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Finance & Markets

Financial Sector Advisory Center (FinSAC)



# **BANK RESOLUTION AND “BAIL-IN” IN THE EU: SELECTED CASE STUDIES PRE AND POST BRRD**

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# INTRODUCTION

In the aftermath of the 2007/08 financial crisis, and lacking sufficient coordinated guidelines or legislation, measures to address failing financial institutions in EU Member States were taken at national level. In an effort to improve cross border coordination as well as to reduce future dependence on public money, the European framework for managing the failure of financial institutions was reformed, building upon the Financial Stability Board's "Key Attributes". From January 1, 2015, all EU Member States were required to transpose the Bank Recovery and Resolution Directive (BRRD) into their national law. A key element of the new powers is the bail-in tool, requiring banks to recapitalize and absorb losses from within, which was made mandatory as of January 1, 2016.

These case studies have been selected as examples of how some EU countries tackled the resolution of several failing European banks. Importantly, the case studies are not meant to be an exhaustive description of all aspects of the resolution of failing banks. The focus of the case studies is on the application of bail-in features, i.e. statutory private loss absorption outside liquidation.<sup>1</sup> Most cases studies also describe other measures used to deal with distressed financial institutions, including but not limited to government guarantees, capital injections, liquidity supports, and the creation of asset management vehicles to put the bail-in into perspective.

While most cases studied took place before adoption of the BRRD they remain both interesting and relevant. They highlight the gradual transition from bail-out to bail-in for the resolution of European banks. A framework for loss absorption was often already in place and applicable, inspired by international good practice, the BRRD negotiations, and the EU state aid rules. A common objective for authorities throughout the resolution processes was to ensure uninterrupted access to banks' deposits and critical functions. Actions taken sufficiently early and rapidly can ensure the continuity of critical functions, while minimizing the impact of an institution's failure on the economy and wider financial system. However, experience shows that this process has often been problematic, with the decision to bail-in being taken only after repeated bail-outs and at a point when there had been substantial erosion of the "bail-inable" base. Some cases discuss how resolution might have been handled differently under the provisions of the BRRD, with clearer bail-in requirements and larger loss absorption likely reducing the need for public support.

The case studies also provide first examples of the No Creditor Worse off than under Liquidation (NCWO) test, i.e. the comparison of the treatment of shareholders and creditors under resolution to the losses that would have occurred under a hypothetical liquidation scenario. They appear to confirm the assumption that losses are substantively lower under resolution than under a hypothetical liquidation.

These real life resolution cases are not meant to be examples of good practice. They are gathered here instead to highlight some of the difficulties, complexities, and practical challenges encountered when applying bail-in, including the bail-in of uninsured depositors, retail bond holders, or liabilities guaranteed by a regional state. Issues of finding appropriate

<sup>1</sup> The term "bail-in" is defined as the write down and conversion of creditors, however it is also used in a broad sense to refer to "private" loss absorption by creditors (in contrast to a public bail-out).

buyers for recapitalized banks are also mentioned. Furthermore, the case studies point to the importance of ensuring sound resolution decisions based on proper valuation and the legal challenges encountered when applying bail-in.

Since most of the cases studied occurred before transposition of the BRRD and/or adoption of the bail-in tool, they cannot be used to draw conclusions about the effectiveness of resolution under a fully operational BRRD framework. For instance, authorities had no pre-existing resolution plans or predefined loss absorbing capacity (MREL/TLAC) available to them in any of the cases presented, both of which are key elements for the successful implementation of bail-in. Such conclusions will only become possible over time now the legislation is fully in place. We hope that, nevertheless, these real life examples of European banks' resolutions provide a useful and interesting source of reference. For more details on resolution under the BRRD, we invite you to refer to the FinSAC Guidebook "Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD".

**Pamela Lintner and Johanna Lincoln**

## **BRIEF OVERVIEW OF EACH CASE STUDY PRESENTED IN ALPHABETICAL ORDER:**

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### **AUSTRIA**

#### **HETA: RESOLUTION OF AN ASSET MANAGEMENT VEHICLE (2014)**

The Austrian case study describes the nationalization of Hypo Group Alpe Adria and the subsequent resolution of HETA, its asset management vehicle. The HETA resolution was conducted under the newly adopted national law transposing the BRRD and without having in place a resolution plan. A two-year moratorium allowed the competent authorities to verify the quality of HETA's assets and prepare for the implementation and application of the bail-in tool. The HETA case is one of the first resolution cases under the new BRRD regime and the first instance where covered bonds were tested under resolution.

The second part of this case study highlights the role of courts in the implementation of a newly created resolution framework pre-BRRD. It discusses how the national law winding down the failing bank (*lex specialis* pre BRRD) was subsequently judged unconstitutional and repealed in its entirety on the grounds that it differentiated within the group of subordinate creditors and declared all securities (incl. public guarantees) expired together with their respective claims. The ruling did not, however, object to a haircut or bail-in of unsecured creditors in general.

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### **CYPRUS**

#### **BANK OF CYPRUS AND LAIKI: RESOLUTION VIA PUBLIC SUPPORT AND BAIL-IN, INCLUDING OF UNINSURED DEPOSITORS (2013)**

The Cyprus case study demonstrates the importance of timely intervention in failing institutions. Delays in tackling problems result in uncertainty and the flight of capital and are likely to impede the efficiency of resolution actions. Moreover, the case study raises some cross-border considerations such as the necessity to prevent and control regulatory arbitrage between different jurisdictions, and the importance of assessing and monitoring potential cross-border sovereign risk transfers. The case highlights the importance of having in place an adequate legal framework as well as the administrative capacity for implementing resolution powers to avoid or minimize bail-out. At the same time difficulties in successfully deploying bail-in are demonstrated by the unexpected bail-in, including of uninsured depositors, after the ad hoc adoption of a resolution law in 2013 inspired by the BRRD (which was then still under negotiation).

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## DENMARK

### **ANDELSKASSEN: RESOLUTION VIA BRIDGE BANK AND BAIL-IN INCLUDING OF UNINSURED DEPOSITORS (2016)**

The Denmark case study reflects on a series of measures taken to deal with distressed banks in the aftermath of the financial crisis. Government guarantees, capital injections, liquidity support, and an integrated asset management division to sell/wind up distressed financial institutions in an orderly manner, were put in place to encourage industry consolidation and restructuring. The Danish case describes the resolution of Andelskassen JAK Slagelse under the BRRD regime via the hybrid application of the bridge bank and bail-in tools. The case demonstrates a bail-in process, including write-down of uninsured depositors and contributions of the deposit guarantee scheme (DGS), while ensuring uninterrupted access to the bank's deposits and critical functions. It is one of the first BRRD bail-in cases that gives a concrete example of the NCWOL test (comparison of the treatment of shareholders and creditors under resolution with the losses that would have occurred under a hypothetical liquidation scenario). It also highlights the complexities involved in successfully divesting the resolved bank and difficulties of finding a suitable buyer. Ultimately, the supervisory authority failed to approve an envisaged transfer to a private acquirer leading to the resolved bank being wound down.

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## GREECE

### **SEVERAL GREEK BANKS AND FOREIGN BRANCHES: RESOLUTION VIA PUBLIC RECAPITALIZATION AND BAIL-IN AND STATE AID ISSUES (2009–2015)**

In 2011, Greece was among the first EU countries to legislate on bank resolution. The first part of this case study summarizes the restructuring and recapitalization process in the context of a severe economic crisis. The Greek experience shows how all the resolution strategies adopted have been designed to protect uncovered deposits and how banks have been resolved by using the bridge bank and sale of business tools (all but one were pre BRRD). The case study reflects that if the BRRD had been in place during this time uncovered deposits would have been subject to bail-in, potentially further undermining public confidence in the banking system. It also underlines the importance of having an independent valuation before and after the resolution process and stresses the need for close cooperation between relevant stakeholders at national and international level to provide for a seamless resolution process.

The second part of the case study focuses on the interplay between the BRRD and the state aid regime during the 2015 recapitalizations of Greek banks. It draws attention to potential issues related to the level of loss absorption/burden-sharing under precautionary public recapitalization (i.e. temporary financial support to a solvent bank), especially if an institution's liabilities are not squarely within the scope of the powers set out in the BRRD. It also elaborates on related cross border mutual recognition provisions. The case study shows how liability management exercises (LMEs) were launched to meet the burden-sharing condition for state aid. LMEs involved the consensual conversion of bonds into equity and were accompanied by rights issues to increase equity reserves.

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## ITALY

### **FOUR SMALL BANKS: RESOLUTION VIA BRIDGE BANK AND ASSET MANAGEMENT VEHICLE TOOLS TO AVOID FULL BAIL-IN (2015)**

This case study reports actions taken to address structural issues in the Italian banking system, in particular the high level of Non-Performing Loans (NPLs) and the concentration of banks' subordinated debt in the hands of Italian households. It demonstrates how, post BRRD but pre obligatory bail-in, a public bail-out as well as a full bail-in (of retail bondholders) was avoided in the restructuring of four small weak regional banks. A bridge bank and asset management vehicle were created and a guarantee scheme on banks' NPLs introduced. The Italian case highlights the importance of public communication and questions the success of the bail-in tool in cases when almost all junior debts are held in fact by "retail depositors". The case also shows how a recently set up resolution fund was used to contribute to absorb losses (at that time without the prior 8% bail-in requirement) by collecting ad hoc ex post bank contributions. Furthermore, the case study questions how Atlas, a fund mostly financed by Italian banks and created to buy junior tranches of securitized NPLs acting as a subscriber of last resort, might increase interconnectedness and risks in the banking sector. Finally, the case discusses how Atlas' structure, powers, and objectives fit with the requirements of the new EU resolution framework.

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## THE NETHERLANDS

### **SNS REAAL: RESOLUTION VIA NATIONALIZATION AND BAIL-IN (2013)**

The Netherlands case study examines the nationalization of one of the country's largest financial conglomerates in 2013. Losses in SNS Reaal's substantial real estate portfolio and its failure to meet its capital ratio requirements led, two years prior to the adoption of the BRRD and after review of all the possible resolution options, to the nationalization and bail-in of all shareholders and subordinated bondholders of SNS Reaal. These measures were accompanied by a capital injection and restructuring plan, whose costs were partly financed by a one-off 'resolution tax' on the banking sector. The case study concludes that under the BRRD the results would have likely been the same for shareholders and subordinated debt holders i.e. full write-down and zero compensation. However, it argues that under the new regime, the bail-in of senior debtholders would have been possible, and there would have also likely been recourse to the Single Resolution Fund.

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## PORTUGAL

### **BANCO ESPÍRITO SANTO, S.A.: RESOLUTION VIA A BRIDGE BANK INCLUDING A RE-TRANSFER (2016)**

The Portuguese case study describes the implementation of the bridge bank tool in the resolution of Banco Espírito Santo S.A. (BES), a systemically important institution. BES business and most of its assets and liabilities were transferred to a bridge institution, called Novo Banco, with new members of the management bodies appointed by Banco de Portugal. A residual institution, still called BES, was intended for liquidation. Novo Banco was capitalized with funds from the Portuguese Resolution Fund as single shareholder, financed by loans from the state and some private banks. About a year after the original transfer, Banco de Portugal re-transferred some non-subordinated bonds back from Novo Banco to BES to make up for an over-evaluation of the assets. The case study highlights the importance of sound ex ante and ex post valuations by an independent valuer to decide the extent of loss absorption (for the creditors left behind at BES) and determine transfer prices. The case study additionally demonstrates difficulties in the sale process of the restored Bridge Bank: Novo Banco, originally set up for two years, had to be extended and the Resolution Fund's equity stake has yet to be sold.

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## SLOVENIA

### **SEVERAL DOMESTIC BANKS: RESOLUTION VIA PUBLIC RECAPITALIZATION AND BAIL-IN (2013)**

The Slovenian case study describes different measures taken by the government and the Bank of Slovenia, including the public recapitalization of several national banks in 2013, the creation of a state-owned asset management vehicle (BAMC) to deal with distressed assets, and the sovereign guarantee to the Central Bank for providing Emergency Liquidity Assistance (ELA). The case study describes how these bail-out measures were accompanied by private loss absorption pre BRRD, required under national resolution legislation adopted in 2013 (and the Commission's state aid "Banking Communication"). It also highlights the importance of judicial review and the role of the European Courts' preliminary rulings, which endorsed in principle the right to enforce "burden sharing" on private investors. The case study finally considers how the process would have been different, and the required recapitalization via bail-in more unambiguous and most likely considerably larger (while reducing the need for state aid), if the BRRD had been in place.



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## SPAIN

### **SAVINGS BANKS: RESOLUTION VIA PUBLIC RECAPITALIZATION, THE CREATION OF AN ASSET MANAGEMENT VEHICLE AND BAIL-IN (2012)**

The Spanish case study describes the EU financial sector assistance program which helped mitigate the impact of the financial crisis on Spanish savings banks. It elaborates on the public Fund for Orderly Bank Restructuring (FROB) which is responsible for managing banks' restructuring processes and channeling public aid to them. The FROB continues to act as one of the resolution bodies in Spain, next to the Central Bank. In addition, all state aided banks had to transfer their real estate assets to SAREB, a private-public asset management vehicle. This case study highlights how the national legal framework developed in 2012/13 anticipated BRRD's principles, and prescribed mandatory burden sharing exercises under the NCWOL principle through "Subordinated Liability Exercises" (SLE) linked to the pre-existing Spanish insolvency legislation. These SLEs contributed to the reduction of public support by bailing-in subordinated debt holders. The case elaborates on how this loss absorption affected retail investors (due to prior mis-selling of products) and how a liquidity mechanism for "bailed-in" (retail) holders financed by the DGS, as well as a less aggressive SLE scope (compared to the BRDD), have played a significant role in reducing litigations. The case study also discusses the resolution of BFA-Bankia, one of the biggest resolution cases in Spain, by the transfer of its "bad" assets to SAREB and its recapitalization via the FROB. It concludes by offering some thoughts on the transition from a bail-out to a bail-in scheme, and the importance for authorities to ensure sound resolution decisions which minimize the risk of legal challenge.

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## THE LOSS ABSORBING CAPACITY

### **UK CO-OPERATIVE BANK: RESOLUTION VIA NEGOTIATED BAIL-IN OUTSIDE THE BRRD (2013)**

The UK case study shows how a Co-operative bank was recapitalized by "consensual" or "negotiated bail-in", better known as liability management exercises (LMEs). LMEs operate outside the legal constraints imposed by the BRRD and can provide a commercial solution to the failure of a financial institution by reaching an agreement between the parties involved in "bail-in".

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# AUSTRIA

## HETA: RESOLUTION OF AN ASSET MANAGEMENT VEHICLE (2014)

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### PART 1 – HETA: THE RESOLUTION OF AN ASSET MANAGEMENT VEHICLE

Authors: Johanna Lincoln and Pamela Lintner

#### Summary

HETA Asset Resolution AG (HETA) was established on October 30, 2014, as the resolution vehicle to continue Hypo Alpe-Adria-Bank International AG (“HBInt”) the parent company of Hypo Group Alpe Adria (HGAA) (subsequently Hypo Alpe Adria/HAA) a failed bank nationalized by the Republic of Austria in 2009. The Austrian Financial Market Authority (FMA), in its capacity as the resolution authority, initiated the resolution of HETA on March 1, 2015, in accordance with the Federal Act on the Recovery and Resolution of Banks (BaSAG) which transposed the BRRD<sup>1</sup>. In order to prepare for the application of resolution tool(s) and since no resolution plan was drawn up ex ante, the FMA imposed a temporary moratorium on the liabilities of HETA until May 31, 2016. The final bail-in decision adopted in April 2016 imposed a haircut of 54 % on senior debt. Overall and since 2008, the Austrian Government injected about EUR 5.5 billion into HAA.

#### Background

Founded as a small regional mortgage bank in the Austrian State of Carinthia, HAA later became a full-service bank. Throughout its existence some of the bank's liabilities were guaranteed by the State of Carinthia<sup>2</sup>, enabling HAA and its Austrian subsidiary Hypo Alpe-Adria Bank (HBA) to benefit from a good credit rating. This allowed the bank to finance its operations in favorable conditions and expand aggressively, especially across South East Europe. However, the bank's risk management and control systems were poorly equipped to monitor this debt-fueled growth.

A special enquiry commission (the “Griss-Kommission”) initiated by the Austrian Government concluded that in 2009 mistakes had been made not only by the bank's owners and its board but also by other key players. In particular, this report highlighted that the State of Carinthia was caught in a permanent conflict of interest. The bank's aggressive expansion generated high revenues (i.e. higher guarantee commissions and dividends paid by HAA) for the State of Carinthia which diminished its incentive to mitigate the risks taken by the bank. The bank's auditors and the authorities responsible for its supervision were also found, in this report, not to have reacted with the intensity required to address the bank's weaknesses.

<sup>1</sup> Bank Recovery and Resolution Directive (BRRD)

<sup>2</sup> Only liabilities, issued between April 2003 and 2007 and falling due before September 2017, were guaranteed by the State of Carinthia.

### Nationalization of HAA

Bayern LB acquired the majority shares of HAA in 2007<sup>3</sup>. In 2008, the group requested state aid and the Republic of Austria subscribed to its capital in the amount of EUR 900 million, under the condition that the bank was sound. An expert review from the Oesterreichische Nationalbank (OeNB), the central bank of Austria at that time concluded that HAA was “not distressed”, and therefore no restructuring plan was drawn up<sup>4</sup>.

In fall 2009, Bayern LB announced that it would not provide additional capital to HAA to even its bad loans. The Austrian Government chose to step in to prevent the collapse of the bank, and the default its guarantor the State of Carinthia. In December 2009, a share purchase agreement was concluded between the Republic of Austria, Bayern LB, and the other shareholders, for a symbolic price of one euro. HBInt was nationalized. At the time of nationalization, HAA's balance sheet amounted to a total of EUR 41 billion, including EUR 20 billion of secured debts. Between December 2008 and April 2014, the Austrian Government has provided up to EUR 5.5 billion to the bank in the form of capital injections via participatory capital, ordinary shares and state guarantees on subordinated debt issued by HAA.

In September 2013, the European Commission (EC) approved the liquidation plan of HBInt, including the use of state aid, which prescribed three strategic steps:

(i) the sale of the Austrian bank (HBA). At the end of 2013 and after the reduction of its balance sheet by two thirds (down to approx. EUR 4 billion at the end of 2012), the Austrian subsidiary of Hypo (HBA) was privatized and acquired by Anadi Financial Holdings Pte. Ltd.

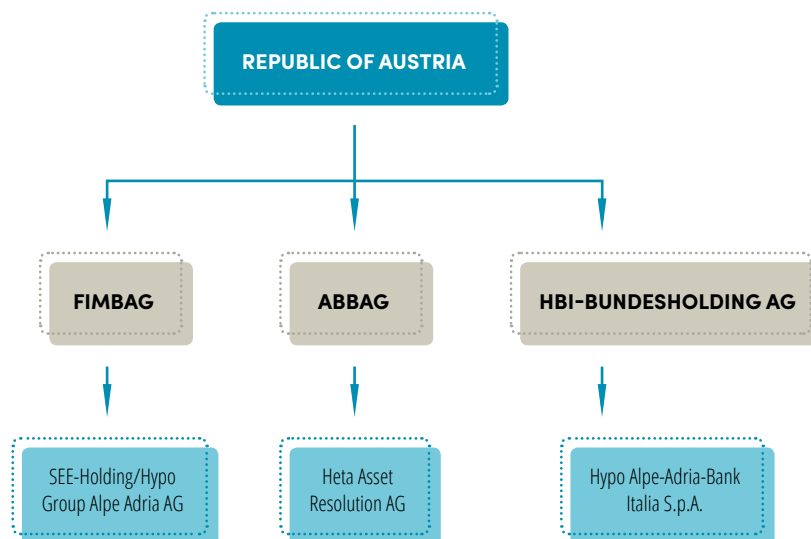
(ii) the sale of its SEE network via the creation of a SEE holding with a banking license. HAA's SEE network consisted of “some 1.2 m customers, 250 branches in five countries, a capital ratio above 20 %, long-term liquidity funding of more than EUR 2 billion, a clean loan portfolio with Non-Performing Loans around 12 %”.<sup>5</sup> The stake of HBInt in the Hypo SEE Holding AG was transferred to Finanzmarktbeteiligung Aktiengesellschaft (FIMBAG) and acquired in July 2015 by Advent International and the European Bank for Reconstruction and Development (EBRD).

<sup>3</sup> Before its nationalization HAA was owned by: BayernLB (67.08 %), State of Carinthia via Kärntner Landesholding (12.42 %), Grazer Wechselseitige Versicherung AG (“GRAWE”) (20.48 %) and Mitarbeiterstiftung Hypo Alpe Adria (0.02 %).

<sup>4</sup> The absence of a requirement for a restructuring plan was due to a particular provision of the 2008 State aid Banking Communication, applicable only for a very short period and under particular circumstances which were subsequently tightened. See also footnote 4 of the 2009 State Aid Banking Communication.

<sup>5</sup> Extract from the press release Hypo Group Alpe Adria AG – SEE banking network – acquired by Advent International and EBRD July 2015 Dr. Christian Stoffel, Director at Advent International in Frankfurt [http://www.hypo-alpe-adria.com/sites/hypo-alpe-adria.com/files/content/announcement/file\\_download/press\\_release\\_hypo\\_group\\_alpe\\_adria\\_ag\\_-\\_see\\_banking\\_network\\_-\\_acquired\\_by\\_advent\\_international\\_and\\_ebrd.pdf](http://www.hypo-alpe-adria.com/sites/hypo-alpe-adria.com/files/content/announcement/file_download/press_release_hypo_group_alpe_adria_ag_-_see_banking_network_-_acquired_by_advent_international_and_ebrd.pdf)

### HETA: The resolution of an asset management vehicle



Source: FMA

and (iii) the creation of a wind-down entity to ensure that the remainder of HBInt (balance sheet of approx. EUR 18 billion) would be liquidated in an orderly manner over a reasonable period of time ensuring the sale of its viable assets and wind down of the others. On October 30, 2014, its license was revoked (deregulation) and an asset management vehicle, HETA Asset Resolution, was created via a special Federal Act on the Creation of a Wind-down Entity (GSA). Separate holding companies took over the Italian subsidiary of HBInt (HBI-Bundesholding AG) and its SEE business (FIMBAG) (see graph above). The Austrian Federal Act on Restructuring Measures for Hypo-Alpe-Adria-Bank International AG (HaaSanG), also enacted in 2014, enabled the restructuring and winding-down of the bank (the constitutional conformity of the Act, inter alia stipulating a haircut and expiry of the State of Carinthia guarantee for junior creditors, was subsequently challenged, see part 2).<sup>6</sup>

Deregulation meant some HETA activities, such as deposit-taking or participation in credit institutions/investment units, became strictly prohibited. Its capital and liquidity requirements were also waived. The bank was, however, able to conduct limited banking and leasing activities under the GSA, for example providing staff, IT, and access to its Continuous Linked Settlement system to the SEE network, and acting as counterparty for HGAA in derivative transactions.<sup>7</sup>

At the beginning of 2015, HETA was subject to an Asset Quality Review (AQR) conducted by external auditors. This made apparent HETA's need for additional funding to avoid insolvency. HETA and the Austrian Financial Market Authority (FMA) asked the Republic of Austria

<sup>6</sup> On April 2, 2015 the Constitutional Court dismissed the individual complaints filed against the HAA legislation due to formal reasons. (VfGH Decision Number G 194/2014)

<sup>7</sup> Since HGAA was a newly licensed credit institution, there was not yet a high level of market confidence to enable the bank to issue derivatives to hedge its foreign currency and interest rate risks in the market.

(HETA's owner) if it would inject further capital into HETA. The Government declined and the FMA concluded that HETA fulfilled all the legal requirements for resolution.

