Recovery and Resolution of Credit Institutions – Crisis Resolution tools in the EU

By Dimitris Tsibanoulis

Offprint from

RDBF (Issue 2013_1, pages 11-19)

Revista de drept bancar si financiar

Revue du Droit Bancaire et Financier

Editura Hamangiu

2013

Dr. Dimitris Tsibanoulis*)

Recovery and Resolution of Credit Institutions - Crisis Resolution tools in the EU

1. Abstract

Europe and the Eurozone are experiencing a deep crisis and the need for structural reforms of the EU banking sector is subject to political and academic debate. Financial integration in Europe had progressed significantly in the years prior to the financial crisis, albeit mainly in the wholesale markets. The realization of a single European Market and the removal of remaining barriers for its completion had formed the primary tasks of the integration process put up by the Financial Services Action Plan in the end of the last century. However, the international financial crisis has placed a sharp halt to the financial integration process and created a harsh fragmentation in the single financial market. The threat of such segmentation is particularly pertinent to the banking sector. There is a risk of re-emergence of the pre-monetary union home bias in banking, which may lead to retrenchment of banks as activities confined within the national borders. The crisis has shown that, while there are clear benefits arising from financial integration, which also poses financial stability risks in the absence of strong governance and institutional frameworks. The financial crisis has also adversely affected the net wealth of European households, reflecting a combination of higher unemployment, low or stagnant wage growth, recession and poverty.

Given the severity of the crisis, one may have expected a rapid restructuring of the banking sector, including a reduction in the capacity and the exit from the market of the weakest banks. However, the restructuring of the entire EU banking sector has so far progressed in a painfully slow pace.

The Eurozone's financial crisis led to a unique and unprecedented fragmentation of the single European financial services market. Banks refocus on the needs of domestic market, where business opportunities are limited by definition. The new reality poses a serious impediment to the recovery and return to growth of the distressed Eurozone economies.

The ongoing bank restructuring and bank recapitalisation reforms are very important steps in tackling the financial and sovereign debt crisis in Europe. Implementation of the Bank Recovery and Resolution proposal would enhance the likelihood for banks to be wound down in an orderly fashion without any impact on other market participants. Recovery and resolution plans will indicate specific problems in the resolution of a bank – deriving from a bank's structure or from other elements. The reform objective is to create a safer, sounder, more transparent and more responsible financial system, operating for the cohesion of the economy and society as a whole, and capable of financing the real economy, as it forms an indispensable precondition for sustainable growth.

The new bank recapitalisation scheme, as announced in the Euro area's Summit of June 29 has to be realized through European direct investments, in order to break the vicious circle between banks and sovereigns. A banking union and a pan-European Deposit Guarantee Scheme are further requirements towards the establishment of a genuine economic and monetary union. Such innovations are core precondition for the restoration of level playing field in the European financial services market and, consequently, for the healthy development of the banking sector so that it would be able to finance the real economy. Bank recapitalisation could chop the two most threatening heads of the Lernaean Hydra: the sovereign debt/banking crisis and the recession spiral. Bank recapitalization would pave the way for realistic growth conditions which constitute a genuine prerequisite for the implementation of the Eurozone recovery plans, not just in the periphery, but in the entire euro area, as well.

2. Banking law, prudential supervision and credit institutions' resolution

2.1. EU banking sector regulation

Adequate bank lending capacity is an indispensable precondition for sustainable economic growth. Banks have a pivotal role in providing finance to firms and households. This is particularly the case in Europe where the share of banks in financing companies and households has traditionally been relatively large compared to capital market financing. Banks' role in corporate finance is vital, especially for small-and-medium sized enterprises. The creation of a safer, sounder, more balanced, transparent, accountable and responsible financial system, operating for the cohesion of the economy and society as a whole and capable to finance the real economy is a vital precondition for recovery and sustainable growth. Making banks more resilient while reducing the impact of a potential bank failure are important steps for this endeavor.

*) AEDBF Chairman, Managing Partner Tsibanoulis & Partners Law Firm, Athens.

