution authority's margin of discretion is considerably narrower. The bail-in tool applies to all liabilities that are not excluded.³¹⁹ On the basis of a fair and reasonable valuation,³²⁰ existing shares are either cancelled or "severely diluted" by converting eligible liabilities into shares at an appropriate rate of conversion.³²¹ Thereafter, BRRD and SRMR establish a waterfall for exercising the bail-in tool that, in principle, follows the reverse order of priority under general corporate insolvency law.³²² Within each class, losses are to be allocated on a pro-rata basis.³²³

In exceptional circumstances, resolution authorities may exclude certain eligible liabilities where this is strictly necessary and proportionate to ensure continuity of critical functions or to prevent widespread contagion.³²⁴ In order to ensure the functionality of the bail-in tool,³²⁵ banks and investment firms are required to maintain at all times a certain minimum level of bail-inable debt in form of a sufficient aggregate amount of own funds and eligible liabilities expressed as a percentage of total liabilities (MREL). A sufficiently large layer of long-term, high-quality, and easy to bail-in capital is essential for the credibility of a bail-in framework as it provides assurance for senior creditors that their claims will remain untouched, thus preventing a flight-to-safety and signaling that bail-in is actually likely to occur.³²⁶ For global systemically important banks (G-SIBs), the FSB has issued a new minimum total loss-absorbing capacity (TLAC) requirement.³²⁷ MREL and TLAC constitute complementary elements of a common framework that seeks to ensure that institutions have sufficient loss-absorbing and

³¹⁸ See BRRD, *supra* note 19, arts. 73–75.

³¹⁹ See *id.* art. 44(1); SRMR, *supra* note 22, art. 27(1). Excluded liabilities are limited to covered deposits; secured liabilities up to the amount of the value of the collateral; liabilities arising from the holding of client assets or client money; fiduciary liabilities; short term liabilities with an original maturity of less than seven days (where owed to a clearing or settlement system with a remaining maturity of less than seven days); and certain liabilities owed to employees, commercial and trade creditors, and tax and social security claims provided they are treated as preferential under national insolvency law; as well as contributions owed to a Deposit Guarantee Scheme. See BRRD, *supra* note 19, art. 44(2); SRMR, *supra* note 22, art. 27(3).

³²⁰ BRRD, *supra* note 19, art. 46(1); SRMR, *supra* note 22, art. 27(13). Where the bail-in tool is applied in order to recapitalize an institution or to capitalize a bridge bank, the aggregate amount thus established must be sufficient to restore the CET1 capital ratio of the institution, to sustain sufficient market confidence in it and to allow it to continue to comply with the conditions for authorization and to carry on the activities for which it was authorized for at least one year. See BRRD, *supra* note 19, art. 46(2); SRMR, *supra* note 22, art. 27(13)(b).

³²¹ BRRD, *supra* note 19, art. 47(1).

³²² *Id.* art. 48; SRMR, *supra* note 22, art. 27(15), (17).

³²³ See BRRD, *supra* note 19, art. 48(2).

³²⁴ See *id.* art. 44(3); SRMR, *supra* note 22, art. 27(5). When doing so, resolution authorities must have regard to the order of preference under national law. See Wojcik, *supra* note 178, at 109.

³²⁵ See Wojcik, *supra* note 178, at 113.

³²⁶ See Tröger, *supra* note 205, at 10; Jon Cunliff, *Ending Too-Big-to-Fail: How Best to Deal with Failed Large Banks*, 2 EUROPEAN ECON. 59, 66 (2016).

³²⁷ Financial Stability Board [FSB], *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution* at 5, 9 (Nov. 9, 2015), <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>.

recapitalization capacity.³²⁸ Pursuant to the amended BRRD and SRMR, GSIBs and so called "top tier banks" with total assets exceeding EUR100bn will be subject to standard TLAC/MREL minimum requirements; which may also be imposed on smaller institutions below the EUR100bn threshold, provided their failure is deemed to pose systemic risks. For these institutions, resolution authorities shall ensure that a part of the respective MREL requirement, equal to the minimum loss absorption amount of 8% of total liabilities, is met with own funds and subordinated liabilities. All institutions, including those that are neither GSIBs nor top tier banks nor deemed to pose systemic risks, will be subject to institution-specific requirements to be determined by the relevant resolution authority. Interestingly, the resolution authority may request any institution to meet its MREL requirements with own funds and subordinated eligible instruments, in particular when there is a clear indication that bailed-in creditors are likely to bear losses in resolution that would exceed their potential losses in insolvency.³²⁹ It has been argued that the only plausible explanation for imposing MREL requirements on institutions that are not systemically important and could be resolved through standard corporate insolvency law is that any liabilities senior to MREL instruments should never have to bear any losses.³³⁰ This would mean a significant alignment of the loss allocation schedules under all three subsystems: for most cases the sharing of losses would be cut off at the level of subordinated debt instruments and no senior unsecured creditor would have to be asked to contribute.³³¹ However, it remains doubtful whether smaller institutions that follow a traditional business model and for their funding mainly rely on capital instruments and deposits with limited capital markets access will be able to easily comply with stringent MREL requirements.³³²

The exclusion of certain liabilities, automatically³³³ or at the discretion of the resolution authority, from the scope of the bail-in tool may constitute a deviation from the ranking of creditors under national insolvency laws. The regulatory framework allows the write down and conversion of senior claims before junior debt has been extinguished, contrary to the absolute priority principle.³³⁴ It

³²⁸ Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, 2019 O.J. (L 150) 296, Recital (2); Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, 2019 O.J. (L 150) 226, Recital (2).

³²⁹ See BRRD, *supra* note 19, arts. 45b(4), (5), 45c(5), (6); SRMR, *supra* note 22, arts. 12c(4), (5), 12d(4), (5).

³³⁰ Tobias H. Tröger, *Why MREL Won't Help Much* 10 (SAFE Working Paper No. 180, Eur. Banking Inst. Working Paper No. 13, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023185.

³³¹ See Thomas Conlon & John Cotter, *Anatomy of a Bail-In* 4 (UCD Geary Institute Discussion Paper Series Geary WP 2014/05, 2014), <https://ideas.repec.org/p/ucd/wpaper/201405.html>. Retrospectively studying the proportion of liabilities that authorities would have needed to bail-in to cover losses associated with the global financial crisis, the authors find "that a bail-in mechanism that largely impacts subordinated investors would help reduce the danger of flight-to-safety, in particular limiting the impact of bank runs by depositors." *Id.*

³³² See Resolution Framework, *supra* note 85, at 4, 6.

³³³ Although, in this respect, it could be argued that the list of excluded liabilities constitutes a pre-publicized modification of the statutory order of priorities which allows private investors to price the respective debt instruments accordingly. See *Bank Stakeholders*, *supra* note 6, at 242.

³³⁴ See *id.*

transforms excluded liabilities into preferred liabilities, whereas equally ranking bail-inable instruments will be subordinated and potentially worse off in resolution than they would have been under otherwise applicable corporate insolvency law.³³⁵ Under the "no-creditor-worse-off" principle, the bailed-in creditors may be compensated *ex post* through a payout from the resolution financing arrangements.³³⁶

In order to provide the necessary funding for the resolution process, the EU resolution framework has established standing resolution funds, pre-funded by risk-calibrated financial industry contributions. The European System of Financing Arrangements under the BRRD consists of national financing arrangements, borrowing, between national financing arrangements, and the mutualization of national financing arrangements in the case of a group resolution.³³⁷ As part of the Banking Union, the SRM relies on a Single Resolution Fund (SRF).³³⁸ The presence of pre-financed standing resolution funds reduces taxpayers' loss exposure but does not eliminate it completely, as these funds are ultimately underwritten by the Member States. Where the funds turn out to be insufficient, taxpayers will have to pick up the bill. This will remain the case even following the installation of the envisaged common backstop in form of a revolving credit line provided by the ESM to the SRF.³³⁹ The ESM members ultimately provide the funding for the ESM itself. Resolution authorities may draw on financing arrangements only to the extent that this is necessary to ensure the effective application of resolution tools and powers.³⁴⁰ Financing arrangements may not be used to directly absorb the losses of an institution under resolution or to recapitalize it, other than in the context of bail-in.³⁴¹ Indirectly, losses may be passed on to the financing arrangements where, for example, contributions made to a bridge bank or asset management vehicle cannot be fully recouped through a subsequent sale of the bridge or a liquidation of the assets under management; and also where creditors have to be compensated in accordance with the "no-worse-off" principle. Moreover, where eligible liabilities have been excluded from the application of

³³⁵ If the institution were to be wound up under normal insolvency law all (senior) unsecured general creditors would share in the proceeds of the pool of assets available for distributions on a *pro rata* basis.

³³⁶ BRRD, *supra* note 19, art. 75.

³³⁷ *Id.* art. 99.

