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The interplay between the resolution framework and the role of creditors, with an application to EU law

Edoardo D Martino[†]

Abstract

Shareholders are the residual claimants on the assets of a corporation. Creditors are fixed claimants whose interest lies in the solvency of the borrower. Consequently, shareholders are usually thought to have optimal incentives to maximise the value of the corporation.

The article challenges this common wisdom in banking and proposes to reform bank governance granting (some) ex-ante governance rights to bank creditors. This aims at finetuning bank governance and incumbent substantive regulation, in particular the resolution framework for distressed banks, and enhance the quality of decision-making of banks in terms of risk-taking. At the same time, the proposed reform should increase the ex-ante credibility of resolution.

The second part of the article operationalises this construct focusing on the specific case of the European Banking Union and discusses the design of the governance status of bail-inable creditors.

The analysis demonstrates how bail-inable creditors can correct for shareholders' perverse incentives and make debt governance work in banking. The policy proposal advanced in the paper would complement substantive regulation and prudential oversight. The governance role of creditors has the potential to be particularly helpful in preventing disproportionate risk-taking decisions in good times, when regulatory and supervisory standards are lax and systemic risk piles-up.

Keywords: Financial Stability; Bank Governance; Debt Governance; Voting Rights; Appointment Rights; Governance Arrangements

JEL Codes: G21; G38; K22

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1. Introduction

Shareholders are the residual claimants on the assets of a corporation and are usually thought to have optimal incentives to maximise the value of the assets. Consequently, in virtually any jurisdiction, they are statutorily granted most of the legal rights to run the corporation. They are usually in charge of appointing the board of directors; moreover, they directly decide on a set of issues identified statutorily or through the corporate charter.[1]

In contrast, creditors are fixed claimants, and their interests is merely for the borrowing corporation to remain solvent. Thus, a limited set of statutory and contractual provisions should protect them from possible abuses of the shareholders and management, decreasing the agency cost of debt.[2] Corporate decisions should still be allocated to the management appointed, directly or indirectly, by the shareholders. Any other possible externality or further market failure is better addressed through regulation than through the modification of governance arrangements.[3]

This simplified explanation of the shareholder centric model reached a fair degree of consensus over the last decades,[4] proving itself quite robust to the many critiques it attracted over the years.[5] This article shows that (at least) in banking this common wisdom does not hold, that important adjustments are warranted, and that taking debt governance seriously is quintessential. The shareholder centric model of governance for banks provides shareholders with incentives to excessively engage in risk-taking.[6] Shareholders also lack the ability and the willingness to internalise systemic externalities that banking activities generate.[7] However, the shareholders themselves are exposed to the market risk generated by such systemic externalities, being market risk undiversifiable.[8] These features make the arguments for opting out the shareholder centric model of governance are particularly strong for banks as it would benefit shareholders' themselves.

This article discusses the case for granting some ex-ante governance rights to bank creditors and demonstrates that this would have three benefits. First, it would enhance the quality of bank governance. Second, it would enhance financial stability as the internalization by individual institutions of system harms would benefit the whole system. Third, it would enhance the resolvability of banks, making resolution more credible.

To this end, the article is structured as follows. Section 2 shows the link between good bank governance and debt, grounding the proposal to grant (some) creditors ex-ante with governance rights. Section 3 discusses the general features of the policy proposal, focusing on which creditors should be granted governance rights, the nature of these rights and possible pitfalls. Section 4 zooms in the European Union framework and operationalises the proposal of granting governance rights to creditors. Section 5 concludes.

2. Debt and good governance in banking

2.1 Bank governance specialty and resolution

The special nature of bank corporate governance has already been highlighted in

[1] Easterbrook and Fischel [1], p. 63.

[2] Tirole [2], p. 389.

[3] Lee [3].

[4] Hansmann and Kraakman [4].

[5] In this regard, the quintessential contribution is a brief article by Milton Friedman appeared 50 years ago in the New York Times. See Friedman [5]. See also Bainbridge [6]. Recently, Hart and Zingales challenged this standard paradigm arguing that shareholders can have pro-social preferences that are not embedded in the share price. See Hart and Zingales [7].

[6] Becht, Bolton and Röell [8].

[7] Armour and Gordon [9].

[8] ibid 39.

previous studies.[9] Also, several and heterogeneous policy proposals to account for the special feature of debt governance were advanced in the literature.[10] However, to this date, only marginal adjustments to governance arrangements were deemed to be fit for purpose and embedded in various regulatory regimes.[11]

In this article, the focus is on the special relationship between bank governance and substantive financial regulation, and in particular with the resolution framework for ailing banks.[12] This captures two crucial yet overlooked aspects of bank governance. First, banking is probably the most regulated industry in virtually any jurisdiction so that models of bank governance cannot disregard the impact of substantive regulation for incentives. Second, debt governance plays an important role in non-financial corporations, whereas it plays virtually no role in banking for reasons that will be detailed later in the article. However, banks heavily rely on debt, mainly short-term, for funding their activities so that taking debt governance seriously in banking is pivotal.

Bank resolution represents one of the centrepieces in the post-crisis regulatory reforms and encompasses both aspects of bank governance highlighted above. Broadly speaking, the resolution framework identifies a category of long-term non-runnable creditors (so-called 'bail-inable creditors') who are prone to suffer losses shareholder-like in case of financial distress.[13] To ensure that resolution is possible at all times, banks should hold at least a certain amount of loss-absorbing instruments, called Total Loss-Absorbency Capacity" (TLAC). In particular, the Financial Stability Board established that the TLAC for the Globally Significant Banks (G-SIBs) is set to at least 18% of banks' risk-weighted exposure and 6.75% of banks' leverage ratio.[14]

TLAC creditors, so the argument goes, should also monitor and discipline the bank ex-ante, to minimise the probability of experiencing losses.[15] However, previous literature showed that the resolution functions better in theory than in practice.[16] Several reasons have been proposed to explain it, mainly focusing on the over-complication of the legal framework and the lack of credibility of resolution.[17]

Building upon these two key concepts – the specialty of bank governance and the shortcomings of resolution –this study highlights the importance of debt governance in banking and proposes to shift some governance rights to bail-inable creditors so to fine-tune the resolution framework with the specific features of bank governance.

In this view, the law should play an active role in truly enhancing the quality of bank decision-making by involving bail-inable creditors in the decision-making process ex-ante. At the same time, such reform should also increase the ex-ante credibility of resolution. Rebalancing the relationship between shareholders and creditors in bank governance would achieve a better alignment of private and social incentives since creditors cannot benefit from excessive risk-taking. This would act as a powerful complement to regulation and supervision, especially in good times when regulation is lax and supervisors tend to delay actions.[18] On the other hand, a more central and better-defined role of creditors out of insolvency would increase the

[9] Becht, Bolton and Röell [8], p. 444.

[10] See, extensively, infra 2.1.

[11] In contrast, many academics found those marginal adjustment not to be fit for purpose. See, for instance, Enriques and Zetzsche [10], van der Elst [11].

[12] Financial Stability Board [12].

[13] Hadjiemmanuil [13].

[14] Financial Stability Board [14]. Hereinafter "TLAC Term Sheet".

[15] Zhou et al.[15].

[16] Philippon and Salord [16].

[17] See Avguleas and Goodhart [17]. In the EU context, Tröger [18] and also Martino [19].

[18] On the concept, cause and consequences of the so-called "regulatory pendulum", see Pacces and Heremans [20].

credibility of resolution. This could trigger a virtuous circle where better-governed banks are more resolvable which, in turn, optimises market discipline (i.e.: ameliorates corporate governance).

To substantiate this claim and translate it into a concrete regulatory proposal, the second part of the article discusses the specific case of the EU resolution framework; namely the Bank Recovery and Resolution Directive (BRRD).[19] Currently, the BRRD creates more problems than the ones it solves. So far, it proved to be ineffective ex-post, in handling the cases of resolution, and inefficient ex-ante in incentivising toward optimal risk-taking. Moreover, these components seem to reinforce one another and generate a vicious circle. Nonetheless, the existence of a common resolution framework represents an important achievement toward a genuine Economic and Monetary Union, at least for the Eurozone, and has the potential to enhance the resilience of single institutions as well as of the system as a whole.[20]

Therefore, the second part of the article focuses on the case of EU law and proposes to make banks' decision-making process "sufficiently accountable" to the interests of MREL creditors.[21] To this end, these creditors should be granted a limited set of governance rights. In particular, the right to appoint a common trustee as well as a qualified minority of strategic board committees, such as the audit committee, the remuneration committee and the risk committee. Moreover, MREL creditors should have a say on remuneration and dividend policies, with the aim of preventing disproportionate distributions in good times.