The banking sector was and is one of the most tightly regulated of all business activities in all EU Member States. In order to protect the general interest (financial stability, depositors protection etc), each EU-member imposed prudential rules and other provisions restricting the exercise of the banking activity. Legislators have developed systems of control on banking activity designed to protect the depositors and consumers of banking services, to maintain stability within the economic and monetary framework of the country concerned and to ensure that banks are properly accountable.

In order to cope with the particularities of such provisions and to enable free establishment of credit institutions and unhindered provision of services by such institutions within the EU, the Banking Directives introduced a minimum harmonised set of rules concerning credit institutions and the European Single Passport became a reality about 20 years ago. The approach adopted was to achieve sufficient harmonisation to secure mutual recognition of authorisations and prudential supervision systems, making possible the granting of a single licence and application of the principle of home Member State prudential supervision. The Banking Directives established a prohibition for undertakings other than credit institutions from carrying on the business of taking deposits or other repayable funds from the public.

To ensure that all credit institutions in the EU do not pose under non-acceptable risk, the stability of the financial system and the savings of their depositors as well as that they can compete on an equal footing, a set of supervisory measures and rules have been adopted, through Directives, harmonising EU members banking legislation, imposing common rules relating to the taking up and pursuit of the business of credit institutions. Banks were licensed in order to ensure their fit and proper management, their sound organisation and structure and continuous supervision of the banks during their operation, so as to safeguard the smooth functioning of the bank, necessary for a healthy banking system.

Subject of such rules were *inter alia*:

- The fit and proper management of credit institutions.
- The organisational and infrastructure requirements of a credit institution, entailing internal controls measures for risk management.
- The capital adequacy principle, based on the concept of minimum adequate „own funds", minimum capital requirements, solvency ratio and the limitation of large exposures incurred by credit institutions: Credit institutions' internal capital should be adequate in quantity, quality and distribution, having regard to the risks to which they are or may be exposed and should have strategies and processes in place for assessing and maintaining the adequacy of their internal capital.
- The effective supervision of credit institutions on a consolidated basis. Competent authorities have responsibility to be satisfied that credit institutions have good organisation and adequate own funds.

Such restrictions are in compliance with the fundamental rights and principles of Community law, being part of the public policy principle and being considered as proportionate to the general goods which were protected by these rules.

2.2. Credit institutions authorisation's revocation

Banking Directives principles are based on the perception that Member State supervisory authorities should not grant or should withdraw an authorization where the prerequisites for granting such a license were not satisfied or where factors occurred equivalent to the absence of such prerequisites.

The Banking Directives do not handle issues like liquidation procedures in a wound up credit institution, satisfaction of depositors and consequences of the revocation of a credit institution authorisation for the smooth functioning of the financial system, especially in respect of its stability; instead, Directives leave upon the jurisdiction of the home Member State the ruling of the liquidation or the regulation of potential reorganisation measures to be adopted by the administrative or judicial authorities of the home Member State and the potential measures to be adopted by persons or bodies appointed by those authorities to administer those reorganisation measures, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims and any other measure which could affect third parties' existing rights. The only prerequisite imposed by the Winding Up Directive is that such measures should be effective in all Member States.

2.3. Prosperity or necessity of institutionalization of a specific European credit institutions' resolution regime

The banking sector plays a special role in the economy and has critical functions which are essential for economic activity to take place. Banks collect funds (deposits and other forms of debt) from private persons and businesses. They carry out maturity transformation and provide loans for households and businesses allowing savings to be allocated most importantly to investments. They also manage payment transactions that are crucial for all sectors of the economy and society. The banking business is founded upon the trust of stakeholders. Banks' most important capital is the reputation i.e. the confidence of others in it. If confidence is lost depositors and other debtors immediately try to withdraw their funds (bank run). This would make the bank unavoidably bankrupt, since no bank holds sufficient liquid assets to cover all short term liabilities.

The impact of a massive banks' insolvency on other market participants and on the society can be detrimental. The crisis affected households' capacity to service existing loans and their ability to continue or increase such borrowing. The number of people running into debt problems has risen. The result is: no functioning of the real economy.

