Law & Economics of Banks Corporate Governance in the Bail-In Era

Martino, Edoardo

DOI
10.2139/ssrn.3100703

Publication date
2018

Document Version
Submitted manuscript

Law & Economics of Banks Corporate Governance in the Bail-in Era

Edoardo Martino, LL.M.†

Abstract

This paper aims at introducing an in-depth analysis of Banks Corporate Governance in the after-crisis regulatory environment, going through theoretical and methodological specifications for starting an economic analysis of the post-crisis stream of reforms in the financial system, especially in the Eurozone.

In a nutshell, this research has two main purposes: on the one hand, assess whether departures from standard corporate governance paradigms in banks are desirable; on the other hand, shed light on the impact of the rules on the resolution of distressed institutions on governance mechanisms.

To achieve those goals, the paper carries out a survey the literature about Bank Governance and Bail-in Regulation in a functional manner to introduce the unexplored link between the new resolution regime and Corporate Governance, focusing the governance role of bail-inable creditors, as "*potential residual claimers*". The literature review is supplemented and enriched by the necessary theoretical tools to properly set a Law & Economic analysis, both for what concerns specific agency relationships between corporate constituencies and the nature of financial regulation and bank insolvency.

The paper concludes that the after-crisis reforms, and the bail-in regulation in particular, represent the cornerstone for a new understanding of the relationship between corporate constituencies of banks. Moreover, the links between governance-related issues and the effectiveness of resolution mechanisms constitute a solid argument in favor of a positive role of Corporate Governance in addressing individual as well as systemic stability issues.

Keywords: Law & Finance; European Banking Union; Bail-in; Financial Regulation; Corporate Governance; Agency Theory.

JEL Classification: G28; G34; K22

---

† Ph.D. candidate of the European Doctorate in Law & Economics at Erasmus School of Law, Erasmus University Rotterdam. Contact: martino@law.eur.nl. This manuscript is part of a Ph.D. Research carried out within the European Doctorate in Law & Economics (EDLE) at the Erasmus School of Law, Erasmus University Rotterdam. I urge to express my gratitude to prof. Alessio Pacces and prof. George Ringe for their inspiring supervision. I am also thankful to the participants at the EDLE workshop in Bologna, the 1st Year EDLE Conference in Hamburg, the Italian Conference in Law & Economics in Roma and the Edinburgh Postgraduate law Conference for feedback and comments.

Law & Economics of Banks Corporatre Governance in the Bail-in Era

Table of Contents

1 Introduction

This research aims to shed some light on the interplay of two pivotal aspects of financial stability: on the one hand the rules on recovery and resolution of distressed banks, especially the bail-in rules; on the other hand, the Corporate Governance of banking institutions.

In fact, on the one hand, nowadays the fact that "good" governance generates value is taken for granted and extensively empirically proved in general (Sahut and Boulerne, 2010; Gugler et al., 2004, see, among many others,) and also specifically for banks (Levine, 1997). On the other hand, there is a broad consensus on the fact that "bad" Corporate Governance of banks played a significant role before and during the crisis[1]. Since then more and more studies have been carried out for better understanding, theoretically and empirically, banks Corporate Governance and its role both before and during the crisis. In fact, historically, the governance of financial institutions was neglected in legal scholarship, as it was plainly associated with the governance of non-financial firms. In the last decade, the interest on the specific characteristics of governance in banks raised remarkably (as noted by Ferrarini, 2017), in forms and directions that will be discussed in more details later on.

For the time being, it is sufficient to say that this flow of research is far to be settled, especially for what concerns the interplay between governance and financial regulation (this link has been first discussed by Dewatripont and Tirole, 1994): is regulation a substitute or a complement for governance, in comparison with unregulated industries?[2]

If the relationship between governance and financial regulation is still somehow shady, the reciprocal links between governance and the recent regulatory bodies represent a wholly unexplored field of research. In fact, the aftermath of the crisis brought some striking innovations in financial regulation, whose efficacy and (unintended) consequences have been, and still are, heavily disputed.

[1] According to the so-called "de Laroisiere report", Corporate Governance "is one of the most important failures of the present crisis. Corporate Governance has never been spoken about as much as over the last decade. Procedural progress has no doubt been achieved (establishment of board committees, standards set by the banking supervision committee) but looking back at the causes of the crisis, it is clear that the financial system at large did not carry out its tasks with enough consideration for the long-term interest of its stakeholders"; De Larosière et al. (2009, page 29). In a similar vein, the OECD concluded that "the financial crisis can be to an important extent attributed to failures and weaknesses in Corporate Governance arrangements"; Kirkpatrick (2009, page 2).

[2] This point has been discussed widely, with slightly different outcomes, by Heremans and Bosquet (2011); Pacces and Heremans (2011); Ferrarini (2017) and will be discussed in section 4 for what concerns governance and bail-in regultion.

One of the cornerstones of the post-crisis reforms consists, indeed, of the rules disciplining the recovery and the resolution of distressed institutions, and in particular the bail-in regulation. Those reforms were driven especially by a political agreement at the G20 level and subsequent technical supranational documents issued by the Financial Stability Board. For what is here of interest, the most important document is the Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB, 2011). Those policy guidelines were, then, implemented differently by different jurisdiction; in Europe, the relevant normative texts are the Bank Recovery and Resolution Directive (BRRD)[3] and the Single Resolution Regulation (SSR)[4] for the Eurozone.

Therefore, this paper aims at challenging the current understanding about the impact of bail-in regulation on the Governance of banking institutions. The present paper will provide a comprehensive problematization of the issue at stake, while the analysis of specific aspects stemming from such a problematization will be the subject of subsequent papers.

This research will specifically deal with the analysis of Eurozone banking market and regulation. In fact, the Eurozone suffered the effect of the crisis heavily and tried to response through the implementation of the so-called "Banking Union", of which the Bank Recovery and Resolution Directive represents a pillar. This approach is in line with the policy orientation of European approach to "Law & Finance", that is mainly boosted by the EU Financial Market Integration, as stressed by Heremans and Bosquet (2011, page 1554).

To the best of my knowledge, any specific in-depth analysis of the interconnections between those two highly problematic and disputed aspect of banking institution exist so far, and up to the end of 2016 there were few contributions at all (see, Chiu, 2014; Binder, 2015a). In the last few months, governance-related issues of banking resolution attracted more and more attention in both sides of the Atlantic[5].

Nevertheless, it is of utmost importance to understand whether those reforms, beyond political overwhelmingness, are going to enhance the resilience of financial system

[3] 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.

[4] 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 (EU) No 1093/2010.

[5] Most of the literature is U.S. based. See in particular Schwarcz (2017); Schwarcz and Jones (2017); Omarova (2017). For what concerns European centered literature see in particular Capriglione and Masera (2016).

in an efficient and effective way, leading towards an optimal financial stability (several authors have raised many concerns, see, for instance, Hadjiemmanuil, 2015).

The paper procedes in building blocks, discussing first (Section 2) the nature of Corporate Governance, its peculiar shape in banks, its role during the crisis and the main attempts of reform in the last decades and some theoretical as well as practical aspect of Corporate Governance regulation in banking.

The second block will consist in the discussion of some general features of financial regulation wich are of utmost importance for the aim of this research (Section 3). The prominent financial reforms in Europe, and in particular in the Eurozone, will be introduced and briefly discussed, focusing on the rules concerning the recovery and resolution of distressed banks and discussing the peculiarities of banks distress and insolvency.

Finally, we will introduce the key features of the interplay between recovery and resolution regulation and Corporate Governance, focusing on the concept of "potential residual claim holder" (Section 4). Section 5 concludes and sets the agenda for future research to dig into the general framework depicted throughtout this paper.

2 Corporate Governance of banking institutions

The governance of modern corporations represents one of the most widely studied topics in social sciences, from many different - even though related - perspectives: company law, corporate finance, business management, business organization, just to name the ones of utmost relevance.

From a Law & Economics perspective, the main issue related to Corporate Governance is to understand and address several agency relationships arising among different corporate constituencies [6].

The aim of Corporate Governance is clear: given the existence of agency problems between corporate constituencies, Corporate Governance should design corporate relationship capable of solving or minimizing the existing agency costs, yielding a second best outcome (see, among many, Easterbrook, 2002, page 740). Nevertheless, different approaches to social science tend to have a sharply different definition of what Corporate Governance is and its constitutive mechanisms. The standard legal approach, that

[6] See the seminal contribution by Jensen and Meckling (1976).

can be summarized by the Cadbury Code[7] which mainly focuses on respective rights and duties of corporate constituencies in carrying out the corporation's activities, taking for granted the existence of a given financial structure of the corporation. Moreover, it only focuses on managing rights directly stemming from ownership rights of shareholders, neglecting the presence of underlying cash flow rights intrinsically linked to the ownership ones.

An almost antithetical approach is the one proposed by Corporate Finance stream of literature [8] This approach endogenizes the financial structure of the firm in the governance discourse, focusing on the rights stemming from the financial position of the investors in the firm. From a Law & Economics perspective, those mechanisms can be thought as a bundle of income rights as well as a bundle of control rights (Devriese et al., 2004), somehow defining the property rights related to the firms[9].

Such a mainstream definition relies on the assumption that the only efficient paradigm in modern corporation is to maximize shareholders' value, as shareholders have a sunk claim on firm's assets. Such an approach has been challenged inside the corporate finance literature by the so-called stakeholders' society approach according to which many other constituencies have to be empowered by means of Governance mechanisms[10].

Moving to the banking sector, the approach that was labeled as regulatory smuggle into the Corporate Governance discourse the role of legal and institutional arrangements. In fact, the updated version of the guidelines on Bank Governance issued by Basel Committee on Banking Supervision (BCBS), after re-affirming the classic OECD

[7] The Cadbury Report was drafted in 1992 for the London Stock Exchange by a committee chaired by Sir. Adrian Cadbury. It represents the first example of Corporate Governance code of best practices and played a pivotal role in the development of this kind of instruments that are now well spread in most of the developed economies. It defines Corporate Governance as:"*the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.*"(Cadbury, 1992)

[8] On which see (Shleifer and Vishny, 1997): *"Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?"*.

[9] Property as a bundle of rights is the standard representation for defining Property Rights in the Law & Economics discourse, see, for instance, Demsetz (1974).

[10] Tirole (2001, page 4) defines Corporate Governance as *"a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined"*.

approach to governance[11], go further and states that: "*Effective implementation of sound Corporate Governance requires relevant legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability*". (BCBS, 2015, § 21).

To reconcile all these approaches in a unified workable definition, one could borrow from Becht et al. (2003): *"Corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders"*.

In the proceeding of the paper, this will be the benchmark in dealing with Corporate Governance mechanisms, starting immediately from analyzing the key agency problems[12] that firms, and banking firms, for what is here of interest, face in efficiently raise finance.

The Corporate Governance literature focused on three main agency problems (see Heremans, 2007; Heremans and Bosquet, 2011) faced by modern corporations, deepening each of them in different periods of time and various legal systems.

1. **Conflicts between shareholders and managers**: this is also known as the problem of separation between ownership and control, and it has been studied since the early 30s (Berle and Means, 1932). Dispersed shareholders generate a moral hazard problem as managers earn less than the full return on their effort. Moreover, shareholders have little incentives in monitoring because of the little individual stake they invested in the company and the diversification of their investment. This result in a risk of expropriation of dispersed shareholders by managers, who become the real "owners" if the company.
2. **Conflicts between majority and minority shareholders**: this second stream of literature insists on situations where a controlling blockholder owns the necessary legal entitlements to pursue his private interests (i.e.: expropriating minority shareholders) while running the company (Hansmann, 1988; La Porta et al., 2000). While the former flow of literature born and developed in the Anglo-Saxon world of dispersed ownership, this latter one is more peculiar to the European world of

[11] Corporate Governance consists of "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (OECD, 2015).

[12] Firms can be described as "nexus of contractual relationships" where contractual relationship and the subsequent agency situation have to be governed. See the seminal contributions in this respect are by Coase (1937); Williamson (1979).

concentrated ownership (Barca and Becht, 2001).