Before discussing in-depth the case for granting governance rights to TLAC creditors, Section 2.2 critically reviews the various literature strands proposing policy reforms to account for bank specialties. This exercise will prove beneficial to clearly position this article in the current debate as well as to appreciate the complementary or substitutive nature of creditors rights vis-à-vis other proposals.

2.2 Governance approaches to account for bank specialties

In the aftermath of the global financial crisis, bank governance was heavily blamed as one of the drivers of the global burst.[22] An impressive amount of academic research, as well as policymakers' attention, stemmed therein. Yet, policy reforms tackling bank governance mainly represented a political reaction against bankers and paid no attention to the special features of bank governance.[23] On the contrary, many academics pointed at the specialty of bank governance and developed proposals for reforming bank governance regulation accounting for such a specialty.[24]

Therefore, before discussing the case of debt, it is worth briefly reviewing this strand of literature, grouping the proposals into four main categories: 1) studies looking at fiduciary duties of bank directors; 2) studies looking at the role of the State in bank governance; 3) studies focusing on modification of the liability regime of bank insiders; and 4) studies

[19] 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 [2014] OJ L 173/190 (BRRD).

[20] Van Rompuy [21].

[21] MREL stands for "Minimum Requirement for Own Funds and Eligible Liabilities" and represents the functional equivalent of TLAC in the specific context of the EU. See Article 45 BRRD and Article 92a of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L 176/1 (CRR).

[22] See De Larosière [22], para. 23. See also Kirkpatrick [23].

[23] See Enriques and Zetzsche [10], p. 217; van der Elst [11], p. 14.

[24] See, in particular, Becht, Bolton and Röell [8], Armour er al. [24].

looking at the role of non-shareholders corporate constituencies.

All of these contributions aim at modifying governance incentives to induce optimal risk-taking and let bank decision-makers internalise the externalities they create. Two preliminary caveats are of order. First, corporate governance research and policymaking in banking mainly dealt with directors' remuneration.[25] Although highly relevant, remuneration is not considered in this context as the focus of this analysis only rests on governance rights and duties of corporate constituencies. Yet, it is important to highlight that remuneration practices represents a natural complement to governance right and they need to co-exist to yield an efficient governance ecosystem.[26] Second, most of the literature and proposals mainly deal with US banks, therefore, with US corporate law and financial regulation. Even though there is a certain convergence between US and EU regimes,[27] considerable differences persist. Thus, proposals that fit the US legal framework might not fit EU law and the and national laws of the Member States.

The first category of studies relates to proposals to alter the fiduciary duties owed by bank directors. In corporate law, directors and managers owe the corporation "fiduciary duties",[28] i.e.: the duty to act with care and loyalty in its best interest.[29] According to the vast majority of scholars, this also means maximising shareholders value[30]. In banking, the claim for opting out, at least partially, of the shareholders' value maximisation paradigm is particularly solid. The peculiarities of bank activities give shareholders incentives to engage in socially inefficient risk-taking.[31] Therefore, some authors proposed to modify the fiduciary duties owed by the management, broadening their scope and opting out from the shareholders' centric paradigm.

In an influential study, Macey and O'Hara highlighted the vulnerabilities of bank governance well before the Global Financial Crisis.[32] According to the authors, the special corporate governance problems in banks weaken the case for fiduciary duties owed to shareholders only.[33] On the contrary, they argued that bank managers should owe fiduciary duties to equity as well as fixed claimants.[34] Such argument is fascinating and theoretically grounded; yet, it remains unclear how the management would be supposed to discharge its fiduciary duties in times where the best interests of shareholders and fixed claimants might diverge.[35] Moreover, courts would be burdened with the impossible task to enforce such duties and decide on directors' liability in case of conflicting legal obligations. In other words, multiple fiduciary duties are likely to work better in theory than in practice, since they would add little to managerial duties in good times and would create spectacular legal uncertainty in bad times.

There have been also other, more radical, proposal of shifting fiduciary duties. In particular, Schwartz argued in favour of a "public governance duty"[36] for

[25] See, for instance, Bebchuk and Spamann [25]; Murphy [26]; Baghat and Romano [27].

[26] Se at length Martino [28].

[27] Hansmann and Kraakman [4], p. 443.

[28] The concept of fiduciary duties is proper of the US legal framework and scholarship. Yet, such paradigm can be used more in general to describe the functional feature of corporate law in different jurisdiction. Yet, the legal details and enforcement strategies may vary considerably cross-country, so that the general reference to "fiduciary duties" has to be understood as a simplified indication of the relation linking management and shareholders.

[29] Frankel [29].

[30] Friedman [5]. But see lately Hart and Zingales [7].

[31] Armour and Gordon[9], p. 58; De Larosière [22], p. 10.

[32] Macey and O'Hara [30]. See also the post-crisis proposals, with similar outcome, by the same authors, Macey and O'Hara [31].

[33] Macey and O'Hara [30], p.97.

[34] ibid 102.

[35] Bainsbridge [6], p. 1705.

[36] Schwarcz [32].

directors of systemically important banks (SIFIs).[37] Such duty would entail "a duty not to engage in excessive risk-taking that could systemically harm the public".[38] This proposal could sound appealing at first. However, at closer scrutiny, it reveals to be even more problematic than the previous proposal. A duty to avoid the creation of systemic harms represent little more than a tautology[39] and it is almost impossible to be verified in court. Thus, if extending fiduciary duties to fixed claimants would cause legal uncertainty, imposing a public fiduciary duty would generate a much more problematic legal vacuum.

The second category of bank governance reform proposals deals with the idea of granting the State pervasive powers to tackle excessive risk-taking incentives of the management. In particular, Omarova proposed a "golden share" approach.[40] A state official would have a seat in the board with no particular powers in good times but with pervasive veto powers should the fear of systemic or idiosyncratic crises materialise.[41] This is based on the idea that the state is the real residual owner of the bank as it guarantees its solvency. Therefore, the State should act as a "manager of last resort".

Such an approach can be criticised both for its paternalism as well as for its inability to solve the underlying problems of bank governance. It is, in fact, difficult to identify functional differences between the "manager of last resort" and the mandate of the supervisor. Additionally, there are no reasons why the classic supervisory problem of forbearance and delayed action should not apply in this case.[42] Moreover, should a State official be sued for liability, as it is likely given the times of turmoil during which he would need to act, a state liability for corporate wrongdoing would materialise, burdening taxpayers.

A third, more promising, stream of research on bank governance focused on modifying the standard liability regime, one focused on the extension of directors' and officers' liability[43] and another on the extension if extend shareholders' liability.[44]

Armour and Gordon acknowledged that traditional private law tools, with special reference to tort law, are ineffective in the presence of systemic harms and that the shareholder' value maximisation paradigm incentivises excessive risk-taking.[45] Moreover, they observe that shareholders' maximisation strategy carried out by individual banks can even turn to be detrimental to diversified shareholders. If bank activities generate systemic harms, they increase overall market risk, and market risk is undiversifiable.[46] Therefore, the authors argue against the application of shareholders' maximisation paradigm for systemically important financial institutions, so to make risk-takers more risk-averse.

To achieve this result, the authors propose to override the "business judgement" rule for bank directors and officers and impose a negligence-based liability regime. Such liability would be owed to the firm and should be triggered by shareholders through derivative actions in case of large losses. It is crucial to highlight how such tortious suit should materialise before insolvency to avoid the judgement

[37] For a relatively similar proposal see, also, Hockett [33], p. 1071.

[38] Schwarcz [32], p. 28.

[39] Min [34], p. 763..

[40] Omarova [35].

[41] ibid 1055.

[42] For a theoretical investigation of the strategic troubled banks and supervisory forbearance, see Marynova, Perotti and Suarez [36].

[43] Mostly based on Armour and Gordon [9].

[44] Building on the classic analysis by Macey and Miller [37]. The debate over this proposal has been revitalised lately in Romano, Enriques and Macey [38].

[45] Armour and Gordon [9], p. 38. The authors argue that "private law does not do an "imperfect job" of internalizing systemic harms; it does no job at all".

