MINIMUM REQUIREMENT FOR OWN CAPITAL AND ELIGIBLE LIABILITIES (MREL)

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Abstract. The concept of "Minimum Requirement of capital and Eligible Liabilities" (MREL) sits atop the new system of banking law, and its essential to make it work, but this also makes it controversial. First, having a cushion of capital and liabilities that may be used for loss absorbency and recapitalization is essential to make bank resolution feasible, but this very nature situates MREL between the exercise of ('preparatory') powers by resolution and supervisory authorities. Second, the calculation of MREL directly depends on the bank's size, structure, business model and resolution strategy, which makes it the catalyst for potential conflicts between the exercise of administrative powers, which try to plan for the bank's smooth demise and the bank's freedom of enterprise, reflected in its business model, its preferred funding structure and its going concern value, which is also a function of its funding costs. Since MREL is institution-specific, a proportionate calibration is necessary to ensure a level playing field across the industry and to prevent unwarranted competitive distortions. Third, since the MREL amount and the writing-off and conversion of MREL instruments is a precondition for the use of the resolution fund, it will be the linchpin of the tension between resolution authorities, which try to ensure burden-sharing, and domestic governments, which may try to minimize losses for certain investors; at the same time, since the single resolution fund can be tapped only after bail-in eligible liabilities have been written down for not less than 8% of "total liabilities including own funds" (TLOF), tensions may arise also between the SRB and the NRAs, when MREL is determined below the 8% TLOF and NRAs are willing to ensure that, in all possible circumstances, if necessary, resolution can be partly funded by the single resolution fund. Finally, while MREL instruments may have to be written down in the future, they certainly have to be subscribed now. But moral hazard is deterred at investors' cost, and a taxpayer's gain is a shareholder's loss, which creates an inevitable tension between the goals of financial stability, and investor protection. This chapter explores the MREL concept, its configuration and its potential for conflict.

1.- Introduction

The concept of "Minimum Requirement for own capital and Eligible Liabilities" (MREL) sits atop the new system of banking law. If the lessons from the 2008-2009 crisis had to be encapsulated in one sentence, it would be "too big to fail (no more), we hope". If reckless behaviour was to be discouraged, moral hazard was to be avoided, and prudence to be fostered, banks had to be self-sufficient in terms of resources. If a crisis stroke, funds had to come from the bank's investors (bail-in), rather than from the government (bail-out). Yet this feat could not be avoided without endangering the system: the solution of writing off equity and debt instruments looks good in theory, but if we were to apply the logic of bankruptcy law, many claims may enjoy the same status, and should be written off *pari passu*, but the disruptive effect may be incomparably larger in some cases (e.g. deposits or derivatives) than in others (e.g. senior bonds), to not mention the divergences between different insolvency laws.

Enter the concept of "Total Loss-Absorbing Capacity" (TLAC) at a global level, and the concept of Minimum Requirements of Capital and Eligible Liabilities (MREL) at an EU level. Its basic idea is simple, and sensible: to try to anticipate the problems that may arise in an *ex post* enforcement setting and identify a layer of debt that can be bailed-in quickly, and, if not painlessly, at least not disruptively. Our focus in the present chapter will be MREL (although a brief comparison will be offered), but the two measures share the same basic underpinning (simple and sensible) philosophy. Yet, despite the simplicity and sensibility of the idea, its implementation is inevitably complex, and must be reasonable and proportionate not to lose sight of the way MREL interplays with other tools. MREL took its place in an already existing, (and already complicated) system of rules and principles.

To provide a succinct, yet comprehensive explanation that captures this narrative the present chapter is divided in three more sections. Section 2 analyses the intellectual foundations of MREL at the level of principle: the concept of burden-sharing, its relationship to fundamental rights, such as property, and some difficulties of its implementation in light of rules on bankruptcy ranking and priorities. Section 3 then proceeds to explain how the concept of MREL draws lessons from the clash of principles and tries to give rise to a system where resolution problems are anticipated and dealt with in the planning stage, and how this inevitably gives rise to other, sometimes difficult, trade-offs. Section 4 discusses the implications of the need to market the securities that help achieve MREL, and how, especially in the face of legacy problems not yet solved at the time of implementation of the MREL targets, prudential, and financial stability considerations, can collide with an investor protection perspective, if this is not properly reconciled in a proportionate and reasonable way with the former. Section 5 concludes.

2.- Burden-sharing, and its implications: bail-in and fundamental rights.

The 2008-2009 financial crisis (and the following EU bank-sovereign crisis) forced Member States to accept the idea not only that banks could go bankrupt, but that they should, at least if a measure of discipline was to be instilled into the market. A constant recourse to bail-out breeds moral hazard. The answer in the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) has been the bail-in tool (art. 43 and ff. and 59 of Directive 2014/59/EU; art. 21, 27 of Regulation 806/2014, "SRM Regulation"). Before it was implemented the initial term of choice was the more neutral "burden-sharing", introduced in the European Commission's Banking Communication on State Aid of 2013. In this Section we examine the potential difficulties arising out of the bail-in tool (2.1) and then discuss the fundamental rights challenges, which were dealt with in case law framed in the pre-BRRD/SRM framework (2.2). Finally, we draw some general conclusions, which help provide the context for the relevance of MREL (2.3).

2.1.- Bail-in of financial instruments and its difficulties

Bail-in is part of the toolkit of instruments that resolution authorities can use when a bank crosses the point-of-non-viability (PONV), i.e. it is found Failing-or-Likely-to-Fail (FOLF), and there is no alternative solution available (art. 32 (1) BRRD, art. 18 (1) SRM Regulation) and it consists in the write-down and conversion of capital and debt instruments (art. 43, 59 BRRD; art. 21, 27 SRMR), in sufficient levels to ensure that the bank is viable and can continue its activity, or at least enough to find a private sector purchaser (art. 38 BRRD, art. 25 SRMR), or to be quite certain that a transfer of its assets and liabilities to a bridge bank (art. 40 BRRD, art. 26 SRMR) will ensure a posterior purchase, or the continuation of the activity. However, rather than just *any* tool, bail-in can be considered *the* tool that more fully expresses the resolution's framework's underpinning philosophy that moral hazard should be avoided, and that no bank should be too-big-to-fail. This pre-eminence can be seen in several details: (a) first, the bail-in tool has the longest, and most detailed regime of all resolution tools by far (art, 43-55, 59 and 108 BRRD compared to 38-39, 40-41, 42); (b) second, the write-down and conversion of capital and debt instruments is the only mechanism that can be used either in resolution or without putting a bank in resolution, i.e. also in cases where it will save the bank from resolution (art. 59 BRRD, art. 21 SRMR); (c) third, the provision is the only one accompanied by a regime, whose goal is not to regulate the use of the tool in a crisis-management situation, but to *anticipate, plan and prepare* for its use in a way that is swift and efficient, i.e. the MREL regime, which is discussed in this chapter (art. 45 BRRD, art. 12 SRMR).

To fully understand the need for such planning provisions in the first place we need to anticipate the problems that an unplanned application of the bail-in tool can cause. A careful reading of bail-in provisions shows that the main cause of concern is not the application of the bail-in tool itself, but the *instruments*, or *liabilities*, over which it may apply, and the sequence that may be used to apply it. Considering that the scenario alternative to resolution would be the bank's liquidation under national insolvency laws, it is wise if the approach in resolution does not unnecessarily depart from the approach of insolvency laws when it comes to the ranking and priorities of the instruments. A starkly different treatment in resolution from what would be expected upon insolvency could provide grounds for a claim of discriminatory treatment. The drafters of BRRD and SRM rules were aware of this, and, for purposes of the "bail-in sequence", i.e. the order in which the different instruments should be written-down or converted, they make a reference to the rules applicable in case of insolvency through the insisted reference to the so called "no-creditors-worse-off" (NCWO) principle (art. 48(1)(d) and (e) BRRD). So, problem solved, right?