Bank failures are capable of undermining financial stability, especially if they lead to loss of depositor confidence in other banks. During the last international financial crisis, it became clear that there was no simple way for a bank to continue to provide essential banking functions whilst in insolvency, and in the case of a failure of a large bank, those functions could not be simply shut down or substituted without significant systemic damage. Larger or more interconnected banks may actually create systemic risk throughout the financial system of a country. Apart from the size, the financial connections with other financial institutions are also important.

A general bank crash constitutes a major problem in the society as well as the domestic and European economy. Contagion and domino effects are the regulators' and supervisors' nightmare. The failure of some credit institutions could cause other credit institutions to fail and ultimately, cause wider damage to the financial system. The turmoil created after the failure of the Lehman Brothers, which the US Government decided not to save, demonstrated the materialization of this risk. If a financial institution fails other banks that provide funds to it would not get access to those funds. This would cause liquidity problems for them that would make these banks vulnerable too. If their debtors and depositors consider that it is better to withdraw funds from these vulnerable banks then a domino effect could take place. This could cause liquidity and ultimately solvency problems to a significant part of the financial sector. Capital markets may also experience shocks and the payment systems be disrupted.

Furthermore, banking and sovereign debt crisis highlighted one other dimension of the issue: Insolvency, even for a small, non-systemic bank, can generate loss of confidence throughout the banking system of a country and cause panic and bank run if the crisis links with doubt for the viability of public debt and fear of the enforcement of measures that would affect the depositors of the country, such as taxation of depositors, expropriation (levy) of deposits, etc.

A general bank crash would create social troubles, because the depositors would lose their funds. No Depositor Guarantee Scheme in the world is in the position to compensate the depositors in case of a massive banks' insolvency, except in the case of state aid. It is well known that the insolvency of several banks in a country creates the need for public support, as no Deposit Guarantee Scheme in the world is able to deal with generalized crisis of the national banking system. Since Deposit Guarantee Schemes are organized at national level, the possible collapse of not only too big or systemic, but also of numerous banks in a country entail the need of public support to avoid systemic instability and problems affecting other institutions (contagion). And in case the State does not have the financial means, such state aid is not feasible so as to finance the banking system. Therefore, state subsidy to the banking system [implicit or direct] has been used in the last financial crisis to rescue the banking system from a systemic crash.

In the crisis many banks were affected and the crisis became systemic. In the UK a number of mid and large banks suffered losses and needed help; all major banks in Belgium (KBC, Fortis, Dexia) faced problems; in Ireland government support for banks amounted to more than 30% of GDP etc.); in Greece, especially after the haircut of the Greek Government Bonds, in which Greek banks had made a lot of investment, the need for recapitalization of banks with total assets of €50 billion was necessary. The issue of banks' recapitalization has been also raised imperatively in Spain, Portugal and Cyprus.

Rescuing banks with public funds (bail-out) helped to avert what could have been economic depression on a scale not seen for many decades, but it has also created a number of medium to long-term problems that are becoming increasingly apparent. That is, increased burden on public finances (increased public debt) and increased downturn in the states, due to austerity measures that these had to be enforced.

Between October 2008 and October 2010, the European Commission has approved €3.6 trillion (equivalent to 31% of EU's GDP) of State aid measures to financial institutions, of which €1.2 trillion has been effectively used (of which €409 billion was used for capital injections and asset relief programs). Budgetary commitments and expenditures in this range are not sustainable from a fiscal point of view, and impose heavy burden on the present and future generations. Moreover, the crisis which started in the financial sector plunged the EU economy in a severe recession, with the EU GDP contracting by 4.2% or €0.7 trillion in 2009.

3. Special insolvency and recovery framework of credit institutions

3.1. Inappropriateness of common insolvency proceedings for credit institutions

The general legal framework for insolvency is not appropriate for banks. The main role of winding up or liquidation proceedings is to distribute assets from the insolvent debtor's estate to satisfy the claims of its creditors. Dealing with insolvency proceedings is time-consuming and the insolvency administrator seeks to increase the price of the assets of the insolvent entity to the greatest possible amount for the benefit of the creditors. In case of a credit institution, the purpose of the liquidator or insolvency administrator, under conventional rules of bankruptcy procedure, would be the rapid and at the highest possible price sell of the assets for the best possible satisfaction of its creditors, without taking into account issues of public interest and protection of the stability of the financial system of the country. These latter factors could take the form of application to save the bank as a going concern.

