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The European Banking Union

Supervision and Resolution

Giuseppe Boccuzzi

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The European Banking Union

Supervision and Resolution

Giuseppe Boccuzzi
Director General, Interbank Deposit Protection Fund, Italy

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Preface

The global financial crisis all but brought down the financial system and real economies of industrial countries. It immediately became clear that reforms of both banking crises management and banking supervision should take centre stage, in order to re-regulate the whole banking system, including measures to remedy the deep cracks that the crisis uncovered. The policymakers' goal was to render the European regulatory and institutional framework robust and efficient. The project was the Banking Union, a broadside approach to resolve the structural fragmentation and distortions in the European banking system that were the major obstacles to a working single market for financial services.

The reform is far-reaching. It is designed to tackle the institutional architecture of banking supervision and crisis management, the powers of the authorities, the tools for administrative actions, the complexities of business and bankruptcy laws, individual rights and their legal guarantees.

This volume examines the numerous changes happening to European legislation for the prevention and management of banking crises. What emerges is a changing picture of regulations and institutions, of goals and tools and of implications of the changes on the various stakeholders, both public and private, at European and national level.

The book focuses on the new framework for banking crisis management. Inevitably, it has to start from the very foundation – banking regulations and supervision – because interventions in crisis management are possible only with reforms of banking supervision that are parallel and in tandem. The new framework for supervision and crisis management is devised to operate at the same Europe-wide level. If this were not the case, we would have divisions with supervisory responsibilities implemented at the European level and crisis management at the national level, with consequent serious distortions in decision-making and difficulties in carrying out interventions.

It is my hope that this volume will be of use to market operators, researchers and students of banking, finance and law by providing them with a picture of the main features of the legal and institutional changes being brought on by the reform of banking rules. My aim is to describe and consider the salient points and by this means to stimulate further discussion and more in-depth analysis into the new European

regulatory framework, which will characterise the industry for many years to come and have profound effects on economy and society.

I would like here to express my very sincere gratitude to Professor Riccardo De Lisa, Professor Christopher Neenan and Dr Manuela De Cesare for their precious comments and advice.

Prologue

The financial and economic crisis of 2007–09 struck like an iceberg in the night. In its wake, banking insolvencies multiplied with disastrous effects on the financial system and, consequently, catastrophe for the real economies in industrialised countries. The need was urgently felt for a profound rethink and reform of how banking crises are managed and how banking supervision is conducted. The crisis had uncovered severe weaknesses in the financial edifice. The intention of policymakers became to put in place a more robust and effective regulatory and institutional system for Europe. They named it the Banking Union, an ambitious project to resolve the fragmentation and distortions in the banking system that militate against the creation of a single European market for financial services. The changing nature of markets and intermediaries, the complexities of risk and the interconnectivity between financial firms and the increasing exposure to contagion increased the urgency of the task.

However, even before the onset of the present crisis, globalisation and technological advances had already opened the debate on initiatives for a reform of banking regulations and insolvency management. The divide between intermediaries acting internationally and a regulatory system still anchored at national level was widening with every passing month. The dangers for the banking system were very much in evidence and should have been heeded more closely. With hindsight, this second great crisis was there in the wings waiting to happen.

Lehman Brothers was the first bank of systemic proportions to be "let go" by the US authorities. The consequences were near catastrophic for global banking. In the aftermath, many questions were raised about why that should have been the only insolvent bank allowed to go belly-up in an environment characterised by bank rescues underwritten by taxpayers' money. These questions remain without convincing answers even to this day.[1]

In 2011, in the midst of the new problems and financial turbulence rendered worse by the perverse link between banking risk and sovereign risk, I published in the Bank of Italy's Legal Studies Series an extended analysis of banking crises in the light of the very serious developments in the US and in Europe and in the context of the new forms the crisis was taking.[2] I examined causes of banking failure, its manifestations

and the extraordinary solutions invented by various jurisdictions to find a remedy for it.

I highlighted a common thread running through all these solutions: bank insolvency was being tackled by bail-outs using public monies and in many ways (recapitalisation, asset relief programmes, nationalisation, guarantees, bad banks into which toxic assets were sent). The costs of the failures were being taken on to State balance sheets and, in the last resort, paid for by the taxpayer.

At the time, reform of the financial system was underway in the United States and in Europe. Some countries had already brought in major changes. Many of the regulations and institutions now being implemented as part of Banking Union were still being worked out in theory. Given their highly complex nature, the potential consequences were being carefully studied. In the meantime, regulatory and organisational solutions intended to enhance international co-operation and coordination of supervision and management of banking group cross-border crisis were seen to be inadequate.

The main concern of policymakers was not simply to add to the box of tools to be used in crisis situations but rather to come up with institutes and instruments capable of warding off any future recurrence of a major systemic crisis. Policy and strategy were focused on having a wide field of interventions that would either strengthen prevention (by means of more stringent prudential rules and more in-depth oversight controls) or completely revisit the rules and methods of crisis management. In Europe, numerous well-directed legislative initiatives were begun.

My choice of title for the 2011 publication, Towards a New Framework for Banking Crisis Management, was designed to reflect my sense that while the process of change had effectively begun, the concrete issues had only been sketched out and no finishing line was yet in sight given the signal complexity of the issues and the extreme differences in institutional and regulatory frameworks from one country to another in Europe and all their different approaches. Perhaps there was more than a touch of skepticism in my tone, in part created by difficulties in the past – particularly in the 1990s, in the search for a common framework for banking crisis management, which had in fact resulted in a very bland and toothless directive on the resolution and liquidation of banks that more or less left all countries to their own devices, rules and tools.

Even the last chapter in that book – *Where are we going?* – continued in the same vein. It expressed a fair amount of doubt that the initiatives

being undertaken would reach any concrete conclusions, together with no small pessimism about the real will and capacity of governments to embark on any genuine reforms in the short term.

Subsequent events helped partly to allay these doubts. The European authorities charged with regulating the financial system showed themselves quite determined to "repair the cracks" caused by the financial earthquake and the lack of an adequate regulatory framework, even though different positions emerged on many essential features during the work towards reform. Up to the very end, there persisted points and positions of intense debate. Solutions could only be reached through compromise. This was especially the case when decisions had to be made about a common pooling of funds for crisis management (the Single European Resolution Fund, Single Deposit Insurance System, European Stability Mechanism). To achieve the targets set, we can say that the work is still ongoing at European and national levels.

Still, questions remain about the completeness of the measures being adopted. Specifically, are they enough to provide a full answer to the structural problems exposed by the present crisis and any problems that could arise in the future? Of course, no set of rules or supervisory structures, however effective, will be able to ward off bank insolvencies in the future given the multitude of variables, internal and external, that could trigger crisis situations, including management behaviour and regulatory error.

Has a limit really been set for the excesses that lay at the origins of the turmoil that shook the edifice of global finance? Have we tackled all the basic causes? Are the new rules well focused, in the sense that they target operators of highest systemic risk, or are they too broad-based, aimed at all intermediaries indiscriminately, big and small, whether in traditional banking business or speculative financing?

In this book, I continue the analysis and investigation begun in the 2011 book. I examine the many innovative aspects of the European regulatory framework as now defined with the approval of regulations, directives and technical rules for the management of banking crises.

The road ahead has been clearly mapped out; the reform lays out the steps to follow for prevention and resolution of a banking crisis through every stage of its gestation. What is available is a collection of regulatory and institutional changes, aims, instruments and considerations for the various stakeholders, public and private, European wide and national in the business of banking.

In this volume, I focus on the new system for managing banking crises. Obviously, I begin from the very foundations, banking law and

supervision: it is from these that the work done on crisis management was possible, through a parallel and tandem reform of the rules of banking supervision. The new model for banking supervision and crisis management exists at the same level, namely European and it could not be otherwise. The alternative is a division of supervisory responsibility, implanted at European level and exercised at national level with all the consequent distortions for the decision-making process and difficulties for carrying out interventions. Banks could no longer be permitted to be "European in life but national in death".

The reform process is underway and is far-reaching. It takes in the institutional architecture of banking supervision and crisis management, the powers of the authorities and the tools for administrative intervention, with all the implications for business law and bankruptcy law, for rights and the legal guarantee of those rights.

This volume is aimed at all those with an interest in banking crisis management, operators, experts, researchers and students of banking and finance. It seeks to provide them with an overview of the main aspects of the various legal institutes and institutions created by the reform and to suggest further points for discussion and investigation of the new European framework. It is my view that this reformed system will have a long life, just like all major reforms that follow in the wake of major upheavals to economic and social life. It will last ... until the next great crisis.

The book is structured as follows: Chapter 1 outlines the lack of an adequate regulatory framework in the pre-crisis period and follows the subsequent steps in the evolution of supervision and crisis management up to the eve of Banking Union. Chapter 2 describes the new supervisory architecture for Europe, the Single Supervisory Mechanism and specifically the supervisory powers of the European Central Bank. Chapter 3 examines the new legal framework for banking crisis management and the harmonised system of institutions and instruments for Europe. Chapter 4 explores the centralised European institutional framework for banking crisis management. Chapter 5 illustrates the innovations brought in by the new EU directive on deposit guarantee, which aims at reaching the maximum degree of harmonisation possible. Chapter 6 tackles the question of State aid in the banking sector. Finally, Chapter 7 deals with the main issues and problems for the transposition of the new crisis management framework into national jurisdictions.

Notes

1. For an explanation of what happened on 13–14 September 2008, see D. Smith, *The Age of Instability: The Global Financial Crisis and What Comes Next*, Profile Books Ltd., 2010; A.R. Sorkin, *Too Big to Fail and The Inside Story of How Wall Street and Washington Fought to Save the Financial System – and Themselves*, Penguin Group, 2009; Mc Donald-Robinson, *A Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers*, Crown Business, New York, 2010; V. Acharya, M. Richardson, *Causes of the Financial Crisis, Critical Review: A Journal of Politics and Society*, Vol. 21, Issues 2–3, 2009. More recently, T.F. Geithner, *Stress Test: Reflecting on Financial Crises*, Crown Publishers, 2014; J.F. Bovenzi, *Inside the FDIC: Thirty Years of Bank Failures, Bailouts, and Regulatory Battles*, Wiley, 2015.
2. G. Boccuzzi, *Towards a New Framework for Banking Crisis Management: The International Debate and the Italian Model,* in the series *Legal Research Papers of the Bank of Italy*, October 2011.

Introduction

A crisis can happen anywhere and at any time. When one does, it calls into question the very foundations of its economic and social context. There follows a search for the causes and remedies, the results of which trigger change. The depth and extent of the changes are in direct relationship to the depth and extent of the crisis.

A crisis is, by its very nature, whether only limited or systemic, a sign of a breakdown, a discontinuity in the life of a firm or in any sector of activity. It reveals that something is deeply wrong, malfunctioning, blighted at the very roots. Yet, it is crisis – particularly systemic crisis – that becomes the trigger for change and innovation and for the quest for new equilibria and new dynamics, whether for a single firm or a whole sector.

The financial system is no exception to this rule. Quite the contrary, it is perhaps the sector most exposed to it, as history has too often borne witness. The great reforms in this area have always had their birth in the major crises that preceded them. The example that most obviously springs to mind is the Great Depression of the 1930s, which was followed by far-reaching structural reforms in banking and financial legislation. In Italy, the outcome was the Banking Law of 1936–38.

Any crises and malfunctions have to be tackled with appropriate measures that can get down to the root causes and apply the appropriate remedies. Otherwise, any actions taken will be inadequate, only patching over the effects and not dealing with the real causes. The malady would remain in place and threaten to fester and break out again with the passage of time. The cure depends on having a clear clinical vision of what is needed, where to intervene, what to remove, what to implant, what instruments and tools to have at hand and what the restored body should be like when the work is finished.

The present crisis has been a global one from the very start. It began in the United States of America in 2007–08. It had originally affected only one sector of the US financial system, one asset class only, the mortgage market, but – given the connectivity of financial systems – quickly spread to infect other countries. From its onset, questions were asked about how a crisis in only one sector of the US financial system, one single asset class, mortgages, could have become so widespread as to infect the whole western economy. Explanations have been sought in the overuse, and often misuse, of securitisation and the derivative products it gives rise to, in the employment of the originate-to-distribute business model (creating credit instruments and passing them on so as to transfer risk) rather than the more traditional originate-to-hold model in which the banks keep their assets on their balance sheet and where they have more responsibility for quality and guarantee at maturity. It is widely held that there were serious failures in regulation, in supervision of banks and in institutional/regulatory drills for dealing with emergencies. Added to these were poor – and often improper – risk management by financial intermediaries, delayed analysis, scant understanding of what was happening and a lack of prompt action to head off the disaster.

Market operators, regulators and economists, except in very rare cases, were not prepared for what happened. Events moved too quickly and were too complex. Liquidity crises and insolvencies hit even major institutions in many national banking systems. The instruments to hand for analysis and emergency controls were inadequate. The whole ideology of self-correcting markets and light touch regulation, with minimum public intervention, collapsed.

The crisis quickly began to take on systemic dimensions and assumed proportions never experienced before. Predominant theoretical schemes showed their fragility in explaining the complexity of events and were of limited help. The crisis seemed to cause a clear break with the past, with profound implications.

In fact, public bail-outs were clear evidence of the weakness of theoretical approaches of a liberal kind. This approach would have entailed abandoning insolvent banks to their own devices, leaving them to sink or swim, and not moving in to save them with public money and consequently socialise the losses. The financial crisis seems to give the lie to the theory of efficient and self-correcting free markets. However, this risks very high, unsustainable social costs whenever public intervention becomes necessary.

The events of 2008–09, with bank failures cascading, in the USA and Europe, posed immediate challenges for policymakers. Decisions had to

be taken almost overnight: theory had to give place to solutions in the field, with immediate impact, to close widening gaps in the financial system and remove the danger of imminent contagion. Two opposing theoretical approaches, the liberal and the interventionist, had to converge.

After that financial tsunami, "nothing will be as before". Principles, rules, behavioural models and risk assessment methods well consolidated in the past: all of these have to be rethought. This has been summed up well: "*When there is marked discontinuity with the past, agents' behavioral changes can be far-reaching and the past fails to provide enough guidance for the present (never mind the future).*"[1]

The pros and cons over how effective, or not, the measures taken to limit the damage to the banking system were can be argued, but one thing cannot be denied, namely, that in a time of systemic crisis of such magnitude, the dilemma to be faced was whether to let the banks go belly up, to leave them to their own devices, with all the possible and unpredictable consequences for the financial and real economies, or to intervene to save them and undertake damage limitation. Governments and supervisory authorities could only take the second course, intervene with taxpayers' money to save the banks and reduce the destructive effects of extensive bail-outs.[2]

The political consequences of this second approach were severe and they set in train an intensive debate on what structural measures to take to ensure that such turbulence could not happen again and that bank insolvencies would never again lead to a socialisation of losses at taxpayers' expense. However, the massive bail-outs did not bring an end to the financial and banking crisis. The repercussions continued to be felt throughout the real economy and they ushered in a deep and prolonged recession with high unemployment and severe social disruption in broad swathes of the populations in weaker economies.

The change in the approach of public authorities came with the second surge in the crisis after the summer of 2011, when a vicious circle of sovereign risk and bank risk became evident. Sovereign debt crises in many European countries, fuelled by tate deficits and high levels of public debt, led to the fragmentation of the European banking market and widened spreads in the cost of access to financial markets by national banking systems. A number of countries and their banks defaulted and had to be rescued with international support under very stringent conditions.

What came to light was that European countries were still nurturing national approaches to problems that were really global in depth and

extent. It became clear how weak and risky the institutions and constitutions were.

Once the more acute phase of the crisis had passed and had been tackled with extraordinary and unconventional measures by the public powers (governments, central banks, supervisory and resolution authorities), the hard tasks of analysis and deciding what actions to take began. International forums questioned how such a thing could have happened and what short-term or structural repairs could be put in place to avoid any recurrence in the future.

Reaching agreement on rules and regulations at international level is by nature a slow and tedious process. It does not seem conceivable that European banking law could have been so radically reformed in such a short time, impacting principles and foundations previously in place for so long. However, just such a sea change has happened. The guiding philosophy has been changed, and changed radically, from what was minimum harmonisation among national legislations to what aims towards maximum harmonisation and a focus on a pan-European system for banking supervision and crisis management. This change has laid the foundations for the Banking Union project.

The overall blueprint is clear and coherent with the progressive integration of financial markets, the reinforcement of intermediaries and the need to arrive at a single European banking market. Banking Union will rest on three pillars:

i) the Single Supervisory Mechanism (SSM),
ii) the Single Resolution Mechanism (SRM), and
iii) the Single Deposit Guarantee Scheme.

For these there is a Single Rulebook, that is, a comprehensive compendium for the whole process of institutional centralisation of prudential supervision, resolution of banks and depositor protection. It collects, in one volume, regulations, directives and rules for their implementation.[3]

The new institutional framework depends on a delicate balance between European and national responsibilities , which was made possible only through the principles of subsidiarity and proportionality outlined in Article 5 of the EU Treaty. The haste with which decisions about reform had to be taken and the high degree of complexity of issues relating to structures and procedures will very probably leave many problems when it comes to the application stage.

The new approach to crisis management is no longer to wait until the moment of insolvency or near-insolvency before intervention but

rather to aim at prevention and resolution in the conviction that "prevention is better than cure". Indeed, for some time now much of the literature, particularly in Economics, has been advocating this. There are two broad outlines:

i) strengthen prudential rules and supervisory action to prevent banking crises and try to ensure that they do not recur; and
ii) identify the most effective ways to manage banking crises and so limit the costs and the impact on stakeholders. The whole idea is to reduce the probability of default and losses, given default of the whole banking system.

The aim is prevention and it is pursued through the following:

i) using the Capital Requirements Directive (CRD IV) package of prudential rules that applies Basel III[4] in Europe through new rules on capital, liquidity and leverage with the purpose of making banks more sound by increased capitalisation and better risk management;
ii) better preparing banks and authorities in their normal course of business to deal with adverse situations through recovery and resolution plans;
iii) early interventions that the supervisory authorities can trigger to tackle ailing situations and head off insolvency;
iv) new crisis management tools suggested in the Banking Recovery and Resolution Directive (BRRD) and Deposit Guarantee Schemes Directive (DGSD) to lessen the impact of crises through better resolution and, especially, to avoid the taxpayer having to foot the bill.

The framework introduces a new way of resolving insolvent banks: it gives the authorities new tools and new powers. New legal concepts and a new widely accepted terminology have entered European and national laws. The objective is to restructure an ailing bank to avoid the destructive effects of liquidation by means of a bail-in, take-over of the business, separation of it into good bank and bad bank, and/or using a bridge bank.

The mechanism for assigning losses first to shareholders and creditors lies in the powers of the resolution authorities to write-down or cancel the bank's capital and to cancel or convert non-guaranteed or non-insured debt into capital in order to restore regulatory capital and the viability of the bank as a going concern. It is a move from bail-out

to bail-in. The whole aim is to avoid a repetition of t the recent crisis, in which, when things went well the profits were private, but when they went badly the losses were public.

Minimum Requirement for Own Funds and Eligible Liabilities – MREL has been introduced to enable banks to survive adverse events through using their own resources rather than relying on public intervention. The idea is to have an additional capital buffer capable of absorbing potential loses (loss absorbing capacity). It is a bail-in support tool and adds to its credibility.

The safety net to support financial stability has been significantly widened to embrace regulations, micro- and macrosupervision, the central bank's lending of last resort, deposit guarantee and crisis resolution.

Some preliminary observations on the new legal framework

In the first place, the new legal framework has put an end to the debate about a judicial or an administrative option for crisis management. The

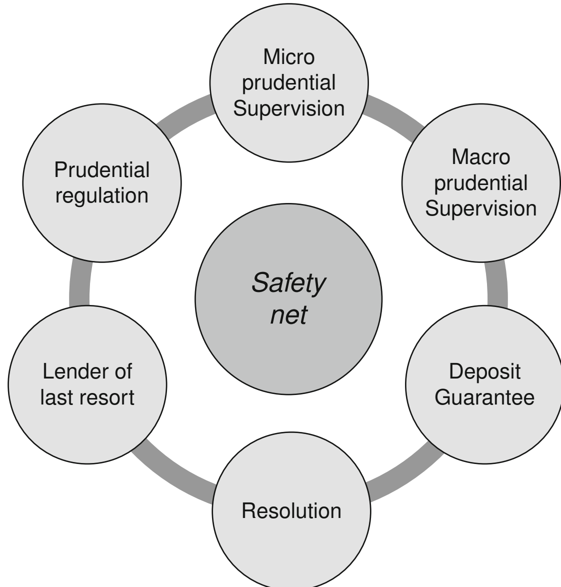

Figure I.1 New configuration of the safety net

Bank Recovery and Resolution Directive and the Deposit Guarantee Directive seem not only to go in the direction of the administrative option, but also even more towards further reinforcing it, the so-called *super-special resolution regime*. This goes far beyond administrative approaches already adopted by a number of countries, for example, the Italian Banking Law of 1936–38. Administrative authorities – whether supervisory authority, central bank, resolution authority or other – are thus given a broader role and so the gap is widened between the private company law approach and the authoritative approach of banking law.

This is a surprising reversal of direction. Before the financial crisis, thinking was moving in the opposite way, namely towards reducing the discretionary powers of the supervisory authorities and fostering prudential rules of a more general character that would allow banks and financial enterprises freedom to pursue their own business targets.

The question is a complex one and demands a rethinking of the institutional framework in many countries. There is, for instance, the problem of deciding to which authority to entrust crisis resolution (central bank, supervisory authorities, a special crisis management authority or the Finance Ministry). Nor can we ignore that when a crisis turns systemic, the role of government naturally increases since the intervention required might demand legislation, regulation or some form of public support. Without having an accepted model to which to refer, the solutions put forward might be different from country to country, depending on the specific nature of the respective legal framework.

A second problem is of who has to carry the cost. The reform tries to give a clear answer to the question of burden sharing, namely, how the costs and consequences of the insolvency are allocated among the various classes of stakeholders. The accepted principle is that the cost of the crisis, first and foremost, falls on shareholders and non-insured and non-guaranteed creditors of the insolvent bank, according to the ranking established in the case of ordinary insolvency procedures.

The European innovation is for *depositor preference*, that is, the covered depositor has priority among the entitled creditors. This is followed by the priority ranking of deposits of individuals, micro, small and medium enterprises with deposits over 100,000 Euros. Once the losses have been covered by the investors and the bail-in, recourse can be had to insurance coverage from the banking system, the resolution fund and the deposit guarantee fund. The whole aim is to avoid the taxpayer having to pay for bank losses in insolvency.

The international debate focused on the controversy around the creation of a crisis resolution fund. There are two opposing camps here.

One advocated the creation of a single European fund, which would imply “mortgaging out” the losses among Member States, and the second, the creation of national resolution funds so that each country would deal with its own insolvency losses. In the end, a compromise had to be reached: a single European fund would be set up but with a very long period allowed for the contribution of financial resources from the individual participating countries.

Although the new system clearly puts losses first and foremost into the private sector, public intervention is not completely excluded: it remains as a last resort after all other means have been used up. When all conventional means have been tried and not fully succeeded, then it is time to try the unconventional: public intervention is one such tool. Private resources might not always be able to deal with systemic crises caused by the insolvency of a major bank or by a multiplicity of small- to medium-sized ones. The private sector could well collapse under the cost of such a bail-out, with dire consequences for itself and the economy at large.

Public intervention has been used in a number of countries to offset the impact of the huge amounts of toxic assets accumulated in the run-up to the crisis, which have choked off the economy’s access to credit. Risky assets have been removed from banks’ balance sheets and placed in bad banks, thus leaving the individual bank “healthy”. In an alternative form of intervention, asset management companies were created to deal with the wider problem in the whole banking system. In the USA, one earlier approach was to set up the Resolution Trust Corporation (RTC) to resolve the Saving and Loan Association crisis (747 banks involved) in the 1980s.[5] Sweden, France, Italy and Malaysia had recourse to similar solutions in the past.[6] In the recent crisis, Ireland set up National Asset Management Agency (NAMA); Spain, Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB); the UK, Asset Purchase Scheme (APS): Germany, Special Financial Market Stabilization Funds (SOFFIN) and the US TARP (Troubled Asset Recovery Program).

In the new European framework, intervention can take many forms, from various ways of providing public money to temporary purchases of property. However, every kind of public backstop must be fiscally neutral in the medium term: the money must be paid back over time through contributions from the banking industry. Likewise, public support must respect EU rules and procedures governing State aid when such aid is justified by the need to safeguard financial stability, avoid deleterious consequences for economy and limit instances of moral hazard and competitive distortions.

In exceptional cases, public support can also be provided to rescuable banks outside of resolution cases: such as, for instance, to fend off very serious damage to the economy of a Member State and to preserve financial stability. Here, too, the measures taken must comply with State aid rules. This could be done by State guarantees to support liquidity operations, new liabilities issued by the bank or through the injection of new capital. This latter case is a kind of precautionary recapitalisation that the authorities could issue for a specific situation, like capital shortfall following a stress test or an asset quality review or similar. This could be seen as an exception to the principle of obligatory recourse to bail-in before the public intervention.

Here, too, we could have the use of funds from the European Stability Mechanism (ESM) as a public backstop of last resort. This would be possible after the implementation of the Single Supervisory Mechanism for the purpose of direct recapitalising of banks.

Through these actions the EU authorities have indicated a change in direction to broaden the space for compatibility of the interventions to resolve bank crises with State aid rules in the belief that financial stability should not be limited to safeguarding only intermediaries from the risk of contagion, but should protect the real economy and economic growth, too. As a result, situations previously considered incompatible are no long felt to be so.

Is this a sea change in European policy? Is it a statement of much more attention to the broader scope of economic development, employment and a fairer distribution of the wealth of a nation?