[46] ibid 39.

proof problem.[47] This proposal attracted two main criticisms, pointing at the fact that quantifying "systemic harm" is likely to be an impossible task both for directors[48] and courts.[49] The second criticism pertains specifically continental Europe, where the efficacy of such reform would be further undermined by the limited room for shareholders' derivative lawsuits.[50]

A second liability-based proposal is to, somehow, re-enact the extended liability of bank shareholders, partially overcoming the limited liability of the corporation.[51] This proposal builds on the old US regime of double shareholder's liability for banks. It served the purpose of "insuring" bank depositors in the absence of a public deposit insurer, minimising the risk of bank run.[52] The double liability regime was eliminated after the creation of FDIC.[53] Double liability implies that shareholders' liability was not limited to the committed capital used to purchase the shares, but in bankruptcy was extended up to the par value (book value) of the shares owned by each shareholder. Relaxing the limited liability of shareholders, so the argument goes, would undermine the roots of excessive risk-taking incentives. Accordingly, it would induce equity holders to internalise the externalities generated by the shareholders' value maximisation paradigm. Lately, Macey and co-authors reconsidered the double liability rule, proposing an "extended" liability regime for SIFIs shareholders.[54] Under such proposal, the amount of the extension would crucially depend on the centrality of each institution in the financial network.[55] In other words, the more systemic externalities an institution is capable of creating because of its size, interconnectedness and complexity, the higher shareholders' liability should be.

Again, such proposal sounds appealing from a theoretical perspective. However, its implementation appears cumbersome: the enforcement of extended liability in court can be difficult and time-consuming, leaving aside the potential judgment-proof problem of shareholders. Moreover, such double or extended liability only works as a gone-concern tool, so that its potential rest on the incentives provided to shareholders and ultimately on the credibility of the threat to impose such liability. Armour and Gordon's proposal, on the contrary, is meant to work as a going-concern tool, as directors' and officers' liability is triggered by large losses while the bank is still solvent. Finally, another, perhaps more fundamental, line of is the potential adverse spillovers of an extended shareholders' liability regime in times of financial turmoil and liquidity scarcity. Such adverse spillovers can work in two directions. First, the liquidity of the stocks with enhanced liability would quickly dry out once the bank approaches insolvency, further decreasing the market value of equity. Consequently, this would endanger the resilience of the troubled bank at the worst possible time.[56] Second, issuing fresh equity would become extremely expensive

[47] ibid 77. Such liability regime should act as a complement to other regulatory and governance measures, such as regulation of executives' pay, ibid 61.

[48] Omarova [35], p. 1039, arguing that director might not be able to appreciate the systemic nature of bank risk-taking.

[49] Spamann [39], p. 359. The author argues that courts might be unable to assess whether the risk undertook by director was "excessive", so that optimal liability could be close to zero

[50] Gelter [40].

[51] Armour et al. [41], ch. 1. See also Dari-Mattiacci et al [42].

[52] See Macey and Miller [37], p. 31; and Macey and Miller [43].

[53] Federal Deposit Insurance Corporation, that from 1933 act as the insurer of US deposits.

[54] Romano, Enriques and Macey [38], p. 993.

[55] On financial regulation taking into consideration the specific topology of the financial system and building on network theory, Enriques, Romano and Wetzer [44], p. 365.

[56] On the disruptive effect of market and funding illiquidity, see Brunnermeir and Pedersen [45]. More in general on the role of liquidity in financial crises, see Brunnermeier [46].

especially when it is more needed, i.e.: when insolvency is approaching.

Finally, the last stream of literature considered here focused on the role of bank creditors and debt governance.[57] Such literature largely consists of proposals for letting creditors' representative seat on the board, building on the paradigm of German labour codetermination. Davies and Hopt critically reviewed such literature in a recent paper, arguing that the scale of benefits of such proposals are likely to be rather limited; whereas, the legal problems arising from such a governance adjustment would be considerable.[58] The first of these problems is the compatibility of creditors representation in the board and the codetermination system.[59]

The present study adds to this last stream of research and focuses on the role of creditors. However, it departs from it quite considerably. The proceeding of this article discusses the theoretical foundations of directly including bail-inable creditors in corporate governance. For the time being, it suffices to say that the distinctive aim of the present proposal is to provide creditors with effective tools to police on the building-up of excessive risk, replicating their role in non-financial institutions while accounting for the specificities of bank governance.

Finally, it is important to stress how various proposals put forward in the last decade are not necessarily mutually exclusive. In particular, a modified liability regime represents a good complement to this proposal; whereas, the proposals pointing at including creditors in bank governance substitute proposals aiming at modifying fiduciary duties or granting governance rights to the State.

2.3 Good governance and the role of creditors

Granting governance rights to creditors in solvent banks represents an unusual proposal. Voting rights are usually allocated to shareholders as residual claimants on corporate assets.[60] Shareholders, so the traditional argument goes, have the incentive to maximise the overall value of the corporation since the value of their claim increases as the overall value of the corporation increases. Consequently, shareholders are better positioned to maximise social welfare.

In contrast, debtholders are entitled to fixed claims that are independent of the value of the corporation as long as it is solvent. Hence, so long as the corporation is solvent, creditors protect their fixed claim through monitoring and contractual arrangements.[61] On the other hand, in insolvency creditors have better incentives to maximise the liquidation value of the firm and, thus, increasing social welfare. Therefore, in insolvency, creditors become the "owners" of the corporation[62] and most of the decision rights are allocated to them.[63]

The clash between the common wisdom on corporate governance and the proposal of granting governance rights to creditors appears clear. On the other hand, the fact that bank governance is special has already been highlighted. Consequently, this section discusses the special features of bank governance in relation to creditors and highlights how such features build a strong case for regulatory intervention granting them governance rights. First, this section examines the reasons leading to standard debt governance tools to be ineffective. Second, it discusses some welfare

[57] Most of the literature related to creditors of banking institutions deal with their (in)ability of creditors to monitor and impose discipline on the borrowing bank. This topic has been largely dealt with also in the context of the newly established resolution framework. See Tröger [47].

[58] Davies and Hopt [48], p. 10.

[59] ibid, 15.

[60] Easterbrook and Fischel [1], p. 63.

[61] For a broad overview, see Armour et al. [45], ch 5.

[62] Tirole [2], p. 389.

[63] In Coasian terms, in insolvency creditors are the ones that value control rights the most. Coase [49].

implications of effective debt governance in general and with specific reference to financial institutions. Finally, the potential positive spillovers in terms of legal certainty and credibility of the resolution framework are also discussed.

Creditors usually protect their entitlements[64] from opportunistic behaviours of the management imposing market discipline through monitoring. [65] Furthermore, debt contracts are used as a device to allocate control rights to creditors contingent on future and uncertain events.[66] Yet, previous research showed that in banking such channels are by and large foreclosed to creditors, making debt governance inefficient and ineffective.

Thus, one of the "special features" of bank governance is that debt governance simply cannot work as in non-financial corporations. Most of the creditors of modern banks do not have proper incentives to discipline their borrowers toward long-term solvency. Junior unsecured – i.e.: bail-inable – creditors seem the better positioned to exert efficient discipline. However, previous research showed how market discipline through monitoring is impaired in banking because of the opacity of bank assets and the persistence of an implicit guarantee on bank solvency.[67] The possibility of the new resolution framework to increase market discipline has been heavily debated. Yet, it seems that the lack of credibility, the complexity and the legal design of the resolution impair the possibility of bail-inable creditors to impose efficient ex-ante discipline.

A similar argument holds for contractual protection. Previous studies showed that the typical covenants attached to debt contracts to protect their entitlements are not available,[68] as they would disqualify junior instruments from capital and TLAC eligibility.[69] There is, indeed, a trade-off between ex-ante discipline through contracts and financial stability. Breaching a covenant usually provides the right to speed up the repayment. This, in non-financial corporations, incentivizes the borrower not to breach the covenant in the first place and allocates bargaining power in renegotiation. Yet, should the bank enter in financial difficulties and breach a covenant, a contractual right to early repayment would cause a flow of funds that are, instead, supposed to be stable such as senior unsecured debt or hybrid capital instruments. Functionally, it would give non-runnable debt the possibility to run.

Also due to the limited possibility to protect credit entitlements through usual mechanisms, the funding models of banks adjust accordingly, making long-term unsecured debt a less attractive and more costly way to fund bank activities.[70] In contrast, other sources of funding, such as short term and secured debt, arose as cheap and attractive channels.[71] Yet, the excessive reliance on such source of funding made banks less stable and more vulnerable to liquidity shocks.[72]

[64] See the definition of Corporate Governance in Shleifer and Wishny [50]. The authors define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". ibid 737.

[65] Defined as "ability of financial markets to provide signals leading borrowers to engage in projects consistent with their solvency". See Lane [51], p. 55.