### **FMA puts HETA into resolution and adopts a temporary moratorium until May 31, 2016**

Although neither a "CRR credit institution" with a banking license nor an investment firm, the law transposing the BRRD into Austrian national law (i.e. BaSAG) explicitly required that HETA was covered by the scope of the EU Directive.

HETA was considered failing because it was deemed unable to pay its debt in the near future (i.e. from 2016 onwards). This was confirmed by the results of a provisional valuation report (AQR). When the Republic of Austria decided that it would not provide additional funding, the Executive Board of HETA announced that they were no longer in a position to service HETA's liabilities. No private solution (i.e. take-over or private capital injection) was available.

The FMA, in its capacity as the national resolution authority, initiated the resolution of HETA in accordance with the BaSAG and the BRRD on March 1, 2015. The FMA deemed HETA's resolution appropriate and in the public interest for the following reasons (see chapter 14, FinSAC Guidebook to the BRRD):

- the essential services provided by HETA to the HGAA's SEE banking network could not be ensured to the same extent and with the same legal certainty under liquidation;
- HETA's bankruptcy would have likely had considerable negative effects on financial stability in Croatia and Slovenia as well as negative consequences on financial stability in Austria;
- the objective of protecting public funds could not be achieved to the same extent in a bankruptcy proceeding (i.e. "If the Province of Carinthia were to become insolvent ... this would also give rise to negative effects for the financial market, as well as bringing fiscal consequences in its wake").

To prevent HETA's insolvency, the FMA imposed a temporary moratorium on HETA's debts until May 31, 2016. A temporary debt moratorium can be applied as a first step before the application of a resolution tool, such as a haircut, to an entity's bail-in-able liabilities. This decision gave the FMA time to check the quality of HETA's assets, to determine their values and to apply bail-in and/or any other resolution tool.

### **The bail-in decision of April 2016**

In April 2016, the Austrian FMA decided to apply the bail-in tool based on an ex ante valuation conducted by an independent valuer (see chapter 12, FinSAC Guidebook to the BRRD). Taking into account past experience, as well as the legal provisions required for an expedient wind-down, the target date for completing the liquidation of HETA was set for the end of 2023. On March 1, 2015, HETA's assets were valued at EUR 9.6 billion and its liabilities at EUR 17.6 billion. The expected loss after adjustments of EUR 7.1 billion was allocated in accordance with the bail-in waterfall ensuring that HETA's net asset value would be zero at the end of the liquidation process. The estimate of the hypothetical insolvency scenario was calculated with a 34 % recovery rate compared to 46 % under resolution (see chapter 20, FinSAC Guidebook to the BRRD). Based on these valuations, the FMA announced the following measures:

- the Tier 1 capital (shareholders) was written down to zero. The economic rights of the shares were cancelled and their control rights exercised by the resolution authority;
- all subordinated debts were written down to zero;
- a 54 % haircut was applied to the nominal value of HETA's senior debt;

- all interest payments were cancelled from March 1, 2015, onwards; and
- the maturity date of all eligible debt were extended to December 31, 2023.

According to the Executive Board of the FMA: “The measures that have been prescribed under BaSAG form the basic structure for an orderly resolution, and fully satisfy the aims of the European resolution regime – namely to guarantee financial market stability, to protect taxpayers and to bail-in creditors. Moreover, this package of measures also ensures the equal treatment of creditors. Orderly resolution is more advantageous than insolvency proceedings.”

As a result of this ruling, creditors face a waiting period of seven years for the repayment of 46 % of the value of the senior bonds they hold. The quota agreed for the write-down is based on a cautious and conservative estimation of the expected future settlement proceeds of HETA. The actual quota of the write-down will depend on how successful the resolution process is and thus could ultimately be higher or lower than 46 %.

### **Bail-in of liabilities guaranteed by the State of Carinthia<sup>8</sup>**

Liabilities ex-lege not covered by the bail-in mechanism included liabilities towards commercial or trade creditors, employees, secured liabilities, and liabilities arising from trustee relationships. Secured liabilities were secured against HETA's assets<sup>9</sup>. Liabilities secured by third party collateral (e.g. the default guarantee of the State of Carinthia) could thus be subject to a haircut according to BaSAG (contrary to a bail-in under the BRRD, see chapter 15, FinSAC Guidebook to the BRRD).<sup>10</sup>

However, because the bail-in decision did not cancel the existing statutory deficiency guarantee provided by the State of Carinthia, creditors sued Carinthia to recover the difference between the amount repaid under HETA's wind-down and their bonds' full face value<sup>11</sup>. The FMA estimated this difference to be EUR 6.4 billion<sup>12</sup>, approximately three times the annual budget of Carinthia.

Carinthia offered to buy back the bonds it guaranteed, funded with loans from the Austrian Government, for 75 % of their face value. Even with a last-minute sweetener from the Austrian Government bringing the offer up to about 82 % too few creditors accepted it and it expired. The Austrian Ministry of Finance continued to believe an out-of-court agreement on dissolving Carinthia's guarantees was the best solution. On May 18, 2016, a Memorandum of Understanding (MoU) was signed by the Republic of Austria and 72 creditors of HETA (i.e. representing 48.7 % of HETA senior debtholders and 12.3 % of its subordinated debtholders) confirming their common intention to amicably settle the restructuring of HETA's debt instruments.

<sup>8</sup> The Hypo Reorganization Act (HaaSanG), adopted in 2014, provided certain categories of unlimited guarantees from the State of Carinthia to expire. However, in July 2015, the Austrian Constitutional Court declared the HaaSanG unconstitutional, and the law was repealed in its entirety. One of the reasons for this decision was that the HaaSanG made a non-justifiable and non-proportionate distinction between the guarantees of junior and other creditors. Furthermore, the Austrian Constitutional Court ruled that guarantees issued by a federal State cannot be rendered completely invalid retroactively through a single law. See part II: Raschauer

<sup>9</sup> These are e.g. covered bonds issued by HETA which have been secured by the corresponding tangible assets of HETA, such as its real estate.

<sup>10</sup> See also EBA, 06.02.2015, Single Rulebook Q&A, Question ID 2015\_1779

<sup>11</sup> The full face value of the guaranteed debt amounted to EUR 11.1 billion. It is legally unclear if the creditors can claim the whole amount from the state of Carinthia and if Carinthia will then be indemnified by the liquidation estate.

<sup>12</sup> Of the EUR 11.1 billion: EUR 10.2 billion was reduced by a 54 % haircut, while the remaining EUR 0.9 billion subordinated debt was cancelled in its totality.

A new public offer, presented in May 2016 and submitted by the Carinthian Compensation Payment Fund (Kärntner Ausgleichszahlungsfonds or KAF) in September 2016, received an overwhelming acceptance from creditors in October 2016<sup>13</sup>. The State of Carinthia is expected to contribute EUR 1.2 bn to the KAF leaving the Republic of Austria to provide the largest portion of the funds.

In this new proposal, the creditors agreed to receive, either:

- a cash payment of 75 % for senior debtholders and 30 % for subordinated debtholders.
- or

- a zero coupon bond from the KAF with a term of 13.5 years (senior bondholders can exchange their bond at a 1:1 ratio while subordinated bondholders at a 2:1 ratio). The yield on the zero coupon is fixed at 0.7835 % which implies a value of 90 % of par. The zero coupon bond will have an “abstract, explicit, irrevocable and unconditional” guarantee from the Federal Republic of Austria. Its credit spread will be stabilized for a period of 180 days after the mandatory 60 day holding period.

Almost all HETA bond holders have opted for the exchange into zero coupon bonds rather than the cash offer.<sup>14</sup> While most of the KAF liabilities should be covered by the assets of HETA and the contribution from the State of Carinthia, there is still a near-term cash risk for the Republic of Austria, since investors can sell their zero coupon bonds back to the KAF during the 180-day stabilization period.<sup>15</sup>

Whether taxpayers will have to provide more funds to HETA in the future will depend on the success of the wind-down process, which should be completed by 2020 with the repayment of all claims scheduled for the end of 2023.

### Relevant Sources

- Report by the Independent Commission of Inquiry for the Transparent Investigation of the Events Surrounding the Hypo Group Alpe-Adria
- FMA Mandatsbescheid HETA ASSET RESOLUTION AG 1.03.2015
- FMA Vorstellungsbescheid HETA ASSET RESOLUTION AG 10.04.2016
- FMA Mandatsbescheid HETA ASSET RESOLUTION AG 10.04.2016
- Beschluss der Kommission vom 03.09.2013 – Staatliche Beihilfe SA.32554 (09/C) – Umstrukturierungsbeihilfe Österreichs für die Hypo Group Alpe Adria (Commission Decision 2014/341/EU)

<sup>13</sup> 99.6 % of senior debt and 89.4 % of junior debt holders have accepted the tender offer. It has also obtained the prior approval from the European Commission state aid offer.

<sup>14</sup> Almost all senior HETA bond holders accepted the 1:1 exchange into the KAF zero bond with an initial recovery value of 90 %. Approx. 3/4 junior bond holders opted for the 2:1 exchange ratio into the KAF zero coupon bond. Junior bonds with an outstanding debt of EUR 105 m will be switched 1:1 into a 50 year 2068 zero coupon Schuldschein issued by the Republic of Austria.

<sup>15</sup> The 180 days stabilization period starts on 1 December 2016.

## **PART 2: RULING OF THE AUSTRIAN CONSTITUTIONAL COURT ON THE LEX-SPECIALIS RESTRUCTURING HBINT AND THE IMPOSED EXPIRY OF GUARANTEES FROM THE STATE OF CARINTHIA**

Author: Nicolas Raschauer

### **Summary**

The Austrian Federal Act on Restructuring Measures for Hypo-Alpe-Adria-Bank International AG (HaaSanG) was enacted in order to restructure and wind-down the Hypo-Alpe-Adria-Bank International AG (Hypo). It provided for the expiration of all supplementary capital emissions as well as of subordinate held by third parties and covered by guarantees of the Austrian province of Carinthia. The Act also applied to liabilities towards the former majority shareholder, Bayerische Landesbank.

In 2015, the Austrian Constitutional Court had to decide on the constitutional conformity of the HaaSanG. The Court found that the right to property was violated because the HaaSanG differentiated within the group of subordinate creditors by declaring only those claims that matured before June 30, 2019 expired. Another violation of the right to property was seen in the fact that the HaaSanG declared all securities (and among them statutory guarantees) expired together with the respective claims.

### **Background**

The HaaSanG entered into force on August 1, 2014. This law in conjunction with the Federal Law on the Creation of a Wind-Down Unit for Hypo (GSA) regulated the institution's restructuring and controlled wind-down. The HaaSanG foresaw the expiry of certain subordinate claims including the guarantees of Carinthia, and the deferral of certain disputed claims. The GSA determined the conditions for the winding-down of portfolios by Hypo. The wind-down unit, HETA Asset Resolution AG (HETA), has been operational since November 2014, charged with managing assets to ensure the orderly and active disposition of its assets on the best terms as quickly as possible.

In 2015, members of the Austrian parliament, and the regional court of Klagenfurt in the province of Carinthia, questioned the constitutionality of parts of the HaaSanG and sought an Austrian Constitutional Court decision on its constitutional conformity. Both HaaSanG and GSA formed part of the proceedings before the Court.

### **Ruling of the Constitutional Court**

HaaSanG stipulated that, with the publication of an ordinance by the Financial Markets Supervisory Authority (FMA), all subordinate claims and shareholders' claims substituting equity which matured before June 30, 2019, expired. Affected creditors might gain a new claim against HETA if assets remained on completion of the wind-down. Disputed claims were deferred until this date or until proceedings deciding their status were complete. The five year period was to allow for an orderly wind-down of portfolios at the best possible conditions, while honoring the remaining subordinated claims.

The applicants, however, submitted that the expiry of claims violated their fundamental right to property. They saw it as an expropriation or restriction of property rights. Since only claims of certain subordinate creditors were affected, while other equally subordinate creditors as well as the Austrian federation as the owner of HETA could keep their claims, the "pari



passu principle<sup>16</sup> was not respected. Even if a public interest were to be granted, the restriction of the right to property would be disproportional and violate the right to equal treatment. An ordinary insolvency procedure could have avoided this discrimination.

The Court took up these concerns. The creditors' claims were deemed to fall under the right to property as protected under constitutional law and under European law. However, the Court found that the expiry of claims according to the HaaSanG was not strictly speaking an expropriation, since the claims were chosen solely for their worth. Moreover, the restructuring of Hypo was held to be in the public interest. Since the legislator had a wide margin of discretion when making economic prognoses, a wind down was considered an appropriate available option in the circumstances, rather than ordinary insolvency proceedings. Also a 'hair-cut' was potentially seen as necessary for the resolution of a bank in crisis. The differentiation between different groups of creditors ('normal' and 'subordinate') was legitimate, since subordinate creditors would also leave empty-handed in insolvency proceedings. Regarding the differentiation between subordinate creditors and the Austrian Federation, as the owner of HETA, it had to be taken into account that the Austrian Federation had already put in more than EUR 5 billion to mitigate damages in the interest of other creditors.

However, the Court found that the right to property was nonetheless violated because the HaaSanG differentiated within the group of subordinate creditors by declaring only those claims that matured before June 30, 2019 as expired. Subordinate creditors with such claims were discriminated further as the securities and guarantees on their claims expired together with the claim, while other equally subordinate creditors were not affected at all and even kept their interest claims. Since, as it turned out, the cut-off date could not prevent HETA from failing before the end of the restructuring period (measures under the Bank Restructuring and Resolution Act had been taken with regards to the remaining creditors after the entry into force of the Hypo Reorganization Act), this discrimination could not be justified as ensuring an orderly restructuring and resolution.

The Court also agreed with the applicants regarding the expiry of all securities together with the claims. This particularly affected guarantees by the province of Carinthia. The Court emphasized that claims resulting from such statutory guarantees (rendering the claims quilt-edged and equipping them with qualified protection) constitute a severe restriction of the right to property. While the government claimed the protection of creditworthiness of Austrian provinces as well as the prevention of an insolvency of the province of Carinthia, the Court saw no reason solely for the specific group of subordinate creditors to be drawn on. The expiry of guarantees, which exclusively applied to those subordinate creditors whose claims expired while guarantees for other creditors remained unaffected, was found to be neither factually justified nor proportionate. Guarantees issued by a federal province must not be rendered invalid retroactively, even when the province is evidently incapable of bearing the risk.

As regards the GSA, the applicants submitted, inter alia, that it was unclear which assets could be transferred to other entities in the course of the winding-down of Hypo and that the minister of finance had too great a discretion in deciding how this transfer was effected (by way of ordinance or ruling). However, the Court found that owing to the legislator's margin of appreciation and the flexibility needed for the resolution of Hypo, the GSA was in conformity with

<sup>16</sup> *Pari passu* is a Latin phrase that literally means "with an equal step" or "fairly", "without partiality". This term is also often used in the lending area and in bankruptcy proceedings, where creditors are said to be paid *pari passu*, or each creditor is paid *pro rata* in accordance with the amount of his claim. Here its meaning is "equally and without preference"

the constitution. Thus, also certain (eg cancellation or approval) rights may legitimately be limited when deciding on restructuring measures and specific insolvency rules foreseen for a wind-down unit.

The Court thus concluded that the HaaSanG was unconstitutional and repealed it in its entirety. Consequently, the FMA ordinance based on it was repealed as well. A deadline for correction was not set and, thus, the HaaSanG is no longer applicable. As far as the applications concerned the GSA, they were dismissed as unfounded.

### **Conclusions**

This decision is of international relevance. The Constitutional Court clarified that the rights of subordinate and other shareholders' claims and the securities thereon were protected. The expiry of claims and securities had to be qualified as a severe restriction of the right to property.

The Court, however, acknowledged that the legislator's judgement on treatment of distressed financial institutions must be respected. Circumstances may dictate the choice of a wind-down under special rules (such as laid down in the HaaSanG) over insolvency proceedings, but these rules must ensure equal treatment of the respective groups of creditors. This had direct implications for the inclusion of HETA in the regime of the Austrian Bank Recovery and Resolution Act (BaSAG), which implements the BRRD.

The Court did not object to a 'hair-cut' of creditors as such. Moreover, the court explicitly clarified that the restructuring of Hypo was in the public interest and a 'hair-cut' was (ex ante) necessary for the resolution of a bank in crisis. After the entry into force of the BRRD, any other position may anyway have been in conflict with EU law. Also the differentiation between different groups of creditors ('normal' and 'subordinate') was deemed legitimate.

For the Court, the violation of the right to property lay in the differentiation within the group of subordinate creditors which resulted from the cut-off date. Creditors with claims maturing after June 30, 2019, were not affected by the hair-cut and, thus, were found to be in a better position for no legitimate reason. In particular, and even with the possibility of new claims if assets remained after the wind-down, these claims would lack the securities of the expired claims. Had the cut-off date not been introduced, the HaaSanG would have been proportionate. The ex-ante prognosis was found to be legitimate, but when a resolution procedure over HETA according to the BaSAG in early 2015 showed that the limitation to claims maturing before June 30, 2019 was not sufficient, the HaaSanG was rendered unconstitutional.

Moreover, when explaining why creditors not affected by the hair-cut were better off despite their claims being subordinate, the Constitutional Court strongly based its argument on the fact that creditors affected by the hair-cut lost all securities together with their claims.

Thus, not all discussions are over yet. HETA's authorization to take deposits (and its qualification as a credit institution according to the EU Capital Requirements Regulation (CRR)) ended before the entry into force of the BaSAG. It is Union-wide not even clear if the BaSAG is still applicable on HETA. The Court of Justice of the European Union has to decide if this separate "Austrian approach" i.e. the application of the BaSAG to an undertaking which is not a credit institution under the CRR is compatible with European Law.

### **Relevant Sources**

VfGH number of Decision G 239/2015 ua, VfGH Press release 7/28/15

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# CYPRUS

## **BANK OF CYPRUS (BOC) AND LAIKI: RESOLUTION VIA PUBLIC SUPPORT AND BAIL-IN, INCLUDING OF UNINSURED DEPOSITORS (2013)**

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Author: Alexander Michaelides

### **Summary**

In March 2013, Cyprus agreed to an originally estimated EUR 7 billion bail-in solution to recapitalize the largest systemic bank (Bank of Cyprus (BoC)), while the second largest bank (Cyprus Popular Bank (Laiki)) was subject to the “sale-of-business” tool merging it with BoC. This was the Cyprus-financed part in an originally estimated EUR 17 billion agreement between the Troika (the International Monetary Fund (IMF), the European Central Bank (ECB) and the European Commission) and the Cypriot government (Cyprus MoU (2013)).

At 100 % of GDP, the total package is one of the largest in financial history and a number of taboos were broken along the way. For the first time in the euro area uninsured depositors were called upon to recapitalize their banks, and capital controls were imposed as a result. The loss in deposit value associated with the final restructuring and resolution of Laiki and BoC was extraordinary. To ring-fence exposure to Greece, all Greek-related assets (loans and fixed assets) and customers’ deposits of all Cypriot banks (including the third largest, Hellenic Bank) were sold to Piraeus Bank at a net asset value estimated using an adverse valuation scenario (around EUR 3.2 billion). The original 2012 ring-fencing idea was to protect Cyprus bank assets from “Grexit” and currency redenomination risk. By March 2013 a new resolution law provided a legal basis for bail-in and avoiding bank run contagion from Cyprus to Greece through the bail-in became equally important. Cypriot assets of Laiki, along with the Emergency Liquidity Assistance (ELA) and insured deposit liabilities of Laiki, were transferred to BoC with the investments in overseas subsidiaries and the uninsured deposits of Laiki remaining in a legacy entity. To recapitalize BoC, an estimated 37.5 % of BoC’s uninsured deposits were converted into full voting shares with additional equity contributions from legacy Laiki. To prevent capital flight, the largest part of the remaining BoC uninsured deposits was temporarily frozen. The exact level of the bail-in (“haircut”), not determined until the end of June 2013, was set at 47.5 %. Recapitalizing the co-operative sector involved a more standard bail-out with the government becoming the major shareholder with a EUR 1.5 billion capital injection.

### **Background**

In the years prior to March 2013 a number of important macroeconomic imbalances developed in the country. After joining the European Union (EU) in 2004 and the euro area in 2008, a combination of lower tax revenues and higher social expenditures increased the budget deficit above 5 % of GDP from 2009 to 2012. Government debt to GDP rose from 49 % in 2008 to 86 % in 2012, including a 10 % initial bailout of Laiki in June 2012 (these were the numbers available at the time, they were later revised slightly downwards in October 2014 by Eurostat). With the worsening economic situation, the government turned to international

markets to finance the rising debt and reduce interest rate costs. This worked well for the first two years but in May 2011, as the euro area sovereign debt crisis worsened, the increasing exposure to foreign debt backfired and Cypriot government bond yields rose above 7 %. That level is considered prohibitive to maintain debt sustainability, and essentially prevented any new borrowing from international capital markets. Prominent economists argued that exit from the euro was in the interest of a small open economy like Cyprus and forecasts of impending economic depression were widely circulated.

The situation was exacerbated by a combination of poor risk management and weak corporate governance practices in the banking sector, aggressive credit expansion, and a large banking and co-operative sector with a strong sovereign-bank nexus, which allowed illiquid loans in property to be funded by liquid, and largely short-term, deposits. As a result of a low tax policy to attract foreign investment, deposits to GDP reached 400 % in 2010, allowing a rapid increase in private sector credit growth with domestic private credit to GDP reaching 300 % in 2012. A search for yields, triggered by lower global interest rates coinciding with entry to the EU and then euro area, resulted in two further imbalances: rapid house price growth and (relatively unproductive) residential (property) investment financed by large capital inflows. The current account deficit in 2008 reached 15 % of GDP, for example, and remained below 5 % in the next four years.

### **Growing pressure on the banking system**

With these macroeconomic imbalances in the background, and the gradual recognition from credit rating agencies (CRAs) that the “sovereign and banking system are joined by the hip” (Mody and Sandri, 2012), it seemed increasingly likely that the economy was in a precarious position. As Reinhart and Rogoff (2009) note, a random event is typically what pushes an overleveraged economy over the abyss. On July 11, 2011, an explosion next to the main electricity-producing plant of the country resulted in 13 deaths, major power cuts, and led to the resignation of the ministers of finance and foreign affairs; and immediate downward revisions of future GDP growth and expedited CRA downgrades.

Although the government was unable to access international capital markets, it chose not to negotiate a bailout agreement with the Troika at this stage. The government instead attempted for the next 18 months to manage the crisis. This delay is striking when compared to the experience of other European countries in such a predicament (Greece, Ireland, Portugal and Spain) where agreement was reached in some cases within three weeks of requesting assistance and exacerbated the weaknesses of the economy. Unemployment rose from 8 % in 2011 to 15 % in 2013 and, following an official request for EU assistance in June 2012, deposit flight soared (mainly from the branches of Cypriot banks in Greece). Depending on the measurement techniques there was a deposit outflow of about EUR 10–17 billion by the time an agreement was reached with the EU/Troika in March 2013. Sophisticated investors with access to information resulted in leaks ahead of official announcements. This made liquidity problems in the banking sector worse, as deposits that flee are not available to be bailed-in (once that decision is taken), and exacerbated the diabolic loop between bank and sovereign balance sheets. As recession worsens the liquidity problem can become a solvency problem.

The Central Bank of Cyprus commissioned the investment management firm PIMCO to undertake a stress test and estimate of banks’ capital needs in June 2012. This was not officially completed until February 2013. Performing independent and transparent tests over a period of time to ensure accuracy from granular information and determine the amount of actual losses is laudable in theory. But this is conditional on the assumption that the banks

will be recapitalized at the end. When no clear backstop exists, transparency and delay can backfire, as the options left on the table disappear (along with deposits).