Not quite, because the rules that represent an exception to this are numerous and relevant:

(i) First, the writing-down and conversion in accordance with the hierarchy of claims under insolvency takes place only *after* the conversion of CET1, Tier 1 and Tier 2 instruments, which are bailed-in in the order stipulated by resolution rules, regardless of what insolvency laws, or corporate liquidation rules may say.

(ii) Second, and crucial, together with rules on the bail-in sequence, resolution rules also regulate the bail-in exclusions (art. 44 (2) BRRD, art, 27 (3) SRMR), which include liabilities such as covered deposits, secured liabilities, liabilities resulting from a bank's clients' assets, or from the bank's fiduciary capacity, or to employees and tax authorities (which are often preferred liabilities in insolvency) but also short-term liabilities, and liabilities associated to the provision of critical services (art. 44 (2) (e), (f) and (g) (ii) BRRD; art. 27(3)(e), (f) and (g)(ii) SRMR), which (together with deposits) are considered ordinary liabilities in insolvency, and are excluded *ex novo* by resolution rules. The difficulty with this is not only in the newly excluded liabilities,[1]but in the fact that the logic of bail-in is *different* from the logic of insolvency rules. One excludes some liabilities (i.e. leaves them *out*) whereas the other merely puts them *up* in the ranking. Furthermore, the fact that resolution rules introduce the concepts, without fully relying on domestic insolvency law for purposes of gap-filling means that the interpretative weight shifts towards resolution rules, and thus away from domestic insolvency law, which creates more potential for divergence.

(iii) Third, and also important, resolution rules empower resolution authorities to exclude other liabilities from bail-in, when this can result in contagion, or make resolution more difficult.

The presence of these elements ensures that, in case of doubt about the status of a specific type of liability, there is a potential for friction. Resolution authorities may decide to interpret resolution rules in a way that classifies a specific instrument as Tier 1-2, even if, in an insolvency scenario, it might have ranked higher than equity or hybrid instruments, they may make a controversial decision as to what amounts to a "secured liability", or about the way to classify a certain class of liabilities as having a maturity shorter than 7 days. The tension may be even greater if resolution authorities decide to leave out of bail-in certain liabilities that, despite not belonging to the list of excluded liabilities, can be disruptive for the system, e.g. liabilities arising from a liquidity-management arrangement, or a hedging arrangement using derivatives.

This shows that, despite the EU legislators' concern about the alignment between resolution and insolvency, there is unavoidable room for friction. In light of this, three questions stand out: first, whether a writing-down and/or conversion of instruments constitutes a disproportionate interference with the property rights of the holders of those instruments, especially looking backwards to the legacy of the quite wide stock of bail-in eligible liabilities whose treatment current holders could not expect when they subscribed or acquired on the secondary market the instruments; second, what happens when the holder of an instrument is treated differently from the holder of another, despite they would have been treated equally under the applicable national insolvency law; third, how important is it for the holders of those instruments to be duly informed of the decision, to

[1] It is worth noting that article 108 BRRD modifies domestic insolvency rules to ensure that eligible bank deposits rank high in the insolvency hierarchy (i.e. above ordinary liabilities) and thus reduces the friction between a resolution and an insolvency scenario. However, this does not happen with short-term liabilities, or liabilities of trade creditors that provide critical services.

have an opportunity to present their case, and what kind of redress they can have, when financial stability is at stake. To these questions we now turn.

2.2.- Bail-in, burden-sharing, and their fundamental rights implications

The fundamental rights implications of bail-in and bank resolution and crisis-management must be drawn from case law that was decided before the BRRD or SRM frameworks were adopted. Still, the main features are general enough to be relevant as of today. The main difference is that, in the absence of resolution rules, the decision to impose losses on shareholders and creditors was adopted pursuant to the discretionary decision of public authorities. The first "framework" of sorts, which stipulated for the need of burden-sharing in general terms was the Commission Banking Communication, where it stated that its approval of a bank rescue would be conditional upon the fact that part of the funding to rescue the bank should come from the writing-off or conversion of shareholders' and creditors' rights.

The full-fledged version of this measure is the bail-in tool but when the BRRD and the SRM Regulation were adopted there were two alternative readings of the tool, as well as the principle (burden-sharing) underpinning it: (i) bail-in is a "neutral" tool, where the law imposes no losses on shareholders and creditors, the bank is simply worth less if not nothing, at the point of non-viability, and the holding of shareholders and creditors simply has to be adjusted; (ii) bail-in is a measure to deter moral hazard, which means that shareholders and creditors interests have to be sacrificed to impose some discipline. It is not difficult to notice that the first simply means a recognition of losses, whereas the second is an imposition of losses. This can result in major differences in terms of fundamental rights protection. First, we try to answer whether the right to property represents a threat to burden-sharing (2.1.1). Second, we discuss which other fundamental rights can be problematic for burden-sharing and bail-in (2.1.2).

2.1.1. Is the right to property a direct threat to burden-sharing?

One should justify burden-sharing and bail-in as a mere way to acknowledge the losses that the bank itself has suffered, regardless of the action of public authorities; however the law's narrative also emphasises the need to ensure that investors "bear", or "suffer" the burden.[2] An investor could then argue that, since public authorities, far from concerned about her losses, are trying to make an example of her, the rules have changed, resulting in an interference with her property. The courts' answer, though, has not been sympathetic so far, in light of precedents such as *Dennis Grainger and Others v the United Kingdom ("Grainger")*, by the ECtHR, and *Tadej Kotnik and Others v Državni zbor Republike Slovenije ("Kotnik")*, *Gerard Dowling and Others v Minister for Finance ("Dowling")"*, and *Ledra Advertising Ltd and Others v European Commission and European Central Bank ("Ledra")*, by the CJEU.

Grainger involved the crisis management of Northern Rock, which was nationalized. Upon calculating compensation for shareholders, the independent valuer was expressly instructed to assume that no financial assistance would be extended to the bank (*Grainger*, paras. 11, 21, 23), which, the expert concluded, resulted in zero compensation. The

[2] The English version of BRRD uses the more neutral verb 'bear' in article 34, but 'suffer' is used in recitals (55), (67) or (71), or articles 107 (3) or 109 (1) (b).

ECtHR accepted all the UK's arguments that the government had a wide margin of appreciation in this field (*Grainger*, para. 39), that zero compensation was a consequence of the bank's losses, not government intervention (*Grainger,* para. 40), that public authorities were not obliged to cover the debts of a private institution, and that the government's decision, was justified by the need to avoid moral hazard, and was thus far from being "manifestly without reasonable foundation" (*Grainger,* para. 42).

Kotnik and *Dowling* analysed the Commission's Banking Communication, which for the first time formulated a *policy* (i.e. not an individual decision) on burden-sharing (Banking Communication paras. 40 – 46). The CJEU held (i) that shareholders or debtholders of a bank cannot harbour the 'legitimate expectation' that the bank would receive financial assistance (*Kotnik,* paras. 63-66); (ii) that a transitional period for the States to adjust to this regime was not necessary, since no legitimate expectation had been created, and, even if it had been created, *the objective of ensuring the stability of the financial system while avoiding excessive public spending and minimising distortions of competition* would qualify as the type of overriding policy interest that would justify excluding any transitional period; and (iii) the burden-sharing measures indicated in the Banking Communication did not constitute an illegal interference with property rights, because they were not the source of losses to shareholders, and no one would suffer losses greater than under insolvency proceedings (*Kotnik*, paras. 78-79). To this effect, the No-Creditor Worse-Off (NCWO) principle (Banking Communication para. 46), which states that any loss by creditors in resolution *vis-à-vis* what they would have received in insolvency must be compensated, was of critical importance (*Kotnik*, para. 77).