[66] Aghion and Bolton [52], p. 475.

[67] Flannery and Bliss [53].

[68] Martino [54].

[69] Financil Stability Board [14], p. 10 (Principle 8).

[70] See Bolton [55], p. i75. Bolton argues that excessive reliance on short term funding for banks represent an inefficient equilibrium caused by limited commitment problems; namely, nonexclusivity. This view, based on the incomplete contract theory, is against the view according to which short term funding represent an optimal capital structure in banking to discipline management. On this, see Diamond and Rajan [56].

[71] Also thank to complaisant regulation, such as the bankruptcy safe harbor for secured claims backed by financial collateral. See, Paech [57].

[72] Brunnermeir and Pedersen [45], p. 2212.

Being unavailable the usual channels, unsecured creditors pre-eminently relied on the implicit guarantee of the State on bank solvency as a way of protection. This kept the cost of capital low, giving banks an implicit funding subsidy over other corporations.[73] Such implicit guarantee was, allegedly, eliminated with the post-crisis regulatory framework, so that the cost of long-term unsecured debt should rise considerably.[74]

Therefore, providing effective tools for protecting the entitlements of creditors would make unsecured long-term debt marginally cheaper as compared with current bail-inable securities. Moreover, it should make these securities comparatively more attractive, at the margin, than other sources of funding that are less stable and more prone to liquidity shocks. This represents the first relevant advantage of granting governance rights to unsecured creditors. It is worth noting that if long-term creditors have tools to protect their entitlements the cost of capital will decrease.[75]

However, a lower cost of capital is ontologically different from the implicit subsidy provided by bail-out expectations. In fact, it rests on a mechanism imposing discipline on the activities of the borrower whereas bail-out expectations generate nothing but moral hazard.[76] Moreover, making long-term non-runnable debt marginally more attractive to issue and hold ease the task of building sufficient TLAC capacity.[77] Consequently, it would make the issuing bank more resolvable ex-ante.

Coming to the welfare implications of efficient and effective debt governance, there are nowadays ample evidence that creditors are active players in corporate governance also outside of insolvency and that their influence generates value.[78]

In particular, Nini and co-authors[79] studied the impact of covenants violation on solvent non-financial firms and demonstrated that the creditors played an active role both through the available legal mechanisms, explicitly forcing the renegotiation of the credit agreements and behind the scene.[80] Such an engagement leads to two notable results. First, unsurprisingly, it led the breaching borrower to more conservative investment and distribution policies, reducing risk-shifting and asset dilution. Second, the engagement "produces" value for the corporation. The corporations in breach of contractual covenants, surprisingly, experienced positive abnormal stock returns in the quarters after the breach happened and stayed constant in the following quarters.[81] This shows that the ineffectiveness of debt governance in banking prevents from enjoying these welfare gains.[82]

Moreover, the ability of debt governance to reduce the agency costs of debt and induce optimal risk-taking incentives. In banking, this has even more important welfare implications due to the ample evidence that shareholder centric governance paradigm incentivises excessive risk-taking, especially in good time, contributing to build-up systemic risk.

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[73] Santos [58].

[74] As long as the elimination of the State guarantee is credible. For fist, partial, empirical evidence see Crespi, Giacomini, Mascia [59].

[75] On the inverse relation between debt interest yield and the presence of covenants; see, Bradley and Roberts [60].

[76] Allen et al. [61].

[77] See Dominique Laboureix, speech at 6th Industry Dialogue: 2017 MREL Policy, accessible at https://srb.europa.eu/sites/srbsite/files/20171120_6th_industry_dialogue_item_2_mrel_dominique_laboureix. pdf. The estimation considers a sample of 76 banks, accounting for almost 80% of total assets of the banks subject to SRB authority.

[78] Whitehead [62].

[79] Nini, Smith and Sufi [63].

[80] For anecdotal evidence on behind the scenes creditors engagement see Baird and Rasmussen [64].

[81] Nini, Smith and Sufi [63], p. 1747.

[82] According to the so-called "representation hypothesis", the supervisor should substitute debt governance, mimicking market forces. See Dewatripont and Tirole [65].

Effective debt governance would provide a "natural" solution for adjusting the shareholder centric paradigm. In this view, making debt governance effective has the potential for early policing of disproportionate risks in good time, complementing the role of the supervisor. For instance, the holder of a perpetual hybrid-capital instrument (e.g.: a CoCo) may not be willing to let the bank take such risk and might block it should she have the tools to do so.

Finally, granting governance rights to creditors may generate a further positive by-product, increasing legal certainty in resolution and the credibility of the entire system. This argument is particularly relevant in the context of EU law, where the constitutionality of bank resolution has been challenged claiming that imposing losses in resolution, without a judicial procedure, would represent a sort of expropriation.[83] In Section 4, this aspect is discussed in some details, explaining how granting governance rights to bail-inable creditors could also solve this problem.

The arguments proposed so far showed that granting governance rights to bail-inable creditors so to enable debt governance in banking firms is theoretically well-grounded. Nonetheless, finding the suitable legal tools for efficiently implementing this proposal is not straightforward. Many questions arise, none of which have an unchallenging answer. Which creditors should have governance rights? Should this right be contingent on financial deterioration? And, crucially, which rights is proportionate to grant? Section 3 attempts to solve these puzzling issues. Thereafter, Section 4 operationalises the proposal in the context of EU law, aiming at developing a framework interacting with various areas of law and regulation; namely, resolution regulation, supervision law and national corporate laws.

3. A new governance status for bank (bail-inable) creditors

The overarching goal of granting governance rights to creditors is to fine-tuning bank governance and the resolution framework. This relates to two complementary aspects: first, it aims at addressing the specificities of bank governance, with particular regard to debt governance. Second, it aims at enhancing the resolvability of financial institutions and, consequently, its credibility.

This section discusses the core features of an efficient and effective governance status for bank creditors. Section 3.1 discusses the relevant trade-offs in granting governance rights to creditors. In particular, the pools of creditors to which the governance rights should be granted, the nature (absolute or contingent) of these rights. It also sketches the possible contents of the rights in very general terms. Section 3.2 discusses one possible drawback of creditors' rights, namely the diffusion of privileged information and their possible impact on financial stability.

3.1 Governance rights to creditors and the quality of banks' decision making

The first step to build a coherent regulatory framework for creditors' right is to identify the pool of creditors whose position and incentives are compatible with limiting disproportionate risk-taking. In so doing, I will proceed by subtraction, skimming the unfit categories of creditors until only the pool of creditors that are fit for purpose remains.

First, it is easy to rule out all the creditors whose claim is not subject to bail-in.[84]

[83] Alexander [66], p. 71.

[84] See Financial Stability Board [14], p. 14-15. The eligibility criteria and exclusions are listed (respectively) in section 9 and 10. In the EU, in principle, all bank's liabilities are bail-inable. Building on this general principle, the BRRD exclude and exempt specific categories of liabilities. See Article 44 BRRD. The

Should the bank enter in resolution, those are not going to bear losses shareholder-like as a consequence of an administrative decision of the resolution authority. Therefore, their incentives cannot be considered appropriately aligned with the willingness of limiting risk-taking ex-ante. Indeed, these creditors seek protection through other mechanisms, such as security interests on some of the bank's assets. Moreover, there are examples of short-term creditors that are radically incompatible with holding governance rights. Think, for instance, of depositors or repo counterparties.

Second, not all bail-inable creditors are equal, at least from an ex-ante perspective. There are considerable discrepancies between the pool of creditors that can be subject to bail-in and a subset of those that are eligible for TLAC purposes. Only committed, long-term non-runnable funding can be counted for TLAC purposes. Therefore, TLAC functionally represents an additional "capital requirement" to be matched with "own funds and other eligible liabilities". Meeting such a requirement should assure that the institution has a solid base of long-term funding in its balance sheet and it is, therefore, at all times, resolvable.

Such functional goal cannot be assured by each and every liability that, should the bank enter in resolution, are theoretically bail-inable. For instance, for the uninsured demand deposits do not count toward TLAC but can suffer losses in resolution.[85] Similarly, a junior bond with a remaining maturity of 8 months is bail-inable in resolution.[86]

At this point, one might wonder whether the subtraction exercise is completed and TLAC creditors are the appropriate pool of creditors. In fact, TLAC creditors represent an extremely heterogeneous class. The common characteristics of such broad class of creditors are that all are long-term, with at least 1 year of residual maturity, and are not secured in any way by the issuing bank. Beyond such common denominators, perpetual Cocos are as TLAC eligible as 5 years senior bonds are. The risk of bearing losses in resolution sharply differs between the two types of creditors.[87] Accordingly, also monitoring and disciplining incentives differ. Therefore, one might wonder whether it is reasonable to grant the same governance rights to these different types of creditors. Or, in other words, should the subtraction exercise go any further?