³³⁸ Contributions are raised by participating Member States at the national level through the national financing arrangements and subsequently transferred to the SRF on the basis of an Intergovernmental Agreement between the participating Member States. Until the Fund reaches its target level, but not later than 8 years from its inception, the SRF remains divided into national compartments, to which the contributions raised at national level are to be transferred. The national compartments are progressively mutualized during the transitional period: by 40% in the second year; 60% in the third year; and by an additional 6.67% in each of the remaining five years. Eventually the national compartments will be merged into a single compartment.

³³⁹ See *supra* note 44 and accompanying text.

³⁴⁰ For that purpose, funds may be used to guarantee the assets or liabilities of, or to make loans to, the institution under resolution, a bridge bank or an asset management vehicle; to purchase the assets of the institution under resolution, to make contributions to a bridge bank or an asset management vehicle; to compensate shareholders or creditors in accordance with the "no-worse-off" principles; to make a contribution to the institution under resolution in lieu of the write down or conversion of liabilities where the bail-in tool is applied and the resolution authority has excluded certain creditors from the scope of the bail-in tool; to lend to other financing arrangements on a voluntary basis; or for a combination of these actions. See BRRD, *supra* note 19, art. 101.

³⁴¹ *Id.* art. 101(2).

bail-in, and the losses to be borne by these liabilities cannot be passed on fully to other creditors, the resolution fund may be used to absorb losses directly.³⁴² Direct and indirect loss absorption by the fund is subject to restrictions: Shareholders and creditors must have contributed to loss absorption an amount of not less than 8% of total liabilities, including own funds, through write down or conversion or otherwise; whereas the fund's contribution must not exceed 5% of total liabilities, including own funds, of the institution under resolution, as established through an independent valuation.³⁴³ The 8% minimum requirement derives from a review of bank recapitalizations in Europe during the height of the crisis, which revealed that banks could have been restored to viability if 8% of own funds and eligible liabilities would have been used for loss absorption.³⁴⁴ The 5% fund aid limit further restricts the exposure to losses of national budgets and taxpayers. Fund aid is subject to the State aid regime and requires prior approval by the Commission.³⁴⁵ Where losses exceed 13% of total liabilities, a further round of bail-in may allocate residual losses to creditors to the extent possible³⁴⁶ before the following funding resources can be tapped into.

In *extraordinary* circumstances, the resolution authority may seek funding from "alternative financing resources"—that is, borrowing from financial institutions and third parties other than financing arrangements—to make a further contribution to loss absorption exceeding the 5% limit, provided that all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full. Alternatively, or additionally, the contribution may be made from unused resources raised through *ex ante* contributions.³⁴⁷ Any such contribution beyond the 5% limit would be subject to the State aid regime.

Only in the *very extraordinary situation of a systemic crisis*³⁴⁸ may the resolution authority seek additional funding from alternative financing sources

³⁴² See *id.* arts. 44(4), 101(1)(f).

³⁴³ See *id.* arts. 44(5), 101(2). The funds for such contribution to loss absorption may come from *ex ante* contributions, extraordinary *ex post* contributions and alternative financing sources. Not however, it seems, from borrowing between financing arrangements. BRRD, art. 44(6). The 8% minimum contribution and 5% cap do not apply to liquidity support measures of the resolution fund. IMF, *supra* note 26, ¶ 18.

³⁴⁴ SVEN SCHELO, BANK RECOVERY AND RESOLUTION 120 (2015); see also Clara Galliani & Stefano Zedda, *Will the Bail-in Break the Vicious Circle Between Banks and their Sovereign?*, 45 COMPUTATIONAL. ECON. 597–614 (2015) ("[A] bail-in of 8% of the total balance sheet would potentially be effective in breaking the vicious circle and preventing contagion between banks and public finances.").

³⁴⁵ See BRRD, *supra* note 19, Recital (47); SRMR, *supra* note 22, art. 19(1), (3).

³⁴⁶ Avgouleas & Goodhart, *supra* note 206, at 12–13.

³⁴⁷ See BRRD, *supra* note 19, art. 44(7); SRMR, *supra* note 22, art. 27(9)–(10). For institutions with assets of less than EUR 900 bn on a consolidated basis, resolution financing arrangements may contribute to loss absorption of up to 5% of total liabilities including own funds, provided that shareholders and creditors have contributed to loss absorption an amount of not less than 20% of risk weighted assets, and the financing arrangement's resources raised through *ex ante* contributions are at least 3% of covered deposits of all credit institutions authorized in the respective Member State. BRRD, *supra* note 19, art. 44(8).

³⁴⁸ "Systemic crisis" is defined as "a disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree." BRRD, *supra* note 19, art. 2(1), ¶ 95. As Gortsos has pointed out, a "systemic crisis" is sufficient to result in a "very extraordinary situation[;]" it does not have to be a "very extraordinary crisis." Christos V. Gortsos, *A Poisonous (?) Mix: Bail-out of Credit Institutions Combined with Bail-in of Their Liabilities Under the BRRD – The Use of 'Government Financial Stabilisation Tools' (GFSTs)* 11 (Oct. 12, 2016) (Paper presented at the Workshop of the Financial and Monetary Law Working Group of the European University Institute), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2876508.

through "government financial stabilisation tools" in the form of a "public equity support tool" and a "temporary public ownership tool."³⁴⁹ These government financial stabilization tools can only be used where the institution under resolution is maintained as a going concern³⁵⁰ and only as a last resort after the other resolution tools have been exploited to the maximum extent practicable whilst maintaining financial stability.³⁵¹ Because of the limitation to going concern resolutions, government financial stabilization tools are, in principle, only compatible with the bail-in tool (and asset separation tool where combined with bail-in).³⁵² Shareholders and creditors must have contributed to loss absorption and recapitalization an amount equal to at least 8% of total liabilities, including own funds and approval must have been obtained under the EU State aid framework.³⁵³ Moreover, the applied resolution strategy must ensure that the taxpayers are the beneficiaries of any surplus that may result from the restructuring of an institution that is returned to viability—the assumption of risk must be adequately rewarded.³⁵⁴ It is not entirely clear whether government financial stabilization tools also apply within the SRM.³⁵⁵ The SRM Regulation is silent on this issue. Given that government financial stabilization tools are only available where the application of resolution tools is insufficient for avoiding significant adverse effects on financial stability, it is probably fair to assume that these measures would be available even within the scope of the SRM framework.

Finally, a Member State of the ESM—currently all Euro-zone Member States—may request a Direct Bank Recapitalization.³⁵⁶ Any financial assistance is to be granted subject to conditionality³⁵⁷ and strict eligibility criteria. Bail-in,

³⁴⁹ See BRRD, *supra* note 19, arts. 37(1), 56. The public equity support tool allows a Member State to participate in the recapitalization of an institution by providing capital in exchange for capital instruments. *Id.* art. 57. Under the temporary public ownership tool, the shares in an institution may be temporarily transferred, on the basis of one or more share transfer orders, to a nominee of a Member State or a company wholly owned by a Member State. *Id.* art. 58.

³⁵⁰ See *id.* Recital (8) ("[T]axpayers are the beneficiaries of any surplus that may result from the restructuring of an institution that is put back on a safe footing by the authorities.").

³⁵¹ The application of government financial stabilization tools is subject to the general conditions for resolution plus the determination that the application of resolution tools would not suffice to either avoid significant adverse effects on financial stability, or protect the public interest where extraordinary liquidity assistance has previously been given. In addition, application of the temporary public ownership tool requires the determination that the application of resolution tools in combination with the public equity support tool would not suffice to protect the public interest. *State-Funded Bailouts*, *supra* note 30, at 105–06.

³⁵² Gortsos, *supra* note 348, at 10. Sale of business and bridge institution tools are likely to result in the becoming of a gone concern of the institution under resolution as the residual entity.

³⁵³ See BRRD, *supra* note 19, art. 37(10); *Bank Stakeholders*, *supra* note 6, at 228; *State-Funded Bailouts*, *supra* note 30, at 106; Avgouleas & Goodhart, *supra* note 206, at 13; Binder, *Systemkrisenbewältigung*, *supra* note 179, at 69.

³⁵⁴ See BRRD, *supra* note 19, Recital (8).

³⁵⁵ See Busch et al., *supra* note 126, at 10–11; IMF, *supra* note 26, at 31 n.48 ("[S]uch tools would not be available in member states participating in the SRM.").

³⁵⁶ When, in accordance with current plans, the ESM takes on the role as provider of a common backstop to the SRF, Direct Bank Recapitalization will no longer be available. See Eur. Council TERMS OF REFERENCE OF THE COMMON BACKSTOP TO THE SINGLE RESOLUTION FUND 1 (2018), https://www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf ("Direct Recapitalisation Instrument (DRI) of the ESM to be replaced by the common backstop at the time it is introduced.").