3. **conflicts between insiders (shareholders, managers, etc.) and creditors**: equity and debt holders have intrinsically different claims towards the corporation[13]. The equity holders earn the residual income and bear part of the losses due to limited liability. On the other hand, debt holders are entitled to fixed contractual payments facing the risk of bearing losses exceeding the share capital of the corporation they financed. Therefore, equity holders are prone to take more risk than the socially optimal level, thanks to the shift on risk-bearing that limited liability generates. This moral hazard problem will be discussed in depth as it assumes an entirely peculiar shape in the financial system and represents a crucial aspect on the interplay between bail-in and governance.

This brief overview on the main definitions and issues arising from the standard Corporate Governance literature is crucial as it allows to have clear idea of the trade-offs and the complexities that granting governance rights imply in general and, eventually, to appreciate the growing complexity when banking firms are involved. From the point of view of the corporation as institutions, we have, on the one hand, the "private" functioning of the mechanisms according to which the corporation operates, as suggested by the "legal approach". On the other hand, the consistency between governance rights and financial position of the claim holder *vis-á-vis* the corporation, as stressed by corporate finance literature. On top of that, the underlying "institutional matrix"[14] is crucial to understand the impact of changes in Corporate Governance, as, for instance, granting new governance rights to other corporate constituencies. The other side of the coin is represented by the individual incentives faced by the different corporate constituencies and, consequently, the conflicts arising among them, which should be solved, or at least minimized, through sound governance arrangements.

2.1 Specialty of Bank Corporate Governance

It is now the right moment to tackle one of the issues of utmost interest in the field: is bank governance somehow special in comparison to the paradigm assumed as valid for non-financial firms?

[13] This specific agency problem has been analyzed in particular by the corporate finance literature, see Tirole (2006, pages 213-220). Legal consequences of this conflict have been tackled, up to a certain extent, by the LLSV literature (La Porta et al., 2000) that sees the legal protection of creditors as a substitute for the lack of shareholder's protection in civil law countries. Moreover, in terms of general legal theory, the interplay between creditors and shareholders represent the ground on which the entire branch of bankruptcy law rest.

[14] Borrowing from North (2008).

The idea that the specific nature, scope, and goals of Corporate Governance for financial institutions and, in particular, banks dates back before the financial crisis broke out (see Adams and Mehran, 2003, 2012).

Nonetheless, the dominant idea was that the existence of a supervisor and the high level of regulation should have acted as a substitute for what Corporate Governance does in non-financial corporations, as expressed by Dewatripont and Tirole (1994) in their “representation hypothesis”. This shift is due, as it was argued, to the nature of banks activity and the way banks raise finance (i.e.: short-term debt). Those features make unable corporate constituencies to exert appropriate monitoring. Therefore, monitoring had to be delegated to regulation and supervision, whose activities should mimic the market. So the most efficient way to carry out banking activity was to empower managers, align their incentives with shareholder maximization benchmark, and make them accountable *vis-á-vis* the supervisor.

To sum up, the special characteristic of banks governance was spotted in the inability of governance mechanism to function as smooth as in non-financial firm; therefore the role of some corporate constituencies had to be taken over by the supervisor and the regulator. For the rest, the usual tools of Corporate Governance were thought to be suitable for minimizing shareholder-management agency costs. This approach has been labeled in the post-crisis literature as “assimilation theory” of bank governance (Armour et al., 2016a, page 371).

After the global financial crisis, the “assimilation theory” had been heavily criticized, as mismanagement was considered one of the drivers that led the financial system to blow up during 2007 (see, in particular, Zingales, 2009; Sahut and Boulerne, 2010). Nevertheless, on both sides of the Atlantic, regulation (especially in the U.S.) and supervision (especially in EU) - even though massively reformed - persist as virtually the sole approach to banking from the point of view of the regulator.

Before moving into the theoretical arguments of this alternative theory, it is helpful to overview the large number of empirical studies showing that the special nature of banks governance does not represent just a theoretical speculation. The most famous and widely cited is the study by Beltratti and Stulz (2009). The Authors studied the determinants of bank performance during the crisis, measured by stock return, in a sample of 98 banks across the world. Even though they did not found governance to be the main determinants of the financial crisis, they detect a systematic negative effect of what is commonly labeled as “good governance” in banks’ performance during the crisis. These pieces of evidence are consistent with the findings of many other empirical papers on this issues. Erkens et al. (2012) found that financial institutions with more independent boards and higher institutional ownership experienced worst stock returns during the crisis. Fahlenbrach and Stulz (2011) found that better alignment between shareholders' interest and CEO compensation yielded worse performance during the crisis. In a similar vein, Anginer et al. (2014) found that shareholder-friendly corporate governance is positively associated with bank risk of insolvency.

The picture emerging from these findings is not intuitive and has not straightforward explanations. Indeed, the fact the good governance yield bad performance is against decades of theoretical and empirical research [15]. An alternative explanation might be that what is good governance for non-financial and financial firms may not coincide. Beyond any other possible implication of this stream of literature, those piecies of evidence make a sound argument for a "specialty theory" of banks Corporate Governance.

Moreover, empirical evidence suggests that bank governance is not only special in terms of scope and underlying mechanisms involved, but even for what concerns its structure. For instance, Adams and Mehran (2003) found that, in a sample Bank Holding Companies in the U.S., the size and structure of the board differed systematically from the Board of manufacturing firms [16].

Given these ambiguities in defining a clear paradigm of what good governance consists of; in the rest of this chapter the expression "good governance" will be used to indicate a model of governance that is optimal from a social standpoint, while carving out (some of) the contents of this concept, identifying the suitable departures from the plain "shareholder value" approach, will be one of the main purposes of the rest of the dissertation.

Moving to the theoretical arguments supporting the "specialty theory" of banks governance, there is nowadays a consensus about the mistakes occurred in the past: poor risk management, perverse incentives were given by executives remuneration, etc. (Bebchuk and Fried, 2006). Beyond such a consensus, there is the domain of a vast number of ideas proposed to address the determinants of the financial crisis, especially the systemic risk issue.

Nonetheless, some authors radically refused the idea that banks governance could play a decisive role in enhancing the overall financial stability, preferring a pure macro-founded supervision approach (see, for instance, the remarkable analysis by Brunner-

[15] Just to cite some of the most famous, see Maher and Andersson (1999); La Porta et al. (2000); Morck et al. (2005); Claessens (2006).

[16] Those findings seem to be persistent, as they were confirmed by a subsequent study carried out after financial crisis. See, Adams and Mehran (2012).

meier et al., 2009). Some other scholars emphasized the role of banks governance for financial stability (Mülbert and Citlau, 2011), focusing in particular on risk management and remuneration policies (see, again, Armour et al., 2016a; Becht et al., 2011; Ferrarini, 2017) as a complement of financial regulation and supervision. These contributions mainly deal with the internal Corporate Governance mechanisms, with primary emphasis on executive remuneration, board committees, and risk management. Some others are, instead, attempting a broader approach (Binder, 2015a; Chiu, 2014), focusing on a wider range of agency problems stemming from banking activities (as categorized in Heremans and Bosquet, 2011), in particular, the conflicts between shareholders and creditors.

The standard argument raised by many scholars in favor of a positive role of Corporate Governance in optimizing financial stability is that the classical approach to governance (i.e.: maximizing shareholders value) in banking fails to incentivize an efficient risk and crisis management. Such a claim is linked with the peculiar shape that agency conflicts, discussed in the previous section, assume in banks.

In fact, scholars disentangled four externalities that are peculiar to banks and shape the agency relationship between corporate constituencies (Becht et al., 2011; Heremans and Bosquet, 2011; Armour et al., 2016a; Ferrarini, 2017):

1. *social costs of failure larger than private ones*: shareholders bear only a fraction of the potential social costs of the bank failure, especially in systematically relevant institutions. This means that they are not able to internalize the costs of failure, so that they have incentives to take excessive risk. Moreover, there was (Gleeson, 2012) - and up to a certain extent there still is (Goodhart and Avgouleas, 2014) - a reasonable expectation of state bail-out in case of failure, increasing the risk of moral hazard by shareholders;
2. *the fiduciary nature of banking services*: banking services can be label as "experience good" and perhaps - up to a certain extent - even as "credence goods"[17]. This is the standard argument for special consumer protection in banking, but it also have governance spillovers, as the difficulty to correctly price the assets and make consistent inter-temporal choice creates incentives for bank management to behave opportunistically and take too much risk, extracting a rent from unsophisticated investors;
3. *opaqueness of banks assets*: this aspect is tightly related to the former one, but its focal point lies in the ability of outsiders, both investors, supervisors and other

[17] This aspect grasps the very nature of banking activity, as the word "credit" itself derives from latin *"credere"*, meaning "trust" (Pacces and Heremans, 2011).

stakeholders, to suitably monitor the quality of the assets owned by the bank. Again, this structural information asymmetry incentivizes the incumbent management to take excessive risk. The magnitude of this kind of problem blew up in the last couple of decades as financial assets became more and more complex[18];

4. *risk shift from shareholders to creditors*: the highly levered nature of banks, combined with the peculiar role of liquidity, make the creditors prone to bear a high amount of risk that is ordinarily borne by shareholders in non-financial firms. The role of leverage and liquidity will be analyzed in greater details later on.

Those peculiar externalities in governing a bank stem from the very nature of banking activities and are tied to two separate but at the same time intrinsically related aspect of banking business model: the level of leverage and liquidity (on this point see, among many others, Ferrarini, 2017, pages 5-7). In fact, banks are by definition highly leveraged institutions, since they perform transformation activities trough short-term funding (whether through deposit or other sophisticated forms of wholesale funding): raising debt is, thus, a pivotal part of the business in banking and not just an instrumental way to finance industry-specific projects. The high level of leverage, although intrinsic to banking activity, yield compelling consequences. Among them, the one of utmost importance is that debt holders mainly bear the risk of default. Therefore, shareholders and - consequently - managers who, according to the standard Corporate Governance paradigm shall maximize the shareholder's value, are incentivized to take excessive risk, as there is a shift in the risk holders due to the high level of leverage.

On the other hand, the transformation activity that the bank performs turn short-term and liquid (deposits and wholesale funds) into long-term and illiquid assets, by way of granting credit (retail, corporate, mortgages, etc.). This represents the role of utmost importance of banks and financial institutions for the economy, especially in continental Europe, as already pointed out in Section **??**. Nevertheless, it entails huge risks in case of liquidity shocks[19]. In fact, the common characteristic of those short-term funds is that they are runnable, meaning that their holders can freely decide to withdraw or not roll over their exposure toward the bank[20].

---

[18] For instance, think about the repo market, the structured assets, the swap instruments, etc.

[19] In the literature, liquidity has been defined in a number of ways. Brunnermeier and Pedersen (2009) define liquidity negatively, focusing on the definition of market illiquidity as the "difference between the transaction price and the fundamental value" (page 2202); Pistor (2013) defines it positively and more generally as the "ability to sell any asset for the other assets or cash at will". The latter definition, although more general and somehow vague, has the advange that ther is no need o determine the fundamental value of the asset.

[20] Perhaps the most famous run of the history is the Northen Rock one, when not-fully-insured depositors physically formed gigantic queues in front of the bank's brances to withdraw their money.

Therefore, in case of either an idiosyncratic or systemic shock draining liquidity out of the market, those transformation activities (and the entailed mismatch in liquidity and maturity) jeopardize the cash flow solvency of the bank Such an occurrence may be forced to fire-sale its illiquid asset, leading - in turn - to balance-sheet insolvency and, thence, triggering the crisis[21].

Having defined the externalities that make banks Corporate Governance "special", the following step is to transpose those externalities into the standard agency issues analyzed in Section 2 and build a clear picture of the agency conflicts in banks governance.

Undoubtedly, the changes of utmost interest happen in the agency relationship between insiders and creditors. Nevertheless, also events of type 1 and type 2[22] are specially shaped. In fact, due to the fiduciary nature of banking services and to the opaqueness of bank assets, controlling the management become more and more difficult, especially in an institution with dispersed or - even worst - levered ownership structure. Moreover, for the same reasons, also the conflict between majority and minority shareholders is worsened, as it is harder to detect whether the blockholders are trying to extract private benefit from their control entitlements.