Thus, there are arguments to further restricting the pools of "suitable" creditors, or at least to differentiate the rights to grant to different classes of TLAC creditors. However, there is a pragmatic argument pushing to stop the subtraction exercise and grant the same governance rights to all TLAC creditors. Indeed, these creditors share the core characteristics necessary to promote good governance.[88] Moreover and crucially, they are already identified for different regulatory purpose. Hence, this would avoid overcomplications.

TLAC creditors should, hence, be considered as a class when granting governance rights. Moreover, alternative methods can better differentiate the position of different creditors. For instance, the voting rights of each creditor can be weighted for a metric of the riskiness of different claims. It is not necessary to go deep into the details of how such mechanism should work. A simple example suffices to set the general idea: a creditor exposed for 1 million euro in non-equity capital instruments should have more voting power than another creditor exposed

exemption and the (ad hoc) exclusions are listed in paragraphs 2 and 3 of the same Article.

[85] Financial Stability Board [14]. Read in combination § 9 (c) and § 10 (b) of the TLAC term sheet.

[86] Ibid.

[87] Financial Stability Board [12], § 3.5, establishing that losses are allocated according to the hierarchy of claims in liquidation. See also § 5.1. In the EU context, see Article 46 BRRD.

[88] See text to n 75, infra 2.3.

for the same amount in senior unsecured debt.

As a further refinement, an ad hoc exclusion within TLAC creditors is still warranted. The so-called "internal TLAC" exposures should not be considered for the purpose of this proposal.[89] Internal TLAC consists of eligible exposures of the holding toward its subsidiaries so to assure that the group as a whole is resolvable with a Single Point of Entry Strategy (SPOE).[90] Thus, internal TLAC has nothing to do with imposing discipline on the borrower, so that granting governance rights would make no sense as it would simply give rights to the holding that is already controlling the subsidiary.

The second step toward the definition of a new governance status for TLAC creditors is to define the nature of their rights. Specifically, defining whether such rights should be contingent on the deterioration of bank financial conditions

In non-financial firms, debt governance mainly consists of control rights allocated through contracts and contingent on future events. For instance, a standard financial covenant can grant the creditors a right to speed-up the repayment of their exposure if the leverage of the borrower increases, breaching a contractually pre-specified threshold.[91] More in general, debt contracts can be seen as a tool to contingently allocate control[92] to creditors once the financial situation of the borrowing firm deteriorates to such a point that makes control rights more valuable to creditors than shareholders.[93]

In an agency setting, the contingent allocation of control over corporate assets and decision-making to creditors can be seen as a bonding cost decreasing the agency costs of debt.[94] Managers and shareholders are interested in retaining control; thus, they have appropriate incentives to avoid situations that are detrimental for the creditors and trigger the covenant. Additionally, should this situation anyway materialise, creditors are entitled with rights to minimise their risk of bearing losses. From an ex-ante perspective, this reduces the cost of debt, so that the borrowing firm is willing to restrict the set of available actions to be taken in the future to access cheaper funds.[95]

Therefore, if the governance status of TLAC creditors is meant to merely mimic debt-governance in non-financial firms, rights should be contingent. However, the special nature of banking and bank governance would suggest otherwise.[96] As professors Armour and Gordon persuasively argue: "private law does not do an 'imperfect job' of internalising systemic harms; it does no job at all".[97] This applies not only to directors' liability – as discussed in Armour and Gordon's article – but also to debt governance.[98] Debt governance as we know it in non-financial firms would not be able to internalise any of the systemic risk generated via banking activities.

[89] The resolution of complex banking groups represents one of the major challenges for financial stability. On this intricate matter, see Binder [67]. More specifically, on the governance of banking groups and on its impact on stability and resolvability, see Wetzer [68].

[90] On the preferable resolution strategy, see Gordon and Ringe [69] (arguing in favour of a Single Point of Entry Strategy).

[91] Smith and Warner [70], p. 142.

[92] Aghion and Bolton [52], p. 475.

[93] Bolton [55], p. i71.

[94] Jensen and Meckling [71], 334.

[95] There is an ample theoretical literature in corporate finance based on the limited possibility to credibly commit ex-ante. For an overview of this literature see Bolton [55], p. i73.

[96] Given the special nature of bank governance, Dewatripont and Tirole proposed the so-called "Representation Hypothesis", according to which financial regulation and supervision should aim at substituting creditors in exerting discipline, mimicking the behavior of the smoothly working market. See Dewatripont and Tirole [65]. The proposal of this article is to go forward and provide creditors with tools that would complement the effort of financial regulation and supervision.

[97] Armour and Gordon [9], p. 38.

[98] For the reasons highlighted in Section 2.3, text to n 75.

As previously discussed, the aim of granting TLAC creditors a new governance status is not just to make debt-governance more effective. In contrast, debt governance should complement regulation and supervision and enhance the resilience of individual institutions and the system as a whole.[99] Therefore, the governance status of bail-inable creditors must consist in absolute rights that can be exercised in any state of the world.

Moreover, it is worth noticing that granting rights contingent on the financial deterioration of the bank would add little, if any, advantage and might generate serious negative consequences. Once the bank enters into trouble it gathers the attention of the supervisor as well as of the market, so that both compliance duties and funding costs are likely to increase. In a moment of hardship, granting rights to creditors would merely increase such hardship, with little room to impose higher or better discipline.[100] In contrast, the governance status of bail-inable creditors is meant to ease early policing of excessive risk-taking.

Having identified who should be granted with governance rights and when such rights should be exercised, the final step is to highlight the relevant trade-off when it comes to the contents of the rights that are necessary and sufficient to achieve the goal of this proposal, i.e.: complement financial regulation and supervision in minimising the creation of systemic externalities due to excessive risk-taking.[101]

Defining the contents of the governance status of bail-inable creditors represents a tricky exercise as it faces two main perils: to "under-entitle" or to "over-entitle" bail-inable creditors. Under the first peril, bail-inable creditors have few and ineffective rights and are unable to positively influence the decision-making of the borrowing bank. Conversely, if creditors are over-entitled with many and highly intrusive rights, the control powers of shareholders and the necessary discretion of the management over corporate decisions would be hindered.

These scenarios are both value-decreasing. In case of under-entitlement, little if anything would change in terms of preventing excessive risk-taking; whereas, non-trivial costs for setting up and running the new governance arrangements would be borne by the banks and probably by the creditors themselves, at least indirectly. In case of over-entitlement, the limitation of entrepreneurship would be excessive, with the risk of letting the bank passing on positive net present value projects for the mere reason that these entail some risk. Moreover, over-entitling creditors may also generate further problems related to the dissemination of information, as section 3.2 will detail.

The exact calibration of the necessary and sufficient rights to grant bail-inable creditors is, therefore, at the same time crucial and complex. Such complexity derives from two crucial idiosyncrasies: the heterogeneity of banks business and funding models (and the specific risks they entail) and the heterogeneity of national corporate laws. That being the case, the law should limit itself to identify a limited set of core provisions making individual institutions sufficiently accountable toward bail-inable creditors in their decision-making process and governance arrangements. Section 4 attempts to operationalise these intuitions and provide a more detailed account of what a governance status for bail-inable creditors may look like in the European Union.

[99] On the potential of governance arrangement to contribute in reaching macro-prudential targets, see Enriques, Romano and Wetzer [44] 373.

[100] On procyclical effects of market discipline see Stephanou [72].

[101] Given the impossibility to propose a set of rights that generally work for any jurisdiction, here I only present general trade-off which applies generally in general to virtually any jurisdiction. Section 4.2 goes deeper in detailing the specific aspects of governance rights within EU law.

3.2 Governance rights to creditors and financial stability

So far, the article discussed the possible drawbacks of creditor's rights from a governance perspective and demonstrated how in banking such drawbacks are not decisive and, on the contrary, creditors rights can enhance the quality of banks' decision making. However, the governance drawbacks are not the only issues to discuss. One may argue that granting governance rights to creditors entails the dissemination of excessive information about the solvency and liquidity of the bank. In turn, this has the potential to fuel banks' fragility and increase the probability of a financial crisis.