The present financial crisis has changed the parameters for regulatory interventions. After the massive interventions in many countries in favour of the banks – the most recent being intervention in Portugal's Banco Espirito Sancto – and in the case of the US help for non-bank intermediaries and major industries, too, it was no longer possible to persist with an over-rigid aversion to government interventions. The shift in emphasis in Europe has been to render State aid compatible with the internal market. This means finding principles and procedures for avoiding distortions to competition by having the private sector share in any losses and having a recovery plan for the firm benefiting from the aid.

The task ahead is not a simple one. For Italy, it is the problem of absorbing into national law the new rules and tools for crisis management. This is often complicated by a lack of clarity in, and an inexact location of, the regulations in the directives. Where should they be put: into the Banking Law or into a new law? How can we combine European regulations with well-established national procedures for extraordinary

administration and liquidation that have served their purpose well in the past? Can both approaches be assimilated without losing any of their original forms and usefulness? Must we accept that they be absorbed into an entirely new framework? How can extraordinary management be used as part of early intervention and resolution – the relationship between resolution and liquidation, which in the new framework are distinct solutions and procedures? Admittedly, some developments are just rationalisations rather than radical change and a more straightforward combination of the old and the new.

A critical innovation is the bail-in and the significant powers it gives to the authorities to intrude on the rights of bondholders and creditors without going through the courts or insolvency procedures, and all the consequent legal and constitutional problems to which they give rise.

The new framework also touches on Deposit Guarantee Schemes. In Italy, the two systems (*Fondo Interbancario di Tutela dei Depositi* and the *Fondo di Garanzia dei Depositanti del Credito Cooperativo*) had solid experience in dealing with crises, even before the obligations imposed in Directive 94/19/EEC on deposit guarantee schemes. They expressed a willingness and capacity in the banking community to solve its own internal problems through a form of self-regulation of insolvency procedures, avoiding any losses to depositors.

Both funds ensured over time that no depositors suffered losses in the (few) bank insolvencies experienced in Italy. This was largely because of their success in preserving any insolvent bank as a going concern wherever this was technically possible and compatible with the principle of being at a "lower cost" than a payout to depositors in the case of liquidation.

The tenets of the new EU Directives serve to enhance the role of the DGS, certainly not to reduce it, and to fit it into the Banking Union safety net. The Directives leave ample room for national legislations and likewise to the funds to carry out their function of deposit guarantee even before resolution and liquidation procedures begin. Member States should, then, make good use of the discretionary margins allowed by the Directives and achieve a true reinforcement of the tools available for dealing with banking crises and not merely a retouching of institutions and instruments.

The run-up to the deadline for transposition into national legislations must serve as a period of reflection. The reform of prudential rules and crisis management was triggered by the recent financial tumult and the numerous banking crises left in its wake. The process had, of course, begun before the onset of the turbulence with the changes happening

in cross-border banks, national banks and inherent risks. The approach followed by international authorities was that of "soft law"; national approaches were not adequate to deal with the new complexities in banking.

European legislatures must now study the new framework carefully and consider its inclusion into domestic law. The basic values of the new regulations, which give rise to general principles and objectives for resolution, have to be considered alongside the principles of administrative and commercial law and crisis management.

Given this, problems relating to the exercise of administrative powers for resolution (general and accessory) assume a degree of significance. How is control exercised over the subject under resolution? What are the safeguards for the rights of subjects affected by administrative intervention? What value has the principle of *par condicio creditorum* – a key point in many bankruptcy laws, though losing importance – in evaluating the adequacy of the safeguards put in place to protect those rights?

The principles of subsidiarity and proportionality[7] must come into play in building a new framework made up of EU rules and national rules. There will not be complete harmonisation of the resolution tool; rather there will be ample space for existing national regulations and institutions. It will be necessary, then, to identify how much national practice to keep since it might have a much richer legacy to contribute than the new EU framework, providing that it does not clash with resolution and State aid principles.

These are only a few observations triggered by the new legal framework. It is new and complex, and there will be much to explore as implementation advances.

It will take time to analyse the full extent and many implications of the bank insolvencies provoked by the recent crisis. In line with this, there is the search for answers to the many questions and debates in theory, law and economics around the reforms now in progress that impact all aspects of finance. Banking Union is a further major step along the journey begun with the introduction of the Euro.

Will the new system work? Will it be able to ward off future crises? Does it approach all the problems, for instance, does it tackle the controversial points on the structure of banks and what business banks are permitted to carry out? Various reports contribute to the debate: the Volcker Rule (USA), the Vickers Report (UK) and the Liikanen Report (EU).[8] Can banks continue to operate as they currently do, or should they return to the clear separation between commercial and investment banks? In Europe initiatives in this direction are under way[9]. From 1930s

to 1990s, the Glass-Steagall Act imposed a separation between the two activities in the US.[10] In Italy, too, reform in the 1990s permitted the universal banks to cancel the existing distinctions among the various kinds of banks with their respective specialisations and risk profiles.

Again, we can ask, in the light of errors and fraudulent behaviour, have operators mended their ways? Do we have a workable system of carrots and sticks to ensure that banks give the best honest advice to businesses and households and truly promote economic growth? Has financial speculation been tamed or just domesticated until the storm blows over, when they will revert to the old ways? Has Too Big To Fail finally been resolved? Recent statistics on derivatives and recent bank mergers might not be seen as promising signs. The answers are neither easy or norimmediate. Only time and experience will show how effective the new instruments are, and whether the will to change really exists.

Money and finance alone are not enough to build a true Europe that is a nation of peoples sharing goals and values. The recentfinancial crisis has brought to the surface all the contradictions of having an institutional framework for Europe based on money, finance and markets without at the same time having in place a fiscal union, a social union and a union of citizens' rights.

The need for a major integration in fiscal policies and for the creation of political union is steadily gaining recognition. These moves could broaden the democratic legitimacy of European institutions and create a new economic order. The alternative is to resign ourselves to living with continuous social and economic upheavals of greater or lesser intensity, growing fragmentation among nations and unequal living conditions throughout Europe. This nourishes Euroscepticism, anti-Europe sentiment and the notion that the EU is a "Europe of banks and finance".

Financial reforms should be followed up with practical economic policy and "high politics" aimed at concretely affirming solidarity and mutual co-operation among European countries, promotion of economic and social progress, appropriate levels of employment, balanced and sustainable growth and reinforcement of economic and social cohesion. Finance is – and should be more so – at the service of the common good. It cannot be perceived as mere speculation that is inimical to the real economy, to businesses and the general good.

It will be a long, steep climb, but the rapidity of the latest changes – despite contradictions, uncertainties and incongruities– provides grounds for optimism. A process has been set in motion that could provide an institutional architecture for Europe and that could give answers the concerns of the Member States and citizens of the Community.

1
The Financial Crisis and the Banking Union Project

1 The weakness of the institutional framework for managing banking crises before the financial crisis

The financial crisis of 2008–09 originated in the US subprime mortgage crash and then spread to Europe. It was an important test for the rules and institutional framework of banking supervision and crisis management in Europe. The high number of bank failures that occurred revealed serious deficiencies in risk management by financial institutions, a low level of preparedness for dealing with difficult situations and serious gaps in financial sector regulation and supervision, significant deficiencies and a lack of homogeneity in the institutional arrangements and tool kit for dealing with pathological situations.[1]

The problems that emerged in the treatment of banking insolvencies were particularly significant, specifically:

(i) the different characteristics of the legal models for crisis management (administrative vs. judicial);

(ii) the different range (or lack of in some cases) of tools to treat the various stages of a banking crisis and varying degrees of supervisor involvement;

(iii) the absence of specific legislation on banking group crises, and consequent difficulties in ensuring a global and unified perspective on the analysis of the problems affecting both the parent company and the subsidiaries and the search for solutions. In the case of crises that affected internationally active banks (financial intermediaries) or groups, the procedures for coordination between the authorities involved in crisis management were inadequate; this was also a result of a lack of discipline in the allocation of

insolvency costs (burden sharing), which prompted authorities to give protection to the assets settled within their own national borders (ring-fencing).

In most countries, systemic bank crisis was usually resolved through public financial interventions (bail-outs) for fear that significant negative externalities could affect multiple stakeholders; the cost of the failures, thus, was carried by taxpayers. The too big to fail principle, that is, that banks too complex and interconnected should not fail, was almost taken for granted, even though never formally established. It was a practice of *constructive ambiguity* that until then the authorities had always followed that left investors in uncertainty about State intervention and thus reduced the scope for moral hazard. Public interventions significantly affect public budgets. Recent such interventions contributed to forming a vicious circle between bank risk and sovereign risk, especially in weaker economies where public debt and budget deficits were already significant.

The turmoil unveiled gaps and inefficiencies in the whole financial structure. European Union (EU) authorities intervened time and time again, setting down institutional arrangements and more effective rules and, especially, boosting cross-border co-operation and coordination. The process accelerated in 2013–14. The result was a new regulatory framework and new procedures and tools for banking crisis management that moved consistently with the general innovations in prudential regulation and supervisory activities evolving at the European level. These initiatives are part of the wider Banking Union project, which is characterised by the centralisation of decisions in the hands of the European authorities, although in co-operation with the national resolution authorities. A single set of EU rules has been established, the Single Rulebook.

2 First timid (and difficult) attempts to regulate banking insolvency

The need for greater convergence between European countries in the discipline and practice of managing banking crises has been felt for some decades, but not consistently. The level of sensitivity to this issue has increased when significant insolvencies have threatenened but has diminished in times of relative bank stability.[2]

Several initiatives were taken towards convergence at EU level but they lacked any substantial support. In some cases, there was even

strong opposition to the creation of a common framework for crisis management, largely because of profound differences between different countries' regulatory and institutional frameworks and a reluctance to surrender national individualities in an area as sensitive and complex as banking crisis management. There were even arguments – both theoretical and from a practical point of view – as to whether or not a special regime for managing banking crises – different from that generally applicable to other commercial enterprises – would be valid.

Consensus on the need for a common set of rules for the treatment of cross-border banking crises began to emerge after the serious events of the 1990s. The aim was to reach a system based on minimum harmonisation, mutual recognition of national procedures and co-operation between authorities. There followed a long and difficult legislative process and approval was finally met on an EU directive for the reorganisation and winding-up of credit institutions (Directive 2001/24/EC of 4 April 2001).[3] This was a significant step forwards in the climate of the time, but the new legislation was still anchored to a vision of minimalist intervention and continued to be heavily centred on the preservation of the peculiarities of national legislation. The Directive did not provide a definition for common insolvency rules but left each country free to keep the institutional arrangements and procedures enshrined in its own national legislations. The Directive did not go beyond the definition of which country had competence to open reorganisation or liquidation proceedings and the laws applicable.

It did, however, set down important principles, namely the unity and universality of procedures in the EU. Based on these principles, the administrative or judicial authorities of the "home Member State" were the only authorities competent to decide the opening of reorganisation and liquidation procedures. Proceedings opened in the home State would be recognised by, and fully effective in, all Member States without further formalities and they would operate in accordance with the law of the home Member State (*lex concursus*). This solution was consistent with the general principle on regulation in the banking sector (Directive 2006/48/EC of 14 June 2006), under which banks and their EU subsidiaries were considered to be a single entity and were subject to the supervision of the competent authorities of the State in which they had been granted authorisation (the so-called Single European Licence).[4]

Given the significant national differences, especially in the discipline of certain rights and legal relations, the Directive permitted flexibility in many areas through a specific derogation to the *lex concursus*, based

on a system of referrals to the laws of another Member State for the regulation of certain contracts and rights. The European regulation on banking crises set out by the Directive moved with a "territorial" logic. It applied the reorganisation and liquidation legislation of the parent home country only to foreign branches, and not to the foreign subsidiaries of a banking group or to investment firms.

In 1994, Directive 94/19/EC set the discipline and rules for deposit guarantee systems (DGSs). This was a milestone in bank depositor protection regulation: it enshrines the principle of mandatory membership of banks in deposit guarantee schemes, making it a requirement for the conduct of banking activity. The 1994 Directive, however, was still only at a minimum harmonisation level, in line with what was typical of European banking legislation at the time.

The points of convergence were limited to a few key elements in national systems. Member States were left free to adapt the structural and functional aspects of the guarantee schemes. The following were harmonised: (1) banks' mandatory membership of a deposit guarantee scheme; (2) liability of the home deposit guarantee scheme for repayment to depositors of branches established inside the European Community and (3) minimum level of coverage (20,000 Euros), with the possibility of depositors sharing part of the losses (co-insurance) up to a maximum of 10% of covered deposits.

In the wake of the severe bank failures in 2008–09 and "bank runs" in some banking systems (for example, Northern Rock in the United Kingdom (UK)), policymakers saw the necessity to reinforce deposit guarantee systems. The first step towards a comprehensive reform was Directive 2009/14/EC of 11 March 2009. This remedied some critical aspects of Directive 94/19/EC and achieved greater convergence between DGSs. The level of coverage was gradually raised to 100,000 Euros and the payout time frame was significantly reduced to 20 working days.

The worsening financial crisis made it clear that the 2009 regulatory intervention was insufficient to deal with the problems arising. It triggered international debate on a further strengthening of deposit guarantee schemes. In June 2009, the Basel Committee and the International Association of Deposit Insurers (IADI) issued jointly 18 Core Principles (CPs).[5] They brought together international best practices and followed the directions given by the Financial Stability Forum (FSF) in 2008.[6] The Core Principles are a set of guidelines for policymakers for the design or improvement of national deposit guarantee schemes, aimed at increasing the effectiveness of the systems while leaving countries

enough leeway to introduce additional measures to take account of national peculiarities.

To assist an effective application of Core Principles, a methodology was designed to assess compliance of individual systems with the principles.[7] They enjoy high credibility in the international financial environment and have been used by the International Monetary Fund (IMF) in the Financial Sector Assessment Program (FSAP). Following a period of public consultation, the CPs were revisited. Work is still underway on a handbook for conducting self-assessments.

The European Commission, in July 2010, issued a legislative proposal for a new directive amending the 1994 Directive.[8] This followed on recommendations by the Financial Stability Board (FSB) and the Basel Committee. The aim was to reinforce further consumer protection and confidence in financial services. The proposal put forward: (1) simplification and harmonisation of coverage and depositor payout; (2) further reduction of the payout time frame; (3) improvement in DGSs's access to information on member banks and (4) making deposit guarantee systems more solid and credible via a wider funding mechanism (a mixed approach of ex ante plus ex post) including mutual borrowing between DGSs.

At the end of the 1990s and beginning of the 2000s, the European Commission issued a number of directives to bolster the EU legislative framework on crisis management in the financial sector.

Specifically:

i) Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings.
ii) Directive 1998/26/EC on settlement finality in payment and securities settlement systems. Its aim is to ensure stability in payment, clearing and transfer carried out in official systems of payment and securities settlement systems, even in the case of insolvency proceedings of a participant in the system. This results in a reduction of risks deriving from the situations of participants and from the individual contracts.

It lays down specific rules for the protection of settlement systems, specifically, (1) the "final" nature of payment, transfer and clearing orders, even if insolvency proceedings are opened against the participants, the effects of insolvency proceedings will not be retroactive on the rights and obligations of the participants themselves; (2) the ability of the systems to dispose directly of the participant's cash and securities

subject to insolvency proceedings and (3) the isolation of the rights to collateral in securities, received by a participant in the system or central banks, from the effects of insolvency proceedings on the party giving the collateral.

iii) Directive 2002/47/EC on financial collateral arrangements. The new legislation introduces, alongside the traditional figure of the pledge (in its various forms of irregular pledge, floating and revolving pledge), new types of financial guarantees. These include contracts for the transfer of property having a collateral function, and the transfer of credit, including repurchase agreements. It is also expressly recognises the validity of the "close-out netting" agreements.[9]

The resulting legislation makes dealings between debtor and creditor more fluid through: (1) the simplification of formalities for the establishment and enforcement of the guarantees given in favour of intermediaries; (2) the provision of the right, granted to the pledgee, to use and dispose of the financial assets of the guarantees and (3) the prediction of a favourable treatment of collateral in the event of the opening of insolvency proceedings against the debtor. Further, it includes specific derogations of insolvency legislation to protect the lender in case of insolvency proceedings being opened. These exceptions relate to, among other things, the replacement and integration of the collateral during the relationship, in order to exclude novation of the guarantee and, therefore, limit the scope for the exercise of revocation actions.

3 The answer to the financial crisis: the Banking Union project

The breadth and depth of the financial crisis and the difficulties encountered in managing insolvencies of systemically important intermediaries with cross-border activity made it clear that laws for European banking crises had to be drastically overhauled. The Directive 2001/24/EC on the reorganisation and winding-up of credit institutions, in particular, proved incapable of effectively regulating the complex crises that could arise in a financial system in rapid evolution and expansion. The inadequacies of mutual recognition and coordination based on national procedures – the cornerstones of the Directive – became very clear very quickly and it became obvious that a new transition was needed to a system based on the harmonisation of rules and the centralisation of powers and tools of intervention.

Bank failures in the USA and Europe at the height of the crisis highlighted a new critical issue, namely the difficulty of managing crises that affect large banks. The term 'too big to fail' entered our vocabulary: this referred to banks that were big and too interconnected to be allowed to fail because of the likely knock-on effects, so governments, central banks and supervisory authorities were forced to bail them out with public funds. The cost of the crisis, then, rather than being charged to appropriate stakeholders of the insolvent bank, was at the expense of the taxpayer. Further, these banks, being cross-border in scope, had to be dealt with in the absence of a clear framework of centralised management or at least one that was effectively coordinated.

The Memorandum of Understanding on Cross-Border Financial Stability came into force in June 2008. It introduced common principles for the management and resolution of systemic financial crises and new procedures to strengthen coordination. Pursuant to the Memorandum, specific Domestic Standing Groups were created for each country, with the participation of the Ministries of Finance and all supervisory authorities involved in financial stability issues. Cross-Border Stability Groups (CBSGs) were also, set up to: (1) enhance cooperation between supervisors, central banks and Ministries of Finance and to help home and host authorities to make joint impact assessments of a systemic crisis on banking groups and financial markets; (2) provide mechanisms for information sharing and (3) achieve effective coordination of interventions. The CBSGs also established ex ante criteria for burden sharing, taking into account the specific characteristics of the banking group.

Banking is a highly integrated industry. However, in crisis it had to rely on national-level crisis management regulations. The situation was not conducive to safeguarding financial stability, to ensuring the continuity of essential banking functions or to avoiding costs for taxpayers. The failure of Lehman Brothers is a clear example of the weaknesses in the international banking and legal framework. Opening insolvency proceedings in every country in which subsidiaries were established, in a climate of uncertainty about which rules should apply, with differences in the treatment of creditors and a lack of coordination and unitary management, proved severely limiting.

The financial crisis deepened again in the autumn of 2011 and gave a new impetus to the efforts to revise European financial supervision and crisis management architecture. Conviction of the need to abandon the logic of decentralised and fragmented decision-making became more clearly established. The search was to find out increasingly integrated organisational solutions in order both to increase the effectiveness and

efficiency of actions taken and to reduce costs. Under pressure from public opinion, lawmakers insisted that the taxpayer should never again carry the costs of bank failures. This clearly moved the focus and costs for rescue towards the participation of the private sector. A new legal framework for managing banking crises began to take shape and to fit coherently – as a fundamental element – within a broader project that would strengthen the integration process and establish a new for of European governance for the financial sector.[10] The concept of the Banking Union was born, a new, broadly based regulatory and institutional framework.[11] It is a response to the complex issues raised by the severe financial crisis and its fall-out, particularly focused on the vicious mechanisms that link sovereign debt crisis and banking crisis.

The Banking Union is an essential element in the process of economic and financial integration in the Eurozone. It rests on three pillars:

(i) the Single Supervisory Mechanism (SSM), entrusted to the European Central Bank and to the national supervisory authorities;
(ii) the Single Resolution Mechanism (SRM);
(iii) a Single Deposit Guarantee Scheme.

The Banking Union aims to achieve many objectives:

(a) break the vicious circle between sovereign risk and banking risk. The crisis has revealed an unhappy relationship between the sovereign

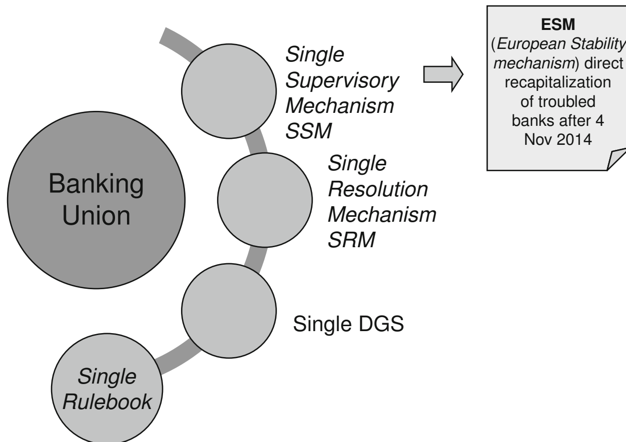

Figure 1.1 Banking Union: three pillars and a single rulebook

risk perceived by the market with regards to the weaker economies (large public debt) and funding conditions for banks located in those countries. The vicious circle operates in two directions:

(i) from banking risk to sovereign risk. Problems arising in the banking sector had a negative impact on the public debt, through banks bail-outs made with public money;

(ii) from sovereign risk to banking risks: budget problems (such as deficit and debt levels) resulted in negative effects on banks' balance sheets because of the decline in the value of government securities in their portfolio and the higher cost of funding;

(b) diminish the fragmentation of the banking market in Europe, given the increasing spreads in access to financial markets by national banking systems. During the crisis this was a hindering factor for the effectiveness of monetary policy;

(c) adjust the structure and rules of banking supervision to match the significant changes happening in banking systems, that is, the growth of intermediaries to pan-European size and operations, and to remove obstacles on a national basis like surveillance systems and ring-fencing in difficult situations. The goal, then, is to establish a system of common controls and shared methods and structure and to bring in supervisory responsibility more in line with the territorial practice of crisis resolution;

(d) facilitate comparison between banks and banking systems in different countries.

Banking Union has a key role to play in strengthening the single market and in the pursuit of an effective European Monetary Union.[12] The full benefits of the single market are obvious to all: increased efficiency, competition, lower cost of intermediation and greater risk diversification. The European Stability Mechanism (ESM) also furthers this goal in its aim to recapitalise banks either directly after the entry into force of the Single Supervisory Mechanism, or indirectly through financing to Member States. A recent study has tried to estimate the reduction of spillover effects on the economy associated with Banking Union. The study shows that during the financial crisis the application of the new instruments for resolution (e.g. bail-in, resolution funds, ESM) could have reduced losses by 30–40% in "periphery" countries and by 10–40% in the Eurozone as a whole.[13]

A common set of rules for all banks, however, remains a *sine qua non*. The definition of a more effective institutional framework, based on

the centralisation of decision-making would not in itself be sufficient to ensure an effective Banking Union. The Single Rulebook has been designed as a single set of laws and secondary implementing regulations for the financial sector. It has crucial importance in filling in gaps and weaknesses in regulations and in ensuring a level playing field for banks and, consequently, a more effectively operating single market.[14]

The Single Rulebook sets out: a more robust framework of prudential requirements (CRD IV and CRR, based on the Basel III accord in Europe[15]); harmonised tools for bank resolution (Bank Recovery and Resolution Directive (BRRD)) and a strengthening of the deposit guarantee schemes (via amendments to the Deposit Guarantee Schemes Directive (DGSD)). The European lawmakers' intentions are to strengthen prudential regulation in order to reduce the possibilities of a recurrence of another major crisis and – with the new rules on crisis management – to reduce the systemic impact of defaults and ultimately minimise the costs of a crisis for stakeholders. The goal is to create a more resilient, transparent and efficient banking system.

The primary legislation (Regulations and Directives) gives EBA a central role in building the Single Rulebook. EBA issues Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS). These standards are binding, are directly and immediately applicable to all Member States and aim to ensure the effective harmonisation of rules and their consistent application within the Union.

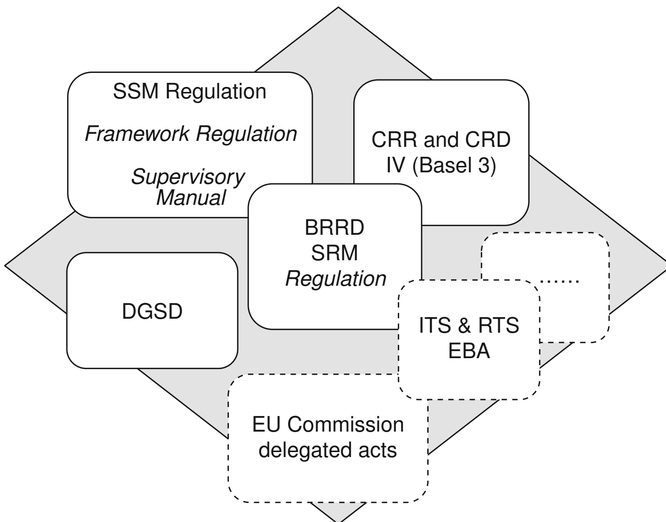

Figure 1.2 Banking Union: the single rulebook

2

The First Pillar of the Banking Union: The Single Supervisory Mechanism

1 The evolution of banking supervision at the European level

Recent decades saw a significant consolidation and internationalisation of the banking sector at the European level. This resulted in profound changes in banks' organisational, operational and distribution structure. The growth of cross-border and cross-sector intermediaries opened a gap between international markets and national rules and structures for banking supervision. This had serious consequences for the efficiency and effectiveness of controls. The situation became even more critical in situations in which intermediaries were operating in a group where entities had independent legal status in the various countries of settlement.

Banking supervision has a purely national dimension. This has fuelled the debate around the institutional framework of banking supervision and the identification of which authority should be given supervisory powers. This is one of the most interesting and delicate issues of economic public law. It involves the forms and methods of financial sector regulation (markets, intermediaries, market infrastructures) in a context of continuous and rapid development of the sector as objectives set by policymakers evolve. Intensifying market integration, internationalisation of intermediaries and competition between legal systems over the efficiency and effectiveness of controls have also increased debate on theoretical models of regulation and control.

