A proposal for a temporarily amended version of precautionary recapitalisation under the Single Resolution Mechanism Regulation involving the European Stability Mechanism

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A PROPOSAL
FOR A TEMPORARILY AMENDED VERSION OF PRECAUTIONARY
RECAPITALISATION UNDER THE SINGLE RESOLUTION MECHANISM
REGULATION INVOLVING THE EUROPEAN STABILITY MECHANISM

Christos Gortsos* – Michele Siri** – Marco Bodellini***

Table of contents

1. General overview
   1.1 The nature of the current Covid-19 crisis and its impact on credit institutions
   1.2 The difficulty to carry out privately funded bank recapitalisations and the need to develop alternative solutions also relying on public intervention

2. The creation of a precautionary recapitalisation standardised procedure based on the dual involvement of private investors and the European Stability Mechanism
   2.1. Introductory remarks
   2.2. Precautionary recapitalisation under the Single Resolution Mechanism Regulation
   2.3. The conditions requested for the proposed revised version of precautionary recapitalisation
   2.4. The provision of resources for the precautionary recapitalisation of credit institutions
      2.4.1. Introductory remarks
      2.4.2. Resort to the Direct Recapitalisation Instrument or an alternative European Stability Mechanism instrument
   2.5. The precautionary recapitalisation to be carried out by the European Stability Mechanism
   2.6. The position of the European Stability Mechanism as holder of contingent convertibles in possibly several credit institutions within the Banking Union

3. Concluding remarks

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Abstract

European credit institutions are expected to pile up a relevant amount of non-performing loans (NPLs) as a consequence of the crisis provoked by the Covid-19 pandemic. Against this backdrop, one of the most critical issues at stake is whether credit institutions currently hold an amount of capital which is sufficient to absorb the losses that they will likely experience in the forthcoming future. If this will not be the case, then they will have to undergo recapitalisations. In a context of global, generalised and prolonged economic crisis, nevertheless, it could turn out to be extremely challenging to find private investors able and willing to significantly invest in their equity. Therefore, a new solution capable to balance conflicting, yet legitimate, needs, such as credit institutions’ recapitalisation without recurring (again) to excessive and generalised public bail-outs, might have to be quickly found.

 Accordingly, because of the high bar set in the recent past by the Single Resolution Board (SRB) for the submission of failing or likely to fail (FOLF) credit institutions to resolution (unless a different interpretation of the public interest criterion in light of the current crisis is put forward), and with a view to avoiding credit institutions’ liquidation financed through public resources, what we propose hereby is a temporary, revised and standardised form of privately and publicly funded precautionary recapitalisation, designed beforehand and operating on an quasi-automatic basis. Thus, this paper advocates a temporary amendment of the so-called precautionary recapitalisation under the Single Resolution Mechanism Regulation (SRMR) with the major involvement of the European Stability Mechanism (ESM). Such proposal should, of course, build on the regime currently in place also in light of the European Commission’s (Commission) decision to temporarily suspend the application of the state aid prohibitions laid down in the Treaty on the Functioning of the European Union (TFEU).

Along with the European Central Bank (ECB), a major role in the process should also be played by the SRB and the ESM, with a view to keeping as much as possible the same level playing field within the Banking Union (BU). The final goal would be to strike a fair balance between the primary need to avoid the collapse of the whole banking system as a consequence of the Covid-19 crisis and the interest to discourage excessive moral hazard and unsound public policies.

Accordingly, for a limited period of time, we propose that some of the conditions currently required by the SRMR for the precautionary recapitalisation of credit institutions established in the BU should be amended in line with the recent measures adopted by the Commission to facilitate public intervention to support the economy. This should be combined with an ESM facility allowing it to buy hybrid instruments issued by the credit institutions that would need to be recapitalised. In this regard, the ESM could raise the resources needed by issuing senior bonds on the market to be then used to buy contingent convertibles (CoCos) with characteristics enabling them to be included in the credit institutions’ Common Equity Tier 1 (CET1) capital, as was the case in Greece in 2015, with a view to divesting as soon as the market conditions will allow it. Such an action, in turn, could be placed within a broader framework permitting the ESM to monitor the credit institutions’ activity against some targets designed to allow them, over time, to pay back the issued instruments.
1. General overview

1.1. The nature of the Covid-19 crisis and its impact on credit institutions

The economic dimension of the crisis provoked by the Covid-19 pandemic has been mostly caused by the lockdown and by the measures on containment and social distancing that several countries all over the world implemented.¹ Such measures, aimed at slowing down the spread of the virus, negatively affected both demand and supply of goods and services, with only few economic activities and sectors (e.g. e-commerce and internet services) benefiting from the new reality.² Yet, despite the fact that its root cause is on the real sector of the economy, the current crisis is expected to negatively affect, sooner or later, credit institutions as well.³ Due to the close and numerous interconnections between the banking system and the real economy it is, indeed, very likely that the former will be soon hit. Several enterprises struggling over the last months due to the impossibility to operate (or fully operate) because of the lockdown and the drastic drop in the demand for their services and goods have, indeed, already started defaulting on their credit lines. Similarly, many households, with members losing their jobs, will likely become unable to repay their mortgages and loans at the end of the support programs activated by the governments, once again transmitting their (in)solvency issues to the banking system. This situation, replicated on a large scale, may initially provoke many banking failures and then strike the entire system, potentially triggering a global financial crisis.⁴

Even though just before the outbreak of the pandemic crisis, the EU banking system was quite robust and, in accordance with the quarterly EBA Risk Dashboard of 14 April 2020,⁵ EU credit institutions’ capital ratios and asset quality have (on average) constantly improved, it is expected that these will indeed end up with plenty of NPLs (and even more broadly with non-performing exposures).⁶

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¹ Ringe, COVID-19 and European banks: no time for lawyers, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, 43.

² Hadjiemmanuil, European economic governance and the pandemic: Fiscal crisis management under a flawed policy process, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, 175.


⁴ Draghi, We face a war against coronavirus and must mobilise accordingly, Financial Times, 25 March 2020, where the former ECB President argues that the pandemic has already provoked a spiral of economic consequences that will inevitably lead to a serious recession, with the risk of it then ‘morphing into a prolonged depression, made deeper by a plethora of defaults leaving irreversible damage’.