We share the Courts' conclusions, but some of the reasons are controversial. First, notably the separation between the "interference with property rights", and the violation of legitimate expectations,[3] and the restrictive interpretation of such "legitimate expectations", which can only arise when there are *"precise, unconditional and consistent assurances, originating from authorised, reliable sources"* (*Kotnik,* para. 62). If that is the benchmark, there is little investors may rely upon, and their property rights amount to little. Second, the causal connection between investors' losses, and the bank's insolvency, which assumes that it is the bank's fault after all (*Grainger,* para. 40; *Kotnik,* paras. 74-75). Yet authors argue that there are banks that are simply illiquid yet solvent, and that differentiating between them is extremely difficult (Goodhart, 2008). Third, at times the rulings seem to justify a bank intervention followed by burden-sharing measures on the existence of "macro" disturbances and systemic risk (*Dowling*, para. 50), but this raises the question of whether it would be possible to effect a bail-in of a bank that is failing-or-likely-to-fail (FOLF) but there is no "serious disturbance" in the economy.

Finally, in *Konstantinos Mallis and Others v European Commission and European Central Bank ("Mallis")* and *Ledra* the CJEU considered the impact of measures adopted by Cyprus and imposed in exchange for an aid package by the European Stability Mechanism (ESM), with the European Commission and the ECB being the main players inside the ESM.[4] In *Mallis* the Court dismissed the case on grounds of lack of imputability of the conduct to EU authorities, and in *Ledra* the Court held that the write-down and

[3] It is hard to see the property over a bank's share/bond as something different from an expectation over payments, which depend on an expectation over the behavior of the market and public authorities

[4] The Court held that the acts of the ESM were its own, and subject to its privileges and immunities (falling outside EU Treaties). The Commission and ECB, however, could be held liable because, as EU institutions, they were always subject to the EU Treaties (including the Charter of Fundamental Rights) even when acting in an institution falling outside those Treaties.

conversion of debt instruments, including the conversion of a 37,5% of Cyprus Popular Bank's uninsured deposits into shares, with the promise of a buy-back of shares if the bank went overcapitalized did not constitute "a disproportionate and intolerable interference impairing the very substance of the appellants' right to property", in light of the imminent risk of financial losses if the banks had failed (*Ledra,* paras. 73-74). Again, regardless of the conclusion, which looks sound, the Court did not explain why 37,5% with a buy-back promise was reasonable, and what would be the yardstick in a different case.

2.1.2. Bail-in eligible instruments and procedural perspective

The general conclusion of the above cases is that burden-sharing is not contrary to property rights, and that insolvency is a good benchmark to measure investors' acceptable losses (NCWO principle) (art. 73-75 BRRD). Beyond that, however, it is hard to draw guidance for the future. One key element that was not discussed in the decisions is the existence (or absence) of equal treatment between banks or investors. This argument was alleged (i.e. differences between treatment of Northern Rock, on one hand, and RBS and HBOS), but not pursued in the ruling (*Grainger,* para. 32). Had the different in treatment been proven, public authorities would have been in a more defensive position., forced to the point of arguing LoLR's fully discretionary nature, to the point of arbitrariness. Differences in treatment led the Austrian Constitutional Court to annul the Austrian Federal Act on Restructuring Measures for Hypo-Alpe-Adria-Bank International AG (HaaSanG), which provided that the supplementary capital and subordinate debt instruments held by third parties would expire *provided* they matured before June 30, 2019, together with all their guarantees (by the State of Carinthia): the Court agreed with the CJEU and the ECtHR that the expiry of claims was not *per se* an expropriation, and it used insolvency as the benchmark to establish the value of claims, but it found that the distinction between claims maturing before and after June 30, 2019 was untenable.[5]

A second set of considerations that opens a risky way to challenge bank interventions concerns the *procedural* angle, where there are some of the few precedents seem to support that courts are readier to exercise closer scrutiny, as the ECtHR did in *Credit and Industrial Bank v the Czech Republic ("Credit v Czech Republic"),* and *Capital Bank AD v Bulgaria ("Capital v Bulgaria")*. Both cases were characterized by the intervention of individual banks (Credit and Industrial Bank, and Capital Bank) to mitigate spill-over effects that would have resulted from insolvency, but which resulted in drastic measures, such as the removal of management in *Credit and Industrial Bank*, and the withdrawal of the bank's license, followed by a declaration of insolvency and winding up *Capital Bank*. In both cases it was not possible to challenge the intervention (*Credit v Czech Republic,* para. 69; *Capital v Bulgaria,* paras. 27-33), in *Credit and Industrial Bank* because the board was replaced by an authority-appointed administrator, which left the former board without standing to sue (*Credit v Czech Republic,* para. 58).

The plaintiffs alleged both "property" and "access to justice" but the Court's reasoning was the same for both rights. In both cases the arguments were very similar (*Capital v Bulgaria,* para. 134): neither Czech nor Bulgarian courts had acted as courts "with full jurisdiction" (*Credit v Czech Republic,* paras. 71-72; *Capital v Bulgaria,* paras. 109, 135). In *Credit and Industrial Bank* the entity's board should have lodged an appeal *before* they

[5] Guarantees issued by a province/state could not retroactively be rendered invalid, even when the province is incapable of bearing the risk.

were formally divested of their powers, which was impossible (*Credit v Czech Republic*, paras. 69-70).[6] In *Capital v Bulgaria*, the rules precluded review by the courts, and the decision by an administrative body could replace a court ruling (*Capital v Bulgaria*, paras. 105-109).

Furthermore, in *Capital v Bulgaria* the Court did not limit itself to find a *prima facie* interference, but went on to analyse whether the measures were proportionate. The State made the usual argument that financial stability was at stake, but the Court retorted that, as special as the banking business may be, this could not justify a total absence of review by an independent body, which could, conversely, aggravate the crisis. Strict time limits could have helped protect the public interest (*Capital v Bulgaria*, para. 113). Posterior cases, such as *Adorisio v The Netherlands*, where Dutch authorities expropriated the investors in a Dutch bank, have shown that human rights courts are ready to be deferential to public authorities, as long as there is an opportunity for review: in that case the deadlines for lodging an appeal were very short (10 days), and the plaintiffs could access the report of an independent firm (on which the decision of intervention was based) only in redacted form, and were allowed to examine the statement of defence by the Minister the afternoon before the hearing (*Adorisio v The Netherlands*, para. 41). Still, the ECtHR did not see that judicial protection rights had been impaired, because the applicants put up an effective challenge (*Adorisio v. The Netherlands,* para. 101) and the Administrative Jurisdiction Division had had access to the full report (*Adorisio v The Netherlands*, para. 109).

2.3.- Preliminary conclusions

The above analysis shows that: (i) property rights as such do not result in an absolute obstacle to burden-sharing through the bail-in of debt and equity instruments; (ii) other principles, such as non-discrimination, can result in such a challenge; and (iii) from a procedural perspective courts were so far ready to be quite deferential, provided there is actual review, and the parties affected have an opportunity to present their case.

