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Who Should Hold Bail-Inable Debt and How can Regulators Police Holding Restrictions Effectively?

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Who should hold bail-inable debt and how can regulators police holding restrictions effectively? *

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Abstract: This paper analyses the demand-side prerequisites for the efficient application of the bail-in tool in bank resolution, scrutinises whether the European bank crisis management and deposit insurance (CMDI) framework is apt to establish them, and proposes amendments to remedy identified shortcomings.

The first applications of the new European CMDI framework, particularly in Italy, have shown that a bail-in of debt holders is especially problematic if they are households or other types of retail investors. Such debt holders may be unable to bear losses, and the social implications of bailing them in may create incentives for decision makers to refrain from involving them in bank resolution. In turn, however, if investors can expect resolution authorities (RAs) to behave inconsistently over time and bail-out bank capital and debt holders despite earlier vows to involve them in bank rescues, the pricing and monitoring incentives that the crisis management framework seeks to invigorate would vanish. As a result, market discipline would be suboptimal and moral hazard would persist. Therefore, the policy objectives of the CMDI framework will only be achieved if critical bail-in capital is not held by retail investors without sufficient loss-bearing capacity. Currently, neither the CMDI framework nor capital market regulation suffice to assure that this precondition is met. Therefore, some amendments are necessary. In particular, debt instruments that are most likely to absorb losses in resolution should have a high minimum denomination and banks should not be allowed to self-place such securities.

JEL classification: G01, G18, G21, G28, K22, K23

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1 Introduction

The Financial Stability Board (FSB) states that "[t]he objective of bail-in is to reduce the loss of value and the economic disruption associated with insolvency proceedings for financial institutions, yet ensure that the costs of resolution are borne by the financial institutions' shareholders and unsecured creditors."[1] The aim of the bail-in tool is to recapitalise a distressed bank by writing down its bail-inable debt and/or converting it into equity, so that the continuity

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[1] FSB, *Effective Resolution of Systemically Important Financial Institutions*, 19 July 2011, p. 12.

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of critical functions is guaranteed, without resorting to public funds (bail-out). Accordingly, bail-in undoes implicit government guarantees.[2]

The bail-in regime also seeks to enhance market discipline. If the risk of bail-in is explicit and credible, investors in bail-inable debt instruments should have stronger incentives to price the risk banks are running in their operations adequately, and monitor their lending behaviour closely.[3] However, regulatory intervention can only achieve such a desirable incentive effect if certain preconditions exist. These include *inter alia* a sufficient sophistication and loss-bearing capacity on the part of investors who potentially invest in bail-inable debt. When these two requirements are missing, on one hand, no meaningful market discipline from pricing and monitoring will ensue and, on the other, especially if the investors are small savers or small and medium-sized enterprises (SMEs), politicians will possess strong bail-out incentives to avoid the unbearable social consequences of private sector involvement. In this paper, we analyse whether the EU's crisis management and deposit insurance (CMDI) framework ensures that these specific preconditions are in place.

We prepare the ground for our analysis by recalling briefly what bail-in *should* achieve in bank crisis management (below in section 2) and why in this context it matters who holds bail-inable instruments (below in section 3). We then identify the positions on the liability side of a bank that should indeed not be placed in the wrong hands, because they are typically exposed to loss bearing once a bank reaches the point of non-viability (PONV) or is declared "failing or likely to fail" (FOLTF) (below in section 4). We finally review the institutions that restrict holdings of the relevant securities, assess their adequacy in light of the objectives pursued by policy makers with the bail-in tool, and propose several amendments to remedy the identified shortcomings (below in section 5).

2 *What bail-in should achieve*

In this section, we outline the key policy objectives regulators pursue with the bail-in tool. We do so by first sketching the evolution of the European regime (below in section 2.1.). Thereafter, we describe the intended impact of the bail-in tool, which is supposed to establish market discipline in the financial sector (below in section 2.2.).

2.1. The evolution of the European framework

Bail-in is the leitmotiv of the EU's CMDI framework, composed of the European Commissions' (EC) Banking Communication 2013,[4] the Bank Recovery and Resolution Directive

[2] Traditionally, the crisis of a bank has been managed by external liquidity support or liquidation (frequently accompanied by the sale of business to a third intermediary). The bail-in represents a «third way» to handling bank insolvency (see W-G. RINGE, *Bank Bail-in Between Liquidity and Solvency*, in 92 *Am. Bankr. L.J.*, 2018, p. 299).

[3]T.H. TRÖGER, *Too Complex to Work – A Critical Assessment of the Bail-In Tool Under the European Bank Recovery and Resolution Regime*, in 4(1) *Journal of Financial Regulation*, 2018, p. 37.

[4] Communication from the Commission on the application, from 1 August 2013 of State aid rules to support measures in favor of banks in the context of the financial crisis [2013] OJ C 216/01 (hereinafter BC2013).

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(BRRD),[5] and the Single Resolution Mechanism (SRM)[6]. The bail-in tool, which carries global DNA as it is also an element of the Key Attributes of Effective Resolution Regimes for Financial Institutions devised by the Financial Stability Board (FSB),[7] became part of the European framework for the first time in the state aid regime. Private investors' burden-sharing represents the evolution of the so-called "contribution" from the potential state aid beneficiary, which the EC always demanded as a precondition for government support. During the first wave of bank rescues in response to the Global Financial Crisis (GFC), the EC did not require creditors to contribute to stabilizing failing financial institutions, but imposed mild compensatory obligations only on the rescued banks and their shareholders[8] (e.g., buyback of hybrid instruments, and coupon and dividend bans). Yet, the sovereign debt crisis demonstrated that such an approach could not ensure financial stability in the long term, because it created a doom loop between banks and sovereigns, particularly in Member States in which the costs of bank bail-outs significantly undermined public finances (e.g. Ireland and Spain). As a policy response, the EC sought to reduce the options for the provision of lavish and unconditional public support to banks and, therefore, raised the "contribution" requirements and compelled so-called "burden-sharing." Under this new regime, state aid would only be allowed if first losses are absorbed by equity, hybrid capital, and subordinated debt holders; to recapitalise failing institutions, banks' subordinated debt must also be converted into equity.[9]

Later, this burden-sharing in accordance with a predefined waterfall was codified in the BRRD and the SRMR. It not only represents a general principle (BRRD, art. 34(1)(a)(b)), but also comes as a highly-specified resolution tool complemented by write-down and conversion powers which can be used independent of, or in combination with, a resolution action (BRRD, art. 59). In resolution, bail-in can be deployed to recapitalise a bank (open bank bail-in) or to support the application of other resolution tools (BRRD, art. 43(2)).

Burden-sharing under the BC2013 and under the BRRD (arts. 43 ff.) are functionally equivalent. However, the two concepts differ in their scope and their legal details.[10] Most importantly, while state aid burden-sharing involves only capital instruments (meaning core equity tier 1 (CET1), additional tier 1 (AT1), and tier 2 (T2) instruments that satisfy the qualitative requirements of own funds as laid down in the Capital Requirements Regulation (hereinafter,

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[5]Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations n. 1093/2010/EU and (n. 648/2012/EU, of the European Parliament and of the Council, [2014] OJ L173/190 (hereinafter BRRD).

[6] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation n. 1093/2010/EU, [2014] OJ L225/1 (hereinafter SRMR).

[7] FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011, s. 3.5 and 3.6 <http://www.fsb.org/wp-content/uploads/r_111104cc.pdf> which remained unchanged in the most recent version, ID., *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2014, s. 3.5 and 3.6 <http://www.fsb.org/wp-content/uploads/r_141015.pdf>.

[8] See point 2.2, Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, 2009/C 195/04.

[9] See para 3.1. BC2013.

[10] K-PH. WOJCIK, *Bail-in in the Banking Union*, in 53 *Common Market Law Review*, 2016, p. 91 and 105.

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CRR),[11] arts. 26-50, 51-61, and 62-71, and the related level 2 legislation), the bail-in tool may involve all liabilities of the bank which are not expressly excluded from loss absorption (BRRD, art. 44(1)). [12]

2.2. Bail-in and market discipline

The adoption of the bail-in tool followed a recommendation in an influential study commissioned by the EC, the so-called Liikanen Report, named after the expert group's chairman.[13] The Report focused on finding a solution to the "too big to fail" problem. Accordingly, banks must be able to exit the market without wreaking havoc on the financial system and destabilizing public finances. Therefore, private investors with sufficient stand-alone loss-bearing capacity should bear the brunt of the losses incurred by a failing institution. The report proposed regulatory changes to create a desirable environment (the Liikanen "greenhouse")[14] for market discipline to also be effective in the banking sector. Together with the introduction of the separation of the proprietary's trading and other risky activities,[15] the Report recommended requiring banks to issue bail-in bonds with staggered maturity, and to prohibit financial institutions from holding such bonds on their balance sheet.[16] These interventions would have generated a sufficient layer of bail-inable liabilities and, at the same time, transferred risks outside of the banking system.