⁵ Available at https://eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios. This dashboard covers data of the 4th quarter of 2019 and summarises the main risks and vulnerabilities in the EU banking system ahead of the crisis. According to Gortsos, The application of the EU banking resolution framework amidst the pandemic crisis, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, 367, even though the rate of NPLs during the last years has, on average, significantly decreased, mainly due to the introduction of the Council Action Plan of July 2017 on NPLs and the accommodating macroeconomic conditions, the existing stock of NPLs resulting from the global financial crisis or the subsequent fiscal crisis in the euro area still varies significantly among Member States.

In this regard, a further increase of NPLs is considered particularly threatening also in light of the fact that many credit institutions had not managed yet to write off and offload previously accumulated stocks of such ‘bad’ assets when the pandemic began.

Obviously, cleaning up their balance sheets in the current market conditions might prove extremely challenging.\(^7\) Nevertheless, despite such a negative scenario, the good news is that credit institutions are, on average, much more and better capitalised than they used to be during the 2007-2009 global financial crisis.\(^8\) Indeed, due to the legislative and regulatory initiatives adopted in the aftermath of that crisis with a view to making credit institutions stronger and more resilient, the latter have been requested to hold a much higher level of capital, mostly composed of more loss-absorbing items.\(^9\)

1.2. The difficulty to carry out privately funded bank recapitalisations and the need to develop alternative solutions also relying on public intervention

Against this background, the main question arising is thus whether such higher levels of capital currently held by credit institutions will be enough to absorb the losses that they might soon end up suffering.\(^10\)

\(^7\) The increase of NPLs in credit institutions’ balance sheets is closely observed by supervisory authorities; accordingly it has been reported that the ECB has been assessing the appropriateness to create a euro area-wide bad bank in charge to manage huge portfolios of NPLs; see Arnold – Espinoza, ECB pushes for Euro Zone bad bank to clean up soured loans, Financial Times, 19 April 2020.


\(^10\) Bodellini – Lintner, op. cit., 191, underline in this respect that there are two schools of thought: according to the first, credit institutions are well equipped to absorb the shock that will hit them and, as a consequence, should be left free to also distribute dividends and buy-back their own shares on the condition that authorities will clarify that there will be no publicly-funded bail-outs; according to the second, more prudent, school of thought, it is not yet possible to forecast whether the amount of credit institutions’ capital will be sufficient for those purposes and, therefore, dividends distribution and share buy-backs should be temporarily suspended, also stressing that public bail-outs cannot be ruled out, on the assumption that they might end up being the only effective way to avoid widespread failures in a new environment where States are increasingly expected to step in and bail enterprises out to enable the economic activity to carry on. For an estimation of
If the banking system were to succeed in absorbing such future losses, it would also manage to avoid a systemic crisis; if, by contrast, this were not to be the case, recapitalisations will be necessary to prevent the submission of many institutions to either resolution or liquidation. Yet, in a context where private investors (in turn individually hit by the crisis) might be unwilling and/or unable to subscribe to extensive increases of credit institutions’ capital, if such increases were to prove necessary, then the creation of a mechanism enabling to recapitalise credit institutions before they formally cross the line of ‘FOLF’, which also relies on public intervention, will be key to limiting spillover effects.

As well-known, at global level, public intervention in the form of bail-outs was the preferred rescue strategy for troubled banks and other categories of financial firms (especially those considered as ‘too-big-to-fail’) before, during and in the aftermath of the 2007-2009 global financial crisis, particularly after the bankruptcy of Lehman Brothers in September 2008. This was mostly due to the fact that back then authorities did not have at their disposal effective legal tools to successfully deal with troubled financial firms. The creation of legal frameworks based on the Financial Stability Board’s (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions has been one of the main responses across the globe to the crisis in the banking system.

Nevertheless, the promise, made after the global financial crisis, to never rescue again banks with public money may not be honoured in the current Covid-19 crisis, even though the will to end the ‘too-big-to-fail’ phenomenon and the implementation of the FSB’s Key Attributes are based on the assumption that taxpayers’ money should, in principle, no longer be used to rescue troubled credit institutions. Accordingly, in the European Union (EU) regulatory framework there are only a few rules enabling the injection of public money, yet on the premise that shareholders and creditors bear a minimum amount of losses.

This is the case of the Government Financial Stabilisation Tools (GFSTs) under Articles 56-58 of the Bank Recovery and Resolution Directive (BRRD), which may be provided to a credit

11 On the ‘dichotomy’ between resolution and liquidation under the EU resolution framework in force, see Lastra - Russo – Bodellini, Stock take of the SRB’s activities over the past years: What to improve and focus on?, Study Requested by the ECON committee of the European Parliament, Banking Union Scrutiny, Economic Governance Support Unit (EGOV), Directorate-General for Internal Policies of the Union, PE 634.392 - March 2019, 11.

12 The four conditions for a credit institution to be deemed as failing or likely to fail are laid down in the first sub-paragraph of Articles 32(4) Bank Recovery and Resolution Directive (BRRD) and 18(4) SRMR.

13 These concerns are discussed also by Morais, The EU fiscal response to the COVID-19 crisis and the Banking sector: risks and opportunities, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, 272.