³⁵⁷ See European Stability Mechanism, *Guideline on Financial Assistance for the Direct Recapitalisation of Institutions*, EUR. STABILITY MECHANISM art. 1(1), (4) (Dec. 8, 2014), https://www.esm.europa.eu/sites/default/files/20141208_guideline_on_financial_assistance_for_the_direct_recapitalisation_of_instit

national bailouts and indirect bank recapitalization take precedence.³⁵⁸ Thus, in line with the SRM, direct bank recapitalization may only be provided where shareholders and creditors have absorbed losses to an amount of at least 8% of total liabilities, the resolution financing arrangement has contributed an amount of 5% of total liabilities, and all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full.³⁵⁹

Thus, whereas under standard insolvency law losses are to be fully absorbed by investors in accordance with a (largely) mandatory order of priority, under the BRRD/SRM resolution framework only the following constituencies may be asked to contribute to loss absorption: the holders of CET1 instruments (shareholders), the holders of capital instruments (Additional Tier1 and Tier2), the holders of subordinated debt, and the holders of unsecured senior debt. Only covered depositors will never have to bear any losses. Further, whereas under standard insolvency law the absolute priority rule and the *pari passu* principle prevent the derogation from statutory priority rules and the discrimination within classes *ex ante*, under BRRD/SRM the resolution authority has discretion to deviate from the applicable order of priority on systemic risk grounds and to treat creditors of the same class unequally (provided they are being treated equitably).³⁶⁰ Investors are protected largely *ex post* through a vague and difficult to apply "no-worse-off" principle.³⁶¹ However, shareholders and creditors are required in all cases to absorb a minimum amount of losses of 8% of total liabilities before further losses can be passed on to the relevant resolution financing arrangement. Fund aid is limited to 5% of total liabilities. Any additional fund aid or State aid beyond the 5% limit is subject to strict pre-conditions. Although the BRRD/SRM loss allocation regime is conceived as mandatory, the practical reality may be quite different, depending on the exercise of discretion on a case-by-case basis.³⁶²

C. EU State Aid Regime

Loss allocation under the EU State aid regime is governed by the rules on burden-sharing pursuant to the Commission's Banking Communication. Accordingly, losses are normally first absorbed by equity; thereafter, the holders of hybrid instruments and subordinated debt contribute to reducing the capital shortfall to the greatest possible extent. Such contribution may take the form of a conversion into CET1 instruments or a write-down of the principal of the instruments. Cash outflows from the beneficiary to the holders of such instruments

utions.pdf (stating "financial assistance shall be subject to specific conditionality") [hereinafter ESM Guideline]. Under the Commission's *Proposal for a Council Regulation on the establishment of the European Monetary Fund*, COM (2017) 827 final (Dec. 6, 2017), the EMF, replacing the ESM, would have as a new task the provision of credit lines and guarantees in support of the SRB for any of the responsibilities assigned to it.

³⁵⁸ See Christos Hadjiemmanuil, *Bank Resolution Financing in the Banking Union* 31 (LSE Legal Studies, Working Paper No. 6, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575372.

³⁵⁹ See ESM Guideline, *supra* note 357, art. 8(3).

³⁶⁰ See BRRD, *supra* note 19, arts. 48(5), 44(2), (3); *Bank Stakeholders*, *supra* note 6, at 237.

³⁶¹ See Wojcik, *supra* note 178, at 120–22; Avgouleas & Goodhart, *supra* note 206, at 18 (pointing out the risk of litigation that the "no-worse-off" principle is likely to generate).

³⁶² See *Bank Stakeholders*, *supra* note 6, at 236 ("The principle of bail-in in the BRRD . . . appears to be highly prescriptive, but the reality may prove to be more nuanced.").

must be prevented to the greatest extent that is legally possible. In deviation from the BRRD/SRM resolution framework, a contribution from senior debt holders, notably uninsured deposits, bonds, and other senior debt, will not be required as a mandatory prerequisite for approval under the State aid rules.³⁶³ In any case, State aid must not be granted before equity, hybrid capital, and subordinated debt have fully contributed to offsetting any losses. Subordinated debt must be converted or written down, in principle, before State aid is granted. An exception to these requirements can be made where their implementation would endanger financial stability or lead to disproportionate results, in particular where the aid amount is small in comparison to the bank's risk weighted assets and the capital shortfall has been reduced significantly through capital raising measures. The "no-creditor-worse-off" principle applies: subordinated creditors should not receive less in economic terms than what their instruments would have been worth if no State aid were to be granted.³⁶⁴ As soft law measure, the Banking Communication imposes a limit on the exercise of the Commission's discretion when approving State aid. However, a Member State may still notify the Commission of aid that does not comply with the guidelines and the Commission may authorize the proposed aid in exceptional circumstances.³⁶⁵ Overall, this system affords the Commission a wide margin of discretion to deviate from national orders of priority and even from its own loss sharing requirements where the Commission sees fit to do so.³⁶⁶ Under the Banking Communications, the replacement of a failing firm's management is not a necessary prerequisite, but may be looked upon favorably by the Commission.³⁶⁷ Although aid should be limited to the necessary minimum amount, there is no cap on the amount of State aid that may be provided and no minimum amount of loss contribution by shareholders and creditors.

Where State aid is subject to approval within the BRRD/SRM resolution framework, the BRRD/SRM loss allocation cascade takes precedence. This is the case for fund aid up to the 5% loss contribution ceiling, and beyond, as well as in the context of government financial stabilization tools and direct bank recapitalization through the ESM. In these cases, shareholders and creditors, including bail-inable senior creditors, must have contributed to losses the minimum amount of 8% of total liabilities.³⁶⁸

D. Implications

³⁶³ Through the new MREL requirement, the situation under BRRD/SRM may be aligned with the Banking Communication, *supra* note 57, in that instruments senior to MREL should never bear losses. See *supra* note 310 and accompanying text.

³⁶⁴ See Banking Communication, *supra* note 57, ¶¶ 41–46; Wojcik, *supra* note 176, at 105.

³⁶⁵ See Case C-526/14, *Kotnik v. Nat'l Assembly of the Republic of Slov.*, ECLI:EU:C:2016:570 ¶¶ 38–44 (July 19, 2016) ("[T]he Banking Communication is not capable of imposing independent obligations on the Member States, but does no more than establish conditions, designed to ensure that State aid granted to the banks in the context of the financial crisis is compatible with the internal market, which the Commission must take into account in the exercise of the wide discretion that it enjoys . . .").

³⁶⁶ Hellwig, *supra* note 35, ¶ 2.5 ("[A] bail-in of subordinated lenders and shareholders cannot be imposed as a matter of course but the Commission must examine in detail whether the burden sharing might take a form other than a bail-in or might not be foregone altogether.").

³⁶⁷ See Gerard, *supra* note 15, at 241.

³⁶⁸ See Gortsos, *supra* note 348, at 18.

The implications for the respective bailout costs may be illustrated with a simple numerical example. Consider an institution with assets of 100 funded by covered deposits of nominal 50, senior unsecured debt of 30, and capital instruments of nominal 10, leaving 10 for equity.

Assets 100	Covered deposits	50
	Senior unsecured debt	30
	Capital Instruments	10
	Equity	10

Now assume that asset values take a hit and have to be written down to 70. In liquidation, of the (net) proceeds of 70, 50 would go to the deposit guarantee scheme subrogated for the covered depositors; the remaining 20 would be shared by senior unsecured creditors on a pro rata basis, resulting in losses of ca. 33% on their claims. Capital instruments and equity would be wiped out. Generally, corporate insolvency law addresses the social costs of bailouts most effectively. Losses are fully absorbed by equity and debt investors. Only covered depositors—whose ability to exert market discipline is very limited—are safe. For instruments other than covered deposits, market discipline would be restored. Within the corporate insolvency law framework, there is in principle no room for State intervention and taxpayer loss exposure would be limited to the amount paid out to depositors (maximum 50) that is not covered by industry contributions to the deposit insurance scheme and cannot be recouped in liquidation.

Now assume that resolution is necessary in the public interest due to the presence of systemically important counterparties of nominal 10 among the senior unsecured debt. Their claims will be exempt from bail-in and remain untouched.

Assets 100	Covered deposits	50
	Senior unsecured debt Non-bail-inable	10
	Bail-inable	20
	Capital Instruments	10
	Equity	10

The BRRD/SRM resolution framework seeks to reduce the social costs of bailout through a mandatory loss allocation cascade. Equity, capital instruments, subordinated debt, and senior unsecured debt may be called upon to contribute to the absorption of losses, not, however, secured debt and preferential debt, including covered deposits. The framework leaves considerable room for differential treatment of creditors of the same class and the beneficial treatment of creditors

and classes in deviation of the statutory order of priority.³⁶⁹ Thus, in our example, equity would be wiped out and capital instruments would be written down to zero. Of the bail-inable debt, 10 could be written down to zero to absorb the remaining losses; and a further 10 may be converted to equity at par (with a market value of 10) in order to recapitalize the institution. Non-bail-inable debt and covered deposits remain unscathed. On the basis of the "no-creditor-worse-off" principle disadvantaged creditors are entitled to *ex post* compensation. Bailed-in senior unsecured debt has sustained a loss of 50%, which exceeds the loss they would have sustained in liquidation so that they would have to be compensated for the difference (3.34) out of the resolution fund.³⁷⁰ The mobilization of resolution fund money requires a minimum loss contribution of shareholders and creditors of 8% of total liabilities and is, in principle, capped at 5% of total liabilities. Market discipline will be enhanced for those investors that contribute to loss absorption; not however for those whose claims are transferred to a private sector purchaser or bridge bank or exempt from bail-in. As compared to liquidation under national corporate insolvency law, taxpayer loss exposure would increase by the amount to be paid out in compensation under the "no-worse-off" principle and not covered by industry contributions. Overall, however, it is limited by the 8% minimum contribution requirement, the 5% cap, and generally through the reliance on standing resolution funds.