By way of principle, this is reassuring, but only slightly so. Consider the case of cross-border banks, especially large banking groups, which may have issued a large amount of financial instruments (in the hands of the public) as well as have multiple intra-group claims. Considering that the status of different instruments may starkly differ between jurisdictions (typically, intra-group claims) qualitatively similar claims can receive a drastically different treatment. If courts in the country of the relatively worse-off creditors are asked to enforce the bail-in decision, and creditors challenge the measures for being discriminatory, what should be the benchmark of comparison? If the crisis-management decision has to be implemented quickly to restore confidence to the market, is it realistic to presume that courts will have the time necessary to consider these nuanced questions?

[6] A similar situation was recently echoed in the case-law of the CJEU: the CJEU held that shareholders may have an interest in bringing proceedings (order of 12 September 2017, *Trasta Komercbanka v. European Central Bank*, T-247/17, EU:T:2017:623, para. 57) when the bank itself would not have standing. This was compounded by the fact that, according to the ECtHR's findings, in the process of review envisaged in the procedural laws, *"It is not the role of the courts to examine the substantive reasons for which the compulsory administration has been imposed or subsequently extended. Moreover, consistently with this limited role, the procedure before the court is exclusively written and takes place in private, without a hearing and without the possibility of opposition from the management of the bank."*

Thus, although the courts' deferential attitude was useful for a first stage, where the priority was to base burden-sharing measures on firm footing in terms of policy, i.e. as something not *per se* contrary to fundamental rights, this is only a first step. Fundamental rights are not only relevant to establish the ultimate bulwarks that protect individual parties from interference by public authorities' actions. *Their second key function is to establish the justificatory channels that should orient such action*. In this respect, the ECtHR is not well-suited to provide the proper interpretative framework, since it is only competent to hear human rights cases, whereas *the CJEU is competent to hear the fundamental rights angle, but also to examine the substantive statutory law. As such, it is uniquely placed to weave the logic of fundamental rights into the fabric of bank resolution, which is filled with open – textured references, open to cross-fertilization (see art. 31 and 34 BRRD).*

After a series of decisions where the CJEU simply granted burden-sharing a solid legal basis, it may adopt a less accommodating stance on substantive (non-discrimination) and procedural (duty to state reasons, judicial protection) safeguards. Otherwise, it may see that domestic courts step in to fill the void. This, as we said above, is risky in a context where the whole system of EU bank resolution is grounded on the automatic mutual recognition on a cross-border basis (art. 66 BRRD). Recent experience shows that domestic courts are often reluctant to follow the spirit of the rules, and ready to cling to weak arguments to refuse recognition, as in the case of the English commercial court in *Goldman Sachs International v Novo Banco SA* ("*Goldman Sachs v Novo Banco"),*[7] corrected by the Court of Appeal (*Goldman Sachs v Novo Banco,* paras. 24-34),[8] and the Supreme Court, and the decision of the Munich court in the *Bayern LB v Hypo Alpe Adria ("Hypo Alpe Adria")* case, which was not corrected. The problem is that if cases make their way up to the Supreme or Constitutional courts, and there is truly a difference in treatment, the CJEU may be facing challenging preliminary references (in a best-case scenario) or annulment decisions (in a worst-case one) from several Member States. In the past the CJEU has been vehement in concluding that EU rules that are clear in their content, and leave no discretion to Member States cannot be circumvented by referring to national constitutions, but in this scenario the Court might face a storm if it tells a national court that they cannot protect their citizens from violations of due process, or non-discrimination.

The above does not wish to paint a doomsday scenario; it merely tries to illustrate what is at stake for the EU and its court system. The risk of an open challenge by national courts to the CJEU's role as the "Supreme Court of Europe" is as "systemic" as one can imagine. If the issue is not duly planned, the CJEU may find itself between the rock of financial meltdown, and the hard place of being challenged, or ignored, by national courts. If only both risks could be averted…

[7] Portuguese authorities stated that the decision in the context of the resolution of Banco Espirito Santo (BES) to transfer assets to Novo Banco ('NB', the bank where the 'good assets' were transferred) did not include a loan facility subscribed by BES with Oak Finance Luxembourg. Since the loan facility included a jurisdiction clause in favour of English courts, the Commercial Court declared itself competent to decide on whether NB had succeeded, or not, BES in the loan facility, despite the previous decision by resolution authorities.
[8] The UK Court of Appeals relied on the broader interpretation of "reorganisation measures" under art 2 of Directive 2001/24 laid out in the *Kotnik* decision.

3.- MREL in the context of bank resolution planning

The above section illustrates what happens whenever the focus of bank resolution falls exclusively on crisis-management: to avoid moral hazard burden-sharing is demanded, to avoid spillover effects the decision to bail-in capital and debt is adopted quickly, maybe leaving out the instruments that could be a source of contagion, which means that a greater burden is shouldered by certain creditors, who are "discriminated", court challenges follow, with uncertain results. Having that scenario in mind, is there anything that can be done? The answer is a certain "yes": one can plan for this eventuality, and make sure that, should the day come, there will be no uncertainty around the bail-in of capital and debt instruments… hence the MREL and similar concepts. We examine those concepts, and discuss the calculation of MREL, and its difficulties. Then, we focus on the divergent conceptions that arose in the different EU countries out of a single concept, and the EU efforts to further harmonize the matter, and the challenges ahead.

Resolution rules include *ex post* tools, such as bail-in, which are deployed once the entity enters a critical stage, but also, and critically, rules that stipulate the need for an *ex ante planning* for the entity's 'recovery' (art. 5-9 BRRD), and 'resolution' (art. 10-18 BRRD). Resolution planning in particular means drafting a 'living wills', where resolution authorities anticipate relevant obstacles to resolution, arising from the corporate structure (which may be too complex), financial arrangements (e.g. centralized liquidity management, financial derivatives etc.) ask the entity to remove them, and devise a clear resolution strategy, including the use of one or more tools. This means that, if bail-in is the chosen tool, as it is for many banking groups, other than a clear corporate structure and operational arrangements the entity must have a layer of capital and debt instruments to ensure loss absorption and recapitalization.

Since the idea is to ensure that such loss absorption and recapitalization (through the writing-off and/or conversion of the capital and debt instruments) is swift and uncontroversial, it is useful if a consensus emerges about the kind of instruments that may be used, to make them easily identifiable in the market. On a global level, where the focus is on Global Systemically Important Financial Institutions (G-SIIBs), the key concept is the Total Loss-Absorbency & Capitalization (TLAC), used by the Financial Stability Board (FSB) in its Term Sheet of 2016. At an EU-level, the key concept is MREL, which applies to all banks (art. 45 and recital (80) BRRD). The idea is to use eligible debt and equity to absorb losses and recapitalize the bank: part of the instruments would be written off to absorb losses, and then the rest would be converted into equity to ensure that the levels of equity enable the entity to continue critical functions without taxpayer support, or, specifically in the case of MREL, that the level of Core Equity Tier 1 (CET1) left after the conversion is compliant with prudential rules (art. 45(6) BRRD). Despite their common conceptual core, TLAC and MREL offer some differences, such as:

(i) Scope of application: TLAC applies to G-SIIBs, MREL to all banks.

(ii) Uniformity: TLAC is a single common requirement (it assumes bail-in as a resolution strategy).[9] MREL is calculated on a case-by-case basis, considering the institution's risk profile and resolution strategy, among other things (art.

[9] TLAC requirements are the greater between a 16% of risk-weighted assets (from 1 January 2019, 18% from 1 January 2022) and the 6% of the assets used to calculate the leverage ratio under Basel rules (from 1 January 2019, 6,75% from 1 January 2022).