14 Available at https://www.financialstabilityboard.org/2014/10/r_141015.

15 Ringe, op. cit., 48.

16 G20 Leaders’ Statement, Pittsburgh, 24-25 September 2009, no. 13; FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October 2014, Preamble.
institution (only) “in the very extraordinary situation of a systemic crisis”\textsuperscript{17},\textsuperscript{17} the Direct Recapitalisation Instrument (DRI) of the ESM and, most importantly the so-called precautionary recapitalisation to be performed outside resolution with regard to credit institutions that are not considered to be FOLF.\textsuperscript{18}

However, for the injection of public money to take place on a large scale, a legislative reform of the SRMR might be necessary. In this regard, it is worth noting that the Commission has already adopted a number of measures aimed at facilitating public intervention with a view to supporting private businesses struggling because of the crisis caused by the pandemic. On the one hand, it has enabled Member States to deviate from the State aid general prohibition and accordingly has permitted them to rescue failing firms;\textsuperscript{19} on the other hand, through its Communication of 20 March 2020, it has activated, for the first time ever, the so called ‘general escape clause’ of the Stability and Growth Pact (SGP),\textsuperscript{20} which allows the Council to derogate from some of the SGP’s prescriptions in the event of ‘a severe economic downturn in the euro area or in the Union as a whole’\textsuperscript{21} In so doing, the Commission, with the approval of the Council, managed to remove the main legal constraints reigning Member States from supporting their economies through the use of public money.\textsuperscript{22}

The argument in favour of facilitating some sort of public intervention also to the benefit of credit institutions finds specific support in the fact that the bail-in-centred approach to be taken in the context of a resolution procedure looks inappropriate to tackle the current crisis which, unlike the 2007-2009 global financial crisis, has not been caused by the banking system (and the financial

\textsuperscript{17} Article 37(10) BRRD. On these tools, see Gortsos, A poisonous (?) mix: Bail-out of credit institutions combined with bail-in of liabilities under the BRRD – The use of ‘government financial stabilisation tools’ (GFSTs), 2016, available at https://ssrn.com/abstract=2876508.

\textsuperscript{18} Gortsos, op. cit., 2020a, 371-381.

\textsuperscript{19} On 20 March 2020, the Commission adopted a Communication on a Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak (2020/C 91 I/01), OJ C 91 I, 20.3.2020, pp. 1-9. This Communication has already been amended on 3 April (OJ C 112I, 4.4.2020, pp. 1-9), on 8 May (OJ C 164, 13.5.2020, pp. 3-15) and on 2 July (OJ C 218, 2.7.2020, pp. 3-8). The initial Temporary Framework did not apply to the recapitalisation of enterprises with public funds. However, on 8 May, the Commission decided to extend its ambit in that direction. Accordingly, Member States are now entitled to notify recapitalisation schemes or individual aid measures; see European Commission, Communication from the Commission, Amendment to the Temporary Framework, 8 May, paras 44-45.

\textsuperscript{20} COM(2020) 123 final, available at https://ec.europa.eu/info/sites/info/files/economy-finance/2_en_act_part1_v3-adopted_text.pdf. The ‘general escape clause’ is laid down in Articles 5(1), 6(3), 9(1) and 10(3) of Council Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Council Regulation (EC) 1467/97 (both of 7 July 1997 and as in force), which constitute the two pillars of the SGP.


\textsuperscript{22} See Hadjiemmanuil, op. cit., 189. A list of the State aid measures already notified and approved since the eruption of the Covid-19 crisis is available on the Commission’s website; see European Commission, Coronavirus Outbreak - List of Member State Measures Approved under Article 107(2)b TFEU, under Article 107(3)b TFEU and under the Temporary State Aid Framework, available at https://ec.europa.eu/competition/state_aid/what_is_new/State_aid_decisions_TF_and_107_2_b_and_107_3_b.pdf.
system at large). It follows that it could be gauged utterly unfair to make shareholders and, even more so, creditors suffer losses, which they do not have responsibility for. As a consequence, the application of the bail-in tool to handle FOLF credit institutions in the current pandemic scenario might be inadequate. This argument is further reinvigorated by the consideration that the amount of available bail-inable instruments may, despite the consistent efforts of the SRB to the contrary, still be sub-optimal for many institutions. The application of this tool, therefore, could turn out to trigger widespread failures; this would happen if, e.g., enterprises’ bank deposits with a balance exceeding EUR 100,000 were to be bailed-in. Clearly, a similar resolution strategy would have severe pro-cyclical effects potentially able to endanger both economic and financial stability.

On this basis, it has been proposed to introduce in the legal framework a distinction between banking crises that result from risk-taking decisions made by credit institutions themselves, and those that have been provoked by external circumstances, such as the Covid-19 pandemic, and by the measures recommended by regulators to mitigate their effects. Accordingly, whilst the current rules should fully apply in the first case, by contrast, in the second case public intervention should be allowed. Despite its inner fairness, such a proposal might, nevertheless, turn out to be practically unfeasible, since the distinction between the two different situations triggering the application of opposite regimes might be regarded as arbitrary, thereby paving the way to litigation brought forward by those credit institutions which would not be allowed to benefit from public intervention. This is the reason why, by contrast, this paper supports an amended, temporary version of precautionary recapitalisation, which would also rely on the involvement of the ESM.

2. The creation of a precautionary recapitalisation standardised procedure based on the dual involvement of private investors and the European Stability Mechanism

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23 See Carstens, Countering Covid-19: The nature of central banks’ policy response, Opening remarks at the UBS High-level Discussion on the Economic and Monetary Policy Outlook, Zurich, 27 May, 2020, pp. 1-2, available at https://www.bis.org/speeches/sp200527.htm. According to Lehmann, Mothballing the economy and the effects on banks, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, 164, this is also motivated by the fact that “the state now places additional strain on the bank’s balance sheets. In order to achieve macroeconomic goals, regulators are actively interfering with commercial decision-making and risk-provisions by encouraging banks to spend more capital”. On the drawbacks arising from an excessively strict application of the bail-in tool, see Tröger, Regulatory influence on market conditions in the Banking Union: the cases of macro-prudential instruments and the bail-in tool, European Business Organisation Law Review, 2015, 16, 588; Bodellini, To Bail-In, or to Bail-Out, that is the Question, European Business Organization Law Review, 2018, 19, passim.

24 See Gortsos, op. cit., 2020a, 370-371, who consequently emphasises the risk that non-excluded deposits, i.e. deposits over EUR 100,000 per depositor per credit institution, could end up being written down or converted into capital.

25 Lehmann, op. cit., 165-166. It is noted that the second type of crises could be considered as systemic ones, triggering under the BRRD the application of the GFSTs. Apart from the fact that some Member States have not transposed the relevant Articles (56-58) into their national legislation (since that was under national discretion), their use during the pandemic crisis may be limited, because the contribution of the private sector through application of the ‘bail-in’ tool is a condition for resorting to them.