Theoretical debates and their results did not produce an optimal model of supervision. Each institutional design remains characterised by its own strengths and weaknesses. All if these have to be carefully

considered to find out an appropriate balance between the many objectives (see Box 1).

Advances towards completing the single European market for financial services ignited debate on the adequacy of the institutional model of banking and financial regulation and supervision at the European level. It still strictly centred itself on the autonomy of competent national authorities and on a system of co-operation and information sharing between them. Many initiatives on European co-operation have been taken at different levels since 2000. They aimed at achieving greater harmonisation of rules and supervisory practices, enhancing the effectiveness of controls and reducing the burden on the subject supervised. However, European legislators and regulators lacked a unitary logic. Their approach was still tightly pegged to the national dimension of supervision; they were far from a vision of greater integration through an upwards devolution of national powers to the European authorities.

In a way, the maximum harmonisation of rules and controls meets the interests of the financial industry itself, to the extent that it reduces the costs of compliance that intermediaries carry in relation to the diversity of the rules in force in the different jurisdictions in which they operate. The deficiencies and weaknesses of prudential regulation and supervision at the European level came to light fully with the 2008–09 financial crisis. The shock triggered a process of change that would have been unimaginable only a few years earlier.

A brief look at the milestones in the evolution of European regulation gives a clear idea of the scope of the reform process underway. Three stages can be identified.

1.1 The first phase: the reform of regulation procedures (the Lamfalussy system) and the logic of co-operation and coordination in banking supervision

The EU reform process began with significant simplification and rationalisation of the way in which the financial rules are drawn up. This was the Lamfalussy Process.[1] It was introduced in 2001 to support harmonisation of the measures envisaged by the Financial Services Action Plan for the integration of EU financial markets: convergence of legislation, coordination and consistency of supervisory practices, international co-operation and exchange of information.

The new regulatory system initially involved the securities sector and was later extended to banking and insurance. It has four levels:

i) Level One: primary legislation (directives and regulations) that sets up the legislative framework containing general regulatory

principles. The regulatory process is governed by the EU Treaty, according to which the development of legislative proposals is entrusted to the Commission. Groups of national experts have been set up at the Commission and the Council level to provide support. The approval of the draft legislation is through a co-decision procedure involving the Council and the European Parliament.[2]

ii) Level Two: this is the secondary legislation needed for implementation of first-level legislation (that is, technical measures for the implementation of Directives). This is a more flexible and lighter procedure called "Comitology", a legislative power entrusted to the European national experts (representatives of the supervisory authorities). There are separate committees for the banking, securities and insurance industries, with representatives of the economic and finance ministries. The Council can take action to resolve any conflicts that arise between the committees and the Commission.

iii) Level Three: these are technical committees. They are composed of representatives of the supervisory authorities for banking, securities and insurance sectors. They advise the Commission on drafting first- and second-level legislation and coordinate supervisors to ensure uniform and consistent implementation of first- and second-level legislation. They monitor the implementation of standards and promote convergence of supervisory practices.

iv) Level Four: this is the power of the Commission to verify that rules are consistently applied by the EU Member States.[3]

The Lamfalussy Process was positively received. However, there was some criticism about the functioning of the different levels and how they interacted. Some revisiting was considered in order to enhance the technical contribution of the level-three Committees (that is, majority voting, and strengthening its legal status and mandate). Some extreme proposals included the transformation of the Committees into agencies as a first step towards the centralisation of supervisory functions at the European level. However, the reform of the regulatory process in the financial sector did not change the allocation of responsibility for the exercise of banking supervision, which still remained firmly anchored in the national authorities.

For cross-border banks, the existing regulatory framework included a substantial allocation of responsibilities between home and host country authorities. This depended on whether cross-border banking groups operated as branches or subsidiaries. Specifically, prudential supervision powers over a cross-border bank or banking group (consolidated

supervision) were attributed to the home authority in the case of branches (home country control) and to local authorities (host country control) in case of subsidiaries. The home authority, responsible for consolidated supervision of the group, was called to play a coordinating role among the different authorities in charge of the supervision of individual members of the group.

The regulations on bank capital adequacy introduced with EU Directives 2006/48 and 2006/49 (Basel 2 - CRD) significantly strengthened the home supervisor. The Directives gave the authority responsible for supervision on a consolidated basis (Consolidating Supervisor) specific powers to coordinate the supervision of cross-border groups. In particular, the Consolidating Supervisor could give precedence to its own decisions over those of the other authorities involved in matters of the prudential validation of internal systems adopted by the group for measuring credit, market and operational risks and for the calculation of minimum capital.

The Capital Requirements Directive (CRD) Article 129 sets a period of six months for the completion of the validation process following an instance of the use of advanced internal models made by the EU parent company and its subsidiaries. The home authorities were given the roles of leadership and coordination of the evaluation process for the purpose of reaching a joint decision. If there is no disagreement, the final decision is attributed to the supervisor of the parent company.

The Directive envisages an architecture for co-operation between home and host authorities for emergency situations that threaten financial stability (Article 130). The authorities could conclude written agreements on coordination and co-operation, allowing the possibility of delegating supervisory functions to the authority responsible for supervision on a consolidated basis, and setting procedures for the decision-making process (Article 131) and provisions for the exchange of information essential for the exercise of supervisory functions over the group (Article 132).

At the operational level, Colleges of Supervisors were set up between the supervisory authorities of the countries in which the groups operated to coordinate and co-operate between home and host authorities. Moreover, specific operational networks were created to reduce divergences in the implementation of CRD for multinational groups and to promote the identification of pragmatic and homogeneous solutions in supervisory action. The results were significant in terms of coordination of supervisory activity over groups. However, this institutional framework was not considered the most effective in the face of the increasing

integration of operators and markets. Possible developments are mainly related to three models:

i) Extension of consolidating supervisory powers to aspects related to the supervisory review process (Basel Pillar 2) and to the disclosure (Pillar 3);
ii) Establishment of an inter-sectoral authority, having a federal structure like the European System of Central Banks (ESCB) model, in which the supervisory authorities of the Member States are supported by an EFA (European Financial Authority) responsible for the supervision of cross-border intermediaries. Consequently, the responsibility for supervising domestic operators is left to national authorities (a two-tier system).
iii) Attribution of the full responsibility for prudential supervision, including liquidity issues, of cross-border banking groups to the consolidated supervisory authority (lead supervisor).

This model would have involved the extension of the decision-making powers of the lead supervisor and required specific legislation for its adoption. Similar results might have been achieved through the adoption of the Statute for a European Company by individual banking institutions (EC Regulation no. 2157/2001 in effect as from October 2004), which implies the transformation of all subsidiaries into branches and consequently would make them subject to home country supervision.

1.2 The second phase: strengthening international co-operation and the creation of European supervisory bodies (De Larosière project)

The financial crisis of 2008–09 reopened the debate on, and initiatives towards, broad banking reform in Europe. Two paths were the harmonisation of rules and a new architecture for European supervision.

In the full turmoil of the crisis, it became abundantly clear that the existing regulations, structures and means for tackling banking crises could not cope. A more sophisticated regulatory regime of objectives, rules and tools was demanded.

Clearly, a more advanced legislative framework for crisis management would need to be strictly linked to the consistent development of the institutional set-up of banking regulation and supervision.[4]

The debate led to the De Larosière Report,[5] a design for a new institutional architecture of banking supervision. The report tracked new arrangements for strengthening macro- and micro-prudential

supervision of cross-border banks. It also outlined new European authorities for closer co-operation in the regulation and supervision of cross-border financial institutions. In the new legal framework, supervision continues to be entrusted to national authorities, as is the case with the fiscal responsibility of the Member States.

The new institutional supervisory framework was approved by the European Parliament in 2010. A number of Regulations set up the *European System of Financial Supervision* (ESFS), consisting of the *European Systemic Risk Board* (ESRB) and the *European Supervisory Authority* (ESA), responsible for macro- and micro-prudential supervision, respectively.[6] It was a reform of historical importance: for the first time it was decided to allocate supervisory powers at the European level, even if not in absolute terms. The choices adopted were a compromise, which was fully acceptable given the differences in the approaches of the various countries entrusted with the responsibility.

The European Systemic Risk Board has macro-prudential supervisory functions. This is the most important innovation in the new institutional design. Macro-supervision is divided into three areas: risk analysis, early warning and action. However, in the last area the Board does not have powers to impose measures on Member States. The Board is composed of a General Board (61 members) and a Steering Committee. It has scientific and technical advisory committees, in which national central banks, supervisory authorities and Community institutions

Figure 2.1 European System of Financial Supervision (ESFS)

may participate. The European Central Bank (ECB) provides logistical and technical support.

The specific task of the ESRB is to identify areas of potential systemic risk, that is "a risk of disruption of the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of intermediaries, markets and infrastructure may be potentially systemically important to some degree" (Article 2 Regulation 1092/2010). It issues warnings on those aspects that require intervention by the regulatory and supervisory authorities. It has responsibility for monitoring the implementation of the necessary measures to resolve the problems identified. Risk assessment activity is carried out in coordination with the Colleges of Supervisors. It has no direct enforcement powers, but acts through other European and national authorities. It actively co-operates with the European Supervisory Authorities to ensure that macro-prudential assessments are reflected in micro-prudential supervision at the single institution level.

The European Supervisory Authorities (ESAs) include three new authorities, for the banking, finance and insurance sectors, respectively. The banking sector authority is the European Banking Authority (EBA), which is composed of national banking supervisors.[7] The three authorities work together in the Joint Committee, a forum with the purpose of strengthening co-operation between the three ESAs and ensuriing permanent information sharing and consistency of supervisory practices. More specifically, the Joint Committee's areas of activity are: supervision of financial conglomerates, accounting and auditing, micro-prudential analysis of cross-sector developments, risks and vulnerabilities for financial stability, retail investment products and anti-money-laundering measures. Major areas are information sharing with the ESRB and promoting of relations between it and the three European Supervisory Authorities.

Day-to-day supervision of banks remains the responsibility of national supervisors. However, the European Banking Authority (EBA) has a multiplicity of functions in banking supervision and is assigned other various roles, mainly in regulation. Specific tasks are to:

i) Build a single rulebook and ensure its application. The Single Rulebook contains common technical standards (Articles 10 and 15), aimed at ironing out differences in the interpretation and application of European legislation. These are Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS). They

are adopted via Commission regulations and are, therefore, directly binding.

ii) Ensure consistent application of EU rules, through harmonised national practices and peer reviews of national authorities with the power to issue guidelines addressed to the National Supervisory Authorities (Article 16). These guidelines are not mandatory but inspired by the principle of "comply or explain".

iii) Strengthen supervision of cross-border groups through participation in the Colleges of Supervisors. The EBA aims to simplify information sharing and promote convergence between the Colleges in applying the European rules.

iv) Coordinate Stress Tests at the European level to gauge financial institutions' resilience to adverse market developments.

v) Build a centralised European-level database by collecting all microprudential information.

vi) Ensure a coordinated response by national supervisors in crisis situations by using its power to act in emergencies. Where coordination is insufficient, the EBA may require national supervisory authorities to act, too, but without affecting the fiscal responsibilities of the Member States.

vii) Promote transparency, simplicity and fairness for consumers of financial products or services in the internal market.

1.3 The point of arrival: the centralisation of supervisory functions (the Single Supervisory Mechanism)

The institutional structure created following the De Larosière Report was a significant milestone for integration of EU financial regulation and supervision. However, it was only a halfway point and set the conditions for a more complete integration of supervision.

At the end of the road is the Single Supervisory Mechanism, introduced by EU Regulation no. 1024/2013 of 15 October 2013.[8] The SSM marks the transition from the traditional principles of co-operation and coordination between national authorities to a centralisation of supervisory functions for the Eurozone.

Recital 5 of the Regulation clearly states the change of approach: "coordination between supervisors is vital, but the crisis has shown that mere coordination is not enough, in particular in the context of a single currency. In order to preserve financial stability in the Union and increase the positive effects of market integration on growth and welfare, integration of supervisory responsibilities should therefore be enhanced. This is particularly important to ensure a smooth and sound

overview over an entire banking group and its overall health and would reduce the risk of different interpretations and contradictory decisions on the individual entity level."

The transition has its basis in the principles of subsidiarity and proportionality set out in the EU Treaty (Article 5). Recital 87 of the SSM Regulation is clear: the creation of an efficient and effective regulatory framework for the exercise of specific supervisory tasks by an EU institution, ensuring the uniform application of a single set of rules, can be best effective at an EU level because of the pan-European structure of the banking market and the cross-border impact of a possible failure. Moreover, the Regulation does not go beyond what is necessary to achieve the objectives set out in it.

2 The Single Supervisory Mechanism: the legal and institutional profiles

The Single Supervisory Mechanism gives to the ECB responsibility for banking supervision over the Eurozone banks, in co-operation with the National Competent Authorities (NCAs). EU Member States outside the Eurozone may opt in on a voluntary basis, by means of close co-operation agreements.

The legal basis used for the SSM is Article 127 (6) of the Treaty on the Functioning of the EU (TFEU). It provides the Council with the ability, by means of unanimously adopted regulations and after consulting the European Parliament and the ECB, to confer upon the ECB specific tasks relating to prudential supervision on banks and other financial institutions (excluding insurance corporations).[9]

The Single Supervisory Mechanism does not have legal personality. Powers and supervisory decisions are allotted to the ECB and the national supervisory authorities in accordance with the responsibilities set forth in the SSM Regulation. The general criteria for allocating micro-prudential decisions, sanctions and interventions refer to whether the bank is More Significant or Less Significant. In the new structure, the costs for carrying out supervisory functions are carried by the supervised banks.[10]

Monetary policy and prudential supervisory powers both lie with the ECB. Many countries (including Italy) combine monetary policy and supervisory powers in the central bank. The model is well tested particularly in terms of the central bank's independence in carrying out the two functions.

The ECB is also endowed with macro-prudential tasks and tools (Article 5). In the exercise of its macro-prudential tasks, the ECB takes into account the specifics of the financial system, the economic situation and the economic cycle in the individual Member States or parts of them. It may act, in place of the national authorities, to impose more stringent capital requirements than those required at the national level (capital buffer or stricter measures designed to tackle systemic risks). The NCAs may also have recourse to macro-prudential measures but notify the ECB, or propose to the ECB such measures required to cope with a specific situation arising in the financial system and the economy of the home country (that is, operating in a system of parallel powers). Article 6 of Regulation 1024/2013 stipulates close co-operation between the ECB and national authorities, on the principle of co-operation in good faith and the obligation to exchange information.

The Single Supervisory Mechanism is not merely an upwards devolution of powers from national authorities to the European authorities. It is a new system for the joint exercise of supervisory powers based on the philosophy of EU integration. It also fosters homogeneous rulesand practices, together with high qualitative standards. The quality of European supervision will depend greatly on the contributions of the National Competent Authorities, which can benefit from long years of experience in matters of supervision.[11] The SSM applies a set of harmonised prudential rules to all financial institutions operating in the single market, such as CRD IV and the Capital Requirements Regulation (CRR), two essential components of the Single Rulebook.[12]

2.1 The division of responsibilities between the ECB and national supervisory authorities

The division of responsibilities between the ECB and national competent authorities is defined by the Regulation (Article 4) and is further specified by secondary implementing regulation.

The tasks conferred upon the European Central Bank exclusively relate to: (1) authorising credit institutions and withdrawing authorisations; (2) assessing notifications and disposing of qualifying holdings in banks; (3) ensuring compliance with the prudential requirements concerning own funds, risk concentration, liquidity and leverage; (4) imposing prudential requirements higher than the minimum and capital buffers (First Pillar requirements); (5) verifying the adequacy of banks' corporate governance arrangements, organisation and internal control mechanisms; (6) carrying out supervisory reviews (Second Pillar) and defining the contents of disclosure to the public (Third Pillar); (7) carrying out stress

test exercises, where appropriate in coordination with the EBA and (8) conducting supervision on a consolidated basis over the parent company and supplementary supervision over financial conglomerates.

The ECB's centralised supervisory functions in crisis management are critical. They include analysis, evaluations and decisions pertaining to the preparatory phase of the management of problematic situations. This is outlined in the new regulatory framework, a combination of the SSM Regulation (Articles 3, 4, 5 and 9), the Directive on Bank Recovery and Resolution (BRRD) and the Regulation on the Single Resolution Mechanism (SRM). The Supervisory Authority has powers in the preventative phase, including the preparation of recovery plans and reaching agreement on group financial support, in coordination with the Resolution Authorities. It also has early intervention powers, in case of non-compliance or potential non-compliance with prudential requirements and powers in the starting phase of resolution.

The ECB has supervisory disclosure, inspection and sanctioning powers to carry out the broad functions entrusted to it. A new peculiarity is that the new institutional architecture of supervision clearly marks the boundaries between the powers of the ECB and those of the national supervisors. There is a high concentration of responsibility on the ECB's shoulders, but the overall system is based on a significant involvement of National Competent Authorities in both decision-making and the exercise of supervisory tasks, with a broad use of delegation for non-systemic banks. In all, the structure strikes an appropriate balance between unity of the system and operational decentralisation.

The articulation of powers and supervisory tasks and the definition of terms and procedures for the exercise of the supervisory activity are assigned to a "Framework Regulation", which came into effect on 15 May 2014.[13] It was issued by the ECB on the basis of a proposal from the Supervisory Board. It is accompanied by the "Supervisory Manual". The two documents provide the general reference framework for the exercise of supervision, with the aim of ensuring the consistency and effectiveness of the whole system. They created the conditions for the ECB to assume its supervisory functions by November 2014.

The Framework Regulation has its legislative basis in Article 6, paragraph 7, and Article 4, paragraph 3 of the SSM Regulation. It regulates the functioning of the Single Supervisory Mechanism and co-operation between the ECB and the National Competent Authorities in the exercise of supervisory tasks, and specifies the rights and obligations of supervised entities and third parties to the SSM. Other issues are provided for in a more general way, such as: procedures for bank authorisation,

assessment of acquisition and disposal of qualifying holdings, macro-prudential supervision, qualification of the bank as a supervised entity, close co-operation with the supervisory authorities of the countries whose currency is not the Euro and administrative penalties. Finally, it provides general rules on the due process for adopting supervisory decisions (Article 25 *et seq*.).

The operational scheme, outlined and detailed by the Framework Regulation, is as follows:

i) ECB direct supervision, assisted by the national competent authorities, over More Significant Banks and banking groups.

Banks and banking groups are considered "Significant" on the basis of size, importance for the EU economy as a whole or for the economy of the participating Member States and amount of cross-border activity. More specifically, the bank is "Significant" if:

a) the total value of its assets exceeds 30 billion Euros;
b) the ratio between its total assets and the Gross Domestic Product (GDP) of the Member State where it is established is more than 20%, unless the total value of its assets is below 5 billion Euros;
c) it is one of the three largest credit institutions in a Member State;
d) it receives direct assistance from the European Stability Mechanism;
e) the total value of its assets exceeds 5 billion Euros and either the ratio of its cross-border activities in more than one participating Member State over its total assets is more than 20% or the ratio of its cross-border liabilities in more than one participating Member State over its total liabilities exceeds 20%.

Regardless of the above criteria, the SSM can still designate a bank as "Significant" in order to ensure consistent application of high quality supervisory standards.

The verification of the requirements for the classification of a bank as more significant is carried out at least once a year by the ECB (Article 43, Framework Regulation). The National Supervisory Authorities will review the situation of "less significant" banks and groups with the same frequency, to check whether the conditions for ECB direct supervision are fulfilled.

Direct supervision by the ECB extends to 120 banking groups, corresponding to approximately 1,200 supervised entities, which represent 85% of the assets of the Eurozone banking system.[14]

ii) Decentralised supervision by the National Competent Authorities on smaller banks (Less Significant banks; about 3,700 banks in the Euro area) is carried out based on the guidelines set by the ECB.

The ECB retains, however, the power to claim supervisory tasks over decentralised banks and directly supervises all banks subjected to support programmes.

In particular, the National Supervisory Authorities have preliminary and preparatory tasks to help the ECB to make decisions; they participate in the decision-making process on supervisory issues through attendance at the Supervisory Board. The Supervisory Board is responsible for the preparation of decisions to be submitted to the Governing Council of the ECB. In addition, the National Competent Authorities carry out day-to-day verification, given their advantages of proximity with intermediaries and the experience of their staff.

Finally, the National Competent Authorities retain the following tasks: (1) exclusive regulatory and supervisory responsibility on all matters other than prudential supervision (such as transparency, fairness of customer relationships, money-laundering, usury, interlocking directorates); (2) supervision over intermediaries other than banks (such as investment firms, asset management companies, electronic money institutions, payment institutions and, ultimately, trust companies, etc.); (3) supervision over payment services; (4) overseeing banking activities on financial instruments markets and (5) supervision of banks from third countries operating in the EU through branches or under freedom to provide services.

The division of responsibilities does not apply to certain procedures, such as bank authorisation, revocation and the acquisition of significant holdings in banks. In these cases, the competence is conferred on the ECB as the authority responsible for the entire system, as well as for the sake of uniformity.

The Supervisory Manual aims at the convergence of supervisory practices and (off-site and on-site) methodologies, as well as verification of the correct implementation of the tasks performed at a decentralised level.[15] In particular, the Manual governs the operational processes, procedures and methods of bank supervision, both centralised and decentralised, and the procedures for close co-operation between the SSM and the supervisory authorities of the EU Member States that do not participate in the SSM. The Manual aims to harmonise national approaches to supervision; currently they can be very different from a structural and functional perspective.

The Supervisory Manual is accompanied by a "Guide to Banking Supervision".[16] It provides practical guidance on the characteristics, tasks and processes of the Single Supervisory Mechanism and helps stakeholders in the preparatory phase.

As part of its supervisory guidance, the ECB has its own model for analysis and assessment of banks (Risk Assessment System (RAS)) and defines the rules for regulatory reporting by banks. Quality and completeness of reporting are prerequisites for the effective supervision of intermediaries. To this end, the SSM will use the standard information provided by the EBA Implementing Technical Standards on Common Reporting (COREP), Financial Reporting (FINREP) and Non-Performing Exposures (NPE).

Another goal of the SSM is to enhance and rationalise supervision on a consolidated level. In the new framework, the ECB both acts as the consolidating supervisor for the Colleges of Supervisors of cross-border banking groups having the parent company within the SSM and is the participating supervisor for the Colleges of Supervisors related to cross-border banking groups having the parent company outside of SSM.

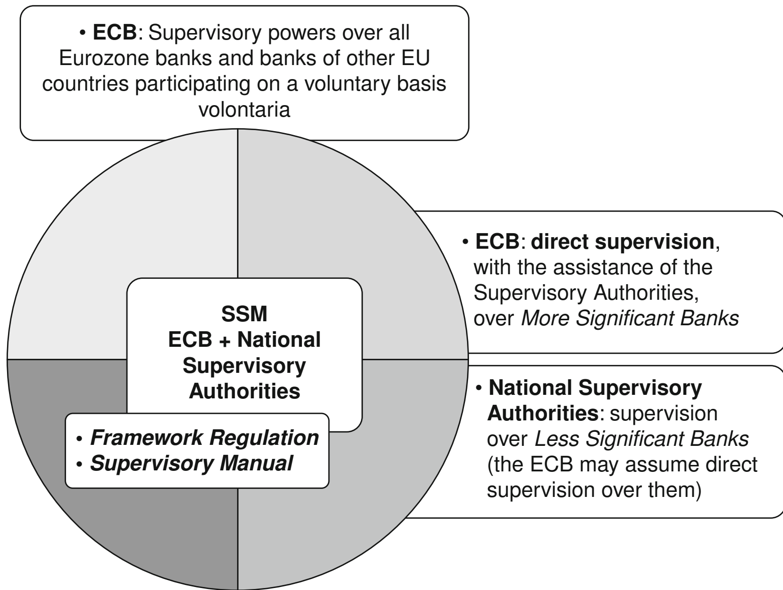

Figure 2.2 Single Supervisory Mechanism

2.2 The potential conflict of interest between supervisory and monetary policy functions: the independence and separation principles

A critical issue with the conferral of direct supervisory tasks on the ECB is the possible conflicts of interest that could arise when monetary policy and banking supervision are jointly exercised. An extensive debate developed on this issue in the preparation phase of the reform. This is a typical problem that all central banks performing supervisory functions have, and different institutional and organisational solutions have been adopted in the various systems.

The Regulation establishing the SSM provides for specific principles and rules on the matter. First, Article 19 states the independence principle in general terms: the ECB and the National Supervisory Authorities are required to observe independence in their work inside the framework of the SSM. The Regulation provides that the bodies of the SSM act independently and objectively (*vis-à-vis* the institutions and bodies of the Union, the national governments and other public and private counterparties) in the interests of the Union as a whole. This independence requirement is closely associated with the separation principle of supervision from monetary policy functions. Under Article 25, the ECB is obliged to pursue only those goals set by the SSM Regulation in the exercise of its supervisory duties, carry out its tasks without prejudice to monetary policy tasks and ensure the separation.

First, the separation principle is expressed in the attribution of the supervisory responsibility to a newly established body, the Supervisory Board. It is internal to the ECB and autonomous (Article 26). The Supervisory Board is a body composed of a chairman and a vice-chairman, four members elected by the ECB Governing Council (provided that they are not directly involved in monetary policy tasks), a representative of the National Competent Authorities of each Member State of the Eurozone and one from the other EU countries that are both "in close co-operation" with the SSM and given full participation and voting rights. A representative of the Commission may, upon invitation, attend the meetings of the Supervisory Board as an observer, but without being accorded access to confidential information on banks.

There is a Steering Committee inside the Supervisory Board. It has a more restricted composition (no more than ten members) and it guarantees appropriate balance and rotation among national supervisors. It assists the Supervisory Board in its activities, including the preparation

of meetings. It does not have any decision-making powers. The bodies are regulated by the ECB Rules of Procedure.