Banks around the world suffer from home bias in sovereign debt. In Cyprus, PIMCO's final calculations for the banking system's capital shortfall was EUR 5.8 billion. One main component reflected EUR 4.5 billion investments in Greek government bonds. The restructuring of Greek debt through "private sector involvement" (PSI) in October 2011 resulted in significant losses for BoC and Laiki (around EUR 4 billion) which had large holdings of Greek government bonds in their portfolios. According to Basel requirements government bonds of Greece got a zero risk weight, the same as other (EU) government Bonds, but earned a higher yield. On the other hand, the moral suasion hypothesis states that local politicians can influence bank executives' decisions when it comes to investment in local government bonds. One could argue that the banks were undertaking the "greatest carry trade ever" (Acharya and Steffen, (2015)) through regulatory arbitrage. The large presence of the two Cypriot banks in Greece may have made Cypriot bank executives susceptible to buy bonds at large scale, even in the secondary Greek government bond market. The concentration risk associated with this exposure should have raised alarms in the risk management departments of the various banks, even though it is also true that concentration risk limits did not legally apply to sovereign debt holdings in the euro area.

The Central Bank of Cyprus was responsible for handling ELA to Laiki in the period leading up to March 2013. ELA is a two-week short-term funding facility that is granted through the national central bank by the European Central Bank (ECB) to illiquid but solvent banks, as long as this funding is backed by eligible collateral. ELA was allowed to reach 60 % of GDP, even though the ECB had since July 2012 opined that resolution might have been the better option for Laiki than the initial bailout of EUR 1.8 billion in June 2012. The justification offered by the Central Bank of Cyprus and ECB was that Laiki was "dynamically solvent" conditional on a program. This argument begs the questions of whether it is empirically useful to condition solvency on future states of the world and for how long such an argument can hold (Xiouros (2016) offers further details).

### **EU intervention, the adoption of a new resolution law and the bail-in**

The Eurogroup (finance ministers of the euro area) agreed a deal with Cyprus on March 16, 2013, involving a horizontal, across-all-banks, tax (haircut) of 6.75 % for (insured) deposits up to EUR 100,000 and a 9.9 % tax for larger (uninsured) deposits. Parliamentary approval was required as the haircut was applied in the form of a tax. Parliament rejected the proposal in the hope that a better deal could be agreed. Touching insured deposits was unprecedented and provoked huge international criticism (and no one taking responsibility for suggesting it). The banking system was shut for almost two weeks while the terms of the deal were revised. In the meantime, on March 21, 2013, the Governing Council of the ECB announced its decision to maintain the current level of ELA for BoC and Laiki until March 25, 2013. After that date, the public announcement stated that ELA would "only be considered if an EU/IMF program is in place that would ensure the solvency of the concerned banks".

On March 22, parliament urgently approved a new law enabling the Central Bank of Cyprus to resolve insolvent institutions (Cyprus Resolution Law (2013)). A new bail-out plan was announced on March 25, which did not require further parliamentary approval. The new bank resolution law now provided a legal basis to implement change: Laiki was resolved immediately with full contribution from shareholders, bondholders and uninsured depositors. Selected Laiki assets and EUR 9 billion of ELA were folded into the BoC with uninsured

depositors converted to shareholders (at a rate to be determined after another detailed asset valuation by the summer of 2013 but expected at the time to be between 40–50 %).

IMF's debt sustainability analysis indicated that with a debt to GDP ratio close to 90 % it was impossible to agree on a bailout of more than EUR 10 billion (close to 65 % of GDP). The tax on deposits (haircut) was intended to provide the rest and was intended to "share the burden" of the crisis more widely.

One major decision to be taken before banks re-opened on March 28, 2013, was whether capital controls would be imposed and, relatedly, whether limits should be imposed on deposit withdrawals and opening new accounts at different banks. The fear was that deposits would flow out of the bailed-in BoC to other banks or out of the country when banks re-opened. ELA was already at a very high level and the ECB might not have been willing to extend liquidity further. To address these fears the Central Bank of Cyprus imposed capital controls (except for documented emergencies and trade needs) and froze uninsured deposits for different periods depending on deposit size. These restrictions were gradually relaxed until they were completely abolished approximately two years later.

After a further independent valuation of assets, the final haircut in BoC was set in July 2013 at 47.5 %. Upon decision of the Central Bank of Cyprus as resolution authority, BoC exited from resolution status that month. On the negative side, non-performing loans rose in the months that followed to 50 % of the banks' balance sheets, close to 150 % of GDP, a problem that is still ongoing at the time of writing. In Cyprus the unexpected bail-in of depositors was perceived as neither fair nor moral, especially because certain households and businesses held simultaneously loans and deposits at different banks. Deposits could be bailed-in but not the loans, generating substantial frustration and damaging further the confidence towards the banking sector. As a result, the idea that loans should also be bailed-in quickly surfaced in the public debate. With the authorities not unequivocally rejecting this idea, one can argue that such public discussions pushed the number of strategic loan defaults higher: the empirical results in Guiso, Sapienza and Zingales (2013) are consistent with higher strategic defaults in such circumstances, especially when the probability of being sued for non-repayment is perceived to be low.

The unexpected bail-in also raised questions about exclusions of certain organizations. The University of Cyprus, a non-profit institution, had large deposits from EU-funded projects in Laiki and was eventually not bailed-in. A similar discussion happened with regards to pension funds (and also distinguishing across different categories by employee size) and this is still ongoing. Sound companies whose working capital was bailed-in were the biggest collateral damage from the bail-in.

Cyprus exited the bail-out support program in March 2016. So while the bail-in might be considered a success it came at a cost. The bail-in involved the resolution of the two largest banks and merging the two proved a costly transition. The smaller horizontal tax on uninsured deposits would probably have been a preferable outcome under the circumstances: simplicity should be preferable to complexity. This becomes especially important in countries where administrative resources and institutional cooperation are not at always the desired levels.



## Conclusions

The Cypriot experience highlights important issues and offers interesting lessons at both the national and European level. The first involves the treatment of Cypriot banks which held Greek government bonds during restructuring of Greek sovereign debt in October 2011. Zettelmeyer et al (2013) describe the consequence from the Greek debt restructuring and calculate the cost to the two systemic Cypriot banks. This decision wiped out an amount equivalent to 25 % of Cypriot GDP of the equity of two Cypriot banks without recourse to any external aid, whereas their Greek counterparts (with larger losses in absolute terms) were separately assured funding through the European Stability Mechanism.

The second lesson learned relates to the effects of the delay in reaching out for an agreement with the Troika and presents one main lesson from the crisis: early resolution of uncertainty is vital, especially when the banking system is involved. The Cypriot government tried to avoid entering into an agreement with the Troika for three reasons. First, signing a memorandum, given the experience of Greece, had become associated with the risk of going through a major economic depression. Second, an element of overconfidence in the local political class emanating from the rapid real economic growth of the previous three decades (between 4 and 4.5 percent real GDP growth per annum). Third, elections were due in February 2013 and the hope must have been to delay the agreement until after that point.

Another critical question relates the role of the central bank during this period. Supervising cross-border banks across different regulatory regimes is a hazardous and challenging task. It is an on-going question whether holding higher-yielding Greek government bonds instead of German Bunds (both with zero risk weights) was the result of the “greatest” carry trade, or moral suasion by local politicians, or both. The EU Single Rulebook (see chapter 2, FinSAC Guidebook to the BRRD) is intended to address regulatory arbitrage, in this case the treatment of sovereign bond exposure across different regimes (in this case between the Greek and the Cypriot one). More importantly, during the period of the crisis (after June 2012) there are two main principles that need to be emphasized: the extent of transparency; and the speed with which a central bank conducts its affairs.

Implementing a successful bail-in is potentially difficult but becomes even more so when inherent problems are not tackled early on. The absence of a resolution law in May 2012 was one of the arguments given in support of the initially bail-out, instead of resolving, Laiki bank. The presence of BRRD mechanisms could have prevented this outcome, but making such tough choices often becomes highly political and requires substantial strength of purpose and administrative capacity to implement successfully in a necessarily short period of time.

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### Timeline

July 11, 2011	Explosion at Mari provides trigger for worsening of crisis
October 26, 2011	Private Sector Initiative (PSI) for Greek sovereign debt restructuring
April 28, 2012	Demetriades’ appointment as Governor to start on May 3 announced. Orphanides’ last day in office is April 30
May 18, 2012	Laiki bailout by state with EUR 1.8 billion
June 27, 2012	BoC requests EUR 0.5 billion state aid to meet EBA deadline
June 28, 2012	Cyprus requests financial assistance from the Troika
December 2012	Preliminary MoU agreement: total EUR 17 billion with EUR 10 billion to recapitalize the banking sector
March 16, 2013	Eurogroup decision to reduce bailout to EUR 10 billion with no funds to recapitalize BoC or Laiki. Decision to implement horizontal levy (tax) on all banks
March 18–28, 2013	Closure of banks and no internet transactions
March 19, 2013	Parliament rejects horizontal bank levy
March 21, 2013	ECB publicly announces no further ELA provision to Laiki unless EU/IMF program agreed to ensure solvency of concerned banks
March 22, 2013	Parliament urgently passes bank resolution law
March 25, 2013	Eurogroup decision to resolve BoC and Laiki
March 28, 2013	Banks re-open with capital controls and limit of EUR 300 daily cash withdrawals per natural person and EUR 500 daily per legal person Ministry of Finance to relax controls progressively depending on ELA and general liquidity in the banking system
July 30, 2013	Final eligible deposits converted to equity equal to 47.5 % Simultaneously, the Central Bank of Cyprus, in its capacity as Resolution Authority, announces that BoC is no longer under resolution
July 28, 2014	Mostly foreign investors including American Mr Ross agree to inject EUR 1 billion equity into BoC boosting capital ratios and diluting existing shareholders
April 6, 2015	Abolition of all capital controls after 27 gradual relaxations
March 7, 2016	Eurogroup announces Cyprus’ exit from program to take place end of March 2016



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# DENMARK

## ANDELSKASSEN: RESOLUTION VIA BRIDGE BANK AND BAIL-IN INCLUDING OF UNINSURED DEPOSITORS (2016)

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Authors: Jens Verner Andersen, Pamela Lintner, Susan Schroeder

### Summary

Denmark experienced an almost systemic financial crisis in the banking sector linked to the global financial crisis. It decided not to rescue distressed banks, but rather to encourage industry consolidation and restructuring under five "bank packages" adopted in response to the financial crisis. To help maintain financial stability, the government provided guarantees, capital injections, and liquidity support, and created a company to wind-up distressed banks. The Danish financial sector was charged to pay for the implemented measures. The BRRD was implemented in Denmark from June 2015. The first bank failure under this new regime, Andelskassen JAK SLAGelse (Andelskassen), was resolved according to the principles of the BRRD. A successful and smooth open bank bail-in including write-down of uninsured depositors and contributions of the DGS combined with a bridge bank ensured private loss absorption while ensuring uninterrupted access to the bank's deposits and critical functions. Ultimately, however, a transfer to a private acquirer was not approved by the supervisory authority and Finansiel Stabilitet decided, in the absence of any viable alternatives, to wind up the bank.

### Background

The years before the financial crisis saw Denmark enjoy economic growth, low and stable inflation and low interest rates. However, this encouraged over-optimism and risky lending behavior similar to other European countries. As a small, open economy with close integration, economically and financially, with Europe and the rest of the world economy even small Danish financial institutions began raising liquidity on the international capital and money markets, contributing to the growth through lending, but exposing themselves to international market fluctuations.

As the global financial crisis took hold a number of factors exerted pressure, including the complex and interconnected nature of the international financial system; a pro-cyclical fiscal policy unable to counteract pressure on the labor market and general economy; and the bursting of price bubbles in housing and commercial real estate, often financed through large loans from small and medium-sized banks, inflicting considerable losses on some financial institutions.

The escalating financial crisis quickly began to impact the Danish banking sector, especially a group of small and medium-sized financial institutions. These banks, lacking effective corporate governance and having lent carelessly, were vulnerable and some soon became distressed. Those unable to devise private solutions (eg mergers or acquisitions) were wound up. In general, the strategy was to avoid a situation where distressed banks in Denmark continued their business. 62 financial institutions in Denmark ceased existing

(not all as a consequence of the crisis) between 2008 and August 2013, of these 26 were identified as distressed during the period.

### Response to the financial crisis

In response to the financial crisis, from 2008 Denmark adopted a number of initiatives, notably five "bank packages", aimed at ensuring financial stability and confidence. The BRRD was implemented via two new laws that took effect on June 1, 2015.

Bank Package	From	Purpose
I – The Bank Package	October 2008	Introduced general state guarantee
II – The Credit Package	February 2009	Individual state guarantee and capital injection from the State.
III – The Exit Package	October 2010	Economic bail-in of unsecured senior loans and deposits (above EUR 100,000)
IV – The Consolidation Package	August 2011	Extension of amended Exit Package
V – The Development Package	March 2012	Initiatives for promoting financing of SMEs
Transposition of the EU Bank Recovery and Resolution Regulation and Directive	June 2015	Legislation implementing the requirements of the BRRD, requiring recovery plans and providing enhanced resolution tools

Bank Package I introduced a general state guarantee for all deposits and other ordinary unsecured obligations of banks, offering a safety net and preventing any potential "bank runs", with small savers queuing to withdraw their money. It also established a financial stability company (Finansielt Stabilitet) to handle the winding-up of distressed financial institutions. Owned by the Danish State through the Ministry of Business and Growth this allowed for a controlled process of winding up during which customers could continue their normal banking business.

Bank Package II provided for individual guarantees, from October 2010 when the general state guarantee expired, increasing the ordinary deposit guarantee to cover up to DKK 750,000. It also led to the government making available up to DKK 100 billion in so-called hybrid capital loans out of which DKK 46 billion was used by 43 financial institutions to reinforce their capital base.

Bank Package III saw the general state guarantee removed and creditors expected to bear the risk of the failure of a financial institution as an incentive to reinvigorate the market mechanism and the pricing of risk.

Bank Package IV sought to create a greater incentive among viable financial institutions to take over, wholly or partially, engagements from distressed financial institutions. It included a process to avoid the resolution of distressed banks after the failure of two banks in the first half of 2011 resulted in losses for senior creditors. It provided for: i) a consolidation process with the possibility of compensation (a "dowry") from the State and the guarantee fund; ii) State-guaranteed funding as part of a merger; iii) funding of the guarantee fund as an insurance scheme with fixed ex ante annual payments (from March 30, 2012); and iv) the designation of national SIFIs (Systemically Important Financial Institutions).

Bank Package V aimed to ensure that businesses could access financing, including increasing available growth and export financing, and establishing an agricultural financing institution for viable farmers.

### **The financial stability company**

The financial stability company, Finansiel Stabilitet, was introduced in the first Bank Package and will continue under the laws implementing the BRRD. Finansiel Stabilitet did pre-BRRD take over distressed financial institutions (excluding equity and subordinate capital). Essential services were maintained for customers while Finansiel Stabilitet looked for a healthy financial institution to take over viable parts of the operation and winds up the remainder.

Depositors with deposits above DKK 750,000 and all ordinary creditors did lose money (Bank Package III). Creditors were in some cases compensated via a “dowry” from DGS or Financial Stability Company (Bank Package IV). If the winding-up resulted in a financial profit, the dividends were to be divided amongst creditors, investors and other parties who have suffered a financial loss. Any financial loss incurred by Finansiel Stabilitet through the winding-up is covered by the Deposit Guarantee Fund, the State had no financial risk.

### **Introduction of the BRRD and resolution of Andelskassen**

Legislation implementing the BRRD was approved by the Danish parliament in March 2015 and entered into force on June 1, 2015. The powers allocated to the resolution authority in the BRRD are divided between the Danish Financial Supervisory Authority (DFSA) and Finansiel Stabilitet. The DFSA acts as the competent resolution authority until a distressed institution meets the resolution conditions. The DFSA decides if an institution is failing or likely to fail and if there are any private sector solutions. The DFSA and Finansiel Stabilitet cooperate on the preparation of resolution plans. The DFSA is responsible for the final wording including orders to remove impediments to resolvability and determining MREL. Finansiel Stabilitet assesses whether the public interest test is fulfilled. When resolution conditions are met Finansiel Stabilitet is granted the resolution powers and is responsible for applying resolution tools in specific resolution situations.

The first bank resolution case under the BRRD in Denmark was Andelskassen. On March 2, 2015, the DFSA ordered Andelskassen to submit a recovery plan and to take steps to meet the solvency requirement. By October 5, 2015, the FSA concluded that attempts to meet the solvency requirement set out in the recovery plan had failed. It therefore notified Finansiel Stabilitet that Andelskassen was likely to fail, and that no alternative measures were available within a reasonable time to prevent the failure. Finansiel Stabilitet considered that the conditions for resolution were fulfilled, including that resolution was in the public interest. Resolution objectives, including allowing critical functions to continue and protecting depositors and client funds, would not be met if the institution were subject to bankruptcy proceedings. An interim valuation was prepared by Finansiel Stabilitet to decide on the extent of bail-in and transfer prices as well as to give an estimate on the hypothetical liquidation value (in light of the No Creditor Worse Off than under Liquidation (NCWOL) principle contained in the BRRD; see chapter 20, FinSAC Guidebook to the BRRD).

On October 5, 2015, Finansiel Stabilitet announced that it had assumed control of Andelskassen under the provisions of the Act on Restructuring and Resolution of Certain Financial Enterprises. Finansiel Stabilitet took on the powers conferred on the institution's board of directors and members. Andelskassen's executive board and board of directors were terminated and new board members and a manager were appointed. On the same day Finansiel Stabilitet established a bridge bank (Broinstitut I A/S), wholly owned by the Danish resolution financing arrangement, to contribute new capital to Andelskassen and take over ownership of the institution, after full bail-in by owners and creditors.

Resolution was initiated on Monday evening (October 5, 2015). Services were available to customers from the following morning. Thus, customers had uninterrupted access to basic banking services even after Finansiel Stabilitet's takeover.

All of Andelskassen's creditors and owners were Danish citizens. Based on the interim valuation, Finansiel Stabilitet decided it was necessary to cancel all contributed capital, write down relevant capital instruments and bail-in for loss absorption all subordinated obligations and certain non-subordinated obligations. The contributed capital of existing members was cancelled (in accordance with article 47 of the BRRD) meaning full ownership passed to the bridge bank with no additional shareholders. All relevant capital instruments were written down to zero (in accordance with articles 59 and 60 of the BRRD). Bail-in for loss absorption meant obligations were written down to zero (in accordance with articles 43, 44, 46, 48 and 103 of the BRRD) or adjusted as if the institution had become bankrupt (in accordance with articles 63 and 64 of the BRRD). Covered depositors (up to EUR 100,000) remained fully protected by the Danish Deposit Guarantee Scheme.

The preliminary valuation indicated that the Depositor and Investor Guarantee Scheme had incurred a loss of approximately DKK 25 million.

The Financial Stability Company established a new subsidiary Broinstitut 1 A/S which took full ownership of Andelskassen. New capital of DKK 37.5 million was injected into Andelskassen after bail-in of all the relevant creditors was conducted and the balance between assets and liabilities was reestablished. The injection of new capital was based on funds from the Resolution Fund. According to Danish legislation transposing the BRRD into Danish law, the Resolution Fund had begun building up capital to the level determined by the BRRD (1 % of covered deposits) in 2015. The injection of equity capital into Andelskassen encompasses 0,5 % of the total level of the Resolution Fund once the final goal has been reached. The new ownership immediately began a process of reducing risk, including reducing credit lines and customers.

The model represents a hybrid application of a bridge bank set-up and bail-in. All the activities remained in the same juridical company but the former owners saw their previous holdings written down to zero, while the Fund took full ownership.

As soon as Andelskassen entered resolution, PricewaterhouseCoopers were appointed to prepare a final independent expert valuation. Finansiel Stabilitet undertook to reassess the preliminary write-downs as necessary depending on its findings. The valuation, published in April 2016, found that the losses in Andelskassen were so great that there was no cover for share capital, subordinated creditors or unsecured creditors' claims. The interim measures were deemed as final and only the receivable from the Depositor and Investor Guarantee Scheme was adjusted to DKK 75 billion. A couple of creditors received compensation under the NCWOL principle. The difference between the losses under resolution (Valuation 2: DKK -96,4 Million) and the hypothetical insolvency losses (valuation 3: DKK -142,7 million) were calculated with DKK 46 million which means losses were assumed to be about 50 % higher under hypothetical liquidation.

On January 21, 2016, the Danish resolution authority began the sale process for the bank or for its customer activities. An open and transparent tender process was launched and prospective investors were invited to contact Finansiel Stabilitet not later than February 5, 2016.

On March 18, 2016, Finansiel Stabilitet announced it had agreed to divest Andelskassen to Netfonds Holding AB, a bank 95 % owned by Rolf Dammann (who also owns 89 % of Netfonds Holding AS, the parent company of Netfonds Bank AS, and Netfonds Livsforsikring AS, which are both under supervision by the Financial Supervisory Authority of Norway). Under this agreement Andelskassen would continue to be governed by Danish financial regulation and supervised by the Danish Financial Supervisory Authority. Netfonds was to acquire the shares in the bank, including approx. 3,200 customers with deposits of approx. DKK 175 million. The agreement was subject to the approval of the Danish Financial Supervisory Authority.

On October 31, 2016, it was announced that Netfonds Holding AB had not obtained the supervisory Authority's approval and that the transaction would therefore not be completed. Given Finansiel Stabilitet's experience from the previous bid process and the bank's situation in general, winding up the bank and returning its banking license as soon as possible was left as the only possibility. The approx. 2,600 remaining customers, with deposits of approx. DKK 132 million, were told to expect to have their deposit accounts and related products closed. Interest rates on loans would increase in accordance with the principles applying to the winding up of banks that have been taken over by Finansiel Stabilitet.

No owners or creditors whose claims in Andelskassen were written down have at this point initiated litigation procedures as a result of the resolution actions taken by Finansiel Stabilitet.

### **Conclusions**

This case further underlines the precariousness of successful resolution and recovery, with so many aspects and actors involved, and the potential for derailing issues at any stage. A successful and smooth open bank bail-in combined with a bridge bank ensured private loss absorption and prepared the ground for a transfer of the restored bank to private acquirer while ensuring uninterrupted access to banking functions. The ultimate winding up, due to the supervisor's non-approval of the transfer to a private acquirer, will change little in terms of financial stability and burden sharing. Losses were already bailed-in and the bank restored. It will make it more burdensome for depositors to transfer their deposits but given its orderly nature the outcome is preferable to a bankruptcy. The main effects are likely to be for the Resolution Fund as shareholder and for the Depositor and Investor Guarantee Scheme, as the winding up of the Bridge Bank is expected to be more costly than transferring the bank to a private acquirer (although the final winding up result will depend on a number of unknown variables).

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# GREECE

## SEVERAL GREEK BANKS AND FOREIGN BRANCHES: RESOLUTION VIA PUBLIC RECAPITALIZATION AND BAIL-IN AND STATE AID ISSUES (2009–2015)

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### PART 1: THE GREEK EXPERIENCE OF RESTRUCTURING AND RECAPITALIZATION OF PROBLEM BANKS

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#### Summary

Over the period 2009–2015, the Greek sovereign crisis had major implications for Greek banks in terms of capital and liquidity. The support program agreed between the Greek authorities, euro area Member States and the IMF called for strict fiscal and structural measures. These deeply affected the loan portfolios, and consequently the capital base, of Greek banks. The restructuring of Greek sovereign debt was another major blow to banks' capital ratios. Moreover, successive downgrades of Greece's sovereign credit rating and the subsequent cut-off from international markets, along with extensive deposit outflows, put significant pressure on banks' liquidity. Since the onset of the crisis, Greek banks faced six stress test exercises and underwent one of the largest restructuring and consolidation processes in Europe: 14 resolutions and 40 % downsizing in the number of Greek banks and foreign branches.

#### Background

The international financial turmoil of 2007–2008 did not have a major impact on Greek banks in terms of capital, as they had limited exposure to US subprime debt or other complex structured products. Greek banks, along with other banks worldwide, faced only liquidity pressures. These pressures were addressed through central bank funding, and in 2008 the Greek Government adopted a government guarantee program (Law 3723/2008) to enhance the eligibility of collateral for funding by the Eurosystem (comprising the European Central Bank (ECB) and the national central banks of euro area countries). As an additional measure to safeguard financial stability, the level of deposit protection per depositor provided by the Hellenic Deposit and Investment Guarantee Fund (HDIGF) increased from EUR 20,000 to EUR 100,000.