The conventional rules of bankruptcy ignore the importance of maintaining the value of the banks' assets in the case the bank was still operating, but also the effect on the stance of depositors when the confidence regarding the prospect of the continued operation of a bank is undermined. Depositors want to have continuing access to their deposits and if there is suspicion that the safety of their deposits in a bank is endangered because this may be proved to be insolvent, they may run to withdraw them.

In support of the above rationale it is in many cases preferred, from a public interest standpoint, – and ultimately it may possibly be proved more inexpensive for the state - to endeavour a bank restructuring en route for a going concern function so as to avert insolvency.

The most important aim intended for the resolution of a credit institution is to preserve economic consistency and curtail any cost of the general public, especially for those who are liable to taxation. Therefore, there is a necessity for particular vital investors and operations, for instance depositors and payment system, to be secured and preserved as functional, whereas other parties that are not regarded as consequential, in terms of economic consistency, be facilitated to become insolvent in the ordinary manner. For the avoidance of moral hazards and utilization of capital resulting from taxes for supporting a bank facing failure, it is essential shareholders and debt holders to take part in the real risks of credit institutions and carry proportional part of the failing. It is assured that, in the route of a bank resolution, determinations and judgments are being reached in a quick manner for the prevention of deployment.

The need of these specific measures emerged over the last years, after the global financial crisis that erupted in 2008.

There was no EU framework addressing the setting and way authorities ought to operate in the case of an occurring crisis in a credit institution. Throughout the duration of the economic crisis, authorities of several Member States lacked the appropriate apparatus and control over the managing of banks' insolvency.

3.2. The need for an EU Directive on Bank Resolution

As stated, the need for a special resolution regime of credit institutions is justified by a serious public interest, namely the prevention of the instability of the financial system.

In the current EU legislation there is lack of special powers and tools to manage the failure of banks in an orderly way. There is no legislation at EU level governing the entire process of bank resolution. This finding is related to the lack of common European measures to address the pathological issues affecting banks, in contrast to the existence of an analytical framework addressing issues of regulation and supervision of credit institutions during the operation.

Despite the fact that the function of cross-border credit institutions has been incorporated to a great extent, managing crisis and the associated banks' legal framework continued to be formed at national level. Disparities, not excepting disparities relating to legislature among Member States and/or deficiency at a statutory level in a number of states, indicate the prospective of causing difficulties and yet impede effective cross border managing of a bank crisis; and this directs to the deterioration of the Internal Market.

The need for EU law is clear both because of the importance for the existence of a single institutional framework to deal with banking crisis in the single European financial services market, but also because today there are impediments to the European law for establishing effective rules for bank recovery and bank restructuring, due to rules mainly of company directives.

There is a strong rationale for dis-applying certain rights protected under the directives in case of a bank in crisis due to serious public interest, e.g. instability of the financial system itself. The emergency bank restructuring measures are of urgency; they need to be rapid and decisive. The recapitalization, e.g. via capital increase of a bank or its division to good bank and bad bank or even by the transfer of assets, for instance via a spin off are often necessary conditions to prevent the bankruptcy of a bank, which, as explained above, should be avoided to prevent systemic consequences on the stability of the financial system. However, regularly, this wanted promptness cannot be achieved mainly due to provisions of company directives: Company Directives require a general meeting of the shareholders to be convened and a mandatory minimum notice period to be granted in addition to an increased quorum and majority. Moreover, such directives provide for preferential rights of the existing shareholders. All these required procedures cause significant delays and their compliance therewith in banks' pathological situations, when there is an urgent need for taking measures, may call off the possibility of rescuing a bank. Indicatively, the following provisions of the company law directives are mentioned:

- Article 25, 2nd Company law directive;
- Article 29, 2nd Company law directive;
- Article 40 of 2nd Company law directive;
- Article 5 of the Takeover bids;
- Article 5.1 of the Shareholder Rights Directive 2007/36/EC.
- Articles 6 – 8, 11, 13, 23 and 24 of the 3rd Company law directive.