For what concerns type 3 conflict, we already highlighted the insiders' incentives to take excessive risk because creditors bear a large part of it. This instance becomes even more salient in financial firms, since the level of leverage, and thus the magnitude of risk shifting, is structurally high[23]. Moreover, creditors of banking institutions are usually dispersed and unsophisticated, while creditors of non-financial firms, that often are banking institution themselves, enjoy exactly the opposite characteristics.

Those mechanisms led scholars and policy-makers to conclude for the necessity to regulate and supervise the banking industry, in such a way that the relevant authorities mimic the role of debtholders, especially depositors, in non-financial firms (Dewatripont

Nowadays, the possibility of a physical run is rather small because of full protection of deposit insurance, and the focal point is now shifted to the risk of wholesale creditors stopping to roll over their exposures, even though - theoretically - sophisticated investors, as wholesale investors are, should not panic.

[21] The is nowadays a wide consensus on the fact the even the big evil of the financial crisis, Lehman Brothers was not completely insolvent from a balance sheet point of view, but just from a liquidity point of view. In fact, when wholesale creditors panicked and stopped to roll out Lehmans liabilities, Lehman was forced to fire-sale its illiquid assets and, eventually, became balance-sheet insolvent as well. For greater detail on Lehamn failure see Gordon and Ringe (2015a, page 16).

[22] According to the taxonomy employed in Section 2 and by Heremans and Bosquet (2011).

[23] To limit leverage possibilities, in both sides of the Atlantic, regulators are implementing measures for risk-unweighted capital requirements.

and Tirole, 1994). After the wave of structural deregulation and even more after the financial crisis, everybody acknowledged that substituting creditors oversight with regulation and supervision does not represent an optimal solution, and governance mechanisms have to be seen as a complement good for achieving optimal level of financial stability.

It was already mentioned and will be further discussed in the next section as well, that the bail-in regulation impacts heavily, and perhaps up to a certain extent unintentionally (Chiu, 2014), on the relationship between some classes of creditors and bank insiders, by making them potential residual-claimers/owners.

2.2 Specificity of Bank Corporate Governance

After defining why bank and its governance is special, we have to take a step forward tackling the issue of specificity of banks governance. By specificity, we mean whether or not banks governance employs specific legal tools to address the special characteristics underlined in Section 2.1.

This aspect had been widely neglected by Law & Economics literature, therefore in this analysis we rely heavily on a paper by Van der Elst (2015), that tackle exactly this issue, and to some extent to the paper by Enriques and Zetzsche (2015).

Van der Elst (2015) critically analyzes the "special theory" of banks and bank governance[24] and eventually countercheck the legal tools employed to cope with such specialties.

The results are mixed and, as a first approximation, it is possible to distinguish between specific interventions in bank governance, stemming from overwhelming political activism in the aftermath of a financial shock and other specific intervention that are instead rooted in the specialty of bank governance.

Nevertheless, Van Der Elst did not found any bank-specific governance tools in the 11 Bank Governance Codes that have been issued across the world, included the guidelines issued by Basel Committee in 1999[25](see, BCBS, 2015, for the updated version). The author did not find any specific tool or guidelines to tackle bank specialty, apart from some rare and rather vague references to the importance of taking into account financial stability in determining the risk profile and the executive remuneration

[24] In doing so the Author mostly rely on the research carried out by Hopt (2013).
[25] And then updated in 2006, 2010 and 2015.

packages[26]. Instead, the attention to the large number of stakeholders inherent to the nature of banking industry remained in the declarations and the *desiderata* without translating them in actual guidelines[27].

This step is crucial to our research as it represents its normative side of the coin. Meaning that after assessing the impact of bail-in regulation impact on creditors' claim, we will have to take a stand on whether, and in case which, specific laws and regulations shall be implemented; i.e.: which kind of specific *ex-ante* governance rights.

How Van der Elst (2015, page 27) stressed: "The 'stakeholders' gap, left by bank governance codes, provides legislative room for improvements". This is even truer when facing bail-in regulation that significantly changed the (potential) claims of creditors without specifically tackling the governance consequences of this sudden swing.

All in all, the arguments discussed so far leave room for departures from the standard efficiency paradigm in Corporate Law and Governance, i.e.: maximizing shareholders value as a homogeneous and residual class of claimers (see, for instance, Becht et al., 2007). Therefore, the desirability of specific regulation about banks Corporate Governance through specific legal tools deserves to be investigated. It is, however, important not to rush to conclusions, as regulation of financial institutions does not represent a "free meal" [28] (Pacces and Heremans, 2011), especially in governance-related issues (Larcker et al., 2011)[29].

[26] Those references appear, for instance, in the Italian and in the Dutch governance codes.

[27] Some more bank-specific tools have been employed in European Regulation of bank governance, on which see Section 2.3.

[28] Borrowing this well-known expression by Milton Friedman (1975).

[29] Larcker et al. (2011) studied, following standard methodologies for event studies, the impact of the announcements of governance-related regulatory interventions in the U.S. on shareholder's value, measured through movements on stock prices. These reforms, from the classical agency-theory perspective, are supposed to be value-enhancing for shareholders as they reduce the possibility for managers to extract a rent out of their office. Nevertheless, the authors found an insignificant impact for *executive pay* announcements in general and even a negative impact for companies with higher compensation packages, conditioned on industry and size. A negative, though weak, relationship was found for reform announcements concerning *proxy access*. Finally, the authors found a significant negative impact of reforms announcing the *ban of staggered boards or CEO-Chairman duality*. Those results are striking and their interpretation is nothing but clearcut. Regardless the specific policy conclusions drew by the authors; those findings clearly indicate that governance-related reforms are a sensible issue that has to be handle carefully.

2.3 Normative Intervention in Corporate Governance

To complete our functional overview on bank governance, it is necessary to go through the laws and regulations enacted in European Legislation dealing with governance-related aspects.

The European Legislator granted a considerable attention to governance-related issues also before the financial crisis broke out. The Directive 2000/12/EC[30] and the CRD I[31] regulated board composition, requiring for sufficient expertise[32], and governance arrangements requiring to define organizational structure, transparent line of responsibility and accountability for risk taking, and a system of internal controls[33]. In 2010, the CRD III[34] additionally mandated to include in the governance arrangements, remuneration policies and practices consistent with effective risk management[35]. Member States were required to issue guidelines for implementing those arrangements.

In the aftermath of the financial crisis, as noted in the previous sections, governance had been blamed for being an influential ingredient of the global turmoil[36], so that CRD IV[37], implementing in Europe the Basel III accords, tackled Corporate Governance arrangements massively. In particular, CRD IV dedicates an entire subsection (Articles 88-96) of its Chapter 2 to the governance of banking institutions making a long list of compulsory requirements related to governance arrangements, composition of the board of directors and remuneration policies. The salient provisions can be summarized in this list:

(1) the duality of chairman and CEO is, in principle, forbidden (Article 88 § 1 (e));

(2) systemically relevant institutions must establish a nomination committee composed only of non-executive directors (Article 88 § 2);

[30] Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

[31] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

[32] See, Article 6 of Directive 2000/12/EC.

[33] See Article 22 of Directive 2006/49/EC.

[34] Implementing Basel II accords, Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

[35] See Article 1 §3.a of Directive 2010/76/EU.

[36] See the harsh positions of Kirkpatrick (2009); De Larosière et al. (2009) back to note 1.

[37] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

(3) management must possess sufficient knowledge, skills, and experience; it must be adequately differentiated in order to possess a broad range of experiences and must be of sufficiently good repute (Article 91 § 1);

(4) board members must devote to their office a sufficient amount of time. To make this requirement effective in systemic institutions, it is required to board members not to hold more than four non-executive positions or one executive combined with two non-executive positions in other corporations (Article 91 §§ 2 and 3);

(5) the remuneration policy should incentivize an optimal level of risk-taking, the resulting remuneration package must consist of both a fixed and variable part. The variable component shall not exceed 100 percent of the fixed remuneration, sufficiently deferred, and provide for *malus* and clawback arrangements (Article 94 §§ 1 and 2);

(6) systemic institutions must establish both a remuneration and risk committee (Articles 95 and 76 § 3).

The opinion of Enriques and Zetzsche (2015) on governance related intervention contained in CRD IV was particularly harsh, as they defined them as nothing more than quack and counterproductive Corporate Governance. Again, the possibility to tackle the issue of stakeholders' - and in particular creditors' - protection at a governance level was dropped, perhaps to avoid the creation of a likely complex mechanism that would have yield ineffective, and thus inefficient, results.

This could be true insofar there were no specific pieces of regulation dealing with the peculiar position of creditors in banking, but bail-in regulation changed the state of the world and, for what is here of interests, now it would represent a safe harbor from where finally tackle debt governance in banking.

Beyond the reforms that have already been voted and implemented, there is a large number of proposals by both practitioners and academics. It is impossible, and would not be useful either, to give a comprehensive and detailed survey of all of these proposals. Nevertheless, it is important to spend some words on proposals, delivered by influentials scholars, which do not focus merely on financial regulation, but - in a more general vein - aim at creating a "special corporate law for financial institutions" (as labeled by Ferrarini, 2017, page 19).

The underlying assumption behind this kind of proposals is that in banking the distance between fiduciary duties (in the interests of shareholders) and regulatory duties (protecting the public interest) results somehow blurred. In fact, theoretically, the difference appears straight both in their nature, as stated above, and in their enforcement mechanism: civil liability for the former, administrative sanctions for the latter. Anyhow, this difference is presumed to get shady and useless in the presence of financial stability concerns.

Macey and O'Hara (2016) assert, analyzing the behavior of U.S. judges toward bank managers[38], that "bank directors [have] a broader, if not a higher, standard of care than other directors"[39]. This approach, on its normative side, begs for more banking-specific expertise in banks boards.

Similarly, Armour and Gordon (2014) argue that the shield provided by the business judgment rule leads to excessive risk-taking behaviors. They propose to "induce board 'ownership' of firm's risk" through a shift from classic 'business judgment rule' approach in non-financial corporations, toward a negligence-based liability, considering the former inappropriate to cope with systemic risk. Other scholars objected that banks, no matter the type of business they are involved in, are still enterprises aimed at producing profits. Therefore, it seems unreasonable to relax the business judgment rule that represents the most important shield to protect entrepreneurship (Spamann, 2016). According to this approach, the optimization of risk-taking behavior from a public interest perspective have to be achieved through regulatory duties[40].

Both types of arguments have their own strengths and weaknesses, and the purpose of this research is not to take stand for one argument over the other. Instead, it is interesting to countercheck both positions in the shadow of the bail-in regulation and its (perhaps unintended) consequences on potential ownership and control structure.

Following Macey and O'Hara (2016) we can affirm that the difference between "public interest" through regulation and "shareholders' interest" through the duty of care become blurry. Nonetheless, unlike Macey and O'Hara, in this setup, such a blurriness does not derive from the fact that banking enterprises face systemic risk, but it follows from regulatory intervention meant at achieving public interest goal that impact on the "private", entrepreneurial, nature of banking firms.

In a nutshell, we can conclude this literature review with an important argument for the continuation of our research. The bail-in regulation not only begs for clarification of the underlying governance mechanisms modified by the changes introduced by bail-

[38] Despite the analysis of the Authors, after the crisis, the Delaware Court of Chancery fully applied the duty of care in the *Citigroup Inc. Shareholder Derivative Litigation*, Civil Action No. 3338-CC, Cout of Chancery, Delaware, February 24, 2009.

[39] The Authors proposed such an interpretation before financial crisis as well, see Macey and O'Hara (2003).

[40] Agreeing with this approach, see also Ferrarini (2017, pages 21 and ff.).

in itself in the relationships among corporate constituencies. But, in addition, bail-in regulation itself offers the possibility to more soundly approach the issue of the relationship between insiders and creditors in banking institutions.

