

Playing with fire

The EC's state aid decisions regarding Greek banks provide an indication as to the approach it will take with Italy. The question is whether they comply with EU law

In the aftermath of the 2008 crisis, the Commission acted as the EU's de facto resolution authority, imposing burden sharing, restructuring and orderly resolution plans on troubled banks as a condition to authorising the granting of state aid.

In 2014, the EU Council and Parliament adopted the Bank Recovery and Resolution Directive (BRRD), a comprehensive framework designed to prevent banking crises through early intervention and resolution measures, and aimed at ensuring that shareholders and creditors bear losses in lieu of taxpayers, that critical functions are maintained and that the financial stability is preserved.

In addition to making burden sharing legally enforceable in all member states (against shareholders, subordinated debt holders but also senior debt holders), the BRRD shifted the resolution powers that were so far exercised de facto by the Commission to banking and resolution authorities.

Nonetheless, in the Piraeus Bank decision (SA.43364 (2015/N)) the Commission developed its own interpretation as to the circumstances in which an institution should be placed in resolution. In doing so, the Commission not only created additional criteria for placement in resolution not foreseen by the BRRD, but arguably acted *ultra vires*, exercising powers that now belong exclusively to the banking and resolution authorities.

'Failing or likely to fail' test

Under Article 32 BRRD, a bank may be placed in resolution *only if the resolution authority considers* that all the following criteria are met: (A) it is failing or likely to fail (FLF), (B) no alternative private solution exists that could reasonably prevent the failure and (C) resolution is in the public interest. Criteria (A) (FLF test) is met if the resolution authority, acting in consultation with the banking authority, considers that either one of the following situations occurs (1) the bank is in material breach of prudential requirements, (2) its assets are (or are likely in the near future to be) lower than

its liabilities, (3) it is (or will in the near future be) unable to pay its debts when due or (4) it requires extraordinary public financial support (EPFS), defined as "State aid [...] that is provided in order to preserve or restore the viability, liquidity or solvency of an institution."

As an exception to condition (4), the provision of EPFS does not constitute an FLF circumstance if certain conditions are met, and in particular where the relevant public support (i) is required to remedy a serious disturbance in the economy of a member state and preserve financial stability, (ii) takes the form of a precautionary capital injection on terms that do not confer an advantage to the institution, (iii) is granted to an institution that is not otherwise failing or likely to fail (ie which is not insolvent or in material breach of prudential requirements), (iv) is limited to injections necessary to address a capital shortfall established in EBA, ECB or national stress tests or asset quality reviews (AQR).

Resolution outside the BRRD

In the Piraeus Bank decision, the Commission expressed the view that, if an institution has a shortfall evidenced in an AQR/base scenario stress test which is not fully covered by the private sector, the institution should be considered as being FLF and therefore placed in resolution. There are three main issues with this position.

Stress test shortfall as a trigger for resolution

First, a stress test shortfall, even in an AQR/base scenario, is not in itself evidence that an institution is failing or likely to fail. Due to the fact that resolution actions can significantly and adversely impact fundamental property rights, the BRRD provides only a limited set of circumstances that constitute triggers for resolution. A stress test shortfall, whether in an AQR/base or adverse scenario, is not one of them. Neither is the failure to complete a capital increase deemed necessary by a banking supervisor on the basis of a stress test result, so long as the institution remains solvent

and is not in material breach of prudential requirements.

Furthermore, the determination as to whether an institution meets the FLF test must be based on a "fair, realistic and independent" valuation of its assets and liabilities carried out in accordance with Article 36 BRRD. A stress test consists in a partial review of certain categories of portfolios and assets based on sampling methodologies, analysed under certain hypothetical stress scenarios devised by the EU authorities themselves, and can therefore hardly be considered as fair, realistic and independent. Stress tests evidence an amount of capital required in order for the institution to be over-capitalised at a level which the supervisor considers to be prudent, not the amount of capital required in order for the institution to remain viable.

Prohibition of precautionary recapitalisation

Second, the Commission considers that a precautionary recapitalisation can be used to cover shortfalls evidenced in adverse scenarios, but not shortfalls evidenced in AQR/base scenarios. However, Article 32 BRRD and the EBA guidelines implementing Article 32, make no distinction between AQR, base and adverse shortfalls. The only requirement for a precautionary recapitalisation to be available is that the amount of the capital injection does not exceed the total shortfall.

The Commission further argues that AQR/base scenario shortfalls cannot be covered by precautionary recapitalisations because they evidence "losses incurred or likely to be incurred in the near future". However, shortfalls evidenced in a stress test do not constitute, and are not evidence of, "losses incurred or likely to be incurred". An institution can have an AQR/base shortfall, ie a need to increase its capital to comply with the target capital ratios established in the stress test methodology, without incurring or being in imminent risk of incurring losses. This was true for several institutions following the 2014 Comprehensive Assessment. Conversely, an institution can incur losses without having evidenced an AQR/base shortfall, for instance if an otherwise healthy institution is the victim of a massive fraud. The assumption that a stress test shortfall equates actual or imminent losses is therefore inaccurate. Moreover, the amount of losses used to determine whether the institution meets the FLF test would not be equal to the stress test shortfall, but would have to be assessed

according to an independent valuation in accordance with Article 36 BRRD (see above).