While the suggested *ex ante* separation of activities ultimately failed in the legislative process,[17] the CMDI did introduce the bail-in tool (BRRD, arts. 43 ff.). The BRRD mandates that at least eight percent of the resolved institution's own funds and liabilities are bailed-in prior to tapping any resolution financing arrangement (art. 44(5)(a)) or resorting to government funds

[11] Regulation n. 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation n. 648/2012/EU, [2014] OJ L 176/1.

[12] Before the adoption of the Banking Package 2019, the perimeter of the burden sharing of the BC 2013 (para 3.1.2. (41)) was the same as that of the write down and conversion tool (BRRD, art. 59). Directive 2019/879/EU (BRRD2) extended the power to write down (or convert), including «relevant capital instruments and eligible liabilities» (BRRD, art. 59(1)). The «eligible liabilities» are those that fulfil, as applicable, the conditions of art. 45b or point (a) of art. 45f(2) of the BRRD2, and Tier 2 instruments that meet the conditions of point (b) of art. 72 a(1) of Regulation n. 575/2013/EU. On these instruments see T.H. Tröger, *Qualitative capital requirements and their relationship with MREL/TLAC*, in B. Joosen – M. Lamandini – T.H. Tröger (eds.), C*apital and Liquidity Requirements for European Banks*, Oxford, 2022, p. 111 ff.

[13] High-level Expert group on reforming the structure of the EU banking sector, *Final report*, 2 October 2012.

[14] An expression of M. Götz -J. Krahnen – T.H. Tröger, *Five years after the Liikanen Report: What have we learned?*, SAFE White Paper, No. 50, 2017, p. 3; see also J. P. Krahnen – L. Moretti, *A Greenhouse for Market Discipline: Making Bail-In Work*, European Economy 2015.1, p. 59.

[15] In an extension of the example of the US "Volcker Rule" (s. 619 Dodd-Frank Act), the Report proposed for large institutions the mandatory separation of proprietary's trading and other risky activities from retail and commercial banking (p. 100 ff.). The separation would have simplified the internal structure of complex institutions, sped up crisis management, and also prevented the need for government intervention to guarantee the provision of essential banking services (see J. P. Krahnen, *Rescue by Regulation? Key Points of the Liikanen Report*, SAFE White paper 9/2013, 15; T.H. Tröger, *Regulatory Influence on Market Conditions in the Banking Union: the Cases of Macro-Prudential Instruments and the Bail-in Tool*, in 16 *EBOR*, 2015, p. 575; M. Götz -J. Krahnen – T.H. Tröger, *Five years after the Liikanen Report*, cit., p. 2).

[16] High-level Expert group on reforming the structure of the Eu banking sector, *Final report*, cit., p. 104. The Report suggested to restrict holdings of such instruments to non-bank institutional investors (e.g. investment funds and life insurance companies).

[17] The BRRD does not impose the general separation of activities *ex ante*. Instead, it subjects banks to a complex resolvability assessment that *inter alia* allows RAs to require structural reforms at individual institutions on a case-by-case basis (see BRRD, arts. 15 and 16; on this topic, see recently Eba, *Guidelines on improving resolvability for institutions and resolution authorities under articles 15 and 16 BRRD (Resolvability Guidelines)*, 13 January 2022, EBA/GL/2022/01).

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(arts. 37(10), 56(1)). Moreover, the supervisory prescriptions of minimum requirements for own funds and eligible liabilities (hereinafter MREL) (BRRD, arts. 45 ff.) ensure that EU banks hold sufficient positions on the liability side of their balance sheet which can be subject to bail-in to offset the losses incurred by the failed bank, and recapitalise the institution. Finally, the institution-specific MREL is supplemented by the minimum requirements for G-SIIs in arts. 92a and 92b of the CRR that implement the FSB's TLAC Standard.[18]

According to the BRRD, the new regulatory framework that gives "shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances,"[19] should provide a momentous push toward market discipline. However, the institutional preconditions to create efficient incentives *ex ante* go significantly beyond the initial regulatory choice of a bail-in-centred CMDI framework.

3. *Why holdings matter*

This section explains that the incentive effect and market discipline that bail-in is supposed to create, hinge pivotally on the credibility of the bail-in tool and that putting bail-inable liabilities into the wrong hands undermines this credibility (below in section 3.1.). In other words, much stronger bail-out pressure can be expected when a large number of retail holders of senior unsecured bank bonds are involved. Unfortunately, the institutional arrangements under the EU's original CMDI were insufficient to prevent the time-inconsistent behaviour of RAs and national governments, and therefore did little to trim bail-out incentives. The recent Italian experience under the BRRD and the SRMR illustrates our point (below in section 3.2.).

3.1. Bail-out incentives beyond financial stability concerns

For market discipline to work efficiently in the banking sector, three distinct yet interacting features are necessary: first, debt holders must have the ability to monitor banks' risk-taking and exert meaningful control on banks' lending operations; second, debt holders must have the capacity to bear losses; and, third, debt holders need to believe that they will share the costs in the event of a bank failure.[20] The first two conditions depend on the nature of the credit held and, primarily, on the personal characteristics of the respective market participants. The third hinges not only on an explicit regulatory choice (of which the debt holder should be aware), but, above all, also on the national government's willingness to actually bail-in bank creditors when a crisis materialises[21] (i.e. a time-consistent commitment to private sector involvement in bank crisis management).

If investors can expect RAs to behave inconsistently over time and bail-out bank capital and debt holders despite earlier vows to involve them in bank rescues, the pricing and monitoring incentives that the CMDI seeks to invigorate would vanish. Among other things, investors in bail-

[18] FSB, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution*, November 2015, p. 5 ff.; more recently, see FSB, *Review of the Technical Implementation of the Total Loss- Absorbing Capacity (TLAC) Standard*, November 2019, p. 11 ff.; EBA, *Draft implementing technical standards on disclosure and reporting on MREL and TLAC*, EBA/ITS/2020/06, 3 August 2020, p. 15 ff.

[19] BRRD, recital 67.

[20] See J. A. CUTURA, *Debt holder monitoring and implicit guarantees: did the BRRD improve market discipline?*, ESRB *Working Paper Series* n. 111, October 2020, p. 3.

[21] On this point see A. SCHÄFER – I. SCHNABEL – B. WEDER DI MAURO, *Bail-in expectations for European banks: Actions speak louder than words*, ESRB *Working Paper Series* n. 7, April 2016, p. 25; E. MARTINO, *The Bail-in Beyond Unpredictability*, cit., p. 793.

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inable debt need to have sufficient loss-bearing capacity to absorb the depreciation of their private wealth that the bail-in forces them to incur. Moreover, if financial instruments that are written-off or converted in a bail-in represent a significant fraction of retail investors' assets, the financial situation of households may become precarious overnight.[22]

The massive self-placements of bail-inable securities to retail investors may precipitate a significant and disproportionate impact of bail-in on weak bank costumers, with severe social consequences. Against this background, as well as financial stability concerns, social considerations may also induce politicians and regulators to back off from bail-in if the affected individuals face financial ruin.

Such bail-out incentives become amplified if post-resolution litigation constantly refreshes voters' memories of the miseries RAs inflicted on small savers and pensioners with the consent of politicians. Recent episodes of banking crisis management in Italy (see below in section 3.2.) prove the validity of these considerations. Markets would anticipate the bail-out proclivity of politicians, question the credibility of the bail-in threat, and price bank debt again with a view to an implicit government guarantee. As a result, market discipline would be suboptimal and moral hazard would persist. Therefore, the policy objectives of the CMDI framework will only be achieved if critical bail-inable debt is not held by retail investors without sufficient loss-bearing capacity at the individual level. Only under this precondition can politicians and RAs be expected to behave consistently over time, thereby allowing the bail-in threat to be credible, and market discipline to prevail.

3.2. Institutional safeguards to repress bail-out incentives

The BRRD originally did not address the demand-side preconditions for inducing market discipline through bail-in.[23] Instead, it only laid down the loss-attribution sequence based on the ranking of the affected liability (BRRD, art. 48). Therefore, retail investors incurred losses in resolution alongside professional investors (such as institutional investors and asset managers). Neither retail investors' modest monitoring capacities nor their limited loss tolerance were adequately reflected in the resolution framework. In other words, the familiar distinction between professional and retail investors enshrined in financial market law (MiFID I)[24], was not carried over to bank resolution.