Therefore, regulations are required at a secondary EU law level, which will enable deviation from the provisions of the company directives in case of recovery of an ailing or an insolvent bank.

The authorities may well make a choice between setting officially the bank under insolvency proceedings and putting at risk systemic difficulties or otherwise saving the bank by the use of public resources. There were no particular tools and powers enforced in the direction of preserving the vital financial services of a banking institution as continuous business operation (special resolution regime) offered in the majority of Member States (for instance, the Fortis selling was not available for the authorities of Belgium; the United Kingdom implemented the new banking act in the course of the crisis to allow resolution of banks in place of bankruptcy and it was then employed in two instances). A reason explaining why often authorities did not require from the creditors to bear crisis costs, or remove the participations of the shareholders, was the fact that there were no available legislative means to act accordingly in an organized and systematic way, not giving rise to additional financial disorder (namely, out of insolvency proceedings).

In the Impact Assessment on the Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (2012), by the presentation of the key concepts used in this assessment the Bank resolution is being defined as: administrative, non-judicial procedures and tools for the restructuring or managed dissolution of failing banks while preserving insured deposits and other services essential for maintaining financial stability such as payment services.

3.3. Bail out or bail in?

The need for a special regime for credit institutions on issues recovery/reorganization has been realized. However, a question arises as to the scope of tools and measures such a framework would include. Recapitalisation of an ailing bank, to make it viable, is certainly one of the measures used in these cases. But the willingness of the private sector and, in particular, the willingness of the existing shareholders to participate in such a project is usually limited. Participation of the public sector, in the form of bail out, raises issues in terms of state aid and burden on taxpayers. In contrast, the alternative being discussed is the use of bail in methods, through the debt write-down tool (see below, under 3.3.). Of course, using both these methods is attainable.

Important resolution tools are usually the sale of business tool, the bridge institution tool and the asset separation tool. In any case, indeed, there is the issue of resolution funding, which is needed to preserve the liquidity of the part of the failing bank that will continue to operate.

3.4. The European Commission's Proposal for a Directive on the recovery and resolution of credit institutions

In June 2012, the European Commission released its Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

The proposal for a Directive addresses crisis management in the sense of preparation, recovery and resolution, in relation to all credit institutions and certain investment firms. Its purpose is to enforce regulations and measures regarding the recovery and resolution of the above entities.

The proposed Bank Recovery and Resolution Directive forms an essential part of the future regulatory structure in the banking sector. It is a significant step forward in ensuring that a bank, regardless of its size and systemic importance, can be transformed and recover, or be wound down in a way that limits taxpayer liability for its losses. It aims, also, at preventing bank runs by protecting depositors more effectively in case of bank failures.

According to article 2 of the above Directive proposal, resolution means the restructuring of an institution in order to ensure the continuity of its essential functions, preserve financial stability and restore the viability of all or part of that institution.

According to article 26 par. 2, the resolution objectives are: (a) to ensure the continuity of critical functions, (b) to avoid significant adverse effects on financial stability, including by preventing contagion, and maintaining market discipline, (c) to protect public funds by minimising reliance on extraordinary public financial support, (d) to avoid unnecessary destruction of value and to seek to minimise the cost of resolution, (e) to protect depositors covered by Directive 94/19/EC and investors covered by Directive 97/9/EC and (f) to protect client funds and client assets.

According to article 2 no 18, resolution tools include the following means: the sale of business tool, the bridge institution tool, the asset separation tool or the bail-in tool. Same article entails the following definitions of the above terms. Further chapter III of the above Proposal for a Directive defines and elaborates the resolution tools it introduces.

Sale of business tool (art. 2 no 50) means the transfer by a resolution authority of instruments of ownership, or assets, rights or liabilities, of an institution that meets the conditions for resolution to a purchaser that is not a bridge institution. According to article 32 of the Directive Proposal, Member States shall ensure that resolution authorities have the power to transfer to a purchaser that is not a bridge institution the following:

a) shares or other instruments of ownership of an institution under resolution;

b) all or specified assets, rights or liabilities of an institution under resolution;

c) any combination of some or all of the assets, rights and liabilities of an institution under resolution,

The above transfer shall take place without obtaining the consent of the shareholders of the institution under resolution or any third party other than the purchaser, and without complying with any procedural requirements under company or securities law that would otherwise apply. Such a transfer shall be made on commercial terms, having regard to the circumstances, and in accordance with Union State aid rules. In the case of a partial transfer of assets of the institution, any proceeds received from the transfer shall benefit the institution under resolution.