The State aid regime requires a contribution to loss absorption of equity, capital instruments, and subordinated debt only; senior unsecured debt and any higher-ranking debt will remain untouched. Moreover, the Commission has wide discretion for differential treatment of creditors within the same class and across classes, subject only to the "no-worse-off" principle.³⁷¹ There is no minimum amount of loss contribution by investors and no cap on the amount of public money that may be advanced. In our example, only equity and the holders of capital instruments would sustain losses and would be wiped out. The remaining loss and capital shortfall would be covered by the Member State by injecting new capital and possibly taking an equity position. Taxpayer loss exposure would be increased by the full amount of remaining losses and capital shortfall; the restoration of market discipline would be limited to equity and capital instruments.

IV. CALIBRATING COSTS AND BENEFITS: INTRA-SYSTEM INTERACTIONS

Given the disparity in bailout cost reduction mechanisms between the system elements, it is essential that the respective eligibility criteria and intra-system interactions ensure that it is more likely than not that the potential bailout benefits outweigh the bailout costs. Eligibility criteria and intra-system interactions are responsible for matching potentially high bailout benefits with lenient cost reduction mechanisms, and for ensuring stringent burden sharing of investors where bailout benefits are (likely to be) limited.

³⁶⁹ Wojcik, *supra* note 178, at 130; *Bank Stakeholders*, *supra* note 6, at 242.

³⁷⁰ In liquidation, our senior unsecured debt of 20 would have received an amount of 13.34. In resolution, it would only be 10 (equity with a market value of 10).

³⁷¹ Gortsos, *supra* note 348, at 18.

The transition between BRRD/SRM, national corporate insolvency law, and EU State aid is determined primarily by the delineation of the BRRD/SRM resolution trigger. Under BRRD and SRM, the application of resolution tools and powers is conceptualized as an alternative and exception to "normal insolvency proceedings."³⁷² Where the public interest requirement as a condition for resolution is not satisfied, "normal insolvency proceedings" apply as the default option for resolving distressed financial institutions.³⁷³ Within their scope of application, the BRRD and SRM resolution regimes supersede and displace the applicable national corporate insolvency law.³⁷⁴ As between BRRD/SRM and State aid, where the use of resolution tools and powers involves the granting of State aid in the form of an intervention by resolution funds and deposit guarantee schemes, the relevant State aid rules apply concurrently with the BRRD/SRM framework. The latter also allows for State aid outside the resolution framework in certain closely circumscribed instances. Where resolution is unavailable, the State aid rules apply concurrently with standard corporate insolvency law and may override and modify the latter.

A. The BRRD/SRM Resolution Trigger

A credit institution or investment firm shall be put into resolution where: (i) the competent authority, after consulting the resolution authority,³⁷⁵ determines that the institution is failing or likely to fail; (ii) there is no reasonable prospect that in the absence of a resolution action the failure of the institution could be prevented within a reasonable timeframe through alternative measures, in particular supervisory action and private sector measures; and (iii) a resolution action is necessary in the public interest,³⁷⁶ which will be the case if it achieves, and is proportionate to, one or more of the resolution objectives,³⁷⁷ and winding up of the institution pursuant to normal insolvency proceedings would not meet those objectives to the same extent.

In addition to a breach of capital requirements, illiquidity and insolvency³⁷⁸, an institution will be deemed to be failing or likely to fail when it requires

³⁷² See BRRD, *supra* note 19, art. 32(1)(c), (5); SRMR, *supra* note 22, art. 18(1)(c), (5); Wojcik, *supra* note 178, at 99.

³⁷³ The new BRRD, *supra* note 19, art. 32b makes this clear: failing institutions the resolution of which is not in the public interest "shall be wound up in an orderly manner in accordance with the applicable national law." See also SRMR, *supra* note 22, art. 18(8) (explaining where the Council object to a resolution scheme on the ground that the public interest requirement is not satisfied, the relevant entity is to be wound up under national insolvency law).

³⁷⁴ See BRRD, *supra* note 19, art. 86 (preventing the commencement of normal insolvency proceedings under national law, except on initiative of or with the consent of the resolution authority).

³⁷⁵ Or *vice versa*, if the Member State so provides and resolution authorities have access to the information necessary in order to make the determination of failure. See *id.* art. 32(2).

³⁷⁶ See *id.* art. 32(1); SRMR, *supra* note 22, art. 18(1).

³⁷⁷ When applying resolution tools and powers resolution authorities must aim: (i) to ensure the continuity of critical functions; (ii) to avoid significant adverse effects on financial stability, including by preventing contagion and maintaining market discipline; (iii) to protect public funds by minimizing reliance on extraordinary public financial support; (iv) to protect depositors as well as client funds and assets; and (v) to minimize the cost of resolution and avoid the unnecessary destruction of value. See BRRD, *supra* note 19, art. 31(2); SRMR, *supra* note 22, art. 14(2).

³⁷⁸ See BRRD, *supra* note 19, art. 32(4)(a)–(c); SRMR, *supra* note 22, art. 18(4)(a)–(c); European Banking Authority, *Final Report: Guidelines on the interpretation of the different circumstances when an*

extraordinary public financial support.³⁷⁹ "Extraordinary public financial support" is defined as State aid under art. 107(1) TFEU and any other public financial support at supra-national level, which, if provided for at national level, would constitute State aid, that is provided in order to preserve or restore the viability, liquidity or solvency of a financial institution.³⁸⁰ This definition makes the concept of "State aid" an integral part of the BRRD/SRM framework and State aid may, in principle, only be granted subject to the BRRD/SRM loss allocation cascade with its 8% minimum contribution and 5% cap.³⁸¹

Advances from national industry financed resolution funds and deposit guarantee schemes amount to State aid in accordance with general State aid doctrine.³⁸² Funds that derive from private sources—such as *ex ante* contributions to a standing fund or a levy on the banking sector—may constitute aid to the extent that disbursements from the private fund are controlled by the State and the respective decision as to the fund's deployment is imputable to the State.³⁸³ The resolution authority as emanation of the State is ultimately in control of the funding decision and, by implicitly underwriting these funds, there is always a potential burden on State finances.³⁸⁴ Given that the participating Member States are also ultimately behind the SRF and the European Stability Mechanism, it is likely that financial support granted through these institutions would also meet the State aid definition;³⁸⁵ in any case the reference to supra-national support measures makes it clear that such support is covered by the definition of "extraordinary public financial support."

According to the Banking Communication, a public intervention does not constitute State aid and therefore "extraordinary public financial support" if it takes the form of central bank emergency liquidity assistance and meets the following requirements: (i) the recipient institution is temporarily illiquid but solvent at the time of the liquidity assistance, which occurs in exceptional circumstances and is not part of a larger aid package; (ii) the facility is fully secured by collateral to which appropriate haircuts are applied; (iii) the central bank charges a penal interest rate to the beneficiary; and (iv) the measure is taken at the central bank's own initiative and is not backed by a state guarantee. Such facilities are deemed to not be selective and do not amount to aid.³⁸⁶ Also, there is no burden on the State

institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU (2015), <https://eba.europa.eu/sites/default/documents/files/documents/10180/1085517/02539533-27ed-4467-b442-7d2fa6fcb3d3/EBA-GL-2015-07%20GL%20on%20failing%20or%20likely%20to%20fail.pdf?retry=1>.

³⁷⁹ See BRRD, *supra* note 19, art. 32(4)(d); SRMR, *supra* note 22, art. 18(4)(d).

³⁸⁰ See BRRD, *supra* note 19, art. 2(1)(28); SRMR, *supra* note 22, art. 3(1)(29).

³⁸¹ *State-Funded Bailouts*, *supra* note 30, at 109 ("[S]upporting role within the resolution framework's financing cascade.").

³⁸² See Case 290/83, *Comm'n, v. French Republic*, 1985 E.C.R. 439 ¶ 15.

³⁸³ See Banking Communication, *supra* note 57, ¶¶ 63–64. In Joined Cases T-98/16, T-196/16 & T-198/16, *Italian Republic et al. v. European Comm'n*, ECLI:EU:T:2019:167, the General Court has held that financial support granted by the Italian *Fondo interbancario di tutela dei depositi* to the ailing Banca Tercas did not amount to State aid because the level of involvement and input of the Bank of Italy as competent authority in the restructuring measures was insufficient to render the Fund's intervention attributable to the State. The EU Commission has appealed the case to the Court of Justice.

³⁸⁴ See Case 290/83, *Comm'n, v. French Republic*, 1985 E.C.R. 439 ¶ 15.