3 Financial Regulation and Crisis Management of Banks

3.1 Banking regulation: generalities and warrants

For understanding the ground reasons why financial institutions, and in particular banks, have always been heavily regulated, it is necessary to come back and discuss the features of leverage and liquidity from a different perspective. In fact, these represent the standard arguments to advocate for financial and banking regulation, which already existed before 2007 crisis and, most notably, led to the implementation of the Basel Accords.

Banks, in fact, provide the real economy with three fundamental transformation services (Armour et al., 2016b, pages 275 and ff.):

(1) *Liquidity Transformation*: investors are provided with liquid assets against the illiquid ones hold by the bank;

(2) *Maturity Transformation*: banks turn short term deposits into long term investments;

(3) *Credit Transformation*: banks transforms low-risk liabilities, such as deposits, into risky investments through screening and pooling risky projects.

Those functions of banking institutions are vital for modern economies, especially in continental Europe; nevertheless, they make banks inherently fragile. In fact, due to their transformations features a bank might face liquidity problems. Those liquidity coinstraints, because of the highly leveraged nature of bank's balance sheet and the "runnable" nature of bank's liabilities might quickly morph into a "cash flow solvency problem", that eventually might become a "balance-sheet solvency issue"[41]. Indeed, liquidity problems would force the bank to fire-sale its illiquid assets to match liquidity demand from bank creditors which, in the meanwhile, are worried about bank viability and want to withdraw their investments.

[41] For a useful taxonomy on insolvency-related concept see Armour (2001, page 3).

The intrinsic fragility of banks and the high social cost of their failure endanger the belief that the banking industry shall be regulated, for making financial institutions more resilient to shocks. For achieving such a goal, four types of regulatory interventions have usually been employed:

(1) require banks to match with specific capital parameters;

(2) require banks to match with specific liquidity parameters;

(3) setting a backstop facility[42] for banks granting short-term loans to retail and wholesale costumers against illiquid assets to enhance the possibility that those banks will be able to match their supply of liquidity with the demand by creditors;

(4) set a scheme to secure deposits.

The narrative about consequences of leverage and liquidity features in banking (exposing banks to the risk of fire-sale of their illiquid assets, leading - in turn - to balance-sheet insolvency) represents a good, even though over-simplified[43], story of what happened in the times that lead up to the global financial crisis.

Such a conventional approach proved to be insufficient both before, during and even after the financial crisis, for a large number of reasons[44]. There is enough evidence to generalize this intuition and state that financial regulation, no matter how good and sophisticated, will always suffer some flaws, which has to be corrected or at least minimize through some alternative channels. This research advocates for a *positive role of Corporate Governance in fixing and/or minimizing regulatory flaws.*

In particular, something that is too often neglected both in academia (especially the legal domain) and policy making is that the effects of regulation do not consist in the contents themselves of the reform, but rather on the reaction of the market players to those reforms[45].

What is crucial is that the outcome of the regulatory activity lies on the reaction of the market players to the contents of the intervention. Therefore, we can qualify the

---

[42] Commonly known as "Lender of Last Resort" (LOLR), usually performed by Central Banks.

[43] As it does not take into account the role of non-banking financial institutions, of tremendous innovations in financial instruments, of off-balance-sheet activities; of market bubbles, etc. For a comprehensive analysis from an economic and regulatory standpoint, respectively, see Brunnermeier et al. (2009); Pacces and Heremans (2011).

[44] The criticisms raised by the literature are countless. Just for the sake of exemplification, think of the pro-cyclical nature of Basel II Accords, or to the disruptive effects of a less-then-hundred-percent deposit insurance in Northen Rock collapse.

[45] On dynamics of regulatory effects see Awrey (2012).

process of reform the financial system as "dynamic"[46], as the final outcome does not depend solely, and neither primarily, on the decisions of the regulator.

It may be objected that this could be the case in all the regulated industries, and, up to a certain extent, it is so. Nevertheless, this dynamic nature of regulatory outcome is markedly vivid in the financial sector because of two main feature. On the one hand, the vast possibilities of regulatory arbitrage; on the other hand, the tremendous impact of financial innovation. As it has been sharply pointed out by Pistor (2013): "Law and finance are locked into a dynamic process in which the rules that establish the game are continuously challenged by new contractual devices, which in turn seek legal vindication" (page 315).

Looking at those issues from the lenses of financial innovation, in the period leading up to the financial crisis, a sort of blind belief arose. According to such a belief, innovative financial instruments should have been able to cope with a gigantic number of issues and even substitute governance mechanisms. In this vein, Easterbrook (2002, page 743), discussing the ability of complex synthetic financial instruments in hedging all kind of risks, asserted: "What I have said so far implies that we can stop worrying about corporate governance. Things will take care of themselves nicely - though that doesn't imply the end of conferences about corporate governance!". It goes without saying, the event of the following years proved him remarkably wrong.

One of the common narratives to show how the origination of "regulatory monsters" is particularly likely in financial regulation, due to its peculiar characteristics, is the famous Glass-Steagall Act, enacted in the U.S. to cope with the Great Depression and primarily aimed at restore trust in the financial system in the short-term. The reform provides for a tight structural separation between commercial and investment activities carried out by banks[47]. The combination of the Glass-Steagall provisions and other tight regulation on banking activities, especially from a geographic point of view, boosted a race to financial innovation and regulatory arbitrage. The result of this process was the development and proliferation of several forms of non-bank market-based financial institution, whose portfolio size increasingly growth since the 1960s: the 2015 FSB report shows that non-bank financial institutions hold approximately 40% of financial assets in the surveyed jurisdictions, that is around 137 trillion $ of assets[48]. It is a bit ironic the fact that many experts and politicians, discussing the 2007-2008 financial crisis, profoundly blame these type of financial institutions and the shadow

[46] This position is consistent with the one by Armour et al. (2016b, pages 80-91); Pacces and Heremans (2011), Brunnermeier et al. (2009).

[47] See Omarova and Tahyar (2011).

[48] FSB (2015), Global Shadow Banking Monitoring Report 2015.

banking system, begging to re-enact something similar to Glass-Steagall, while those institutions can be considered, at least up to a certain extent, sons of the Glass-Steagal itself[49].

Another, contemporary, example of regulatory arbitrage that caused huge consequences, according to Acharya and Richardson (2009) is represented by the Basel Accords, which incentivized financial institutions to extensively use off-balance sheet instruments and structured finance, making more vulnerable the financial system.

This caveat had the only, but crucial, aim to show how complex and almost unpredictable financial regulation may turn out to be. Therefore, in the analysis of the post-crisis stream of reforms, those theoretical aspects shall be taken into serious consideration in order to avoid the creation of new "regulatory monsters" [50].

With these methodological specifications in mind, this section will proceed to analyze the main European regulatory reforms in the banking sector implemented in the last decade and in particular the reforms dealing with crisis management, discussing their theoretical foundation and actual implementation by the European legislator.

---

[49] This narrative is consistent with the one by Pacces and Heremans (2011, page 21): "The Glass-Steagall Act was repealed in 1999. It was observed that this approach did not contribute to financial stability in the long run. Structural measures resulted in disintermediation as funds could be more profitably directly invested in and obtained from financial markets. Also, many financial innovations were introduced to circumvent these restrictive regulations". In the same vein, Armour et al. (2016b, page435) noted: "The rise of market-based credit intermediation since the 1960s had two main drivers: [...]; and second, the way that regulation in the US - most notably the Glass-Steagall Act and geographic limits to bank expansion - gave investment banks the incentive and opportunity to pursue market-based credit finance vigorously".

[50] Those kind of considerations have been taken even further by the so-called "Legal Theory of Finance" (Pistor, 2013), stressing how financial markets are inherently legally constructed and, therefore, legal norms and commitments can determine both the success and the collapse of financial markets. For what is here of interests, the "Legal Theory of Finance" aims at relaxing the underlying assumption of the mainstream Law & Finance literature, according to which there is a unidirectional link between law and finance: legal norms that better protect investors yield a better financial system. According to Law & Finance literature, all the departures from this paradigm are considered exogenous. The "Legal Theory of Finance" criticizes such an approach that consider law and finance as two different spheres and liquidity as a free good. On the contrary, the LTF asserts that legal commitments - in a world of Knightian uncertainty and liquidity volatility - can lead to the collapse of the system. For what is here of interest, this new stream of literature underly, from a normative perspective, the need for "safety valves" scattered in the system, in order to make the legal system and financial markets able to face the next financial crisis, whose timing and characteristics are uncertain. In this respect, specific governance arrangements stemming from specific regulatory interventions might be considered - up to a certain extent - as "safety valves".

3.2 Financial reforms in Europe and the creation of the "European Banking Union"

As already noted above, financial reforms were particularly deep and interesting in the Eurozone, both because of the particularly harsh effects of the financial crisis and its spillovers and for the legal, economic and political development of the European Union.

The interventions were numerous and deep, ranging from market infrastructures to a completely new institutional design for supervision and resolution. As this is not the appropriate occasion to give a complete overview of all of these reforms[51], a functional approach will be employed, briefly discussing the salient aspects of the so-called Banking Union.

The Banking Union has been, perhaps, the most important innovation in European financial system after the crisis. Commissioner Barnier, the responsible for the internal market and services in the period that led to the approval of Banking Union's pieces of regulation, described it as a revolution and the "most ambitious project since the creation of Euro"[52]. It consists of common European rules on deposit insurance[53], banking supervision[54] and crisis management and resolution[55]. It has, primarily, the macroeconomic goal to supplement the Monetary Union. Indeed, many commentators argued that one of the main drivers of the particularly harsh crisis in Europe, and particularly Eurozone, has been the incompleteness of economic and monetary integration, of which common rules on banking should have been a crucial component (Van Rompuy et al., 2012).

The new Deposit Guarantee Schemes Directive does not represent a revolution, as the first European Directive in the field dates back to 1994 and a wide academic and

[51] For a comprehensive survey, see Duffie et al. (2016).
[52] Commissioner Barnier Speech at the Peterson Institute for international Economics, Whashington DC, June 13, 2014. Available at `http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm`.
[53] DIRECTIVE 2014/49/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on deposit guarantee schemes.
[54] COUNCIL REGULATION (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.
[55]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; the BRRD had been supplemented, for the Eurozone, by a regulation establishing a centralized Single Resolution Mechanism, 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 Reso lution Fund and amending Regulation (EU) No 1093/2010.

political consensus around the salient aspect of guarantee schemes is consolidated since the Northen Rock scandals, especially about the necessity of a full insurance up to 100.000 €[56]. Moreover, insofar there is no political accord on a single deposit insurance scheme nor for the European Union at large, neither for Eurozone countries. Therefore, the new Directive represents an attempt to make more efficient and trustworthy the deposit insurance mechanism, with a speed up of the procedure for the reimbursement and mechanisms of settlement between national deposit insurances that yield an enhanced protection of depositors in cross-border situations.

The new Single Supervisory System represents, instead, a decisive innovation towards a "genuine economic and monetary union"[57]. Now, the Single Supervisory Board (SSB), composed of a dedicated unit of the ECB and the National Competent Authorities (NCAs), is in charge of the supervision over Eurozone banks. Moreover, ECB directly supervises all the "systemically relevant" institutions as defined by Article 6, which represents around the 80% of the market. The main goal of this new institutional design is to break the vicious circle between domestic banks and their sovereign since it is considered one of the main determinants of the Sovereign Debt crisis of 2010-2011[58]. The principal criticism moved against the SSM is the high level of complexity of the institutional design for what concerns the interplay between the ECB and the NCAs, and between ECB and EBA, which retains regulatory power[59].

Finally, it is worth to spend some words on the governance-related issues arising by the SSM as discussed by Binder (2015a). In fact, this represents one of the few pieces of research on the governance consequences of the Banking Union. The author focuses mostly on the impact of the new centralized institutional design on Corporate Governance of European banks, arguing that it is likely to yield a standardization of governance best practices and business models that would make the banking system more resolvable. This research, although mostly centered on supervisory issues and not on resolution, can be considered complementary to this one, as it emphasizes the role of centralized competent authorities and not on the individual incentives stemming from

[56] For a deeper analysis of DGS Directive, especially in its interconnections with resolution, see Gros and Schoenmaker (2014).