45(6) BRRD). Thus, a low-risk bank should need less MREL, a bank whose resolution strategy is liquidation would need very little. Since MREL levels need to ensure a compliant CET1, and this is a risk – weighted ratio, MREL levels will vary. Besides, the calculation of MREL must take into account the size, business model, funding model and risk profile of the institution, the potential contribution of the Deposit Guarantee Scheme, and the adverse impact of the institution's failure on financial stability. This point was clearly stated by the SRB Appeal Panel in its decision no. 8/2018 of 16 October 2018, where the Appeal Panel held that a discretionary determination of the Board to require a MREL at 4,9% of total own funds was justified, noting that:

> "Whilst the Appeal Panel agrees, in principle, that a thoughtful MREL ammunition should be made in good times, conversely the Appeal Panel also notes (a) that in the calibration of MREL requirements the Board enjoys a margin of technical discretion because the MREL calibration implies, by its very nature, a technical assessment of all specific factual circumstances and a balancing of interests and (b) that it is not the Appeal Panel's role to second-guess the Board's technical assessment. The MREL determination may have far-reaching implications on the return on capital, the business model and the competitive level playing field for all involved institutions and cannot be considered in isolation from the actual and prospective responsiveness of capital markets to the issue of large amounts of MREL-securities. Their assessment falls within the technical remit of the Board and a margin of discretion is essential to grant to the Board the necessary flexibility in tailoring the MREL requirements to the individual circumstances of the case, taking into account all the above mentioned aspects. It is the Appeal Panel's role to verify that, in all events, the Board's MREL determination fully satisfies all applicable legal requirements and - upon close and thorough scrutiny by the Appeal Panel (which can also rely for that purpose on the economic expertise of some of its members given the nature of the matter at stake -, the decision is not affected by violations of the applicable legal framework or by any manifest error".

(iii) Calculation. There are some differences on the eligibility of debt, since TLAC-eligible debt has to be subordinated to non-TLAC,[10] whereas MREL has not (which affects the numerator); and the assets to calculate the requirement, since TLAC uses risk-weighted assets (RWAs) and the assets used to comply with the leverage ratio (TLAC levels are calculated with reference to both), whereas MREL uses total liabilities and own funds as a reference (art. 45(1) BRRD).

(iv) Relationship with prudential requirements. TLAC is integrated with prudential requirements, whereas MREL enjoys separate treatment under the resolution framework (FSB, 2015),[11] which also means a potential for developing different interpretative criteria for difficult cases.

(v) The relative size of the debt and equity amounts used to comply with the requirement. Debt is 'expected' to be at least 33% of TLAC (FSB, 2015), whereas there is no minimum expectation in case of MREL, which can be complied with fully with equity.

[10] To be precise, the FSB provides that entities subject to the TLAC framework *may* use instruments that are not subordinated to satisfy TLAC requirements, but with the limit of 2,5% of Risk-Weighted Assets (FSB, 2015).

[11] Integration makes it easier, in the case of TLAC, to ensure that the calculation of firm-specific requirements is aligned for capital and MREL requirements.

The potential frictions and misalignments led to review MREL rules and adopt new ones at an EU level, to ensure that the TLAC standard was complied with.[12]

The key consequence of TLAC/MREL is that *not all bail-in eligible liabilities will be TLAC/MREL-eligible*. Bail-in can be disruptive if used over 'operational' liabilities, such as those resulting from funding, liquidity, or hedging (e.g. derivatives) arrangements. Thus, TLAC/MREL rules try to ensure that only 'clean' liabilities are used to plan for the entity's resolution, through several requirements: (a) First, the rules include a list of criteria that the instruments have to comply with to be eligible: (i) They have to be fully paid-up. (ii) They have to be unsecured. (iii) They cannot be subject to set-off/netting. (iv) They must have 1-year remaining maturity. (v) They cannot be redeemable. (vi) They cannot be directly or indirectly funded by the resolution entity or related party. (b) Second, the rules introduce a list of excluded liabilities, which includes deposits, derivatives, non-contractual liabilities (including taxes) preferred liabilities (including secured liabilities) and other bail-in-excluded liabilities.

A final consideration is that the TLAC standard expressly provides for the possibility to rely on different subordination mechanisms to comply with it (FSB, 2015). These are: (i) 'contractual subordination', whereby the specific debt instrument indicates that it is subordinated in case of insolvency or resolution, to instruments of ordinary debt; (ii) 'statutory subordination', i.e. ear-marking debt that is junior in the insolvency ranking; (iii) 'structural subordination', i.e. creating a group structure where (operating) subsidiaries hang from a 'clean' holding company, which has no major liabilities other than capital and debt instruments that are issued for purposes of bail-in, which means that there will be no frictions arising from the relationship between bail-in eligible liabilities and other liabilities.

TLAC rules, being a semi-prudential standard, try to ensure a seamless transition between the instruments that form part of the Basel Framework, and those that will be used in resolution to ensure a continuity of compliance. MREL rules, being anchored in the resolution framework, are less explicit, which can create problems.

Thus, for example, they stipulate the possibility of clauses providing for a contractual recognition of bail-in (art. 55 BRRD), but that is not exactly the same as a *contractual subordination* to ordinary debt (art. 45(13) and (14) BRRD), i.e. the clause concerns the recognition of bail-in, but problems could still arise about the relative ranking of the instrument, which would depend on the vagaries of the joint interpretation of the insolvency and resolution frameworks,[13] thus making the process less safe.

Likewise, MREL rules implicitly allow for the use of ordinary debt to meet the mandatory requirements, as long as the requirements (issued, fully paid-up, etc.) are met but, since they do not include a requirement of subordination, like TLAC does, this means that certain ordinary liabilities would be bailed-in (e.g. senior bonds), and others would not

[12] Council *Conclusions on a roadmap to complete the Banking Union* 17 June 2016 no. 7 (a) highlighted the amendments to implement TLAC standard and reviewing the minimum requirement for own funds and eligible liabilities (MREL)'. See EU Commission Proposal for a Directive amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC. Brussels, 23.11.2016 COM(2016) 852 final 2016/0362 (COD).
[13] *Supra* 2.1.

(e.g. derivatives) despite the fact that, upon insolvency, they would rank *pari passu*, thus creating a difference in treatment, which constitutes a source of problems.

Finally, EU rules make no room for the allocation of capital and debt across banking groups. MREL rules stipulate a calculation of requirements both at consolidated and individual level, but there is little in the rules as to a smart allocation of instruments across the group to ensure that losses are absorbed and entities recapitalized as they should, and that there are no bottlenecks.

These lack of specifications can constitute a source of interpretative difficulties. This was also witnessed by the first decision on a MREL determination adopted by the SRB Appeal Panel (case 8/2018), where the crux of the problem revolved around a MREL determination below the 8% 'total liabilities including own funds' (TLOF). The concern raised in that case was that, lacking an *ex ante* ammunition of MREL liabilities sufficient to reach the 8 % TLOF, there could be a risk that, if necessary at the point of non viability, the resolution could not rely on any contribution of the SRF, because, as provided for in Article 44(4) and 44(5) BRRD, the fund contribution can occur only when:

> "a contribution to loss absorption and recapitalisation equal to an amount of not less than 8% of the total liabilities, including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 36, has been made by the shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise".