The sensitive nature of information is at the core of bank specialty. Performing qualitative asset transformation, banks are an inherently fragile construction and trust represents the crucial element to avoid disruptive runs.[102] Even more so, in modern banking where a large part of the bank's liabilities consist of short-term debt that is a medium of exchange and is designed to be information-insensitive.[103]A strand of the literature in finance highlight the importance of maintaining banks' short-term debt insensitive to private information to avoid runs.[104] In this setting, a crisis is triggered when debt securities switch from being information insensitive to information sensitive.

TLAC securities are information sensitive by design, even more so if one believes that the new resolution framework is effective and that the probability of bail-out is limited. This also provides additional justification for the exclusion of a large portion of bank creditors previously discussed. Granting governance rights to creditors that are designed to be information insensitive would not only be ineffective from a governance standpoint, but would also generate financial stability risks.

What remains to assess is whether the information generated by the proposed corporate governance reform would impact adversely on the stability and trust of the short-term investors. This issue cannot be solved once and for all with a clear-cut answer. Rather, the impact of the reform depends on the specific design of the governance rights and will be discussed in Section 4 focusing on the EU case.

However, the delicate nature of information on banks' stability highlights another trade-off that is generally relevant for the design of sensible governance arrangements involving bank's creditors. On the one hand, the "exact" amount of rights should be provided to improve the quality of the decision.[105] On the other hand, these rights should not entail the production and disclosure of information that would weaken the trust in bank's solvency and increase the probability of disruptive runs.

Considering all the trade-offs depicted above, it is now time for tackling the natural and foremost critique of this policy proposal: can it work? The concern is legitimate, as granting governance rights to creditors is rather unconventional. Yet, several elements suggest that the proposed reform could marginally improve bank resilience and resolvability. In the context of European banks, a clear path emerging from the evolution of such composition is the increasing share of professional investment in TLAC eligible securities. Moreover, it was shown that bank cross-

[102] Diamond and Dybvig [73].

[103] Dang, Gorton and Holmström [74], p.2. A security is information insensitive if the cost of producing costly private information about a security's payoff outweighs the benefit, so that traders should have no incentives to gain such information. This avoids the destabilization of the value of the debt.

[104] See theoretically Dang et al. [75]. The model has been empirically tested in Gallagher et al. [76]; Bracanti and Macchiavelli [77].

[105] "Exact" here refers to the trade-off between under-entitlement and over-entitlement discussed above in the Section.

holdings, although stable, are shifting toward more senior positions.[106] TLAC creditors increasingly consist of professional investors that are capable and willing to influence bank governance and assure of getting a return on their investment.[107] However, these investors may pass on valuable opportunities of disciplining their borrower because of the lack of legal tools apt to this purpose.

4. The EU resolution framework and creditors' rights

The case of the European Union is interesting for several reasons. First, bank resolution is a complete novelty of the post-crisis regulatory framework, as several Member States lacked a specific insolvency regime for failing banks.[108] Second, and relatedly, bank resolution is embedded on a wider project for enhancing the economic and monetary union within Euro Area countries through the creation of a European Banking Union.[109] Finally, the EU is a multi-level legal system, where regulatory competences are shared between centralised authorities and Member States.[110] In particular, EU institutions have a wide mandate to regulate banks and financial institutions,[111] whereas corporate law remains largely a competence of Member States. The harmonization of corporate law at European level is limited and aims at establishing a level playing field for EU corporations and guaranteeing corporate monitoring.[112] Therefore, granting governance rights to creditors in the context of banks face a further layer of complexity, as the central and national policymakers must cooperate. Moreover, the heterogeneity of national corporate laws allows for sharply diversified implement among Member States.

In light of the above, the article argues in favour of a structured legal approach in granting governance rights to bail-inable debtholders. This approach should primarily comprise of a general principle of "sufficient accountability" toward bail-inable creditors in corporate governance. Building on this general principle, a limited set of core rights should be provided at national level. The proposed approach is structured in the sense that it proceeds top-down, proceeding from the centre to the periphery of the EU legislative process, with national corporate law implementing the principle and adapting it to the specificities of their national system.

What follows represents a first, tentative, attempt to operationalise this intuition: Section 4.1 discusses the desirability of including MREL creditors in the governance arrangements of banks; whereas, Section 4.2 proposes substantive rights to grant MREL creditors.

4.1 Banks governance arrangements at EU level

The general principle of "sufficient accountability" should be codified as one of the principles on governance arrangements itemised by Article 88 of the Capital Requirement Directive[113]. The principle

[106] See ECB, 'Financial Stability Review - November 2016' (2016). In Box 7 there is the analysis: "The evolution of Sectoral holding of bail-inable debt".

[107] Paraphrasing Shleifer and Vishny [50], p. 737.

[108] Hüpkes [78], p. 2.

[109] Van Rompuy [21], p. 4.

[110] Craig and De Búrca [79], p. 3.

[111] This mandate is grounded on the establishment of the internal market and in particular on Article 114 of the Treaty on the Functioning of the European Union (TFEU). Establishment of the internal market, art 114 TFEU: "The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market".

[112] Ringe and Armour [80].

[113] 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. OJ L 176/338 (CRD).

The other general principles listed in Article 88 CRD are:

(a) the management body must have the overall responsibility for the institution and approve and oversee should require the management body to set up governance mechanisms assuring sufficient accountability toward bail-inable creditors.

Sufficient accountability represents a vague and open-ended concept and voluntarily so. The goal of this principle is that banks, in their decision-making process, should take into account the interests of MREL creditors not to suffer losses and to receive the principal amount and interests when those come due. The generic formulation of the principle is important for two reasons. First, it allows individual banks to set up governance arrangements that are consistent with their business model and organizational structure and to experiment different arrangements. Second, it gives the supervisor some flexibility in determining the "sufficiency" of the governance arrangements of individual banks, allowing for a proportionate implementation of the principle.

Section 4.2 discusses a potential set of rights be granted to MREL creditors. Yet, before moving to that part of the analysis, it is important to discuss the advantages of the "structured" legal design outlined so far. Two main advantages are worth mentioning.

First, including the "sufficient accountability" clause among the governance arrangements codified in the CRD provides competent authority with the mandate to continuously supervise the compliance of individual banks.[114] The review and evaluation of the bank's governance arrangements fall within the so-called "Supervisory Review and Evaluation Process" (SREP),[115] to be carried out by the competent authority at least annually. This would make the Competent Authority, hence the Single Supervisory Mechanism for the Euro Area, the gatekeeper of the governance status of the MREL creditors, overseeing its sufficiency on a yearly basis. This design fits the framework depicted before, where governance and supervision complement one another in achieving the safety and soundness of banking institutions.[116]

For assessing the compliance with the standard of "sufficient accountability" transparently and predictably, guidelines from the European Banking Authority should be issued. Those guidelines are crucial to guarantee the level playing field between different jurisdictions as well as granting the necessary flexibility of a differentiated implementation.[117] The guidelines should allow for the widest diversification possible as for the specific arrangements to be considered "sufficient", so to encourage experimentation and anti-herding behaviours.[118]

Second, this proposal allows for a proportionate and, potentially network sensitive, implementation of the "sufficient accountability" standard. Including the evaluation of the "sufficient accountability" within the SREP gives a gatekeeping responsibility to the competent authority which is legally mandated to apply it proportionally.[119] Clearly, what can be

the implementation of the institution's strategic objectives, risk strategy and internal governance;

(b) the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards;

(c) the management body must oversee the process of disclosure and communications;

(d) the management body must be responsible for providing effective oversight of senior management;

(e) the chairman of the management body in its supervisory function of an institution must not exercise simultaneously the functions of a chief executive officer within the same institution, unless justified by the institution and authorised by competent authorities.

[114] Article 98(7) CRD.

[115] Article 97 CRD.

[116] Supra infra 2.1, text to n (18).

[117] In discussing a possible menu of creditor's right, Section 4.2 will indirectly discuss the desirable content of the guidelines.

[118] Ayres and Mitts [81].

[119] Proportionality can be considered a general principle of EU administrative law as an application of the principle of

deemed sufficient for a medium-size regional bank is likely not to be considered so for a Globally Significant Bank (G-SIB). In this regard, requiring different governance arrangements to different banks can be considered a direct application of the proportionality principle. Looking at this from a substantive perspective, the differentiated application of the "sufficient accountability" principle can be implemented in a "network sensitive" manner, accounting for the contribution of each institution to systemic risk.[120] In so doing, the competent authority should require higher standards for those banks that generate higher systemic externalities because of their centrality and interconnectedness within the financial network.[121] Again, this design relates to the complementary nature of governance, regulation and supervision. The internalization of systemic risk cannot be achieved by one component alone, but the complementary effort of all these aspects can achieve superior results.