[57] Borrowing from the incisive words by Van Rompuy et al. (2012).

[58] As explicitly stated in the recital §6 of the Single Supervisory Regulation: "The stability of credit institutions is in many instances still closely linked to the Member State in which they are established. Doubts about the sustainability of public debt, economic growth prospects, and the viability of credit institutions have been creating negative, mutually reinforcing market trends. This may lead to risks to the viability of some credit institutions and to the stability of the financial system in the euro area and the Union as a whole, and may impose a heavy burden for already strained public finances of the Member States concerned".

[59] On those issues see, widely Ferrarini (2015).

agency relationships in banks and their interplay with financial regulations.

3.2.1 Specialty and Specificity of Bank Insolvency

One area in which financial reforms were remarkably profound and innovative is the bankruptcy and restructuring law of banks: the European Legislator, finally approved in 2014 the Bank Recovery and Resolution Directive (BRRD), and - specifically for Eurozone - the Single Resolution Mechanism Regulation SRM. In fact, this package concerning crisis management and resolution of distressed banks affects both the institutional design for eurozone resolution procedure, but it also harmonizes - and most importantly - innovates the substantive rules to deal with banking crises, widening the set of available tools to resolution authorities.

Again, unlike failures of non-financial firms, failure of banking institutions display many peculiarities and complexities. Therefore, before moving to a brief survey on the BRRD and SRM, it is useful to introduce and discuss such peculiarities.

In banking, the goal itself of bankruptcy differs sharply from standard corporate insolvency law. For corporate insolvencies, the legal framework provides bankruptcy and reorganization procedures to cope with creditors' collective action problems (Gertner and Scharfstein, 1991) and reduce agency costs in distressed corporations (Li and Li, 1999). This shall lead to the maximization of return for creditors (Baird and Jackson, 1984) and, from an *ex-ante* perspective, shall minimize the cost of debt finance (Schwartz, 1998)[60]. In a nutshell, the private interests of creditors (*ex-post*) and companies (*ex-ante*) outweigh, at least in the mainstream literature and in policy-making, public interest considerations (Armour, 2001).

On the other hand, in bank insolvencies, given the role of banks in the real economy, the primary object is to preserve the continuity of their essential functions, i.e.: public interest considerations are by far predominant. This should be a sufficient argument for implementing an *ad hoc* normative framework. Nevertheless, until BRRD entered into force, many European jurisdictions heavily rely on corporate bankruptcy procedures, supplemented by some specific rules[61].

In recital § 4 of BRRD, the European Legislator acknowledges both the need for

---

[60] For a outstanding even though outdated survey of the Law & Economics literature on insolvency see Armour (2001), for a more up to date review see also Levratto (2013).

[61] The level of specialty of bank bankruptcy in different European jurisdictions had huge variability and it is not possible neither useful now to report them. For a survey on the pre-crisis insolvency regimes in several European countries see Hüpkes (2002).

harmonization at European level of bank insolvency regimes and the necessity for a special regime: "[...] the financial crisis has exposed the fact that general corporate insolvency procedures may not always be appropriate for institutions as they may not always ensure sufficient speed of intervention, the continuation of the critical functions of institutions and the preservation of financial stability".

The necessity for "special" bankruptcy regime to cope with banks failure spring from specific externalities created by banks bankruptcies that normal insolvency rules are not able to detect and deal with. Marinc and Vlahu (2011) disentangled four externalities linked specifically with bank distress; namely:

1. *role of trust*: in non-financial industries, the failure of a firm represents an advantage for the other firms in the market that can try to capture the market share of the failing competitor. This is not true in the banking industry, since the failure (or even a severe distress) of one institution may have negative spillovers on all the relevant market, endangering a decrease in the level of trust of retail and wholesale costumers. Standard bankruptcy procedures, aiming at solving a collective action problem among creditors, are unable to make creditors and incumbent insiders internalize those negative spillovers on the whole banking market;
2. *risk of contagion*: the negative spillovers deriving from the failure of a bank do not end in increasing mistrust in investors. In fact, financial institutions are more and more interconnected and banking market is systemic[62], meaning that the insolvency of even a single systemically significant institution[63] might trigger a domino effect because of the interconnection of the risk profiles of financial institutions;
3. *social costs of failure larger than private ones*: as already discussed back in Section 2.1, shareholders bear only a fraction of the risk of failure and management is, therefore, incentivized to take excessive risk. In non-financial corporations, the *ex-ante* threat of future bankruptcy can be seen as a disciplining mechanism for incumbent management, incentivizing it to take optimal risk. But this is not the case in banks, where the highly levered nature of the balance sheet impedes to internalize negative effects of excessive risk-taking. This represents an argument against a Chapter-11-like restructuring procedure, as *ex-ante* incentives of incumbents are even worsened, even though some other externalities can be better

[62] On systemic risk, see the formal model by Acharya (2009) and its empirical application in Acharya et al. (2017).

[63] A list of Global Systemically Important Banks (G-SIBs) is produced by the Financial Stability Board and updated annually. The 2016 version is available http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf.

dealt through restructuring than through liquidation[64]. The BRRD tries to design tailored procedures able to combine good aspects of both approaches, keeping the continuity of critical functions provided by the distressed institution as the primary goal.;

4. *Likelihood of bail-out*: the latter point is linked with the famous "too-big-to-fail" (alleged) characteristic of systemically important financial institutions. This doctrine asserts that, because of many of the arguments that have been raised so far, States cannot (do not want to) allow an important domestic bank to fail. Therefore, the State saves, according to various scehmes the distressed institution, restoring its viability. The debate over the desirability of those mechanisms is still nowadays open[65] but there are two unquestionable features representing the main external costs of bail-out operation on banks. On the one hand, there are raw costs borne by the State (i.e.: taxpayers) for bailing banks out[66]. Moreover, and arguably more importantly, the *ex-ante* incentives had been perversely shaped due to the expectation of a future bail-in, inducing moral hazard in carrying out banking activities.

In the aftermath of the crisis, the general public and many politicians emphasized especially the first of the highlighted components, strongly proposing a shift in paradigm from bail-out to bail-in to safeguard taxpayers' money (Rutledge et al., 2012; Calello and Ervin, 2010). Those proposals led the Financial Stability Board to draft the "Key Attributes of Effective Resolution Regimes for Financial Institutions "(FSB, 2011) and subsequently to the BRRD.

Finally, but of utmost importance, distress of financial institutions need to be handled quickly[67] to be effective, so that judicial-based procedures are inherently inappropriate to match this requirement. Therefore, it appears completely reasonable to design a quick administrative procedure that minimizes the time necessary to enforce and implement the resolution a concrete strategy and in which individual rights can be judicially protected only *ex-post*.

[64] On the choice between creditors-friendly insolvency regime, made up by shareholder foreclosure and liquidation, in comparison with debtor-friendly procedures focused on firm restructuring in the banking context see, extensively, Marinc and Vlahu (2011).

[65] Especially in Europe, where this debate is linked to the State Aid regulation as a measure to preserve competition.

[66] During the 2007-08, crisis almost 37% of aggregate EU Member State GDP was spent to avoid banks failure. See ECB, EU Banking Structure, September 2010.

[67] Huertas (2016, page 9) shows how resolution of distressed institutions needs to begin after the closing of Wall-Street on Friday and before the opening of Japan and China stock exchanges on Monday, in a time-window of about 38 hours.

So far, we furnished sufficient evidence that bank insolvency is special and need specific rules and procedures to be effective. As already mentioned, the European Legislator recently implemented a common European framework to cope with banks distress, made up by the BRRD and the SRR. We, now, analyze how these reforms answers to the special features raised by bank insolvencies. Eventually, we will focus on the reforms' main shortcomings, as underlined by the literature.

3.2.2 Role, relevance, and ambiguities of Bank Recovery and Resolution Directive (BRRD)

The first draft of BRRD was published in June 2012. Afterward, in August 2013, European Commission issued a Banking Communication establishing, in its § 3.1.2, a mandatory burden-sharing of losses among shareholder and subordinated debt holders.

Accordingly, the Burden Sharing Communication stated that any public intervention in banking crises should be conditioned by a contribution of insider investors (stockholders, hybrid capital holders and subordinated debt holders) [68]. That document informed the approach of the European Legislator in addressing bail-in, seen at first as a mechanism to redistribute losses, in response to the widespread perceived unfairness of bail-outs (Ringe, 2016).

In May 2014, the European Parliament approved the Bank Recovery and Resolution Directive, which entered into force the 31st December of the same year. The redistributive approach appears crystal-clear already in recital § 1, where it is stated that: "During the crisis, those challenges [lack of tools for addressing banking crises] were a major factor that forced Member States to save institutions *using taxpayers money*. The *objective* of a credible recovery and resolution framework is to *obviate the need for such action* to the greatest extent possible"[69].

The new resolution framework is made up of three pillars: Preparation (Title II), Early intervention (Title III) and Resolution (Title IV). Among the four resolution tools provided by the Directive (Chapter IV BRRD Articles 37 and ff.), the bail-in one represents, by far, the most innovative and intrusive. Hence, European legislator delayed its entering into force by year, the 1st January 2016.

The introduction of the bail-in tool brought up the attention of several scholars and

[68] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis, available at `http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2013:216:FULL&from=IT`.

[69] Emphases added.

practitioners so that an extensive literature about its general features has already been developed[70]. Bailing-in a distressed bank consists in the power of resolution authorities to write down (art. 63 § 1 lett. e, BRRD) or convert into ordinary shares (art. 63 § 1 lett. f, BRRD) eligible liabilities issued by the resolved bank. Therefore, bail-in materializes in a balance sheet operation to recapitalize and restore its viability (Armour et al., 2016a, page 359).

As a first approximation, the bail-in is a mechanism that preserves a likely to fail institution as a going concern without the implicit guarantee of government intervention (Gleeson, 2012, page 4). In fact, shareholders and creditors mandatorily born the losses, according to the seniority order of their claims. Therefore, taxpayer money shall be no longer threatened by banking failures (Rutledge et al., 2012, page 5).

The idea of bail-in is particularly attractive since it offers the regulator a workable alternative to direct liquidity intervention for the resolution of too big, too complex or too international to fail institutions (Gleeson, 2012, page 2). Indeed, both Financial Stability Board and Basel Committee stressed the importance of implementing the bail-in reform specifically for SIFIs, while the EU adopted the one-size-fits-all approach, establishing a level played field within European banking market (Santos, 2014; Goodhart and Avgouleas, 2014, page 30).

To sum up, in the eyes of European Legislator and according to FSB as well, the bail-in should represent the cornerstone of bank resolution procedures. It should avoid resorting to taxpayers money and wipe out, once and for all, the too-big-too-fail policy by eliminating the government implicit guarantee on domestic bank solvency (see, among many others, Coffee Jr, 2010, p. 6).

Nonetheless, tremendous uncertainties and worries remain about bail-in effectiveness and efficiency. As this is not the place where to properly discuss all of them, the crucial ones will be just briefly introduced.

First of all, the biggest fear is that bail-in tool will not be employed after all because of the reluctance of resolution authorities to affect non-shareholders investors (Ringe, 2016, pages 29 and ff., where some preliminary anecdotal evidence are provided). That is the result of both the perceived unfairness of involving creditors in the resolution procedure (Chiu, 2014) and the lack of credibility the - *de jure condito* - affects bail-in (Armour, 2015).

The lack of credibility is due to several ambiguities inherent to bail-in regulation.

[70] See in particular Gleeson (2012); Conlon and Cotter (2014); Goodhart and Avgouleas (2014); Hadjiemmanuil (2015); Joosen (2014) Armour (2015).

Some of them have a general validity, some other are, on the contrary, European-specific.