In practice, the separation of Supervisory Board and Governing Council is achieved through a delicate balance of power between them. The distinction of the functions is very important.

The Supervisory Board plans and implements supervisory tasks. It is mainly technical in nature: conducting investigations and making proposals on the supervisory decisions. The ultimate responsibility for supervisory decisions rests with the Governing Council. To entrust this power to the Supervisory Board would have required an amendment to the Treaty.

The decision-making process strengthens the separation between the two functions. Specifically, the Supervisory Board performs the preparatory activities for the supervisory tasks conferred on the ECB and proposes its draft decisions to the Governing Council. These draft decisions are at the same time transmitted to the supervisory authorities of the Member States concerned. The Governing Council takes the final decisions through a procedure of tacit consent, that is, a draft decision is considered approved if, within a predetermined time limit (not exceeding 10 days or 48 hours for an emergency), the Governing Council does not raise any objections (Article 26, paragraph 8).

If the Governing Council raises objections, it is required to give its reasons in writing making particularly reference to monetary policy issues. Equilibrium is achieved through the provision that the Council cannot enter into the merits of the proposals and that any disagreements can be returned for judgment of a group of experts for mediation (Mediation Panel).[17]

Finally, the combined provisions of Article 26, paragraph 8 and Article 7, paragraph 8, regulate cases in which a non-Eurozone-participating-State does not agree with a draft decision of the Supervisory Board. In this case, within five days of receipt of the project, the State may communicate its disagreement to the Governing Council. The Council, taking into account the reasons, decides on the merits within a further five working days, explaining its decision in writing to the State. The State has an opt-out right: it may request the ECB to terminate its close cooperation with immediate effect and will not be bound by the subsequent decision.

Rules on the functioning of the Governing Council further clarify its separation from monetary policy functions. The ECB ensures that the Council operates in a completely differentiated way with regard to monetary and supervisory functions. Meetings and agendas are strictly

separated (Article 25, paragraph 4). Internal rules further enhance the separation through professional secrecy, pursuant to Article 38 of the Statute of the ESCB and of the ECB and Union laws on the exchange of information (Article 27 of the SSM Regulation).

In taking decisions, the ECB follows normal Rules of Procedure to safeguard the rights of all parties concerned: motivation, the right to be heard and the right of access to documents (Article 22). These procedural guarantees increase as we pass from supervisory measures to sanctions. To guarantee this protection, the European Union Court of Justice exercises full jurisdiction when it comes to sanctions. There is a separation between the investigative and decisional functions – to guarantee due process. Concurrent sanctions may not be applied.

The ECB has established a Special Commission – the *Administrative Board of Review* – to protect the rights of parties (banks, directors, shareholders) affected by ECB decisions. It is a means for internal administrative review of the decisions taken by the ECB in the exercise of its supervisory tasks. The Administrative Board has five independent members with prestige, expertise and long professional experience. They are appointed for five years. The review is limited to procedural and substantial compliance of the decision with the SSM Regulation. The Administrative Board can reach out-of-court settlements (Article 24).

A request for review does not prejudice an appeal to the Court of Justice and does not have suspending effect. However, the Governing Council – as a result of a proposal by the Administrative Board – can rule on such appeals. The review is concluded within a reasonable time frame given the urgency of the matter and, in any case, no later than two months after the request. The Supervisory Board takes into account the views expressed by the Administrative Board and is required to submit a new draft decision to the Governing Council. This repeals the initial decision and replaces it with a decision that is the either same or modified. The new draft decision is considered adopted unless the Governing Council objects within a maximum of ten days.

The independence of administrative authorities is fundamental to all legal systems. It is safeguarded through appropriate checks and balances. The SSM's independence also is ring-fenced by its own set of transparency and accountability rules. It is separate from monetary policy functions. To emphasise this, the status of the Chairman of the Supervisory Board is that of ECB representative for supervisory purposes. Among its provisions, the Regulation requires: (1), the publication by the ECB of an annual report on the execution of supervisory tasks, to be sent to the European Parliament, the Council, the Commission and the

Eurogroup; (2), the participation of the Chairman of the Supervisory Board in public parliamentary hearings at the European and national levels and (3), an inter-institutional agreement between the ECB and the European Parliament on practical arrangements for the exercise of democratic accountability and oversight of the implementation of the supervisory tasks conferred on the ECB.

2.3 Relations with the EBA

In accordance with the SSM, Regulation no. 1093/2010 was amended, bringing the EBA inside the new architecture for supervision.[18] It also set out the new voting procedures.[19] Realigning the functions of the two bodies was not easy. The SSM had been introduced shortly after the establishment of the EBA, significantly changing the framework. In general, the ECB and EBA functions are distinct in the new architecture: the ECB is entrusted with supervisory tasks while the EBA is regulatory.[20]

Regulation no. 1022 of 22 October 2013 gives the EBA important regulatory tasks that contribute to the establishment of an effective Single Rulebook for the EU. EBA issues *Regulatory Technical Standards* and *Implementing Technical Standards*, which are enacted by the EU Commission. They integrate and implement first-level legislation to ensure the necessary convergence of rules and supervisory practices in the European Union. In addition, the EBA might issue guidelines and recommendations to supervisors or intermediaries with the aim of fostering stability and soundness of markets as well as the convergence of regulatory practice. The ultimate goal is to have a common, uniform and consistent application of Union law. The ECB complies with the Regulatory and Implementing Technical Standards issued by the EBA. However, it can contribute to the developments of the technical standards and report to EBA the need to enact new ones.

Regulation no. 1022 also entrusts the ECB with regulatory power, but only to the extent that this is necessary to organise and clarify how it performs its tasks under the SSM Regulation (reference is specifically made to the adoption of the Framework Regulation and Supervisory Manual). In the exercise of that regulatory power, the ECB carries out public consultation and cost-benefit analysis, except in cases of urgency (recital 32 and Article 4, paragraph 3 of Regulation 1024/2013). The need for a clear distribution of responsibilities and effective coordination between the two authorities is widely felt. It is necessary to avoid both overlapping functions and gaps in regulation and intervention. Coordination is ensured by the participation of a representative of the

ECB Supervisory Board on the EBA Board of Supervisors, albeit without voting rights.

The roles of the two authorities deserve further study, especially with regard to banking supervision. The consequences arising from both the different scope of functions and the different scope of application of the same functions (the EU countries, for the EBA; countries participating in the SSM, for the ECB) need to be investigated more fully. Theorists have already begun reviewing this delicate issue, even making proposals.[21] Checks were recently conducted by the bodies of the Union in order to evaluate the performance of the EBA within the new regulatory and supervisory framework.[22]

2.4 The organisation of shared supervision

From an organisational perspective, the supervision of More Significant Banks is exercised by special structures created by the ECB at the central level: these are the *Joint Supervisory Teams*.[23] Co-operation between the ECB and the National Supervisory Authorities and the dialogue with the supervised entities is achieved in the Teams. They are entrusted with the duties of supervision and implementation of the decisions taken by the Supervisory Board and the Governing Council.

The Joint Supervisory Teams consist of staff of the ECB and the National Competent Authorities under the coordination of the ECB. The composition of the Teams will depend on the specific characteristics of the bank/banking group in question, with the goal of being able to have recourse to the same information on the intermediaries as the NCAs. Members of the national authorities will continue to participate in the processes of inquiry and evaluation on More Significant Banks. Controls on “Less Significant Banks” are carried out by the National Competent Authorities.

The tasks of the Joint Supervisory Teams include the supervisory review and evaluation process (SREP) of the Significant Bank or banking group supervised (Article 97 of CRD IV)[24]. The SREP requires the Teams to review the arrangements, strategies, processes and mechanisms implemented by banks to comply with prudential requirements. The frequency and intensity of the review depends on size, systemic importance, nature, extent and complexity of the bank’s activities. The principle of proportionality is taken into account.

The SREP has three main areas of interest:

i) Risk Assessment Systems (RAS), which assesses the levels of banks’ risk and their risk controls;

ii) review of the Internal Capital Adequacy Assessment Process (ICAAP) and of the Internal Liquidity Adequacy Assessment Process (ILAAP) made by banks;
iii) methodologies to quantify the need for capital and liquidity on the basis of the results of the risk assessment.

Actions against supervised banks also are harmonised at the European level and are within the competence of the ECB. They include a wide range of measures, that is, to:

i) impose more stringent capital requirements;
ii) strengthen the organisational set-up;
iii) restrict certain activities;
iv) prohibit profit distribution;
v) impose additional or more frequent reporting requirements;
vi) remove managers who do not meet the requirements set by the legislation (Article 16, paragraph 2).

These sanctioning powers are shared between the ECB and the national competent authorities. The ECB applies pecuniary penalties for violations of directly applicable European laws (regulations); National Competent Authorities have the power to impose sanctions (other than pecuniary) against bank managers for violations of provisions not directly applicable (Directives).

2.5 The preparatory stage of the SSM

Before starting the SSM and the assumption of responsibility for microprudential supervision by the ECB, a full and thorough *Comprehensive Assessment* was carried out in accordance with SSM Regulation Article 33, paragraph 4. It assessed the soundness of the More Significant Banks. The assessment included:

i) a quantitative and qualitative analysis of each bank's risk profile, in terms of liquidity, leverage and funding (Supervisory Risk Assessment (SRA));
ii) an analysis of the quality of the bank's assets (Asset Quality Review (AQR)), for more transparency about exposure to credit and market risk, the adequacy of guarantees and related provisions; and
iii) a stress test, carried out in co-operation with the EBA,[25] and based on the results of the AQR, to assess the bank's ability to absorb shocks from adverse scenarios.

A basic scenario and an adverse scenario were used. The preliminary exercise was necessary in view of the significant differences existing in both national accounting systems and supervisory practices, particularly on the definition and impairment of non-performing loans.

The assessment pursued those goals that were the focus of much debate: (1) increased transparency about the actual technical situation of the banks, reducing market uncertainty; (2) repair, through discovering a bank's weakness and identifying appropriate corrective measures; (3) increased confidence in the banking system and (4) laying the foundations for a sounder financial system and a level playing field for all players.

The comprehensive assessment was to find out which banks were revealed to have a capital shortfall after both the AQR and the Stress Test and would require recapitalisation. The ECB set out possible actions in such events, that is, how to cover the capital shortfall and determine the time frame for corrective measures.[26]

2.6 The role of the ECB in banking crisis management

The scope of ECB intervention, in addition to ordinary bank supervision, extends to the various stages through which a bank or a banking group in difficulty could go. ECB actions have their legal basis in the SSM Regulations and in other legislation governing bank crisis management (CRD IV, BRRD and SRM). The SSM Regulation establishes a harmonised regulatory framework that provides for the actions to be taken for an effective and timely response for a bank in a difficult situation and for an adequate flow of information, even in the event of a systemic banking group crisis.

In the way of ordinary supervision, the SSM Joint Supervisory Teams are required to verify that banks subject to supervision prepare and regularly update detailed recovery plans. The Teams express an opinion on the resolution plans prepared by the Resolution Authority. The aim is to upgrade the level of preparation for banking crises and to facilitate management and resolution in case it occurs.

In addition, the ECB organises Stress Test exercises, taking into account the standards defined by the EBA, in order to examine the shock-absorbing capacities of banks.

In crisis management, the ECB may require banks to take steps to remove any obstacles to timely solutions and prevent further deterioration. Should deterioration continue, the ECB will increase supervision over the institution in question. Targeted analysis, on-site inspections,

more frequent meetings with other national authorities and further information requests are the appropriate instruments.

The ECB can then decide on: early intervention tools to be applied to prevent the deterioration of a bank's situation, a bank's state of viability/non-viability and the preparation of proposals for decisions to be submitted to the Supervisory Board and the Governing Council. It monitors the implementation of intervention tools activated for possible further action. In the case of a cross-border banking group, the ECB coordinates its actions with the supervisors of third countries, involving the Cross-Border Stability Groups (CBSGs) provided for in the Memorandum of Understanding on Financial Stability (in effect as of June 2008).

The ECB has a special structure for crisis management: the High Level Crisis Management Team (CMT), which organises and coordinates all parties involved. A key moment for ECB action is the assessment of a bank's viability/non-viability for the purpose of resolution. It is the ECB that takes the decision about whether or not a bank or banking group is failing or likely to fail. In such cases, the ECB assesses, under the BRRD, both whether there is a reasonable prospect that any alternative private sector or supervisory action (including the write-down or conversion of capital instruments) can prevent the failure of the bank in a reasonable period of time and whether resolution is in the public interest because of a bank's systemic nature and the possible negative effects on financial stability. Once a reason for resolution action is determined, the ECB makes the necessary communication to the Single Resolution Board and the European Commission or the National Resolution Authorities.

The most important decisions in resolution are those of the Resolution Authorities (either the SRM or National Resolution Authorities). In this, the SSM has a consultative role – participating in the SRM board, providing support for the resolution plans and taking advice on the assessment of resolvability and the minimum capital requirements – and provides assistance in carrying out on-site inspections. It is clear that, for an effective and efficient implementation of the crisis management framework, adequate co-operation and coordination agreements between the SSM and the National Resolution Authorities through Memoranda of Understanding (MOUs) is a *sine qua non*.

Box 1 The institutional supervisory models at a national level

The choice of the institutional supervisory set-up reflects the manner in which a legal system meets the basic need to protect savings. In some countries, protection of savings is even enshrined in the constitution. The purposes of supervision might include: (a) placing the savings in forms that guarantee the repayment of the capital entrusted to the banks (system stability); (b) knowing the risks related to the various forms of investment (transparency and fairness of the intermediaries) and (c) being able to choose among risks and various forms of investment (competition). More generally, legislation demands that financial activity be conducted with integrity and in compliance with the law so as to build and keep public confidence (regulatory compliance).

The thrust towards harmonisation of rules at the EU level in recent decades has not been matched by a similar drive towards a single institutional model of regulation and supervision at the national levels. Institutional setups differ from country to country. Different emphases might be given to the above supervisory purposes; history, tradition, legal framework, level of development and structural characteristics of the financial system, political equilibria, etc. all play a significant part. Some countries decided on a single authority (United Kingdom, with the creation of the FSA, and Germany, with the BaFin); other countries adopted a pluralistic model (for example, Italy).

In 2006 the ECB, published an analysis that identified three main models of supervision:

a) the Sectoral Model: each sector (banking, finance and insurance) is supervised by its own authority;
b) the Dual Model (or Twin Peaks Model): the objective of supervision is the deciding philosophy: prudential supervision is given to one authority and controls on the transparency and fairness of behaviours to another;
c) the Single Authority Model: the one authority is entrusted with supervisory functions covering both prudential supervision and the protection of investors.

According to a research of the ECB, models of supervision in Europe have moved in the following directions:

a) the consolidation of supervisory authorities (witnessed by the reduction in the number of countries with the Sectoral Model);
b) the prevalence of the Single Authority model;
c) greater involvement of central banks in supervision, mainly associated to the Dual Model;
d) establishment of macro-prudential supervision in the national context.

In the wake of the 2008–09 financial crisis, many countries revisited the structure of financial supervision. The role of central banks in banking supervision became further accentuated.

The Single Authority model has strengths in terms of:

a) *accountability*: less ambiguity and uncertainty about the allocation of responsibility for the controls;
b) *absence of regulatory arbitrage*: similar cases do not come under different forms of control, rules and controls are uniform and fair competition is ensured;
c) *effectiveness of supervision*: it enables better assessment of the overall exposure to risks, better coordination and co-operation at both national and international levels;
d) *reduced costs*: absence of overlapping requests and analyses.

But there are disadvantages too:

a) *excessive concentration* of power in a single entity;
b) *higher risks of "capture" of the regulator*, especially in market contexts with large operators;
c) e*xcessive bureaucracy* and less specialisation in supervising increasingly innovative intermediaries;
d) ability to impose one purpose over another, resulting in possible inefficiencies in the controls.

When the central bank is given the supervisory functions further strengths and synergies are gained. These are:

i) lender of last resort function;
ii) supervision over the payment systems;
iii) macro-prudential supervision;
iv) experience in controlling liquidity;
v) greater independence and autonomy.

On the negative side, there is a risk of interference with monetary policy functions.

The Pluralistic Model has advantages in terms of specialisation, removing conflicts between different objectives and fostering greater institutional interaction. It gives rise, however, to the issue of the appropriate allocation of responsibilities and powers among the various authorities. There are several possible criteria for allocating responsibilities and difficulties in precise identification of the boundaries between the assigned responsibilities. There are also significant coordination problems and possible higher costs for the supervised entities. Plurality of supervisory authorities causes a risk of overlap, even turf wars between authorities at both the regulatory and specific measures level, and can be costly for the financial system as a whole. Coordination of activities and interventions requires appropriate forms of information sharing, mechanisms and procedures, including coordinating committees or Memoranda of Understanding.

There are four main schemes for the division of powers:

a) Supervision of specific intermediaries (or **institutional model**):
Supervision is entrusted to an authority on the basis of its particular specialisation in a type of financial operation. Supervision extends to all activities performed by this category of intermediaries. This approach provides a single point of reference for the supervised entities; it avoids possible duplication of controls.

By contrast, with the increasing integration of the financial market sectors, the specificity of individual operational intermediaries decreases. The risk lies in applying different provisions for similar activities carried out by different intermediaries. Consequently, different objectives of supervision might clash; the case of the trade-off between stability and competition is typical. Finally, a structured supervision based on intermediaries is likely to benefit, given the same activity, companies controlled by the most accommodating authority (so-called "capture" of the supervisory authority).

b) Supervision by purpose: each authority is entrusted with the task of pursuing a certain goal, regardless of the legal status of intermediaries or form of business. It relates to an integrated concept of the financial sector, thus avoiding unequal treatment of operators. Furthermore, through the dialectic between the different authorities, it highlights the trade-off between the different objectives pursued by each of them. Conversely, the model presents risks of overlap, uncertainties in the identification of the boundary lines of attributions and responsibilities, conflicting interventions and even control deficiencies;
c) Supervision by activity: the distribution of responsibilities is shared between the authorities on the basis of the activities of the intermediaries subject to control, regardless of the intermediary that performs it. This approach allows the application of uniform rules to intermediaries carrying on the same activities, reducing the risk of unequal treatment between operators; however, it presents the extreme of possible excessive competence fragmentation, which could jeopardise the overall assessment of the position and activity of the supervised entities;
d) Supervision by function: each function characterising the financial system, however configured (clearing systems and settlement of payments, provision of tools to hedge financial risks, transparency of information on financial products, collection of savings into finance large investments, intersectoral transfers of financial resources), is given to a certain authority. It is a theoretical model, not fully defined and not easily applicable, given the difficulty to distinguish between functions that are often performed by the same intermediary.

3

The European Reform of the Rules for Banking Crisis Management: The Bank Recovery and Resolution Directive

1 The new European rules for crisis management

The European framework on crisis management is set out in Directive 2014/59/EU (*Bank Recovery and Resolution Directive* (BRRD)),[1] which entered into force on 1 January 2015; the *bail-in* tool will enter into force by 1 January 2016.

The Directive constitutes the translation at European level of the "*Key Attributes of Effective Resolution Regimes for Financial Institutions*",[2] issued by the *Financial Stability Board* (FSB) in October 2011 after the G20 Recommendations, with the purpose of reducing the impact of the failures of *Systemically Important Financial Institutions* (SIFIs), including *holding companies* and group entities, insurance companies and market infrastructures. The *Key Attributes* identify new international standards and tools to ensure the orderly exit from the market of insolvent banks, in a harmonised and strengthened legal framework, also in terms of cross-border co-operation.

The new European Directive is highly innovative; it aims at modifying in a significant way the regulatory and institutional framework of crisis management, through the introduction of new harmonised tools and the assignment to resolution authorities of broad powers for the activation of these instruments. Thus it marks a shift in approach from the 2001 Directive, which was based on the mutual recognition of national proceedings on the reorganisation and liquidation of banks.[3]

The main strategic element of the new framework lies in the fact that the Directive not only defines new instruments for the treatment of crises in the final stage, that is of insolvency or near-insolvency, but also identifies a framework clearly aimed at prevention, applicable in the early stages of bank difficulties: thus a complete framework is being put into place (defined as "*comprehensive and credible*"),[4] aimed at enhancing the prevention of pathological situations and level of preparedness of banks and authorities in handling them, so as to preserve the financial stability and continuity of essential services offered by banks, thus avoiding losses for taxpayers.

At the same time, it aims at establishing a harmonised set of rules for *burden-sharing*, that is the sharing of the costs of banking crises between the different categories of stakeholders. The main principle is that costs are shared first between shareholders and creditors, avoiding any kind of public intervention (*bail-out*) – such as occurred during the financial crisis – which *de facto* introduced in the banking sector the unacceptable principle of the privatisation of profit when the bank is in business and the socialisation of losses in the event of insolvency.

Therefore, by adopting Directive 2014/59/EU, the European authorities intended to establish a strong framework of legal certainty for the restructuring of banks, the continuity of their key functions and the allocation of costs between shareholders and creditors: a set of effective rules for handling bank insolvencies at both national and cross-border level.

The BRRD is a flexible framework, based on minimum harmonisation; Member States can adopt or maintain rules that are stricter than, or additional to, those provided for by the Directive (this means they can retain specific powers and tools already operating in their national legal framework), provided that such rules are of general application and are not incompatible with the general objectives established by the Directive.

The Directive is applicable to the following entities:

i) banks and investment firms established in the Union;
ii) financial institutions that are established in the Union when the financial institution is a subsidiary of a credit institution or investment firm, or of a company referred to in point (iii) or (iv), and is covered by the supervision of the parent undertaking on a consolidated basis in accordance with Articles 6 to 17 of Regulation (EU) no. 575/2013;

iii) financial holding companies, mixed financial holding companies and mixed-activity holding companies that are established in the Union;
iv) parent financial holding companies in a Member State, Union parent financial holding companies, parent mixed financial holding companies in a Member State, Union parent mixed financial holding companies;
v) branches of institutions that are established outside the Union in accordance with the specific conditions laid down in the Directive.

2 The setting up of National Resolution Authorities

Besides defining a new set of rules and instruments for the treatment of banking crises, the BRRD establishes that at national level the management of bank resolutions shall be entrusted to a *resolution authority*, an independent public administrative authority identified on a discretionary basis by Member States, either already existing or newly set up, consistently with the national institutional setting (Central Bank, Financial Supervisory Authority, Ministry of Finance, *ad hoc* special authority). This authority must be empowered to apply the tools and exercise the resolution powers provided for by the Directive.

When the resolution function is exceptionally entrusted to the supervisory authority, Article 3(3) of the Directive requires Member States to introduce specific rules aimed at ensuring operational independence and avoiding conflicts of interest between the two functions, without prejudice to the exchange of information and co-operation obligations. In particular, the Directive sets out **the principle of structural separation**, establishing that the staff dedicated to resolution must be separated from the staff assigned to supervisory functions, and subject to different reporting lines. Moreover, all internal rules, including those on professional secrecy and the exchange of information between the various functional areas, should be made public.

These provisions are grounded in the consideration of the risk of potential conflicts, which might trigger situations of *forbearance*, that is of tolerance of crisis or pre-crisis situations by the supervisory authorities. Instead, when a new authority is empowered with the resolution function, appropriate institutional co-operation among the authorities is of primary importance, in order to improve the performance of the respective functions in the general interest.

3 A significant innovative theme: the handling of cross-border group crises: the establishment of Resolution Colleges

The introduction of a specific framework for insolvent groups is one of the cornerstones of the Directive. The solution identified is neither a single authority for the management of the group crisis, nor a single procedure for the group considered as a single entity, nor, finally, consideration of the group's assets as a single "estate", since the legal autonomy of each group entity is maintained.

The approach followed by the Directive for these cases is aimed substantially at pursuing the same result through *Resolution Colleges* (Articles 88–92), which are structurally similar to the *Supervisory Colleges* (established pursuant to Article 116 of Directive 2013/36/EU), but have a wider composition.

Indeed, the composition of Resolution Colleges (Article 88) reflects the need for participation of all the authorities involved in the management of the different phases of the crisis:

i) The group-level resolution authority (the parent bank's authority) is the Chair of the college and leads and coordinates college activity; in this way, the Directive extends the consolidated supervision structure to the area of crisis management;
ii) the resolution authorities of each Member State in which a subsidiary covered by consolidated supervision is established; the parent bank (Article 1(d)) of one or more entities of the group or the significant branches;
iii) the supervisory authorities of the countries involved;
iv) the competent ministries that do not perform resolution functions, but which participate when issues that might affect public funds are addressed;
v) the authority responsible for the Deposit Guarantee Schemes (DGSs) of the States whose resolution authority participates in the college;
vi) the European Banking Authority (EBA).

The resolution authorities of third countries in which subsidiaries are located may be invited to participate, on their request, as observers.[5]

An important aspect of group crisis management is the role of EBA, which is to promote and monitor the efficient, effective and uniform functioning of the Resolution Colleges, as well as to develop drafts of Regulatory Technical Standards (RTS) to specify the operational

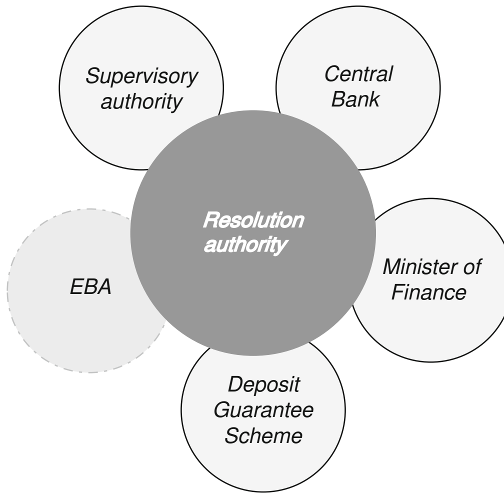

Figure 3.1 Authorities in the Resolution Colleges and in the Crisis Management Groups (CMGs)

functioning of the colleges.[6] The EBA may therefore, if deemed appropriate, participate without voting rights in specific meetings or activities and may play a mediation role if no agreement is reached within the college.