Lack of private sector participation

Third, the Commission considers that a lack of appetite by the private sector to participate in a capital increase means that the institution requires EPFS and therefore meets the FLF test. However, there are circumstances in which an institution may require EPFS, not as a result of being intrinsically unhealthy or non-viable, but as a result of external circumstances preventing or discouraging private sector participation. This is particularly true now that bail-in is in force since it applies without any priority given to new money and therefore in itself discourages private sector investment in periods of instability or uncertainty, regardless of the financial situation of any individual bank. This is also particularly true following sector-wide stress tests, which may create a need for recapitalisations of a significant number of banks and reduce investors' appetite to recapitalise any individual bank.

The EU legislator expressly contemplated these circumstances, as reflected in the Recital 41 BRRD:

“Furthermore, the provision of extraordinary public financial support should not trigger resolution where, as a precautionary measure, a Member State takes an equity stake in an institution, including an institution which is publicly owned, which complies with its capital requirements. This may be the case, for example, where an institution is required to raise new capital due to the outcome of a scenario-based stress test or of the equivalent exercise conducted by macroprudential authorities which includes a requirement that is set to maintain financial stability in the context of a systemic crisis, but the institution is unable to raise capital privately in markets.”

Failing to take them into account would violate the legislative intent of Article 32 and deprive it of its “effet utile”.

Respective powers

Regardless of whether the assessments made by the Commission as to the FLF test are grounded in substance, the question is whether the Commission has any legal basis to even make these assessments.

In the Piraeus decision, the Commission considers that EPFS in the form of precautionary recapitalisation is subject to approval under state aid rules. It should be noted that, the BRRD only provides that guarantee or equivalent measures shall be “conditional on final approval under the

Union State aid framework”. This does not include capital injections, which is consistent with the fact that precautionary capital injections are permitted under Article 32 only if they do not confer an advantage to the institution, ie if they are conducted on market terms and therefore, by definition, do not constitute state aid.

Even in circumstances where the Commission does have, pursuant the BRRD, the power to assess measures under the state aid framework, the Commission's assessment is always expressed to be made under the state aid framework. Nowhere in the BRRD or in the framework is the Commission granted powers to make a determination as to whether an institution is meets the FLF test or should be placed in resolution, or whether equity or debt should be written down or converted, which determinations are to be made by the banking/resolution authorities, as acknowledged by the Commission itself: *“It is for the respective supervisor or resolution authority, and not for the Commission, to apply this EU law and put a bank in resolution. The responsibility of the Commission is to ensure that State aid used in resolution does not unduly distort competition.”* (Speech by J Laitenberger, January 25 2016).

Indeed, the BRRD has effectively deprived the Commission of the power to implement two of the three tools underpinning its state aid policy as set forth in its August 2013 state aid communication and reiterated in its February 2015 policy: (1) deciding that an institution that it deems not viable on the long term without public support should be placed in resolution and (2) imposing burden sharing on equity and subordinated debt holders, while the Commission retains the possibility to (3) require the implementation of restructuring plans, to ensure a contribution by the institution itself and minimise competition distortions.

Nonetheless, the Commission has been creative in overcoming these limitations.

Intrinsic competence

In the Piraeus decision, the Commission conducted a detailed analysis as to whether the institution meets the FLF test and concluded that, because the institution is not required to be placed in resolution, aid can be granted (Paragraphs 172-173) The

Commission justified its power to make such assessment on intrinsic competence: *“In the case at hand, the Commission needs to verify whether any intrinsically linked provisions of [BRRD] have been breached.”* (Paragraph 58)

The assumption that a stress test shortfall equates to actual or imminent losses is therefore inaccurate

In other terms, based on the fact that BRRD requires certain state aid assessments, the Commission deems itself competent to control the legality and adequacy of decisions within the exclusive competence of banking/resolution authorities, and to substitute its own judgment to that of those authorities. This contradicts Article 32.1, which provides that “resolution authorities shall take a resolution action *only if the resolution authority considers that the institution [meets the conditions for resolution,* Article 32.4, which provides that the Commission's approval, where required, must be made under the state aid framework, as well as the fundamental principles of judicial review of resolution decisions, set forth notably in Article 263 TFUE and Article 85 BRRD.