Moreover, although the ban on the provision of unconditional government support to banks in distress was repeated like a mantra throughout the BRRD, both the substantive rules and the institutional design of the CMDI leave ample space for the injection of public funds and/or managing banking crises (within or outside the perimeters of the BRRD)[25], without constantly applying the stringent bail-in tool of the BRRD. Already, the plethora of resolution goals (BRRD, art. 31) indicates that bank crisis management under the BRRD involves painful trade-offs

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[22] M. GÖTZ - T.H. TRÖGER, *Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, SAFE White Paper n. 35, 2016, p. 7.

[23] See J. ZHOU – V. RUTLEDGE – W. BOSSU – M. DOBLER – N. JASSAUD - M. MOORE, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions*, IMF Staff Discussion Note. SDN/12/03, 2012, p. 13; M. GÖTZ -J. KRAHNEN – T.H. TRÖGER, *Five years after the Liikanen Report*, cit., p. 14.

[24] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004, in [2004] OJ L 145.

[25] See art. 32(4)(d) of the BRRD. Moreover, recital 47 of the BRRD requires that «when the use of the resolution tools involves the granting of State aid, interventions should have to be assessed in accordance with the relevant State aid provisions», i.e. the co-legislators already perceived the possibility of government support under the BRRD.

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between maintaining financial stability, safeguarding competition and public finances, and protecting depositors, investors, and other clients, that can be soothed with the injection of public funds. As a consequence, the confident outlook of EU legislators and executives on the effectiveness of the current regime[26] may prove overoptimistic. The resolution framework has thus far been applied in very few cases,[27] and no bail-in of debt instruments other than own funds positions has yet occurred. The unwillingness of the Single Resolution Board (SRB) to take on resolution cases can be seen as an indication that national interests of avoiding a stringent and impartial application of the bail-in can prevail even within the SRM.[28] The interplay of a weakened commitment to private sector loss-absorption in a resolution framework geared towards multiple, partly-irreconcilable policy goals and the lack of adequate investor protection under the original CMDI, thwarted the full realization of optimal incentives of for bail-inable creditors. As episodes in Italy and other European jurisdictions[29] demonstrate, the bail-in tool failed to interrupt the link between banks and sovereigns: instead of bailing out banks, governments bailed out retail investors, partly within but mostly outside the perimeters of the BRRD. As a consequence, rational market participants could anticipate the bail-out proclivity of politicians and price bank debt again with a view to an implicit government guarantee. We now illustrate this interrelation by referring to the Italian experience.

3.3. The Italian experience

The first application of the CMDI framework was particularly ill-conditioned in Italy, because retail investors held a significant part of banks' debt issuances subject to bail-in. In October 2015, the total amount of subordinated bonds issued by Italian banks was €67 billion; of the circulating bonds (€59 billion), €31 billion were held by retail investors.[30]

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[26] See B. Jazbec, *SRB Annual Conference Closing Speech*, 19 September 2022: «I think we can say that most banks, by now, are resolvable».

[27] At EU level, only Banco Popular Español S.A. (Banco Popular) in 2017 and the Croatian and Slovenian subsidiaries of Sberbank Europe AG in 2022, have been resolved (see the decisions at *srb.europa.eu/en/cases*).

[28] See T.H. Tröger – A. Kotovskaia, *National interests and supranational resolution in the European banking union*, SAFE Working Paper n. 340, February 2022, p. 3 ff.

[29] For a comparative study see S. Alvaro - M. Lamandini - D. Ramos Muñoz - E. Ghibellini - F. Pellegrini, *The marketing of MREL securities after BRRD. Interactions between prudential and transparency requirements and the challenges which lie ahead*, in Consob, *Quaderni giuridici*, 15 dicembre 2017, p. 67 ff.; P.H. Conac, *Mis-selling of Financial Products: Subordinated Debt and Self-placement*, Study Requested by the ECON committee of the European Parliament, Brussel, 2018, p. 18 ff; Id., *Le self-placement: un obstacle au bail-in qui doit être levé*, in *Revue Banque*, n. 859, Septembre 2021, p. 24 ff.; World Bank Group, *Bank Resolution and Bail-in in the EU: Selected Case Studies Pre and Post BRRD*, p. 3 ff; with reference to the Spanish experience see M. Lamandini – D. Ramos Muñoz, *Minimum Requirement for Own Capital and Eligible Liabilities*, in V. Santoro – M. Chiti (eds.), *The Palgrave Handbook of European Banking Union Law*, Cham, 2019, p. 342 ff.

[30] Banca d'Italia, *Domande e risposte sulla soluzione delle crisi delle quattro banche poste in "risoluzione"*, su https://www.bancaditalia.it/media/approfondimenti/2016/d-e-r-quattro-banche/index.html; see also Ministero dell'economia e delle finanze, *Consultazione pubblica concernente il recepimento dell'art. 44-bis BRRD, relativo alla commercializzazione a clienti al dettaglio di strumenti soggetti a bail-in*, 26 Aprile 2021, p. 5, at www.dt.mef.gov.it/it/dipartimento/consultazioni_pubbliche/consultazione_pubblica_44bis.html; Commissione Finanze e Tesoro, *Atti dell'indagine conoscitiva sul sistema bancario e finanziario italiano e la tutela del risparmio, anche con riferimento alla vigilanza, la risoluzione delle crisi e la garanzia dei depositi europei*, 9 febbraio 2017, p. 8, 76 and 349, at https://www.senato.it/application/xmanager/projects/leg17/attachments/dossier/file_internets/000/002/242/Atti_dell_Indagine_conoscitiva_sulle_condizioni_del_sistema_bancario_e_finanziario_italiano_e_la_tutela_del_risparmio.pdf; S. Micossi, *Testing the EU Framework for the Recovery and Resolution of Banks: the Italian Experience*, Luiss Policy Brief, 15 February 2019, p. 4 at https://www.astrid-online.it/static/upload/sep_/sep_testing-the-eu-framework.pdfp.

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In November 2015, four regional Italian banks in special administration (Cariferrara, Banca Etruria, Banca Marche, and Carichieti) were resolved, with their healthy parts transferred to bridge banks and their troubled assets left to bad banks.[31] Since the bail-in tool was not yet applicable in national law,[32] burden-sharing was instituted through a write-down and conversion (BRRD, art. 59), which did not involve senior bondholders and depositors, but only shareholders and junior bondholders (investors in own funds).[33] Many affected creditors were individual savers, pensioners, and SMEs.[34] The imposition of losses on non-professional investors resulted in heavy political and social repercussions. These were due in part but not exclusively to the novel approach of the CMDI framework and its rigid burden-sharing requirement, which also revoked the traditional implicit government guarantee on retail investments. The social implications and the public outcry they triggered stemmed mostly from the revealed practice of reprehensible mis-selling.[35] Specifically, subordinated bondholders were largely unaware of the true risks associated with their investments, and sometimes considered themselves as mere depositors.[36] Against this background, the Italian legislator adopted several compensatory measures,[37] some of which even relied on public financial support.[38] The objective was to indemnify the bondholders, and later even the shareholders, although to a lesser degree,[39] and thereby prevent litigation and perhaps popular uprising. Yet still, numerous mis-selling claims have been brought against both the bridge banks and their subsequent buyers (namely Unione Banche Italiane s.p.a.

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[31] On the resolution of the four banks, see C. BARBAGALLO, Camera dei Deputati, Sesta Commissione Finanze, Indagine conoscitiva sul sistema bancario italiano. *Audizione del Capo del Dipartimento Vigilanza Bancaria e Finanziaria Banca d'Italia*, December 2015, p. 6 at www.bancaditalia.it/pubblicazioni/interventi-vari/int-var-2015/Barbagallo-09122015.pdf; G. SANTONI, *Tre interrogativi sull'operazione di salvataggio delle quattro banche*, in *Riv. dir. banc.*, 2016, p. 1 ff.; L. SCIPIONE, *Crisi bancarie e disciplina degli aiuti di stato. Dalla prospettiva europea all'attuazione nell'ordinamento italiano. Elementi di confronto e spunti di riflessione*, in *Innovazione e diritto*, 2017, p. 184 ff.; I. MECATTI, *Il decreto salva banche*, in M. CHITI - V. SANTORO (eds.), *L'Unione bancaria europea*, Pacini, 2016, p. 585; L. PAJEVIC, *La risoluzione della crisi delle Quattro Banche e le Argonautiche giurisdizionali*, in *Il diritto bancario europeo* in M. Chiti – V. Santoro (a cura di), Pisa, 2022, p. 129 ff.