The Appeal Panel held however that the 8% TLOF threshold can be reached not only via MREL instruments but also through other bail-in eligible liabilities, even if they do not qualify as MREL, provided these additional bail-in eligible liabilities are not excluded from bail-in. This proved to be the case, in that appeal, with regard to not-covered and not-preferred deposits. In turn, the Appeal Panel considered that, in the MREL determination, a case-by-case and proportionate approach must be adopted. Specifically, it was held that the principle of proportionality must guide in properly calibrating the MREL requirement to ensure that the MREL target of the relevant credit institution (measured against its risk weighted assets) compares in a balanced way with the average national banks and the average Banking Union banks and is duly calibrated to the bank's size, business model and risk profile. To back-test this, the Appeal Panel decision considered that:

> "A possible scenario that would in fact make the MREL determination adopted with the Appealed Decision insufficient, would be an increase of risk-weighted assets (hereinafter "RWA") by 45% which uses as reference the 2014 EBA stress tests. The Board stressed, however, that this is a quite unlikely assumption in the current circumstances and that in the 2016 EBA stress tests the average increase of RWA in the adverse scenario was 10% and for the [other] participating G-SIIs was below 20%. (...) The Appeal Panel further points out that the Board has appropriately shown that the MREL calibration in the present case is consistent with the O-SII buffer set for the same Relevant Credit Institution (0.75% of RWA) as set by the competent macro-prudential authority on the basis of the systemic risk posed by the Relevant Credit Institution and for which there are no indications by the same authority that it has to be increased. The Board further clarifies that in the calculation of the MREL requirement for the Relevant Credit Institution both the O-SII and other macro-prudential measures are automatically included. In this context, based upon the elements brought to its attention, the Appeal Panel holds that there are no reasons to reject the Board's argument that, in such circumstances, an increase of MREL to 8%

> of TLOF would most likely imply a disproportionate approach vis-à-vis peers active in the [same national] market but also in the Banking Union and could possibly have unintended consequences of serious distortion of the competitive level playing field."

This shows that, albeit MREL rules provide a clear method for the calculation of eligible capital and debt levels, these rules are also open for interpretation on some relevant aspects. This can be a source of tension between the entity and the resolution authority, as well as between the resolution authorities themselves. Different countries may have chosen different strategies to ensure compliance with MREL. In the following pages, we illustrate, first, how, in an initial stage, the open-textured nature of MREL rules provided the room for divergent approaches, and how the EU legislators had to step in again, to further harmonize the rules. Then, we examine what room is still left for divergent approaches and interpretations.

The basic idea underpinning MREL is simple: ensure that bail-in is easier to execute. Yet this imposes a burden on banks, which, when we transcend the scope of G-SIIBs (which MREL does) can result in an unpalatable choice between (a) closing shop or being acquired by a larger rival; or (b) using whatever strategy is available to comply with MREL that does not involve issuing new amounts of equity and debt. It is not surprising that, once banks (or whole banking sectors) find themselves in this conundrum, their plight will be taken up by their Member State as its own and translated into a specific MREL-compliance strategy. In the initial stages of BRRD-SRM this is what Member States did, using the openness of the rules.

Germany and Italy, for example, followed a strategy of *statutory subordination*, which consisted in amending the *insolvency ranking* of *existing* debt instruments. Germany's amended rules provided that, in case of insolvency, senior unsecured bonds and similar debt instruments would be subordinated to every other senior instruments (which includes "operational" liabilities, which constituted the main concern) (Section § 46f (5) *et seq.* German Banking Act, "*Kreditwesengesetz"*). Italy chose the opposite way, and gave preferential status to *all* bank deposits, including large corporate deposits and interbank deposits (modifications to art. 91 Leg. Decree No. 385/1993), and thus a statutory *privilege*, rather than subordination strategy.

The advantage of this approach is that German/Italian banks could comply with MREL with their long-term non-operational debt without issuing new debt. The ECB concluded that German rules made senior debt TLAC/MREL compliant, but ineligible for ECB operations (CON/2015/31), and was more cautious about TLAC-eligibility of Italian banks' senior debt, because some operational liabilities, such as derivatives, would still rank *pari passu* with senior unsecured bank debt (CON/2015/35), which meant that (i) they could be bailed-in simultaneously with bank bonds, thus wreaking havoc in the market, or (ii) they could be excluded on an *ad hoc* basis using resolution authorities' powers, thus opening the possibility of a challenge based on discriminatory treatment.

Interestingly, since both countries chose to amend their *insolvency* law they introduced a relative harm to some ordinary creditors without having to compensate them, i.e. since the NCWO principle, states that creditors have to be compensated if they are treated worse than under insolvency rules (CON/2015/31). Still, by affecting existing rights, these measures could be challenged as a retroactive interference with property. In the case of Italy there would be less grounds, since the rules privilege certain types of liabilities, rather than harming others. German rules, on the other hand, blatantly subordinated ordinary liabilities. Yet, in this case the argument is that, by interfering with an ongoing process, the rules would not be a case of strict retroactivity (*echte Rückwirkung),* but of 'not real retroactivity' (*unechte Rückwirkung*) and would be backed by German Supreme Court's case law, which accepted the statutory introduction in 2014 of collective action clauses (CACs) in outstanding bonds.

The strategy has been different in Spain and France, which have introduced a new type of 'Tier 3 debt', which, upon resolution, would be senior to Tier 2 debt, but junior to other senior debt (e.g. art. L 613-30-3 French Financial and Monetary Code; Additional Provision 14th, Spanish Act 11/2015), such as derivatives, non-covered deposits, and other operational liabilities. This approach mixes 'contractual subordination', because the debt must include specific contract provisions, and 'statutory subordination', since the actual enforcement is supported by specific statutory provisions on the debt ranking (art. 151 II and III of LOI n° 2016-1691). The advantage of Tier-3 approaches is their legal certainty and 'fairness', as investors can know their status from the moment they subscribe; its disadvantage is that they are costly (CON/2016/7).

The existence of different national strategies can cause problems in cross-border cases. Imagine the case of an entity issuing bonds under a subordination clause, and others under a non-preferred status clause, subject to the laws of a Tier-3 country, such as Spain (subordination) or France (non-preferred), but where the entity is subject to the rules of a statutory subordination country, such as Germany or Italy. Should non-preferred bonds be bailed-in before ordinary bonds, despite German law makes no distinction? What would be the result if the applicable insolvency law were France's? Would France treat subordinated Spanish bonds differently from French Tier-3, despite they both fulfil the same function, or would they be deemed "equivalent"?

The risk of uncertainty led to further efforts to harmonize the rules on insolvency ranking (Directive 2017/2399, "Directive on Insolvency Hierarchy of Unsecured Debt Instruments"). To the already existing deposit preference the new rules regulate a new kind of senior debt with 'non-preferred' status, and the following conditions: (i) maturity of at least 1 year; (ii) no features typical of derivatives; and (iii) explicit reference in contractual documentation to the insolvency ranking (new art. 108(2) BRRD as drafted by Directive 2017/2399). Following the French approach, the rules introduce a new EU-wide Tier-3 debt which would rank below ordinary unsecured debt, and above the CET1, Tier 1 and Tier 2 instruments (new art. 108(2) and (3) BRRD). This was accompanied by transitional provisions: (i) the rules ensure the application of insolvency law to debt issued before the entry into force of the new provisions (new art. 108(4) BRRD); (ii) for debt issued under the laws of countries, like France, that had already adopted a 'domestic Tier-3 debt', the rules give this debt the same ranking as 'EU Tier-3 debt' (new art. 108(5) BRRD); and (iii) for debt issued under the laws of countries like Germany or Italy, which split unsecured debt into two or more rankings, or changed the ranking of some instruments in relation to others, the rules say that those States *may* give the lowest ranking category of ordinary debt the same ranking as 'EU Tier-3 debt' (new art. 108(7) BRRD). Doubts remain as to what a State may do, or what happens if it does not modify its rules, as well as the interpretative margin left for State authorities, even if the rules are the same.