³⁸⁵ See François-Charles Lapr v te & M lanie Paron, *The Commission's Decisional Practice on State Aids to Banks: An Update*, 14 Eur. St. Aid L. Q. 88, 89–91 (2015).

³⁸⁶ See *supra* Part I.

because central bank liquidity can be freely created at no cost to the State.³⁸⁷ Liquidity assistance on this basis is subject to neither the BRRD/SRM nor the State aid framework. The emergency liquidity assistance that Banco Popular received from the Bank of Spain in June 2017, which was used up within 2 days comes under this heading. It demonstrates that these measures are not costless in terms of their implications for moral hazard and market discipline: certain sophisticated creditors were allowed to exit without sustaining any losses. Moreover, where granted to doubtfully solvent institutions, emergency liquidity assistance may only delay the inevitable, resulting in increased costs for the taxpayer, in particular where the exiting sophisticated investors are then replaced by retail investors.³⁸⁸

B. EU State Aid Only: "Precautionary Recapitalization"

In general, an institution's need for extraordinary public financial support will trigger the application of the resolution framework, including its mandatory loss allocation cascade, provided there is no private sector option available and resolution is necessary in the public interest.³⁸⁹ However, exceptionally, the BRRD/SRM resolution framework will not be triggered, and the measure will be assessed exclusively on the basis of the State aid regime, where extraordinary public financial support takes the form of a so-called "precautionary recapitalization."³⁹⁰ This is extraordinary public financial support through an injection of own funds or the purchase of capital instruments.³⁹¹ It will not trigger the resolution framework and will be subject exclusively to the State aid regime if: (i) support is being granted in order to remedy a serious disturbance in the economy of a Member State and to preserve financial stability; (ii) the beneficiary is solvent; (iii) the measure is of a precautionary and temporary nature and proportionate for remedying the consequences of a serious disturbance; (iv) it is not used to offset losses that the institution has incurred or is likely to incur in the near future; (v) the injection of own funds or purchase of capital instruments is made at prices and on terms that do not confer an advantage upon the institution, that is, it is made at market prices and not as overpayment; (vi) the institution is not failing on other grounds; and (vii) a precautionary recapitalization is limited to injections necessary to address a capital shortfall established through a stress-test or similar exercise conducted by the ECB, EBA, or national authorities.³⁹² Precautionary recapitalization is conceptualized as an exception to the resolution framework, reserved for unique situations and subject to strict conditions, some of which are puzzling and ambiguous, possibly due to sloppy drafting. For example, the

³⁸⁷ See RYAN-COLLINS ET AL., *supra* note 36, at 67.

³⁸⁸ See Hellwig, *supra* note 35, ¶ 2.5.

³⁸⁹ See BRRD, *supra* note 19, art. 32(4)(d); SRMR, *supra* note 22, art. 18(4)(d).

³⁹⁰ *State-Funded Bailouts*, *supra* note 30, at 109; Gortsos, *supra* note 348, at 16. In addition, state guarantees to back liquidity facilities provided by central banks according to the central bank's conditions, and state guarantees of newly issued liabilities do not trigger resolution, subject to the following conditions (i) to (iv).

³⁹¹ See BRRD, *supra* note 19, art. 32(4)(d)(III); SRMR, *supra* note 22, art. 18(4)(d)(III).

³⁹² See European Banking Authority, *Guidelines on the types of tests, reviews and exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive* (EBA/GL/2014/09, 22 September 2014), <https://www.eba.europa.eu/documents/10180/821335/EBA-GL-2014-09+%28Guidelines+on+Public+Support+Measures%29.pdf>.

solvency requirement seems to be ill at ease with the additional requirement that the institution must not be failing or likely to fail; that the injected amounts may not be used to offset losses incurred or likely to be incurred in the near future is open to various interpretations; the no-advantage condition does not seem to fit with the assessment under the State aid framework (the adjective "undue" would appear to be missing); the temporary and precautionary nature of any injection also raises questions.³⁹³ According to the SRB's chair, Elke Koenig, precautionary recapitalization may only be used to cover a capital shortfall arising under the adverse scenario of a stress test; capital shortfalls under the baseline scenario should be covered by private means or trigger resolution or insolvency. Solvency—a positive net worth in the baseline scenario—is a static criterion to be assessed at the moment of determination. By contrast, the further requirement of the institution not failing and not being likely to fail on grounds of insolvency, illiquidity, or undercapitalization is a forward-looking concept assessing the institution's overall viability.³⁹⁴ At face value, these are strict prerequisites, however, in practice they may not pose an insurmountable hurdle for transitioning out of the BRRD/SRM framework and into the State aid regime.³⁹⁵

The "precautionary recapitalization" exit clause has been relied on for the recapitalization of Banca Monte dei Paschi di Siena (MPS), Italy's fourth largest lender.³⁹⁶ In July 2016, an EBA stress test revealed a CET1 ratio of 2.4% in the adverse scenario, amounting to a capital shortfall of EUR5bn. Capital in the baseline scenario was positive. The bank's market capitalization had decreased from EUR10bn in 2008 to EUR500m by end 2016. An envisaged private sector recapitalization failed due to the uncertain political situation following a failed referendum in Italy. After a lengthy negotiation process, a restructuring plan seeking to ensure the bank's long-term viability was agreed between Commission, ECB, and the Italian authorities.³⁹⁷ The plan envisaged a 5-year restructuring period, with a reorientation of the business model towards retail and SME customers and a strengthening of efficiency through branch closures, layoffs, and an executive pay cap. The plan also included the disposal of MPS' non-performing loan portfolio. The burden of the by then EUR8.8bn capital shortfall was shared as follows: of the EUR6.3bn required to realign the CET1 ratio to 8%, EUR4.3bn

³⁹³ See Nicolas Veron, *Precautionary recapitalization: time for review*, EUROPEAN PARLIAMENT IN-DEPTH-ANALYSIS ¶ 3 (July 2017), [http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602090/IPO_L_IDA\(2017\)602090_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602090/IPO_L_IDA(2017)602090_EN.pdf); Willem-Pieter de Groen, *Precautionary recapitalization: time for review*, EUROPEAN PARLIAMENT IN-DEPTH-ANALYSIS ¶ 4 (July 2017), <https://www.ceps.eu/system/files/PrecautionaryRecapitalisations.pdf>; Hellwig, *supra* note 35, ¶ 3.

³⁹⁴ FINANCIAL RISK AND STABILITY NETWORK, FINANCIAL STABILITY CONFERENCE: FIFTH JOINT CONFERENCE ON EU REGULATORY REFORMS: REPORT 2017 33–34 (Oct. 18, 2017), http://financial-stability.org/wp-content/uploads/2017/11/Report_Financial-Stability-Conference-2017.pdf.

³⁹⁵ See Binder, *Systemkrisenbewältigung*, *supra* note 179, at 70; Hellwig, *supra* note 35, ¶ 4; but see Veron, *supra* note 393, ¶ 4 (arguing in the past "the conditions for precautionary recapitalization were assessed rigorously by the relevant EU authorities").

³⁹⁶ See *The 'Precautionary Recapitalization' of Banca Monte dei Paschi di Siena*, BANCA D'ITALIA (Dec. 29, 2016), https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/precautionary-recapitalization-MPS.pdf?language_id=1.

³⁹⁷ Statement, European Commission, Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS) (June 1, 2017), https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_17_1502; Press Release, European Commission, State aid: Commission authorizes precautionary recapitalization of Italian bank Monte dei Paschi di Siena (July 4, 2017), http://europa.eu/rapid/press-release_IP-17-1905_en.htm.

resulted from the conversion of junior bonds into equity and the resulting dilution of existing shareholders; EUR2.1bn was provided by the Italian state. As compensation for eliminating the subordinated bonds as capital instruments, a further EUR2.5bn was provided by the Italian State to reach a total capital ratio of 11.5%. In order to compensate retail junior bondholders who allegedly were the victims of mis-selling, a further EUR2bn was necessary to fund the exchange of converted shares into senior MPS bonds. It is questionable whether the strict prerequisites of the precautionary recapitalization exemption were rigorously applied in case of MPS.³⁹⁸ The bank had been struggling ever since the global financial crisis and the ever-increasing capital shortfall (EUR5bn to almost EUR9bn over a six-month period) raises serious doubts as to MPS' overall viability. On the other hand, it is well known that there were good political reasons for not applying the BRRD/SRM resolution framework, notably retail investors holding junior debt and the overall fragility of the Italian banking sector.³⁹⁹ This suggests that the pre-requisites for a precautionary recapitalization are malleable and susceptible to political manipulation, opening up escape routes into a more lenient burden-sharing regime.⁴⁰⁰

C. Default Regime: Corporate Insolvency Law

Where the resolution authority determines that resolution pursuant to BRRD/SRM is not in the public interest, the failing institution is to be dealt with under the applicable national insolvency law as the default option.⁴⁰¹ Whether the BRRD/SRM resolution framework will be triggered in any given case is largely a matter of discretionary judgment on the part of the resolution authority.⁴⁰² For example, the presence in the market of institutions with a business model that is similar to that of the failing institution may support the assumption of an enhanced risk of contagion justifying resolution;⁴⁰³ or may suggest easy substitutability of the functions provided by the institution so that corporate insolvency would be sufficient.⁴⁰⁴ Under the SRM, the Commission may propose to the Council to object to the scheme on the basis that the public interest requirement has not been met.⁴⁰⁵ Where the Council objects on public interest grounds the entity is to be

³⁹⁸ See Binder, *Systemkrisenbewältigung*, *supra* note 179, at 70–71; but see Veron, *supra* note 393, ¶ 4 ("[O]pen to debate, but not altogether implausible").