[32] In general, the BRRD had to be implemented in member states' national law by December 31, 2014, art. 130(1) subpara. 1 BRRD allowed member states to apply the bail-in tool only from January 1, 2016 at the latest.

[33] On the scope of the write down and conversion tool see, *supra*, § 1.

[34] COMMISSIONE FINANZE E TESORO, *Atti dell'indagine conoscitiva*, cit., p. 5 and 362

[35] The four banks massively sold shares and subordinated instruments to retail investors in violation of the suitability, appropriateness, and conflict of interest rules embedded in MiFID I (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, in OJ L 145, 30.4.2004, p. 1); on this point see I. MECATTI -V. SANTORO, *Write-down and conversion of Capital Instruments*, in M. CHITI - V. SANTORO (eds.), *The Palgrave Handbook of European Banking Union Law*, Palgrave, p. 359 ff.; P.H. CONAC,, *Mis-selling of Financial Products*, cit., p. 25 ff.; L. ENRIQUES – M. GARGANTINI, *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case. The Italian Law Journal*, Vol. 3, 2017, p. 493.

[36] S. ALVARO - M. LAMANDINI - D. RAMOS MUÑOZ - E. GHIBELLINI - F. PELLEGRINI, *The marketing of MREL securities after BRRD*, cit., p. 58.

[37] I mean the Fondo di solidarietà financed and managed by the Fondo Interbancario di tutela dei depositi (FITD), introduced by l. n. 208/2015, art. 1(855-861); d.l. n. 59/2016, converted into l. n. 119/ 2016. Later, the d.l. n. 99/2017, converted into l. n. 121/2017, extended the forfeit-rate reimbursements also to retail bondholders of the Veneto Banks (art. 6).

[38] I refer to the Fondo di Ristoro Finanziario (FRF) set by l. n. 205/2017 and the Fondo indennizzo per i risparmiatori (FIR) set up by l. n. 145/2018, founded out the public budget. On these funds see P.H. CONAC, *Mis-selling of Financial Products*, cit., p. 35; S. MICOSSI, *Testing the EU Framework*, cit., p. 9 ff.; I. MECATTI, *The Role of Deposit Guarantee Schemes in Preventing and Managing Banking Crises: Governance and Least Cost Principle*, in 17 *European Company and Financial Law Review*, n. 6, 2020, p. 674, ft. 54.

[39] After the resolution, cases of false in prospectus were also ascertained. This is why also shareholders have been indemnified.

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- UBI Banca, now Intesa San Paolo s.p.a. and BPER Banca s.p.a.), as new counterparties of the investment services contracts transferred in the sale of business.[40]

In June 2017, the ECB deemed two other regional Italian banks, Veneto Banca and Banca Popolare di Vicenza, to be "failing or likely to fail" (FOLTF),[41] but the SRB denied a public interest in resolving the institutions at the supranational level.[42] Then, the Italian authorities structured a taxpayer-funded orderly liquidation justified by the need to preserve the public interest which - in this case - was deemed to exist according to the BC2013.[43] The wind-down comprised the transfer of the business (performing loans, financial assets, deposits, and senior debt) to Intesa San Paolo (ISP), sweetened with the injection of €4.8 billion cash and the provision of state guarantees up to €12 billion and the transfer of the non-performing portfolio to Società per la

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[40] While the Italian Financial Ombudsman (ACF) has always recognized the capacity of the acquirers to be sued by the failed banks' (retail) clients and, therefore, in principle, also their liability as successors of the bridge banks (see the decisions of the ACF at https://www.acf.consob.it/web/guest/decisioni-del-collegio/ricerca-avanzata?p_auth=WsnkdLHC&p_p_id=ricercadecisioniavanzata_WAR_acfClientPortlet&p_p_lifecycle=1&p_p_state=normal&p_p_mode=view&p_p_col_id=column-1&p_p_col_pos=1&p_p_col_count=2&_ricercadecisioniavanzata_WAR_acfClientPortlet_javax.portlet.action=ricercaDecisioni), a final decision of the Supreme Court is still pending and courts' decisions on the matter vary. These lawsuits have the potential to increase the resolution costs imposed on public finances sharply, due to the guarantees Ubi banca and Bper demanded and received before closing the acquisitions of the four bridge banks (see BANCA D'ITALIA, *Rendiconto del fondo nazionale di risoluzione 2021*, 31 Marzo 2022, p. 9 ff., at https://www.bancaditalia.it/pubblicazioni/rendiconto-fondo-nazionale-risoluzione/2022-rendiconto-fondo-nazionale-risoluzione/index.html). For some decisions see B. INZITARI, *Legittimazione passiva dell'ente-ponte rispetto alle domande risarcitorie per il collocamento e l'emissione delle azioni e delle obbligazioni ridotte*, in *Dir. fall.*, 2018, II, p. 261; I. MECATTI, *La responsabilità dell'ente ponte per le pretese risarcitorie degli azionisti di banche sottoposte a risoluzione*, in *Banca, borsa e tit. cred.*, 2018, p. 570; App. Milano, 28 February 2019, n. 917. at https://www.cbalex.com/en/ability-bridge-institutions-defend-trial-court-appeal-overturns-conclusions-court-milans-business App. Bologna, 30 aprile 2021, n. 1055, at; https://www.expartecreditoris.it/provvedimenti/legittimazione-passiva-va-esclusa-in-capo-allente-ponte-rispetto-ad-azioni-risarcitorie-post-cessione; Trib. Milano, 29 settembre 2022, proceeding n. 30427/2016, in Nomos Basileus, n. 21, Ottobre 2022; Trib, Venezia, 6 luglio 2021, at http://www.fallimentiesocieta.it/sites/default/files/Sentenza%20Trib.%20Venezia%202.7.2019.pdf.

[40] BANCA D'ITALIA, *Rendiconto del fondo nazionale di risoluzione 2021*, 31 Marzo 2022, p. 9 ss., at https://www.bancaditalia.it/pubblicazioni/rendiconto-fondo-nazionale-risoluzione/2022-rendiconto-fondo-nazionale-risoluzione/index.html.

[41] See https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html. With respect to Veneto Banca, the SRB found that «the failure of the Institution, on a standalone basis, is not likely to result in significant adverse effects on financial stability in Italy» and, that «considering the relatively low financial and operational interconnections with other financial institutions, an adverse impact (contagion) on other financial institutions and considerable spill-over effects to other intermediaries are regarded highly unlikely»; the SRB concluded that «while a potential adverse impact on retail customers and SMEs in certain regions, in which the Institution has a stronger presence, cannot be excluded, there would be no significant impact at national level» (art. 4.2.2). The SRB reached the same conclusions with respect to Banca Popolare di Vincenza (art. 4.2.2).

[42] See https://www.srb.europa.eu/system/files/media/document/srb-ees-2017-11_non-confidential.pdf and https://www.srb.europa.eu/system/files/media/document/srb-ees-2017-12_non-confidential.pdf

[43] The EC, in decision SA.45664 (Brussels, 25.6.2017 C(2017) 4501 final) authorised liquidation aid for the two banks on the grounds that «Article 107(3)(b) TFEU enables the Commission to find aid compatible with the internal market if it is 'to remedy a serious disturbance in the economy of a Member State» (para 95); «According to the Italian authorities it would not be possible to avoid a serious disturbance in the economy in the areas where VB and BPVI operate with a particular impact on interruption of SME's business activities and lending to households» (para 98). On the two controversial assessments see I. G. ASIMAKOPOULOS, *The Veneto Banks Resolution: It Shall Be Called 'Liquidation'*, in 15 *European Company Law Journal*, n. 5, 2018, 161; P. NICOLAIDES, *State aid after the Banking Union: serious disturbance and public interest*, *in Journal of Banking Regulation*, n. 23, 2022, p. 83 f.

