Bank rescue in the European Union. From bail-out to bail-in

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States have traditionally faced banking crisis through the so-called bail-out tool: public resources have been used for a long time in order to rescue banks, putting the burden on public finance, thus on taxpayers. Actually, this is what still happens in the most part of the world, but not in the European Union (EU).

The bail-in tool to reduce State aids

Since the beginning of the crisis in 2007-2008, the European Commission (Commission) has adopted special rules for the rescue of banks, providing guidance on the use of bail-out principles but without any precise exit strategy. In particular, those special provisions were based on Art. 107(3)(b) TFEU, the derogation provided by EU Treaties to the prohibition of State aid in cases of "serious disturbance in the economy of a Member State".

However, exceptions cannot last forever, especially when it comes to State aid. Therefore, between 2008 and 2013, the Commission has gradually introduced the so-called burden-sharing principle – also known as bail-in – in order to reduce public support to banks. In fact, the so-called Banking Communications on State aids to banks (Banking Communications) and, then, the new Bank Recovery and Resolution Directive (BRRD) have enacted rules that have more and more moved the burden of bank rescue on shareholders and subordinated creditors while minimising the burden on taxpayers.

Burden-sharing measures included in the Banking Communications and bail-in tool encompassed in the BRRD can be considered as functionally equivalent, notwithstanding some differences among them (see K.-Ph. Wojcik, *Bail-in in the Banking Union*, in *Common Market Law Review*, vol. 53, 2016, 91-138, at 105). Thus, ‘bail-in’ and ‘burden-sharing’ can be used as synonyms.

The bail-in tool pursues two main objectives. On the one hand, the need to reduce to the minimum necessary public expenditures for the rescue of banks and consequently to tackle the moral hazard that public subsidies to enterprises usually entail. On the other, the need to shorten the anti-competitive impacts of aid to banks.

The bail-in in the BRRD and in the Banking Communications

Since January 2016, according to the BRRD, the bail-in has definitively entered into force as resolution’s tool for banks. In other words, each time a bank is failing or likely to fail, it must be put under resolution and their shareholders and subordinated creditors must participate to the rescue with their own resources (*i.e.* write-down of shares or conversions of subordinated debts into equity). Moreover, under the BRRD the bail-in tool applies irrespective of the granting of an aid by States or resolution funds.

However, in some specific circumstances, the bail-in tool applies also when the BRRD does not. Indeed, when a bank – which is not failing or likely to fail – needs a so-called precautionary recapitalisation, a Member State can grant a support measure in compliance with the Banking Communications. Differently saying, according to Art. 32(4) BRRD, if a solvent bank requires some public support in order “to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises”, a Member State can provide the bank with a capital injection, but it should apply bail-in measures as required especially by the 2013 Banking Communication.

Thus, also in the case of a precautionary recapitalisation, shareholders and subordinated creditors must carry their weight. Nevertheless, point 45 of the 2013

Banking Communication states that the application of bail-in measures to subordinated creditors can be derogated "where implementing such measures would endanger financial stability or lead to disproportionate results". The European Court of Justice (ECJ) has recently clarified the relation between the principle of proportionality and the application of the bail-in tool to subordinated creditors.

The judgment of the ECJ in the 'Kotnik case'

On July 19, 2016, the ECJ released it decision in the *Kotnik case* regarding the compatibility of bail-in provisions included in the 2013 Banking Communication with, *inter alia*, the general principle of proportionality. With this judgment the ECJ found the bail-in tool compatible with EU Law. However, according to the ECJ, burden-sharing measures applied to subordinated creditors must comply with the proportionality principle, as required by point 45 of the 2013 Banking Communication.

Indeed, "an obligation to effect the conversion, or write-down, of subordinate rights in their entirety before the granting of State aid cannot be imposed on a bank if, inter alia, *the conversion, or write-down, of a part of the subordinate rights would have been sufficient to overcome the capital shortfall of the bank concerned*" (*Kotnik case*, p. 101, emphasis added).

Therefore, according to the ECJ decision, in cases of precautionary recapitalisation – where only the Banking Communications apply – Member States should be allowed to apply *ex post* burden-sharing measures to subordinated creditors, only to the extent that is strictly necessary to cover the capital shortfall established by stress tests or asset quality reviews. In other words, once the bail-in tool has been applied to shareholders, the Member States should be able to provide the bank with a limited capital injection and to apply the bail-in tool to a restricted percentage of all subordinated debts.

Concluding remarks

The judgment of the ECJ in the *Kotnik case* is not a revolution in the framework of

State aid to banks. However, with this decision the ECJ establishes that – contrary to what is provided for in the Banking Communications – the burden-sharing measures don’t have to be applied to subordinated creditors before the granting of a public aid and that proportionality continues to play a key role in EU Law, especially for the protection of retail investors.

Authors work at Intesa Sanpaolo. Views expressed here are strictly those of the authors. An extended version of this post will be published in an article on the Journal of European Competition Law & Practice.