



Council of the European Union  
General Secretariat

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**Interinstitutional files:  
2023/0112 (COD)**

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**Brussels, 17 July 2023**

**WK 9952/2023 INIT**

**LIMITE**

**EF  
ECOFIN  
CODEC**

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## **WORKING DOCUMENT**

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From:	Commission services
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés
N° Cion doc.:	ST 8482 2023 INIT
Subject:	CMDI Review: working party 20.07.23 Item 9: Commission non-paper on precautionary recapitalisation (BRRD proposal)

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WK 9952/2023 INIT

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## Commission services' note on precautionary recapitalisation

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### **1. Introduction**

The existing Article 32(4), point (d), BRRD<sup>1</sup> lays down the scope of measures and conditions for precautionary recapitalisation, which are aligned with the exceptional nature of these measures. However, past experiences show divergent interpretation and the need for some targeted amendments to lay down more clearly the permissible forms of precautionary measures provided outside of resolution and aimed at recapitalising the entity concerned, and to ensure legal certainty and convergence of practices with respect to the conditions for the application of such measures.

### **2. Scope of precautionary recapitalisation**

The existing BRRD provision (Article 32(4), point (d)) lists only the injection of own funds or purchase of capital instruments as possible forms of precautionary recapitalisation, along with two other forms of public financial support – State guarantees of central bank liquidity facilities and State guarantee of new issuances. However, impaired asset measures such as providing guarantees for troubled assets or establishing asset management companies have proven effective and efficient measures<sup>2</sup> to address causes of possible financial distresses faced by institutions and entities and preventing their failure. These could, therefore, constitute relevant tools to tackle challenges such as those arising from non-performing loans. In its 2018 Asset Management Companies (AMC) blueprint, the Commission already expressed its view that such measures could be structured in such a way as to meet the conditions for being deemed precautionary recapitalisation<sup>3</sup>. The Commission proposal therefore provides for the explicit addition of such impaired asset measures.

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<sup>1</sup> For the sake of streamlining the document, we will only refer to the BRRD provisions. However, parallel amendments are also proposed to the SRMR (Article 18(4), point (d) and addition of new Article 18a).

<sup>2</sup> In particular, public guarantees granted for a specified period in relation to the impaired assets of the institution or entity concerned may ensure better compliance with the temporariness condition than transfers of such assets to a publicly supported entity.

<sup>3</sup> See Commission Staff Working Document (March 2018), *AMC Blueprint*, SWD(2018)72 final, p.35: “Such a transaction, if properly structured, may achieve exactly the same recapitalisation objective for the beneficiary bank as a straight-forward injection of own funds or purchase of capital instruments.” See also Section 9 of Annex 8 of the Commission’s Impact Assessment.

### 3. Conditions for precautionary recapitalisation <sup>4</sup>

The current Article 32(4) BRRD already lays down a number of restrictive conditions for precautionary measures outside resolution that should be met to avoid triggering the failing or likely to fail (FOLF) determination:

*Financial stability condition:* precautionary recapitalisation “*is required (...) in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability*”.

*Viability condition:* the bank must not meet any of the criteria for FOLF under Article 32(4)(a), (b) or (c) BRRD, or for write down and conversion under Article 59(3) BRRD.

*Solvency condition:* Article 32(4), second subparagraph BRRD provides that precautionary recapitalisation ‘*shall be confined to solvent institutions*’.

*Limitation related to capital shortfalls:* precautionary recapitalisation ‘*shall not be used to offset losses that the institution has incurred or is likely to incur in the near future*’ and ‘*shall be limited to injections necessary to address capital shortfall established in the national, Union or Single Supervisory Mechanism (SSM)- wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank (ECB), European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority*’<sup>5</sup>.

*No-advantage condition:* The precautionary recapitalisation should take place at pricing and terms that ‘*do not confer an advantage upon the institution*’.

*State aid control condition:* in addition to the previous condition, any precautionary recapitalisation ‘*shall be conditional on final approval under the Union State aid framework*’.

*Precautionary/temporary/proportionality conditions:* the capital support measure ‘*shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance*’.