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Gestione di Attività s.p.a. (SGA), a vehicle previously used to manage the crisis of Banco di Napoli.[44]

The potential implications of bailing senior debt holders played a decisive role in the choice to carry out an orderly liquidation, rather than opting for resolution.[45] In fact, in a resolution scenario, state aid –confirmed as necessary by the EC[46] – would have been possible only if, *inter alia*, not less than eight percent of the total liabilities of the two banks contributed to absorbing losses (BRRD, art. 37(10)). Considering the business model and the balance sheet of the Veneto banks,[47] the bail-in would have involved senior creditors, instead of only shareholders and subordinated debt holders contemplated in the state aid burden-sharing (BC2013, par. 77). In order to facilitate the sale of business, all claims of shareholders and subordinated bondholders, as well as claims deriving from mis-selling in the placement of the shares and subordinated bonds, were explicitly excluded from the transfer to ISP, and remained in the liquidated entity.[48] However, due to the high percentage of bank bonds held in the household sector, in this case the abovementioned[49] compensation of aggrieved investors was also provided.[50]

In July 2017, the EC announced the approval of the precautionary recapitalisation of Banca Monte dei Paschi di Siena s.p.a. (MPS).[51] This amount included a state recapitalisation of € 5.4 billion, which, together with the conversion of the subordinated debt instruments into shareholders' equity of €2.9 billion (burden-sharing) and the capital-generating effect from the sale of the merchant-acquiring business of €0.5 billion, should have in the end increased the bank's CET1 by approximately €8.8 billion. Again, the burden-sharing hit numerous mis-sold retail investors.[52] Therefore, to prevent an exacerbation of the mis-selling issue—which already emerged during the "four banks" turnaround—making the crisis politically unmanageable,

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[44] The orderly procedure is regulated by the d.l. 25 June 2017 n. 99 converted into l. 31 luglio 2021 n. 121, in GU n. 184, 8 August 2017. On the crises of the Veneto banks see, *inter alia*, B. Mesnard – A. Margerit - M. Magnus, *The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza. Briefing*, 6 July 2017, PE 602.094; I. Mecatti, *La responsabilità della banca cessionaria nell'ambito della l.c.a. delle banche venete per le pretese risarcitorie degli azionisti e restitutorie dei creditori della banca cedente*, in *Banca, borsa e tit. cred*., 2019, II, p. 778; M. Ventoruzzo – G. Sandrelli, *Oh Tell Me the Truth about Bai l-in*, cit., p. 293 ff.

[45] B. Mesnard – A. Margerit – M. Magnus, *The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza*, Briefing 6 July 2017, PE 602.094, p. 6; I. G. Asimakopoulos, *The Veneto Banks Resolution*, cit., p. 158.

[46] The precautionary recapitalisation was meant unfeasible only because two banks were already in serious financial difficulty: see Mef, *The liquidation of Banca Pop. di Vicenza and Veneto Banca*, p. 4, at https://www.mef.gov.it/inevidenza/documenti/Liquidation_of_banks_in_Veneto.pdf.

[47] See B. Mesnard – A. Margerit– M. Magnus, *The orderly liquidation*, cit., p. 10.

[48] See art. 3, d.l. n. 99/2017.

[49] See ft.38 and 39.

[50] Despite this compensation, another wave of lawsuits hit both the ACF and the Italian courts. The main legal question remains the liability of the buyer (ISP) for the damages the Veneto banks inflicted on mis-sold investors. In this case, however, the presence of the specific exclusion clause made the claims so complex to require a decision of the Constitutional Court which was asked to assess, *inter alia*, whether art. 3, d.l. n. 99/2017 is compatible with the rights to equality, defence and property, respectively enshrined in artt. 3, 24 42 of the Italian Constitution. The Constitutional Court has recently deemed the requests inadmissible on procedural and substantial grounds, without analysing the questions of Constitutional legitimacy (decision n. 225/2022, 4 October 2022, at https://www.giurcost.org/decisioni/2022/0225s-22.html?titolo=Sentenza%20n.%20225).

[51] See EC, State Aid SA.47677 (2017/N) – Italy, *New aid and amended restructuring plan of Banca Monte dei Paschi di Siena*, Brussels, 4.7.2017C(2017) 4690 final. On the crisis of MPS see Commissione Finanze e Tesoro, *Atti dell'indagine conoscitiva*, cit., p. 649 ff.; B. Mesnard – A. Margerit – M. Magnus, *The precautionary recapitalisation of Monte dei Paschi di Siena*. Briefing, PE 587.392, 6 July 2017; M. Clarich – A. Pisaneschi, *Aiuti di stato e tutela della concorrenza: I casi Tercas, Monte dei Paschi e Carige*, in M. Chiti – V. Santoro, *Il diritto bancario europeo*, Napoli, 2022, p. 170 ff.

[52] M. Ventoruzzo – G. Sandrelli, *Oh Tell Me the Truth about Bai l-in*, cit., p. 279 and 297.

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publicly-funded compensation was provided: the former subordinated retail bondholders (now shareholders) were given the opportunity to swap their shares for newly-issued senior bonds, which had the same maturity as the converted junior subordinated bonds[53]. Nevertheless, mis-selling claims of shareholders (old and new) and bondholders against MPS are still pending.[54]

In sum, following the distressing experience of applying burden-sharing to retail investors in a banking crisis managed within the CMDI framework, Italian decision makers have gone to great lengths to avoid resorting to retail investors in bank resolution significantly. Insofar as the goal of these efforts was also to steer clear of headline-catching litigation from aggrieved retail bondholders, only limited success was achieved. The related public tumult caused by even modest private sector involvement in burden-sharing further adds to the disincentive to bail-in retail investors again.

4. *The holdings which really matter*

This section sets out the background for our analysis as to whether the regulatory framework provides sufficient precautions to prevent the holding of bail-inable debt instruments by unsuitable retail investors. For that purpose, we sketch the scope of the bail-in tool (below in section 4.1.) to delineate which liabilities will typically be subject to burden-sharing under the CMDI framework. We specifically describe the G-SII TLAC requirement (below in section 4.2.) and institution-specific MREL (below in section 4.3.) requirements to highlight the key characteristics of the liabilities designated for burden-sharing. The negative implications of unsuitable holders are most pronounced in these instruments (below in section 4.4).

4.1. *Scope of the bail-in tool and minimum requirement for own funds and eligible liabilities (MREL)*

In principle, the bail-in tool as stipulated in art. 44(1), BRRD and art. 27(1), SRMR allows RAs to re-engineer the whole liability side of a troubled institution's balance sheet, although some exceptions apply.[55] The order in which equity and debt holders bear losses and, if the bank is not liquidated, contribute to the failed institution's recapitalisation, is determined by the waterfall that mirrors bankruptcy priorities (BRRD, art. 48(1)).

The regulatory framework prescribes MREL to make sure that banks, at all times, maintain sufficient high-quality loss-absorbing, easy to bail-in liabilities that allow for meaningful private sector involvement in bank resolution beyond own funds. MREL levels are calibrated in a way that, depending on the preferred strategy foreseen in the resolution plan for the bank or banking group, allows either the orderly liquidation of the failing bank (loss absorption amount) or its recapitalisation (recapitalisation amount, BRRD, art. 45c(3)).[56] In either case, MREL instruments

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[53] The exchange was subject to the condition that the investors waived, in a settlement, any claim relating to the valuation and conversion of the subordinated financial instruments (art. 19, par. 2, d.l. n. 237/2016, converted in l. n. 15/2017, decreto salva risparmio). See I. MECATTI, *Il decreto salva-risparmio*, in *Riv. dir. banc.*, 2017, p. 327 ff.; D. ROSSANO, *Il decreto "salva risparmio" e la vicenda MPS*, 2016, at dirittobancario.it; M. VENTORUZZO – G. SANDRELLI, *Oh Tell Me the Truth about Bai l-in*, cit., p. 74 ff.

[54] See the several decisions of the ACF at https://www.acf.consob.it/web/guest/decisioni-del-collegio/ricerca-avanzata?p_auth=DJybG74c&p_p_id=ricercadecisioniavanzata_WAR_acfClientPortlet&p_p_lifecycle=1&p_p_state=normal&p_p_mode=view&p_p_col_id=column-1&p_p_col_pos=1&p_p_col_count=2&_ricercadecisioniavanzata_WAR_acfClientPortlet_javax.portlet.action=ricercaDecisioni.

[55] T.H. TRÖGER, *Too Complex to Work*, cit., p. 57.

[56] See SINGLE RESOLUTION BOARD, *Minimum Requirement for own Funds and Eligible Liabilities*, June 2022.

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are earmarked for write-down or conversion in the reorganisation of the troubled bank's balance sheet. Therefore, regardless of the resolution strategy, MREL instruments are those that are most likely to be bailed-in after the bank has been declared FOLTF. They thus represent the debt instruments that are least suitable for retail investors.