By late 2009, attention was rightly drawn to Greek public finances, since Greece was the worst performer among euro area member States in terms of Public Debt, Fiscal and Current Account deficits, as shown in Table 1.

**Table 1: The Greek public finances: main indicators in 2008–09**

	GDP growth (%)	Public Debt as % of GDP	Fiscal Deficit as % of GDP	Current Account Deficit as % of GDP
2008	-0.3	109.4	-10.2	-15.1
2009	-4.3	126.7	-15.2	-12.3

Source: Elstat, Bank of Greece

During the same period, Greek banks had sound regulatory and financial ratios:

**Table 2: The Greek banking sector (solo basis) – main indicators in 2008**

	Assets in EUR bn	Assets as % of GDP	CAR	NPL ratio	Household Debt as % of GDP	NII in EUR bn
2008	412	171	10.7 %	5 %	50.3	8.1

Source: Elstat, Bank of Greece

In late 2009, concerns over the sustainability of sovereign debt led to successive and sharp increases in Greek government bond yields. Following downgrades from the credit rating agencies, Greece was eventually excluded from international capital markets.

Developments in the Greek debt rating were inevitably followed by Greek bank downgrades, while bank liquidity pressures intensified since their access to wholesale funding was significantly impaired. These pressures were further exacerbated by mass deposit withdrawals; from 2010 to 2015, Greek banks lost almost 45 % of their deposit base. Banks had extensive recourse to Eurosystem funding to address these unprecedented liquidity needs, either through monetary policy operations or through emergency liquidity assistance (ELA). The Greek Government additionally supported banks by extending and increasing the guarantee program introduced in 2008.

In April 2010, the Greek Government requested bilateral financial assistance from euro area Member States and the IMF, which led to agreement for an economic adjustment program in May 2010. As it was evident that Greek banks would face major capital challenges in the aftermath of the sovereign crisis, the assistance program also included a support package for banks. From May 2010 to August 2015, three adjustment programs were agreed, which included a total of EUR 75bn earmarked for Greek banks. In H1 of 2015 economic uncertainty, already widespread since end 2014, increased further and peaked with the proclamation of the referendum, the launching of the bank holiday and the imposition of capital controls in June 2015.

### Recapitalization needs and process

The capital needs of Greek banks increased significantly due to deterioration of the macro-economic situation in Greece and the restructuring of Greek Government debt which took place in 2012. In the absence of fiscal integration and flexible labor and product markets, the assistance program focused on fiscal discipline and structural reforms. This took a heavy



toll on households and businesses, which were simultaneously hit by a rise in unemployment, wage reductions and tax increases. Between end 2008 and end 2015, a notably adverse macroeconomic environment developed, as evidenced by the cumulative effect on key macroeconomic indicators shown in Table 3.

**Table 3: Cumulative change in key macroeconomic indicators 2008–2015**

	GDP in EUR bn	GDP %	Unemployment	Housing prices
2008–2015	-66	-26.2 %	7.8 % → 24.9 %	-39.9 %

Source: ElStat, Bank of Greece

The deterioration in the financial condition of borrowers led to a sharp increase in non-performing loans (NPL) with the NPL ratio increasing from 5 % at the end of 2008 to 32.6 % at the end of 2015, while Non-Performing Exposures (NPEs ratio EBA definition) stood at 44.2 % at the end of 2015. As a result, profitability plummeted and banks were forced to make substantial loan-loss impairment charges. Moreover, in spring 2012, the implementation of the PSI program, one of the biggest international debt-restructuring deals affecting some EUR 206 billion of Greek government bonds, resulted in a EUR 37.7 billion loss for Greek banks, wiping out their entire capital base.

In March 2012, the Bank of Greece conducted a strategic viability assessment of the banking sector using a set of quantitative and qualitative criteria including: shareholders' soundness and willingness to inject new capital; quality of management and risk management systems; capital, liquidity and profitability metrics (both forward and backward looking); the Bank of Greece's assigned ratings to bank risks; and a sustainable business model (as envisaged in the Memorandum of March 2012). The aim was to assess which banks were more likely, within a reasonable time frame, to repay the funds they had been granted. Those banks were deemed viable and were eligible for state funds if they were unable to raise private capital to address their needs. The remaining "non-viable banks" would be resolved, unless private capital could be raised.

In the period 2010–2015, Greek banks underwent unprecedented scrutiny by means of six stress-testing exercises. These exercises took into account the Private Sector Involvement (PSI) losses in banks' balance sheets, as well as the expected losses in their loan portfolios. Apart from the capital mitigating actions taken by banks to address these shortfalls, the viable banks proceeded with Liability Management Exercises (LMEs) and share capital increases to cover capital needs as estimated by the supervisory authority. Under the LMEs the banks offered to exchange previously issued Additional Tier 1 and Tier 2 instruments held by investors against newly issued Common Equity Tier 1 instruments. To this end, in late 2015, the four significant Greek banks raised EUR 2.7 billion through this liability management exercise by offering a voluntary bond swap to their bank bondholders. Overall in the period 2010–2015, private sector participation in the three share capital increases during this period amounted to EUR 25.1 billion.

To address the banks' capital shortfall state aid was granted through the use of public funds injected by the Hellenic Financial Stability Fund (HFSF) established in 2010 under the first



assistance program. HFSF participation, on behalf of the state, in share capital increases of the four core banks from 2011 to 2015 totaled EUR 32.7 billion. An additional EUR 5.1 billion was disbursed by the government in the form of preference shares (Law 3723/2008). Total funds, both private and state, injected in the Greek banking system for recapitalization purposes during the period 2011–2015 amounted to EUR 63 billion. Following receipt of state funds, the banks agreed with European Commission restructuring plans.

Furthermore, the support program envisaged a consolidation of the Greek banking sector. To this end, between 2010 and 2013, three subsidiaries of foreign banks were acquired by local banks, while 8 branches of foreign banks suspended their operations, marking the exit of foreign banks from the Greek banking market. Another major development was the acquisition by a Greek bank of the domestic branches of the three Cypriot banks in March 2013. This action was taken in order to avoid contagion from the Cyprus banking crisis.

From 36 banks with Greek banking authorization and 30 branches of foreign banks in 2008, by the end of 2015 the Greek banking system had reduced to 18 banks and 22 branches.

### **Resolution process**

In the face of a profound economic crisis and with a suffering banking sector, Greece was among the first EU countries to pass a law regarding bank resolution, in October 2011, granting resolution powers to the Bank of Greece.

During the following years the Bank of Greece, as the national resolution authority, applied resolution measures to 14 credit institutions: seven commercial banks and seven cooperative banks. The resolutions of the first 13 banks were implemented under the national legal framework<sup>1</sup>, while the latest resolution (Peloponnese Cooperative Bank) took place under the provisions of the Bank Recovery and Resolution Directive (BRRD), as transposed into national law (by Law 4335/2015) in July 2015.

Up to the end of 2015, two resolution tools have been applied: the Sale of Business tool has been used in 12 cases and Bridge Banks have twice been established (prior to BRRD framework). The two bridge banks were under the control and management of HFSF who acted as the sole shareholder of the banks (whereas the new BRRD framework foresees that bridge banks are managed by the resolution authority).

Before each resolution, the Bank of Greece determined the perimeter of the assets and liabilities of the bank under resolution to be transferred to the acquirer or the bridge bank, as appropriate. In the case of Sale of Business tool, an informal and confidential bidding process was conducted. For commercial banks placed under resolution, the perimeter of the transferred assets and liabilities was selected on a case-by-case basis, focusing mainly on the “healthy and viable” parts, including the loan portfolio. Cooperative banks, by contrast, had only their deposits transferred, due to the relative low quality of their loan portfolio and the limited interest from bidders in acquiring additional assets.

Prior to each resolution, during the preparative stage, the resolution authority carried out an initial valuation determining the preliminary difference in the value of the transferred assets and liabilities (the preliminary funding gap) based on limited, typically supervisory and

<sup>1</sup> Law 3601/2007 and Law 4261/2014

published, data. Following the resolution, an independent auditor was appointed to review and finalize the fair value of transferred assets and liabilities within a period of six months. The independent auditor had extended access to the resolved bank's data and records and determined the final resolution cost under conservative assumptions.

**Table 4: Resolution Cost for the Greek credit institutions (in mn euros)**

Credit Institution	Date of Resolution	Resolution Tool	Acquirer	Resolution Cost	Funded by HFSF	Funded by HDIGF
<b>Resolved banks</b>						
<b>Proton Bank</b>	09.10.11	Bridge Bank	–	1.122	260	862
<b>T-Bank</b>	17.12.11	Sale of Business	Hellenic Post Bank	677	227	450
<b>Cooper. Lesvou-Limnou</b>	23.03.12	Sale of Business	National Bank of Greece	56	56	
<b>Achaiki Cooperative</b>	23.03.12	Sale of Business	National Bank of Greece	209	209	
<b>Cooper. of Lamia</b>	23.03.12	Sale of Business	National Bank of Greece	55	55	
<b>ATE-Bank</b>	27.07.12	Sale of Business	Piraeus Bank	7.471	7.471	
<b>Hellenic Post Bank</b>	18.01.13	Bridge Bank	–	3.733	3.733	
<b>First Business Bank</b>	10.05.13	Sale of Business	National Bank of Greece	457	457	
<b>Probank</b>	26.07.13	Sale of Business	National Bank of Greece	563	563	
<b>Cooper. of West. Macedonia</b>	08.12.13	Sale of Business	Alpha Bank	95	95	
<b>Cooperative of Evia</b>	08.12.13	Sale of Business	Alpha Bank	105	105	
<b>Cooperative of Dodecanisou</b>	08.12.13	Sale of Business	Alpha Bank	259	259	
<b>Panellinia Bank</b>	17.04.15	Sale of Business	Piraeus Bank	297		297
<b>Cooperative of Peloponnese</b>	18.12.15	Sale of Business	National Bank of Greece	93		93
<b>Total resolution cost</b>				<b>15.191</b>	<b>13.489</b>	<b>1.702</b>

Source: Bank of Greece

In the most recent case of the Cooperative Bank of Peloponnese, which was resolved in December 2015 under the BRRD framework, the Bank of Greece carried out the required preliminary valuation and proceeded with the application of the Sale of Business tool. Under the new national framework, all depositors have a preferred status against all other liabilities and all senior unsecured debt is subordinated to all other senior liabilities eligible for bail-in. Exceptionally for the year 2015, the bail-in instrument was applicable only to subordinated and senior debt bondholders. Since the Cooperative Bank of Peloponnese did not have any subordinated or senior unsecured debt eligible for bail-in, only the shareholders were wiped out, and full depositors' protection was ensured through the transfer of deposits to the acquirer, as in the case of all other resolved cooperative banks.

As evidenced by the resolution actions taken, the main objective of the resolution strategy has been the protection of uncovered deposits in order to safeguard depositors' confidence and avoid further deposit outflows.

In all 14 Greek banks placed under resolution, shareholders were entirely written off. In some banks, notably the cooperatives, these were mainly retail investors. In two cases subordinated debt was also wiped out.

As already mentioned, all but one of the Greek bank resolutions were implemented prior to the introduction of the BRRD framework, hence full bail-in was not in place.

When attempting a counterfactual “what if” assessment of the developments that might have occurred if the BRRD had been in place when the crisis started, one may find it difficult to see how financial stability would have been efficiently protected under the BRRD. More specifically, full depositors’ protection would not have been ensured since, in some resolution cases, the minimum 8 % bail-in foreseen in the Directive would have resulted in the bail-in of uncovered deposits. Such a development in a systemic crisis environment would have further deteriorated depositors’ confidence, thus triggering additional mass withdrawals, with domino effects for the other banks.

One of the key “lessons learned” from the Greek resolution experience addresses the need for close and effective cooperation among all involved authorities: resolution and supervisory authorities, the national financing arrangement, as well as the European institutions (European Commission, European Stability Mechanism, etc). The timely preparatory work for supervisory and resolution authorities introduced by the BRRD as well as the close cooperation between resolution (Single Resolution Board and national resolution authorities) and supervision (Single Supervisory Mechanism and national competent authorities) are necessary conditions for the efficient management of any bank crisis, given the complexity of the new framework.

### **Conclusions**

As a result of the Greek sovereign crisis, the Greek banking sector experienced significant capital and liquidity pressures and underwent an impressive restructuring and consolidation phase. The actions of the Greek authorities, together with the support program, as well as the ample liquidity provided by the Eurosystem, safeguarded financial stability and prevented what could have been a fatal deepening of the banking crisis. The effective resolution of the failed banks has had a major contribution in this respect.

Today’s transformed Greek banking sector still faces substantial challenges, with the efficient and sustainable NPL management topping the list. Full restoration of public confidence, which will lead to a return of some of the deposits in the financial system, is another important challenge.

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## **PART 2: PUBLIC RECAPITALIZATION UNDER THE BRRD AND THE EU STATE AID REGIME**

Authors: Barney Reynolds and Ellerina Teo

### **Summary**

The 2015 recapitalizations of the Greek banks involved the interaction between the BRRD and the state aid regime. Uncertainties arising from the interplay between the two regimes caused certain Greek banks to engage in liability management exercises (LMEs) in order to meet the burden-sharing condition for state aid. For further recapitalizations requiring state aid, regulators should consider the uncertainties arising from the interaction between the two regimes. In particular, they should consider how to effect mandatory burden-sharing if an institution's liabilities are not squarely within the scope of the BRRD, whether burden-sharing under the state aid rules is satisfied by the requirement on institutions seeking State aid to absorb losses equivalent to 8 % of their total liabilities, and whether the super-equivalent implementations of the BRRD in one Member State will be subject to legal challenge in the courts of another Member State.

### **Background**

Greece has been receiving financial support from eurozone Member States and the International Monetary Fund, in the form of economic adjustment programs, since 2010. Greece entered into its Third Economic Adjustment Program in August 2015, which earmarked up to EUR 25 billion of assistance to address the potential recapitalization needs of viable banks and the resolution costs of non-viable banks. In October 2015, as part of this Program, the European Central Bank published the results of a comprehensive assessment of four significant Greek banks: Piraeus Bank, Eurobank, National Bank of Greece and Alpha Bank. This identified a total capital shortfall of EUR 14.4 billion, which was approximately 6.9 % of Greece's 2014 GDP.

### **Use of state aid within the context of the BRRD**

Recapitalization of the Greek banks occurred against the backdrop of the BRRD, which applied under national law from July 23, 2015. Certain Greek banks required state aid to recapitalize due to a thin capital base. The need for state aid within the context of the BRRD gave rise to two main regulatory considerations.

First, under Article 32(4)(d) of the BRRD, institutions that require state aid are deemed to be "failing or likely to fail", which is likely to trigger one of the conditions for resolution. However, a bank may avoid meeting that condition if the state aid is required for the purposes of "precautionary recapitalization". Broadly, this is an injection of own funds or purchase of capital instruments as a precautionary and temporary measure necessary to address capital shortfalls established by stress tests or asset quality reviews conducted by certain regulatory authorities. A precondition of precautionary recapitalization is that the institution is not failing or likely to fail at the time the public support is granted (on government stabilization tools see chapter 9 and 19, FinSAC Guidebook to the BRRD). For the Greek banks receiving state aid, this meant ensuring that the capital shortfall under the asset quality review and base case scenario of the comprehensive assessment was met through private capital, leaving only the adverse case under the comprehensive assessment to be met from public funds.

Secondly, under current state aid rules, "burden-sharing" must occur as a condition to receiving state aid, which requires holders of hybrid capital and subordinated debt to contribute to reducing the capital shortfall "to the maximum extent" before state aid is granted. It was unclear whether, given the thin capital bases of certain banks, burden-sharing to the maximum extent required subsidiaries of the banks to contribute to reducing the capital shortfall. Mandatory burden-sharing was considered under Greece's Hellenic Financial Stability Fund (HFSF) Law, which contained powers to write down or convert the subordinated liabilities of an institution, but the scope of the powers did not extend to instruments issued by subsidiaries of the bank. Mandatory burden-sharing was also considered under the BRRD. Article 59 of the BRRD sets out the power to write down or convert relevant capital instruments, which can be exercised outside resolution in circumstances where the institution would no longer be viable if the power was not exercised (see chapter 13 on WDCC). However, Article 59 could not be used in this case to write down or convert instruments issued by unregulated special purchase vehicle (SPV) subsidiaries. Even if the relevant instruments had been issued by the bank itself or its regulated subsidiaries, the relevant instruments did not qualify as relevant capital instruments to which the Article 59 power applied. Another option was to use the bail-in tool under Article 43 of the BRRD. However, again, the bail-in tool could not be used to write down or convert the liabilities of unregulated SPV subsidiaries and the exercise of this power would necessitate the institutions entering into resolution.

As mandatory burden-sharing proved difficult for certain Greek banks, the banks engaged in liability management exercises involving the consensual conversion of bonds into equity to reduce liabilities and boost Common Equity Tier 1 capital. Rights issues were also conducted to increase equity reserves independently of liability management exercises. The European Commission then approved EUR 2.72 billion of state aid to Piraeus Bank and EUR 2.71 billion of state aid to National Bank of Greece to address the outstanding capital shortfalls identified in the adverse scenario. (Alpha Bank and Eurobank raised sufficient capital through private recapitalizations without requiring state aid.)

### **Conclusions and lessons learned for recapitalizations under the BRRD**

The interplay between state aid rules on burden-sharing and the BRRD should be considered for future recapitalizations. Where an institution's liabilities are not squarely within the scope of the powers set out in the BRRD, it will be difficult to effect mandatory burden-sharing unless there are separate powers contained in national legislation. The issue is to some extent resolved by the requirement on institutions to meet a minimum requirement for own funds and eligible liabilities under Article 45 of the BRRD (MREL, see chapter 11, FinSAC Guidebook to the BRRD) and the requirement on an institution seeking state aid in a systemic economic crisis to absorb losses equivalent to 8 % of its total liabilities under Article 56 of the BRRD, neither of which applied in Greece until January 1, 2016. However, questions still arise as to whether satisfaction of the 8 % requirement would amount to satisfying the requirement to burden-share "to the maximum extent" under state aid rules.

Another issue related to burden-sharing is mutual recognition of super-equivalent implementations of the BRRD (so called "gold plating"). Some Member States, such as the UK, recognize limitations arising from the application of the write-down and conversion power to relevant capital instruments and included super-equivalent provisions to extend the use of the power to legacy capital instruments. Such Member States should be mindful that the exercise of super-equivalent powers may be subject to legal challenge in cross-border scenarios if courts determine that the powers do not fall within the mutual recognition provisions of the BRRD or the EU Directive on the reorganization and winding up of credit institutions (CIWUD).

## Relevant Sources

### EU Legislation:

- Directive 2014/59/EU of the European Parliament and of the Council of May 15, 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 (the "Bank Recovery and Resolution Directive" or "BRRD")
- Directive 2001/24/EC of the European Parliament and of the Council of April 4, 2001, on the Reorganization and Winding Up of Credit Institutions (CIWUD)

### Greek Legislation:

- Law 3864/2010 on the establishment of the Hellenic Financial Stability Fund (the "HFSF Law")
- Law 4335/2015: Urgent Measures for the Implementation of Law 4334/2015 (A'80): Recovery and Resolution of Credit Institutions and Investment Firms (integration of Directive 2014/59/EE, EE l 173) and other regulations (the "Greek BRRD Law")

ESM Press release, Board of Directors approves EUR 2.72 billion disbursement to recapitalise Piraeus Bank of Greece

Commission Decision on State Aid C(2015) 8626 final – Greece Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank, November 29, 2015

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# ITALY

## FOUR SMALL BANKS: RESOLUTION VIA BRIDGE BANK AND ASSET MANAGEMENT VEHICLE TOOLS TO AVOID FULL BAIL-IN (2015)

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Author: Silvia Merler

### Summary

Having escaped the first wave of the financial crisis in 2008 relatively unscathed, problems in the Italian banking sector then began to grow due to bad loans, high structural costs, and sectoral inefficiencies (such as Italy's very high number of branches). Measures to address these issues stepped up in late 2015, likely triggered in anticipation of the introduction of obligatory bail-in rules under the BRRD per 2016, with failing or troubled banks being liquidated or resolved. At the end of November 2015 four small Italian banks (Banca Marche, Cassa di risparmio di Ferrara, Popolare Etruria e CariChieti) which were under special administration, were resolved under the new legal framework transposing the BRRD into national law (the new bail-in rules only had to be applied as of 2016). After agreement was reached with the European Commission on the creation of a guarantee scheme on banks' Non-Performing Loans (NPLs), a new bank-financed Fund (Atlas) was created to buy junior NPL tranches and act as an underwriter of last resort in the capital raised by two other banks.

### Background

Italian banks were very resilient to the first wave of financial crisis in 2008, due to their low exposure to US sub-prime products and to the fact that Italy did not have a pre-crisis housing bubble (unlike Spain, for example). However, when the global financial crisis turned into a euro sovereign banking crisis in 2010, things started to deteriorate for the sector.

In October 2014, the ECB and the EBA published the results of their comprehensive assessment of banks' balance sheets, and Italian banks were found to be among the worst performers. Overall, the stress tests singled out 25 banks that fell short of the 5.5 % minimum Common Equity Tier (CET1) threshold, based on data as of end 2013. Once measures already enacted in 2014 were taken into consideration, the number of banks failing the test was reduced to 13. Of these, four were Italian. Banca Monte dei Paschi di Siena, Banca Carige, Banca Popolare di Vicenza and Banca Popolare di Milano were found to be in need to raise respectively 2.1 billion, 0.81 billion, 0.22 billion and 0.17 billion, for a total of 3.31 billion.

Table 1

	MPS	Unicredit	Intesa	Popolare	UBI	Carige	Popolare di Milano	Popolare Emilia Romagna
Total Assets	170.2	874.0	668.2	123.4	120.5	31.6	49.3	59.4
Total Loans	118.9	564.8	379.1	86.6	88.0	24.2	33.4	43.5
NPE	47.5	80.7	64.5	21.5	13.7	6.8	6.1	11.4
NPE coverage	48.6 %	51.0 %	47.0 %	33.7 %	27.7 %	41.0 %	39.5 %	42.0 %
NPL ratio	39.9 %	14.3 %	17.0 %	24.8 %	15.5 %	28.0 %	18.4 %	26.2 %
CET1	11.7 %	10.5 %	13.4 %	12.2 %	12.6 %	12.2 %	12.1 %	11.8 %

Source: banks' reports

### The burden of non-performing loans

There was particular concern about the unresolved and sizable burden of NPLs. As the economic situation worsened, bad loans accumulated on banks' balance sheet, making it increasingly difficult for them to lend to the private sector and support the economic recovery. Bad loans have been growing constantly since 2008. About 71 % of the total bad debt is to non-financial corporations, and 27 % is loans to households. The NPL ratios are higher in the Southern and Islands regions – where the economic situation is worse – than in the North.

Out of the aggregate 360 billion euros of Italian NPLs, the more serious bad debts ("sofferenze") account for 14 % of total loans on average (about 200 billion euros), with a coverage ratio of 59.8 %. Assuming a price of 20 cents on the euro (in line with the cases of resolution carried out in 2015), banks would be covered for 79 % of the nominal value of their impaired assets, while the remaining 21 % would face a net loss of EUR 42 billion on bad debts (or 2.6 % of GDP).

At bank level the situation is mixed (Table 1), with NPL ratios ranging from about 14 % for Unicredit to as much as 39.9 % for Monte dei Paschi, and coverage ratios also varying considerably. Worries about increasing bad loans, together with longer-lived factors, such as high structural costs and sectoral inefficiencies (such as Italy's very high number of branches) may partially explain the mediocre profitability of Italian banks over recent years.