4.- MREL, financial stability and investor protection

After the adoption of the Banking Communication and of the BRRD and in the wake of recent banks' restructurings and resolutions, the risk profile of bank debentures reflects their actual exposure to burden-sharing. This is something that should be disclosed to, and considered by, the investors (Alvaro et al., 2017). The issue has become relevant enough to be the subject of attention by the Basel Committee on Banking Supervision (2015), by ESMA as well as the EBA's 2016 Report, which included a recommendation on transparency (No. 12).[14] The problems in this regard are twofold.

First, the risk of conflict of interest is multi-level. On one hand, the conflict of interest at the level of the intermediary, because very often it will market its own securities to its clients. On the other hand, there is the conflict of interest at the supervisory level, because as important as compliance with transparency, and know-your-customer duties is, this importance loses strength when the stability of the system is in jeopardy, as it happens when banks need to comply with exacting MREL rules.

Second, since the new resolution framework lacks any grandfathering provision for instruments issued before the Banking Communication (2013) and the BRRD (2014) and the CJEU ruled out the principle of legitimate expectations did not include the expectation of not being bailed-in, this created a "legacy" problem, which has different size and significance depending on the profile of the investors holding the specific securities. In countries where hybrid securities, convertible bonds, and, generally, MREL-debt, is in the hands of retail investors, it is likely that a major bail-in process will be followed by legal challenges (and public outrage) based on the mis-selling of financial instruments by investors alleging to have been misled, which, to the extent that those investors were unable to understand the risk of burden-sharing and have enough loss-bearing capacity to incur losses, will be true (SAFE, 2016). On the implications of these elements nothing teaches like experience, which is why we will focus on the Spanish and Italian experiences to understand how seemingly "micro" problems associated to the client-bank relationship can easily have "macro" implications.

4.1. Spain: the pendular movement from pro-bank to anti-bank stance, and its implications

The case of Spain also reflects the risk of pendular movements in policy positions. Traditionally, the courts' views in Spain were relatively formalistic and pro bank, including in the mis-selling of financial products.[15] Yet a confluence of events resulted in a drastic change. First, the Spanish courts were confronted, for the first time, *on a massive scale*, with cases on the mis-selling of financial products, primarily of two kinds: the marketing of hybrid capital instruments similar to preferred shares (*participaciones preferentes*) (Ramos Muñoz, 2012), and the marketing of swap instruments, which should have operated as insurance against interest rates rises, but in practice guaranteed banks a

[14] The recommendation called for the introduction of new EU requirements, whereby: "in the steady state, credit institutions in the EU should be required to disclose the quantum and composition of their MREL-eligible liabilities, as well as the MREL required from them by the resolution authority. The BCBS recommendations, once finalised, should serve as a starting point and should be extended to cover all of the MREL-eligible liabilities of G-SIBs and non-G-SIBs. They should also be extended to include information on other financial instruments subject to bail-in as well as information on the creditor hierarchy. In the transitional period, and pending finalisation of the BCBS recommendation in this area credit institutions in the EU should be required to disclose to investors the quantum and composition of their stack of MREL-eligible liabilities, as well as information on the creditor hierarchy (at a minimum). In addition, disclosure should be required or actively encouraged if a failure to roll over MREL debt could lead to automatic restrictions on distributions."

[15] Up until 2012, the Supreme Court rejected that the breach of conduct rules related to the transparency in the marketing of financial products, could constitute the basis for a claim of annulment, and thus restitution.

stable interest rate.[16] The trickle of cases turned into a tide, suggesting that something could be structurally wrong.

Second, supervisory authorities were slow to respond, despite clear evidence that, in some cases, financial products had been sold to the wrong people for the wrong reasons. The National Securities Market Commission (Comisión Nacional del Mercado de Valores, "CNMV") and Banco de España had the tools to craft some "macro" solution based on restitution, but they preferred to leave it to the "micro" and case-by-case solution by the courts. The "macro" solution was provided by the government, with an arbitration mechanism, but enough *preferentes* cases were already in the courts to effect change: given the limited evidence and investigatory powers in civil (i.e. unlike criminal or supervisory) proceedings civil courts' option was to simply change the view.

Third, the Spanish courts were scolded by the Court of Justice of the European Union (CJEU) in *Mohamed Aziz v Caixa d´Estalvis de Catalunya, Tarragona i Manresa ("Aziz")* and similar cases for failing to stop the wheels of the efficient and expedient Spanish executory proceedings for the enforcement of mortgage loans to allow the debtor to allege the nullity of contract clauses under the 93/13 Unfair Contract Terms Directive, i.e. Spanish courts were accused of being 'too pro-bank', and leaving consumers at the mercy of banks in eviction actions.

These circumstances resulted in an important change of attitude towards the bank-client relationship. First, the Supreme Court decided that 'floor clauses' (*cláusulas suelo*) were unfair, pursuant to Directive 93/13/CEE, in a controversial decision, with such potentially devastating effects that the Court limited the effects of its annulment decision to the future payments (i.e. avoiding nullity's retroactive effect). Second, the courts decisively sided with clients in mis-selling cases, leading to a new doctrine by which breach of MiFID marketing rules would justify prima facie a claim of 'mistake', and thus lead to the annulment of the contract. The CJEU had confirmed that MiFID applied to products marketed by banks, even when loosely tied to mortgage loans, and expanded the scope to apply the enhanced "suitability" duties (*Genil 48 SL and Comercial Hostelera de Grandes Vinos SL v Bankinter SA and Banco Bilbao Vizcaya Argentaria SA, "Genil v Bankinter",* paras. 49–55), since the marketing of complex products tended to be considered as giving rise to a relationship of "advice". This resulted in a wave of pro-client decisions (among many, see RoJ 2015/4664, RoJ 2015/5461, RoJ 2015/674, RoJ 2015/5777), which started with derivatives products, but did not make too many distinctions when it came to hybrid capital instruments, which, complex or not, can reflect a simple buy-sell relationship, not giving rise to "advice" (see Spanish decisions RoJ 2015/608, RoJ 4004/2015, RoJ 610/2016, RoJ 3138/2016).

The number of "micro" conflicts in civil courts soon became "macro", and a political headache. Thus, the government created a high-level commission to study and monitor the problem, and established a system for a collective arbitration of sorts to help expedite the recovery for retail clients (Royal Decree-Law 6/2013). Both measures were accompanied by the enhancement of the role of the Spanish Deposit Guarantee Scheme.[17]

[16] Again, the clients alleged that they were not duly informed of the risks, which included the risk of cancellation paying the price of the swap at that moment.

[17] The DGS (*Fondo de Garantía de Depósitos de Entidades de Crédito*) would be allowed to both acquire shares and debt from SAREB, and to acquire shares from entities that transferred NPLs to SAREB, in order to lessen the impact of the conversion mandated by the resolution authority (FROB), which shows how much the problem of NPLs was linked to the problem of hybrid capital instruments, from both, a solvency, and investor protection perspectives.

This system was later used as a blueprint by the Italian government in its 2016 measures meant to hold retail investors harmless from the losses deriving by the mis-selling of shares or hybrid securities issued by failed or troubled banks.

Yet, the dispute resolution mechanism was not a full-fledged arbitration, because the criteria to determine eligibility mixed: (i) legal criteria associated to the marketing of the product, and (ii) "social" criteria associated, for example, to the loss suffered by the investor as a percentage of her patrimony, or to the fact that the investment was lower than EUR 10.000 (Commission's resolution of 17 April 2013). Thus, the procedure was not trying to ascertain the facts, but to compensate retail clients who suffered the most and could cause more trouble, politically speaking. Furthermore, the 'legal' criteria that *gave access* to the specific procedure should have automatically granted clients a favourable court ruling, such as the total absence of information on risks, the lack of classification of risk profile, the absence of a contract document, or the fact that the investor was a minor or incapacitated. In these circumstances, some investors, especially wealthy ones, who could not count on winning in arbitration, continued to go to the courts instead. American-like trial lawyers, with billboards and TV advertisements, became a new feature in the Spanish market. Banks have lost, and lost, and lost again. The result is that, looking at precedents, it is difficult to identify a sure way in which a bank may market to its clients a financial instrument that exposes them to a risk of loss, without being exposed to an annulment action. It is difficult to imagine a massive distribution of MREL securities in Spain under these circumstances.