Crucially, the principle of "sufficient accountability" toward MREL creditors differs from the concepts of "fiduciary duty" directors owe to shareholders or the corporation.[122] This allows not to fall in the same critique exposed before about multiple fiduciary duties. On the contrary, as Article 88 CRD clarifies, governance arrangements itemised at EU level are supervised by the competent authority and aim to "ensure the effective and prudent management of the institution". Therefore, mandating banks to be sufficiently accountable toward MREL creditors does not create rights via-a-vis those creditors in itself; rather, this represents an obligation toward to competent authority. In contrast, the positive actions taken by the bank to comply with the principle of sufficient accountability may well generate specific rights of the management vis-à-vis MREL creditors, but not of the fiduciary nature characterising the relationship between directors and shareholders.

To allow the management to discharge such duty effectively, EU law should mandate Member States to provide tools compatible with national corporate laws that banks can use to comply with the general principle of sufficient accountability. To this end, Section 4.2 proposes a possible set of rights to be implemented nationally.

4.2 Governance rights implemented at national level

This Section discusses the minimum sets of rights allowing creditors to have a positive impact on bank governance, complementing regulation and supervision, and argues that a mix of targeted appointment and decision rights can be considered fit for purpose. Yet, an adequate "governance infrastructure" constitutes the prerequisite making the governance status of MREL effective and will be discussed first (infra 4.2.1). Subsequently, the article discusses a possible menu of substantive governance rights encompassing both appointment and decision rights (respectively, infra 4.2.2 and 4.2.3).

4.2.1 Governance Infrastructure

Two indispensable components should be established so to provide effective rights to MREL creditors: a general meeting and a common trustee.

"open, efficient and independent European administration". See Article 298 TFEU.

[120] Enriques, Romano and Wetzer [44], p. 373.

[121] It is worth noticing that such account for systemic risk is necessarily qualitative and not strictly quantitative, contrarily to the examples provided by Enriques and co-authors. In fact, governance rights and arrangements cannot be conceptualised as continuous variable assuming every possible value, but rather discrete and complex modules of rights and duties that can be target only by clustering covered institutions into various group with different coefficient of systemic relevance. An example of such an approach is the "bucket approach" employed by the Financial Stability Board. See Basel Committee on Banking Supervision [82].

[122] Supra (n 28-29).

The General Meeting of MREL creditors should be composed by all the holders of MREL instruments. The voting rights in the meeting should be defined by the amount of exposure toward the bank weighted according to the riskiness of such exposure. Riskier instruments grant higher voting rights. The General Meeting should vote on a limited and standardised number of items.

The common trustee of MREL creditors should facilitate the coordination among MREL creditors.[123] To this end, she should be responsible for calling and organising the Annual General Meeting and representing MREL creditors in court, if needed. She should possess all the required characteristics of independence required to independent directors.[124] In the same vein, the remuneration should be fixed and insensitive to the performance of the bank or other performance metrics.

These two basic structural features are necessary for coordination purposes and enforcement. Sections 4.2.2 and 4.2.3 discuss, respectively, appointment and decision rights that should be granted to MREL creditors. Moreover, those explain the role of General Meeting of MREL creditors and the common MREL trustee in each specific instance.

4.2.2 Appointment rights

According to the framework of the analysis, granting MREL creditors with some rights of appointment makes sense only if their appointees enhance the decision-making process of the bank, optimising its risk-taking appetite. Following this line of argumentation, MREL creditors should have the power to appoint qualified minorities of strategic committees; namely, the risk committee, the audit committee and the remuneration committee.

Such a choice needs to be preliminarily explained and justified. The fact that the MREL creditors representatives should count for a qualified minority of each committee aims at striking an appropriate balance between the risks of over and under entitlement previously discussed in Section 3. In the same vein, granting MREL creditors with the right to appoint members of the committee but not necessarily members of the board are meant to achieve the same balance. Moreover, such choice delivers two additional advantages. First, it allows for a certain degree of flexibility in the legal design of MREL representatives, so that this can fit more easily in national corporate law and institution-specific arrangements.[125] Second, it allows designing a system in which the presence of MREL creditors representatives can make a difference and where the representatives are incentivised to do so. This latter point is developed and better explained in the proceeding of the Section when the duties and responsibilities of the MREL representatives are discussed.

To assure that the potential for a positive impact of bondholders' representatives in strategic committees is fully exploited, the rights and duties of the

[123] It is worth noticing that the type of trustee discussed here is different in means and scope from the traditional indenture trustee who has the power to enforce the indentures of a bond. As a means of comparison, the MREL trustee is closer to the figure depicted by Amihud, Garbade and Kahan [83].

[124] Note that the standard concept of "independence" in corporate governance, indicating individuals without significant personal and financial links with the company. Thus, the status of the trustee should be integrated by the requirement for independent directors set down in national corporate law or corporate governance code. This differs from the more substantive but vague concept of "independence of mind" introduced in the European Legislation as a feature with which each member of the management must discharge its duties. See Article 91(8) CRD: "Each member of the management body shall act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management decision-making".

[125] The MREL creditors representatives might or might not have a seat in the board and if they are granted with a seat in the board they might or might not have a voting rights for all or some of the issues to be discussed. Yet, in compliance with the proposed general principle of Article 88 CRD, MREL creditors representatives should always have voting rights in the board committees.

MREL creditors' representatives need to be further detailed.

In terms of rights and duties vis-à-vis the management of the bank, the MREL creditors' representatives should be given access to all the relevant information as any other non-executive director. On the other hand, committee members should be held liable for unduly revealing confidential information or damaging the bank with intent or gross negligence. This relates to the possible drawbacks in terms of information dissemination. To this end, the representatives should also be considered "person discharging managerial responsibilities" for the purpose of the Market Abuse Regulation (MAR).[126] Consequently, MREL creditors representatives are prevented from engaging in insider dealings and to unlawfully disclose inside information.[127]

The situation is more entangled and delicate when it comes to the relationship between committee members and MREL creditors. Agency problems arise and the probability of the committee members to be captured by bank management seems non-trivial. If this is the case, the presence of committee representatives would be irrelevant because their ability and willingness to voice the interests of MREL creditors in the committee would be impaired.

Standard governance strategies might help to mitigate such agency costs. Committee representatives should possess all the characteristics of independence and integrity required to independent directors.[128] Moreover, committee representatives should owe fiduciary duties to MREL creditors. Thus, in discharging their duties, the representatives must act in the best interests of the creditors. This duty is mitigated by the duty not to intentionally or gross negligently harm the bank revealing privileged information, as discussed above. In this respect, having MREL creditors' representatives only seating in the committees and not in the board might alleviate possible legal problems arising from multiple fiduciaries owed both to MREL creditors and the corporation.

The liability regime of MREL creditors' representatives closely follows their fiduciary duties. Thus, committee members should be held liable vis-à-vis MREL creditors if they negligently avoid acting. Similarly, they should be held liable for failing to be appropriately informed on the matters to be discussed and decided within the committees and their inaction causes serious damage to bondholders.[129] The initiation of any liability lawsuits should be decided by the General Meeting of MREL creditors with a simple majority and the common MREL trustee should have standing.

Finally, committee representatives should draft a report on the activities of the committees and the impact of bank decision-making on the stability and resilience of the bank as well as the probability of MRE creditors to incur in losses. The report should be based on publicly available information and complement the yearly proxy material from the point of view of MREL creditors.

The report should be made available to MREL creditors before their Annual General Meeting. Particular attention should be devoted to the remuneration and

[126] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC OJ L 173/1 (MAR).

[127] Articles 8, 9 and 14 MAR. The infringement of these provisions is punished according to the administrative measures and sanctions provided by Chapter V of MAR.

[128] Supra (n 124).

[129] The standard of negligence mitigated by the duty not to harm the bank should be considered appropriate. In fact, further shielding committee representatives from liability, e.g.: imposing gross-negligence standard, would not achieve the goal to minimise agency costs between MREL creditors and their representatives.

dividend policies, as the report should represent the underlying material on which MREL creditors exercises the decision rights.

4.2.3 Decision rights

The appointment of committee representatives may not be enough to efficiently impact on the decision-making of the bank management. As discussed in the previous Section, the representatives of MREL creditors should count for a qualified minority of the committees, so that the rest of the members can overcome the reservations or proposals of the creditors' representatives. Therefore, it seems necessary to give the generality of creditors limited decision rights, complementing the role of creditors' representatives.