### Increasing pressure to address banking sector issues

Despite awareness of these problems, the Italian banking system had avoided the kind of deep monitoring and restructuring process that was undertaken in Spain and other countries that were subject to the EU/IMF financial assistance programs. However, market pressure to find a solution began intensifying in early 2016, probably driven by concerns about how the NPL issue could play out now that the BRRD had entered into force.

### Tackling failing banks

#### Bail-in of junior debt in Banca Romagna Cooperativa (BRC)

On July 17, 2015, the Italian authorities began the liquidation of Banca Romagna Cooperativa (BRC). BRC's assets and liabilities, including deposits, were transferred to Banca Sviluppo, which is part of the ICCREA Group. In the process, BRC equity and junior debt were bailed-in whereby subordinated loans were not transferred to the buyer of BRC's



asset and liabilities but left behind in the liquidation estate. The case passed largely unnoticed abroad, but this is effectively the first instance of a “quasi bail-in” in Italy, conducted under national insolvency law by selling only parts of assets and liabilities out of liquidation (gone concern; contrary to a BRRD bail-in under resolution). As it took place before the obligatory entry into force of the BRRD bail-in provisions this case did not require the application of the full BRRD bail-in (see chapter 15, FinSAC Guidebook to the BRRD), but only a reduced version. The rule was set in the amended state aid regime, which constituted the transition framework to the new recovery and resolution regime. The amended state aid framework prescribed that a loss absorbance of junior debt had to be carried out before any public money could be injected into the bank. Although junior bondholders were accordingly bailed in (i.e. not transferred), no loss was suffered by retail bondholders as the Italian mutual sector’s Institutional Guarantee Fund decided to reimburse them in full and became the only senior creditor of the entity in liquidation. The Institutional Guarantee Fund is technically not public money, as it is financed by contributions from banks having voluntarily agreed upon the mutual sector fund. However, this operation looked like a circuitous way to avoid placing losses on private creditors. This approach was probably taken because all junior debt in BRC was actually held by retail depositors.

#### **Bail-in and the set-up of a good /bad bank for 4 small cooperative banks**

In November 2015, four Italian banks (Banca Marche, Cassa di Risparmio di Ferrara, Banca Etruria e CariChieti) entered resolution. After absorbing part of the losses with equity and subordinated debt – the four banks were split into a “good” bridge bank each and one single “bad” bank (asset management vehicle) was set up for the transfer of all of the problem assets and liabilities (especially NPLs). The Italian Resolution Fund replenished capital of the bridge banks to 9 % and provided guarantee to the Asset Management Vehicle (the bad bank). The resolution fund contribution is expected to total about EUR 3.6 billion: 1.7 billion to absorb losses in the original banks, 1.8 billion to recapitalize the good banks, and 140 million minimum capital injection to the bad bank (according to the note on the operation published by the Italian Central Bank). The resolution fund is financed by contributions from the Italian banking sector, but as it was only recently set up it did not have sufficient funds available for this operation. Resolution fund money is not public money “in the strict sense” as it is financed by the banks (via ex ante contributions or levies) but the use of resolution funds must be compatible with EU state aid rules. To keep bail-in to the pre-BRRD regulatory minimum, and to ensure the State remained formally out of the picture, the money was advanced to the resolution fund by three large Italian banks (Unicredit, Intesa and UBI). The Italian Resolution Fund collected the 2015 ordinary contribution (EUR 588 million) and the 2015 extraordinary contribution (three times the ordinary contribution EUR 1.750 million).

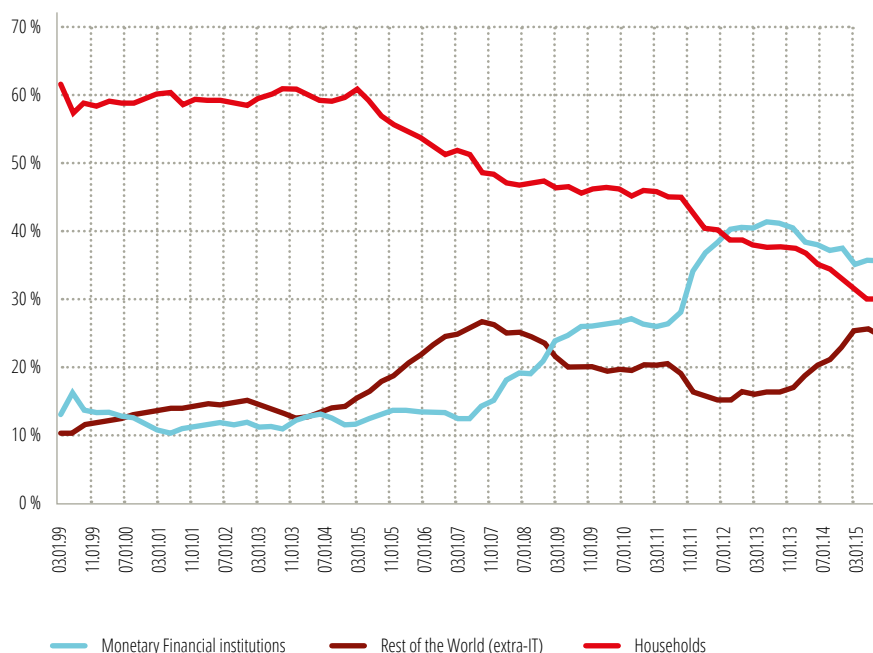
Addressing high levels of “bail-inable” subordinated debt held by retail consumers

The episodes of banking resolutions carried out in 2015 highlighted an issue that could potentially be very problematic for banking resolution in the Italian context. Over past years some Italian banks placed their subordinated debt with retail customers, who were probably largely unaware of the true risk associated with these products, sometimes not even being aware of their bondholder status but considering themselves as simple depositors. The entry into force of the BRRD makes this a thorn in the side of the Italian government. The BRRD aims to reduce the cost of bank rescues for taxpayers, which would be especially problematic for states – like Italy – that have high public debt. This requires sizable bail-in of bondholders, but if, as in Italy, these are retail holders with limited awareness of the risk and limited diversification in their portfolios the result could be potential inadvertent social and political costs.

Figure 1 shows that the percentage of bank bonds held by the household sector is historically high in Italy. This was partly due to the preferential tax treatment of interest income on bonds, which was in place between 1996 and 2011. After then, the share has declined, but it was still very high at about 30 % of the total, as of September 2015. This problem was known, but it has been brought into the spotlight by the episodes of bank resolutions carried out in 2015, before the entry into force of the new regime.

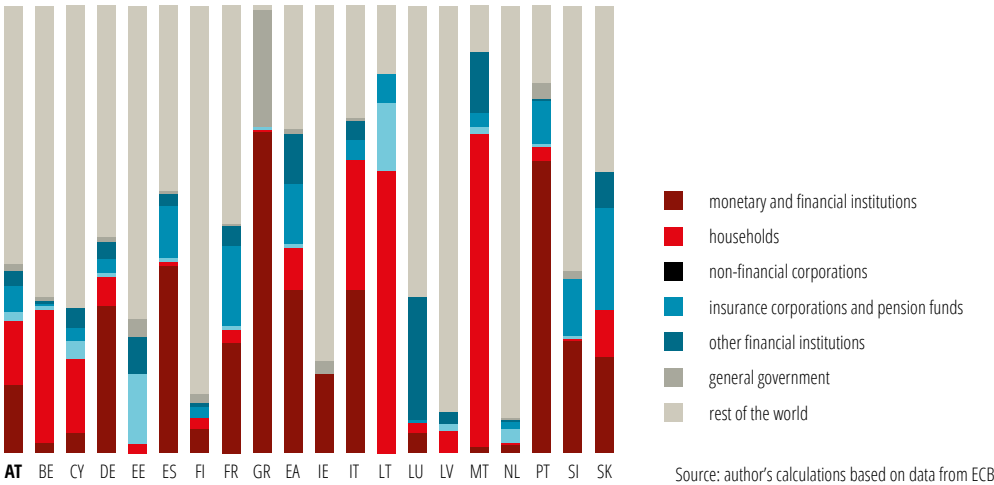
For comparison, figure 2 reports a breakdown of bank bonds by holding sectors for all euro area countries. Excluding Malta and Latvia – which appear to be large outliers – Italy and Belgium have the highest percentage of bank bonds held in the household sector. An equally large share of bank bonds in Italy is held within the domestic banking sector, further increasing vulnerability and providing ground for systemic spillover effects from bail-in. It is also interesting to note how the Italian bank debt market is only internationalized to a limited extent, with just slightly more than 10 % of total bank bonds being held out of the country.

**Figure 1 – holdings of Italian bank bonds by sector (% total)**



Source: author's calculations based on data from Central Bank of Italy

Figure 2 – Holdings of Banks' Bonds – by holding sector (% of total)



Notes: MFI=Monetary and Financial Institutions, HHs= Households, NFC=non-financial corporations, IC and PF= Insurance corporations and pension funds, OFI= Other financial institutions, GG= general government, RoW= Rest of the World

**Dealing with NPLs and creating a shareholder of last resort (“Atlas”)**

These worries, and the resulting market stress, speeded up talks between the Italian government and the European Commission about the creation of a guarantee scheme on non-performing loans (named GACS in Italian). This could be a potentially positive step to clean Italian banks’ balance sheets, but it is unlikely to be miraculous and it would not be as easy as when Ireland and Spain adopted similar solutions.

The idea in the Italian case is to reduce the balance sheet impact of NPL write-downs by having the bad loans sold to special purpose vehicles (SPV), which would issue bonds to fund the purchase. To make the bonds appealing and cheaper to issue Italy will offer a state guarantee on them, in the hope that this helps limit the balance sheet impact.

The banks will need to pay a fee for the guarantee, for it not to qualify as state aid. The fee will be calculated based on the guaranteed amount, and the price of the guarantee will be computed taking as reference the prices of credit default swaps (CDS) for issuers with a “comparable level of risk” to the guaranteed bonds. The fee will increase over time, to take account of “the higher risks connected to the longer duration of the guaranteed bonds” and in order to “introduce in the scheme a strong incentive to recover quickly” the value of the bad loans.

However, before the GACS guarantee can be activated on the senior tranches of securitized NPLs, 50 % of the less senior tranches need to be placed with private investors. The market appeal of these riskier tranches is low, and the market price could be very different from the value at which the NPLs are accounted for on banks’ balance sheets, which would translate into impairments and consume capital.

Under these conditions, the guarantee scheme for Italian NPLs runs the obvious risk of still-birth unless Italian banks pool their funds together into a private fund and buy a significant

part of the junior products themselves. A fund, named Atlas, was set up in April 2016, to do precisely that – buy junior tranches of securitized NPLs and “ensure the success of capital raising requested by the supervisory authority from banks that face market difficulties” acting as a subscriber/shareholder of last resort.

### **While GACS is a step in the right direction, the Atlas set-up is problematic**

First, the effect of Atlas on investors’ confidence in the Italian banking system is dubious. Ideally, a backstop should be reassuring enough for it never to be used. This was not the case with Atlas, which was tested by the Banca Popolare di Vicenza (BPVI) capital raising exercise and eventually had to underwrite the entire capital increase and hold 99.3 % of the bank.

Second, Atlas can significantly increase systemic risk in the longer term, because of its structure. The fund is mostly financed by Italian banks, with Intesa and Unicredit contributing the largest share. By acting as a shareholder of last resort for banks that are not able to raise capital on the market, the fund accumulates risk onto the balance sheets of a banking system that is already very interconnected and that retains areas of weakness. The risk of a domino effect could worsen in the long term, as the fund increases the exposure of stronger banks to weaker banks, with potentially negative effects on the stronger banks’ creditworthiness.

Third, the nature of this initiative is unclear. While there have been reports that the fund is “government-inspired”, the Italian government has stressed its private nature. Yet, if this is supposed to be a fully private initiative, it is not clear why it should include a EUR 500 million contribution from the Italian National Promotional bank Cassa Depositi e Prestiti, which is a joint-stock company under public control. The role of Cassa Depositi e Prestiti should be clearly spelled out (the rationale for transparency goes well beyond state aid considerations). Atlas will buy unsold shares from those banks that have been asked to raise capital by the supervisor: the involvement of a publicly controlled institution into a fund that acts as a buyer of last resort could cast doubts on the strength and impact of supervisory action.

### **Conclusions**

Italy certainly constitutes an interesting case study as long-lived problems in the banking sector have started to be more directly addressed during the transition and entry into force of the BRRD regime.

A first obvious lesson from the Italian example is the cost of procrastination in relation to the reform of the banking system. While Italian banks were initially resilient, resilience soon turned into complacency which led to the situation described above. The potentially inefficient structure of the NPL guarantee scheme was designed to meet the toughened European stance on state aid to the financial sector. The solution could have been more effective, had Italy acted earlier rather than waiting until it was almost too late.

A second lesson concerns the approach to the new regime of bank recovery and resolution. While the date for entry into force of BRRD bail-in had long been known, Italy was not entirely prepared for it. After the two episodes of resolution conducted in 2015, one fact could not be clearer: in a country like Italy that ranks poorly in terms of financial literacy, and where about a third of bank bonds are held by the household sector, even a limited bail-in can have painful consequences for people’s lives.

With the full entry into force of the new BRRD framework in 2016, the bail-in requirement will be tougher. A prior bail-in equal to 8 % of total liabilities will be required before the use

of resolution fund money or public support, and the supranational Single Resolution Board will have a much stronger role. This will limit the potential scope for arrangements like those implemented in the 4 resolution cases described to protect senior (retail) bondholders, and even if they were allowed the costs would be prohibitive. The November 2015 operation to resolve the four banks without a haircut to senior bondholders required the three biggest Italian banks to advance money to the resolution fund and was only possible because the banks to be resolved were tiny, accounting for only 1 % of Italian deposits in total. Assuming that the “public interest” for avoiding liquidation of these banks was strong enough (which is unclear), replicating this approach for a big or even medium-size bank would be much more expensive.

After BRRD bail-in entered into force in January 2016, the Italian approach seems to be one of trying to avoid resolution as much as possible. As a public-only solution to recent banks' problems is impossible to envisage under the BRRD, the Atlas fund has been set up to act as a shareholder of last resort and ensure that even a bank like BPVI, that fails to raise capital, is not resolved. Yet this cannot be a long-term solution. Atlas is problematic, as highlighted, and it has limited power. The good will and resources of the healthier part of the Italian banking sector cannot be relied upon indefinitely to rescue weaker banks.

More generally, regardless of whether one thinks that keeping weak banks alive at all costs is a good idea, it is beyond doubt that the aim of EU-wide rules on bank recovery and resolution is to provide certainty on how banking problems will be dealt with. For now, the Italian approach to bank resolution has been an ad hoc one, which achieves the opposite and appears at odds with the aim of making progress towards a solid European Banking Union. Ultimately, the most important question raised by Atlas is therefore what will come next.w

# THE NETHERLANDS

## SNS REAAL: RESOLUTION VIA NATIONALIZATION AND BAIL-IN (2013)

Author: Professor Dr. Matthias Haentjens

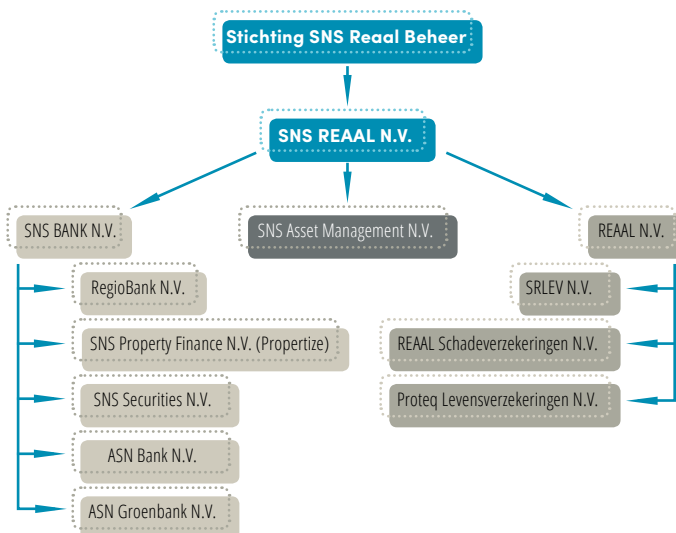
### Summary

On February 1, 2013, the Dutch Minister of Finance decided to expropriate all shareholders and subordinated bondholders of SNS Reaal, one of the four largest financial conglomerates in the Netherlands. By means of this expropriation order, all shares issued by the holding company SNS Reaal N.V. and subordinated bonds issued by the holding company or its subsidiary, SNS Bank N.V. transferred to the State of the Netherlands. All subordinated debts (not issued as securities) were transferred to a separate entity. In derogation of the otherwise applicable corporate law rules, the Minister also ordered that members of both the management board and non-executive board were to be appointed, suspended and dismissed by the general assembly of shareholders, i.e. by the state. New management board members were subsequently appointed this way.

### Background

The SNS Reaal group (SNS Reaal) resulted from the 1997 merger of the SNS banking group and the insurance company REAAL. The holding company SNS Reaal N.V. held all shares in SNS Bank N.V. (SNS Bank) and Reaal N.V. In 2006, SNS Reaal N.V. went public and 50 % of its shares were listed on Euronext Amsterdam. The other 50 % were held by the foundation Stichting SNS Reaal Beheer, as a measure against a possible hostile takeover (cf. Figure 1).

Figure 1



SNS Bank then acquired shares in a company that financed real estate acquisitions: SNS Property Finance N.V. (Property Finance). At the time of nationalization about 77 % of Property Finance's loans concerned real estate in the Netherlands, the rest concerned North-American and (southern) European property. The portfolio amounted to around EUR 8.55 billion, around 9.6 % of SNS Bank's balance sheet. Other Dutch banks held a substantially lower ratio of around 4.5 %.

In mid-2012, SNS Reaal estimated Property Finance's possible future losses, i.e. defaults on the loans made by Property Finance, at between EUR 1.4 billion and EUR 2.1 billion. The government's own estimates, in October 2012, pointed at between EUR 2.4 billion and EUR 3.2 billion. SNS Reaal's external auditor held that it was not clear that SNS Reaal could satisfy its statutory capital requirements, not least because in 2008 the state had lent EUR 750 million to SNS Reaal (see below) and by January 2013, SNS Reaal had been able to repay only EUR 185 million.

SNS Reaal's preliminary 2012 financial statements were scheduled to be made public in February 2013. Negative press reports in January led to deposits being withdrawn and a plummeting share price. The Dutch Central Bank (DNB) assessed that SNS Reaal fell short EUR 1.9 billion of its capital requirements and ordered immediate redress. When SNS Reaal did not meet the deadline, the Minister of Finance decided to nationalize the group.

### **Early intervention measures**

When the global financial crisis hit the Netherlands in 2008, SNS Reaal's insurance division needed additional funding. The state provided EUR 750 million. Two years later, DNB asked SNS Reaal to draft exit plans for its international real estate portfolio. After the Supervisory Review and Evaluation Process (SREP) in 2010, DNB asked SNS Reaal to drastically wind down its entire 'non-core' real estate portfolio. SNS Reaal subsequently achieved a reduction of Property Finance's net exposure from EUR 14 billion to EUR 8 billion by end 2012. Following the 2011 SREP, DNB and the Ministry of Finance created a project team to investigate possible scenarios for SNS Reaal, because the group proved unable to reinforce its capital position. This team investigated the following options: capital injections by private parties, sale of (parts of) SNS Reaal, bankruptcy, public-private joint stabilization measures, forced asset transfers, and immediate government measures such as recapitalization by the government and nationalization.

### **Nationalization and bail-in of subordinated debt as the best resolution option**

On February 1, 2013, the insurance division's balance sheet totaled around EUR 54.3 billion. The banking division maintained around 1.6 million deposit accounts and 1 million payment accounts. Customer deposits amounted to around EUR 36.4 billion, of which around EUR 35.2 billion was insured under the national deposit guarantee scheme (DGS). If SNS Reaal became insolvent the ex post DGS funding structure would require the other Dutch banks in the DGS to have to pay EUR 35.2 billion. Moreover, the Minister expected the aggregate losses for the Dutch banks to amount to a maximum of EUR 5 billion.<sup>1</sup> DNB assessed payouts to account holders under the deposit guarantee scheme as it was then in existence would take 20 days. DNB and Ministry of Finance concluded that this would have serious negative consequences for confidence in the Dutch financial system given market conditions, and that there was a risk of social unrest if 2.6 million accounts were unable to be accessed for up to 20 days.

<sup>1</sup> See Expropriation Letter, page 6, footnote 9 and Expropriation Decision, pp. 9–10.

Of the possible resolution options discussed, the issuance of new equity instruments and a sale of (parts of) the bank proved impossible. No private party could be found that was willing to take on the risks that Property Finance entailed. Public-private joint stabilization measures, in which the three largest Dutch banks together with the state would recapitalize SNS Bank and its real estate portfolio, were thwarted by the European Commission, inter alia on competition law grounds. A possible joint recapitalization, for which a private equity fund had presented itself, was dismissed as the Minister considered this option to place a disproportionate burden on the state in relation to the fund's gains. Bankruptcy was dismissed as a viable option because SNS Reaal qualified as a systemically important financial institution and the Ministry of Finance considered that its bankruptcy would have had most serious consequences for the stability of the financial system.

SNS Reaal's finance structure is also relevant. Like many other financial conglomerates, it was financed with 'double leverage' – only the holding company was externally financed (EUR 909 million at end 2012) and this money was injected, as equity, in the holding company's subsidiaries. The failure of Property Finance would therefore have led to the failure of both SNS Bank and SNS Reaal N.V. because of their substantial exposure through the double leverage structure. Additionally, the proceeds of a possible sale of good parts of the group (such as the insurance division) would have to be used to pay back the holding company's external liabilities, rather than to rescue ailing Property Finance. Thus, the double leverage structure effectively prevented the sale and split-off of 'good parts' of the group and an isolated bankruptcy of Property Finance or SNS Bank.

The Minister of Finance concluded that nationalization and the immediate implementation of measures, such as the decision on the appointment of new board members (see above), were the only viable options. The legal basis for these immediate measures and the nationalization were Articles 6:1 and 6:2 of the Financial Markets Supervision Act (FMSA).

### **Costs for the state, capital injection and restructuring**

The expropriation of shareholders and subordinated debt holders effectively resulted in a capital relief for SNS Reaal of around EUR 1 billion. Shareholders and the holders of subordinated debt instruments were fully expropriated, i.e. ownership of their capital instruments transferred to the state. In addition, all subordinated debts (not issued as securities) were transferred to a separate entity, so that this entity (which was then put into liquidation) replaced SNS Reaal and SNS Bank as debtor. This was not enough to rescue the group. The Ministry of Finance added a capital injection of around EUR 3.7 billion and announced a restructuring, which included loans totaling EUR 1.1 billion and guarantees worth EUR 5 billion. The Treasury levied a EUR 1 billion one-off 'resolution tax' on the banking sector to contribute to these costs. EUR 0.3 billion was injected as equity in SNS Reaal N.V.; EUR 1.9 billion in SNS Bank; and EUR 0.7 billion in Property Finance. The earlier EUR 0.75 billion loan from the state to the group was amortized.

Restructuring is being accomplished by the transfer of the shares in Property Finance to Stichting NL Financial Investments (NLFI), a semi-public entity which holds the shares in all financial institutions of which the state is the owner. Property Finance (renamed as Propertize) will be resolved over time. SNS Bank remained – at least initially – liable for the financing of Property Finance, i.e. for the separate property management vehicle created after the restructuring. But to minimize exposure on this, the State of the Netherlands has issued a EUR 5 billion guarantee to the benefit of SNS Bank. Reaal N.V. has been renamed VIVAT Verzekeringen, and was acquired by the Chinese insurance company Anbang Group



Holdings Co. Ltd. in early 2015. The state has committed to the privatization of SNS Bank in due course.

### **Impact on shareholders and creditors**

As a consequence of the nationalization shareholders and subordinated debt holders were fully wiped out, amounting to losses of approximately EUR 240 million and EUR 1.67 billion respectively. Senior bondholders remained untouched.