Bridge institution tool (art. 2 no 51) means the power to transfer the assets, rights or liabilities of an institution that meets the conditions for resolution to a bridge institution. "Bridge institution" (art. 2 no 52) means a legal entity that is wholly owned by one or more public authorities (which may include the resolution authority) and that is created for the purpose of receiving some or all of the assets, rights and liabilities of an institution under resolution with a view to carrying out some or all of its services and activities.

According to article 34 of the Proposal for a Directive on Recovery and Resolution, Member States, in order to give effect to the bridge institution tool, shall ensure that resolution authorities have the power to transfer all or specified assets, rights or liabilities of an institution under resolution, and any combination of those assets, rights and liabilities, to a bridge institution without obtaining the consent of the shareholders of the institution under resolution or any third party, and without complying with any procedural requirements under company or securities law that would otherwise apply. A bridge institution shall be a legal entity that is wholly or partially owned by one or more public authorities (which may include the resolution authority) and that is created for the purpose of carrying out some or all of the functions of an institution under resolution and for holding some or all of the assets and liabilities of an institution under resolution. The resolution authority shall ensure that the total value of liabilities transferred to the bridge institution does not exceed the total value of the rights and assets transferred from the institution under resolution or provided by other sources. The resolution authority may transfer any assets, rights or liabilities of the institution as it considers appropriate in pursuance of one or more of the resolution objectives. The bridge institution shall be considered to be a continuation of the institution under resolution and may continue to exercise any such right that was exercised by the institution under resolution in respect of the assets, rights or liabilities transferred, including the rights of membership and access to payment, clearing and settlement systems. Shareholders or creditors of the institution under resolution and other third parties whose property, rights or liabilities are not transferred to the bridge institution shall not have any rights over or in relation to the bridge institution or its property.

Asset separation tool (art. 2 no 48) means the transfer by a resolution authority exercising the transfer powers of assets and rights of an institution that meets the conditions for resolution to an asset management vehicle. According to article 36 of the Proposal for a Directive on Recovery, Member States shall ensure that the resolution authorities have the power to transfer assets, rights or liabilities of an institution under resolution to an asset management vehicle. An asset management vehicle shall be a legal entity that is wholly owned by one or more public authorities, which may include the resolution authority. The resolution authority shall appoint asset managers to manage the assets transferred to the asset management vehicle with a view to maximising their value through eventual sale or otherwise ensuring that the business is wound down in an orderly manner. Resolution authorities shall determine the consideration for which assets are transferred to the asset management vehicle in accordance in accordance with the Union State aid framework.

Bail-in tool (art. 2 no 49) means the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution that meets the conditions for resolution.

According to article 37 of the Proposal for a Directive on Recovery, member states, in order to give effect to the bail-in tool, shall ensure that resolution authorities have the following resolution powers:

a) to write down or convert the instruments referred to in Article 51 into shares or other instruments of ownership of the institution under resolution or of a relevant parent institution under resolution;

b) to reduce, including to reduce to zero, the principal amount of or outstanding amount due in respect of eligible liabilities, of an institution under resolution;

c) to convert eligible liabilities of an institution under resolution into ordinary shares or other instruments of ownership of that institution, a relevant parent institution or a bridge institution to which assets, rights or liabilities of the institution are transferred;

d) to cancel debt instruments issued by an institution under resolution;

e) to cancel shares or other instruments of ownership of an institution under resolution;

f) to require an institution under resolution to issue new shares, or other instruments of ownership, or other capital instruments, including preference shares and contingent convertible instruments;

g) to require the conversion of debt instruments which contain a contractual term for conversion in the circumstances provided for in Article 51.