4.2. Key characteristics of MREL instruments: requirements for global systemically important institutions (G-SIIs)

For global systemically important institutions (G-SIIs), art. 92a(1) of the CRR implements the TLAC Standard of the FSB[57] and stipulates specific G-SII requirements for MREL, marking the starting point for institution-specific calculation of MREL by the SRB (BRRD, art. 45d(1)). Quite importantly for our analysis, the G-SII requirements also follow item 11 of the TLAC Standard and stipulate – with some exceptions – a rigid subordination precondition in CRR (art. 72b(2)(d)), whereby eligible instruments must be subordinated to ineligible liabilities to facilitate bail-in under the no creditor worse off (NCWO) principle.[58] Within the EU, the new art. 108(2) of the BRRD bolsters the robustness of private ordering solutions to achieve subordination, because harmonised insolvency laws in the Member States shall provide for subordination of eligible debt instruments that are issued with explicit reference to the respective ranking under national implementing provisions. The introduction of this new tranche of (unsecured) senior non-preferred liabilities followed autonomous and thus heterogeneous initiatives in several Member States[59] that sought to minimise the costs of compliance with the G-SII-subordination requirement by relieving their institutions of the need to issue more costly subordinated debt instruments. The respective amendment of the BRRD[60] was already promulgated before the adoption of the Banking Package in 2019 (BRRD II)[61] to limit the variation in the solutions Member States had adopted autonomously. Still, the earlier national initiatives require some grandfathering for bond issues pre-dating the European harmonization. In the interim, this leads to some variations in the class of senior non-preferred debt across Member States, which creates a challenge with respect to data collection.

4.3. Institution-specific MREL

The subordination requirement generally does not apply to institution-specific MREL, that is the requirements that are set either on top of the G-SII minimum or as original specifications for all other banks. BRRD art. 45b(1)(b) deliberately does not refer to the subordination requirement in Article 72b(2)(d) of the CRR. However, for G-SIIs, institutions that are part of a resolution group with total assets of more than €100 million (tier 1 banks) (BRRD, art. 45c(5)), and institutions whose failure may have systemic implications (fished banks) (BRRD,

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[57] See, *supra*, § 1.

[58] For alternative ways to achieve subordination see CRR, art. 72b(2)(d)(ii) and (iii). On this point see T.H. Tröger, *Qualitative capital requirements*, cit., p. 112.

[59] Relevant creditor hierarchy legislation was passed for instance in France (Code monétaire et financier, art. L.613-30-3 as amended by Loi n. 2016-1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique), Germany (Kreditwesengesetz, § 46f(6) as amended by Gesetz zur Ausübung von Optionen der EU-Prospektverordnung und zur Anpassung weiterer Finanzmarktgesetze vom 10 Juli 2018, art 8(10)), Belgium (Wet op het statuut van en het toezicht op kredietinstellingen en beursvennootschappen, art 389/1), and in Italy (art. 12-*bis*, tub, as introduced by l. 27 dicembre 2017, n 205) before the adoption of the EU Banking Package.

[60] Directive 2017/2399/EU of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy, [2017] OJ L345/96.

[61] See, *supra*, § 2.

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art. 45c(6)), an indirect subordination requirement may apply from 2024 onward. The respective RAs must fulfil MREL in the amount of at least eight percent of total liabilities using own funds (TLOF), subordinated eligible instruments, or specified liabilities issued by an EU subsidiary (BRRD, art. 45b(4)). Depending on the own funds endowment of the covered institutions, this eight percent TLOF requirement can translate into a stringent subordination requirement for part of its eligible liabilities. Finally, for all other institutions, RAs may invoke the eight percent TLOF requirement and thus also trigger a need to fulfil parts of the institution-specific MREL with subordinated liabilities (BRRD, art. 45b(5)). The critical factors here are both the capital structure of the institution and the preferred resolution strategy because RAs ultimately must determine whether the NCWO principle would be violated in the resolution of the respective institution. The risk that bailed-in senior creditors would incur greater losses in resolution than in insolvency because some *pari passu* or junior ranking creditors are exempt from bail-in according to BRRD, art. 44(2) and (3) can be eliminated if the MREL cushion contains sufficient amounts of own funds and subordinated liabilities.

According to a recent analysis,[62] MREL instruments cannot always be easily identified by looking at a certain class of securities. Under the current regulatory framework, MREL in non-G-SIIs may be fulfilled to significant degrees with non-subordinated debt instruments. Therefore, while RAs receive granular information on the amount and characteristics of outstanding MREL instruments from banks (BRRD, art. 45i(1) and (2)), these characteristics, particularly their ranking in insolvency proceedings, are hard to determine from publicly-available data. The relevant pillar 3 disclosures currently only apply to G-SII requirements, thus leaving substantial parts of the European banking sector in the dark.[63]

4.4. MREL, TLAC, and bail-inability

The post-GFC reform agenda focused on bolstering balance sheet positions available for loss absorption rather than pushing for higher equity ratios. The G-SII requirement (TLAC) refers to the layer of capital available for bail-in foreseen by the FSB for global systemically important banks (G-SIBs) (of which there are currently 30 in Europe). MREL is the extensive European implementation of the TLAC Standard, required by the BRRD for all institutions in the EU, including smaller banks. Finally, bail-inable debt comprises all debt of a bank that can be used to recapitalise the institution under the BRRD.

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[62] T. Farina, J. P. Krahnen, I. Mecatti, L. Pelizzon, J. Schlegel, T.H. Tröger*, Is there a 'retail challenge' to banks'resolvability? What do we know about the holders of bail-inable securities in the Banking Union?*, SAFE White Paper No. 92, November 2022, p. 28 ff.

[63] See CRR, art. 437a. The disclosure requirement under BRRD, art. 45i(3) will not enter into force before January 1, 2024.

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Figure 1: Waterfall of loss attribution

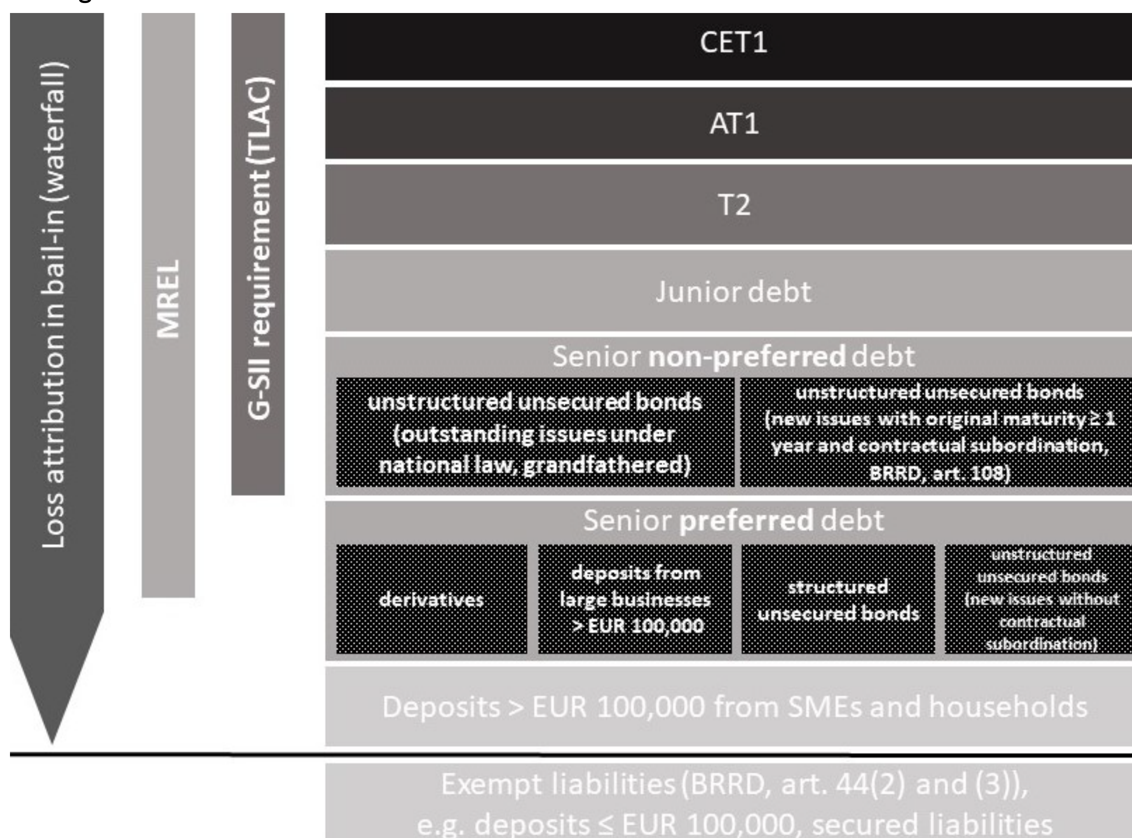

Figure 1 depicts the creditor hierarchy, which determines the order in which bail-in ensues if a bank is resolved under the BRRD. Even though the G-SII requirement and MREL primarily absorb losses in a gone concern scenario, private sector involvement does not stop once these balance sheet positions are exhausted.

