Precautionary Recapitalisation

National Bank of Greece, Piraeus Bank and Banca Monti dei Paschi di Siena (2015-2017)

Precautionary recapitalisation framework under the EU Bank Recovery and Resolution Directive (BRRD)

To reduce the cost of bank failures falling on taxpayers, in 2014, the EU issued the BRRD. Under this regime, resolution costs must first be borne by the shareholders and creditors of banks through a "bail-in" mechanism. Only once this happens, can there be an injection of state aid for banks, for example from national resolution funds. However, to promote financial stability, EU lawmakers also allowed for extraordinary public support measures under certain conditions. These measures include a state guarantee in respect of new liabilities incurred by the bank or access to central bank refinancing, or the recapitalisation of a solvent bank, subject to strict conditions (Article 32.4 of the BRRD). In essence, the policy caters for situations such as systemic liquidity shortages, when solvent banks might not be able to raise sufficient private capital to make good shortfalls required by authorities arising from stress tests or other assessments.

The primary justification for state aid is 'to remedy the serious disturbance in the economy of a Member State'. Second, precautionary recapitalisations are 'confined to solvent institutions'. According to the European Banking Authority (EBA), these are banks that do not and are not likely to, in the near future: (i) infringe the conditions for continuing authorisation; (ii) hold less assets than liabilities; and (iii) fail to pay debts as they fall due. In other words, these institutions must not be deemed to be failing or be likely to fail under the BRRD rules.

Third, capital injection into the beneficiary bank would require the approval of the European Commission (Commission). A submission for approval would need to include a restructuring plan, which details the measures for a bank to return to long-term viability, burden sharing plans and details about how distortion of competition could be limited, as well as assumptions about how the business would evolve in the future. Fourth, the precautionary recapitalisation should be 'proportionate' to the capital shortfall estimated by the banking supervisor. Fifth, the measures taken are 'temporary and precautionary', signifying the forward looking nature of the recapitalisation, which would not cover retrospective losses. The new capital 'should not be applied to offset losses that the institution has incurred or is likely to incur in the near future'. Essentially, this means that losses originating from the baseline scenario of stress tests or asset quality reviews must be absorbed by private funds.

Application of precautionary recapitalisations in Greece (2015) and Italy (2017)

In August 2015, Greece agreed to a third economic adjustment programme of €86 billion ($96.4 billion) with creditors, amid a severe economic downturn. These proceeds were deployed, among others, to recapitalise four major Greek banks impacted by high NPLs and deposit outflows. However, the European Central Bank's (ECB) asset quality review and stress test for these banks revealed significant capital shortfalls of between €4.4 billion ($4.9 billion) under the baseline scenario and €14.4 billion ($16.1 billion) for the adverse scenario.

While the banks proceeded to raise private capital, it proved inadequate in the cases of National Bank of Greece (NBG) and Piraeus Bank (Piraeus). Hence, in December 2015, the Commission approved precautionary recapitalisations of €2.7 billion ($3.0 billion) each for NBG and Piraeus. This capital was injected by the Hellenic Financial Stability Fund (HFSF)– in the form of contingent convertibles and ordinary shares – to bridge the capital shortfall required to meet the stress test threshold under ECB's adverse scenario.

Table 6: Summary breakdown of capital injection into four major Greek banks (2015)

Details / € Million	NBG	Piraeus	Eurobank	Alpha	Total	%
Conversion of creditors into equity	759	582	418	1,011	2,769	19%
Capital raised from private investors	757	1,340	1,621	1,552	5,271	37%
Capital injected by HFSF	**2,706**	**2,720**	**-**	**-**	**5,426**	**38%**
of which ordinary shares	***676***	***680***			***1,356***	***9%***
of which convertible instruments	***2,029***	***2,040***			***4,069***	***28%***
Other capital actions	380	291	83	180	935	6%
Total capital shortfall*	4,602	4,933	2,122	2,743	14,400	100%

* As determined by the ECB's stress test under the adverse scenario
Source: European Commission