Resolution authorities may apply the bail-in tool for either of the following purposes:

a) to recapitalise an institution that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation and to carry on the activities for which is authorised under Directive 2006/48/EC or Directive 2004/39/EC;

b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred to a bridge institution with a view to providing capital for that bridge institution.

Bail-in tool may be applied to all liabilities of an institution except the following:

a) deposits that are guaranteed in accordance with Directive 94/19/EC;

b) secured liabilities,

c) any liability that arises by virtue of the holding by the institution of client assets or client money, or a fiduciary relationship between the institution (as fiduciary) and another person (as beneficiary);

d) liabilities with an original maturity of less than one month;

e) a liability to any one of the following:

(i) an employee, in relation to accrued salary, pension benefits or other fixed remuneration, except for variable remuneration of any form;

(ii) a commercial or trade creditor arising from the provision to the institution of goods or services that are essential to the daily functioning of its operations, including IT services, utilities and the rental, servicing and upkeep of premises;

(iii) tax and social security authorities, provided that those liabilities are preferred under the applicable insolvency law.

4. The recapitalisation needs

4.1. Changes in banks' funding structures following the financial crisis

Credit institutions are experiencing nowadays capital erosion due to the financial crisis. The crisis has revealed important risks related to banks' trading book and derivatives activities: toxic products, bad loan granting practices, but also losses resulting from the sovereign debt. The new capital and liquidity requirements impose further financial pressures on the financial system to perform its basic function of intermediation. As to funding structures, these changed dramatically following the financial crisis. Prior to the crisis, many banks increasingly relied on short term wholesale funding.

Since the crisis, banks have had to re-adapt their funding structures towards more balanced funding sources, such as customer deposits and equity, while reducing their exposures on short-term wholesale and interbank funding. In crisis-economies there was significant deposit flight to core country banks, due to currency risk, banking risk and the legal uncertainty of remaining in the euro. Moreover, banks have limited success in raising equity capital because of the reluctance of investors to invest in banking stocks. In general, most European financial institutions slowly, but surely, have been blocked from access to capital markets. These phenomena exacerbated the crisis in several Eurozone domestic banking systems. The inability of fund raising is a fact of life for many banks and especially for those of the week Eurozone countries.

4.2. Bank recapitalisation necessity and sovereign debt crisis

In 2010 a recovery starting from the financial crisis shock has been noticed for the real economy. However, the same year was the beginning of the sovereign debt crisis in Eurozone countries. In the light of high sovereign debt levels the trust in the European banking system eroded. A deterioration of the situation occurred after summer 2011, with respect to the weak economic growth prospects. In March 2012, only 17 European banks were able to sell senior unsecured debt. Banks' response was deleveraging of the balance sheet and restriction of the credit supply. The consequences of such banking policy in the real economy were obvious:

- In connection with the sovereign debt crisis, the banking system crisis has triggered recession and significant job losses in many EU Member States
- Sharp increase of the unemployment rate has been experienced
- Rising poverty in many Member States
- Significant increase in public debt levels [also due to banking crises], and
- Recession

4.3. The financial crisis enhanced European market fragmentation enlarging bank recapitalisation needs and sovereign recovery plans

As a consequence of the financial crisis, national supervisors have raised firewalls. There is no meaningful ability to resolve cross-border institutions to date. Banks have been encouraged to invest their liquidity pools in domestic debt. Some other important factors have played a crucial role in the development of the banking crisis in Europe: As long as uncertainty in relation to the currency risk exists or even increases, and in the absence of a European deposit-guarantee scheme, deposits will fly from financially weak states and accumulate in the banks of the strong ones.

The recession deepens:

- the need for the bank recapitalization of the financially troubled states increases;
- funds for financing business sector are lacking;
- privatizations do not perform efficiently, and in so far as the financially weak states show lack of prospects for recovery, the investors are unwilling to proceed to investments, because deterioration is anticipated, so that higher profits can be achieved by way of a further drop in the prices of the assets;
- besides, banks themselves do not liquidate their collaterals, due to fear of the – severe – economic results that will be deteriorated to a greater extent and a further drop will occur in the prices of their security assets, intensifying in this manner the recession;
- the vicious circle exacerbates.