26 For a similar recent proposal and the principles that should apply, see Schularick - Steffen - Tröger, op. cit., 13-15.
2.1. Introductory remarks

Because of the high bar set in the recent past by the SRB for the submission of FOLF credit institutions to resolution (unless a different interpretation of the public interest criterion in light of the current crisis is put forward), and with a view to avoiding credit institutions’ liquidation financed through public resources, this paper proposes a temporary, revised and standardised form of privately and publicly funded precautionary recapitalisation, designed a priori and operating on a quasi-automatic basis. Indeed, since, as previously mentioned, credit institutions will likely need to recapitalise but, at the same time, private investors might be either unwilling and/or unable to sufficiently invest in their equity instruments, we advocate an amended version of the precautionary recapitalisation under the SRMR, based on the major involvement of the ESM, which should be kept in place until the crisis provoked by the pandemic will be over. Such a revised instrument should be available for every credit institution under the SRB’s remit whose resolution plan provides for resolution as the procedure to initiate in the event of the credit institution itself becoming FOLF. In such a case, it could be considered that it is the ECB in tandem with SRB which should be in charge of deciding which institutions are eligible to be precautionary recapitalised in accordance with the provisions of their resolution plans. Thus, the former could be the one ascertaining that the amended conditions for precautionary recapitalisation are met on a case by case basis, while the latter could be the one checking if the institution concerned is eligible to be precautionary recapitalised on the basis of its resolution plan.

Obviously such an approach would not entirely solve the issues that the banking system will soon face since the proposed instrument would not be available for the vast majority of credit institutions, even within the BU (i.e. all the non-significant credit institutions and those under the SRB’s remit whose resolution plan provides for liquidation in the event of them being FOLF).

2.2. Precautionary recapitalisation under the Single Resolution Mechanism Regulation

Currently, the SRMR (as well as the BRRD) enables the use of public money outside a resolution procedure and without the corresponding duty to bail-in at least 8% of the eligible liabilities through the so-called precautionary recapitalisation under Article 18(4). Pursuant to this provision, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support can take the form of a precautionary

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29 According to Lastra - Russo – Bodellini, op. cit., 18, within the EU legal framework there are misalignments, which create incentives to prefer liquidation – with the provision of taxpayers’ money – over resolution, thereby leading to solutions which can end up being inefficient from a system-wide perspective.

30 It is noted that, in accordance with the existing regulatory framework (Article 18(1), second sub-paragraph, second sentence SRMR), the SRB is allowed to make an assessment of the FOLF resolution criterion, albeit after accordingly informing the ECB and provided that the latter does not make such an assessment within three days of receipt of that information. Hence, no regulatory amendment would be required.

31 With regard to these banks, Bodellini, Alternative forms of deposit insurance and the quest for European harmonised deposit guarantee scheme-centred special administrative regimes to handle troubled banks, Uniform Law Review, 2020, 2-3, forthcoming, proposes a revision of the EU legislation to enable national deposit guarantee schemes to play a major role both at the early intervention stage and in the context of liquidation.

32 Article 18(4), first sub-paragraph, point (d) SRMR; see Micossi – Bruzzone – Cassella, Fine-Tuning the Use of Bail-in to Promote a Stronger EU Financial System, CESP Special Report No. 136, April 2016, 7, available at https://www.ceps.eu.
recapitalisation, prescribed as “an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution” where the latter is not FOLF.

Still, pursuant to this article, a number of conditions have to be met for a precautionary recapitalisation to be conducted. In particular, such measures: are confined to solvent institutions;\(^{33}\) are conditional on final approval under the EU State aid framework; are of a precautionary and temporary nature; must be proportionate to remedy the consequences of the serious disturbance; and cannot be used to offset losses that the credit institution has incurred or is likely to incur in the near future. Also, this form of recapitalisation is limited to injections necessary to address capital shortfall established in national, EU-wide or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, the European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority. Paraphrasing the words of Article 18(4) SRMR, the ECB has provided a definition of precautionary recapitalisation, under which it is described as “the injection of own funds into a solvent bank by the state when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure that is conditional on final approval under the EU State aid framework. It does not trigger the resolution of the bank”.\(^{34}\)

Accordingly, a precautionary recapitalisation can take place when a credit institution, although in need to be recapitalised, is not deemed to be FOLF. In this regard, the underlying assumption justifying public intervention is that the capital shortfall of such a credit institution could quickly deteriorate as a consequence of ‘a serious disturbance in the economy’ of a Member State and then potentially create financial instability.\(^{35}\) It is still uncertain whether precautionary recapitalisation, as currently regulated under the SRMR, could be a useful tool to face the crisis provoked by the pandemic. In this regard, it has already been indicated as “a strong candidate for the granting of public financial support” in the midst of the Covid-19 crisis.\(^{36}\) Yet, it has also been pointed out that it should not be used to the benefit of credit institutions that do not have “a sound business model simply to address legacy issues”.\(^{37}\) It has also been reported that both individual financial institutions and governments have been asking for a significant relaxation of the strict conditions to take benefit of State aid provision as well as of the SRMR rules.\(^{38}\)

Accordingly, the Commission has already made some steps into that direction through the Temporary Framework, which, as will be discussed in section 2.3, in relation to recapitalisations

\(^{33}\) With regard to precautionary recapitalisation, the ECB has defined a credit institution as solvent if it fulfils the minimum capital requirements (i.e. Pillar 1 requirements) as laid down in Article 92 of the Capital Requirements Regulation (CRR). In addition, the credit institution concerned should not have a shortfall under the baseline scenario or the relevant stress test; see European Central Bank, What is a precautionary recapitalization and how does it work?, 27 December 2016, available at https://www.bankingsupervision.europa.eu.

\(^{34}\) See European Central Bank, op. cit.; similarly, see Banca d’Italia, The ‘precautionary recapitalisation’ of Monte dei Paschi di Siena, available at https://www.bancaditalia.it.

\(^{35}\) See Bodellini, Greek and Italian ‘lessons’ on bank restructuring: is precautionary recapitalization the way forward?, Cambridge Yearbook of European Legal Studies, 2017, 19, 155.

\(^{36}\) See Gortsos, op. cit., 2020a, 377.