Those conditions are maintained in the Commission’s proposal in the new Article 32c (1), point (a), and Article 32c (2), points (a) to (d) BRRD<sup>6</sup>. However, experience has revealed that further clarity is needed with respect to the ‘financial stability’ and ‘solvency’ conditions (including with

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<sup>4</sup> The conditions apply to all forms of extraordinary public financial support under Article 32(4)-point (d) BRRD (new Article 32c (1), point (a) of the Commission proposal amending BRRD) even though the paper is focused on precautionary recapitalisation

<sup>5</sup> In accordance with Article 32(4), fourth subparagraph, the EBA published guidelines on 22 September 2014 on stress testing and asset quality reviews.

<sup>6</sup> The rules on extraordinary public financial support (EPFS), including precautionary recapitalisation, are laid down in point (d) of Article 32(4) BRRD as exceptions to the rule that the need for EPFSF is grounds for determining that an institution or entity is failing or likely to fail (FOLF). To enhance the readability of this provision, the Commission proposal moves those rules to a standalone Article 32c BRRD. The condition that any support not meeting the conditions set out in the text constitutes grounds for the recipient to be FOLF is retained in Article 32(4), point (d) BRRD. Yet its original wording is very broad, targeting all types of support and therefore precluding the possibility for the use of public DGS for preventive measures under Article 11(3) DGSD. To maintain the level playing field between private and public DGSs and to ensure legal certainty, the new Article 32c BRRD set out an exhaustive list of the types of public financial support that are admissible without triggering a FOLF determination.

respect to the identification and quantification of incurred or likely losses), and the condition for the ‘precautionary and temporary’ nature of the measures.

### 3.1. Necessity to remedy a serious disturbance in the economy

The condition set out in Article 32(4), point (d) BRRD is that the precautionary recapitalisation is granted ‘*in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability*’. This is a direct reference to Article 107(3), point (b), of the TFEU that lists among the types of State aid that may be considered as compatible with the internal market ‘*aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State*’. In the context of the global financial crisis and up to date, the Commission exceptionally used Article 107(3)(b) TFEU as the legal basis for the approval of State aid measures to financial institutions.

The Commission proposes to change the ‘and’ into ‘or’ (Article 32c (1), point (a) BRRD) in order to make it possible to also invoke in the future the legal basis set out in point (c) of Article 107(3) TFEU<sup>7</sup> when assessing the compatibility of the precautionary recapitalisation that is granted within the internal market. This should provide additional flexibility on the use of the tool under the applicable conditions, especially in the context of a potential upcoming review of the State aid framework for banks.

### 3.2. Definition of solvency

Article 32(4), second subparagraph, BRRD requires the institution or entity receiving the precautionary recapitalisation to be ‘*solvent*’. This requirement is separate and distinct from the requirement that none of the conditions for being failing or likely to fail are met. However, it was left undefined. Experience has revealed that this lack of clarity is problematic, as cases have been witnessed in which banks benefitted from extraordinary public financial support, and therefore were assessed as solvent but shortly after were determined to be failing or likely to fail<sup>8</sup>.

The Commission therefore proposes to introduce a specific definition of solvency for purposes of precautionary recapitalisation (Article 32c (2), second subparagraph BRRD) that builds upon the practice of the ECB, based on past experience, which considers as solvent an institution for which the ECB or the relevant national competent authority have concluded that no breach of any of their pillar 1 or pillar 2 capital requirements has occurred or is likely to occur in the 12 following months. The forward-looking nature of the definition makes it possible to take into account foreseeable developments and to capture the population of banks for which precautionary recapitalisation is intended, that is, institutions or entities that are not failing or likely to fail, nor likely to be in the foreseeable future, but face funding needs in a tail scenario.

### 3.3. Identification and quantification of incurred or likely losses

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<sup>7</sup> ‘... aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest’.

<sup>8</sup> See section 2.1.1, section 7.1.3.3. of Annex 5 and Section 9 of Annex 8 of the Commission’s impact assessment.