In particular, the right to vote on executive remuneration and dividends represents an effective set of core rights to be granted through EU law. Those would be relatively easy to implement in each jurisdiction and would complement the existing regulatory and supervisory framework. In this regard, the report of the MREL representatives discussed in the previous section represents an important background material. Therefore, the report should provide a clear-cut and straightforward indication on the matters MREL creditors are asked to vote on, stating whether the remuneration and dividend policy takes adequate consideration of the interests of MREL creditors and, more in general, the solvency and stability of the bank. In this sense, the report does not represent a source of inside information, not publicly available to the market. On the contrary, it decreases the cost of MREL creditors to gain and compute the relevant available information. This seems to represent a sensible balance in the trade-off between the incentives to creditors monitoring and the fear of disseminating an excessive amount of information endangering the trust on, hence the stability of, the bank.

Currently, the competent authorities can limit both dividend and variable remuneration[130] only once the bank is in material breach of the so-called combined buffer requirement.[131] Granting an unconditional right to creditors to block disproportionate distributions in good times would provide an important complement to the prudential tools currently in place.[132] On the other hand, it does not seem proportionate to grant a generalised veto right on other types of distribution such as share repurchase or, more in general, capital instruments redemptions. The Competent Authority has already ample and non-contingent power to authorise such operations only if the bank satisfies stringent conditions.[133]

The most entangled aspect of the proposal consists of the legal effects of a possible rejection of remuneration and/or dividend policies of the bank. Making the decisions of the MREL creditors binding might be considered an over-entitlement whereas if these decisions are merely consultative the opposite risk of under-entitlement arises. Moreover, in this matter is also important to provide some flexibility in the implementation, so to account for the heterogeneity of national corporate laws and bank's business models and strategic decisions.[134]

[130] Article 141 CRD, setting the cases in which distributions can be restricted, the types of distribution that should be restricted and the maximum amount of distribution possible in case the combined buffer requirement is breached.

[131] Article 128 CRD.

[132] A blueprint for the design of this voting right can be traced in the newly implemented Say-on-Pay regime embedded in Article 9a and 9b of the Shareholders Right Directive II, Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement OJ L 132/1 (SRDII).

[133] Articles 77 and 78 CRR.

[134] Again, a blueprint for a flexible approach can be found in Article 9b SRDII.

There are several dimensions to consider in designing the exact scope and effect of the voting rights granted to MREL creditors. The timing of the deliberation is essential. If MREL creditors vote on remuneration and dividend after the general meeting of shareholders already deliberated on these issues, making the creditor's decision binding would be particularly difficult from a legal perspective and highly intrusive. Whereas, if the opposition of creditors is on a proposal by the management, the management could revise its proposal accordingly or explain why the proposal continues to diverge from the creditors' deliberation. Hybrid forms in between consultative and binding decisions are possible and likely desirable.[135]

Finally, the MREL creditors during the Annual General Meeting can deliberate on the initiation of liability lawsuits. In particular, the common trustee should be allowed to act on MREL creditors' behalf against the committee representatives for breaching their fiduciary duties. Moreover, they should be allowed to initiate a derivative lawsuit against the directors and the management for damaging the corporation.

4.3 Governance rights and resolvability

This article argues that fine-tuning bank governance and resolution by granting governance rights to creditors enhances the quality of banks' decision making and let them internalize part of the systemic externalities they create. Besides, such a finetuning can be beneficial also for the effectiveness and credibility of the resolution framework. As anticipated, the resolution framework for ailing banks, especially in the EU, suffer from a severe lack of credibility, hampering its ex-ante impact on market discipline and diminishing the probability of implementing resolution ex-post, should a bank become insolvent.[136]

Governance rights provide creditors with legal tools to discipline their borrowing banks, coping with the ex-ante problem. However, governance rights can also generate an indirect positive spillover in terms of the ex-post credibility of resolution. The link between ex-ante right and ex-post credibility consists in the protection of creditors' property rights.

The protection of property entitlements of creditors subject to resolution represented one of the major criticisms raised in legal scholarship against bank resolution.[137] The use of the bail-in tool, so the argument goes, would violate the right to property of the creditors bearing losses. In the first cases disputed in front of the ECJ, the existence of the no-creditors-worse-off rules was deemed to be a decisive argument in favour of the constitutionality of bail-in.[138] Such rule implies that creditors cannot bear higher losses in resolution than the amount of losses they would have borne in the counterfactual liquidation scenario.[139] Yet, the practical judicial implementation of such safeguard is more difficult than it might seem at a first glance, generating a great ex-ante uncertainty and negatively impacting the incentives of creditors to exert discipline.[140] In this regard, Chiu argued that: "the 'no creditor worse off' principle could also convince bail-inable debt holders that taking a back seat in monitoring would make no difference".[141]

Ex-ante governance rights provide better protection to property entitlements than an uncertain cap on losses that can be

[135] For an overview of the various policy options already implemented worldwide see Thomas and van der Elst [84].

[136] Armour [85].

[137] Wokcik [86], p. 117.

[138] Case C-526/14 *Tadej Kotnik and Others v Državni zbor Republike Slovenije*. [2016] ECR-I 570.

[139] For more details on the no-creditors-worse-off rule see de Serière [87].

[140] Martino [19], 816.

[141] Chiu [88], p. 627.

borne in resolution.[142] Therefore, providing ex-ante market-based safeguards could substitute for the ex-post judicial (and uncertain) safeguard in terms of property right protection. This, in turn, would have two more general positive consequences. First, it would enhance the incentives of bail-inable creditors to impose market discipline on the borrowing banks. Second, it would make the resolution more credible, eliminating one material impediment to resolution. In fact, if the NCWO rule is violated the creditors are entitled to ex-post compensation paid out by the Single Resolution Fund.[143]

5. Conclusion

This article argues in favour of including (some) bank creditors in the decision-making process of their borrowers through statutory reforms. It shows how such a major adjustment to the standard governance arrangements is warranted.

In so doing, the article reviews several strands of literature proposing to "alter" corporate governance arrangements of banks accounting for systemic externalities. Some of the proposals, such as the ones extending the responsibility of directors in the pre-insolvency phase, complement the argument in favour of more robust debt governance. In contrast, other proposals, especially those pointing at modifying the fiduciary duties of bank directors, are in a relation of mutual exclusiveness with granting governance rights to creditors.

The article proposes two main theoretical justifications for statutorily including creditors in the decision-making process of their borrower. First, the specialties of bank governance make a particularly strong case for departing from a purely shareholders-oriented approach to governance. Second, analysing the problematic relation between governance incentives and financial regulation, the article argues that the room for debt governance in banks is particularly narrow. Yet, a functioning and efficient debt governance would be needed especially in banks. Moreover, as an additional positive spillover, governance rights to creditors would increase the credibility of the resolution framework and, thus, the resolvability of the single institutions. This latter consideration highlights the potential for triggering a virtuous circle where debt governance enhances the overall quality of bank corporate governance which, in turn, increase the credibility of the resolution framework. Being the resolution framework more credible, the disciplining pressure on banks risk-taking appetite increases, further enhancing the quality of the decision-making process, i.e.: the quality of bank governance.

Finally, the contribution attempts to operationalise a framework for granting creditors some governance rights, focusing on the case of the European Union. It proposes to grant unconditional rights to creditors holding instruments that are eligible for MREL purposes. Moreover, it proposes to include among the principles on bank governance arrangements a general clause of "sufficient accountability" toward MREL creditors in decision-making. This approach has the advantage to include the quality of debt governance within the annual evaluation carried out by the supervisor. The adequacy of governance arrangements would become part of the annual SREP with the potential to put in motion a virtuous iterative procedure between the individual bank and the supervisor. This would help refining the governance role of the MREL creditors and fitting it to the specificities of each bank.

To complement such general principle and make it effective, few specific appointment and decision rights should be granted to MREL creditors with the aim to

[142] For the proprietary foundation of property rights see Armour and Whincop [89].

[143] Article 75 and 78 BRRD.

balance the interests of both shareholders and creditors constituencies. Specifically, in terms of appointment rights, MREL creditors should be able to appoint a qualified minority of the member of some strategic committees, such as audit, risk and compensation. On the other hand, MREL creditors should be asked to vote on the remuneration and dividend policy, complementing the role of committee representatives in restraining the possibility of the bank to engage in disproportionate risky projects in good times.

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