5. *Precautions to prevent retail investor from holding bail-inable debt*

This section assesses whether the regulatory framework provides sufficient precautions to prevent unsuitable retail investors from holding debt instruments that will typically be subject to bail-in. We describe the regulatory framework (below in section 5.1.) before we evaluate the policy relevance of our findings (below in section 5.2.)

5.1. Direct and indirect holding restrictions for retail investors

The response to the retail challenge presented by a bail-in scenario arrived with the implementation of both the BRRD II and MiFID II.

While the original resolution framework did not address the retail challenge at all, the 2019 banking package introduced BRRD, art. 44a to prevent mis-selling of MREL instruments to unsuitable retail customers, particularly in self-placements of financial institutions. The regulatory strategy which Member States had to implement by 28 December 2020 (BRRD II, art. 3), relies primarily on a detailed suitability test that follows the example of MiFID II[64] (BRRD, art. 44a(1)-

[64] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, art. 25, [2014] OJ L 173/349.

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(4)). Alternatively, Member States can also prescribe a minimum denomination of MREL securities to be sold to retail clients of at least €50,000 (BRRD, art. 44a(5)).[65] Quite importantly, both additional requirements only apply to subordinated MREL securities,[66] meaning no specific restrictions apply for primary or secondary market transactions of non-subordinated MREL securities even if the buyer is a retail client. Moreover, even in those Member States that opt for a minimum denomination of subordinated MREL securities, European law does not prevent banks from issuing MREL securities with lower denominations, if they do not intend to sell them to retail clients. In sum, the new regime does not prohibit the self-placement of MREL securities to retail investors per se, and therefore does not comprehensively address the retail challenges we identified earlier.

As aptly illustrated by the mis-selling of bail-in debt that occurred in Italy under the investor protection rules of MiFID,[67] the original regime was insufficient to address abusive practices. Hence, the European co-legislators also amended the relevant provisions in MiFID II. However, despite the glaring conflicts of interest, the new regime does not ban the self-placement of securities, and instead specific rules have been devised for such transactions that seek to invigorate investor self-protection.[68]

First, the legal regime requires that EU-licensed banks,[69] offering own securities, which are included in the calculation of prudential requirements, shall explain to clients the nature and source of the conflicts of interest inherent to this type of activity, providing details about the specific risks related to such practices in order to enable clients to make an informed investment decision.[70] Furthermore, if the instrument is bail-inable, banks shall provide clients with additional information explaining the difference between the instrument placed and bank deposits in terms of yield, risk, liquidity, and any protection provided in accordance with Directive 2014/49/EU (DGSD).[71] These disclosure obligations, combined with others embedded in the legal framework,[72] should allow clients to make well-informed decisions on investments, and be aware of any material conflict of interests that could prevent the bank from acting in their clients' best interests.[73] However, although the legal framework

[65] Investment firms subject to MiFID II, art. 25, still need to perform a suitability test before selling covered MREL instruments to their clients.
[66]Cf. BRRD, art. 44a(1) that explicitly and without exception refers to all the eligibility requirements in CRR, art. 72a that includes the rigid subordination requirement in CRR, art. 72b(2)(d).
[67] See, *supra*, § 3.3.
[68] On the interplay between bank resolution and investor protection rules see. A. Sciarrone – U. Malvagna, *Misselling in Self-placement and Bank Resolution under BRRD2*, in 17 *European Company and Financial Law Review*, n. 5, 2020, p. 534 ff.; I. G. Asimakopoulos, *Self-placement. Mitigating the silo effects between banking regulation and investor protection rules*, in K. Ligeti – K. H. Brodersen (eds.), *Study of Enforcement in Multilevel Regulatory Systems*, Baden-Baden, 2022, p. 263 ff.
[69] The pertinent parts of MiFID II not only apply to investment firms, but also to CRD credit institutions when they provide one or more investment services such as the reception, transmission, or execution of client orders, see MiFID II, art. 1(3). The same is true for all level 2 acts promulgated under MiFID II, see for instance Commission Delegated Regulation 2017/565/EU of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, art. 1(2), [2017] OJ L 087/1.
[70] Art. 41 (3), Commission Delegated Regulation 2017/565/EU.
[71] Art. 41(4), Commission Delegated Regulation 2017/565/EU.
[72] See MiFID II, art. 24 and Commission Delegated Regulation 2017/565/EU, arts. 44, 46, 48.
[73] On the organizational duties of banks and investments firms to prevent and manage conflicts of interest see below.

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establishes the basic content of transparency obligations, it does not outline at which stage of the customer's decision-making process they have to be fulfilled. This may lead to different practices, such as giving the due information at a late stage. Moreover, according to a recent policy analysis, disclosure "is a necessary but not sufficient means to support retail investors in making their choices."[74] In addition, the information mandated by the MiFID framework is typically standardised boilerplate yet still potentially complex, which may prevent average retail investors from making fully rational and accurate comparisons and choices.[75]

Second, MiFID II does not modify the basic placement duties, but rather reinforces the suitability and appropriateness test. In cases of investment advice or portfolio management services, the intermediary shall ensure that retail investors are not recommended complex financial products or services that are not suitable for their (i) level of knowledge and experience in the relevant field, (ii) financial capacity, and (iii) investment objectives, including risk tolerance.[76] According to the ESMA's Guidelines, all bail-inable debt instruments are considered "complex"[77] due to the difficulties in understanding the characteristics of these products and the possibility of a conversion into equity in a bail-in.[78] When personal investment advice is absent, financial institutions need to alert their clients, with a warning which can have a standardised format, when the product is inappropriate for them.[79] Although a deep analysis of these safeguards is beyond the scope of this paper, even a cursory assessment casts doubts on their efficacy. As recent studies demonstrate, the timing, procedure, and controls put in place by investment firms and banks do not ensure that clients' best interests are protected.[80] Moreover, the information provided by retail clients and households may often be unreliable, because, depending on the given socio-demographic and socio-economic profile, the self-reports overstate these clients' risk tolerance and thus potentially overexpose them to financial risks.[81]

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[74] European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, D. Uličná, - M. Vincze - M. Mosoreanu et al., *Disclosure, inducements, and suitability rules for retail investors study*, Final Report, Brussels, May 2022, p. 90; see also Esma, *MiFID practices for firms selling complex products*, Opinion, 7 February 2014, ESMA/2014/146, p. 1; for an analysis of the limitations that financial products complexity poses for retail investors see S.L. Schwarcz, *Regulating complexity in financial markets*, in 87 *Washington University Law Review*, vol. 2, 2019, p. 211 ff.; E. Avgouleas, *The global financial crisis and the disclosure paradigm in European financial regulation: The case for reform*, in 6 *European Company and Financial Law Review*, 2006, p. 440.

[75] See Oecd, *Improving online disclosures with behavioral insights*, OEDC Digital Economy Paper n. 269, April 2018, p. 19

[76] MiFID II, arts. 24(1), 24(4), 24(5), 25(3) and 25(4). More specifically, the appropriateness assessment seeks to verify that clients have a sufficient level of knowledge and financial experience to understand the risks their investment is subject to. The suitability assessment gauges whether the product is appropriate for the clients based on their objectives, knowledge, experience and financial situation, taking a broader scope than the appropriateness test.

[77] Esma, *Final Report - Guidelines on complex debt instruments and structured deposits*, ESMA/2015/1783, 20 f. This includes all the eligible liabilities under the BRRD with the exclusion of those excluded from bail-in under art. 44(2), BRRD. ESMA specifies that the mentioned criterion should also apply to debt instruments issued by third country entities.

[78] Commission Delegated Regulation 2017/565/EU, art. 57(d)(f).

[79] MiFID II, art. 25(3).

[80] See the reports of National Competent Authorities recalled by European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, D. Uličná, - M. Vincze - M. Mosoreanu et al., *Disclosure, inducements,* cit., p. 337.