\(^{37}\) See König, Foreword, in Gortsos – Ringe (Eds.), Pandemic Crisis and Financial Stability, European Banking Institute, 2020, vi, who also states that she “would be extremely concerned at any attempt to turn it into a bail-out in disguise”.

\(^{38}\) See Ringe, op. cit., 48.
aimed at addressing issues provoked by the Covid-19 pandemic, allows for the application of the exception under point (45) of the Banking Communication of 2013. Such an exception is of particular significance, since it empowers the Commission to exclude the application of the burden sharing mechanism when this would endanger financial stability or lead to disproportionate results. Thus, despite the use of public resources to perform the recapitalisation, the burden sharing mechanism, affecting both shareholders and subordinated creditors, does not necessarily have to apply.

In any case, the main point to understand if precautionary recapitalisation could actually be a viable option to address the capital shortfall that credit institutions may soon experience relates to whether the authorities involved in the decisions will be willing to interpret the conditions requested for resorting to this tool (particularly the FOLF condition) in a flexible way with a view to accommodating the special needs resulting from the Covid-19 pandemic. This would mean that competent supervisory and resolution authorities might have to engage in what is defined as supervisory forbearance, thereby pretending that a FOLF institution is actually not FOLF and, as such, is eligible for a precautionary recapitalisation. To make it work, the same approach should also be taken with regard to the requirement concerning incurred and likely future losses. Obviously, such a line of action would have a number of side effects, starting with a potentially excessive degree of discretion, fully disconnected from law provisions, given to the authorities, as well as the implicit permission to use public money to the benefit of credit institutions that possibly were already in distress before the pandemic outbreak. This in turn could lead to the adoption of inefficient and inconsistent decisions across the borders. For these reasons such a strategy has already been strongly discouraged.


40 On this possibility in the past, Micossi – Bruzzone – Cassella, op. cit., 7, argued that “on the basis of these criteria, it is reasonable to expect that the prudential recapitalisation of a solvent bank, following a stress test, would not entail the risk of losses for junior creditors even where, due to general market conditions, there is a need for some temporary public support”; see also Hadjiemmanuil, Limits on State-Funded Bailouts in the EU Bank Resolution Regime, European Economy, 2016, 2, 91, arguing that the 2013 Banking Communication “is framed in terms sufficiently flexible for enabling the approval of almost every conceivable solution by way of “exception”. What must be doubted, however, is the actual willingness of the Commission to soften its stance. At present, all indications suggest that, even in the face of a simmering crisis with potentially highly detrimental consequences, such as that affecting the Italian banking sector, the Commission remains unperturbed and unwilling to budge. With the final entry into full effect of the BRRD’s provisions on burden-sharing on 1 January 2016, the Commission has found additional reasons for doing so”.

41 See European Commission, Communication from the Commission, Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 8 May, point 17 (replacing point 7 of the initial Temporary Framework).

42 See Gortsos, op. cit., 2020a, 384; differently, Morais, op. cit., 304, argues that the use of the precautionary recapitalisation tool requires a “new focus and, possibly, an overall review of the 2013 Banking Communication (in spite of some minor elements of increased flexibility that result from the articulation between this Communication and the new Commission Communication on the Temporary Framework for State Aid Measures to Support the Economy in the Current COVID-19 Outbreak”.

43 See Bodellini – Lintner, op. cit., 210-211.

44 See König, op. cit., vi-vii.

Electronic copy available at: https://ssrn.com/abstract=3688973
significant number of recapitalisations would very likely be performed with public money mostly in the Member States enjoying more fiscal capacity.\footnote{See Bodellini – Lintner, \textit{op. cit.}, 211.} By contrast, if this were not to be the case, other solutions would have to be explored.

\section*{2.3. The conditions requested for the proposed revised version of precautionary recapitalisation}

Building upon the framework currently in place, we hereby propose the amendment, for a limited period of time, namely until when the crisis provoked by the pandemic will be over, of some of the conditions laid down in Article 18(4) SRMR to make this tool available on a larger scale, irrespective of the fiscal capacity of the Member State where the credit institution which needs to be recapitalised is established. This section discusses the requested conditions to be met in the current context and advances the proposal for the revision of some of them to enable a more widespread use of such tool. In particular:

The first condition to be met is that precautionary recapitalisation should take place in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability. If this condition was considered to have been met in 2017 when Monte dei Paschi was precautionary recapitalised by the Italian Ministry of Finance, it can be assumed that it can also be met in the current situation in which the entire world is facing the most violent economic recession since World War 2.

The second condition to be met is that such a measure should only be employed with regard to solvent credit institutions. The SRMR provisions require both that the institution is not FOLF and that it is solvent.\footnote{It is noted, though, that the FOLF condition seems to be a broader category also including insolvency as defined by the ECB with specific regard to precautionary recapitalisation. See in this regard footnote no. 33.} Such requirements might soon become an issue. Indeed, depending on the amount of NPLs accumulated by credit institutions and due to the regulatory requirement to write them off, several institutions will likely end up being balance sheet insolvent, and thus FOLF, in the forthcoming future. To face this obstacle, there might be some alternative solutions to consider, \textit{i.e.}: first, a more lenient approach of supervisory authorities and regulators allowing credit institutions to phase-in, over a reasonably long period of time, the write off of NPLs; and second, a narrower application (just for the purposes of the proposed temporarily amended precautionary recapitalisation) of the concepts of insolvency and FOLF limited only to situations relating to institutions whose assets were already less than their liabilities before that recently accumulated stocks of NPLs will be written off.