The action of the college covers all phases of *crisis management*, through extensive exchange of information, also with the competent ministries,[7] aimed at developing group resolution plans, applying group preparatory and preventative measures and group resolution. The tasks of the Resolution College include the assessment of resolvability and the removal of obstacles to it, as well as the coordination of the use of resolution financing mechanisms and the definition of the minimum requirement of own funds and *bail-inable liabilities* (MREL).[8]

Therefore, the colleges may act as forums for discussing the issues relating to cross-border group resolution.

Management of a group crisis is based on a specific coordination procedure (Article 91). In particular, if a resolution authority has ascertained that a subsidiary is in a condition that requires a resolution action, it must notify the appropriate measures to the home authority of the parent bank (if different), the supervisory authority on a consolidated basis and all the members of the Resolution College. Following this notification, the group resolution authority, after consulting the members of the Resolution College, will evaluate the possible impact of the actions

listed in the notification on the group and on the group banks operating in other Member States, in order to ascertain whether those actions will trigger the conditions for starting the resolution of other group members as well.

Should the home authority consider that the crisis of the subsidiary has a negative impact on the group as a whole, it must prepare, within 24 hours, a resolution scheme at group level, to be submitted to the Resolution College. In the absence of such a proposal, the resolution authority that made the initial notification will adopt the notified measures.

The coordination and leadership of the Resolution College are entrusted to the group-level crisis resolution authority. Its role is to establish operating procedures, coordinate activities, convene and chair meetings and inform, in advance, all members of the college about the organisation of the meeting, the items on the agenda and the activities to be carried out. In the event of specific needs, the authority decides which members and observers must participate in specific meetings of the college, taking into consideration the nature of the needs and, in particular, the potential impact on financial stability. It also ensures the distribution of timely information to all members of the college regarding the decisions taken in the meeting and the measures adopted.

The Directive requires the college to reach an agreement within four months; if no agreement is reached by this time limit, the group-level resolution authority shall adopt its own decision on the group resolution plan, unless within the same term one of the authorities concerned requests the EBA's assistance in reaching a joint decision in compliance with Article 31(c) of the Regulation instituting the authority (*non-binding mediation*). Furthermore, the Directive provides that, if other groups or colleges carrying out the same functions as Resolution Colleges are already in place and are operating, they may be used as Resolution Colleges.

Another area of innovation is found in the procedures in the event that the European banking group is part of a wider international conglomerate. In such a case, the Directive provides that if a bank or a parent bank from a third country has subsidiaries considered relevant by two or more EU Member States, the resolution authorities of the countries where these subsidiaries are established must set up a European college acting as a resolution authority with respect to these subsidiaries. In any case, the Member States involved may decide, by mutual agreement, not to establish a Resolution College, if other groups or Resolution Colleges have already been established and are operative in accordance with the Directive.

4 A new strategic approach: towards a complete and integrated vision to deal with crisis phenomena

The most significant innovation of the new Directive is the general methodological approach to the management of problematic situations. Indeed, the new framework does not merely cover the final stage of a banking crisis, when the bank has failed or is likely to fail, but considers the crisis as the result of a process of deterioration developing over time, through various phases, that must be adequately and promptly detected and governed by the bank's internal structures and competent bodies and by the supervisory and resolution authorities.

A crisis in any banking enterprise, like that of any other commercial firm, rarely comes out of the blue; normally, it is the outcome of a variety of causes (internal and/or external) and may assume different forms (illiquidity, capital shortfall, balance sheet losses), the development and severity of which the bank's management (and the supervisory authority) should be able to detect promptly. Each crisis, in any case, has its own history and peculiarities. Differently from other problematic or irregular events that a bank might face in its life in a competitive market (which may be labelled as "*weak bank*"), a banking crisis (insolvency or near-insolvency) is a more advanced stage of distress that can be defined as "*a profound alteration in the economic, financial and patrimonial conditions of the bank, which requires appropriate and timely interventions to*

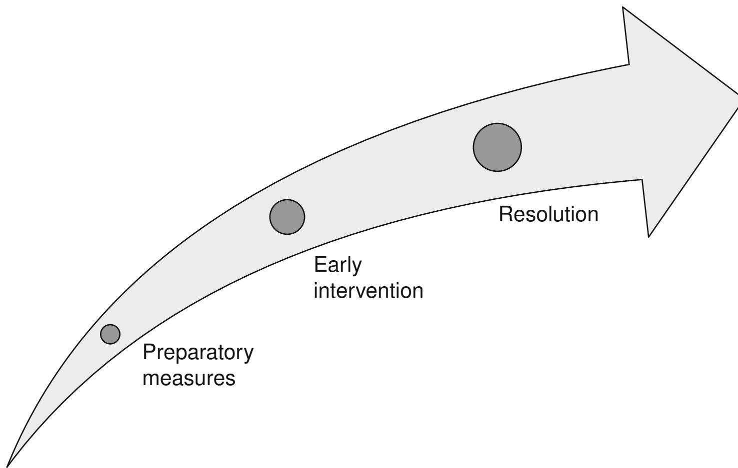

Figure 3.2 New framework for bank recovery and resolution: an integrated approach

remove the real causes and minimise its negative effects to depositors and other relevant stakeholders".[9]

The innovative approach of the new Directive derives from the emphasis placed on preventing the crisis and not only on ways to resolve it when it has already reached the insolvency or near-insolvency stage.[10] To this end, the Directive distinguishes three phases, each of them associated with specific sets of tools for action by banks and authorities: preparation and prevention, early intervention and resolution.

4.1 Preparatory and preventative measures

This phase is represented by the set of activities and measures addressed to a bank or a banking group in the normal course of business, aimed at avoiding or reducing the likelihood of crisis situations. It implies the strengthening of ongoing supervision, in terms of greater capacity of risk detection in the financial sector, and the adoption of measures aimed at increasing the level of preparedness of supervisory authorities and banks, in order to avoid the occurrence of problems and ensure the orderly resolution or liquidation of the bank.

The strengthening of supervision translates into strong attention to compliance with prudential requirements (with reference to the Basel III framework and, in Europe, to the joint application of the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV)) and to the effective performance of off- and on-site supervision, within the framework of formalised supervisory programmes, based on adequate methodologies and procedures. In this picture we can also include the use of *Stress Tests* by banks and supervisory authorities based on adverse, but predictable, future scenarios (a combination of the micro and macro views). The same logic of prevention underlies the system of penalties laid down in the new prudential rules.

However, even effective supervisory activity cannot prevent all crisis situations from occurring, given the many internal and external factors that may trigger pathological events. This is why banks should carry out preparatory activities: specifically, they should draft, in normal times, *recovery and resolution plans* in order to plan adequately the activities to be carried out in the event of difficulty or crisis (the so-called *living wills*, according to which banks must define, when in business, their recovery and resolution strategies in case of negative events that may jeopardise their survival).

4.1.1 Recovery plans

Recovery plans set out the arrangements made by banks or the measures that they would adopt in order to take prompt action to restore long-term viability in case of deterioration of their financial situation in terms of capitalisation, liquidity and profitability. As stated by the Directive, recovery plans are a governance tool based on prudential requirements. Consequently, because of their strategic relevance for the achievement of a bank's objectives, they confer powers to its bodies (strategic supervision, management and control), according to their competences. They must be considered in accordance with the *Risk Appetite Framework* (RAF) and the *Internal Capital Adequacy Assessment Process* (ICAAP).[11]

The plans must be prepared by the banks and be updated annually at both company and group level; furthermore, they are subject to the approval of the supervisory authorities. Recovery plans must also to be communicated to the resolution authority. The plans prepared at group level must be submitted to the consolidating supervisor. The mandatory contents of the recovery plans are listed in the Directive;[12] Member States may require additional data and information. In particular, the plans must contain: a summary of the main elements of the plan and a summary of overall recovery capacity; a range of actions, in terms of capital and liquidity, necessary to maintain or restore the viability

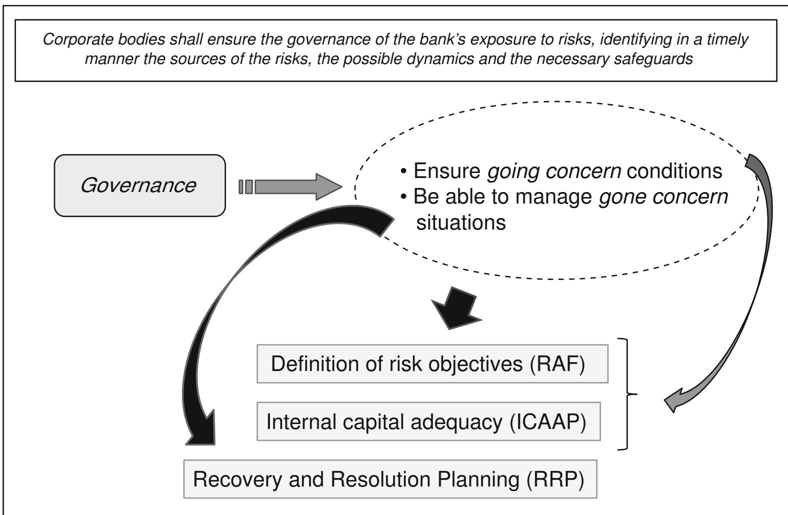

Figure 3.3 Governance: the central role of the risk appetite framework

and financial position of the bank; an estimate of the time frame for implementation of the various aspects of the plan; a description of any material impediment to the timely and effective execution of the plan; a description of the processes for determining the value and marketability of the bank's core business lines, operations and assets; a description of how recovery planning is integrated into the bank's corporate governance structure; arrangements and measures to conserve and restore capital; arrangements and measures to ensure emergency funding, reduce risk and leverage, restructure liabilities and business lines, maintain continuous access to financial market infrastructures and ensure the continuous functioning of operational processes, including IT services, together with any other preparatory measures (including the sale of assets and business lines) appropriate for the restoration of financial soundness.

Furthermore, each *recovery plan* should include (Article 9) a set of indicators defined by the bank and referring to its financial conditions, identifying the points at which the actions and measures should be applied.[13] These indicators must be approved by the competent authorities when evaluating the recovery plan; they must be of a quantitative and qualitative nature and must be easy to monitor.

The plans must be prepared without assuming the possibility of making recourse to or obtaining extraordinary public support. They include, among other things, an analysis of the methods and timelines by which, should the situations specified in the plan occur, the bank may access the central bank's support, and they specify the assets that could be considered to be eligible as collateral.

The plan may include various forms of intra-group financial support, that is the support that intra-group companies may grant to each other (loans, guarantees, transfer of assets as collateral, increase of capital), to facilitate the overcoming of difficulties that might involve the parent bank or individual group members. To this extent, the possible introduction into the European legal framework of the notion of "group interest" could clearly make the option of intra-group asset transfer more effective. This concept of group interest goes beyond that of individual group companies and aims at dispelling concerns about management responsibilities and revocation risk that might arise in the event of a subsequent declaration of insolvency. This would support the possibility for a group of enterprises to be considered as a single economic entity, overcoming the traditional separation between the group's individual entities.

Without making a legislative intervention in this area, the Directive nevertheless introduces the possibility of voluntary agreements on intra-group financial support; these agreements are subject to the authorisation of the supervisory authority and to the approval of the shareholders of each group entity (*agreement on intra-group financial support*).[14]

The voluntary agreement, once authorised by the supervisory authority, must be approved by the shareholders' meeting of each company party to the agreement, so that the management of each company can be authorised to grant rapidly support measures to other group companies requiring them.

In order to verify that the agreement complies with the law and prudential requirements, supervisory authorities will verify and authorise the draft agreement (this may also be done through a joint decision within the Supervisory College). The supervisory authority of the transferor company may prohibit or restrict the transfer of assets, should it deem this necessary to preserve the transferor company's solvency and liquidity or financial stability.

However, the Directive does not implement the original proposal to confer on the supervisory authorities, in the event of non-compliance with the prudential requirements, the power to order banks to rely on the other banks' financial support under the terms and conditions of the agreement, after consulting the supervisory authorities of the other banks party to the voluntary agreement.

Undoubtedly, the introduction in the new crisis management framework of intra-group financial support, together with the supervisory authorities' authorisation, could contribute significantly to the strengthening of the cross-border crisis management tool kit, since it would remove the obstacles (and the associated uncertainties) to the transfer of financial resources (that is, *ring-fencing* imposed by authorities). As a result, moreover, the legal certainty and transparency of cross-border intra-group transactions should increase. The new mechanism constitutes a stimulus for *home* and *host* authorities to come jointly to an agreement concerning the interests of a *cross-border* banking group, overcoming the potential conflicts that might arise between *home* and *host* authorities as to the direction of intra-group financial flows. Moreover, in the event of disagreement, the EBA may act as a mediator to help reach an agreement.

A particularly important phase is evaluation of the recovery plans by the supervisory authority, with the involvement of the resolution authority. The Directive requires the supervisory authority to pass on the recovery plan to the resolution authority, which examines it

- Define the measures a bank would adopt to restore long-term viability in the event of a significant deterioration of its financial situation (capital, liquidity profitability);
- are developed by banks which must update them at least annually or following a change to their legal or organisational structure, their business or financial situation; they are approved by the competent authorities;
- do not assume any access to or receipt of extraordinary public financial support;
- include an analysis of how and when a bank may apply, in the conditions addressed by the plan, for the use of central bank facilities, and identify those assets that would be expected to qualify as collateral;
- also include measures that could be taken by the bank if the conditions for early intervention are met;
- contemplate a range of scenarios of severe macroeconomic and financial stress relevant to the bank's specific condition, including system-wide events and stress specific to the bank;
- with reference to groups, include measures taken in accordance with the arrangements for intra-group financial support;
- include indicators (qualitative and quantitative) defined by the bank and agreed with the authority, which identify the moment when the actions stated in the plan are to be applied; indicators must be easy to monitor;
- must be submitted by the competent authority to the resolution authority, which can examine them in order to detect the possible negative impact on the resolvability of the bank and make recommendations to the bank.

Figure 3.4 Recovery plans

in order to identify any actions that might have a negative impact on the resolution capability of the bank and to make recommendations to the supervisory authority. If substantial deficiencies in the plan are revealed, or substantial impediments to its implementation are detected, the supervisory authority will notify the bank or the parent bank of its assessment, formally requesting changes to the plan in order to eliminate the shortcomings and the impediments detected, and allow the bank to give its opinion on the authority's request. If the revised plan is not submitted or is not judged to be suitable to overcome the deficiencies found, and if it is not possible to remedy the problems through an instruction to make specific changes to the plan, the supervisory authority will require the bank to identify, within a reasonable time frame, the changes to be made to its business in order to remedy the deficiencies or impediments to implementation of the plan. If the bank fails to comply, the authority may order it to take appropriate and proportionate measures, which may include:

- reducing its risk profile, including liquidity risk;

- enabling timely recapitalisation measures;
- reviewing the bank's strategy and structure;
- changing the funding strategy in order to improve the resilience of the main business lines and essential functions;
- changing its governance structure.

4.1.2 Resolution plans

Differently from recovery plans, which are drawn up by banks and approved by supervisory authorities, resolution plans are prepared by resolution authorities, in co-operation with the supervisory authorities, in the course of ongoing bank and banking group activity, based on the information given by banks. Resolution authorities may require the assistance of the banks in drafting and updating the resolution plans.

These plans contain the actions to be taken in a timely manner should a financial institution enter a phase of irreversible crisis and should orderly liquidation or resolution become necessary. The plans must define in detail the resolution actions that the competent authority may implement if the bank meets the conditions for resolution and the tools for ensuring continuity of the essential functions of banks or their orderly liquidation in case of failure.

In particular, the resolution plan should contain: a summary of the plan's key elements; a description of how the essential functions and the business lines could be economically and legally separated from the other functions in order to ensure their continuity in case of the insolvency of the bank; a description of the measures necessary to face or remove the impediments to resolvability; details of the processes to determine the value and marketability of the bank's critical functions, business lines and assets; a description of the various options for financing the resolution without recourse to public support; the options for maintaining access to payment and clearing services and to the other infrastructures; the minimum requirement for own funds and eligible liabilities for bail-in and the timeline for fulfilling it.

Within the resolution plans, particular importance is attached to the evaluation of the resolvability of banks in case of insolvency, that is, their capacity to carry out in a feasible and credible manner an orderly resolution or liquidation within ordinary insolvency proceedings, without causing systemic damage and protecting the economic and essential financial services performed by the bank. The assessment of resolvability regards the bank's capacity to carry out a resolution or liquidation in full autonomy, without recourse to public financial support, to the resolution fund, central bank emergency liquidity assistance or central

bank liquidity support at non-standard conditions (duration, interest rate or collateral).

The objective of the evaluation, therefore, is to identify both the factors that have an impact on the bank's (or group's) resolvability and the actions to improve the situation. To this end, the resolution authority should consider specific factors identified by the Directive (Section C of the Annex) that may be endogenous – linked to the structural, operational and organisational characteristics of the bank – or exogenous, related to the existing framework in the various countries and the presence of co-operation agreements.

For *cross-border* groups (Articles 12 and 13), a group resolution plan must be prepared within the Resolution Colleges, ensuring the consistency and coordination of the measures adopted for the parent bank with those prepared for the subsidiaries. The coordination function is entrusted to the *home authority*, taking into account the evaluations of the host authorities. The group plan must, among other things, contain measures for financing the resolution and define criteria for burden sharing and the allocation of responsibilities among the different countries, considering the different economic impacts and distribution of costs among the various authorities. The evaluation of resolvability must be conducted at the time of drafting and updating the resolution plan, which must not produce disproportionate impacts on any of the countries concerned.

The EBA published in July 2014 a consultation paper on the *draft* RTS concerning the content of the resolution plans and the evaluation of resolvability for banks and banking groups.[15] On this last point, in particular, the paper proposes harmonisation of the phases of the evaluation process, for the purposes of ensuring consistent and proportionate application of the rules, according to the complexities of the banks. Another EBA consultation document addresses the identification of measures to reduce or eliminate impediments to resolvability.[16]

For cross-border groups, the resolvability assessment (Articles 16–17) is made within the Resolution Colleges, with a coordinating role played by the home authority and taking into account the evaluations of the host authorities. The authorities may require corrective action concerning group structure and operations in order to improve resolvability, considering the effects on stability and ongoing operations.

A key element in the preparation of the plan is that the loss absorption capacity within a group should be distributed as a function of the risk level of the individual components. In this sense, the minimum requirement of own funds and eligible liabilities (MREL, see Section 4.3.3 below) should be established consistently with the resolution

strategy defined in the group resolution plan and imposed on the pertinent level of the group to reflect the *single-point-of-entry* (SPE) or *multiple-point-of-entry* (MPE) approach identified in the plan (recital 80 of the BRRD and 84 of the Regulation on the Single Resolution Mechanism (SRM)). Notwithstanding this, in particular circumstances a different approach from that set out in the resolution plan may be applied for the purpose of better achieving the objectives of the proceedings.

The SPE approach expresses a consolidated vision of cross-border group resolution management. The resolution powers are applied at parent bank level and the loss absorption capacity must be assessed with reference to the whole group. Therefore, the single point of entry of resolution is that of the parent bank. As a consequence, the main role is played by the resolution authority of the parent bank itself, with which the subsidiaries' authorities are called upon to co-operate for the effective implementation of the resolution action.

The underlying assumption of this model is that the *parent company* absorbs the losses within the group in the case of insolvency, both those originating in its own balance sheet and those of the subsidiaries; likewise, the reorganisation and restructuring of subsidiaries take place through the capital flows from the parent bank to them.

The MPE approach, on the contrary, is characterised by a higher degree of financial separation between the group entities, and loss-absorption capacity is available not only at parent bank level but also at the level of the subsidiaries where risks are present. As a consequence, resolution powers are also applied in the individual subsidiaries where problems may arise. In the MPE model the resolution authorities of the countries where significant subsidiaries are located play a considerable role in designing resolution plans and strategies, always in collaboration with the home authorities.

In any case, the choice of the resolution model is not a theoretical exercise and there is no optimal model; rather, the model is the outcome of in-depth evaluation of the group structure and of the resolution strategy chosen within the group resolution plan.

The forum where these problems must be discussed is the *Crisis Management Groups* (CMGs, KA 8.1) for global groups and the *Cross-Border Resolution Groups* (Article 88 BRRD) at European level. The latter, as stated, include supervisory and resolution authorities, financial ministries and the authorities responsible for DGSs in the various countries involved in cross-border resolution.

The SPE solution seems prima facie preferable, as it implies assessment and unitary management of the whole group's resolution. However, is this assumption really feasible in the current phase of

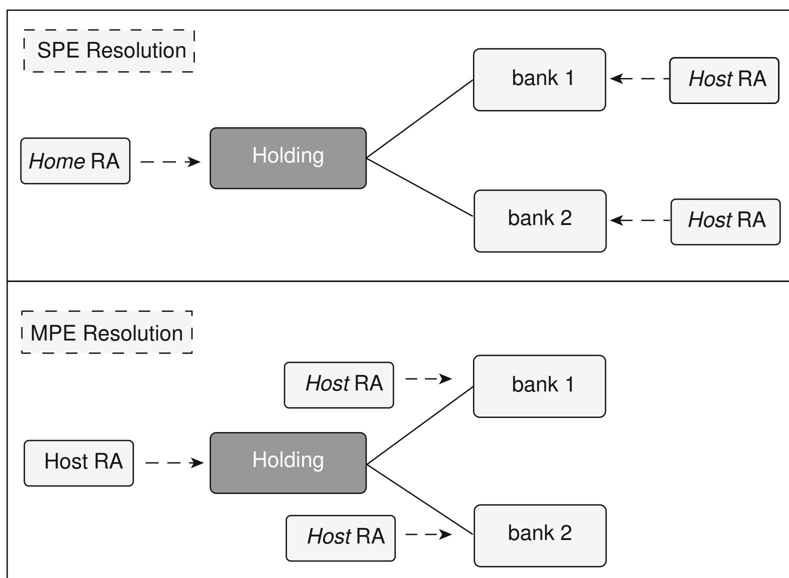

Figure 3.5 Global Loss Absorbency Capacity (GLAC) – SPE and MPE resolution

regulatory development? Or, rather, is it a reference model to be approximated? To address this question we must examine the relationship between *home* and *host* authorities and their interest in maintaining control and power with respect to intervention on the entities located in their respective countries. Where the group is of systemic relevance in the host authority's country, will this authority be willing to accept the SPE model and to limit its role to collaboration with the home authority?

The Directive governs the case where assessment of the resolution plan shows that the conditions ensuring group resolvability are not met, because the banks are too big, too interconnected or too complex to be resolved in an effective way in the short term.[17]

To this end, Article 17 provides that the authorities have the power, *inter alia*, to:

- impose measures to simplify a group's corporate, organisational and operational structure;
- reduce the size and interdependence of some banks;
- modify contractual agreements and business practices;
- limit and modify some exposures and assets, in order to facilitate resolution, or intervene on possible negative factors of an exogenous

nature, that is linked to the legal framework existing in the various countries and to the presence of co-operation agreements.

The preparation of crisis resolution plans constitutes an effective tool in the hands of the authorities for the timely resolution of an insolvent bank, since these plans enable full acknowledgement of the structure and business plan of complex banks, increasing their preparedness to face negative events that could jeopardise relevant public interests (financial stability, continuity of essential banking services, protection of depositors and lending relationship with enterprises).

One critical aspect, arguably, of such a construction is the fact that the powers of intervention aimed at ensuring resolvability are conferred on the resolution authority instead of the supervisory authority. Indeed, resolvability is a matter relating to crisis prevention, hence it clearly falls within the purview of supervisory activity and, in particular, within the measures that the authorities may impose according to the Second Pillar of Basel III. Otherwise, it risks having the effect of hastening the resolution authority's intervention in the normal course

- Issued by the resolution authority, in cooperation with the competent authority, during the ordinary course of business of banks or banking groups, on the basis of information provided by intermediaries;
- updated at least annually and following any substantial change to the legal and organisational structure of the bank, to its business or its financial condition that could have a material impact on the effectiveness of the plan or require its revision;
- take into account relevant scenarios, including the possibility that the failure is idiosyncratic or may occur during a broader financial instability or systemic crisis;
- contain actions to be promptly taken in the event that a bank enters into a state of crisis that requires its restructuring;
- define in detail the tools to be activated to ensure the continuity of the essential functions of the bank or its liquidation in the event of a failure;
- shall not assume any extraordinary public financial support or liquidity assistance. They may include an analysis of the conditions for access to forms of central banks assistance and the identification of assets eligible as collateral;
- in the event of significant obstacles to resolvability, plans can provide for changes in corporate and operational structure of the group and in contractual agreements and business practices in order to facilitate resolution.

Draft EBA RTS (*Resolution planning*)
Draft EBA Guidelines (*Measures to reduce or remove implements to resolvability*)

Figure 3.6 Resolution plans

of the business of the bank before any pathological event has occurred. Therefore, while there may be good reasons for entrusting drafting of the resolution plan to the resolution authority (in co-operation with the supervisory authority), it seems excessive to give the same authority the power to intervene outside of a resolution proceeding.

4.2 Early intervention

This category includes all interventions that supervisory authorities carry out in order to resolve in a timely manner problems that may arise in the technical situation of banks or in specific areas. These actions are designed to restore ordinary conditions in the performance of a business and to prevent further deterioration that could lead to resolution.

The Directive provides for the strengthening of supervisory powers in order to overcome the shortcomings existing in the various frameworks that were brought to light during the financial crisis. This regulatory harmonisation focuses on some critical profiles of timely and effective supervisory action:

i) the definition of the triggers for the intervention;
ii) the identification of the most effective intervention tools in the early phase of the crisis;
iii) a fast-track procedure for capital increases in emergency situations.