Many legal proceedings have been brought before almost all possible courts including:

- Some 700 plaintiffs challenged the legality of the expropriation order with the highest Dutch administrative court. They argued that the expropriation violated civil rights, that the expropriation of subordinated debt was unnecessary and that SNS Reaal's situation did not pose an immediate threat to financial stability. The court upheld the expropriation order.
- Dutch law requires that expropriated investors are fully compensated for their losses. The Minister of Finance had offered EUR 0.00 compensation, arguing that if SNS Reaal had gone bankrupt there would have been no capital left for subordinated creditors or shareholders. The Enterprise Chamber of the Amsterdam Court of Appeal held that this did not compensate for the damage suffered and it appointed experts to advise on an amount of compensation. The Dutch Supreme Court struck down the judgment and held that the Enterprise Chamber must determine the level of compensation independently and it clarified the manner in which compensation for expropriation should be determined. It provided further guidance for the application of the FMSA provisions saying that compensation should be based on the future prospects of the financial institution if no expropriation had taken place, and on the price that would have been achieved in a hypothetical sale in the open market at the time of the expropriation between the expropriated party as a reasonable seller and the expropriating party as a reasonable buyer. On February 26, 2016, the Enterprise Chamber appointed three experts to advise on the price.
- The European Court of Human Rights rejected several complaints concerning the expropriation and held other applications inadmissible.

### **Conclusions**

The SNS Reaal case took place about two years before adoption and transposition of the BRRD into Dutch law. Its legal basis, however, relates to the BRRD in several respects. First, from an economic point of view, the Dutch rules on expropriation and the BRRD provisions on bail-in and write-down may boil down to the same result for investors, especially if bail-in and write-down under BRRD result in a reduction of investors' claims to zero, and 'full compensation' for expropriated investors under the Dutch FMSA is also zero (based on a hypothetical market price).

In the SNS Reaal case full compensation was deemed to be zero as no capital would have been left under bankruptcy proceedings. This is essentially a negative application of the No-Creditor-Worse-Off rule formulated in the BRRD (NCWOL, see chapter 20, FinSAC Guidebook to the BRRD), which ensures creditors and shareholders never receive less than they would have under 'normal insolvency proceedings', i.e. bankruptcy under national law. For compensation, the BRRD takes a gone-concern situation as a starting point, whereas the FMSA takes into account a broader set of circumstances, including the future prospects of the failing institution and a hypothetical sale of the expropriated instruments.

The result for shareholders and subordinated debt holders may have been the same had the BRRD been implemented into Dutch law when SNS Reaal failed because these investors

would probably also have been fully written-down under the BRRD. Moreover, they may not have received more if SNS Reaal had entered into ‘normal’ Dutch insolvency proceedings, so would not have been entitled to any compensation under BRRD’s NCOWL principle. Additionally, senior debt holders may also have been written down or converted into equity, and there may have been recourse to the Single Resolution Fund if BRRD and the Single Resolution Mechanism had already been in force. At the time of the SNS Reaal nationalization, the Minister explicitly considered expropriating/bailing-in senior bondholders, but concluded that financial stability reasons prevented that. He argued the measures taken were least burdensome for public finances, especially considering the special ‘resolution tax’ levy on the banking industry discussed above, which can be compared to a drawing on the Single Resolution Fund which is also funded by the industry.

BRRD Articles 56–58 allow for the possibility of ‘public equity support’ and ‘temporary public ownership’ as a last resort (see chapter 19, FinSAC Guidebook to the BRRD). The Netherlands Government has argued that these provisions allow for retaining FMSA Articles 6:1–6:13, the legal basis on which the Minister of Finance’s power to nationalize a failing bank rests. However, the Government also stated that under the Single Resolution Mechanism, where the Single Resolution Board is responsible for the resolution of failing credit institutions, it will be unlikely – other than in a state emergency – that the nationalization power will ever have to be used. This was also the conclusion of a commission tasked with drawing lessons from the SNS Reaal nationalization, although the Minister of Finance’s nationalization power should be retained as a last resort.

Other findings by the commission, and by a committee set up to evaluate the relevant FMSA provisions, included that:

- 1 All financial institutions should be required by statutory law to draft “living wills”. Complex operational, financial and corporate interdependencies should be controllable and separable. Authorities should have the power to require financial institutions to adopt changes to their structure, organization or business practices to improve their resolvability;
- 2 Statutory law should explicitly empower the Minister of Finance to expropriate debts (rather than only rights and claims); and
- 3 The scope of DNB’s resolution powers should be extended to financial holding companies.

Recommendation 1 has been effectuated through the implementation of the BRRD and the Single Resolution Mechanism, which requires the drafting of recovery and resolution plans and empowers authorities to take resolvability decisions. Recommendations 2 and 3 have been implemented by amendment of the FMSA as of April 1, 2016.

## Relevant Sources

### Statutory materials

- Grondwet (Constitution), esp. Article 14
- Wet op het financieel toezicht (Financial Markets Supervision Act), esp. Articles 6:1–6:13

### Government materials

- Proceedings of the Senate May 22, 2012, 30–6–27
- Besluit ex artikel 6:1, eerste lid, 6:2 eerste, vierde en vijfde lid, en 6:4, eerste en tweede lid, van de Wet op het financieel toezicht, February 1, 2013 (Expropriation Order), available at <http://www.rijksoverheid.nl/documenten-en-publicaties/besluiten/2013/02/01/onteigeningsbesluit-sns-reaal-en-sns-bank.html>

- Letter of the Minister of Finance to the Parliament, February 1, 2013 (Expropriation Letter), available at <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2013/02/01/kamerbrief-over-de-onteyening-van-sns-reaal.html>
- Letter of the Minister of Finance regarding the offer for compensation, March 4, 2013, available at <http://www.government.nl/news/2013/03/04/dutch-minister-of-finance-makes-offer-for-compensation-due-to-the-nationalisation-of-sns-reaal.html>
- Kabinetsvisie Nederlandse bankensector (Government position re. Dutch banking industry) August 23, 2013
- Parliamentary Proceedings 2014–2015, 34 208, no. 3 (Explanatory Memorandum)

#### Case law

- European Court of Human Rights (ECHR) January 14, 2014, application no. 47315/13 (Adorisio and Others v. the Netherlands)
- ECHR February 11, 2014, application no. 50494/13 (VEB NCVB and Others v. the Netherlands)
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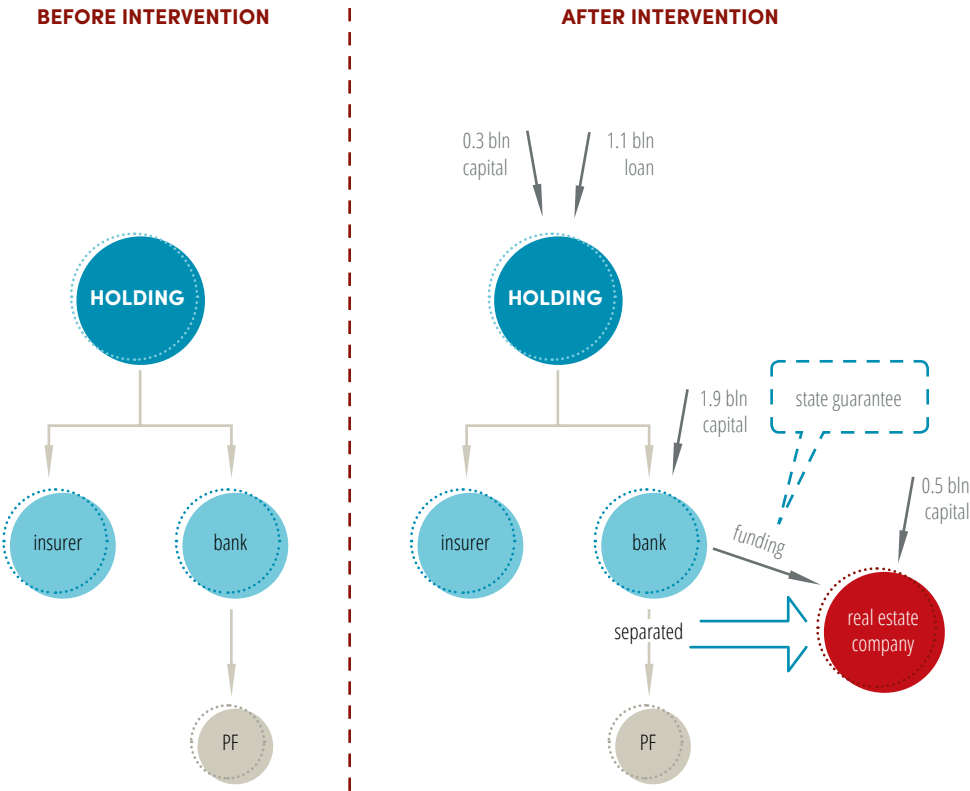
#### Reports

- Financial Stability Board, Peer Review of the Netherlands, Review Report November 11, 2014, available at <http://www.fsb.org/wp-content/uploads/Netherlands-peer-review-report.pdf>
- Rapport van de evaluatiecommissie nationalisatie SNS Reaal (2014) (Report of the evaluation committee nationalisation SNS Reaal (2014))

#### Literature

- M Haentjens, What Happens when a Systemically Important Financial Institution Fails: Some Company Law Observations re. SNS Reaal, *European Company Law Journal*, nr. 2, 2013
- LGA Janssen & JT Tegelaar, How to Compensate Expropriated Investors? The Case of SNS Reaal, *JIBLR* 2016
- Figure 1 has been copied from the Expropriation Letter
- Figure 2 has been copied from the FSB Review Report

Figure 2 – Structure of SNS REAAL before and after intervention



Source: ministry of finance

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# PORTUGAL

## **BANCO ESPÍRITO SANTO, S.A.: RESOLUTION VIA A BRIDGE BANK INCLUDING A RE-TRANSFER**

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Author: Ana Rita Garcia<sup>1</sup>

### **Summary**

On August 3, 2014, Banco de Portugal applied a resolution measure to Banco Espírito Santo, S.A. (BES), transferring the majority of its activity to Novo Banco, S.A. (Novo Banco), a bridge bank created for that purpose whose equity capital was provided by the Resolution Fund. This decision had to be urgently taken due to the imminent risk of cessation of payment by BES, at the time the third largest Portuguese bank, which would have had very serious consequences for financial stability and for the Portuguese economy.

### **Background**

In mid-2014 BES was the third largest bank in the Portuguese banking system and was considered a significant credit institution by the European Central Bank under the Single Supervisory Mechanism. BES had a market share of around 11.5 % of total deposits received from residents in Portugal, approximately 14 % of total loans granted and 19 % of loans granted to non-financial corporations. Also, its market share of the financial and insurance sector financing amounted to 31 %, showing a strong interconnection with the rest of the financial services industry<sup>2</sup>. BES belonged to a larger economic group (Grupo Espírito Santo – GES), which was active both in the financial sector and also the nonfinancial sector, with a broad geographical scope (25 countries on four continents). The bank therefore played a very significant role in the national economy and financial system, especially in the financing of non-financial corporations, and a possible disruption of the financial services it provided would have had a very significant systemic effect.

At the end of July 2014, BES released the results for the first half of the year, with losses of around EUR 3.6 billion (on a consolidated basis).<sup>3</sup> This included the negative impact of above EUR 1.5 billion of unexpected losses resulting from operations mainly conducted in the first half of 2014 and unknown to the external auditor. As a result, BES's losses largely exceeded the amount previously estimated on the basis of the information that had been disclosed by BES and its external auditor to the market and to the competent authorities. Those estimated losses had already exhausted the bank's EUR 2.1. billion capital buffer, reinforced in May–July following a determination of Banco de Portugal.

<sup>1</sup> Banco de Portugal. The opinions expressed in this case study are those of the author and do not necessarily coincide with those of Banco de Portugal. Any errors and omissions are the sole responsibility of the author.

<sup>2</sup> Recital 9 of 3 August 2014 Decision

<sup>3</sup> Recital 1 of 3 August 2014 Decision

The situation described above had very serious consequences for BES:

- A substantial reduction of the Common Equity Tier 1 ratio to around 5 % (on a consolidated basis)<sup>4</sup>, significantly below the minimum required by Banco de Portugal;
- The significant deterioration of the public perception of BES, reflected in the strongly negative performance of its securities in the days leading up to resolution and a very significant fall in the market-value of its shares to around 12 cents, which culminated with the suspension of the trading of BES's shares by the Portuguese Securities Market Commission on August 1, 2014;
- The downgrade of BES's rating by the Canadian rating agency DBRS, also on August 1, 2014. There was indication that further rating cuts were also a possibility;
- The growing pressure on the bank's cash flows;
- Increased uncertainty over BES's balance sheet given the evidence of internal control failure and harmful mismanagement.

In addition to the serious breach of its minimum own funds requirements, BES was also in a situation of severe liquidity shortfall (from the end of June until July 31 the liquidity position of BES declined by around EUR 3,350 million<sup>5</sup>). BES could not accommodate such sharp pressure on its liquidity through recourse to funds obtained in monetary policy operations due to the exhaustion of the assets accepted as collateral for that purpose, and to the limitation imposed by the European Central Bank (ECB). BES was therefore forced to resort to Emergency Liquidity Assistance.

The magnitude and the nature of the losses unexpectedly made public in late July significantly damaged the external perception of BES's financial position, making a private capitalization solution unfeasible in the short run. On July 31, 2014, the Board of Directors of BES informed Banco de Portugal that it would not be possible to submit a capitalization plan based on private investment, under the terms and within the deadlines requested by Banco de Portugal in the face of the urgency of the situation and the rapidly deterioration of confidence in the bank.

On August 1, 2014, the Governing Council of the ECB decided to suspend BES's Euro-system monetary policy counterparty status, effective as of August 4, 2014, and, in parallel, requested the bank to fully repay its outstanding credit with the Eurosystem to an amount of around EUR 10 billion by close of business on August 4.

Considering all the above, BES was in a situation of serious risk of not meeting, in the short term, its obligations and consequently of not complying with its authorization requirements. Given the importance of BES within the Portuguese banking system and in the financing of the Portuguese economy, the risk of suspension of payments or failure to meet its obligations carried high risk of contagion that could compromise the stability of the national financial system.

Banco de Portugal, faced with the imperative and urgent need to adopt a solution that simultaneously guaranteed deposit protection and ensured the stability of the financial system, decided on August 3, 2014, to apply a resolution measure to BES.

<sup>4</sup> Recital 2 of 3 August 2014 Decision

<sup>5</sup> Recital 5 of 3 August 2014 Decision

### **The national legislation then in force**

In August 2014, the Bank Recovery and Resolution Directive (BRRD) had already entered into force but had yet to be enacted in national legislation. However, the Portuguese resolution regime then in force, which had been introduced in 2012, already took into account to a large extent the ongoing international debate on bank resolution. The resolution regime provisions included the application of corrective measures, the appointment of an interim board, and resolution measures, including the main resolution objectives and general principles. At that moment, the only measures available were the sale of business tool and the bridge institution tool, as the regime did not yet stipulate for bail-in. Thus, it partially anticipated, internally, what would later become the framework enshrined in the BRRD and, therefore, the national regime was already, in substance, very similar to the BRRD.

### **The resolution of BES and the creation of Novo Banco**

On August 3, 2014, Banco de Portugal, acting as the national resolution authority, started the resolution of BES. The business conducted by BES i.e. selected assets, liabilities, off-balance sheet items, and assets under management, were transferred to Novo Banco, a bridge bank set up by Banco de Portugal for that purpose, leaving behind assets and liabilities connected to the GES and most of the contingent elements of BES balance-sheet. Given that there were no immediate viable solutions for selling the activity of BES to another authorized credit institution, this was the only measure that ensured the continuity of the provision of its financial services and that allowed the new bank to be adequately ring-fenced from the risks created by the exposure of BES to entities of GES.

Novo Banco is a credit institution with the status of a bank and bridge institution. As such, it can carry out all bank-related activities, under the management mandate set out by Banco de Portugal, as the Resolution Authority. It also complies with all the rules, including prudential requirements, imposed on banks operating in the market. Being a significant credit institution for the purposes of Article 6(4) of Council Regulation (EU) No 1024/2013, of October 15, 2013 (SSM Regulation), Novo Banco has been directly supervised by the ECB since November 4, 2014. Novo Banco has had full access to the liquidity facilities provided by the European System of Central Banks, under the Eurosystem framework, having the same funding conditions of the remaining national credit institutions.

The by-laws of Novo Banco were approved by Banco de Portugal, as the resolution authority, which also appointed the members of the management and supervisory boards of Novo Banco upon a proposal submitted by the Resolution Fund, as the single shareholder.

The equity capital for Novo Banco, of EUR 4.9 billion, was fully provided by the Resolution Fund. The Resolution Fund, only created in 2012, did not have sufficient available financial means (arising from the ex ante contributions paid by the industry, and the proceeds from a special levy on the banking sector) to fully finance the operation. The Resolution Fund therefore took out loans from the Portuguese State (EUR 3.9 billion) and from a group of credit institutions that are members of the Resolution Fund (EUR 700 million). This allowed the State's resources to be used in the form of a financing operation to the Resolution Fund and not as capitalization of the failed bank, protecting the public purse from the risks inherent to a position of shareholder or of a direct creditor of a credit institution and ensuring that the disbursed amount is to be reimbursed by the Resolution Fund based on contributions paid by the industry.

Use of the Resolution Fund, legally a public law legal entity even if it is financed by the industry and whose intervention is decided by Banco de Portugal, constitutes state aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) (see chapter 21b FinSAC Guidebook to the BRRD). This meant that the resolution measure had to be properly notified to the European Commission, which had to decide whether the aid was compatible with the internal market under the EU rules on state aid to banks in the context of the financial crisis. In its assessment, the Commission found that the orderly resolution aid was limited to the minimum necessary, that the distortions of competition stemming from the market presence of Novo Banco until the completion of its sale were limited, that an adequate burden sharing was ensured and that, therefore, the state aid was compatible with the internal market for reasons of financial stability on the basis of Article 107(3)(b) TFEU.

### **Assets and liabilities transferred from BES to Novo Banco, burden sharing and the “no creditor worse off” principle**

The selection by Banco de Portugal of the assets, liabilities, off-balance sheet items and assets under management to be transferred from BES to Novo Banco took into account the purposes of resolution, particularly the need to ensure the continuity of the essential financial services provided by BES, to avoid systemic risk, to protect depositors and to safeguard the public purse. This selection also aimed to adequately ring-fence BES's activity, now transferred to Novo Banco, from the risks created by the exposure to the non-financial entities of GES, and was defined in order to have a stable perimeter (which was crucial to calculate capital needs), thus excluding all contingencies.

More importantly, the selection of the assets and liabilities to be transferred to Novo Banco pursued the guiding principle of resolution according to which shareholders of the credit institution under resolution bear first losses, followed by its creditors, in equitable conditions. In compliance with this guiding principle, the following were among those not transferred to Novo Banco:

- Instruments that were, or had once been, eligible for BES's own funds;
- Liabilities or contingent liabilities related to shares, instruments, or contracts from which subordinated claims arise towards BES;
- Liabilities to shareholders whose holdings were equal to or higher than 2 % of the equity capital of BES at the time of resolution or in the preceding two years;
- Liabilities to members of the management and supervisory boards and to the audit firms;
- Liabilities to the persons or entities that had been shareholders or who had performed the functions mentioned in the two subparagraphs above in the four-year period before the creation of Novo Banco and whose action or failure to act caused the financial difficulties experienced by BES or helped aggravate that situation;
- Liabilities to the relatives of the persons and entities mentioned in the three subparagraphs above and any person or entity acting on their behalf or account;
- Liabilities or contingent liabilities, if any, arising from the placement by BES of financial instruments issued by entities belonging to the GES Group with
- All contingent liabilities.

It should be noted that burden sharing took place not only due to the applicable rules of the resolution legal framework then in place but also because of the state aid rules in force in the European Union since 2013, according to which the losses of a credit institution must first be borne by shareholders and subordinated creditors before any state aid can take place. This means that, had public recapitalization been an available and feasible option in August 2014,



such public recapitalization would necessarily entail a similar contribution to loss absorption from shareholders and subordinated creditors (See chapter 9 FinSAC Guidebook to the BRRD).

An independent valuation of the assets, liabilities, off-balance-sheet items and assets under management transferred to Novo Banco was later carried out by PricewaterhouseCoopers & Associados – Sociedade de Revisores Oficiais de Contas, Lda (PwC) and resulted in significant adjustments to the net book value of the assets as booked in the balance sheet of BES at the timing of resolution. These adjustments were fully reflected in Novo Banco's opening balance sheet.

The resolution of BES is also bound by the principle that no creditor shall incur greater losses than would have been incurred had the credit institution entered into liquidation instead of being resolved (the 'no creditor worse off' principle). If, at the end of the liquidation procedure of BES, according to independent valuation, creditors whose claims were not transferred to Novo Banco are found to have incurred greater losses than the losses they would have expectedly incurred had BES entered liquidation procedures immediately before the application of the resolution measure, those creditors are entitled to the payment of that difference from the Resolution Fund (see chapter 20 FinSAC Guidebook to the BRRD).

In compliance with the applicable law, Banco de Portugal appointed an independent entity, Deloitte Consultores, S.A. (Deloitte), to estimate the level of recovery of the claims of each class of creditors of BES, in accordance to the priority ranking provided for by law, in a scenario in which BES had been liquidated immediately before and instead of the application of the resolution measure. In accordance with the estimation carried out by Deloitte, in a liquidation scenario, shareholders and subordinated claims would have zero recovery and the recovery rate of unsubordinated, unpreferred claims would be of about 31.7 %. This means that if those creditors whose credit claims were left behind at BES recover less than 31.7 % following the liquidation of BES, they will be entitled to compensation by the Resolution Fund. Any right to compensation by the Resolution Fund can only be determined at the end of BES's judicial liquidation proceedings.

### **Further developments in the resolution of BES**

On December 29, 2015, the Board of Directors of Banco de Portugal approved a number of decisions that completed the resolution measure applied to BES on August 3, 2014. The package of decisions taken on December 29 was intended to finally close the perimeter of assets and liabilities of Novo Banco, including by making sure that the losses of BES were effectively absorbed by the bank's shareholders and creditors in accordance with the legal framework.

Given evidence that the economic and financial situation of Novo Banco had been negatively affected since its creation by losses originating prior to the resolution of BES (whose assets had been overvalued), Banco de Portugal decided to transfer back to BES the liabilities related to non-subordinated bonds issued by BES and intended for institutional investors. The nominal amount of the bonds retransferred to BES totaled circa EUR 2 billion.

The exercise of this power by Banco de Portugal to re-transfer at any time assets and liabilities between BES and Novo Banco, expressly provided for in the legal framework and in the original resolution decision of August 3, 2014, was deemed necessary to ensure that, as stipulated in the resolution regime and in accordance with the State Aid Decision, the losses of BES were absorbed by its shareholders and creditors and not by the Resolution Fund.

The selection by Banco de Portugal of the bonds transferred back to BES was based on grounds of public interest and aimed to safeguard financial stability and ensure compliance with the purposes of the resolution measure applied to BES.

Other measures taken by the Board of Directors of Banco de Portugal on December 29, 2015, included:

- The clarification that no liabilities had been transferred to Novo Banco that were contingent or unknown on the date of the resolution of BES (including disputed liabilities in connection with pending litigation);
- The clarification that it is the Resolution Fund's responsibility to make neutral for Novo Banco – through an appropriate compensatory measure – any potential negative effects of future decisions in the resolution process that might give rise to liabilities or contingencies.

These decisions represented the final and definitive adjustments of the perimeter of the assets, liabilities, off-balance sheet items and assets under management transferred from BES to Novo Banco.

### **Consequences of the resolution measure for BES**

With the application of the resolution measure to BES, the members of its Board of Directors and the Board of Auditors were automatically suspended. The new members of the management bodies of BES were appointed by Banco de Portugal.