First of all, there is not clear consensus about the amount of bail-in eligible liabilities needed (Hadjiemmanuil, 2015; Armour et al., 2016a, pages 361-363). BRRD ask for bank-specific Minimum Requirements of Eligible Liabilities[71]. At international level, the Financial Stability Board issued guidelines for SIFIs requiring, in a not yet completely define timespan, to comply with a "Total Loss Absorbency Capacity" (TLAC) requirement (Financial Stability Board, 2011) that shall amount to 18 % of RWA by 2022 [72].

Such a long lasting implementing period is a price to be paid for such a profound change in the approach to bank regulation. Somehow related to this aspect, a substantial fraction of eligible liabilities currently outstanding were issued before of the FSB Key Attributes, the first draft of BRRD and the 2013 Banking Communication. Therefore holders could not price bail-in possibility when purchasing those financial instruments. Moreover, especially in some countries as Italy (see, Figure 1), unsophisticated investors (mostly households) holds considerable amount of those instruments without having a sufficient understanding of the entailed risk (Götz and Tröger, 2016).

That is one of the reasons why Italian Resolution Authority (Resolution Unit of the Bank of Italy) is resistant to make use of bail-in powers, as denounced by Ringe (2016, page 29)[73].

Beyond the ambiguities due to the long implementation and adjustment period, many commentators raise doubts about the very ability of bail-in to cope with systemic crises. In fact, while there is a widespread consensus that bail-in is a superior mechanism to address idiosyncratic crises of non-systemic institutions, many scholars argued that bail-in might even increase systemic risk[74] and facilitate contagion in case of a systemic crisis (Kashkari et al., 2016; Schwarcz, 2016, pages 26 and ff.).

Another relevant issue, stressed by many scholars (Gleeson, 2012; Rutledge et al., 2012, pages 14 and ff.), pertains to cross-border institutions, which is a common feature of systemically important banks. Nevertheless, it needs to be noted how cross-border issues do not represent a bail-in specific feature. On the contrary, it had been one of the

[71] Article 45 of BRRD, for the EBA implementation see European Banking Authority (2016).

[72] According to some authors, as Jeffrey N. Gordon (Gordon and Ringe, 2015b) or Martin F. Hellwig and Anat R. Admati (Admati et al., 2013), setting capital requirements and TLAC requirement high enough represents a necessary and sufficient means to avoid any future banking crisis.

[73] See also the specific comment about the Monte Paschi Siena case by Christos Hadjiemmanuil, available at `https://www.law.ox.ac.uk/business-law-blog/blog/2017/05/monte-dei-paschi-test-european-policy-against-bank-bailouts`.

[74] As defined by Schwarcz (2008).

Holders of banks subordinated debt (Data in billion €)		
Holders	**Amount**	**Share**
- Italian Banks	**3**	**5,11%**
- Italian Households	**31**	**52,81%**
- Italian Institutions of which	**8,1**	**13,80%**
other financial intermediaries	3,1	5,28%
investment funds	2,2	3,75%
companies	2,2	3,75%
- Foreign investors	**13,2**	**22,49%**
- Not classified	**3,4**	**5,79%**
Total	**58,7**	**100,00%**

Figure 1: *Banks Subordinated Debt Market in Italy. Bank of Italy, 2015b*

main flaws of the previous regime in handling banking crises, markedly in Europe, for example in the resolution of Fortis Group (European Commission, 2009, pages 18-19).

Coming to the European-specific ambiguities, we should focus our attention on three main aspects: the resolution strategy, the trigger event and the role of liquidity.

For what concerns the first feature, the literature identified two competing approaches: the Single Point of Entry (SPOE) and the Multiple Point of Entry (MPOE). In the first resolution strategy, the resolution authority aims at resolving any possible distress arising within a banking group at the holding level, meaning that regardless of the identity of the distressed entity, the resolution authority will only bail-in the Holding Company, so that all the subsidiaries will keep alive their core activities as a going concern.

On the other hand, the MPOE strategy endorses an opposite atomistic approach, in which each legal entity is considered individually from a resolution policy perspective.

As we mentioned before, the choice between these two different strategies represents an issue only in the European context. Indeed, the structure of the banking industry in the U.S. allowed the Dodd-Frank Act[75] to opt for a SPOE approach (for a detailed description of FDCI resolution strategy, see Gordon and Ringe, 2015b, pages 1310 and

[75] Dodd-Frank, Title II - Orderly Liquidation Authority, secc. §§ 210 and ff.

ff.).

On the contrary, the European legislator did not, and maybe could no either, take this decision. Therefore, the BRRD explicitly states that: "This Directive should allow for a multiple-point-of-entry or a single-point-of-entry resolution" (Recital § 80).

Such an ambiguity represents itself a shortcoming, as it decreases the level of legal certainty about future resolution policies and increases transaction costs. Moreover, in the literature some authors pointed out that a SPOE strategy allows minimizing the value destruction during the resolution process (Gordon and Ringe, 2015a, page 9).

For the U.S. legislator, the choice to opt for a SPOE strategy had been straightforward because of the path dependence of the group structure of the U.S. financial institutions, which dates back to the Glass-Steagall Act[76]. On the other hand, the legal organization of European financial institutions is not uniform, so that sharply opting for one or the other strategy is more complicated.

Gordon and Ringe (2015a) argue in favor of a structural regulation in Europe as well, endorsing the Liikanen structural regulation proposal (see, Krahnen, 2013)[77], stressing that this might be the missing layer to achieve effective resolution policy in the Eurozone.

The rationale stressed by Gordon and Ringe (2015b) sharply differs from the traditional wisdom about structural Glass-Steagall-like regulation, that is ring-fencing the assets pertaining to different business model and thus protect the costumers of commercial banks (see, for instance, Babis, 2014).

A related issue pertains to the moment in which resolution have to be triggered. The normative framework sets two general and non-quantitative criteria for triggering a resolution procedure: the institution has to be failing or likely to fail, with no prospect that any other measure will solve the distress. Moreover, the resolution has to be "necessary for the achievement of and is proportionate to one or more of the resolution objectives referred to in Article 31" (public interest clause)[78].

Those criteria, stated in the Directive, leave considerable flexibility to the resolution authority. Therefore the concrete implementation of them will depend on a choice of

[76] The narrative that has led to the current path-dependent legal structure has been discussed back in Section 3.1.

[77] EUROPEAN COMMISSION, COM(2014) 43 final. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on structural measures improving the resilience of EU credit institutions. Brussels, 29.1.2014. Available at `http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN`.

[78] BRRD, Article 32 §§ 1 and 5.

resolution policy. Recently, Ringe (2016) argued in favor of an early resolution trigger, treating the distressed institution as a going concern (see also, Goodhart and Avgouleas, 2014, page 10). Such an approach follows the development of understanding about the nature of bail-in, from a "redistribution" towards a "stabilization" focus (Ringe, 2016).

From a systemic stability perspective, the conceptual discrepancy between resolution and insolvency increase far beyond a different mechanism to allocate losses. From this standpoint, an early trigger, complemented by appropriate "living wills"[79], would allow to better maintain the assets value the distressed institutions, without endangering the continuation of the critical functions carried out by the institutions themselves (Ringe, 2016, pages 23 and ff.).

The last issue to be discussed is still closely related to the development of bail-in toward a stabilization mechanism. In fact, a bank bail-in basically consist in a mandatory recapitalization of a distressed institution operated by an administrative authority. From a stability perspective, a mere recapitalization of a bank is a necessary but not sufficient step to assure its viability. In fact, the bailed-in bank will need extensive liquidity assistance by the Lender of Last Resort (LOLR).

This instance is also connected with the debate about the possibility that bail-in itself might increase systemic risk. In fact, without an adequate liquidity assistance, a bailed-in institution would be viable from a balance-sheet perspective, but not from a liquidity one, with the risk to be forced to resort to fire-sale of assets, affecting the interconnected institution and harming the public trust in the whole sector.

In designing liquidity facilities for distressed institution, the redistribution approach to bail-in played a predominant role. In fact, anything related to the use of public funds are not mentioned in the BRRD, while the liquidity assistance shall be provided only by a Resolution Fund. Such a Fund should be constituted by the market players themselves, which shall consist of the 1% of deposits by 2023 (around 55 bln €), which is not nearly close to the amount needed in case of a systemic crisis (Ringe, 2016, pages 33 and ff.).

[79] On the pivotal importance of Living Wills for the effectiveness and credibility of resolution see Binder (2014); Avgouleas et al. (2010).

4 The Interplay between Bail-in and Corporate Governance

In Sections 2 and 2.1, the agency problems between corporate insiders (i.e.: shareholders and incumbent management) and creditors were described and discussed. In banking, this agency problem assumes a peculiar nature and scope, due to the risk shift between shareholders and creditors and the highly leveraged nature of the banking firm. Moreover, unlike non-financial corporations, the class of banks creditors is mainly composed of unsophisticated investors that are incentivized to free-ride on supervisor and (for depositors) deposit insurance so to avoid exerting the monitoring activity.

Bail-in regulation and - more generally - the Banking Union, almost inadvertently, tackle the issue of agency problem between insiders and creditors. As Armour et al. (2016b, page 359) correctly pointed out: "This [the use of bail-in tool] has both financial and governance consequences for the bank [...] as the former debt-holders become equity holders"[80].

To describe how this happens, we can isolate three classes of banking creditors resulting from the Banking Union. The first class is composed of insured depositors, that are not affected by bail-in and whose protection have been enhanced by the new DGSs Directive. The second class of creditors is represented by a heterogeneous group of creditors listed in Article 44 § 2 and § 3 of the BRRD, ranging from secured creditors to employee remuneration, through short-term interbank operation, etc. Those creditors, for different reasons, are exempted from the application of bail-in and therefore are not directly impacted by the regulation. Finally, the third class consists of the so-called bail-inable creditors whose agency relationship with the banks has been altered, as they are not plain creditors endowed with a fixed claim anymore, since - potentially - they can become shareholders or even be directly written down.

As noted by Pacces and Heremans (2011, page 33): "all aspects of behaviour of financial firms can be ultimately understood as Corporate Governance issues". Indeed the modifications operated by the bail-in regulation affect the behavior of financial firms and their corporate constituencies since bail-inable creditors should now be incentivized to exert better monitoring, so that market disciple should be enhanced and, in turn, risk appetite of financial institution should be driven toward a socially optimal level.

Nevertheless, as we stressed in Section 3.1, the effect of regulations shall not be

[80] In fact, Article 47 of BRRD mandates at least the heavy dilution of the shares held by incumbent shareholdes.

appraised only by looking at the contents of the regulation itself, but analyzing or figuring the likely reaction of the relevant players involved in the regulation.

For what specifically concerns bail-in, among many commentators, for a number of reasons discussed in Section 3.2.1, there is a wide-spread belief that a pure mandatory bail-in regime will turn out to be - to some degree - ineffective, jeopardizing the *ex-ante* monitoring effect on bail-inable creditors.

This possibility can be interpreted in the light of the dynamic mechanism showed in Figure 3: external factors lead market players to react to the implementation of a new piece of regulation, and thus to change the outcome of the regulation itself.

To cope with this kind of events, the role of governance as a complement of regulation has been already mentioned several times in this chapter. This idea is shared by an increasing number of influential scholars in the field (Ferrarini, 2017; Schwarcz, 2017; Capriglione and Masera, 2016; Heremans and Bosquet, 2011; Pacces and Heremans, 2011), even though their approaches for what concerns motivation, scope and solutions might markedly differ.

The complementarity hypothesis implies the relaxation of the "representation hypothesis" proposed by Dewatripont and Tirole (1994), according to which supervision should mimic the market safeguarding the interests of the free-riding creditors, *de facto* substituting governance mechanism. Corporate scandals in the early 2000s and the financial crisis made clear that the substitution approach could not be sufficient.

The complementary hypothesis expects Corporate Governance to have a positive role in dealing with regulatory flaws and to facilitate the smooth functioning of regulatory mechanisms. Such a hypothesis have been tested by Becher and Frye (2011) for regulated industries in general, including the financial sector. The authors compared IPO data of regulated and unregulated companies and documented that firms engaged in regulated industries show a higher monitoring level than the unregulated ones. Based on these empirical results, the authors reject the "substitution" hypothesis and propose a sharply different narrative to explain the interplay between regulation and governance according to which the existence of substantive regulation exert "pressure on firms to adopt effective governance structures" (page 742).