4.2.1 Definition of triggers for intervention

With regard to identification of the triggers for early intervention measures, the regulatory options have gone in two directions:

i) the first approach limits supervisory intervention to the breach of predefined quantitative thresholds (*hard triggers*) relating to the main indicators of the bank's technical situation, such as capital, leverage and liquidity. The initial idea was to base supervisory interventions on strict quantitative thresholds, that is, to oblige the supervisory authority to apply predefined measures, with no flexibility related to the peculiar situation of the bank or banking group;
ii) the second, based on greater discretionary powers, tends to derive early intervention measures from an evaluation of the supervisory authority (*soft triggers*). This model of intervention may include the cases of current or prospective non-compliance with prudential requirements. In this regard, it is worth noting that under the previous prudential framework the supervisory authorities already had powers of intervention in the event of violation of capital requirements. Article 136 of the CRD provides that supervisory authorities

have the power to impose measures to remove irregularities and restore capital requirements, including the raising of additional capital, the improvement of governance and of the internal control system and the placing of limits on specific operations and on risk exposure. The CRD extends the cases in which measures may be imposed to include not only actual but also potential breaches of prudential requirements. These broader objective requirements allow the authority to intervene in the early stages of bank distress, increasing its flexibility of action.

The compromise envisaged is a combination of supervisory evaluation with predetermined quantitative indicators, in the sense that, if certain threshold values are breached, the supervisory authorities may intervene and impose corrective measures; the intervention, however, is not mandatory and the corrective measures are not predefined, but left to the authorities' discretion. This solution, therefore, combines the advantages of the two systems: the intervention based on the breach of predefined indicators gives greater certainty and protects the authorities from possible appeals against the measures adopted; on the other hand, the necessary flexibility and adaptability of the system is preserved, to cover the peculiarities of each case.

The option ultimately chosen is based on *soft triggers*, that is, on the evaluation by the supervisory authority of early intervention triggers (the infringement of prudential requirements) and the activation of corrective measures.

In particular, Article 27 of the BRRD specifies in greater detail the *trigger* represented by actual or likely infringement of capital requirements: it derives, among other things, from a rapid deterioration in the bank's financial condition or a worsening of its liquidity situation, as well as increasing levels of leverage, non-performing loans or concentration of exposures, as assessed on the basis of a set of triggers, which might include the institution's own funds requirement plus 1.5 percentage points.[18]

4.2.2 Choice of early intervention tools

Instead of defining a closed list of tools applicable at European level (the maximum harmonisation approach), the EU legislature has chosen to expand the supervisory powers provided for by Article 136(1) to other measures designed to limit the shareholders' and management body's powers, which include, the request to the bank's bodies to:

- take the necessary initiatives to increase capital;

- devote the profits to strengthening the capital base;
- request intra-group financial support;
- implement one or more of the measures foreseen in the recovery plan;
- examine the situation of the bank and formulate corrective measures;
- convene the shareholders' meeting to deliberate on the activities on the agenda established by the same authority;
- present a recovery plan (debt restructuring, increase of capital, restriction of parts of business, divestiture of riskier activities, restriction in the distribution of dividends, revision of risk management structures and control tools);
- replace one or more directors deemed unfit to hold office;
- make changes in the bank's business strategy and operational structure;
- collect, also through inspections, of information for transmission to the resolution authorities, for the purpose of updating the resolution plan and preparing for the possible resolution of the bank;
- set in hand direct contacts with potential buyers, in view of the resolution of the bank, on request of the resolution authority.

The supervisory authority will need to establish appropriate deadlines for the completion of each of these measures and activities, in order to allow correct assessment of its effectiveness. Within 12 months from the entry into force of the Directive, the EBA will issue guidelines aimed at promoting the consistent application of the *triggers* for the adoption of the early intervention measures foreseen in the framework.

In the event of deterioration of the financial situation of a bank, one of the most frequent measures of the bank recovery plan is an increase in capital, an operation often necessary to rebalance capital ratios and other prudential indicators and restore capital buffers suitable to foster business development. One critical aspect of such an action is normally represented by the fact that the time required by civil law to implement an increase in capital might be inconsistent with the need to carry out operations in emergency situations. Hence, the need to identify appropriate ways and procedures to fast-track the operation.

One option could be ex-ante attribution, by a shareholders' meeting, of a mandate to the management body to approve an increase in capital in emergency situations within the limits indicated by the shareholders' meeting. This option has been set aside, because it was considered too restrictive of shareholders' rights; another option was chosen instead,

that is, to leave decision-making powers in the hands of the shareholders' meeting, which – within the recovery plan – should decide to reduce the timing for convening a shareholders' meeting to deliberate the increase of the bank's capital in emergency situations. Within the *early intervention* tool kit, the replacement of the bank's management (Article 28) and placement of the bank under a *temporary administrator* (Article 29) are especially important actions.

Article 28 provides that, in the event of a significant deterioration in the bank's financial situation or where there are serious infringements of law, regulations or the bank's statutes, or serious administrative irregularities, as well as in those cases in which the bank is not compliant with the CRD's requirements and the corrective measures adopted pursuant to Article 27 have proved insufficient, the supervisory authority may require the removal of all or part of the management body and its replacement.

Article 29 provides that, where this decision is found to be insufficient to remedy the situation, the supervisory authorities may appoint a *temporary administrator* for a limited period, in order to take on the management of the bank or assist the existing management body.

The function of the *temporary administrator* consists of ascertaining the financial situation of the bank and managing its activity, in whole or in part, with a view to restoring safe and prudent management. The competent authority must specify the powers of the temporary administrator and may require that specific acts carried out by the administrator be submitted to the authority's prior consent.

A temporary administrator is appointed when the competent authority finds that the prior partial or full replacement of the bank's management was insufficient to remedy the problematic situation. For the pursuit of his mandate, the *temporary administrator* may replace the bank's management body or work temporarily with it and exercise the powers specified by the competent authority at the time of the appointment.

When the temporary administrator is appointed to work with the previous management instead of replacing it, problems of allocation of powers and responsibilities might arise. Thus, when the temporary administrator is appointed to work with the bank's management body, the authority must specify not only the administrator's role, functions and powers, but also those cases in which the management of the bank must consult with the administrator, or obtain the administrator's consent before taking specific decisions or actions.

The maximum term of office of the temporary administrator is one year, and may be extended in only exceptional cases. The proceedings

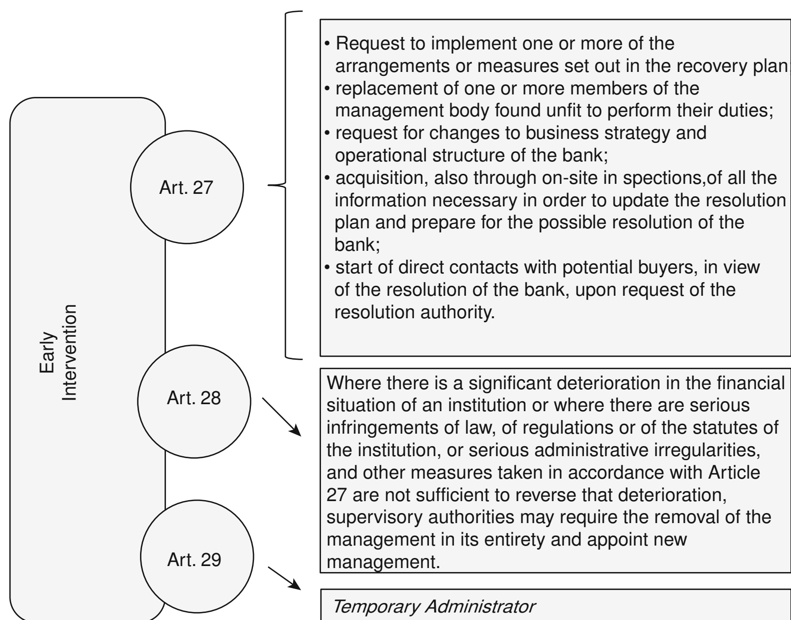

Figure 3.7 Early intervention tools

do not affect shareholders' rights; on the authority's authorisation, the temporary administrator may convene a shareholders' meeting and prepare the agenda.

For cross-border groups, the use of timely intervention powers should be agreed within the Supervisory Colleges; in the event of disagreement between the authorities, the EBA may play a binding mediation role.

4.3 Resolution

The term "resolution" is new in the legal vocabulary, especially in bankruptcy laws, since it does not refer to a specific tool or procedure.[19] Since resolution is generically intended as an action aimed at resolving a problem, it may take on a variety of meanings. *De facto*, in the field of banking crises the term indicates the action – hence the use of the tools – aimed at remedying a compromised situation, that is insolvency or near-insolvency. In a broader sense, this word may include the liquidation and pay-off of depositors as well, or the application of insolvency proceedings to some parts of an entity under resolution, together with the exercise of resolution powers.

Thus, in view of the range of meanings that the word "resolution" may encompass, we can infer the appropriate meaning from the whole context of banking insolvency regulation and from the BRRD framework; as a result, we might have a functional definition of resolution, intended as restructuring, which is clearly different from liquidation and cannot be confused with it. Rather, resolution aims at avoiding liquidation, when the disruptive effects of the latter might jeopardise the continuity of the bank's essential functions and financial stability or the pursuit of other significant public interests.

The conceptual distinction between these two legal categories is even more clear in the case of bail-in, which is a tool available only outside liquidation proceedings, since it is aimed at ensuring the continuity of the bank's business; in this sense, the Directive assigns to the resolution authority the power to take resolution measures directly for the purposes of avoiding liquidation and to preserve the bank as a going concern.

Thus, resolution means the set of tools aimed at reorganising and restructuring the bank; these tools are intended to bring about deep changes in the bank's ownership, organisational, management and operational structure, so that the entity or ownership structure resulting from the resolution takes on distinctive features that are very different from the initial ones; this is true both in the going concern solutions and in gone concern perspectives.

Resolution is not meant, in the Directive, as a bankruptcy law proceeding, but, as said, as a tool kit to use for the restructuring of an insolvent bank.[20] However, when implemented under the various national legislations, it becomes a structured proceeding, similar to other domestic insolvency proceedings, with clear definitions of the starting requirements; of the effects on ownership and creditors, the enterprise, third parties and other stakeholders; of the *concursus* rules and of the liability regime.

In general terms, the legal framework resulting from the Directive does not modify, especially from an economic perspective, the ordinary schemes of intervention in crisis situations, because when a bank is insolvent or likely to become insolvent, it may be placed in liquidation according to ordinary insolvency rules and procedures or it may be restructured through a set of measures aimed at protecting its corporate business.

In the framework outlined by the Directive, the resolution action entails far-reaching interventions on the bank's situation and, *inter alia*, raises the problem of the distribution of crises costs among the various

stakeholders (burden-sharing).[21] The new approach to burden-sharing in banking insolvencies is radically different as it shifts from public bail-outs relying on taxpayer money to a system that charges losses to all those parties, that is shareholders and creditors, who have invested in the bank and who, albeit to a different extent, are responsible for the management choices that led to the bank's insolvency.[22]

These **key principles** are laid down in Article 34, according to which the first losses deriving from the resolution must be charged to shareholders; after the shareholders, losses must be borne by creditors, according to the priority rules established by ordinary insolvency proceedings; the board of directors and the management body must be replaced, unless their continuance in office is necessary to pursue the resolution objectives; the parties responsible for the failure are subject to civil or criminal liability; creditors belonging to the same class must be treated equally; no creditors shall bear greater losses than they would have borne in the case of the bank being liquidated and of application of insolvency rules (*no creditor worse-off principle*); covered deposits must be protected; safeguards must be applied for shareholders and creditors who could suffer worse treatment from the resolution with respect to what they would have received from the liquidation and provisions for the protection of workers' rights should be applied.

In addition to the general principles of resolution, of particular importance are also the **objectives of resolution**, which the authorities have to consider in the resolution decisions and in the choice of resolution tools. These objectives are set out in Article 31 as follows:

- to ensure the continuity of essential functions;
- to avoid adverse significant effects on financial stability, in particular by avoiding contagion to market infrastructures and by maintaining market discipline;
- to protect public funds by minimising reliance on extraordinary financial public support;
- to protect the depositors guaranteed by the deposit insurance systems under Directive 2014/49/EU and the investors covered by Directive 97/9/EC;
- to protect the funds of customers and the assets of clients.

The Directive does not define a hierarchy among these resolution objectives; they are placed at the same level, with equal dignity; the choice

of the authorities regards which tools they will use from among those available for the pursuit of the objectives that are relevant in the specific case.

One central aspect of resolution activity is the necessity to obtain – before making a resolution decision – a preliminary "fair, prudent and realistic" valuation of the assets and liabilities of the bank under resolution by a person independent from any public authority, including the resolution authority, which in any case is called upon to endorse the valuation (Article 36).[23] A temporary valuation can be carried out by the resolution authority only in case of urgency, pending the assessment bing conducted by an independent person.

The objective of the independent valuation is to estimate – based on prudent and realistic assumptions – the value of the bank's assets and liabilities, in order to inform the assessment of the conditions for the resolution (or for the write-down/conversion of capital instruments) and the decision on the appropriate resolution action and tools. The debts of the bank are split up into classes according to the priority rules applicable under insolvency law, and the losses to which each class would have been exposed in case of ordinary liquidation are estimated. This assessment does not prejudice the application of the "*no creditor worse-off*" principle or the associated ex-post determination of possible different treatment under Article 74.

The importance of conducting the valuation in accordance with these principles and criteria is connected with the need to prevent the valuation from justifying the provision of extraordinary public financial support to the bank under resolution. The valuation implies the acquisition of accompanying documents and information from the bank's accounting books and records; it also implies the sorting of creditors into classes, according to the respective priority order provided for by current insolvency law and an estimate of the treatment applicable to each class within the insolvency proceedings.

4.3.1 Triggers for resolution action

A key feature of the resolution framework is that it establishes when, that is in the presence of which triggers, it is possible to start the resolution proceedings and to use the relevant tools. The option chosen by the European legislature has been to entrust this evaluation to the discretion of supervisory and resolution authorities (*soft triggers*) and not to predefined quantitative parameters, such as the fall of capital ratios below certain thresholds (*hard triggers*).

In accordance with Article 32, the opening of resolution proceedings constitutes the outcome of a technical assessment made by the authority with reference to the existence of the following conditions:

a) the bank is failing or likely to fail. This determination is made by the supervisory authority, after consulting the resolution authority;
b) with regard to timing and other relevant circumstances, there is no reasonable prospect that an alternative action by the private sector – including measures taken by an *Institutional Protection Scheme* (IPS) or supervisory action (including *early intervention* measures or the write-down or conversion of capital instruments) would prevent the failure within a reasonable time frame;[24]
c) the resolution action is necessary in the public interest.

With reference to the first trigger, that is, the assessment of whether the bank is failing or likely to fail, the Directive (Article 32(4)) takes into account a set of circumstances of a different nature, already in existence at the moment of the decision or probability-based, considering objective elements:

- the bank infringes or might infringe the requirements for the authorisation to a significant extent, for example, its losses will deplete all or a significant amount of its capital;
- the assets of the bank are (or will become) less than its liabilities;
- the bank is not (or will not be) able to reimburse its debts or other liabilities as they fall due;
- the bank needs extraordinary public financial support.

This *trigger event* is characterised, therefore, by the magnitude of the cases that can be taken into account in order to determine that the bank is failing or likely to fail; its purpose is to allow the authorities to take the measures necessary for resolution before the bank reaches the point of insolvency, from a capital and liquidity point of view. EBA has recently issued guidelines to promote the convergence of supervisory and resolution practices, in situations in which a bank is considered to be failing or likely to fail, in order to start resolution action.[25]

Under this framework, assessment of the existence of the conditions for resolution is made by the supervisory authority, which has all the information and analytical instruments necessary to deliver an opinion on the bank's solvency, on a prospective basis, too. As already said, the supervisory authority takes a decision on the presence of the conditions

for intervention after consulting the resolution authority, which – after ascertaining the lack of other private or supervisory measures able to prevent the failure and the presence of public interest – commences the resolution proceedings and selects the appropriate resolution tools. Under Article 32(2), assessment of the existence of the conditions for resolution (that is, determination that the bank is failing or likely to fail) can be made by the resolution authority, in consultation with the supervisory authority (when the resolution authority has suitable instruments for this purpose, in particular adequate access to the relevant information).

For banks belonging to a group, the conditions must be verified both at an individual level and at a consolidating entity level; it is possible to extend the resolution tools to the holding company even when the resolution triggers are met only by a subsidiary institution, when this is necessary for the resolution of the subsidiary or the group as a whole.

The second condition for resolution occurs when alternative instruments of intervention are not applicable, whether in the form of measures by the private sector, including the measures adopted by an Institutional Protection Scheme, or supervisory action, including early intervention measures and the write-down or conversion of capital instruments according to Article 59(2) of the BRRD, which might be able to avert the insolvency of the bank in a reasonable time frame.

Finally, the third condition for the start of resolution is compliance of the resolution action with public interest; this condition is met where

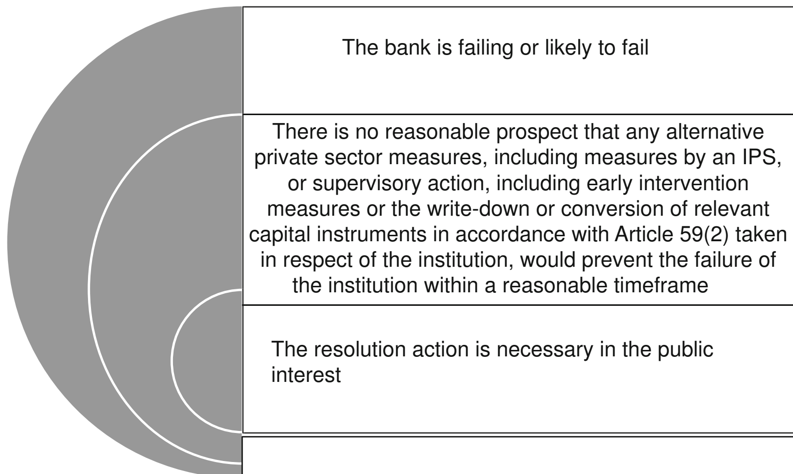

Figure 3.8 Triggers for resolution

resolution is deemed necessary to achieve one or more of the resolution objectives set out in Article 31 and is proportionate to them, and where liquidation based on ordinary insolvency proceedings would not achieve the resolution objectives to the same extent.[26]

4.3.2 Powers of the resolution authority

Resolution is the phase of the crisis in which the resolution authority has the most penetrating intervention powers, which it may exercise without the consent of shareholders, management or creditors. This may include in some cases the possibility of intervening in the enforcement of contracts and contractual clauses concluded by the bank in crisis, for the purpose of strengthening the effectiveness of resolution.

The new legal framework of resolution requires Member States to adopt the necessary measures to ensure that resolution authorities have full powers to apply resolution tools and that these powers are not limited by any legal or contractual requirements such as the requirements to obtain consent or approval from public or private parties, including the bank's shareholders and creditors, to notify third parties, to publish notices or statements or to file documents with other authorities.

The general powers of resolution authorities are clearly detailed in Article 63. Their main powers are the following:

- to obtain from any party the information necessary to execute the resolution actions, also through on-site inspections;
- to control the bank under resolution and to exercise all the rights and powers conferred upon the shareholders, other owners and the management body of the institution under resolution;
- to transfer shares or other instruments of ownership issued by an institution under resolution, as well as to transfer assets, rights and liabilities to other entities, including a *bad bank* or a *bridge bank*;
- to reduce the nominal amount of shares or other instruments of ownership of an institution under resolution and to cancel such shares or other instruments of ownership, reduce eligible liabilities and convert them into shares or other instruments of ownership of the same bank, of the parent bank or of a *bridge bank* to which assets, rights and liabilities have been transferred;
- to require the issue of new shares or capital instruments to the bank under resolution or to its parent company;
- to remove or replace the *management body*;
- to amend or alter the maturity of debt instruments and other eligible liabilities issued by an institution under resolution or amend

the amount of interest payable under such instruments and other eligible liabilities, or the date on which the interest becomes payable, including by suspending payment for a temporary period;
- the power to close out and terminate financial contracts or derivatives contracts.

As a preliminary remark, it should be noted that the Directive does not prescribe the exact methods through which the resolution authorities may exercise their resolution powers in respect of the failing bank. Two options are possible:

a) the authority takes *control* of the bank under resolution, so as to make possible its operation and to direct its activities exercising all the shareholders' and directors' powers, as well as to manage and dispose of the bank's assets and goods. To this end, during the resolution period the voting rights attached to the shares and the other capital instruments of the bank under resolution are suspended. Control over the bank under resolution may be exercised directly or indirectly through the appointment of one or more persons. In particular, resolution authorities may appoint a *special manager* who, under Article 35, will replace the management of the failed bank and exercise the shareholders' and directors' rights in the same bank, under the control of the resolution authority. To this end, the Directive empowers the *special manager* to adopt all the measures necessary to promote the resolution objectives decided by the resolution authority. These measures may include an increase of capital, the reorganisation of ownership or its acquisition by another bank that meetis the necessary financial and organisational requirements. The term of office is one year, but may be renewed exceptionally if the resolution authority deems that the conditions for the appointment of a special manager continue to be met;[27]
b) with regard to specific cases and to the objectives and principles of resolution, resolution authorities can decide to take resolution action through an *executive order*, in accordance with national administrative competences and procedures, without exercising control over the bank under resolution.

Resolution authorities must also have at their disposal *ancillary powers* (Article 64) – which can lead to limitations of the rights of the contracting counterparties of the bank under resolution – for the purpose of guaranteeing the effectiveness of the transfer of shares, debt instruments, assets, rights and liabilities. Moreover, subject to specific

safeguards, resolution authorities also have other powers, including the power to:

i) effect the transfer excluding any liability or encumbrance on the instruments, rights, assets and liabilities transferred;
ii) remove rights to buy further shares or other instruments of ownership;
iii) discontinue or suspend admission to trading on a regulated market or the official listing of financial instruments;
iv) enforce contracts and ensure operational continuity by the buyer of the business, with particular reference to the continuity of contracts entered into by the institution under resolution, so that the recipient assumes the rights and liabilities of the institution under resolution relating to any financial instrument, right, asset or liability that has been transferred and acts as substitute (either expressly or implicitly) for the institution under resolution, in all relevant contractual documents;
v) require the bank under resolution or an entity of the group to which the bank belongs to provide the recipient bank or the bridge bank to which the assets and the shares have been transferred with the services and mechanisms necessary for the effective performance of the transferred activity (except for any form of financial support).[28]

For transfers, some powers are established to allow the transferee to use the transferred assets effectively, in other Member States or in third countries, too. To this end, the resolution authorities must have the power to require the group entities established in their territory to comply with the obligations that the corresponding authorities of other Member States have imposed on them.

The resolution authorities also have the **power to suspend certain obligations**, such as payment or delivery obligations pursuant to contracts to which the bank under resolution is a party. The suspension is effective from the publication of an appropriate notice of suspension until midnight of the working day following publication.[29] However, the suspension does not apply to deposits or investments covered, respectively, by a deposit guarantee system or an investor protection scheme,[30] or to payment and delivery obligations owed to central counterparties, central banks or within payment systems.

Lastly, resolution authorities have the power, subject to issue of an appropriate notice, **to restrict the enforcement of security interests** by creditors in relation to any assets of the bank under resolution

(Article 70), as well as the power to **temporarily suspend the termination rights** of any party to a contract with a bank under resolution (Article 71), in order to allow the resolution authority to identify and evaluate the contracts to which the intermediary is a party and to choose whether to transfer them to the buyer.

The supervisory and resolution authorities may require the bank to maintain detailed records of financial contracts if they believe that there is a real likelihood that the bank might enter into resolution. When exercising suspension powers the resolution authorities must, in any case, take into account the possible impact of suspension on the regular functioning of the financial market.

The provisions on the powers of the resolution authorities have a particularly invasive force, with substantial impacts on the ordinary equilibrium of the relationship between the administrative authority and the institutions under resolution, with significant implications for the respect of fundamental rights (protection of property rights, the right to conduct business, judicial protection, etc.). These powers produce a gap between the principles and practices that have marked banking crisis management up to the present, as each crisis was managed within the institutional framework of the competent jurisdiction.

The existence of these problematic aspects has been fully addressed by the European legislature, as is shown by the fact that several recitals of the BRRD and of the SRM Regulation uphold the respect of "*fundamental rights and (...) the rights, freedoms and principles recognised in particular by the Charter, and, in particular, the right to property, the right to an effective remedy and to a fair trial and the right of defence.*"[31]

4.3.3 Resolution tools

Resolution tools consist of special bank restructuring measures applicable by the administrative authorities empowered to handle crisis management outside of ordinary judicial insolvency proceedings. They are applicable either singularly or jointly, and produce different effects on the bank and on third parties.

The Directive contemplates a minimum set of tools for the orderly restructuring of the insolvent bank, while allowing Member States to add other tools available at national level that are consistent with the objectives pursued by the Directive.[32]

The resolution tools provided for by the Directive are as follows:

- *bail-in* tool, aimed primarily at preserving the insolvent bank as an autonomous legal entity (***going concern solutions***);

- *sale of business*, *bridge bank* and *good bank-bad bank* separation, which involves the disappearance of the bank as an autonomous legal entity and its restructuring so as to minimise the negative effects on the various categories of stakeholders (***gone concern solutions***).

In practice, the distinction is not so clear, since a resolution action may be the result of a set of operations involving the joint use of various resolution tools, such that the survival of the bank may be compatible with the sale or liquidation of parts of the group or of the non-viable components of the enterprise.