[81] K. Kochaniak - P. Ulman, *Risk-Intolerant but Risk-Taking—Towards a Better Understanding of Inconsistent Survey Responses of the Euro Area Households*, in *Sustainability*, 2020, 12, p. 6912. For example, in Germany, a Bafin Survey (Federal Financial Supervisory Authority, *Annual Report*, 2019, p. 118), demonstrates that in only 11.3 % of the suitability reports, the institutions explain how the characteristics of the recommended product match all of the client's

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Third, the product governance regime is aimed at ensuring that firms behave in their clients' best interests during all phases of the investment product's life-cycle, avoiding conflicts of interest and preventing mis-selling. The regime specifies a set of conduct rules for investment firms and banks that sell financial instruments to retail investors. First of all, these institutions shall identify and periodically review their target market of end clients, as well as adopt a distribution strategy which has to be consistent with the identified target market, when they design and distribute financial products.[82] While for simple and more common products the target market could be identified with a broad brush, for "more complicated products such as bail-inable instruments, the target market should be identified with more details."[83] Moreover, firms have to identify and manage conflicts of interest[84] and, under all circumstances, act in accordance with the interests of their clients.[85] In case of self-placements, firms shall refrain from engaging in any activity where conflicts of interest cannot be appropriately managed, in order to prevent any adverse effects on clients.[86] Despite the undeniable significance of the product governance regime, this area of the regulatory framework also seems to suffer from deficiencies. Based on a common supervisory action (CSA) with national competent authorities (NCAs), the ESMA underscored, *inter alia*, that the definition of a target market appears to be approached as a formalistic exercise, with insufficient granularity and unclear definitions of critical terms.[87] Indeed, for this reason, the current guidelines are under review.[88]

5.2. Policy implications

Although the regulatory framework is aware of the retail challenge in bail-in-centred bank resolution and provides for several specific safeguards to address it, our assessment indicates that there are still significant shortcomings. Neither the amended BRRD nor MiFID II effectively counter the fundamental incentive problem that arises for banks that cannot place their bail-inable debt on markets, and therefore face an existential conflict of interests that makes them effectively sanction-proof: if the alternatives are to either mis-sell bail-inable securities to unsuitable retail investors or go into resolution, decision makers will no longer be motivated by looming sanctions for abusive selling practices (i.e. they cannot realistically be expected to fully comply with their legal obligations).[89] Thus, a regime that relies on self-restraint induced through regulation in the form of mandatory suitability and appropriateness tests or customer-oriented loyalty obligations remains unconvincing. Furthermore, the bounded rationality and the

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requirements (e.g. the attitude to risk, knowledge, experience and ability to bear losses). As a consequence, by 2019, the suitability reports failed to meet the legislation's objective to enable investors to have a complete overview of the reasons behind a recommendation, «with 39.3% of the sample group's suitability reports merely containing vague standard phrases».

[82] MiFID II, arts. 16(3) and 24(2).

[83] See *Statement of the EBA and ESMA on the treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive*, EBA/Op/2018/03, 30 May 2018, point 41.

[84] MiFID II, art. 23(1).

[85] MiFID II, art. 24(1).

[86] Commission Delegated Regulation (EU) 2017/565/EU, art. 41(2).

[87] *ESMA presents the results of the 2021 Common Supervisory Action (CSA) on MiFID II product governance requirements*, ESMA35-43-3137, 8 July 2022, p. 2. It also emerged that the product reviews «are not always performed frequently enough and with an adequate scope to verify if the financial instrument remains consistent with the needs, characteristics and objectives of the target market» (p. 3).

[88] ESMA, *Review of the Guidelines on MiFID II product governance requirements*, ESMA35-43-3114, 8 July 2022.

[89] On the importance of compliance with pertinent market regulation see also Hearing of Andrea Enria in the Treasury Standing Committee of the Senate of the Republic of Italy, *The 'banking reform package': CRD 5/ CRR 2/ BRRD 2*, Rome 5 July 2017, p. 8

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behavioural determinants of unseasoned retail investors make it unlikely that even fully-fledged transparency requirements will lead to adequate decision making and meaningful self-protection.

The most radical solution to the problem would be to ban retail investors from holding debt instruments that are likely to be bailed-in should the bank go into resolution (i.e. prohibiting the purchase of MREL instruments on both primary and secondary markets outright). However, this might be excessive. Yet, the critical aspect is not whether retail investors are permitted to invest in bank equity, which is inherently riskier than subordinated debt, or in convertible debt securities of corporate issuers, which are just as complex in their operations as bail-in.[90] First, the common misperception of the riskiness of MREL instruments does not apply to investments in bank equity, which are correctly perceived as a volatile and default-prone residual claim. Second, the specific incentive problems most prominent at ailing banks are typically absent when corporates sell their convertible securities. Nevertheless, we perceive an outright ban for retail investors to be inadequate. Such a prohibition would excessively restrict the universe of investment options for retail clients, and, inversely, reduce market depth and liquidity for MREL securities too much, particularly for small and medium-sized banks. It should be recalled in this context that from the perspective of financial stability, retail investors are "good" risk bearers, as they absorb losses outside of the financial system. The key is, however, that not all retail investors under all circumstances are suitable holders, because they might lack the required capacity to absorb losses *ex post* and might be unable to assess the risks of their investment correctly *ex ante*.

Even though it is unlikely that any regulatory regime could achieve a perfect separation of suitable and unsuitable retail investors in the real world, some targeted amendments following the recommendations below could enhance the efficacy of the current framework.

1. Instead of relying on extensive disclosure requirements that might cause nothing but an information overload, the regime should send one loud and clear signal that MREL securities are not designed for unseasoned retail investors. A high minimum denomination, which is optional for subordinated MREL bonds under BRRD, art. 44a(5), should be mandatory. This would not only serve as a heads-up for investors, alerting them that the respective instruments are not supposed to be bought with shallow pockets, as well as providing a coarse test of loss-absorption capacity. To be sure, we understand that such a requirement would only provide imperfect protection, but it has very low administrative costs and thus stands in stark contrast to the red-tape-laden suitability and appropriateness tests that might not even achieve better results in the end. Moreover, such a requirement could be easily enforced by market supervisors.

2. The regulatory framework should allow suitable (retail) investors to arrive at adequate risk calculations *ex ante*. A key factor in achieving this objective would be to make resolution outcomes as predictable as possible.[91] What sets MREL and other bail-in debt apart from convertible securities of corporate issuers is the discretionary powers of RAs which have a bearing on both the probability of default and the loss given default. Although some discretion remains inevitable to achieve *ex post* efficient results in resolution, critical sources of extreme variation could be eliminated. This is, for instance, true for the difference between resolution under the CMDI on the one hand, and liquidation under national (bankruptcy) laws on the other.

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[90] *Contra* see M. LAMANDINI, *Risposta a consultazione pubblica concernente il recepimento dell'art. 44-bis BRRD relativo alla commercializzazione ai clienti al dettaglio di strumenti soggetti a bail-in*, 12 maggio 2021, p. 1, at www.dt.mef.gov.it/it/dipartimento/consultazioni_pubbliche/consultazione_pubblica_44bis.html.

[91] On this overarching normative objective see T.H. TRÖGER, *Too Complex to Work*, cit., p. 148.

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In particular, the differences in the burden-sharing requirements (see above in section 2) create incentives to prefer liquidation over resolution, which seem hard to predict *ex ante* as the pivotal public interest assessment (PIA) is a gateway for national special interests,[92] that may or may not prevail, once the bank fails. Therefore, the differences in the burden-sharing requirements should be reduced[93] and the scope of the CMDI framework should be expanded.

3. Finally, the regime should rule out line-ups that are fraught with the most egregious forms of conflicts of interest. Therefore, we propose an outright ban on self-placements. Such a ban automatically removes the sanction-proof problem we identified as the root cause of the failure of conduct rules. If the ailing bank can only place its MREL securities through an independent and financially-healthy investment firm, compliance with the critical regulatory requirements (e.g. suitability assessment, and duty to act in the client's interests) becomes significantly more likely.

Beyond addressing the retail challenge more effectively, the proposed amendments should also have another benefit for the efficacy of the CMDI framework. If they were indeed apt to reduce mis-selling practices, they would also reduce the liability risks faced by potential acquirers of the failed bank (or its viable parts). This, in turn, would facilitate resolution schemes that rely on a sale of business, without compelling decision makers to resort to extensive government guarantees or capital injections.[94]

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[92] M. VENTORUZZO – G. SANDRELLI, *Oh Tell Me the Truth about Bai l-in*, cit., p. 308; T.H. TRÖGER – A. KOTOVSKAIA, *National interests and supranational resolution in the European banking union*, cit., p. 11.

[93] We do not make a claim here in which direction the alignment should go, i.e. if the ambitious eight percent of total liabilities requirement under the BRRD and the SRMR should be abolished and resolution financing arrangements or deposit guarantee scheemes should absorb losses earlier and to a greater extent.

[94] On the interdependence of litigation risks and successful sale of business resolutions see M. VENTORUZZO – G. SANDRELLI, *Oh Tell Me the Truth about Bai l-in*, cit., p. 310.

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