In the case of bail-in, the European legislator underestimated that bail-in, impinging upon the behaviors of the bank and its creditors, had to be also considered in its governance perspective. As underlined by Chiu (2014), Corporate Governance represents the missing paradigm between financial institutions and bail-inable creditors. So, for example, Schwarcz (2017), analyzing the U.S. post-crisis regulatory environment, proposed to give more power to bondholders, arguing that they are more risk adverse, and thus able to restrain management from excessive risk-taking activities, and that bond prices are nowadays increasingly tied to firm performance. For what concerns European-specific analysis, Capriglione and Masera (2016) argue in favor of granting governance rights to bail-inable securities holders because of the impact of bail-in in the balance of corporate constituencies of banks.

On the other hand, not only governance is a complement to regulation, but also the other way round is true, meaning that regulation and supervision can be seen as a complement to create incentives for good governance[81] (Pacces and Heremans, 2011, page 33).

From a legal theory standpoint, Schwarcz (2016) categories regulation of financial institutions into two domains: "regulating substance" vs. "regulating governance". The traditional approach to regulation of financial institutions is regulating substance[82], since - so arguments run - regulating governance is assumed to weaken [...] the wealth-producing capacities of the firm. (Lee, 2012, page 124), therefore negative externalities created by corporate activities should be coped with substantive regulation (Bainbridge, 2002, page 425). On the contrary, Schwartcz argues that substantive regulation is inherently unable to restrain excessive risk-taking on its own.

Back in section 3.1, along these lines of arguments, we went even further by showing how substantive regulation often generates regulatory arbitrage and, consequently, perverse incentives that might undermine the very goal of the regulation itself.

Piecing together those arguments, we have strong basis to argue how regulating governance, notwithstanding the alleged *vulnus* in the wealth-producing capacities of the firms, might be less costly - from a social point of view - than any alternatives in achieving an optimal level of financial stability.

In terms of "substitution" vs. "complementarity" debate, we can state that the complementarity between substantive and governance regulation is weakly superior to the straight substantive approach in the presence of systemic risk, regulatory arbitrage and financial innovation.

A direct consequence of this approach is that the effects of good Corporate Governance are not limited to increase the entity-level stability, but they have positive spillovers also beyond the individual institution. In fact, if good governance is able to

[81] The concept of "good governance" follows the definition we gave in Section 2.1.
[82] Capital Requirements, Costumer Protection rules, structural regulation etc. are all examples of substantive regulation.

adjust or at least minimize some regulatory flaws, making - for instance - bail-in more effective, then governance plays a role also in financial stability at large, as argued by Mülbert and Citlau (2011) and Schwarcz (2017).

Therefore, all the players involved in the banking market enjoy positive spillovers from the good governance of a single institution, in terms of increased financial stability. At the same time, the institution is not able to seize all the benefit it generates through good governance, i.e.: it generates a positive externality. Therefore, from standard microeconomic theory, the straightforward consequence is the underprovision of "good governance", whose "amount" fell well below the socially optimal level in the years leading up to financial crisis.

This narrative seems to fit in the financial crisis events. However, it represents, for the time being, nothing more than theoretical speculations that need to be tested though the analysis of the role of bail-inable creditors in the governance of financial institutions.

5 Preliminary Conclusions: setting a Research Agenda

From the theoretical considerations set out throughout the paper and the vast amount of literature that has been reviewed, it is possible to draw at least two key conclusions concerning the understanding of the intrinsic characteristics of Bank Governance and the link between governance and systemic stability.

For what concerns the first conclusion, throughout this paper what appears crystal clear is that Corporate Governance of Banks has been understudied and even though it attracted a considerable attention by many scholars in the last years, much work is still to be done. So far, the existing contributions can be described as symptomatic, meaning that it reacted to scandals or severe shortcomings, as the, by now, immense literature on executive remuneration.

What is lacking is a widespread attention to the roots of such symptoms, that accurately take into account the specific externalities in governing banking institutions[83]. As we argued in Section 3.2.1, a similar narrative can be sketched for bank insolvency as well, even though this area developed astonishingly in the aftermath of the financial crisis.

To the little attention paid to special characteristics of bank governance corre-

[83] Remarkable exceptions do exist, see for instance Becht et al. (2011) and Armour et al. (2016a).

sponds, as a policy-making side of the coin, the lack of specific legal consideration to governance related issues for banks. In this case, the symptomatic and circumstantial attitude in approaching governance issues in the aftermath of the crisis had been even more evident (as denounced by Enriques and Zetzsche, 2015),

This was the state of the art. The good news is that bail-in regulation, almost inadvertently, impacted on the relationship between corporate constituencies and now offers a safe harbor for tackling the issue of the role of creditors in governing banks. This shall be regarded as the starting point to overcome the current normative approach in dealing with bank governance, that is perfectly identified by Basel III requirment[84].

Moreover, the arguments related to the dynamic effect of financial regulation, the regulatory flaws theory and the complementarity theory between governance and regulation/supervision underline how Corporate Governance actually have a role in addressing systemic stability. This position is becoming increasingly appealing among scholars[85]

Once again, the interplay between Bail-in Regulation and Corporate Governance represents a safe harbor to address those issues in a rigorous and workable manner. In fact, establishing a link between bail-in and its impact on governance represents a necessary step in the process of understanding the role of banking resolution for financial stability.

In fact, as noted by Ringe (2016), there has already been an important step in the understanding of the bail-in tool from a mere redistribution of losses (from taxpayers to creditors) to a stability mechanism. To further develop in this process, a better understanding of the governance-related issues raised by bail-in is crucial to include in the analysis the individual incentives of bank both in normal and crisis times and converge toward a safe and sound governance of the banking system as a whole.

Those preliminary conclusions should represent a starting point for claiming the desirability of normative interventions toward the involvment of the bail-inable creditors in the governance of banks. This represents the ultimate goal of this research project.

In order to do so, some intermediate steps seem to be needed, in order to contextualize the normative claim and make it theoretically and empirically sound. In setting such a research agenda, the next step is to analyze in greater details the functioning of the market for bail-inable securities, focusing our attention on whether the BRRD

[84] Discussed back in Section 2.3.
[85] See, in particular, (Mülbert and Citlau, 2011; Capriglione and Masera, 2016; Schwarcz and Jones, 2017; Omarova, 2017).

itself and the consequent adaptive behaviours of market players enhance the quality of corporate governance without the need for further intervention.

Eventually, this issue shall be analyzed empirically as well, testing for market discipline of junior debt in the banking industry.

Those represent, in themeselves, original contributions to the existing literature, improving the scientific understanding of the european banking industry in the Banking Union era.

Eventually, as a second part of this reseach agenda, a related but separe issue might be deepened, that is the impact of bail-in mechanism and - more generally - of the Banking Union on the standard governance themes such as executive compensations, managerial duties, group governance, etc.

In other terms, the first part of the research agenda focuses on whether the effectveness and efficacy of the Banking Union might be improved through governance. On the other hand, the second part deals with the complementary qyuestion of whether the BRRD and the bail-in in particular might improve some of the traditional governance issues in banking. If the answer to both these questions will turn out to be positive, it will be possibile to infer the existence of a virtuos circle between resolvability and goverance of banking institusion which have been triggered by the Banking Union.

Bibliography

Acharya, V. V. (2009). A theory of systemic risk and design of prudential bank regulation. *Journal of financial stability*, 5(3):224–255.

Acharya, V. V., Pedersen, L. H., Philippon, T., and Richardson, M. (2017). Measuring systemic risk. *Review of Financial Studies*, 30(1):2–47.

Acharya, V. V. and Richardson, M. (2009). Causes of the financial crisis. *Critical Review*, 21(2-3):195–210.

Adams, R. B. and Mehran, H. (2003). Is corporate governance different for bank holding companies?

Adams, R. B. and Mehran, H. (2012). Bank board structure and performance: Evidence for large bank holding companies. *Journal of financial Intermediation*, 21(2):243–267.

Admati, A. R., DeMarzo, P. M., Hellwig, M. F., and Pfleiderer, P. C. (2013). Fallacies, irrelevant facts, and myths in the discussion of capital regulation: Why bank equity is not socially expensive.

Anginer, D., Demirguc-Kunt, A., Huizinga, H., and Ma, K. (2014). Corporate governance and bank insolvency risk. *Development Research*.

Armour, J. (2001). The law and economics of corporate insolvency: A review.

Armour, J. (2015). Making bank resolution credible. *The Oxford Handbook of Financial Regulation*, page 453.

Armour, J., Awrey, D., Davies, P. L., Enriques, L., Gordon, J. N., Mayer, C., and Payne, J. (2016a). Bank governance.

Armour, J., Awrey, D., Davies, P. L., Enriques, L., Gordon, J. N., Mayer, C., and Payne, J. (2016b). *Principle of Financial Regulation*. Oxford University Press.

Armour, J. and Gordon, J. N. (2014). Systemic harms and shareholder value. *Journal of Legal Analysis*, 6(1):35–85.

Avgouleas, E., Goodhart, C., Schoenmaker, D., et al. (2010). Living wills as a catalyst for action. *DSF Policy Paper*, 4.

Awrey, D. (2012). Complexity, innovation, and the regulation of modern financial markets. *Harv. Bus. L. Rev.*, 2:235.

Babis, V. S. (2014). European bank recovery and resolution directive: Recovery proceedings for cross-border banking groups. *European Business Law Review*, 25(3):459–480.

Bainbridge, S. M. (2002). *Corporation law and economics*. Foundation Pr.

Baird, D. G. and Jackson, T. H. (1984). Corporate reorganizations and the treatment of diverse ownership interests: a comment on adequate protection of secured creditors in bankruptcy. *The University of Chicago Law Review*, 51(1):97–130.

Balachandran, S., Kogut, B., Harnal, H., Gabriel, T., Glasserman, P., Gow, I., Meier, S., Penman, S., Rusticus, T., Spamann, H., et al. (2010). Did executive compensation encourage excessive risk-taking in financial institutions. *Retrieved February*, 18:2012.

Barca, F. and Becht, M. (2001). *The control of corporate Europe*. Oxford University Press.

BCBS (2015). Corporate governance principles for banks. *Guidelines*.

Bebchuk, L. A. and Fried, J. (2006). *Pay without performance*. Harvard University Press Cambridge, MA.

Bebchuk, L. A. and Spamann, H. (2009). Regulating bankers' pay. *Geo. LJ*, 98:247.

Becher, D. A. and Frye, M. B. (2011). Does regulation substitute or complement governance? *Journal of Banking & Finance*, 35(3):736–751.

Becht, M., Bolton, P., and Röell, A. (2003). Corporate governance and control. *Handbook of the Economics of Finance*, 1:1–109.

Becht, M., Bolton, P., and Röell, A. (2007). Corporate law and governance. *Handbook of law and economics*, 2:829–943.

Becht, M., Bolton, P., and Röell, A. (2011). Why bank governance is different. *Oxford Review of Economic Policy*, 27(3):437–463.

Becker, G. S. (1968). Crime and punishment: An economic approach. *Journal of Political Economy*, 76(2):169–217.

Beltratti, A. and Stulz, R. M. (2009). Why did some banks perform better during the credit crisis? a cross-country study of the impact of governance and regulation. Technical report, National Bureau of Economic Research.

Berle, A. A. and Means, G. C. (1932). Modern corporation and private property.

Binder, J.-H. (2014). Resolution planning and structural bank reform within the banking union. Technical report, Research Center SAFE-Sustainable Architecture for Finance in Europe, Goethe University Frankfurt.

Binder, J.-H. (2015a). The banking union and the governance of credit institutions: a legal perspective. *European Business Organization Law Review*, 16(3):467–490.

Binder, J.-H. (2015b). The position of creditors under the brrd.

Brunnermeier, M. K., Crockett, A., Goodhart, C. A., Persaud, A., and Shin, H. S. (2009). *The fundamental principles of financial regulation*, volume 11. ICMB, Internat. Center for Monetary and Banking Studies.