The final version of the BRRD added another tool: in an extraordinary scenario of systemic crisis, the resolution authority may resort to an alternative financing source, through **government financial stabilisation tools** (Articles 56–58), provided that a bail-in of at least 8% of bank liabilities is applied and authorisation for the use of State aid is obtained (Article 37(10)). The activation of financial stabilisation tools is entrusted to government authorities, in collaboration with the resolution authority, and may consist of *public capital support* and the *temporary acquisition of ownership*; therefore, these tools represent the last resort, aimed at maintaining financial stability when this cannot be sufficiently safeguarded by the other resolution tools. The Directive leaves ample room for national authorities in the resolution phase, in order to avoid excessive interference with the legal and institutional

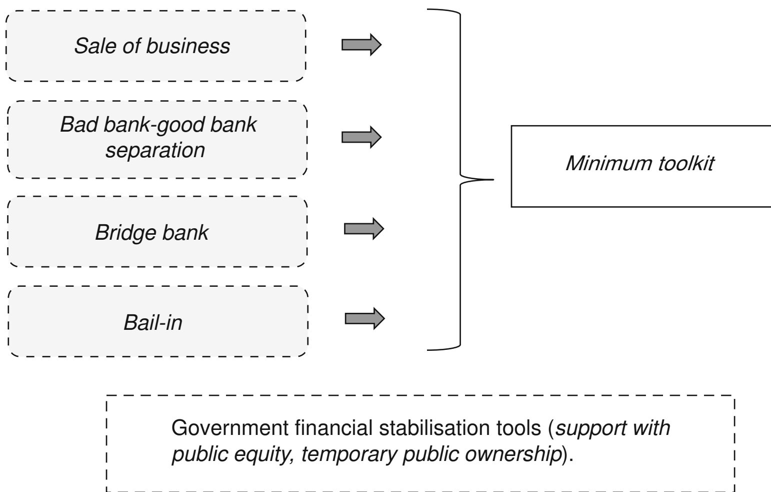

Figure 3.9 Resolution tools

setting of each country: this explains the choice of minimum harmonisation of resolution tools made by the legislature. This flexibility is also reflected in the fact that resolution measures may be implemented directly by the resolution authority or indirectly through the appointment of a special manager, with different implications in terms of responsibility in the conduct of resolution proceedings.

A) Going concern solutions: the *bail-in* (write-down and conversion of liabilities into capital). The resolution measures included in this category represent the main innovation of the new system of crisis management, as they aim at translating into practice the key principle of the new legal framework, according to which shareholders and creditors must contribute first to cover the losses of the insolvent or near insolvent bank, in place of taxpayers. Thus, the phenomena of moral hazard are reduced and the incentive for investors to monitor banks adequately increases.

Bail-in (governed by Articles 43–55), together with the power to write-down capital instruments (Article 59), is a tool introduced by the Directive into the European framework to ensure the participation of shareholders and creditors in the coverage of losses and the recapitalisation of the insolvent bank.

The *bail-in* tool is defined by the Directive (Article 2) as "the mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution under resolution in accordance with Article 43". It is a special regime (or better, a *super-special resolution regime* – super-SSR),[33] consisting in the annulment of capital instruments and in the cancellation (*haircut*) in full or in part of unsecured liabilities or their conversion into capital – without a formal declaration of insolvency and in order to avoid the closure of the bank – to establish the ordinary capital endowment, according to capital requirements.

Accordingly, the main objective of the *bail-in* is the recapitalisation of the bank, in order to allow it to continue operating as a *going concern*; this approach might be the only solution for certain large banks, in respect of which the total or partial sale of business without public support might be difficult to achieve.

The *bail-in* may also be functional to the transfer of liabilities, after *haircut*, to a bridge bank or to the sale of business or the separation of assets. In these cases, the aim is not continuity of the activity of the bank under resolution, given that the part of the business remaining after the transfer to a bridge bank or to a vehicle is destined to be liquidated according to ordinary insolvency procedures (*closed bank scenario*).

The *bail-in* is based on the consideration that the losses of creditors constitute an inevitable consequence of the failure of a bank or any other commercial firm, but normally such haircuts take place within insolvency proceedings. The *bail-in tool,* in practice, replicates the effects of insolvency, but brings forward the impact on creditors outside formal insolvency proceedings. However, such an advancing of effects is subject to application of the insolvency rules concerning priority in the satisfaction of the different categories of creditors. According to these rules, the first to incur the write-off should be the owners of subordinated debt, followed by the other senior creditors. To this end, the Directive introduces some provisions to ensure that creditors do not incur greater losses than they would have incurred in insolvency proceedings.

The write-down and conversion of capital instruments (Article 59) is closely linked to *bail-in*, although it differs from it. In the framework of the new principles established by the Directive, even before the start of resolution, capital instruments (Tier 1, additional Tier 1 instruments and Tier 2) may be written down or converted. These are instruments that, in any case, from the onset, are intended to be used for recapitalisation on a contractual basis.

To this end, resolution authorities may write-down or convert capital instruments, independently of a resolution action, or in combination with a resolution action where the conditions for resolution are met (Articles 32 and 33).

Under Article 60, the resolution authority may write down or convert capital instruments when the conditions laid down in Article 59(3) are met. These conditions are the following:

- conditions for resolution have been ascertained, but no action has been taken;
- failure to exercise this power would determine, in the evaluation of the supervisory authority or the resolution authority (as chosen by the State according to Article 61(2), the non-viability of the bank (or of the group);[34]
- the bank requires extraordinary public financial support.

Article 60 establishes the priority order for exercising the write-down and conversion (at all times) of capital instruments, in line with the rules applicable in ordinary insolvency procedures: Tier 1 capital instruments are cancelled first; then the additional Tier 1 and Tier 2 instruments are cancelled or converted into Tier 1 capital.

The *bail-in* mechanism may be applied according to different legal, contractual or authoritative methods, with different implications and consequences.[35] On the up side, the losses deriving from the insolvency will be covered by investors and creditors and not by taxpayers; on down side, funding cost and *bank run* risk may increase.

Within the debate on the legal regime for *bail in* that preceded the presentation of the Directive, the contractual approach option was also considered. This consists of a clause included in a financial instrument, under which the owner of the instrument will not be reimbursed in full and his credit will be converted into equity if a specific event occurs (*trigger event*) on the basis of a predefined conversion rate established in the contract. This solution would require banks to issue a specific proportion of debt instruments convertible into equity (*bail-inable instruments)* when a specific event occurs preceding insolvency.[36]

In the final stage of the legislative process the authoritative approach prevailed, according to which the cancellation of the unsecured debt or its conversion into capital will be decided through an authoritative act by the authorities. The latter will have the administrative power to make such a decision when the conditions for resolution are met, independently of any specific contractual provisions.

In any case the Directive regulates the contractual recognition of the *bail-in*. Pursuant to Article 55, banks must provide a contractual clause through which the creditor, or the contractual party that issued the debt instruments, recognises that the liability may be subject to write-down, conversion, modification of the maturity of the instruments or changes in the payment of interest, according to the decisions of the resolution authority, provided that the liability is:

- not excluded from the bail-in;
- not a preferred deposit within the meaning of Article 108(a);
- not governed by the law of a third country;
- issued or entered into after implementation of the *bail-in* in national legislation.

The specific topic is regulated by EBA through ad hoc RTS, which define the content of the contractual clause and the list of the liabilities to which the exemptions from the obligation of introducing the contractual clause will apply[37]. In any case, the contractual clause is not necessary if the resolution authority of a Member State determines that the liabilities or the instruments are subject to *bail-in* on the basis of the

regulation of a third country or of a binding agreement concluded with the said third country.

The scope of application of a *bail-in* may differ according to the range of instruments eligible for it. The scheme outlined by the Directive is very extensive (*comprehensive approach*): Article 44 provides that *"The Member States shall ensure that the bail-in tool may be applied to all liabilities of an institution or entity"*, except for those expressively excluded. As a consequence of this approach, resolution authorities have the power not only to write down capital and to write down subordinated debt and convert it into capital, but also, on a discretionary basis, to write down and convert into capital all of the liabilities or a wide range of them (such as unsecured debt, non-covered deposits or unsecured interbank exposures), in order to achieve the fullest loss-absorbing capacity and restore bank solvency. Thus, the alternative, narrower approach (*targeted approach*) has been put aside. The targeted approach aimed at restricting the bail-in power of the resolution authority to a certain amount of bail-inable liabilities (such as long-term unsecured debts and unsecured deposits);[38] this would have restricted the authority's capacity of intervention in the event of bank insolvencies with significant losses.

To this end, in order to make the resolution capacity of the *bail-in* tool substantial and effective – and thus credible – the Directive provides that banks must comply with a minimum requirement of own funds and bail-inable liabilities,[39] expressed by the ratio of the amount of eligible liabilities and own funds to total liabilities including own funds (MREL - *Minimum Requirement for own funds and Eligible Liabilities*), in order to ensure adequate loss coverage capacity and to prevent banks from changing the composition of liabilities in favour of excluded liabilities. As a matter of fact, this solution introduces a further rule on regulatory capital in terms of MREL, which measures the bank's loss-absorbing capacity (LAC).[40] Thus, while the rules of CRD aim at defining the bank's loss-absorbing capacity in the normal course of business, the bail-in regime aims at establishing loss-absorbing capacity when the bank is approaching the insolvency scenario.

An international debate is currently under way on application of the same requirement, *total loss-absorbing capacity* (TLAC) to the *Global Systemically Important Banks* (G-SIBs). The requirement aims at facilitating the recapitalisation of insolvent systemically important banking groups and, in this way, reducing the burden on taxpayers. Furthermore, it is an additional requirement with respect to the other existing requirements (capital, liquidity and leverage). The Financial Stability Board, in the consultative document of November 2014, outlined the framework

describing the main features of the loss-absorbing capacity of G-SIBs. The document analyses the following points: (1) the minimum Pillar 1 TLAC requirement is still to be officially defined, but the FSB proposal fixes it within a range of 16–20% of Risk Weighted Assets (RWAs) and at least twice the Basel III Tier 1 leverage ratio requirement, currently set at 3%. This percentage might increase to 21–25%, taking into account other additional capital requirements already mandatory for large banks; (2) resolution authorities might introduce additional requirements, which take the name of Pillar 2 TLAC, specific for each G-SIB; (3) the eligible TLAC instruments must be unsecured and must have a minimum remaining maturity of at least one year, in order to ensure that in case of financial distress the loss-absorbing capacity available in any subsequent resolution is not diminished through a withdrawal of funds and (4) to ensure that the eligible TLAC liability absorbs losses, it must be contractually subordinated to all excluded liabilities on the balance sheet of the G-SIB, junior in the statutory creditor hierarchy or issued by a resolution entity that does not have excluded liabilities on its balance sheet. The FSB is currently reviewing the consultation responses on the proposal for TLAC published last November and work is on track to finalize the international standard by the Antalya G20 Summit, scheduled in November 2015.

The Directive conferred on the EBA the power to issue draft technical regulatory standards, subject to the approval of the European Commission, in order to specify criteria and conditions for the counting of eligible liabilities not qualifying as additional Tier 1 and Tier 2 ones, for the purpose of determining, for each institution, the minimum requirement of bail-inable liabilities and own funds[41]. In any case, the possibility for Member States to define additional criteria for the determination of the requirements remains open.[42]

Thus, the option of introducing into the European framework a harmonised percentage of minimum *bail-inable* liabilities has not been followed; on the contrary, the choice has been to empower the resolution authorities to define additional requirements, which have been to an extent proportionate to risks and to the capital structure of the banks, and also reflecting the specific features of the banking models of each Member State and of the impacts on the funding costs of banks. The requirement is applied at both individual and consolidated level.

In the case of groups, when specific conditions occur and taking into account the degree of centralisation of some activities, the authorities may choose to apply the requirement only at consolidated level.

When the bail-in tool is applied to recapitalise a bank (Article 51(1)), it must be accompanied by a **business reorganisation plan** (Article 52) aimed at restoring *long-term viability*, subject to the approval of the resolution authority. This plan may include the appointment, by the resolution authority, of one or more special managers with a mandate to prepare and implement the reorganisation plan.

A number of questions were raised in the course of the debate, including whether the power to haircut debt and convert it into capital should be given to a supervisory authority or another administrative authority and whether creditors' claims could be sacrificed through an administrative decision.

In the light of these issues, a well structured legal framework governing use of these far-reaching administrative powers was deemed necessary, covering:

- clear definition of the categories of banks involved in the haircut mechanisms. The issue was whether these measures should apply only to banks of systemic relevance, thus excluding small and medium-sized banks. The choice ultimately made has been to apply resolution measures, in principle, to all banks independently of their size;
- precise identification of the triggers for the application of these measures (*trigger events*);
- clear identification of the types of debt instruments subject to write-down and those excluded, in order to ensure legal certainty for the whole system and easier assessment of the impact of this tool on the funding market for banks.

On the basis of the agreement reached in December 2013 between the Council and the European Parliament, the bail-in tools will apply from 1 January 2016, thus bringing forward the initial proposal made by the Commission, which was to introduce bail-in by 1 January 2018. The effective date of 1 January 2016 has been confirmed by Article 130 of the Directive.

The instruments eligible for *bail-in* and the exclusion regime. For the purpose of applying the *bail-in*, the new framework outlines a detailed sequence of write-down and conversion, thus defining the priority in the loss-absorbing capacity of capital instruments and debt.[43]

Box 1 Sequence of application of bail-in (BRRD, Article 48)

Sequence of application of bail-in (Article 48)

i) *the first to be reduced are the Common Equity Tier 1 items, up to the total amount to cover losses;*
ii) *if, and only if, the reduction mentioned in the previous point is not sufficient to cover losses, authorities reduce the principal amount of Additional Tier 1 instruments to the extent required and to the extent of their capacity;*
iii) *in case of insufficiency of items i) and ii) authorities reduce the principal amount of Tier 2 instruments to the extent required and to the extent of their capacity;*
iv) *if there are still losses to be covered, authorities reduce to the extent required the principal amount of subordinated debt that is not Additional Tier 1 or Tier 2 capital in accordance with the hierarchy of claims in normal insolvency proceedings;*
v) *if, and only if, the total reduction is insufficient, authorities reduce to the extent required the principal amount of, or outstanding amount payable in respect of, the rest of eligible liabilities in accordance with the hierarchy of claims in normal insolvency proceedings.*

The category under point (v) includes some kinds of deposits, according to the hierarchy established by Article 108, with the exception of covered deposits (which are excluded from the *bail-in* by Article 44).

In this regard, Article 108 introduces the principle of "*depositor preference*", with particular reference to deposits of specific categories of persons within the ordinary insolvency proceedings. More specifically:

- *eligible deposits* over 100,000 Euros of natural persons, micro, small and medium-sized enterprises have priority over unsecured creditors (unsecured and non-preferred) and over the deposits of other persons, also eligible but non-preferred;
- *covered deposits* (deposits protected up to 100,000 Euros) have higher priority than the part of eligible deposits of the persons specified above that exceed the coverage level of 100,000. DGSs that subrogate to the rights of covered depositors enjoy the same priority ranking as the latter.

This approach represents an innovation with respect to that initially contained in the legislative proposal made by the European Commission, which ranked DGSs *pari passu* with unsecured creditors.[44] For this particular aspect, therefore, the need for an adjustment to national insolvency laws has long been felt.

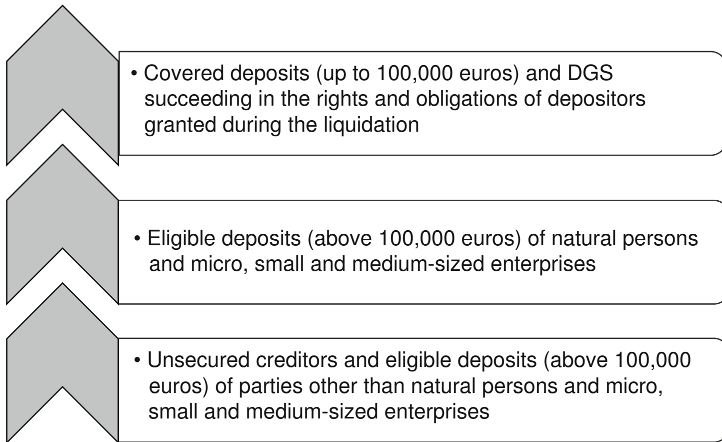

Figure 3.10 Depositor preference

In line with the general approach of June 2013, Article 44 (Scope of bail-in tool) has been reformulated, providing for a set of exclusions from the scope of application of the tool, divided into *permanent exclusions* and *optional exclusions* of eligible liabilities. Article 44 also sets out the conditions for use of the resolution fund and of alternative forms of financing.

The **permanent exclusions** from the *bail-in* regard the following liabilities: deposits covered by a DGS; *secured liabilities*, including *covered bonds* and liabilities in the form of financial instruments utilised for *hedging* purposes and secured, according to national laws, similarly to the *covered bonds*, as well as the interbank liabilities with residual maturity of less than seven days (excluding those to companies of the same group); liabilities deriving from the participation in the payment system having a remaining maturity of less than seven days; debts for salaries and pensions; tax debts and debts towards providers of essential services. Last, liabilities towards the DGSs for the contributions due pursuant to the Directive are included.

The mechanism of **optional exclusions** (total or partial) is more diversified: these are the exclusions left to the decision of the resolution authority when exceptional circumstances occur. They concern liabilities that are eligible for conversion but which the resolution authorities may decide to exclude from the *haircut* and conversion into capital in order to ensure the continuity of essential functions or avoid contagion situations. In these cases, moreover, the following points should be taken into account: (1) the principle that losses should be borne first

by the shareholders and subsequently by the bank's creditors in accordance with a predefined hierarchy; (2) the residual *loss-absorbing capacity* after the discretionary exclusion of some eligible liabilities and (3) the need to maintain adequate resources for financing the resolution.

However, the use of optional exclusions is clearly linked to the possibility of increasing the *bail-in* burden on other eligible liabilities, and must comply with the *no creditor worse-off principle*. Alternatively, where losses are not completely transferred to other creditors, the resolution fund can provide a contribution to the bank in order to cover the losses not absorbed through the *bail-in* and the capital shortfall, as well as to buy shares or other capital instruments of the bank under resolution in order to recapitalise it[45].

The Directive, however, establishes specific conditions for activation of the resolution fund in the presence of optional exclusions: the fund can be used only after the bail-in has been applied in the amount of at least 8% of the bank's total liabilities (including own funds);[46] furthermore, a maximum limit on the use of the fund is established, corresponding to 5% of the total liabilities of the bank under resolution, calculated at the moment of the resolution action, according to the valuation provided for by Article 36 of the Directive.

Therefore, as a consequence of the *bail-in*, the losses of a bank would be covered, in order, by:

- paid-in capital;
- hybrid instruments included in regulatory capital;
- other subordinated instruments not included in the capital;
- *senior liabilities* (bonds, non-excluded derivatives, deposits of large enterprises in excess of €100,000, all subject to bail-in at the same level) that are not included in optional exclusions;
- uncovered deposits (above €100,000) of individuals and small and medium-sized enterprises;
- deposit guarantee schemes (on behalf of the covered deposits).

Thus, all deposits up to €100,000 are excluded from the bail-in since they are protected by deposit guarantee schemes; however, on their behalf, the DGS can be called upon to contribute to the resolution (as a loss absorber) to the maximum extent represented by the total amount of losses that the DGS would be exposed to in case of liquidation of the bank; this in effect is a form of "***virtual bail-in***" of deposits through the DGS.

In order to guarantee the orderly functioning of the new mechanism, no divergence should exist between the ranking of creditors in

resolution and in insolvency, for the purpose of reducing the risk of litigation by creditors and the risk that the resolution fund could be called upon to set off the creditors who feel damaged by the resolution vis-à-vis liquidation.

An especially important step when applying the *bail-in* is determination of the amount of the write-down: this depends on the expected short-term losses and on the definition of forms of compensation for the affected creditors.

Thus, before the resolution authority exercises the power to write down, the amount of the write-down (the *bail-in*) must be determined through prudent and realistic valuation of assets and liabilities, according to Article 36 of the BRRD.[47] This valuation is an integral part of the decision to apply a specific instrument, exercise a specific power or cancel or convert the capital instruments. In particular, the valuation specifies the grouping of creditors into classes, according to their priority order under the applicable insolvency law, and estimates the treatment that each class would have received in the case of liquidation according to ordinary insolvency proceedings.

Clearly, these are issues of extreme importance, which require due consideration of the possible contagion effects on investors and other financial institutions that hold bonds eligible for bail-in. Finally, the possible negative effects deriving from the existence of such powers of cancellation should be weighed, as creditors might withdraw their deposits at

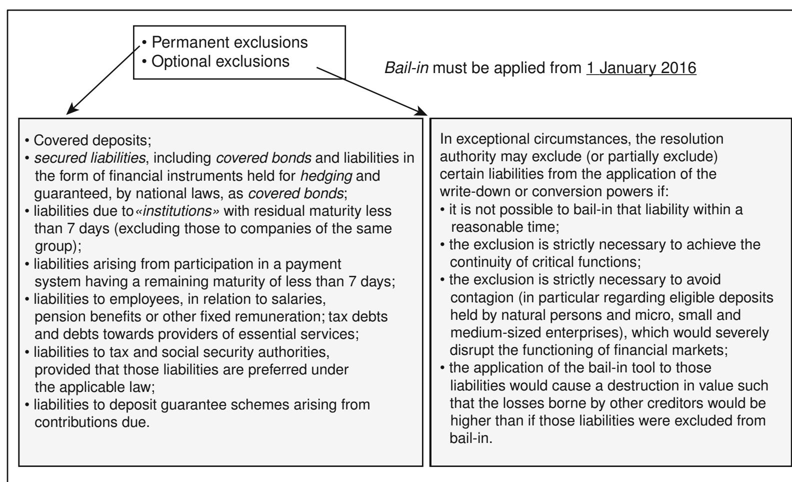

Figure 3.11 Exclusions from bail-in

the first signals of difficulties of the bank, thus exacerbating the bank's crisis. This is why the regulators decided to make the new rules applicable with effect from 2016, one year after the entry into force of the BRRD, thus allowing banks, investors and the authorities to be prepared for the major innovations introduced by the new instrument[48].

B) Gone concern solutions. These kinds of operations may be effected when the bank is no longer considered viable, so that orderly resolution can be achieved through specific tools that imply the disappearance of the bank as a legal entity.

These solutions may be implemented through the transfer of *assets* (sale of business, establishment of a *bridge bank,* separation between good assets and deteriorated assets) or when the *bail-in* is applied jointly with other tools and the bank under resolution is destined to disappear. When the resolution tools are used to effect the partial sale of assets, rights and liabilities of the bank under resolution, the residual part of the bank must be liquidated according to ordinary proceedings within a reasonable time frame (Article 37(6)).

B1) The *Sale of business* tool. Under Article 38, the sale of business tool may consist in the transfer to third parties of:

- shares or other instruments of ownership in the bank;
- assets, rights and liabilities, or parts thereof.

The purchaser must not be a *bridge bank* and must hold authorisations to exercise the activity or provide the services resulting from the sale.

An essential element of this tool is that the transfer is not subject to the consent of the shareholders of the bank under resolution or to the procedural obligations under company or securities law.

For the safeguard of the entities involved in the resolution action, the sale must be carried out in a rapid and transparent way and at market conditions, through competitive procedures, in order to maximise the value of the transferred assets. Therefore, it must be implemented without creating conflicts of interest or discrimination between potential buyers. However, while complying with the above-mentioned principles, the resolution authority may nevertheless directly solicit certain potential buyers.

The Directive provides that the authority does not need to comply with the requirements and procedures for the sale of business if it determines that compliance with those requirements might compromise the achievement of resolution objectives, in particular if it considers that the failure of the bank would pose a serious threat to financial

stability or that compliance with those requirements would undermine the effectiveness of the sale in addressing that threat. With respect to these objectives, the disclosure to the public of the sale of business may also be delayed for the period necessary to plan and structure the bank's resolution.

The Directive also governs the case of **partial transfer** of the assets, rights and liabilities of the bank under resolution, which must be designed for only the *viable* assets and the liabilities that pose a risk for systemic stability. For these cases the Regulation establishes particular precautions and safeguards (see Section 4.3.5), considering the delicate implications that might arise, in terms of *par condicio*, between the holders of transferred positions and those whose positions have not been transferred. In particular, similarly to the case of *bail-in*, the shareholders and the creditors whose claims have not been transferred should be no worse off than that they would have been if the bank had been liquidated according to ordinary insolvency proceedings immediately before the transfer.

B2) The *bridge-bank* tool. Of particular relevance are the rules governing operation of the *bridge bank*, which are subject to the approval of the resolution authority; in particular, the resolution authority may appoint the directors of the *bridge bank*, determine their remuneration and powers and approve the bank's strategies and risk profile. The *bridge bank* must be authorised to exercise banking activities under the applicable EU and national legislation and must comply with prudential requirements; it is also subject to supervision.

The management of the bridge bank must operate such a bank with a view to maintaining access to critical functions and selling the bank, its assets, rights or liabilities, to one or more private sector purchasers when conditions are appropriate.

The resolution authority must take the decision that the bank is no longer a bridge bank if the latter merges with another entity; if all or substantially all of the bridge bank's assets, rights or liabilities are sold to a third party; two years after the date on which the last transfer from an institution under resolution pursuant to the bridge institution tool was made or, finally, if the bridge bank's assets are completely wound down and its liabilities are completely discharged. However, the resolution authority may extend the period for one or more additional one-year periods if such an extension is necessary to ensure the continuity of essential banking or financial services. Where the operations of a bridge institution are in force, the bridge bank shall be wound up under normal insolvency proceedings.

Another important issue related to the transfer to the bridge bank regards the treatment of the shareholders and creditors of the bank subject to resolution, who should not have any right on the bridge bank, but only on the residual value realised from its sale after paying other creditors and the expenses associated with the management of the crisis. Following the transfer of core activities, the bank's remaining assets must be liquidated and the proceeds, net of costs, should go to the benefit of the bank resolution.

Application of the bridge bank tool requires valuation of the assets in order to transfer the good assets of the bank, net of the doubtful positions, which are left in the bank under resolution; the compulsory contribution of DGSs in the resolution, where due, in favour of covered deposits, would thus complement the amount of assets transferred to effect the transition of total deposits to the bridge bank, constituting at the same time a debt position for the transferring bank.