According to Article 32(4), point (d), BRRD, precautionary recapitalisation must ‘*not be used to offset losses that the entity has incurred or is likely to incur in the near future*’. The proposal (Article 32c (2), third subparagraph, BRRD) maintains this principle and develops and operationalises it further.

To this aim, it requires the competent authority to be in charge of quantifying incurred or likely losses. The proposal strives to reconcile this aim of increased objectivity with the proportionality principle and with the risk-based approach followed by supervisors by offering a range of possible means to perform the valuation. While the most reliable instrument to identify incurred or likely to be incurred losses remains an asset quality review by the ECB, the EBA or national competent authorities, this is not always possible to accomplish in a timely way. In those cases, competent authorities should identify incurred or likely to be incurred losses in the most reliable way possible under the prevailing circumstances: as a minimum, on the basis of IFRS 9-compliant balance sheet confirmed by an independent auditor, or on AQRs where available, or on-site inspections where appropriate.

#### 3.4. Temporariness

Precautionary recapitalisation must be temporary in nature. This principle is retained and further clarified in the BRRD amending proposals through the introduction of a requirement for an exit strategy and rules on the instruments to be used for the capital support measures.

##### a) Exit strategy

The new Article 32c (2), first subparagraph, point (b), BRRD requires the granting of precautionary recapitalisation to be accompanied by an exit strategy that should be approved by the competent authority. This is intended to require the institution concerned and its competent authority to think and plan ahead for the end of the unwinding of the support measures, thereby increasing the chance of successful exit. As the authority with the deepest and more direct knowledge of the situation, activity and business model of the institution, the competent authority has been considered the best placed to assess the necessity of the support measures and approve the exit strategy.

In case the support measure is not redeemed, repaid or otherwise terminated in accordance with the terms of the exit strategy established at the time of granting such measure, the competent authority should determine that the institution or entity is failing or likely to fail (Article 32c (2), sixth subparagraph BRRD).

Along with serving as an enforcement mechanism strengthening the requirement for the temporary nature of the support measures, this is a logical consequence of the initial conditions for granting the aid no longer being met. In other words, if the exit strategy is not followed, then the measures could no longer be considered temporary and actually provide more permanent support. Therefore, the conditions laid down in BRRD for the public support to derogate from the general BRRD rule and not to trigger a failing or likely to fail determination are no longer complied with. Consequently, the general rule set out Article 32(4), point (d), BRRD should apply.

##### b) Rules on instruments to be used for precautionary recapitalisation

Under Article 28(1), point (e), of CRR, financial instruments must be perpetual in order to be eligible for CET1. In case this type of instrument is used for precautionary recapitalisation, their perpetual nature entails the need for active steps to be taken by the Member State to divest the instruments concerned in order to meet the temporariness requirement. By contrast, other instruments that qualify for meeting the own funds requirements under the CRR typically have a maturity date and therefore their divestment after a certain period is ensured by design, without any effort or specific step to be taken by the authorities. Their use thus facilitates compliance with the requirement of temporariness.

The Commission proposes in the new Article 32c (1), point (a)(iii), BRRD that the acquisition of own funds instruments other than CET1 in a precautionary recapitalisation is the default option. As an exception, the Commission proposal allows derogations to this rule, where the nature of the shortfall identified requires the injection of capital by way of CET1 instruments (Article 32c (2), fifth subparagraph BRRD). In such cases, the Commission proposes to subject the amount of CET1 that may be acquired in a precautionary recapitalisation to an overall cap of 2% of the total risk exposure amount (TREA) of the institution or entity concerned. This limit is designed to anchor the principle that CET1 must, for the reasons set out above, be exceptional and address temporary needs. If the stress test identifies a larger capital need for the bank concerned, then the 2% TREA provided in the form of CET1 capital could be topped up with further support in the form of other instruments that should be more temporary in nature. Where the CET1 shortfall in the adverse scenario of the stress test exceeds this cap significantly, it could be a sign that the bank has more fundamental problems and that precautionary support may not be justified – as the 2% TREA cap represents almost half of the risk-based pillar 1 CET1 requirement to which credit institutions are subject under Article 92(1), point (a) CRR.