In this regard, a practically feasible way to enable such a mechanism to work could be the introduction of a timeline (\textit{i.e.} the World Health Organisation’s (WHO) pandemic declaration on 11 March 2020). For the purposes of the proposed revised precautionary recapitalisation, only loans which have become non-performing due to repayment defaults occurred after the WHO declaration will be relevant. Accordingly, credit institutions which already had less assets than liabilities before 11 March 2020 will not be considered solvent, while the ones whose liabilities have exceed the assets as a consequence of their requalification as NPLs due to defaults occurred after the WHO declaration will keep on being considered solvent for the purposes of the proposed temporarily amended precautionary recapitalisation. Both solutions would in fact enable credit institutions to

\begin{footnotesize}
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\item See Bodellini – Lintner, \textit{op. cit.}, 211.
\item It is noted, though, that the FOLF condition seems to be a broader category also including insolvency as defined by the ECB with specific regard to precautionary recapitalisation. See in this regard footnote no. 33.
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continue being considered solvent, hence not FOLF, and therefore potentially eligible for precautionary recapitalisation.\footnote{Bodellini – Lintner, op. cit., 211, similarly proposed to relax, on a temporary basis, the conditions requested for the application of precautionary recapitalisation and accordingly suggested that Articles 32(4) BRRD and 18(4) SRMR could be redrafted with a view to narrowing down the applicable FOLF condition by restricting its scope only to situations where the credit institution’s assets are already less than its liabilities. Although the risk to end up helping credit institutions that were already in distress before the pandemic outbreak would not be removed, the advantage could be to more clearly guide the authorities decision-making process, thereby limiting the excessive amount of discretion that supervisory forbearance, fully disconnected from law provisions, would bring about.}

The third condition to be met is that the measure must be of a precautionary and temporary nature. There should not be any specific issue with regard to the precautionary nature of the measure as far as it is put in place in advance to actually prevent credit institutions’ insolvency (and the FOLF condition), which can in turn create (further) financial instability. The temporary nature of the measure, by contrast, might turn out to be more problematic on the basis of the experience gained from the Monte dei Paschi case, in which the Italian Ministry of Finance, more than 3 years after the recapitalisation, has not been able to divest yet. Obviously, the issue relates to the exit strategy of the public entity recapitalising the credit institution and, hence, some effective mechanism enabling the former to divest must be developed, as further discussed in section 2.4 below.

The fourth condition to be met is that the intervention needs to be approved by the Commission according to the State aid framework. In this regard, as previously mentioned, the Commission has adopted a ‘Temporary Framework for State aid measures to support the economy in the current Covid-19 outbreak’, which also deals with precautionary recapitalisation. According to this framework, as in force, if due to the Covid-19 outbreak credit institutions would need extraordinary public financial support in the form of liquidity, recapitalisation or impaired asset measure, it would have to be assessed whether the measure meets the conditions of Article 18(4), first subparagraph point (d)(i), (ii) or (iii) SRMR. If these conditions were to be fulfilled, the credit institution receiving such extraordinary public financial support would not be deemed to be FOLF.\footnote{See European Commission, Communication from the Commission, Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 8 May 2020, op. cit., para 7, first and second sentences, which read as follows: “\textit{If due to the COVID-19 outbreak, credit institutions would need direct support (...) in the form of liquidity, recapitalisation or impaired asset measure, it will have to be assessed whether the measure meets the conditions of Article 32(4), point (d) (i), (ii) or (iii) BRRD. Where the latter conditions were to be fulfilled, the credit institution receiving such direct support would not be deemed to be failing-or-likely-to-fail.”} Also, to the extent that such measures were to address problems linked to the Covid-19 outbreak, they would be deemed to fall under point (45) of the 2013 Banking Communication, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors.\footnote{Id., para 7, third sentence which reads as follows: “To the extent such measures address problems linked to the COVID-19 outbreak, they would be deemed to fall under point 45 of the 2013 Banking Communication, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors”.}

The Temporary Framework, therefore, potentially paves the way for widespread precautionary recapitalisations to be conducted through the injection of public money in light of the fact that, in this way, the authorities would be empowered to exempt both shareholders and subordinated creditors.
creditors from the application of the burden-sharing requirement when the need for such a measure arises from the situation provoked by the Covid-19 pandemic.\textsuperscript{50}

The fifth condition to be met is that the measure should be proportionate to remedy the consequences of the serious disturbance. This requirement should not hinder the application of the measure in question, although the determination of what is proportionate and, therefore, of the amount of the capital increase, requires a discretionary assessment to be made by the involved authorities, \textit{i.e.} the ECB and the SRB with the agreement of the ESM since the latter, according to the proposal, is supposed to provide the credit institutions concerned with (at least some of) the necessary resources for the recapitalisation.

The sixth condition to be met is that the measure should not be used to offset losses that the institution has incurred or is likely to incur in the near future. This requirement might represent an issue since the proposal conceives the amended precautionary recapitalisation tool as the instrument to prevent the bank from becoming FOLF and insolvent as a consequence of the Covid-19 provoked crisis. As previously discussed, the impact of such crisis on credit institutions will cause a significant increase of NPLs that, at some point, will have to be accounted and subsequently written off, thereby leading the institutions to record losses. Whether it can be argued that these losses are not previous losses already incurred by the institution to recapitalise, it seems more difficult to claim that they are not to be considered as losses that the institution ‘is likely to incur in the near future’, according to the language of Article 18(4) SRMR.

As a consequence, in order to make the proposal operational, this requirement should be either temporarily removed or reformulated with a view to excluding from its scope losses resulting from the Covid-19 provoked crisis. A possible reformulation of this requirement could be based on the same time-line previously discussed. In other words, losses arising from loans which have become NPLs due to repayment defaults occurred after the WHO declaration on 11 March 2020 would not be considered likely future losses relevant to rule out the application of such tool.

Finally, the seventh condition to be met is that the capital increase should be limited to injections needed to address capital shortfall resulting from stress tests and asset quality reviews. In this regard, even though the EBA has decided that stress tests will be suspended until 2021,\textsuperscript{51} credit institutions should be encouraged to undergo a recapitalisation to promptly react to their borrowers’ inability to pay back their outstanding loans and credit lines. Therefore, a standardised, yet case-by-case, assessment of capital shortfall could be performed by supervisory authorities, as an alternative to system-wide stress tests, with a view to determining the amount of losses to cover.\textsuperscript{52}

\subsection*{2.4. The provision of resources for the precautionary recapitalisation of credit institutions}

\textsuperscript{50} See Bodellini – Lintner, \textit{op. cit.}, 209.

\textsuperscript{51} On 12 March, the EBA decided to postpone the 2020 EU-wide stress test exercise to 2021; see European Banking Authority, EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector, available at \url{https://eba.europa.eu/sites/default/documents/files/document_library/General\%20Pages/Coronavirus/EBA\%20Statement\%20on\%20Coronavirus.pdf}.