³⁹⁹ See James Politi, *Monte dei Paschi Shortfall Hits EUR8bn, Says ECB*, FIN. TIMES (Dec. 26, 2016), <https://www.ft.com/content/60576ada-cbbd-11e6-864f-20dcb35cede2> (describing the efforts to shield retail investors who hold junior debt from suffering in the ensuing fallout); see also *The Rescue of Italian Lender will not End Banking Woes*, FIN. TIMES (June 1, 2017), <https://www.ft.com/content/a624ccc8-46cf-11e7-8519-9f94ee97d996> (explaining the political risks that would occur if the banks were to go under).

⁴⁰⁰ See Binder, *Systemkrisenbewältigung*, *supra* note 179, at 71; Gortsos, *supra* note 348, at 18.

⁴⁰¹ See BRRD, *supra* note 19, arts. 32(5), 32b; SRMR, *supra* note 22, art. 18(5); *Proportionality at Resolution Stage*, *supra* note 179, at 8 (stating the resolution is "reserved as an ultima ratio for extraordinary scenarios, namely failures of systemically relevant institutions").

⁴⁰² See Binder et al., *supra* note 12, at 12 (explaining the definition of the threshold of systemic relevance is specific to each case and is open to question).

⁴⁰³ See SRB *Banco Popolare*, *supra* note 121, ¶ 4.4.2.

⁴⁰⁴ See SRB *Veneto Banca*, *supra* note 122, ¶ 4.2.1.1; SRB *Banca Popolare di Vicenza*, *supra* note 122, ¶ 4.2.1.1.

⁴⁰⁵ See SRMR, *supra* note 22, art. 18(7).

wound up under national insolvency law.⁴⁰⁶ Thus, acting in concert with the Commission, a simple majority of Member States may object to a resolution scheme with the effect that the failing institution can be resolved under national insolvency law. Whereas the SRM has always been clear that the entity is to be wound up under national insolvency law where the Council so objects, this was less obvious where the resolution authority determined that the public interest requirement has not been met. The newly inserted BRRD, art. 32b now provides that an institution the resolution of which is not in the public interest shall be wound down in accordance with national law. Although it seems to be clear that the institution as a legal entity has to be liquidated, this does not seem to preclude a reorganization of (parts of) its business on a going concern basis where this is possible under national insolvency law and would not adversely affect any of the resolution objectives.⁴⁰⁷

When Latvian Bank ABLV and its Luxembourg subsidiary had to be closed in the wake of allegations of money laundering, sanctions violations, and bribery, the SRB decided for both institutions that resolution was not in the public interest: the functions they performed were not critical and their financial and operational interconnectedness with other institutions was limited.⁴⁰⁸ Consequently, both institutions were, eventually,⁴⁰⁹ liquidated under, respectively, Latvian and Luxembourg insolvency law. However, the mandatory order of priority under national corporate insolvency law does not prevent the granting by a Member State of State aid to a failing institution, which will then be assessed under the EU State aid regime. This is not specific to financial institutions; approval by the Commission of State aid in the corporate rescue and restructuring context has a long history, and Commission practice has been codified in the Rescue and Restructuring Guidelines.⁴¹⁰ The handing back of failing institutions to national insolvency law combined with generous State aid support can be observed in the cases of *Banca Popolare di Vicenza* and *Veneto Banca*, two regional banks active in the Veneto Region with total assets of EUR34.4bn and EUR27.9bn, respectively.⁴¹¹ On 23 June 2017, the ECB determined that both banks were failing or likely to fail on the basis that they had repeatedly breached their capital requirements. On the same day, the SRB determined that there was no private sector or regulatory alternative: the banks were unable to raise sufficient additional capital, their business plans lacked credibility; and a write down and conversion of

⁴⁰⁶ See *id.* art. 18(8).

⁴⁰⁷ See SRB *Banco Popular*, *supra* note 121, ¶ 4.3 (referring to winding up as applicable to Spanish insolvency law in its entirety, presumably including the restructuring option).

⁴⁰⁸ See Single Resolution Board, Notice summarising the decision taken in respect of ABLV Bank, AS (Feb. 2018), https://srb.europa.eu/sites/srbsite/files/20180223-summary_decision_-_latvia.pdf; Single Resolution Board, Notice summarising the decision taken in respect of ABLV Bank Luxembourg S.A. (Feb. 2018), https://srb.europa.eu/sites/srbsite/files/20180223_summary-decision_-_luxembourg.pdf.

⁴⁰⁹ On application of the Luxembourg resolution authority, the Luxembourg Commercial Court initially refused the opening of liquidation proceedings due to insufficient evidence of the Luxembourg entity's precarious financial state. See Lastra et al., *supra* note 202, at 8–9.

⁴¹⁰ *R&R Guidelines*, *supra* note 145 (replacing previous guidelines the earliest of which were promulgated in 1994).

⁴¹¹ See generally European Commission, State Aid SA. 45664 (2017/N) – Italy – Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid, Brussels, C(2017) 4501 final (Jun. 25, 2017) [hereinafter *State Aid Italy*] (discussing the Commission approved liquidation of Veneto Banca and Banca Popolare di Vicenza).

capital instruments would be insufficient to remedy the breach of capital requirements. The SRB further determined that resolution under BRRD/SRM was not in the public interest: although classified by the ECB as significant institutions, business volumes had been rapidly declining and neither institution had been classified as systemically important; the deposit-taking, lending, and payment services provided by the institutions were not critical because these services were provided only to a limited number of third parties and were easily replaceable; moreover, failure was unlikely to result in significant adverse effects on financial stability due to the banks' low financial and operational interconnections. Therefore, normal insolvency law was deemed to be sufficient as it offered a comparable degree of protection for depositors, investors, and clients. In particular, the Italian bank specific insolvency law provides for the transfer of assets and liabilities, so that covered deposits could be protected in a way similar to resolution, thus achieving the resolution objectives just as effectively.⁴¹² This decision opened the door for liquidation under Italian insolvency law, financed through extensive State aid. As a result of an open sales process, the bank Intesa Sanpaolo bought the deposits, employees, senior debt, and performing loans for the symbolic amount of EUR1 out of the liquidation. The Italian State contributed EUR4.8bn by way of a cash injection to shore up Intesa's capital in respect of the taking on of risky assets from the banks and the granting of loans to finance the liquidation. In addition, the Italian State guaranteed the repayment of these loans to the tune of EUR12bn for the eventuality that the proceeds of the liquidations turn out to be insufficient. The Commission approved the State aid on the basis that it was necessary to avoid an economic disturbance in the Veneto region. The shareholders and junior creditors fully contributed to loss absorption by staying behind in the liquidation. However, junior retail investors would be fully compensated.⁴¹³

D. Implications

The decision by the SRB that resolution was not in the public interest—because failure was unlikely to cause significant adverse effects for financial stability—and the Commission's decision approving liquidation aid as being necessary to avoid an economic disturbance in the Veneto region demonstrate the operation of two different public interest tests. The "resolution public interest" test requires that resolution is necessary and proportionate for the achievement of one or more of the resolution objectives, notably to avoid a significant adverse effect on the financial system, and winding up the failing institution under normal insolvency proceedings would not meet these resolution objectives to the same extent.⁴¹⁴ This threshold had not been met in the case of the Veneto region banks. Pursuant to TFEU, art. 107(3)(b), State aid may be considered to be compatible with the internal market where the aid seeks to "remedy a serious disturbance in the economy of a Member State." The liquidation aid in the case of the Veneto region

⁴¹² See SRB *Veneto Banca*, *supra* note 122; SRB *Banca Popolare di Vicenza*, *supra* note 122.

⁴¹³ See *State Aid Italy*, *supra* note 411.

⁴¹⁴ *Proportionality at Resolution Stage*, *supra* note 179, at 7.

banks was held to meet this threshold. In its Decision,⁴¹⁵ the Commission seems to indicate that in deviation from the wording of the provision, a disturbance in the region of a Member State was sufficient. This would be contrary to the case law of the General Court, which held that "the disturbance in question must affect the whole of the economy of the Member State concerned, and not merely that of one of its regions or parts of its territory."⁴¹⁶ In any case, it is clear that the State aid threshold as applied by the Commission is lower than the resolution threshold applied by the SRB. As a consequence, institutions that did not pose any systemic risk and the services of which would have been easily replaceable were not subjected to loss allocation under national insolvency law, neither were they subject to the limited loss allocation under BRRD/SRM with an 8% minimum contribution and the 5% fund aid ceiling. Rather, the State aid burden sharing rules applied, based on soft law, limited to shareholders and subordinated creditors with no minimum contribution and aid ceiling. On that basis, no bank seems to be too small for it or its senior creditors to be bailed out with State aid.⁴¹⁷ In addition, Intesa Sanpaolo, Italy's second largest bank, has become even bigger with generous support from the Italian State.

