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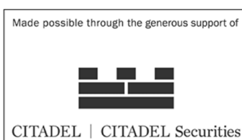

The long-lasting legacy of banks' bailouts

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Failing banks are often rescued through some form of bailout. These interventions usually imply a switch in the bank's ownership, which becomes publicly controlled. Despite the frequency and relevance of this phenomenon, little attention has been paid to the fact that rescued banks tend to remain in public hands for a long time after the bailout. A recent study by the International Monetary Fund shows that public ownership of rescued banks imposes fiscal

costs, limits the objectives of an effective resolution regime, distorts competition, and increases the probability of credit misallocation.

In a recent paper, we examine the 'precautionary recapitalization' tool, which—according to EU law—allows Member States to inject capital into solvent but distressed banks under the conditions of Article 32(4) of the Bank Recovery and Resolution Directive. This tool represents a compromise between the will to avoid bailouts and the need to recapitalize distressed banks, avoiding further value destruction should the crisis deepen.

Precautionary recapitalization is designed as a precautionary and temporary tool and aims to remedy a serious disturbance in the economy of a Member State. Solvent but undercapitalized banks that cannot gather fresh finance in the market or find a buyer can apply for it under the EU State aid framework. Such aid can take several forms, all entailing the use of taxpayers' money. We analyze the capital injection form as it is the most commonly used and shifts the bank's ownership from private to public entities. Accordingly, this form of precautionary recapitalization is subject to stricter conditions and can only be used to address the capital shortfall arising from failing an EU stress test or equivalent.

The recapitalization—hence, the public ownership—shall be temporary. However, there are no effective means of enforcing this requirement, and divestment turned out to be more complicated than the legislator envisaged. The result is that public ownership sticks after several years in all cases in which it was granted, namely National Bank of Greece, Piraeus Bank, and Monte dei Paschi di Siena Bank.

Most of the problems arise from the fact that the current framework was designed to minimize the bank's *ex-ante* moral hazard and limit the use of public funds. While these are sensible aspects, this approach overlooks the *ex-post* consequences of the capital injection. Indeed, if the aim is also to avoid distorting competition in the internal market and limit the use of public funds, the law should be designed to better ensure the 'temporary nature' of such recapitalization.

The difficulties in divestment often stem from the fact that precautionary recapitalizations happen too late—hence, they are not truly precautionary—and benefit banks that are not simply in distress but virtually insolvent.

This has financial, legal, and political ramifications. Banks' assets are inherently opaque and complex to evaluate correctly. Therefore, assessing the solvency of an institution entails considerable discretion. Second, under the current legal framework, there is a misalignment between the concepts of 'solvency', applied

to precautionary recapitalizations, and 'failing or likely to fail', applied to banks' resolution. These uncertainties leave yet another margin for discretion in assessing whether an institution should be eligible for a precautionary recapitalization, undermining the credibility of the tool and of the resolution system at large.

Moreover, banks tend to postpone the recognition of losses, leveraging their superior information about the quality of their assets. Relatedly, supervisors also have incentives to delay action and forebear, as they are afraid of triggering a run or spreading market panic. This results in late intervention, which, in turn, decreases the credibility of the temporary clause.

Against this backdrop, we propose a 'forward-looking' approach to precautionary recapitalizations, which aims to increase the credibility of its temporariness. This approach has two guiding principles:

1) precautionary recapitalization benefits exclusively solvent but undercapitalized banks: the law should identify a reliable proxy to avoid the verifiability problems surrounding banks' solvency. We propose that if a bank is undercapitalized in the baseline scenario of a stress test, it should not be eligible;

2) precautionary recapitalization intervenes early in the crisis: this is when a recapitalization is truly precautionary and most effective. The law should provide a clear mandate and considerable discretion to the competent authorities in this regard.

This approach would preserve the precautionary nature of the tool and would markedly increase the credibility of its temporary nature, easing the State divestment as the bank is recapitalized preventively and not simply bailed-out.

Recently, the debate on the long-lasting legacy of bailouts and the *ex-post* effects of precautionary recapitalization has been reignited.

On the one hand, the proposal for a new Crisis Management and Deposit Insurance (CMDI) Framework addresses the temporary nature of precautionary recapitalization. However, in doing so, it targets the symptoms, not the causes. The result is a *de facto* useless instrument in which the enforceability problems of its temporary nature are not addressed. We call for a revision of this proposal or—alternatively—for the elimination of the tool, as the current version only increases uncertainty and undermines the credibility of the resolution framework.

On the other hand, the recent high-interest rates environment increased banks' profitability, opening new opportunities for public divestments. Accordingly, the Italian State recently sold a part of its public stake in Monte dei Paschi Siena, which benefited from precautionary recapitalization in 2016. Similarly, ABN AMRO (nationalized in 2008) reduced the State's participation to under 50% in September 2023. Despite such a favourable window of opportunity, public actors still control those banks, demonstrating, once more, the long-lasting effects of bailouts and highlighting how the legal framework remains unfit to facilitate the transition of rescued banks back to the market.

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