Being an institution under resolution which had its most significant share of activity and property transferred to Novo Banco, BES ceased to be in a position to carry out its activity in an autonomous manner or to continue to operate in the market under normal conditions. Accordingly, Banco de Portugal applied the following corrective measures to BES, taking effect on August 3, 2014:

- Prohibition to grant credit and invest funds in any types of assets, except where the investment of funds was necessary for the preservation and enhancement of the value of its assets;
- Prohibition to take deposits;
- Waiver of compliance with the prudential rules applicable and the timely fulfilment of previously contracted obligations, except when this fulfilment was indispensable to the preservation and valuation of its assets, in which case Banco de Portugal could authorize the operations required for the purpose.

Because BES was not carrying out any activity, and given that it no longer served any purpose in ensuring the successful implementation of the resolution measure, the ECB withdrew its banking license on July 13, 2016. In accordance with the applicable law, this has the effect of a declaration of insolvency. Judicial liquidation proceedings of BES are ongoing and the assets and liabilities that were not transferred to Novo Banco, which were being managed by the Board of Directors of BES, are now part of BES's insolvency estate.

### **Sale process of Novo Banco**

Under the legal framework in force in August 2014, Novo Banco was established for a period of two years, renewable for periods of one year for reasons of public interest. Accordingly, Portugal committed, in the context of the state aid assessment undertaken by the European Commission, to sell the activity transferred to Novo Banco, or the equity stake held by the Resolution Fund, through an open, transparent, non-discriminatory and competitive selling process until August 2016.

The sale process was launched in December 2014 and elicited three binding offers for the purchase of the Resolution Fund's equity holding in Novo Banco. However, Banco de Portugal opted, on September 15, 2015, to interrupt the sale process and to terminate the then-ongoing procedure without accepting any of the three binding offers, as it deemed the terms and conditions of these offers not satisfactory.

The duration of Novo Banco as a bridge institution was later extended and, in its decision of December 19, 2015, the European Commission decided to extend the deadline for the sale of Novo Banco. On January 15, 2016, Banco de Portugal decided to re-launch the sale process of the Resolution Fund's equity stake in Novo Banco. The sale process is on-going at the time of writing.

### Conclusions

The application of the resolution measure to BES has made it possible, even in the face of the collapse of the third largest banking group in the country, to safeguard stability and confidence in the Portuguese financial system, protect depositors, and ensure the ongoing provision of key financial services previously conducted by BES. However, as this was the first time that a resolution measure was applied to a Portuguese credit institution, the implementation of that decision was challenging and has provided important lessons.

Preparation is of the utmost importance. This is something that can be partially addressed in the resolution planning phase, where resolution authorities can, for instance, obtain thorough knowledge of the group's structure and activity as well as remove impediments to resolution. However, several significant components of a successful resolution can only be properly addressed in the weeks or days before resolution because they require the most up-to-date financial data possible. Information about the credit institution's liabilities, in as much detail as possible, particularly regarding counterparties, is essential at that stage. If the circumstances prompting resolution arise suddenly because of undisclosed liabilities, as was the case with BES, implementation issues will inevitably add to the inherent difficulties of a resolution process.

A key aspect that is particularly highlighted in the BRRD is the need for a detailed and comprehensive valuation of the institution's assets to ensure the proper recognition of its losses. These include both the losses determined in accordance with accounting and prudential rules from a going concern perspective (which inform the resolution authority's decision on whether the conditions for resolution are met); as well as the losses arising from determination of the economic value of the institution's assets, in accordance with the impact of the chosen resolution strategy, from a gone concern perspective (which inform the choice of resolution action to be adopted). This helps to ensure that losses are properly absorbed by the institution's shareholders and creditors and that the institution is recapitalized to a prudent extent.

An interesting difference in the resolution regime introduced by the BRRD to the regime in place in Portugal when BES entered resolution is the possibility of converting creditors of the institution under resolution into shareholders of the bridge institution. This new financing option allows for the use of less resources from the Resolution Fund aimed at providing the equity capital to the bridge institution.

The importance of a strategy to follow-up implementation of the resolution measure should not be overlooked, particularly when the chosen resolution tool is a bridge bank. The

resolution authority, together with the management of the bridge bank, need to ensure that the bridge bank has access to liquidity and funding in the days following resolution and that it can access payment, clearing, and settlement systems, with the purpose of ensuring continuity of critical functions. To safeguard the public's confidence in the financial system, an effective communication strategy has to be put in place.

While Directive 2001/24/EC (Reorganization and Winding-up Directive) already provided for the recognition and enforcement of resolution decisions adopted within the European Union, the BRRD helpfully reinforces the mutual recognition of crisis management measures and states that creditors affected by the transfer of rights, assets, and liabilities under a resolution action cannot prevent, challenge, or set aside said transfer under any provision of law of the Member States where the assets are located or which govern the rights or liabilities. Accordingly, the UK Court of Appeal has recently held that the UK was obliged to give immediate effect in its law to the transfer of rights and liabilities of BES to Novo Banco under Banco de Portugal's decision of August 3, 2014, and other decisions that completed it (because the obligation to recognize the decision involves giving it the effect that it had in Portuguese law), and that a debt claim brought by investors whose liability was not transferred to Novo Banco can only be pursued after, and only if, those decisions are overruled by the courts in Portugal.

In conclusion, the case of BES has proved that the resolution of a large and complex banking group facing idiosyncratic difficulties is possible and that resolution is an efficient although not risk-free tool for preserving financial stability.

### **Relevant Sources**

#### **EU Legislation:**

Directive 2014/59/EU of the European Parliament and of the Council of May 15, 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 (the 'Bank Recovery and Resolution Directive' or 'BRRD')

#### **European Commission's State aid temporary rules established in response to the economic and financial crisis:**

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 (OJ C 216, 30.7.2019, p. 1) ('Banking Communication')

#### **Portuguese Legislation:**

Legal Framework of Credit Institutions and Financial Companies, approved by Decree-Law No 298/92, of December 31, as amended

#### **Banco de Portugal Decisions:**

Decisions are available on the Banco de Portugal's website, <http://www.bportugal.pt/en-US/OBancoeoEurosistema/Esclarecimentospublicos/Pages/DeliberacoesBes.aspx>

**European Commission State Aid Approvals:**

- Decision of August 3, 2014, C(2014) 5682 final, State aid n° SA.39250 (2014/N) – Portugal, Resolution of Banco Espírito Santo, S.A.
- Decision of December 19, 2015, C(2015) 9762 final, State aid n° SA.43976 (2015/N) – Portugal, Amendment of the 2014 Resolution of Banco Espírito Santo, S.A

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# SLOVENIA

## SEVERAL DOMESTIC BANKS: RESOLUTION VIA PUBLIC RECAPITALIZATION AND BAIL-IN (2013)

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Authors: Mitja Mavko and Lars Nyberg

### Summary

In late 2013 and 2014, before the BRRD came into force in January 2016, the Slovenian government had to recapitalize a number of domestic banks considered to be of domestic systemic importance. In the process equity of EUR 381 million and subordinated debt of EUR 582 million were written off. Equity and debt holders have questioned the legal support for this. A constitutional appeal of bail-in debt holders was referred to the Court of Justice of the European Union (CJEU) for preliminary ruling which endorsed, in principle, the right to enforce “burden sharing” on private investors. If the BRRD had been in place, the process would have been unambiguous and the bail-in considerably bigger at around EUR 1,900 million.

### Background

Like many other industrial countries, and especially as a small and very open economy, Slovenia was hit by the financial crisis of 2007–2008. Interestingly, and in contrast to many other countries in the crisis, household debt was not a problem. The balance sheets of households were generally sound in Slovenia and housing prices did not increase in the way they did elsewhere. However, a number of corporate groups had borrowed heavily from the banks to expand their operations. The banks, in turn, largely depended on wholesale financing in the EU. With those sources drying up, pressure began to mount. A large part of the corporate sector was overleveraged and non-performing loans (NPLs) in the banks increased quickly. When new international capital requirements were announced and after the results of a comprehensive asset quality review, it became clear that a number of banks would have to be recapitalized or resolved. As a result of the previous banking rehabilitation undertaken in the 1990s, the Slovenian state had been heavily involved in partly owning and controlling the largest banks, those of systemic importance. Injecting fresh capital into the banks was partly an issue for the state as an owner, but – more importantly – the state had responsibility to safeguard the country’s financial stability. The Bank of Slovenia, independent and part of the euro-system, was and continues to be the supervisory and resolution authority for banks – today it performs its role as national supervisor in the Single Supervisory Mechanism (SSM).

As an EU Member State, Slovenia had to observe state aid rules in recapitalizing its banks. The European Commission had to be involved in calculating the maximum support possible to avoid conflicts with competition legislation. In line with the Banking Communication<sup>1</sup> shareholders and holders of subordinated debt were supposed to contribute before any

<sup>1</sup> Communication from the Commission on the application, from August 1, 2013, of state aid rules to support measures in favour of banks in the context of the financial crisis

provision of state aid. The BRRD was still under construction and the concept of bail-in was still controversial, while experience from other EU Member States varied.

### Recapitalization and other public support

Following the Cyprus bail-out in Spring 2013 (See Cyprus case study), the financial markets and the European institutions insisted on a comprehensive asset quality review and a stress test in the Slovenian banking sector. The exercise was concluded in December 2013 and determined the scope for recapitalizations in the form of state aid and transfers of assets to the newly created Bank Asset Management Company (BAMC).

The two biggest Slovenian banks, Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBK) were fully recapitalized by the Slovenian state in December 2013. Abanka was partly recapitalized in 2013, and a restructuring plan was drawn up in 2014 which would enable its merger with Banka Celje. The state provided EUR 3.647 million (EUR 2.524 million in cash and EUR 1.123 million in bonds), while the rest was to be provided through banks' own capital-generating capacities. As part of the process, all distressed assets to be transferred to the state-owned BAMC from the four major banks were identified and priced. The assets consisted mainly of loans, but there was also some equity included.

The process was deemed a successful rescue of the Slovenian financial system by the international financial markets. In January 2014 Moody's immediately changed its outlook for Slovenia to "stable", while the spreads on Slovenian government bonds lowered by more than 260 basis points in the first quarter of 2014, reaching pre-crisis levels.

Moreover, two small banks Probanka and Faktor Banka were partly recapitalized by the Slovenian state in the amounts necessary to prevent bankruptcy and to allow orderly winding down of both banks in 2013. The Bank of Slovenia, appointed extraordinary management while the state made provision for the capital shortfall after bail-in of equity and junior liabilities had been performed. After more than two years of wind-down in which deposits in the two banks were fully repaid, the remaining assets and liabilities of these two banks were merged into the BAMC and their banking licences were revoked.

**Table 1: Slovenian banks at the end of 2013**

Bank	Capital shortfall	Recapitalization	Transfer to BAMC	Equity	% State Ownership	Hybrid and subordinated debt
NLB	1904	1551	2300	184	90	250
NKBK	1056	870	1011	143	50	56
Abanka Vipra	756	591 <sup>2</sup>	1144	7	41	120
Banka Celje	388	190	411	17	54	92
Faktor Banka	n/a (283)	269	–	12	–	23
Probanka	n/a (214)	178	–	18	–	41
Total	4601	3649	4866	381		582

Figures in million euros

Source: Bank of Slovenia ([www.bsi.si](http://www.bsi.si))

<sup>2</sup> The recapitalization was provided in two steps: EUR 348 million in 2013 and EUR 243 million in 2014 when the final restructuring plan for merging with Banka Celje was approved. Banka Celje was recapitalized in 2014.

In addition to the capital support, EUR 4.866 million of distressed assets at book value (as revised after the asset quality review) were taken from the banks' balance sheets and transferred to the BAMC.<sup>3</sup> The state further provided EUR 204 million in equity in the BAMC and guaranteed the EUR 1.560 million in bonds issued by the BAMC to pay for the assets transferred. Within its first year of operations, the BAMC liquidated EUR 129 million of assets. By December 2015 its portfolio, net of cash, decreased further to EUR 1.2 billion and the BAMC was able to repay its first bond, issued to pay for the transferred assets, in the amount of EUR 505 million.

A sovereign guarantee of EUR 1.030 million was given to the Bank of Slovenia for providing emergency liquidity assistance (ELA) to Faktor Banka and Probanka. Part of the guarantee of EUR 428 million of was invoked and the state thereby effectively replaced the central bank in providing liquidity in the wind-down process. As of February 2016 the remaining balance sheets of Probanka and Faktor banka were merged with the BAMC.

### **Bail-in and state aid**

In discussions preceding the recapitalization, European regulation clearly demanded that shareholders and holders of subordinated and hybrid debt must contribute in full before state aid could be granted. This implied a complete bail-in of all instruments except for deposits and senior liabilities. Since the state and state-owned enterprises featured dominantly on the liabilities' side of the four major banks, the impact on the Slovenian public sector of the equity write-down and the bail-in was profound. The remaining equity of the six banks amounted to EUR 381 million, and the hybrid and subordinated debt to EUR 582 million.

Amendments to the Banking Act were enacted in the fall of 2013. The role model for the respective with regard to resolution tools and bail-in, was the draft BRRD and the Spanish resolution law (Law 9/2012 on the restructuring and resolution of credit entities). Amendments were also made to comply with state aid rules to support measures in favor of banks in the context of the financial crisis, contained in the EU Commission's "Banking Communication" of August 1, 2013. This states that in cases where a bank no longer meets the minimum capital requirements, subordinated debt must be written down or converted to equity before state aid is granted. Furthermore, state aid must not be granted before equity, hybrid capital and subordinated debt have fully contributed to offset any losses. The Banking Communication also states that before granting any kind of restructuring aid to a bank all capital-generating measures, including the conversion of junior debt, should be exhausted provided that "fundamental rights are respected" and financial stability is not at risk.

### **Legal challenges**

This all sounds pretty clear. However, the parties bailed-in questioned the legal grounds. The parties launched a constitutional appeal concerning the amendments to the Banking Act and the write-off of subordinated liabilities, claiming that it represented interference with private property. At the time when expropriated shareholders and debt holders bought their shares and bonds, possible future state aid was not conditional on prior loss absorbance ("bail-in") of shares and equity. Hence they claimed the actions taken violated the principle of legitimate expectations as developed by the Court of Justice of the European Union (CJEU) and rejected the (retrospective) application of the burden sharing principles of the Banking Communication in an administrative resolution procedure rather than actual liquidation

<sup>3</sup> BAMC paid EUR 1,559 million for the EUR 4,866 million transferred from the banks or approximately 32 % of the book values. Detailed valuations performed by BAMC showed the transfer prices to be reasonably correct.



(under a judicial bankruptcy procedure). The BRRD, adopted after this action had been taken in Slovenia cannot be interpreted supporting this view. It provides for burden sharing of creditors also with respect to liabilities which were entered into before the date of transposition of the directive into national legal systems (also under Article 55, which only applies to cross border cases, contractual recognition clauses are not conditional for applying statutory bail-in).

At the time of writing (September 2016) the jury is still out on this Slovenian legal bail-in issue. The Constitutional Court in Ljubljana has, before issuing a final judgement, requested preliminary ruling from the CJEU. The CJEU in its July 2016 judgement<sup>4</sup> noted that the Banking Communication may not be binding on a Member State. Nevertheless, the CJEU is clear in its opinion that (i) the Commission is authorized to adopt guidelines for assessing the compatibility of Member States' aid measures with the internal market; (ii) in adopting such guidelines burden-sharing by shareholders and subordinated creditors as a prerequisite to the authorization of state aid by the Commission is compatible with the internal market; (iii) even if the subordinated creditors had not been called upon to contribute in the first phases of the international financial crisis, this does not put them in a position to rely on the principle of protection of legitimate expectations; and (iv) burden sharing (bail-in) when required by the European Commission during state aid procedures, does not infringe fundamental rights of investors (right to property) when write down is based on valuation (rather than on actual liquidation). The Court also notes that while a Member State may not be compelled to impose burden-sharing by subordinated creditors prior to provision of state aid, in not doing so it is taking a risk of incompatibility of measures with the internal market. A final ruling by the Slovenian Constitutional Court is expected before the end of 2016.

## Conclusions

How would the recapitalization process have been handled if the BRRD had been in place? The four banks would most likely have been considered as "systemic" i.e. being in the public interest under the new Directive (for details on the conditions for resolution see chapter 14, FinSAC Guidebook to the BRRD). Whether Faktor Banka and Probanka would have been seen as "systemic" is more questionable, but in 2013, given the fragility of the financial system at the time, the conduct of the Slovenian government and the Bank of Slovenia towards orderly wind-down seems warranted.

According to the BRRD, in circumstances of extraordinary systemic stress authorities may provide public support to a bank under resolution instead of imposing losses in full on private creditors, but only after the bank's shareholders and creditors have borne losses equivalent to 8 % of the bank's liabilities (see chapters 15 and 21 FinSAC Guidebook to the BRRD). The table below sets out the first approximation of the scope of "bail-inable" instruments in each of the banks, based on the end-2012 audited financial results.

<sup>4</sup> Case C-526/14

Table 2: A hypothetical BRRD scenario

	Size of liabilities	Equity	8 % Liabilities	"Bail-inable" liabilities (other than equity)
NLB	11,487	1,067	919	n/a
NKBM	4,339	193	347	155
Abanka Vipra	3,598	169	288	119
Banka Celje	2,270	158	182	24
Probanka	1,059	52	85	32
Faktor banka	1,028	83	82	n/a
<b>Total for bail-in under BRRD</b>			<b>1,902</b>	

Figures in million EUR

Source: Banks' 2012 Audited Annual Reports; own calculations.

The table indicates that up to EUR 1,902 million of liabilities could have been bailed-in had the BRRD already been in force. The largest portion of this amount refers to equity. However, it should be noted that the 2012 results overestimated the equity available and that this had to be adjusted following the asset quality review undertaken in 2013. In fact, it is clear from Table 1 that in 2013 only EUR 381 million of equity was available to cover the capital shortfall. If the BRRD had been in force in 2013 in addition to state aid rules, bail-in under the BRRD could have been applied and liabilities well beyond hybrid and subordinated instruments would have had to contribute to covering the capital shortfalls before any state aid could have been contemplated, subject, of course, to the decision of the resolution authority (see chapters 15 and 21, FinSAC Guidebook to the BRRD). The considerable scope of senior liabilities, however, suggests that none of the deposits would have been subject to bail-in.

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# SPAIN

## **SAVINGS BANKS: RESOLUTION VIA PUBLIC RECAPITALIZATION, THE CREATION OF AN ASSET MANAGEMENT VEHICLE AND BAIL-IN (2012)**

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### **Summary**

The 2007 financial crisis triggered by the subprime mortgage crisis, together with the real estate crash in Spain, and the subsequent sovereign debt crisis, exposed the weaknesses in the capitalization of Spanish financial institutions. After domestic efforts to support and restructure financial institutions proved insufficient (state aid of EUR 22.4 billion was provided), up to EUR 100 billion aid from the European Stability Mechanism (ESM) was made available (about EUR 41.3 billion has been used) and eight banking groups were recapitalized via the public Fund for Orderly Bank Restructuring (FROB), created in 2009. To minimize public support part of the losses had to be borne by shareholders – who were almost completely diluted – and by the holders of preference shares and subordinated debt (about EUR 13.6 billion were generated through “Subordinated Liability Exercises” (SLE)). A liquidity mechanism for “bailed-in” (retail) holders of subordinated debt financed by the DGS as well as a less aggressive SLE scope has played a significant role to reduce litigation in resolution. A private-public asset management vehicle (SAREB) was set up for the orderly winding down/liquidation of real estate assets of EUR 51.8 billion within 15 years.

### **Background**

After 15 years of growth and a considerable construction boom in Spain, domestic and external factors since 2007 have had a significant impact which led the economy to fall deep into recession and its financial sector to enter into crisis. The burst of the real estate bubble, the increase in the ratio of non-performing loans, the fall in house prices, as well as huge leveraging, and excess risk taking, have raised banks’ capital and provisions needs.

Regulatory requirements, strengthened to avoid systemic risk and to ensure a more realistic valuation of real estate assets, further increased capital requirements. Despite its systemicity, the financial crisis in Spain did not affect banks to the same extent as in other countries, but was largely concentrated in saving banks, the so called “Cajas”. Commercial banks were able to cover their capital requirements by their own private means and were not deeply affected. But some “Cajas”, were unable to undertake recapitalization without public financial support due to their particular structural deficiencies – savings banks had an ownership structure without formal shareholders, governed by both public and private stakeholders without profit distribution – and had often displayed poor risk management and aggressive lending behavior.

### **The Financial Sector Assistance Program**

In 2009, the Government created the Fund for Orderly Bank Restructuring (FROB), a 100 % state owned public agency, responsible for managing the restructuring processes and

channeling public aid to financial institutions. Between 2009 and 2012 the FROB injected around EUR 15 billion capital from the state budget into eight savings banks (EUR 0.9 billion subscribing convertible preference shares, and EUR 13.5 billion subscribing common shares). The Deposit Guarantee Fund provided an additional EUR 7.9 billion of public aid, basically strengthening the capital of the Cajas.

In July 2012, the European Union approved a Spanish request for up to EUR 100 billion financial support to recapitalize the financial sector – approximately 10 % of Spain's GDP. This support was provided by the European Stability Mechanism (ESM) under an 18-month program established in the "Memorandum of Understanding on Financial Sector Policy Conditionality" (MoU). Under this program, the ESM disbursed EUR 39.5 billion in December 2012 and a further EUR 1.8 billion in February 2013. The majority of the funds were used for the direct recapitalization of 10 banks via the FROB (subscribing common shares and convertible contingent bonds (CoCos)) and EUR 2.5 billion for capitalizing SAREB, the public/private asset management company (AMC) created in November 2012 to segregate and manage the orderly disposal of assets related to the real estate sector over a period of 15 years. The program was successfully completed in January 2013, with no extension of the initial deadline. As of end-April 2016, the outstanding amount of the European Stability Mechanism (ESM) loan is 35.7 billion.<sup>1</sup>

The MoU imposed stringent conditions, based on three pillars:

- An independent asset quality review and bank-by-bank stress test to identify, through a bottom-up exercise<sup>2</sup>, overall capital needs, followed by the implementation of the measures needed to address the shortfall, including bail-in of junior debt and public injections.
- The segregation of the real estate portfolios of state-aided banks (real estate developers' loans and foreclosed assets) and their transfer to an external independent asset management company (SAREB).
- The completion of reform of the financial sector's legal framework to improve the resilience of banks, savings banks in particular, and to strengthen transparency and supervision.

The national legal framework for the implementation of these conditions took into account the BRRD (then still under development). It allowed the FROB to apply mandatory burden-sharing exercises and to impose losses on shareholders and on holders of hybrid capital and subordinated debt instruments, under the No Creditor Worse Off principle (see chapter 20, FinSAC Guidebook to the BRRD). One of the conditions imposed by the MoU was that, prior to receiving any public aid, the shareholders and the holders of hybrid instruments and subordinated debt had to absorb losses to the greatest possible extent. Shareholders were nearly wiped out in all the entities and the holders of preference shares and subordinated debt absorbed losses under SLEs.

Moreover, the Government committed itself to improving the Spanish legal framework for the financial sector, and a package of regulations have been approved in recent years to comply with this condition. Especially remarkable are the measures introduced by Law 26/2013

<sup>1</sup> Government has reimbursed this amount with i) the amounts derived from the sale of the Banks under resolution (Catalunya Banc, NCG); ii) the repayment of CoCos (Liberbank); iii) the amount returned by CaixaBank in April 2013, arising from the assistance received by Banca Cívica before its integration into CaixaBank.

To be added to these figures are the EUR 1,304 million obtained from the divestment by BFA in Bankia. The FROB still is the main shareholder of two banks (Bankia and BMN).