Under such circumstances, there are no prospects for recovery and growth.

Eurozone's financial crisis led to a unique, unprecedented fragmentation of the single European financial services market. This segmentation is based on domestic market driven characteristics predetermining the business possibilities and perspectives of the banking entities. Such reality constitutes a crucial impediment for growth and recovery of the distressed Eurozone economies.

The shortcomings of the institutional frameworks to support the Single Market are evident. Financial integration was not followed by adequate regulatory and supervisory institutions and the required economic governance frameworks. During the Euro area Summit of June 2012, the issue of the "vicious circle between banks and sovereigns" was laid down for the first time in the political agenda; it was decided, how the issue would be treated.

4.4. Towards a new Bank recapitalisation model

A new Bank recapitalisation scheme has to be realized through European direct investments, in order to break the vicious circle between banks and sovereigns. Following the introduction of an effective single supervisory mechanism to be established for the euro area banks, the ESM shall recapitalize banks directly, and not indirectly, as it is the case to the present day. The method used for funding financially weak Member-States is based on capital lending by the EFSF-IMF to the said states. Recapitalisation is achieved through investments made by the domestic National Stability Fund, which is funded by the State through the capital it receives from those international mechanisms.

Such a device may impede the resolution of the crisis for two reasons:

It increases the public debt of the Member-State receiving the financial aid, thus worsening its fiscal health and the investors' motivation.

It does not really foster growth. Financial discipline and austerity measures used as a means to reduce public debt very often lead to recession. In order for growth to be achieved, not only investments but also a community of interests between investors (financially healthy European states and their national enterprises) on the one hand and the weak states on the other hand, is required. The current form of funding of Euro area Member-States has been proven to hinder economic development, since it lacks that element of community of interests between the financially strong (funding states) and the financially weak (funded) states, which is a prerequisite for growth.

A banking union and a pan-European Deposit Guarantee Scheme are further requirements towards the endorsement of a genuine economic and monetary union.

Such innovations constitute vital prerequisite for the restoration of level playing field in the European financial services market and, consequently, for a healthy development of the banking sector, which would be able to finance the real economy. Bank recapitalisation on these terms could create realistic growth conditions. It could build the background for efficiently fighting the Lernaean Hydra-like dipole of sovereign debt/banking crisis on the one hand, and the recession spiral that resulted from the measures taken to resolve those problems on the other hand. All the above are genuine preconditions for the implementation of the Eurozone recovery plans.

Banks' recapitalisation measures cannot only be national, thus raising real hopes for growth aside; they need to be pan-European and market-oriented. The breakthrough, included in the radical proposal of the 29 June 2012 Euro-Summit, constitutes a distinguished feature of the so far Eurozone policy: By means of participating effectively in the recapitalization of the banks, Eurozone will be forced to take a real interest in relation to economic growth; thus, acting as investor, the Eurozone will inevitably abandon its hitherto impassive stance that leaves recovery under the control of each troubled state. Accordingly, national factors that distort fair competition within the single market and hinder economic growth in the weak states will be constrained.

Following the completion of bank recovery, the ESM will be able to place its shares of the recapitalized banks on the market without incurring the loss which relates to the conditions of the economy of the weak state in which the investment was made. In the case that the economy of the weak state starts to recover, both the value of the banks and the ESM's participation increases. As a consequence, the risk exposure of funding state's taxpayers, which currently acts as a disincentive to financial unity, decreases. Thus, it will be not in Europe's interest to maintain depreciation of the weak states' economies, so as the healthy state's enterprises invest in at low-prices; on the contrary, a collective interest would emerge creating prospects for the effective operation of the national banking sector along with the troubled state's economic recovery.

This community of interests is the most promising solution for success, since it creates genuine growth prospects. It will be the first time after the outbreak of the Member-States' public debt crisis that Eurozone operates on market terms so as to confront the problem. In particular, it will be asked to take effective measures for the growth of the funded Member-States, since these measures are fully consistent with the interests of the financially strong states. It is self-evident that the aforementioned mechanisms require EU to play a more decisive role in the economic affairs of each state. That is to say, they require the endorsement of a united economic and banking supervision.