Brunnermeier, M. K. and Pedersen, L. H. (2009). Market liquidity and funding liquidity. *Review of Financial studies*, 22(6):2201–2238.

Cadbury, A. (1992). Cadbury report: The financial aspects of corporate governance. *Tech report, HMG, London*.

Calello, P. and Ervin, W. (2010). From bail-out to bail-in. *The Economist*, 30.

Capriglione, F. and Masera, R. (2016). Bank corporate governance: A new paradigm.

Chiu, I. H. (2014). Corporate governance: the missing paradigm in the mandatory bail-in regime for creditors of banks and financial institutions. *Journal of business law*, (8):611–634.

Claessens, S. (2006). Corporate governance and development. *The World Bank Research Observer*, 21(1):91–122.

Coase, R. H. (1937). The nature of the firm. *economica*, 4(16):386–405.

Coffee Jr, J. C. (2010). Bail-ins versus bail-outs: Using contingent capital to mitigate systemic risk.

Conac, P.-H. et al. (2013). Director?s duties in groups of companies–legalizing the interest of the group at the european level. *European Company and Financial Law Review (ECFR)*, 10:194–226.

Conlon, T. and Cotter, J. (2014). Anatomy of a bail-in. *Journal of Financial Stability*, 15:257–263.

De Larosière, J., Balcerowicz, L., Issing, O., Masera, R., McCarthy, C., Nyberg, L., Pérez, J., and Ruding, O. (2009). Report of the high-level group on financial supervision in the eu. *European Commission. Brussels.*

Demsetz, H. (1974). Toward a theory of property rights. In *Classic Papers in Natural Resource Economics*, pages 163–177. Springer.

Devriese, J., Dewatripont, M., Heremans, D., Nguyen, G., et al. (2004). Corporate governance, regulation and supervision of banks. *Financial Stability Review*, 2(1):95–120.

Dewatripont, M. and Tirole, J. (1994). The prudential regulation of banks. *The Walras-Pareto*, 1.

Duffie, D. et al. (2016). Financial regulatory reform after the crisis: an assessment. In *ECB Forum on Central Banking on ?The Future of the International Monetary and Financial Architecture*, pages 27–29.

Easterbrook, F. H. (2002). Derivative securities and corporate governance. *The University of Chicago Law Review*, pages 733–747.

Enriques, L. and Zetzsche, D. (2015). Quack corporate governance, round iii? bank board regulation under the new european capital requirement directive. *Theoretical Inquiries in Law*, 16(1):211–244.

Erkens, D. H., Hung, M., and Matos, P. (2012). Corporate governance in the 2007–2008 financial crisis: Evidence from financial institutions worldwide. *Journal of Corporate Finance*, 18(2):389–411.

European Banking Authority (2016). Final report on mrel - report on the implementation and design of the mrel framework. Technical report.

European Commission (2009). Impact assessment accompanying the communication from the commission to the european parliament, the council, the european economic and social committee, the european court of justice and the european central bank on an eu framework for cross-border crisis management in the banking sector - com(2009) 561 final. Technical report, Commission staff working document.

Fahlenbrach, R. and Stulz, R. M. (2011). Bank ceo incentives and the credit crisis. *Journal of Financial Economics*, 99(1):11–26.

Ferrarini, G. (2015). Single supervision and the governance of banking markets: Will the ssm deliver the expected benefits? *European Business Organization Law Review*, 16(3):513–537.

Ferrarini, G. (2017). Understanding the role of corporate governance in financial institutions: A research agenda. Technical report, European Corporate Governance Institute (ECGI) - Law Working Paper No. 347/2017.

Financial Stability Board (2011). Principles on loss-absorbing and recapitalisation capacity of g-sibs in resolution - total loss absorbency capacity. *Financial Stability Board.*

Friedman, M. (1975). *There's no such thing as a free lunch.* Open court LaSalle, IL.

FSB (2011). Key attributes of effective resolution regimes for financial institutions. *Financial Stability Board, Basilea.*

FSB (2015). Global shadow banking monitoring report 2015. *Financial Stability Board.*

Gertner, R. and Scharfstein, D. (1991). A theory of workouts and the effects of reorganization law. *The Journal of Finance*, 46(4):1189–1222.

Gleeson, S. (2012). Legal aspects of bank bail-ins. Technical report, Financial Markets Group.

Goodhart, C. and Avgouleas, E. (2014). A critical evaluation of bail-in as a bank recapitalisation mechanism. *Bearing the Losses from Bank and Sovereign Default in the Eurozone*, page 65.

Gordon, J. N. and Ringe, W.-G. (2015a). Bank resolution in europe: the unfinished agenda of structural reform.

Gordon, J. N. and Ringe, W.-G. (2015b). Bank resolution in the european banking union: a transatlantic perspective on what it would take. *Colum. L. Rev.*, 115:1297.

Götz, M. R. and Tröger, T. (2016). Should the marketing of subordinated debt be restricted/different in one way or the other? what to do in the case of mis-selling?

Gros, D. and Schoenmaker, D. (2014). European deposit insurance and resolution in the banking union. *JCMS: Journal of Common Market Studies*, 52(3):529–546.

Gugler, K., Mueller, D. C., and Yurtoglu, B. B. (2004). Corporate governance and the returns on investment. *The Journal of Law and Economics*, 47(2):589–633.

Hadjiemmanuil, C. (2015). Bank stakeholders' mandatory contribution to resolution financing: Principle and ambiguities of bail-in.

Hansmann, H. (1988). Ownership of the firm. *Journal of Law, Economics, & Organization*, 4(2):267–304.

Heremans, D. (2007). Corporate governance issues for banks: a financial stability perspective.

Heremans, D. and Bosquet, K. (2011). The future of law and finance after the financial crisis: new perspectives on regulation and corporate governance for banks. *U. Ill. L. Rev.*, page 1551.

Hopt, K. J. (2013). Corporate governance of banks and other financial institutions after the financial crisis. *Journal of Corporate Law Studies*, 13(2):219–253.

Huertas, T. (2016). European bank resolution: Making it work!

Hüpkes, E. H. (2002). Insolvency–why a special regime for banks?

Informal Group of Company Law Experts (ICLEG), Armour, J., Bartkus, G., Clarke, B. J., Conac, P.-H., de Kluiver, H., Fleischer, H., Fuentes, M., Hansen, J. L., Knapp, V., Lamandini, M., et al. (2016). Report on the recognition of the interest of the group.

Jensen, M. C. and Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of financial economics*, 3(4):305–360.

Joosen, B. P. (2014). Bail in mechanisms in the bank recovery and resolution directive. In *ANNUAL CONFERENCE of the NETHERLANDS ASSOCIATION FOR COMPARATIVE AND INTERNATIONAL INSOLVENCY LAW*.

Kashkari, N. et al. (2016). Lessons from the crisis: Ending too big to fail. *remarks at the Brookings Institution, Washington, DC, président and PDG de la Federal Reserve Bank de Minneapolis, Washington, DC*, 16.

Kirkpatrick, G. (2009). The corporate governance lessons from the financial crisis. *OECD Journal: Financial Market Trends*, 2009(1):61–87.

Krahnen, J. P. (2013). Rescue by regulation? key points of the liikanen report. Technical report, White Paper Series.

La Porta, R., Lopez-de Silanes, F., Shleifer, A., and Vishny, R. (2000). Investor protection and corporate governance. *Journal of financial economics*, 58(1):3–27.

Larcker, D. F., Ormazabal, G., and Taylor, D. J. (2011). The market reaction to corporate governance regulation. *Journal of Financial Economics*, 101(2):431–448.

Lee, I. B. (2012). 7. the role of the public interest in corporate law. *Research Handbook on the Economics of Corporate Law*, page 106.

Levine, R. (1997). Financial development and economic growth: views and agenda. *Journal of economic literature*, 35(2):688–726.

Levratto, N. (2013). From failure to corporate bankruptcy: a review. *Journal of Innovation and Entrepreneurship*, 2(1):20.

Li, D. D. and Li, S. (1999). An agency theory of the bankruptcy law. *International Review of Economics & Finance*, 8(1):1–24.

Macey, J. R. and O'Hara, M. (2003). The corporate governance of banks. *Economic Policy Review*, (Apr):91–107.

Macey, J. R. and O'Hara, M. (2016). Bank corporate governance: a proposal for the post-crisis world.

Maher, M. and Andersson, T. (1999). Corporate governance: Effects on firm performance and economic growth. *OECD Working Papers*.

Marinc, M. and Vlahu, R. (2011). The economic perspective of bank bankruptcy law.

Morck, R., Wolfenzon, D., and Yeung, B. (2005). Corporate governance, economic entrenchment, and growth. *Journal of economic literature*, 43(3):655–720.

Mülbert, P. O. and Citlau, R. D. (2011). The uncertain role of banks? corporate governance in systemic risk regulation.

North, D. C. (2008). Institutions and the performance of economies over time. In *Handbook of new institutional economics*, pages 21–30. Springer.

OECD (2015). Oecd principles of corporate governance.

Omarova, S. T. (2017). Bank governance and systemic stability: The'golden share'approach.

Omarova, S. T. and Tahyar, M. E. (2011). That which we call a bank: Revisiting the history of bank holding company regulation in the united states.

Pacces, A. M. and Heremans, D. (2011). Regulation of banking and financial markets.

Pistor, K. (2013). A legal theory of finance. *Journal of Comparative Economics*, 41(2):315–330.

Ringe, W.-G. (2016). Bail-in between liquidity and solvency.

Rutledge, V., Moore, M., Dobler, M., Bossu, W., Jassaud, N., and Zhou, J. (2012). From bail-out to bail-in: Mandatory debt restructuring of systemic financial institutions. *Journal Issue*, page 3.

Sahut, J.-M. and Boulerne, S. (2010). Flaws in banking governance. *International Journal of business*, 15(3):319.

Santos, J. A. (2014). Evidence from the bond market on banks"too-big-to-fail'subsidy.

Schwarcz, S. L. (2008). Systemic risk. *Geo. LJ*, 97:193.

Schwarcz, S. L. (2016). Misalignment: Corporate risk-taking and public duty. *Browser Download This Paper*.

Schwarcz, S. L. (2017). Rethinking corporate governance for a bondholder financed, systemically risky world. *Wm. & Mary L. Rev.*, 58:1335–1403.

Schwarcz, S. L. and Jones, A. (2017). Corporate governance of sifi risk-taking: An international research agenda.

Schwartz, A. (1998). A contract theory approach to business bankruptcy. *The Yale Law Journal*, 107(6):1807–1851.

Seiler, M. and Fischer, D. (2015). ?bonus bonds? for bankers: A new type of debt-based remuneration in the financial industry. *ECFR*, 425:461.

Shleifer, A. and Vishny, R. W. (1997). A survey of corporate governance. *The journal of finance*, 52(2):737–783.

Sironi, A. (2003). Testing for market discipline in the european banking industry: evidence from subordinated debt issues. *Journal of Money, Credit, and Banking*, 35(3):443–472.

Spamann, H. (2016). Monetary liability for breach of the duty of care? *Journal of Legal Analysis*, page law009.

Tirole, J. (2001). Corporate governance. *Econometrica*, 69(1):1–35.

Tirole, J. (2006). *The theory of corporate finance*. Princeton University Press.

van der Cruijsen, C., de Haan, J., and Jansen, D.-J. (2016). Trust and financial crisis experiences. *Social Indicators Research*, 127(2):577–600.

Van der Elst, C. (2015). Corporate governance and banks: How justified is the match? *European Corporate Governance Institute (ECGI)-Law Working Paper*, 284/2015.

Van Rompuy, H., Barroso, J. M., Juncker, J.-C., and Draghi, M. (2012). Towards a genuine economic and monetary union. *European Council. Brüssel*, 5.

Williamson, O. E. (1979). Transaction-cost economics: the governance of contractual relations. *The journal of Law and Economics*, 22(2):233–261.

Zingales, L. (2009). The future of securities regulation. *Journal of Accounting Research*, 47(2):391–425.