As a final reflection on the Spanish case, aside from enduring a comprehensive restructurings of the banking sector, Spain also inaugurated the Single Resolution Mechanism (SRM), with the decision by the Single Resolution Board (SRB) over Banco Popular. The resolution action in that case consisted in a write down of CET1 and Tier 1 instruments, and the conversion of Tier 2 instruments into capital, followed by the sale to Banco Santander, for 1 euro (SRB, 7 June 2017). The decision was followed by immediate action by Mexican investors, international bondholders, a Spanish association of consumers, and other parties, including a distressed-debt US firm, who announced legal action (Hale, 2017). To mitigate the effects of the lawsuit Santander already announced that it would offer compensation to some of the retail customers/investors in Banco Popular, for which it already raised specific amounts.

The decision has been considered a successful example of resolution, and the attitude is one of wait and see (Binder, 2017). The legal challenges however will be a decisive test of the robustness of resolution tools. It is too soon to tell whether retail clients will succeed if they seek annulment of contracts for the sale of Tier 2 instruments, or even shares. However, the fact that in such seemingly exemplary context the acquirer is preparing itself to pay billions to the bailed-in shareholders may suggest that investments in bank capital or MREL are not suitable for retail investors.

4.2. Italy: a long tradition of bail-outs, a perceived equivalence between deposits and bonds (what could possibly go wrong?) and the long, winding road towards clear transparency requirements

Up to the recent 2015-2017 bank crises holders of Italian banks' debentures, including subordinated debt, had never been affected by a bank's failure and had always been bailed out. Thus, bank debentures were widely considered risk-free assets, and qualitatively different from other corporate securities, also because they were issued by the same entity that granted deposits, and, unlike these, they posed no maturity mismatch problem: bonds were long-term, and raised no liquidity issue arising from early redemptions. This perception was to some extent supported, at the outset, by national and European legislation, which treated similarly savings flowing into banks as deposits *and* bank bonds subscriptions, and differently from other financial activities.

This happened with domestic rules, which excluded bank bonds from the rules applicable to public offerings (art. 12(3)(c) Law n. 77/83), and at a European level, which allowed national exemptions from prospectus rules. Consob interpreted Article 100, paragraph 1, letter f), TUF as mandating a prospectus for banks' "reverse convertible securities" but deemed it non-mandatory both for securities (different from shares or financial instruments that allow to purchase or subscribe shares) that did not guarantee a 100% reimbursement of the paid-up investment at maturity, and in case of bonds issued by foreign banks. A prospectus was not necessary because the securities were perceived as "special", and, although criticised by some academics, and regulators, to many this meant "especially safer". This impression was confirmed by the inapplicability of certain investor protection duties conceived for intermediaries to the direct sale by a bank of its debentures to its clients, as well as by the scarcity of court cases dealing with the mis-selling of banks' securities. Subsequent years would witness a pendular movement towards the restriction of these practices.

The European approach changed with the Prospectus Directive, which subjected the exemption to uniform, and more demanding conditions (art. 1(2) and 30(2)), and the domestic approach excluded the previous broad exemption, and left one based on the economic value of the offering, and another based on the special features of some banking (and insurance) products. All other offerings would be subject to a regular prospectus.

In the field of intermediaries, however, the advent of MiFID led Consob to adopt a new Regulation on Intermediaries (No. 16190/2007), which extended the application of MiFID rules also to the subscription and placement of financial products issued by banks (in particular the principles "know your costumer" and "know your products"), and restricted the *execution only* regime to non-complex products, where the order (genuinely) originated in the client, applying suitability and appropriateness requirements to all other cases (Consob, 2011).

After the Commission's Banking Communication, Consob asked banks to include in the first pages of their prospectuses (also for bonds) a new risk factor linked to burden-sharing, and adopted a new Communication to preclude intermediaries from selling complex financial products, including subordinated bonds to retail investors. This was accompanied by supervisory and enforcement actions, including on-site inspections, sanctions, and guidelines on banks' self-placement transactions (Consob Communications No. 9019104 of 2 March 2009; No. 0097996 of 22 December 2014; No. 0090430 of 24 November 2015). Its zealous enforcement of the rules led Consob to demand that, instead of signing the usual pre-printed form, investors should make a handwritten statement confirming their full awareness of the risks connected to the investment. Thus, some savings were diverted to mutual funds or bank deposits, while bank bonds' relative weight in clients' portfolios dropped by about 28% in 2015-2016. Still, for those who despite rules, inspections and sanctions had been allegedly mis-sold securities, an *ad hoc* arbitration for the rapid out-of-court dispute settlement with retail investors was set up in January 2016.

Directive 2014/65/EU of 15 May 2014 ("MiFID II") does not alter the basic scheme of marketing duties, but makes suitability and appropriateness requirements more exacting requires investment firms to ensure that those providing advice and information have the necessary knowledge and expertise to abide by the Directive. Furthermore, an increased number of instruments would be considered "complex". ESMA confirmed that this included subordinated debt instruments, because holders of subordinated debt instruments are in a less favourable position than holders of ordinary debt, but this less favourable position is deemed difficult to grasp for the average retail investor, adding the ominous warning that the more complex a product, the harder it is to demonstrate that retail clients have sufficient financial knowledge and experience to understand its key features.

Regulation No. 600/2014 (MiFIR) introduced a "product governance" regime, which tries to ensure that there is a firm-level strategy to ensure that the substantive content of the financial products offered to their clients, and the information related thereto, are conceived to best serve their interests.[18] This paves the ground for "product intervention" by authorities, which ranges from a simple request to modify advertising materials, to the temporary suspension of a product's marketing, or the imposition of restrictions in the sale or distribution of a product or service, e.g. a limitation to distribute to non-retail clients only, to the permanent ban on the marketing, sale or distribution of a specific financial instruments, or on a particular activity or financial practice.

On self-placement, the MiFID framework requires now that financial institutions offering own-securities that are used for capital-debt requirements under CRD-CRR-BRRD shall provide those clients with additional information to explain the differences between the instrument and bank deposit in terms of yield, risk, liquidity and any protection provided in accordance with the Deposit Guarantee Schemes Directive (Article 41 MiFID II Delegated Regulation).

ESMA accompanied this with an emphasis on subordinated, convertible and bail-inable debt, to ensure that its features were disclosed in the prospectus, and understood by an intermediary's clients, an effort in which it was aided by Consob's Communication n. 0090430 of 24 November 2015, and Guidelines adopting ESMA's ones.

As opinions and policy positions on the marketing of equity and debt instruments varied drastically, old marketing habits were hard to die, but, crucially, most instruments had already been placed in the market under circumstances that did not so clearly indicate that this was wrong, which meant that solutions had to be sought for them. In this regard, Italy offers a full range of examples of what did not work and is a telling example of the regulatory and supervisory challenges which must be addressed when, in bad times, potential trade-offs between micro and macroprudential policies and consumer protection materialise.

[18] This implies both a duty to design products in such a way that they meet the demands of their specific reference market (end clients), and a duty to ensure that they are then actually marketed to that reference market through coherent commercial and business practices.

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