<sup>2</sup> This exercise was preceded by a top-down assessment, which helped decide the total figure of the program.

on Cajas (savings banks) and Law 10/2014 on Regulation, Supervision and Solvency of the credit entities. Under the new regulation former savings banks (Cajas) have been redefined, and their activities have been limited to their core territory and original function (which is a kind of foundational and cooperative activity).

### **Bank Recapitalization and Restructuring**

Restructuring institutions with public support was considered necessary to avoid a significant adverse effect on the financial system, to prevent contagion, and also to protect depositors. In all cases, the resolution decision by the Bank of Spain was adopted on the basis of an independent economic valuation of the assets and liabilities of the institution in question, with respect to both going-concern and liquidation scenarios. This valuation assured the proportionality of the measure and ensured shareholders' and creditors' treatment was no worse than if the institution had been wound up under normal insolvency proceedings.

Stress tests of banks' balance sheets assessed whether they would face capital shortfalls under an adverse scenario, and if so, the amount of the shortfall. The stress tests identified capital shortfalls totaling EUR 55.9 billion. Ten credit institutions were identified as undercapitalized, only two (Banco Popular and Ibercaja) met their capital requirements through capital increases and without having to resort to state aid.

Banks were divided into four groups on the basis of the stress tests. Banks in Groups 1 and 2 were determined to need public support for their recapitalization, these included eight entities or groups of former savings banks that were converted into normal commercial banks to allow the implementation of recapitalization tools (BFA-Bankia, Catalunya Banc, NCG Banco-Banco Gallego, Banco de Valencia, Banco Mare Nostrum, CEISS, Liberbank and Caja 3). The European Commission approved resolution or restructuring plans for each of them. These plans, which are expected to be completed by 2017, foresaw a comprehensive range of measures to ensure the sustainability of the banks' core activity, such as cost-cutting both in staff and branches, lending restrictions (especially on new loans linked to real estate developments), and limits on wholesale activity. The plans also defined and specified the mechanisms and amounts payable for recapitalization: public capital injections and burden sharing exercises. Between December 2012 and February 2013, the FROB injected EUR 38.8 billion through subscribing shares (EUR 37.7 billion) or contingent convertible bonds (EUR 1.1 billion). The capital generated through burden sharing exercises affecting holders of preference shares and subordinated debt amounted to EUR 13.6 billion.

To reduce the impact of burden sharing by taxpayers and investors, all state-aided banks were obliged to transfer their most illiquid and impaired assets (Real Estate Development loans and foreclosed real estate, above a certain value) to the SAREB, receiving as payment government-guaranteed senior bonds issued by the SAREB itself. The total transfer value of the assets segregated and transferred to SAREB was EUR 50.8 billion (at a media transfer price of about 63 % of the asset's book value).

### **Burden-sharing: Subordinated Liability Exercises (SLEs) in addition to public recapitalization**

One of the main commitments included in the MoU was the establishment of a rigorous legal framework to conduct Subordinated Liability Exercises (SLEs). The result of these exercises was that shareholders were almost completely wiped out. Holders of undated subordinated debt and preference shares received common equity or equity-like instruments after a haircut of the face value of their holdings (in an amount that was worth a non-negligible

## Quantification of Public Financial Support – support provided/committed (mEUR)

		FROB 1		FROB 2	Subsequent to Law 9/2012 <sup>1</sup>		
	Date of the agreement	CIDGS capital and other contributions <sup>2</sup>	Preference debt instruments (participaciones preferentes)	Capital	Capital	Contingent convertible bonds (CoCos)	Total
Group 0	<b>CAIXA BANK</b>	2010	977				977
		2012		998			5,498
		2012			4,500		
	<b>BBVA</b>	2010	380				953
		2011		568			
		2012	953	-568			
		2010	1,250				12,052
		2011		1,718			
		2012	-1,250	1,250			
		2012			9,084		
Group 1	<b>IBERCAJA</b>	2012				407	407
	<b>BANCO SABADELL</b>	2011	5,249				5,249
		2013			245		245
	<b>UNICAJA BANCO</b>	2010		525			1,129
		2013				604	
		2013	-525	525			
	<b>BANCO MARE NOSTRUM</b>	2010		915			1,645
		2012			730		
		2013	-915	915			
	<b>BFA</b>	2010		4,465			22,424
Group 2		2012		-4,465	4,465		
		2012			17,959		
	<b>NCG BANCO NOVACAIXA GALICIA</b>	2010		1,162			9,052
		2011		2,465			
		2012		1,162			
		2012			5,425		
	<b>LIBERBANK</b>	2009	1,740				1,740
		2012				124	124
			7,942	977	13,498	37,943	1,135
							61,495
Group 1	<b>BFA Bankia<sup>1</sup></b>	2010 and 2012			15,638		

<sup>1</sup> Contributions of EUR 38,833 million, made under the Financial Support Programme: EUR 37,943 million in capital contributions subsequent to Law 9/2012, plus EUR 1,135 million in contingent convertible bonds, less EUR 245 million in capital contributions to Banco Gallego that were not from ESM funds.

<sup>2</sup> The Credit Institution Deposit Guarantee Scheme (CIDGS) receives from its member banks annual contributions that depend on the deposits they have attracted.

<sup>3</sup> Restructuring support to Bankia, subsidiary of the BFA group (this support is already considered in the above table, under "Institutions included in BFA")

Source: Banco de España, based on [http://www.frob.es/es/Documents/presbe2016\\_41en.pdf](http://www.frob.es/es/Documents/presbe2016_41en.pdf)

fraction of the face value of their holdings). The holders of dated subordinated instruments were able to choose between receiving equity or senior debt after a haircut of the face value of their holdings.

This gave rise to unprecedented legal challenges regarding the retrospective application of the new mechanism to instruments previously issued, the breach of the hierarchy between creditors, and the infringement of the right of hearing in the resolution process. This was resolved by linking the definition of resolution that might trigger those SLEs to the pre-existing Spanish insolvency legislation, which was clearly outlined in all investors' initial prospectuses or contracts.

In conclusion, the resolution framework was designed as a special regime and more beneficial to investors than the ordinary rules of insolvency, thus reducing litigation and allowing the FROB to act with a margin of safety in compliance with the aforementioned No Creditor Worse Off principle.

#### Capital generated through burden sharing exercises (million Euro)

Credit entity	Initial outstanding (nominal)	Initial discount	Initial discount (% nominal)	Purchase price (exchange for capital)	Purchase price (exchange for debt)	Capital generated
BFA Bankia	6,911	1,817	26 %	4,852	242	6,669
NCg	2,047	604	30 %	1,355	88	1,959
CatalunyaBanc	1,818	457	25 %	1,218	142	1,676
Liberbank	866	63	7 %	787	16	850
CEISS	1,433	274	19 %	1,159	0	1,433
Caja3	91	35	39 %	9	47	44
BMN	449	116	26 %	309	24	425
Banco Gallego	192	45	23 %	122	25	176
Banco de Valencia	416	357	86 %	59	0	416
<b>Total</b>	<b>14,223</b>	<b>3,768</b>	<b>27 %</b>	<b>9,870</b>	<b>584</b>	<b>13,648</b>

Source: FROB

#### Loss absorption by Retail Investors

A remarkable feature in Spain was that the majority of holders of preference shares and subordinated debt holders of the Cajas were individuals, more traditionally linked to savings products (similar to household bond holders in Italy. See Italian case study). This raised the possibility of potentially large numbers of claims and complaints related to the mis-selling of products affected by bail-in. With this in mind, the measures implemented ensured the effectiveness of SLEs and thereby reassured customers. Internal arbitration procedures, based on previous court rulings, were drawn up by the Government for Catalunya Banc, NCG Bank, and Bankia, and a similar mechanism for reviewing financial product sales was created for Banco CEISS. Ultimately the number of legal claims could be reduced and 63 % of retail investors' either did not claim or settled their claims in non-judicial litigations proceedings.

As part of SLEs and in case of unlisted banks (e.g. Catalunya Bank and NCG), a liquidity mechanism was established for the conversion of former holders of hybrid instruments into shareholders. This liquidity mechanism was financed by the Deposit Guarantee Fund (DGF) which offered to buy shares from converted retail holders at a discount. As a result, the DGF became the shareholder and bought shares up to EUR 1.8 billion. This mechanism in combination with a less aggressive SLE design i.e. one limited to preferential shares and subordinated debt, was effective at reducing litigation. The SLEs allowed a significant part of the initial value held to be converted into new debt or capital instruments and thus avoided a large “haircut”. These measures enabled credit institutions to absorb the impacts of litigations, without the need for further state aid, and through their own capacity to generate capital organically via conversion.

### **Resolution of BFA-Bankia**

The case of BFA-Bankia merits specific mention due to the amount of money involved – its capital shortfall, after the relevant stress test, was set at EUR 24.74 billion – as well as its systemic nature for the Spanish financial sector.

In December 2012, the FROB determined the economic values of both Bankia and its parent company BFA based on reports commissioned from three independent experts. The economic valuation of the BFA Group fixed by the FROB on the basis of the experts valuations was EUR -10.44 billion, whilst that of the listed bank Bankia was EUR -4.15 billion. In the event of a liquidation the negative value determined by the same experts would have increased to EUR -64.02 billion, so resolution was objectively justified in terms of public interest.

BFA-Bankia received a capital injection of EUR 18 billion via FROB and transferred “bad” assets valued at EUR 22.3 billion to SAREB (representing nearly half of SAREB’s portfolio). The FROB also demanded the issuance of contingent convertible bonds by Bankia without a preferential subscription right amounting to EUR 10.7 billion, which were subscribed by BFA (owned by FROB). These bonds were supposed to temporarily cover the capital shortfall in Bankia and their repayment period was up to 5 years.

In April 2013, FROB completed the recapitalization of BFA-Bankia, adopting the following measures: 1) a reduction in capital for loss-absorption that meant reducing the nominal value of the existing shares from their then value of EUR 2 down to EUR 0.01; 2) following the capital reduction, in order to reduce the number of shares outstanding and, especially, to allow the shares to trade at an appropriate price, a counter-split or bundling of shares was carried out to return the nominal value of the shares to EUR 2 ; and 3) an initial capital increase, underwritten by the FROB through BFA, followed by a second capital increase so that holders of the group’s preference shares and subordinated debt could be brought into Bankia’s capital. By early 2015 the nominal value of a share had been reduced to EUR 0.8, with FROB still owning 64 % of Bankia.

It should be noted that this percentage share has increased due to court rulings regarding hybrid instruments claims. The Courts have ruled in favor of the plaintiffs in approximately 85 % of cases of mis-selling, which means the holders could recover their full investment.

### **Litigation**

Although a high level of litigation was expected, the margin of safety with which the resolution actions were designed and implemented, vis-à-vis the results of any given liquidation scenario (NCWOL), actually led to very few lawsuits challenging administrative decisions.



The FROB, in particular, has been sued fewer than thirty times, a relatively low number when compared to the more than one million people affected by its decisions.

And while at the time of writing (2016) some of these lawsuits are still pending, the first judgements have validated the initial decisions on the restructuring process. In April and May 2016, the Audiencia Nacional has found in various cases that FROB's measures regarding shareholders and holders of preference shares and subordinated debt, were not expropriatory and fully complied with the legislation in force at the time – setting a clear precedent.

However, the Supreme Court recently found that information contained in the prospectus registered for the issuing of Bankia shares was not accurate for retail investors, and, as a consequence, has ruled in favor of the plaintiffs in two cases. Subsequently, to avoid further judicial claims, for the case of the civil proceedings relating to the initial public offering of Bankia shares, the entity is returning the money to all individuals who subscribed through a private mechanism.

### **Conclusions**

The Spanish experience allows to draw certain lessons and conclusions relevant also for future resolution cases under the newly established BRRD framework:

- The transition from a bail-out to a bail-in scheme requires a learning period to minimize litigation risk. In Spain, this learning curve resulted in the implementation of a less aggressive SLE scope, i.e. preferential shares and subordinated debt. Law 11/2015 on recovery and resolution foresees that the bail-in could affect any creditor, except deposits guaranteed by the Deposit Guarantee Fund, but the measure has not yet been applied in practice.
- As resolution actions need to be implemented in a short period of time, legal and procedural safeguards—particularly, the permanent judicial control during the actions— cannot be the same as in an ordinary insolvency procedure. Administrative resolution powers are more dynamic than processes foreseen during the ordinary functioning of a company as board meetings and general assembly decisions are ex-lege substituted by administrative decisions.
- The judicial process and audited accounts must be replaced by independent valuations and the right to appeal each administrative (FROB) decision. The ordinary insolvency procedure requires audited financial statements which is not compatible with the need for taking quick resolution action under BRRD, which provides for independent expert valuation to be carried out in a short time frame (possibly even within 24/48 hours).
- Resolution authorities must act with a clear safety margin between resolution and insolvency scenarios, so that those affected by their decisions have no arguments to challenge them.
- Flexibility in the process of resolution and an appropriate balance between public and private contributions minimize legal risks and preserve the stability and effectiveness of the capitalization tools.
- An adequate balance between state aid rules and re-privatisation is needed. Some flexibility, in terms of timing for the sale of publicly-owned shares, should be given to the resolution authority to minimize the cost for the taxpayer.

### **Relevant Sources**

Royal Decree-Law 24/2012 on restructuring and resolution of credit institutions, passed by Parliament as Law 9/2012 on November 14.

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# THE UNITED KINGDOM

## UK CO-OPERATIVE BANK: RESOLUTION VIA NEGOTIATED BAIL-IN OUTSIDE THE BRRD (2013)

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Author: Barney Reynolds

### Summary

The UK Co-operative Bank was recapitalized via a commercially negotiated consensual bail-in arrangement supported by retail investor groups. A “consensual bail-in” also known as liability management exercise (LME) can provide a commercial solution to the problem of a failing financial institution which, because it operates outside of the constraints of a statutory resolution, has certain advantages to it. Certainty of ownership rights in particular is more achievable if the creditors of the financial institution agree to the proposed conversion of their rights. Certain key issues will still require consideration but are not insurmountable. The inclusion of consensual bail-in in a firm’s recovery plan should, where appropriate, be contemplated by national regulators and resolution authorities.

### Background

A resolution authority can take resolution steps under the BRRD only if there is no reasonable prospect of private sector measures preventing a financial institution from failing within a reasonable timeframe. Where private sector measures are available, the institution cannot be deemed “no longer viable”, even if the quantitative triggers for non-viability are met, making the exercise of write-down/conversion powers by the authorities outside of resolution not possible either (see chapters 13 and 14, FinSAC Guidebook to the BRRD).<sup>1</sup>

The BRRD does not state how far the requirement to prefer private sector measures extends.<sup>2</sup> Before any resolution action is taken, a resolution authority would need to be satisfied that private investors are unwilling or unable to recapitalize the institution, and that negotiations with shareholders on dilution of their equity, and creditors on voluntary conversion of their claims, have failed. In practice, a national regulator could also use its early intervention powers to require a failing institution to consider a commercially negotiated bail-in without specifying the terms of the restructuring.<sup>3</sup>

<sup>1</sup> BRRD, Articles 59(3)(b), (c) and (d) and Article 59(4). With regard to Article 59(3)(e), it should be noted that, under the 2013 Banking Communication of the European Commission, private capital solutions must be exhausted before state aid can be used for the purposes of recapitalization.

<sup>2</sup> BRRD, Recital 23 states that a resolution authority should consider the effectiveness of any early intervention measures that have been imposed.

<sup>3</sup> According to BRRD, Article 27(1)(e), a national regulator may require the management to draw up a plan for negotiation on restructuring of debt with some or all of the creditors.

An advantage of a commercially negotiated consensual bail-in is that it operates outside the legal constraints imposed under the BRRD.<sup>4</sup> It can be managed by the institution rather than subject to the decisions of resolution authorities, but still meets the same core objectives of a resolution action by keeping the financial institution operational, protecting retail customers, ensuring financial stability and avoiding the use of public funds (see chapters 3 and 4, FinSAC Guidebook to the BRRD).

### **The Experience of the Co-operative Bank**

The first creditor bail-in of a UK bank took place prior to implementation of the BRRD but against a backdrop of UK legislation<sup>5</sup> that permitted effectively the same actions. It was a commercially negotiated consensual arrangement supported by retail investor groups that provided for the recapitalization of the Co-operative Bank (the "Co-op").

Following the Co-op's announcement on June 17, 2013, of its capital shortfall, the Prudential Regulation Authority (PRA) required the Co-op to raise £ 1.5 billion of further Common Equity Tier 1 capital by the end of 2013. The Co-op published its proposed recapitalization plan in June 2013, which was to be effected through an exchange offer. However, by failing to provide bondholders with sufficient information about the proposed exchange offer and related capital-raising, the Co-op was unable to secure bondholder support for its proposed recapitalization plan. In October 2013, the Bank engaged with the bondholders in lengthy negotiations regarding the terms of a revised plan. The terms provided that the Lower Tier 2 bondholders (LT2 bondholders) would receive 70 % of the shares in the Co-op plus £ 100 million in principal amount of newly issued Tier 2 securities, while the bank's parent, The Co-operative Group, retained a 30 % equity stake. The LT2 bondholders injected £ 125 million capital into the Co-op. The consensual bail-in and rights offering was effected through a UK Scheme of Arrangement under the Companies Act 2006, Part 26. The Scheme was subject to court sanction and had to be agreed by a numerical majority, representing at least 75 % in value, of each class of scheme creditors. The PRA also had to approve the plan.

This innovative restructuring put the Co-op on a sound financial footing. It was a market-based solution agreed expeditiously between the bondholders and the bank.

### **Advantages and Issues of Consensual Bail-In**

Consensual bail-in raises some key issues that require careful consideration. Practicalities such as valuation, confidentiality, and access to and sharing of key data need to be worked through. Most of the same issues would arise during a resolution. Consideration should be given to any insider dealing issues and the duties of directors to creditors – uncertain in many legal systems against the backdrop of regulatory capital or liquidity shortfalls as opposed to insolvency. Existing shareholders may potentially need to buy back into the equity if the value of the institution means that this equity is effectively worthless and should be treated as wiped out. Such issues are, however, not insurmountable.

The consensual bail-in route has the advantage, however, of not being subject to the tight time constraints that a resolution imposes. As the financial institution remains a going

<sup>4</sup> For a discussion of the legal constraints to resolution under the BRRD see "Legal Constraints on resolution measures and the application of the bail-in tool under BRRD and SMR", Dr. Axel Kunde, Single Resolution Board, presented at the European Central Bank Conference held on September 1 and 2, 2015.

<sup>5</sup> The UK Banking Act 2009 provided for the resolution of a bank according to a special resolution regime that included (and still does) many of the same resolution options available under the BRRD such as transfer to a bridge bank. There was no explicit provision for bail-in.

concern at all times, certain disadvantages can be avoided, such as a bank run or any moratorium on activities that the entity may carry out (although the regulator may separately impose certain requirements if deemed necessary).

### **Conclusions**

Consensual bail-in is potentially more favorable than bail-in within resolution in terms of certainty of ownership rights. If the financial institution's creditors do not support a proposed conversion of their rights, litigation is likely to ensue. Further, any resolution which is based on the use of funds from a resolution fund is potentially subject to legal challenge through the European courts. Under European laws, advances from resolution funds constitute state aid. Resolution of a financial institution that is imposed on a non-consensual basis is therefore open to a multitude of lawsuits. For example, litigation resulted from the resolution action taken for Banco Espírito Santo (Portugal), SNS Reaal and SNS Bank (the Netherlands) and Hypo Alpe Adria/Heta (Austria).

National regulators and resolution authorities should consider whether the specific circumstances of a financial institution warrant the inclusion of a negotiated bail-in as a recovery option within the institution's recovery plan.<sup>6</sup>

### **Relevant Sources**

- UK Banking Act 2009
- UK Companies Act 2006, Part 26
- UK Financial Services and Markets Act 2000
- "Legal Constraints on resolution measures and the application of the bail-in tool under BRRD and SRMR", Dr. Axel Kunde, Single Resolution Board, presented at the European Central Bank Conference held on 1 and 2 September 2015

<sup>6</sup> This is anticipated by the BRRD through the early intervention rules, see BRRD, Article 27(1).

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Jens is responsible for finance and accounting issues related to the Financial Stability Company's (FSC's) main objective: resolution of weak financial institutions. Since joining FSC in 2009 he has been involved in the take-over and divestment of more than ten financial institutions. The main tasks are related to both conceptual and practical issues such as configuration of resolution plans for Danish financial institutions, set-up of the Resolution Fund, management of the Deposit and Guarantee Fund and divestment of previously acquired real estate and securities that are currently offered for sale. Jens additionally holds the group CFO responsibility and is thus responsible for safeguarding FSC's financial resources, group financial statements, asset and financial management of the Guarantee Fund and the Resolution Fund. Moreover, he is CEO of the FSC's main subsidiaries including Andelskassen JAK Slagelse under control.

Jens previously worked for eight years for the Danish Central Bank, holding various positions. In his last job, as Head of Government Debt Management, he worked mainly with risk management and funding strategies for the Danish Treasury. Jens worked as Financial Advisor at the OECD in Paris as from 2001 to 2003. Jens holds a master degree in Economics from the University of Aarhus.

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She served as a member of the SRM Regulation negotiating and drafting team during the 2014 Greek presidency of the Council of the European Union and she contributed to the preparation of policy notes and compromise texts for the political and technical trilogies between the Council, the European Parliament and the European Commission in the course of the negotiations. Triantafyllia has previously worked as an auditor and financial analyst. She studied Economics and Banking & Finance and is currently performing research in the area of banking.

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Maria began her professional career as a State Attorney, representing and defending the State in civil, criminal, contentious-administrative and labor cases. Until 2012 she was the Chief State Attorney for the Community of Valencia. In 2012 she was appointed as Deputy State Attorney in the Secretariat of State for Budgets and Expenditure at the Ministry of Finance and Public Administrations before moving on to work for the Fund for Orderly Bank Restructuring (FROB). Within these roles she was actively involved in the process of restructuring the Spanish banking sector, assisting in the design and implementation of the Settlement and Restructuring Plan for banking entities receiving public aid, as well as the formation and running of the Management Company for Assets Arising from the Banking Sector Reorganization (Sareb).

She was previously Chief Coordinator of Legal Aid Agreements entered into by the State Legal Office-Directorate for State Legal Services and the State-owned Industrial Holding Company (SEPI), and has held the position of Secretary and Advisor in several state-owned entities. Additionally, she has served as speaker for the Central Administrative Tribunal of Contractual Appeals and the Regional Economic-Administrative Tribunal of the Community of Valencia.

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Matthias studied Greek and Latin at the University of Amsterdam (BA cum laude), and obtained his Master degree in 2001. He became a teacher of classics, but subsequently obtained a Master degree in Law (cum laude) in 2003, also at the University of Amsterdam. He obtained his PhD at the University of Amsterdam in 2007 and was a visiting scholar at Université de Paris II (Panthéon-Assas), Harvard Law School and New York University School of Law.

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Prior to becoming State Secretary, from 2001 he covered international relations in the domain of the Finance Ministry. In 2009 he became Head of the International Finance Department. His main obligations included relations with international financial institutions, EU affairs under the competence of the Ministry of Finance and international development cooperation.

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Maria is the Director of Resolution Department which was established in March 2012. During the period, March 2012 to end December 2015, her role involved the oversight and management of the preparation process and due application of resolutions tools to 12 domestic credit institutions. With the transposition of BBRD in August 2015 and the entry into force of SRM in beginning of 2016, currently the Department is focusing on implementing the new framework, and particularly the drafting of resolution plans.

Since early 2015, she is a member of the Plenary Session of the SRB. Maria joined the Bank of Greece in 1984. Previous roles include in Financial Stability Department, focusing on the development of tools to efficiently monitor and assess financial stability issues, and in Financial Operations Department, as Deputy Head of the Risk Management Office, analyst and trader. During the Greek Presidency of the Council of European Union, she served as President of the Ad hoc Working Party on Single Resolution Mechanism (SRM) and was heavily involved in the negotiations on the SRM Regulation among the European Council, the European Parliament and the European Commission.

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