\textsuperscript{52} The ECB is, indeed, conducting ‘vulnerability analyses’ of the credit institutions which it directly supervises within the SSM. The results of the analysis concluded on 28 July, show capability to withstand the pandemic-induced stress; see at \url{https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm_pr200728--7df9502348.en.html}.
2.4.1. Introductory remarks

Assuming that the conditions for applying precautionary recapitalisation will be temporarily relaxed through an amendment of the SRMR, as proposed, an issue still remains. Notoriously, the fiscal capacity of Member States is different, with some having room for manoeuvre for further public expenses and others already overburdened with extremely high levels of public debt and therefore with little possibilities to rescue troubled credit institutions. This situation, which obviously does not only characterise the EU, might be particularly disruptive within the (still incomplete) BU, thereby threatening the same level playing field between credit institutions established in different countries. Indeed, if every Member State were to be left free to intervene with no limitation and with no centralised mechanism in place, then only credit institutions established in the fiscally strongest countries would be publicly recapitalised, with the ones established in the fiscally weakest countries likely to be left in trouble. If this were to happen, the BU as such would potentially collapse and probably only credit institutions established in the fiscally strongest countries would survive, possibly also taking over the good parts of the ones established in the fiscally weakest countries. To avoid such an outcome and considering that limitations to public intervention have just been correctly relaxed by the Commission, a tool centralised at supranational level should be developed to recapitalise credit institutions in need within the BU.

The most appropriate candidate to play such a function would be the ESM; this is even more so due to the well-known reluctance of euro area Member States to request credit lines under the ‘Pandemic Crisis Support’ instrument. This new temporary instrument was made operational by the ESM Board of Governors (the ESM’s highest decision-making body composed of the euro area finance ministers) on 15 May 2020 as a response to the Covid-19 pandemic to enable investments in the health sector and is based on the existing Enhanced Conditions Credit Line (ECCL).

Accordingly, in order for these resources to be fruitfully utilised to the benefit of Member States that do not actually feel comfortable in asking for a credit line under the new facility, the ESM could be the supranational player providing resources to precautionary recapitalise credit institutions within the BU that need an increase of capital.

Yet, since the role of the ESM is confined to Member States whose currency is the euro, the proposal is limited to credit institutions operating in the euro area, even though its centralised implementation at EU level and availability to every credit institution established in the EU Member States would potentially be even more effective to protect the EU single market. In

53 This issue is also emphasised by Hadjiemmanuil, op. cit., 2020, 181.
54 See Bodellini – Lintner, op. cit., 205-206.
55 See also Schularick - Steffen - Tröger, op. cit., 15-16, who correctly consider that the ESM is the only European institution with substantial financial firepower.
56 Article 5 of ESM Treaty.
57 See European Stability Mechanism, ESM Pandemic Crisis Support, Explainer, Timeline and Documents, available at https://www.esm.europa.eu/content/europe-response-corona-crisis; the main legal basis is article 14 ESM Treaty. On this instrument, see Hadjiemmanuil, op. cit., 2020, 198-206. On the financial assistance instruments of the ESM provided for in Articles 14-18 ESM Treaty, see Forsthoff - Aerts, Financial Assistance to Euro Area Members (EFSF and ESM), in Amtenbrink – Hermann (Eds.), The EU Law of Economic and Monetary Union, 2020, 984-994.
addition, there would be a fragmentation even within the BU, since upon joining the SSM and the SRM later this year, Bulgaria and Croatia will not be signatories to the ESM Treaty.

2.4.2. Resort to the Direct Recapitalisation Instrument or an alternative European Stability Mechanism instrument

The direct recapitalisation instrument (DRI) of the ESM has been operational since 8 December 2014 and is governed by the Guideline of the ESM Board of Directors “on Financial Assistance for the Direct Recapitalisation of Institutions” (DRI Guideline). It is available to euro area credit institutions, which are of ‘systemic relevance’ or pose a serious threat to financial stability, but cannot be used for the purpose of precautionary recapitalisation. It is only provided if the beneficiary credit institution is (or is likely in the near future to be) in breach of the capital requirements established by the ECB within the SSM; it is unable to attract sufficient capital from private sector sources to resolve its capital shortfall; and the contribution of the private sector by application of the ‘bail-in’ tool is not expected to address the capital shortfall fully. The contribution of the requesting ESM Member to the recapitalisation operation is determined by a burden-sharing scheme.

The conditionality attached is detailed in a Memorandum of Understanding (MoU), in accordance with Article 13(3) ESM Treaty, addressing both the sources of difficulties in the financial sector and, where appropriate, the overall economic situation of the requesting ESM Member.


59 The consolidated version of this Treaty, signed on 2 February 2012, is available at https://www.esm.europa.eu/legal-documents/esm-treaty. According to Article 44 (first sentence), the Treaty is open for accession by other Member States upon application for membership, in accordance with Article 2, filed with the ESM only after the adoption by the Council of the European Union of the decision to abrogate its derogation from adopting the euro in accordance with Article 140(2) TFEU (see also recital (7)).


62 Systemic relevance can refer to either systemically important institutions falling into the main criteria laid down in the Guideline, or to other institutions, not necessarily cross-border, whose insolvency could have a significant negative impact on the financial system because of adverse market circumstances or financial stress.

63 Article 8(1) of DRI Guideline.

64 Article 3(1) of DRI Guideline; the conditions laid down in Article 8(3) for the application of ‘bail-in’ are identical to those laid down in the BRRD (Articles 43-62).