Subsequent to the Greek experience, Italy carried out precautionary recapitalisation in relation to Banca Monte dei Paschi di Siena (MPS) pursuant to an unsuccessful private capital raise. In the EU-wide stress test results disclosed in July 2016, MPS fared the worst and recorded a negative Common Equity Tier 1 (CET1) ratio of 2.44% under the adverse scenario. However, the ECB recognised that MPS remained solvent, also taking into account the stress test results under the baseline scenario. Precautionary recapitalisation was aimed at covering the unexpected and unrealised losses (the gap between the adverse results and 11.5% CET1), which was considered as a reference by the ECB. Hence, losses of the Additional Tier 1 (AT1) and Tier 2 (T2) buffers resulted in a maximum precautionary recapitalisation amount of €8.8 billion ($9.9 billion). MPS was further supported by the approval of State guarantees to senior bonds, of which €11 billion ($12.3 billion) was issued by MPS. Owing to protracted negotiations between the Italian authorities and the Commission, the precautionary recapitalisation in MPS was only approved in July 2017.

The total recapitalisation (taking into account registered losses and the proceeds of certain disposals by MPS) finally amounted to approximately €8.2 billion ($9.3 billion). These losses were met by the conversion of junior bondholders (AT1 and T2 bonds) amounting to €4.3 billion ($4.9 billion), and a government capital injection of €3.9 billion ($4.4 billion). The Italian government also provided compensation for MPS' mis-selling of subordinated bonds to retail investors to the tune of €1.5 billion ($1.7 billion). Therefore, total state aid amounted to €5.4 billion ($6.1 billion), which was approved by the Commission together with a comprehensive restructuring plan. This included plans for MPS to enhance risk management, divest €26.1 billion ($29.5 billion) in NPLs to a private securitisation vehicle (Atlante II), and re-focus its business model towards national retail customers and Small and Medium Enterprises (SMEs).

Compared to the case of MPS, another two Italian banks – Banca Popolare di Vicenza and Veneto Banca (Venetian banks) – had applied to the Commission for precautionary recapitalisation in April 2017, but their requests were not approved. Based on the EU stress test in 2016, both banks registered a total capital shortfall of €6.4 billion ($7.2 billion) and failed to raise private capital in an initial phase. The Venetian banks then received funds from a private-sector fund (Atlante) mainly provided by Italian banks, which planned to merge both banks. However, the conditions for precautionary recapitalisation were not met since the ECB declared both banks to be "failing or likely to fail" on 23 June

2017. Subsequently, after the Single Resolution Board (SRB) concluded that resolution was not in the public interest, the two banks went into liquidation under Italian insolvency law. As part of this procedure, the performing businesses of both banks were transferred to Intesa Sanpaolo (Intesa) for €1, subject to the provision of aid by the Italian government. This liquidation aid took the form of a direct cash injection into Intesa of €4.78 billion ($5.5 billion), and the provision of state guarantees of up to €12 billion ($13.7 billion).[71] The liquidation aid was approved by the Commission.

Key takeaways

Precautionary recapitalisation accords some flexibility to the authorities to provide State aid to a solvent institution facing unexpected losses and to avert its potential failure. Various safeguards have been established to ensure that government funds – in the form of capital or liquidity support to the banks – are deployed in an appropriate, necessary and proportionate manner. Over and above fulfilling specific conditions, the cases in EU demonstrate that, in practice, applying precautionary capitalisation would involve complex negotiations. Among others, extensive negotiations are needed to determine if the conditions for this aid are met (mostly, that State aid should not cover any registered or expected losses), the extent of burden sharing with other parties, or the raising of private capital from investors. Nevertheless, these rules and negotiations mean greater levels of accountability for the early provision of government capital support to institutions.

71 The cash injection of €4.78 billion comprised €3.5 billion for Intesa to maintain its capital ratios and €1.28 billion for restructuring costs related to staff layoffs and branch closures. The state guarantees covered financing of the liquidation (€5.3 – €6.3 billion), future NPLs from high-risk performing exposures, and legal risks (€4 billion)