Automatic placement in resolution in case of public support

Commission officials have repeatedly stated that public support constitutes an automatic trigger for placement in resolution, allowing it to bypass the need for a decision by the banking/resolution authorities. In a letter dated November 19 2015 to Pier Carlo Padoan, Commissioners Hill and Vestager stated: “If an assessment leads to the conclusion that the use of the deposit guarantee scheme is state aid, resolution of the bank will be triggered under the Bank Recovery and Resolution Directive”.

In the press release regarding the Piraeus Bank decision, the Commission states: “Under the Bank Resolution and Recovery Directive, a bank in need of state aid has to be put in resolution.” In a speech dated January 25 2016, J Laitenberger states: “It is also important to remind that under the BRRD [...], any state aid support will imply that an institution is deemed as failing or likely to fail and would therefore

be an automatic trigger for resolution of the entity.”

First, the notion that there would be any form of automatic trigger for the FLF test, such as a predefined level of stress test shortfall or private sector participation in a capital increase, directly contradicts the position of the banking regulators, according to which the FLF determination should always be made on a case-by-case basis, based on each bank's individual prudential situation.

BRRD provides only a limited set of circumstances that constitute triggers for resolution

In its 2012 opinion on BRRD, the ECB states that: “The determination of the circumstances in which an institution is failing or likely to fail should be based only on an assessment of the prudential situation of an institution. Thus, a particular need for State aid should not, in itself, establish an adequate objective criterion.”

The EBA, in its 2015 guidelines on failing or likely to fail states that:

“The identification of a single objective element specified in these guidelines with regard to a particular institution should neither lead to an automatic determination that it is failing or likely to fail, nor automatically trigger resolution actions. On the contrary, in each case, the relevant authorities should decide whether the institution is failing or likely to fail on the basis of a comprehensive assessment of both qualitative and quantitative objective elements, taking into account all other circumstances and information relevant for the institution.”

Second, even where the banking/resolution authority determines that an institution meets the FLF test, placement in resolution can take place only if the resolution authority also determines that the two other aforementioned conditions are met, ie that no alternative

private solution exists that could reasonably prevent the failure, and that resolution is in the public interest, an assessment which by nature requires a certain level of discretion and cannot reasonably be based on any automatic trigger.

Burden sharing

The Commission could, as it did with the Greek “HFSF Law” in 2015, require member states to pass laws making burden sharing enforceable in circumstances other than and beyond what is foreseen by BRRD. However, pursuant to Article 32 BRRD, member states are not entitled to implement in their legislation resolution triggers not contemplated by the BRRD such as the stress test capital shortfall or lack of private sector participation triggers envisaged by the Commission. National resolution authorities that would exercise resolution powers on that basis would therefore face a significant risk of legal challenge.

This leaves the Commission with the solution that was used in the Piraeus case, ie raising the threat of resolution if the private sector does not cover the entirety of the AQR/base shortfall through new capital injections or liability management exercises. Due to bail-in risk, especially in periods of financial instability, this type of capital increase results in extreme dilution, ie effective burden sharing of existing shareholders and subordinated debt holders, but carried out without complying with the due process and property rights protections set forth in BRRD. Leaving aside legality considerations, it remains to be seen whether the private sector will be persuaded to participate in a similar exercise in the Italian banking sector.

Possible scenarios

Two possible scenarios would comply with both the BRRD and the state aid frameworks.

- An institution requires EPFS to offset actual or imminent losses, as determined on the basis of an Article 36 valuation.

In this case, a precautionary recapitalisation is likely not available and the institution will likely be deemed to meet the FLF test. If the resolution authority decides to place the institution in resolution, it will be entitled to exercise resolution tools including bail-in or transfer to bad bank structures.

- An institution requires EPFS, not to offset actual or imminent losses determined on the basis of an Article 36 valuation but solely as a result of an AQR/base/adverse shortfall not covered by the private sector. In this case, provided the institution is solvent and is not in material breach of prudential requirements, there is not a sufficient legal basis for the banking/resolution authorities to place it in resolution. Provided the Article 32 conditions are met, a precautionary recapitalisation would be available up to the entire amount of the shortfall, regardless of private sector participation in the capital increase. If the support measure constitutes state aid, the Commission will be entitled to impose restructuring measures.

Conversely, if an institution is placed in resolution on the sole basis of stress tests outcomes and lack of private sector participation, regardless of the institution's individual prudential situation and Article 36 valuation, the EU authorities and the relevant resolution authorities would be exposed to a significant risk of legal challenge, on the basis notably of ultra vires, violation of BRRD and undue and disproportionate infringement of property rights.

While the Commission's objectives—avoiding moral hazard, avoiding losses being borne by taxpayers, preventing competition distortions—are legitimate, imposing these objectives at the expense of EU law, is not, and neither is its attempt to impose a vision of bank resolution based solely on state aid rules, which the EU Parliament and Council rejected when they adopted BRRD.

Amélie Champsaur, partner at Cleary Gottlieb Steen & Hamilton in Paris

This article reflects the views of the author only