65 Article 9 of DRI Guideline.

66 Article 4 of DRI Guideline.
principle, it must be conducted against the acquisition of common shares satisfying the requirements laid down in Articles 28-29 CRR on CET1 instruments.\textsuperscript{67}

In view of these strict conditions attached and, in particular, of the fact that bail-in is a prerequisite, this instrument has never been used since its introduction.\textsuperscript{68} Nevertheless, its activation might be important in the context of supporting the involvement of the ESM according to the proposal advanced in this paper. In such a case, the requirements for its application, albeit within the limitations set by Article 15 ESM Treaty, could potentially be adjusted accordingly by means of the review clause laid down in Article 15(1) of the DRI Guideline.\textsuperscript{69} Alternatively, the creation by the Governing Board of a new \textit{ad hoc} facility could be envisaged, in accordance with a (prompt) procedure similar to that followed for the creation of the above-mentioned Pandemic Crisis Support instrument.\textsuperscript{70}

2.5. The precautionary recapitalisation to be carried out by the European Stability Mechanism

The ESM could perform the above-mentioned task through raising resources by issuing senior bonds on the market in accordance with Article 21 ESM Treaty, also satisfying, in this way, the investment needs of those households and businesses that, paradoxically, during the lockdown have seen their stock of savings significantly increase mostly due to the impossibility to spend. The resources raised on the market could be then used to buy CoCos issued by credit institutions in need. Such CoCos should have a set of contractual clauses allowing them to be included, for regulatory purposes, within the CET1 of the institutions concerned, as happened in 2015 in Greece with regard to the precautionary recapitalisation of Piraeus Bank and National Bank of Greece.\textsuperscript{71} CoCos are expected to permit the ESM to more easily exit from its investments in the investee institutions when this will be possible.

Against this background, and with a view to limiting the resources that the ESM is meant to disburse to recapitalise credit institutions, a publicly supported mechanism to manage NPLs

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\textsuperscript{67} Article 10 of DRI Guideline.

\textsuperscript{68} See at https://www.esm.europa.eu/assistance/lending-toolkit.

\textsuperscript{69} There is no doubt that the condition laid down in this clause for the review of the Guideline by the Board of Directors, at least every two years, to assess whether changes are required in light of developments related to the establishment of the BU is fully met under the current conditions.

\textsuperscript{70} The legal basis nevertheless in such a case would not be Article 14 but rather Article 15 ESM Treaty. It is also noted that, in accordance with Article 19, the Board of Governors may review the list of financial assistance instruments provided for in Articles 14-18 and decide to make changes to it.

\textsuperscript{71} For details on the precautionary recapitalisation of both Piraeus Bank and National Bank of Greece, see Bodellini, op. cit., 2017, 157-159. On the conditions governing the CoCos issued by the two Greek credit institutions and held by the Hellenic Financial Stability Fund, which was set up in 2010 with the exclusive task to provide financial support to the Greek banking system, amidst the fiscal crisis that had just erupted, through funds provided by the European Financial Stability Facility (the predecessor of the ESM), see also European Commission, State aid: Commission approves aid for Piraeus Bank on the basis of an amended restructuring plan, Press Release IP/15/6193, 29 November 2015, https://ec.europa.eu/commission/presscorner/detail/en/IP_15_6193; and European Commission, State Aid SA.43365 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece, C(2015) 8930 final, 4 December 2015, https://ec.europa.eu/competition/state_aid/cases/261565/261565_1733770_121_2.pdf.
centralised at European level and with a long-term view, thus hopefully less loss-making, should potentially, albeit under strict conditions addressing the inherent moral hazard problems, be developed as well.\textsuperscript{72}

Still another problem has to be considered. Since, according to this proposal, the ESM would issue senior bonds and use the proceeds to buy CoCos, a refinancing issue might arise when the ESM senior bonds would expire and the bondholders would have to be reimbursed. A way to face this potential financing mismatch could be by issuing bonds \textit{cum} warrants, \textit{i.e.} senior bonds providing their holders with the call option to buy, at pre-determined conditions, CoCos previously purchased by the ESM. A further alternative could be to enable ESM bondholders to convert CoCos in ordinary shares of the credit institution after a given timeframe. Obviously both these possibilities would work on a voluntary basis and, if bondholders were not to have the risk appetite to buy CoCos or convert their senior bonds into shares, the ESM should still be able to refinance its investments by issuing new bonds at the expiration of the previous ones.

2.6. The position of the European Stability Mechanism as holder of contingent convertibles in possibly several credit institutions within the Banking Union

The role of the ESM as holder of CoCos in potentially several credit institutions within the BU should be to monitor the investee institutions’ senior management and board of directors and to provide them with some targets to meet. Obviously, such targets should be designed in such a way to encourage credit institutions to make efforts to become able to pay back the money invested by the ESM. Some penalising mechanisms to put in place in the event such targets are not met should also be developed. An example could be the prohibition of distributing dividends, buying back the credit institution’s own shares and paying out bonuses and variable remunerations to senior management and material risk-takers for a given period of time and in any event until when the institution becomes able to repay the ESM’s investment.\textsuperscript{73}

The involvement of the ESM as an investor should in turn also encourage private investors to buy equity instruments of the investee credit institutions on the grounds that an institutional player is closely overseeing their operations. On top of this, a widespread presence of the ESM in the (regulatory) capital of several credit institutions in the BU, although without strong and formal prerogatives, could pave the way for a cross-border consolidation of the sector also through ‘Europeanising’ the culture and the mentality of the investee credit institutions’ senior management and board of directors.

\textsuperscript{72} On the discussions to create a euro area-wide bad bank, see footnote no. 7.

3. Concluding remarks

In light of the fact that credit institutions might soon have to undergo significant recapitalisations to react to the crisis provoked by the Covid-19 pandemic, this paper has advanced the proposal for a temporary amended version of the precautionary recapitalisation under the SRMR based on the major involvement of the ESM. Such proposal builds on the regime currently in place and is conceptually aligned with the new Commission’s temporary Framework.

Along with the ECB, a major role in the process is to be played by the SRB and the ESM, with a view to keeping as much as possible the same level playing field within the BU. The final goal is to strike a fair balance between the primary need to avoid the collapse of the whole banking system as a consequence of the Covid-19 crisis and the interest to discourage excessive moral hazard and unsound public policies.

Accordingly, for a limited period of time the conditions for the precautionary recapitalisation should be relaxed and a new ESM facility (or a revision of the DRI) allowing it to buy hybrid instruments issued by the credit institutions that would need to be recapitalised should be developed. In this regard, the ESM could raise the resources needed by issuing senior bonds on the market to be then used to buy CoCos with characteristics enabling them to be included in the credit institutions’ CET1 with a view to divesting as soon as the market conditions will allow it.
The European academic joint venture for research in banking regulation