From the perspective of the overall system objective—to ensure that when they occur, bailouts are pie-increasing—this result makes little sense: a lower risk to financial stability and therefore limited bailout benefits may justify a more comprehensive public intervention with less restrictive burden sharing mechanism, resulting in higher potential bailout costs. However, the SRB and the Commission are independent institutions; as a hallmark of their independence they may come to different conclusions on a given set of facts when applying different legal texts the rationales of which do not perfectly overlap. The resolution threshold has a dual rationale. It, first, justifies and seeks to legitimize a departure from the base line loss allocation standards in corporate insolvency. It allows the resolution authority to modify and override the statutory order of priority by disregarding *pari passu* and absolute priority for the benefit of certain systemically important counterparties at the expense of others, the latter being protected only by the "no-worse-off" principle. Secondly, and closely related, the resolution threshold seeks to justify the intrusive re-writing of property rights through the exercise of resolution tools and powers, which is liable to interfere with the institution's and its investors' rights to property as protected under the EU Charter of Fundamental Rights⁴¹⁸ and the European Convention of Human Rights and Fundamental Freedoms (ECHR). Such interference may only be justified in the public interest and subject to the principle of proportionality and may require fair compensation.⁴¹⁹ By contrast, the

⁴¹⁵ See State Aid Italy, *supra* note 411, ¶ 49 (referencing a note in which the Bank of Italy laid down the grounds for the State aid measures and recognizing that "negative effects would entail the risk of a serious disturbance to real economy at local level").

⁴¹⁶ Joined Cases T-132/96 & T-143/96 Sachsen & Volkswagen AG v. Comm'n, 1999 E.C.R. II-3670, ¶ 167.

⁴¹⁷ Gebiski, *supra* note 60, at 94.

⁴¹⁸ Charter of Fundamental Rights of the European Union, 2010 O.J. (C 83) 389, 395. The Charter was rendered legally binding by the Lisbon Treaty, affording it the same status as the Treaties. See TEU, *supra* note 109, art. 6(1).

⁴¹⁹ EU Network of Independent Experts on Fundamental Rights, *Commentary of the Charter of Fundamental Rights of the European Union* 166 (2016), <https://sites.uclouvain.be/cridho/documents/Download.Rep/NetworkCommentaryFinal.pdf>.

State aid threshold does not have the function of justifying interferences with property rights. In particular, conditioning the approval of State aid on burden sharing measures being imposed on shareholders and (subordinated) creditors does not amount to an interference with their rights to property. These constituencies would have suffered losses, at least to the same extent, if no State aid had been granted.⁴²⁰ Rather, in accordance with the State aid regime's primary rationale, the State aid threshold seeks to justify primarily possible distortions of inter- and intra-State competition caused by State aid measures. On that basis, it is plausible to assume that limited distortions caused by State aid granted to insignificant firms may be more easily justified on the basis of a lower threshold. Viewed in isolation, the Commission's decision in the Veneto region banks' case is perhaps not so surprising. However, granting and approving State aid measures in these cases also results in a departure from the baseline loss sharing arrangement, which is justified by the secondary rationale of the State aid framework for the financial sector: financial stability. It is here that the rationales of the resolution threshold and the State aid threshold meet. Given that the EU bailout elements constitute a system with a clearly demarcated system objective, divergent decisions of the key independent institutions within this area of overlap result in incoherence as measured against the overall system goal.

CONCLUSION: IMPROVING SYSTEM GOAL ATTAINMENT CAPACITY

The goal of the EU's bailout system is to limit bailouts to those that are likely to be "pie-increasing"—that is, where expected social benefits exceed expected social costs. The system currently lacks output legitimacy because its goal attainment capacity is significantly diminished. First, it invites extensive bailouts of institutions that are likely to generate, at best, only modest bailout benefits. "Minor institutions" may be resolved through national corporate insolvency law, supported by generous State aid packages granted by the home Member State, as was the case with *Banca Popolare di Vicenza* and *Veneto Banca*. The State aid regime overrides the baseline loss sharing arrangement under national corporate insolvency law, combining a limited and "soft" bailout cost reduction mechanism with limited bailout benefits. Accordingly, under the EU bailout system, every bank is systemically important and no bank is too small to be bailed out.⁴²¹ This is perhaps tolerable. The bailout of minor institutions with few counterparties at limited cost is unlikely to generate high hidden costs, even in the absence of strict cost reduction measures. The ensuing bailouts may not be pie-increasing; but the overall "damage" is likely to be limited.

Secondly, and more importantly, resolution authorities have a strong incentive to avoid the difficult decisions that would be required under the BRRD/SRM loss allocation regime: any decision as to the constituencies that should be called upon to contribute to the loss absorption minimum requirement will invite public scrutiny and criticism and is likely to generate extensive litigation. "Hard cases"

⁴²⁰ Case C-526/14, *Kotnik and Others* ECLI:EU:C:2016:570 ¶¶ 61–80.

⁴²¹ See Gebbski, *supra* note 60, at 94 ("This legal requirement of non-discrimination, driven by internal market concerns, has the effect that not only large and 'systematic' banks, but in practice also smaller banks are eligible for aid.").

are therefore likely to be resolved through a public bailout subject only to the State aid framework, using any of the escape routes available. Zombie banks like Monte dei Paschi di Siena may be propped up through a very flexible interpretation of the prerequisites for a "precautionary recapitalization." Still more worrying, the vagueness of the public interest threshold in resolution would seem to allow the "handing back" of a "national champion," or any global systemically important institution, to national insolvency law and the State aid regime. Where a (powerful) national government strikes a deal with the Commission on the granting of State aid to an ailing national giant, it may easily be argued that resolution under BRRD/SRM would not meet the resolution objectives of ensuring the continuity of critical functions and avoiding adverse effects on the financial system to the same extent as resolution under national insolvency law combined with generous State aid would.⁴²² As the Bank of Italy has argued, where the SRB has decided to launch the BRRD/SRM procedure, the entire value of the equity and the junior bonds of an institution may be lost, and senior bonds and unprotected deposits may be subject to bail-in. This may generate higher costs for all the parties involved: the State, banking customers, and the rest of the banking system, contrary to the goal of minimizing the costs of resolution and avoiding the destruction of value.⁴²³ As Hellwig has pointed out, if the Bank of Italy's argument was accepted it would simply mean that banks would be entitled to fund at the low costs that are available under an implicit taxpayers' guarantee for their debt.⁴²⁴ In these cases potential bailout benefits are likely to be high, but so are the hidden potential costs. Strict bailout cost reduction measures could make all the difference. As it stands, the BRRD/SRM's strict loss allocation cascade is likely to be relevant for only a small number of "easy cases" where the application of resolution tools and powers is straightforward, the potential spillover effects limited and/or the political implications minimal,⁴²⁵ as with Spanish banking group Banco Popular. And even here, the true costs may remain largely hidden.

Given that the system goal is pre-mandated by international standard setters, the actual system outcome may be aligned with the system purpose by modifying either the behavior of individual system elements or their interactions.⁴²⁶ Recent reforms target the behavior of the system elements. Facilitated by the introduction of the new asset class of non-preferred senior debt, the new MREL regime allows resolution authorities to request any institution to meet its institution specific MREL requirements with subordinated debt instruments with a view to ensuring

⁴²² The new BRRD, *supra* note 19, art. 32(b), mandating the wind down of an institution under national law if resolution is deemed to not be in the public interest would not make a difference here. Where possible under national law, the institution's business (or parts thereof) could be transferred on a going concern basis out of the liquidation to a private sector buyer or a newly incorporated holding structure perhaps with a new banking license; the residual entity could be wound down. The transaction could be funded by generous State aid.

⁴²³ See *Is it true that the cost of the crisis would have been lower if, earlier on the Veneto banks had been placed under resolution?*, Banca D'Italia Eurosystema, <https://www.bancaditalia.it/media/fact/2017/0712-venete-anticipo/index.html> (last visited Nov. 4, 2019).

⁴²⁴ See Hellwig, *supra* note 35, ¶ 2.5.

⁴²⁵ See Binder, *Systemkrisenbewältigung*, *supra* note 179, at 68; *Bank Stakeholders*, *supra* note 6, at 247 ("[A] publicly financed bailout continues to provide a valid policy alternative, because, even if it remains technically feasible, it may appear highly undesirable.").

⁴²⁶ See MEADOWS, *supra* note 27, at 16.

that the resolution entity can be resolved in a manner suitable to meet the resolution objectives. Where the resolution authority utilizes this power, and requires an institution to issue subordinated debt even if only to cover the loss absorption amount, the loss allocation schedules under all three systems would be significantly aligned.

If we modify our earlier example by introducing an additional layer of debt, MREL in the form of subordinated debt of 15, the outcome would change as follows:⁴²⁷

Assets 100	Covered deposits	50
	Senior unsecured debt	15
	Subordinated debt (MREL)	15
	Capital Instruments	10
	Equity	10

In liquidation, of the (net) proceeds of 70 the deposit guarantee scheme subrogated for the covered depositors would receive 50; senior unsecured debt would receive 15; and the remaining 5 would be shared by subordinated debt on a pro rata basis, resulting in losses of 66.67% on their claims. Capital instruments and equity would be wiped out. With the presence of systemically important counterparties of nominal 10 among the senior unsecured debt in resolution, equity and capital instruments will be wiped out; of the subordinated debt, 10 may be written down to absorb the remaining losses, and a further 5 may be converted to equity at par to recapitalize the institution. The remaining senior unsecured creditors (of which 10 are non-bail-inable), as well as the covered depositors, will remain unscathed. (Only) subordinated debt would sustain losses of 66.67% on their claims. Under the State aid regime, equity and capital instrument would be wiped out, and subordinated debt would have to sustain losses of 66.67% before aid may be granted. The effect on moral hazard and market discipline under the individual system elements will have been aligned. However, the extent of taxpayers' loss exposure remains very different: the amount of the deposit insurance pay out not covered by contributions or liquidation proceeds in corporate insolvency; capped and with a resolution fund buffer in resolution; and un-capped and with no buffer under the State aid regime. Incentives to game the system thus still remain. Moreover, under current proposals the setting of firm-specific MREL standards depends on a myriad of discretionary decisions by competent resolution authorities and may also change over time. This is likely to prevent the risk-adequate pricing of bank capital and thus impair the restoration of market discipline.⁴²⁸

Although particular system elements can be essential for system outcomes, changing the system elements generally has the least effect on the system. As

⁴²⁷ As before, asset values take a hit and have to be written down to 70.

⁴²⁸ See Tröger, *supra* note 330, at 8.

Meadows writes, if you change all the players on a football team, it is still recognizable as a football team. By contrast, changing the interconnections between system elements can have a significant impact on system outcomes.⁴²⁹ Modifying the interaction between system elements seems indeed to be a more effective means for aligning the bailout system's outcomes with the overall system goal. A first step should be the removal of the "precautionary recapitalization" loophole. In combination with unreliable stress tests, its criteria are open to political manipulation and allow for unlimited government support of ailing zombie banks, subject only to the soft and limited State aid loss sharing rules. The counter-arguments are unpersuasive. A first argument concerns the necessity of a statutory basis for extraordinary public interventions in case of future financial disruptions of systemic proportions.⁴³⁰ However, such intervention remains always possible at national level, and where the crisis is truly systemic it is extremely unlikely that the Court of Justice would find the respective Member State in breach of EU law.⁴³¹ The presence of the precautionary recapitalization loophole, on the other hand, invites suboptimal bailout decisions contrary to the overall system objective. The second argument concerns the lack of binding agreements on a single-point-of-entry resolution strategy in a cross-border group context. Precautionary recapitalization seems to be the only option for ensuring the continuity of integrated operations that are necessary for maintaining systemically important functions in different jurisdictions outside the Euro-zone.⁴³² However, the precautionary recapitalization of an institution through its home Member State does not guarantee that foreign branches and subsidiaries will not be seized and ring-fenced by host country authorities. Only the strengthening of the international coordination and cooperation framework will be able to provide the necessary safeguards and address the issue effectively.

By closing the precautionary recapitalisation loophole, the public interest requirement would remain as a way out of the BRRD/SRM loss allocation cascade. Therefore, in a second step the public interest requirement should be removed as a prerequisite for resolution. Any credit institution or investment firm that is failing or likely to fail without any reasonable private sector alternative would be subject to the BRRD/SRM resolution framework. The latter would emerge as the EU Code for the resolution and insolvency of credit institutions and investment firms. National corporate insolvency law and the State aid regime would still be relevant in supporting roles within the BRRD/SRM resolution framework. The State aid regime would provide the standard of assessment for fund aid up to the 5% cap and beyond. Corporate insolvency law would be relevant for supplementing the

⁴²⁹ See MEADOWS, *supra* note 27, at 16 ("Change the rules from those of football to those of basketball, and you've got, as they say, a whole new ball game.").

⁴³⁰ See Veron, *supra* note 393, ¶ 2; Rodrigo Olivares-Caminal & Costanza Russo, *Precautionary recapitalisation: time for review*, EUROPEAN PARLIAMENT IN-DEPTH-ANALYSIS ¶ 8 (July 2017), [http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602092/IPOL_IDA\(2017\)602092_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602092/IPOL_IDA(2017)602092_EN.pdf).

⁴³¹ For example, in *Kotnik and Dowling* the Court of Justice held that the Second Company Law Directive (now Directive (EU) 1132/2017) does not stand in the way of "exceptional measures" taken by national authorities intended to prevent a company's failure in circumstances where there "is a serious disturbance of the economy of a Member State and with the objective of preventing a systemic risk and ensuring the stability of the financial system." Case C-526/14, *Kotnik and Others* ECLI:EU:C:2016:570 ¶¶ 87–90; Case C-41/15, *Dowling and Others* ECLI:EU:C:2016:836 ¶¶ 48–53.

⁴³² See Hellwig, *supra* note 35, ¶ 2.1.

incomplete regulatory structure of the BRRD/SRM, notably as regards the ranking of creditors and a claims procedure, and for dealing with the residual entity following the exercise of transfer tools. On these issues, the harmonization or unification of financial institution specific national insolvency law is justified and necessary. According to Binder,⁴³³ the BRRD/SRM resolution framework was not deemed to be the appropriate instrument for dealing with bank insolvencies of all shapes and sizes for two main reasons: the less secure and more uncertain position of creditors in resolution (administrative procedure with no input; *ex post* compensation through difficult "no-worse-off" considerations) as compared to corporate insolvency law (creditor participation; *ex ante* protection through *pari passu* and absolute priority); and the consideration that liquidation may sometimes be the most efficient solution for a failing firm. As for the latter, there seems to be no reason why an institution may not be liquidated in resolution where this is the most cost-effective way for dealing with firm failure. In particular, the resolution authority has the power to take control of an institution, either directly or indirectly, to operate it with all the powers of the shareholders and the board of directors, and to manage and dispose of its assets.⁴³⁴ This would seem to allow for a piecemeal liquidation where necessary. The former argument carries more weight. However, by closing the public interest loophole, uncertainty for creditors would actually be removed: creditors would be faced with a unitary system of creditor rights as the new baseline and could more easily price their investments accordingly, in particular if supporting national corporate insolvency law would be further harmonized. The BRRD/SRM resolution framework, supported by national insolvency law and the State aid regime, would have the capacity to also deal with "hard cases." The cap on resolution fund contributions may be exceeded in exceptional circumstances and government financial stabilization tools remain available as a last resort. The requirements of these measures would force greater transparency: authorities would have to explain why circumstances are exceptional to a far greater extent than is currently the case. The main issue is the mandatory 8% loss contribution requirement, which may pose a risk of contagion and/or hurt retail investors. For larger institutions with easy access to capital markets, both issues could be addressed through the adequate calibration of MREL. MREL quality requirements could ensure that the holders of MREL instruments would not experience undue stress from absorbing losses. The setting of MREL levels with a view to loss absorption and/or recapitalization capacity could ensure that retail investors are insulated from sustaining any losses. Smaller banks may not have the capacity to issue sufficient MREL instruments, at least not without changing their business model. However, for these institutions the risk of contagion is unlikely to be very high and retail investors could be protected through transition periods and effective conduct of business regulation. There is no justification for generally insulating the holders of unsecured senior debt from bearing any losses; otherwise these losses would just fall on the taxpayer.⁴³⁵ If no bank is too small to be systemic

⁴³³ See *Proportionality at Resolution Stage*, *supra* note 179, at 14–20.

⁴³⁴ See BRRD, *supra* note 19, art. 63; see also IMF, *supra* note 26, ¶ 28 (advocating the introduction of a supranational liquidation tool).

⁴³⁵ See Hellwig, *supra* note 35, ¶ 2.5.

and to be bailed out under the State aid regime,⁴³⁶ corporate insolvency law is redundant as a free-standing bank resolution regime. Closing the public interest loophole would force competent and resolution authorities to deal with any failing institutions within the BRRD/SRM resolution framework subject to mandatory but reasonably flexible loss allocation principles, keeping the indirect social costs of bailouts in check. This would make it more likely that bailouts would actually be "pie-increasing." Moreover, the suggested reforms would significantly reduce the complexity of the current EU bailout framework and thereby enhance transparency and legitimacy of future bailout decisions.⁴³⁷

⁴³⁶ See Gebski, *supra* note 60, at 94.

⁴³⁷ See BRAUN, *supra* note 158, at 25.