There is extensive international experience in the use of bridge banks for the resolution of financial institutions in crisis, particularly in the English-speaking world.[49] In the USA, the Federal Deposit Insurance Corporation (FDIC) can create a bridge bank in the event of a bank failure if there is insufficient time to sell the company on the market or seek other solutions. The bridge bank usually guarantees a temporary solution that provides the FDIC with the flexibility and time needed to evaluate the state of the bank in crisis, stabilise it and determine the most appropriate type of resolution to be submitted to the market. The operation, with the objective of maximising the value of the "good" portion of the bank in crisis and – at the same time minimise costs – is associated with a strategic plan for resolution of the bank in crisis.

In those European countries in which a resolution regime was introduced even before the approval of BRRD (for example, France, Germany, Spain and the UK), the bridge bank is the most frequently applied tool in practice, or is at least provided for by the regulatory framework.

B3) The *Bad bank-good bank* separation tool. This instrument is aimed at conferring on the resolution authority the power to separate the good assets from the deteriorated assets or those that are difficult to measure on the balance sheet of the bank in crisis (or of a bridge bank) and to transfer the latst two categories to one or more *bad banks* in order to facilitate the use or ensure the effectiveness of another resolution tool. Thus, a *bad bank* may be established only in conjunction with another resolution tool. The vehicle for the management of the deteriorated assets is a legal entity wholly or partially owned by one

or more public authorities, including the resolution authority and the resolution fund.

The resolution authority appoints the board of the *bad bank,* tasking it with maximising the value of the transferred assets through sale and with ensuring the orderly liquidation of the bank.

Therefore, the activation of the tool is based on the premise that the resolution authority has the power to transfer to the vehicle the assets, rights and liabilities of the bank under resolution or of the bridge bank. However, this power can be exercised only if liquidation of the assets through ordinary insolvency proceedings could negatively impact the financial market and if the transfer is deemed necessary for ensuring the correct functioning of the bank under resolution (or of the bridge bank) or for maximising the proceeds of liquidation. The Directive allows the EBA to issue specific guidelines in order to facilitate the convergence of supervisory and resolution practices, with reference to the decision as to the negative impact on the financial market of a liquidation of assets according to ordinary insolvency proceedings.

In the sale of deteriorated assets to the bad bank, the safeguards provided for the partial transfer of assets are applicable. Moreover, if the transfer of assets is accompanied by partial transfer of liabilities, the principle of *par condicio creditorum* (equal treatment of creditors) should be preserved. Finally, the shareholders and creditors of the bank under resolution – and any other third parties whose assets have not been transferred – have no rights over the vehicle, its capital or its directors, who have no liability for management of the vehicle, other than in cases of serious negligence or fault in accordance with national legislation.

4.3.4 Government financial stabilisation tools

The Directive allows recourse to public support for the resolution of an insolvent bank when specific conditions are met. The objective of public support is to aid the resolution of a bank in order to avoid its liquidation, having regard to stability and to the other objectives of the resolution, with reference both to the individual State and the whole European Union. Use of these tools involves close co-operation between the resolution authority and the governmental authorities, which, to this end, should have the appropriate resolution powers.

However, these measures must be used as a last resort, when an exceptional situation or a systemic crisis occurs. The decision must be taken by the competent ministry or by the government, in consultation with the resolution authority, after having evaluated and

applied the other resolution tools to the maximum extent practicable without affecting financial stability. The public resolution tools (Articles 56–58) might consist of public equity support or of the temporary acquisition of ownership.[50] Such instruments can be applied only when triggers for resolution occur and the following specific conditions are met:

- the application of the other tools would be insufficient to avoid negative repercussions on financial stability, according to the assessment made by the government and the resolution authorities in consultation with the central bank and the supervisory authority;
- the competent ministry or government and the resolution authority determine that the other resolution tools would not ensure sufficient protection of the public interest, where the bank under resolution has already benefited from extraordinary liquidity assistance from the central bank;
- the competent ministry or government, after consulting the resolution and supervisory authorities, deems that the application of other tools is insufficient to protect the public interest, when the bank has already benefited from public equity support.

In any case, public stabilisation tools may only be used after the shareholders (or the owners of other capital instruments) and creditors have participated in losses and recapitalisation through write-down, conversion or any other tool, for an amount of no less than 8% of the bank's total liabilities (including own funds), calculated at the moment of the resolution action, in accordance with the valuation under Article 36.

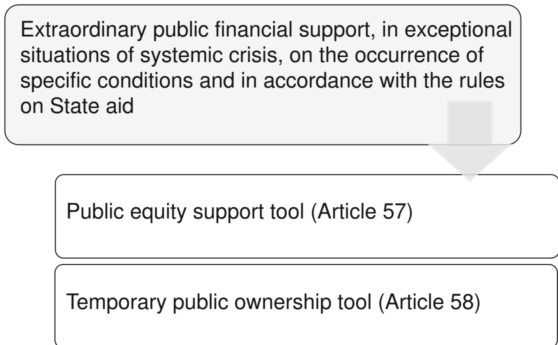

Figure 3.12 Public interventions in resolution

Furthermore, approval under State aid rules is necessary, pursuant to Article 37(10).

A specific type of public financial intervention is provided for by Article 32(4). Under this provision, the need for extraordinary public financial support is an indicator that the bank is failing or is likely to fail, and thus is a resolution trigger. The only exceptions to this rule are established in Article 32(4)(d), which lists the situations under which extraordinary public financial support by itself does not suffice to trigger resolution. Furthermore, at the moment of the granting of support the other conditions implying the obligation for a write-down or conversion of the capital instruments should not be met (Article 59(3)).

In other words, the Directive recognises that in some cases public financial support, *per se*, is not an indication that the recipient bank is failing or likely to fail. Thus, it recognises the possibility that public support might be granted, outside the resolution, to solvent banks, in order to remedy a serious disturbance in the economy of a Member State and to preserve financial stability, provided that the operation is approved under State aid rules (see Chapter 6).

Public support may assume different forms, among them:

i) a State guarantee to support liquidity facilities by the central banks;
ii) a State guarantee of new liabilities issued by the bank;
iii) a new capital injection or the purchase of capital instruments for the specific purpose of overcoming a capital shortfall of solvent banks established by an asset quality review, Stress Tests or equivalent exercises carried out by the authorities; these are situations independent of the existence of insolvency and the opening of the resolution procedure.

These measures represent a sort of precautionary recapitalisation, which is in no way referable to the principle of the mandatory application of the bail-in before the activation of other forms of public support. On this point, the EBA is entitled to establish which kind of tests, reviews or exercises might justify the application of such a form of public recapitalisation.[51]

4.3.5 Safeguards for third parties

To balance the extensive powers given to the resolution authority for the use of very penetrating resolution tools, with impacts on shareholders, creditors and contractual counterparties, the European framework

establishes an appropriate system for the protection and safeguarding of these third parties. This objective is pursued by a wide range of rules – representing a fundamental component of the new legal framework – aimed at striking an adequate balance between the effectiveness of resolution action and the protection of the rights of third parties affected by resolution measures.

The safeguards provided for by the Directive may be grouped as follows:

i) safeguards for shareholders and creditors in the case of partial sale of assets, rights and liabilities and of application of the *bail-in* (Articles 73–75). In this regard, Article 73 provides that the treatment of shareholders and creditors whose claims have not been transferred or have been written down or converted into capital is not worse than if the bank had been liquidated under ordinary insolvency proceedings (*no creditor worse-off principle*). Assessment of their treatment is carried out by an independent person, to be carried out as soon as possible after the resolution action has been implemented. This assessment, differently from that referred to in Article 36 (valuation of assets and liabilities before implementing a resolution action), takes into account the treatment that shareholders and creditors would have received if the bank had entered normal insolvency proceedings, the actual treatment that shareholders and creditors have received and whether there is any difference between the two (Article 74).[52] Where independent valuation reveals that the shareholders, creditors or the deposit guarantee scheme that intervened in support of a resolution pursuant to Article 109 have received worse treatment than they would have received under normal insolvency proceedings, these parties are entitled to payment of the difference from the resolution fund;
ii) safeguards for counterparties in the partial sales of assets, rights and liabilities of a bank under resolution (Article 76), providing for specific forms of protection of collateral arrangements, contracts of financial collateral arrangements, set-off arrangements, secured obligations, structured finance contracts and trading, clearing and settlement systems. The forms of protection are specified in Articles 77–80 of the Directive.

The only exception to application of these safeguards, as a result of the need to ensure the availability of covered deposits, is the power of the resolution authority to transfer covered deposits that are part of any of

the arrangements mentioned above, without transferring other assets, rights or liabilities that are part of the same arrangements, as well as the power to transfer, modify or extinguish the said assets, rights or liabilities without transferring the covered deposits.

The **procedural obligations** of the banks and of the authorities involved in the process are an important component of the resolution. First of all, the bank that is failing or likely to fail must notify the supervisory authority of such a situation. The supervisory authority, in turn, must inform the competent resolution authority of the notification and of any preventative measures and actions it has imposed on the bank (in accordance with Article 104 of Directive 2013/36/EU) and, where the conditions for resolution are met, it must notify the competent resolution authorities of this, having regard to the characteristics of the bank or group, as well as any other public authorities that might be involved in the resolution process, including the deposit guarantee scheme[53].

After receiving the notification, the resolution authority verifies that the conditions for resolution are met and takes its decision, indicating the reasons for the decision and the action that it intends to take, for example, filing for liquidation, appointing an administrator or any other measure provided for by the applicable insolvency proceedings.

As soon as possible after starting a resolution action, the resolution authority must comply with particular procedural obligations, in terms of giving information and publicity to third parties (Article 83). Last, in consideration of the effects that might stem from the disclosure of sensitive information, with significant consequences on public and private interests connected with the bank in crisis, the Directive establishes very strict confidentiality requirements for all the authorities involved in the resolution process, which must maintain professional secrecy on all the information obtained in performance of their activity (Article 84).

To strengthen the effectiveness of resolution action, specific rules are introduced for coordinating the procedural aspects of the resolution authorities' decisions with those of the judicial authorities in national jurisdictions. To this end, the Directive provides for some limitations to judicial proceedings, to avoid the start of insolvency proceedings against a bank under resolution.

In view of this objective, ordinary national insolvency proceedings may only be activated on the initiative of the resolution authority or with its consent.

To this end, the Directive provides that:

i) the competent court must inform without delay the resolution authority of any application for the opening of ordinary insolvency proceedings;
ii) a decision on the application can be made only if the resolution authority has informed the court that it does not intend to start a resolution action, or if seven days have expired from the date on which the notification under point (i) was given.

As an exception to all the restrictions on the enforcement of security interests set out in Article 70, where necessary for the effective application of the tools and exercise of resolution powers, the resolution authorities may request the court to apply a stay, for an appropriate period of time, to any judicial action or proceeding in which a bank under resolution is involved.

Finally, another key element in striking a balance between the exercise of authoritative powers and the exercise of private autonomy is found in the provisions on **ex-ante judicial approval** of the measures taken by the authority in the exercise of resolution powers. The Directive, in Articles 85–86, regulates the right to challenge decisions and the restrictions applicable to other proceedings.

Article 85 recognises the right to challenge the authorities' decision to take crisis management measures. In this case, Member States must ensure that the review of the appeal is expeditious and that national courts use the complex economic assessments of the facts carried out by the resolution authority as a basis for their own assessment.

However, the right to challenge is subject to some restrictions: lodging of the appeal does not entail automatic suspension of the effects of the contested decision, and the decision taken by the resolution authority is immediately enforceable, under the rebuttable presumption that any suspension of its enforcement by the court would be against the public interest.

Furthermore, for the purpose of safeguarding third parties that in good faith have concluded contracts with the bank under resolution, the annulment by a court of a decision made by the resolution authority should not jeopardise the validity of the acts or transactions effected by the resolution authority on the basis of the annulled decision. In this case, compensation is provided for the loss incurred by the applicant as a consequence of the wrongful decision or action taken by the resolution authority.

4.4 Liquidation

Liquidation is a further option available to crisis management authorities. In the light of economic considerations and of the negative impacts of a bank's liquidation on the various categories of stakeholders, liquidation should be seen as a last resort, when all other resolution measures are impracticable. Liquidation normally implies withdrawal of the banking licence and the *winding-up* of the enterprise, that is the creation of the "estate" by the liquidator (or by the *receiver*) and its realisation or sale on the market, with subsequent distribution of the proceeds among creditors under the rules of insolvency law or other insolvency measures applicable to banks.

The Directive seems to prefer resolution measures to liquidation, for purposes of public interest, whenever the liquidation of a failing bank with ordinary insolvency proceedings "*might jeopardise financial stability, interrupt the provision of critical functions and affect the protection of depositors*" (recital 45 of the BRRD). However, the Directive also states that the authorities should always consider the liquidation of an insolvent bank before deciding to keep it alive, since this hypothesis is strictly linked to financial stability purposes and to the verification that shareholders and creditors have borne a significant part of losses.[54]

During liquidation, the bank ceases to exist as a legal entity, all the relationships with counterparties are suspended and its organisational structure is disbanded. Depositors are protected by the intervention of deposit guarantee schemes.

The powers of administrative authorities in a liquidation process are substantial, in order to minimise costs for creditors and other *stakeholders*. In countries where the liquidation of banks falls under the competence of the courts, administrative authorities should nevertheless have significant powers in the insolvency proceedings' opening phase. They should have the power to require the court to put the bank into liquidation and, if such a request is made by any other party, they should be consulted before any decision is taken.

The role of the administrative authorities is also essential during the liquidation process, since this might take different forms. The authorities may use alternative liquidation methods to safeguard the continuity of specific financial services and contracts through their sale *en bloc* to another financial institution.

A fundamental issue regarding liquidation concerns its application to banking groups, for which very often there is a lack of a specific framework at national level, with consequent problems for creditors and other

parties involved. More complex problems arise when the liquidation has to be applied at international level, to banks or banking groups, given the differences between national insolvency laws. This is an extremely delicate and complex topic, since it is closely linked to other areas of national legislation, such as property, contracts and other commercial relationships. While this complexity explains the exclusion of the matter from the BRRD, it does indicate the need for a harmonisation process. This raises the issue of how to harmonise the different regimes in an effective and feasible way.

In this context, another aspect of essential importance is the priority rule introduced by Article 108 (*depositor preference*) for the eligible deposits of some categories of depositors, covered deposits and deposit guarantee systems, which will impact on national insolvency laws and will be implemented at national level in the context of resolution.

5 Financing resolution. The establishment of the Bank Resolution Fund (BRF)

An effective banking crisis management system requires adequate financial means to be used when a bank's internal resources are insufficient to cover losses, achieve recapitalisation and implement other restructuring operations. This problem is connected to the more general issue of the categories of stakeholders that should be charged with the losses (*burden-sharing*) arising from the insolvency and of the injection of the capital necessary for bank recovery.

The solution adopted by Directive 2014/59/EU, discussed at length in international forums, has been to create a financing mechanism for resolution to be borne by the whole banking system, through the establishment of national resolution funds financed by the banks (*bank resolution funds*).[55] The scheme, applicable to the 28 EU countries, is contained in Articles 99–109;[56] it requires each State to adopt a specific funding mechanism for the effective application of the appropriate tools and powers of resolution to ensure rapidity of action and reduce contagion effects. These funding mechanisms can be used by the resolution authority exclusively for the purposes set out in Article 101 of the BRRD and only to the extent strictly necessary to ensure the effective application of resolution tools.

Hence, the BRRD sets out a *comprehensive* private mechanism of resolution financing, based on the distribution of losses among shareholders and creditors of the insolvent bank (*bail-in*) and on resolution funds financed by the whole banking system (private *bail-out*). Thus, this

framework pursues the stabilisation of the financial system through financial resources taken from the whole financial sector. The Directive establishes a priority ranking in the financing of the resolution: losses, costs and the other expenditures for application of the resolution tools must be borne first by the shareholders and creditors of the bank under resolution, that is, by those who invested in the bank, while the intervention of the resolution funds – borne by the whole banking system – may take place only subsequently.

In the legislation's design, while the deposit guarantee systems are aimed at paying-out to depositors in the case of liquidation, the resolution fund aims at implementing resolution measures as an alternative to liquidation of the bank, in support of both *going concern* and *gone concern* solutions.

5.1 Funding mechanism

Article 99 establishes a *European System of Financing Arrangements*, which is made up of three main components:

i) national financing arrangements (Article 100);
ii) borrowing between national financing arrangements (Article 106) and
iii) pooling of the financing arrangements in the case of cross-border group resolution (Article 107).

The creation of the European System of Financing Arrangements aims at ensuring coordination in the use of funds available at national level, guaranteeing equal effectiveness in the resolution of European banks and the stability of the internal market.

The Directive requires Member States to establish one or more national funding arrangements in order to allow the resolution authority to exercise its powers and apply the resolution tools (Article 100). It also provides that the resolution financing arrangements must have adequate resources, coming from contributions paid by banks prior to, and independently of, any resolution action. The funds are controlled by the resolution authorities for the pursuit of the principles and objectives of resolution.

In order to create a critical mass and avoid the pro-cyclical effects that could derive from an exclusively ex-post funding system, especially in the presence of a systemic crisis, the Directive provides that the national funding mechanism must have financial means (**ex-ante funding**) of at least 1% of the covered deposits (target level) of all the banks authorised

in the national territory, to be reached within ten years (by 31 December 2024). The fund is fed by banks with ordinary contributions, (at least) annually, starting from 2015 (Article 103). Member States can, therefore, establish target levels above such amount.

A part (up to 30%) of the financial resources available for the attainment of the target level may consist of *irrevocable payment commitments*, collateralised by low-risk assets, unencumbered by third parties' rights and destined for the exclusive use of the resolution authorities for the purposes of the resolution.

These contributions are calculated pro rata to the amount of the liabilities of each bank, net of own funds and covered deposits, with respect to the aggregate liabilities, net of own funds and covered deposits, of all the banks authorised in the Member State. The contributions so determined are corrected on the basis of the risk profile of each bank (*risk-based contribution*).

The Commission is empowered to adopt delegated acts establishing the operational criteria for calculation of the *risk-based* contributions,[57] taking into account a series of elements for the measurement of the bank's risk exposure.[58] In particular, the risk factors to be considered include (Article 103(7)):

- the importance of the bank's trading activities, its off-balance sheet positions and its leverage level;
- the stability and mix of the bank's funding sources and unencumbered highly liquid assets;
- the bank's financial situation and its probability of undergoing resolution;
- the extent to which the bank has previously benefited from extraordinary public financial support;
- the complexity of the bank's structure, its resolvability and the relevance of the bank for the stability of the financial system or for the economy of one or more Member States or the Union.

Another factor to be considered is whether the bank is part of an IPS, a system aimed at preserving the solvency and liquidity of member banks, and thus aimed at preventing the occurrence of resolution triggers. Accordingly, Article 32 of the Directive includes the measures taken by an IPS among the alternative actions of the private sector able to prevent resolution within a reasonable time frame.

The Commission is empowered to adopt delegated acts in order to specify the registration, accounting and reporting obligations and other

obligations (Article 103(8)) aimed at ensuring the effective payment of contributions by banks, and the measures allowing adequate verification of their correct payment.

Should the resources available to finance a resolution prove to be insufficient, Member States can raise **extraordinary ex-post contributions** (Article 104) from banks; these contributions are calculated using the same criteria provided for ex-ante contributions. The amount of ex-post funding cannot exceed three times the amount of the ex-ante annual contributions.

If both contributions are found to be insufficient or if the ex-post component is not immediately accessible, **alternative funding means** may be sought (Article 105), that is, through borrowing or other forms of support from banks, financial companies or other entities.

In particular, the recourse to alternative forms of financing may take place in extraordinary cases, after the use of the resolution fund has reached the limit of 5% of total liabilities, including own funds, of the bank under resolution and when all unsecured and non-preferred liabilities, other than eligible deposits, have been written down or entirely converted. Alternatively, or in addition, the resolution fund may make a contribution using the resources from ex-ante contributions that have not yet been used (Article 44(7)).

The second component of the European System of Financing Arrangements is represented by the **voluntary borrowing between national financing arrangements** (Article 106) when specific conditions are met.[59] Specifically, the resolution funds may borrow from all other Union financing arrangements (or lend to them on request), when the sums collected ex-ante are insufficient to cover losses, costs and other expenses, the ex-post extraordinary contributions are not immediately accessible and the alternative funding means pursuant to Article 105 are not immediately accessible at reasonable conditions. The conditions for borrowing – in terms of interest rate, duration and methods of reimbursement – are agreed between the parties concerned and the amount of the loan in each arrangement is determined pro-rata to the amount of covered deposits in the Member State of that financing arrangement with respect to the aggregate covered deposits of all participating Member States.

The third component of the European System of Financing Arrangements is represented by the **mutualisation of the national funds in cases of group resolutions** (Article 107). The Directive provides that, in the case of a group resolution, the national financing arrangement of each bank belonging to the group shall contribute to the financing of resolution.

It is worth noting that the European Commission, right from the start, has given great importance to the financing of cross-border group resolutions, in view of the lessons learned in the management of a series of banking insolvencies during the financial crisis (Fortis, the Icelandic banks), which revealed major weaknesses in the coordination of two different approaches: on the one hand, the EU perspective, which tends to deal with the different parts of a group as a whole; on the other hand, the concrete actions of the individual States, generally dictated by national interest, not necessarily agreed upon and potentially clashing with the EU level. The BRRD regulates expressly the pooling of the national-level funds in the case of cross-border group resolutions, as an integral part of the European System of Financing Arrangements.

The contribution of each national fund is established according to the financing plan prepared within the group resolution plan, agreed within the Resolution College. Such a plan will reflect the criteria for resolution burden-sharing previously established in the resolution plan, which take into account the impact of the resolution in the various countries in which the group operates and the distribution of supervisory powers among the various authorities involved.

The financing plan covers, *inter alia,* the following aspects: the losses that each component of the group would bear and, for each of them, the losses that each class of creditors and shareholders would bear; any

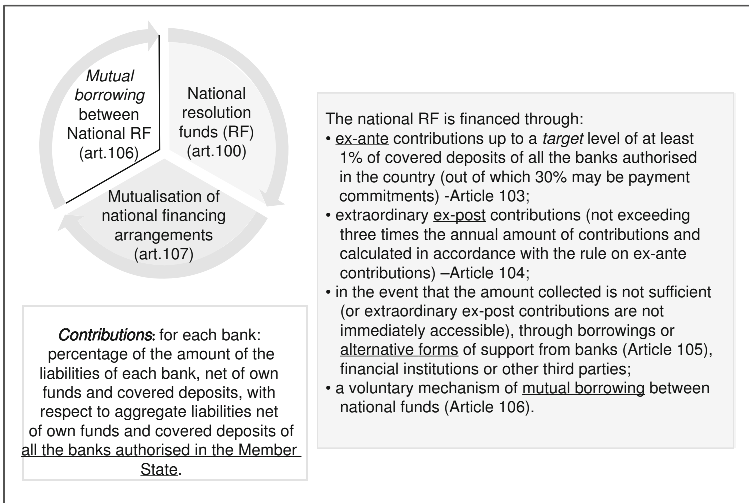

Figure 3.13 National bank resolution fund: funding

contributions that deposit guarantee schemes would have to make pursuant to Article 109; the total contribution from financing arrangements, the basis for calculating the contribution from each national fund and the related amount;[60] the amount of borrowing that national resolution funds can obtain as alternative financing forms and the time necessary for use of the national financing arrangements.

5.2 The use of bank resolution funds

The definition of the circumstances in which the resolution fund can intervene is an important aspect of the whole system of crisis resolution. To this end, the Directive provides that the fund can be be used only to finance the resolution measures and guarantee the effective application of resolution tools. As a consequence, resolution funds cannot be used for banks in liquidation under ordinary insolvency proceedings because in these cases the deposit guarantee schemes intervene to pay off depositors.

There are several cases justifying the use of resolution financing arrangements (Article 101). They can be used to support any resolution operation, in different ways and technical forms:

- to guarantee the assets and liabilities of the bank under resolution, its subsidiaries, a bridge bank or an asset management vehicle;
- to provide loans to the same entities;
- to purchase assets from the bank under resolution;
- to provide contributions to a bridge bank or asset management vehicle;
- to pay compensations to shareholders and creditors within the safeguards regime provided for by Article 75;
- to make a contribution to the bank under resolution in place of the amount it would have obtained from the write-down or conversion of the liabilities of specific creditors, if the authority has decided to exclude some liabilities from the bail-in;
- to provide loans to other resolution financing arrangements on a voluntary basis.

In any case, the resolution fund cannot be used to cover losses directly or to recapitalise a bank or another entity referred to above. Moreover, if the resolution fund incurs indirect losses, the principles regulating the use of the resolution fund within the bail-in framework – pursuant to Article 44 – will apply, including the use of bail-in covering at least

8% of total liabilities and the rule that use of the fund may not exceed 5% of total liabilities.

5.3 Intervention of deposit guarantee schemes in the resolution

The use of deposit guarantee schemes in the context of resolution is regulated by Article 109 of the BRRD. While recognising the different purposes of the two financing mechanisms, the BRRD provides that deposit guarantee schemes might contribute to losses connected to the resolution process. DGSs contribute to resolution in place of covered depositors, who are excluded from application of the resolution tools such as bail-in. Moreover, one of the objectives of resolution is to ensure uninterrupted access to covered deposits. Excluding the involvement of guarantee schemes would constitute *"an unfair advantage compared to the rest of creditors, which would be subject to the exercise of the powers by the resolution authority"* (recital 71).

The coexistence of the two funds raises the delicate issue of how to coordinate the activities, funding and contribution mechanisms of the DGSs and the BRF. In this regard, the Directive provides that the Member States may use the same administrative structure as their resolution fund for the purposes of their DGS (Article 100), with appropriate safeguards to protect the resources of the DGS and its primary mandate, which is to reimburse depositors.

This issue was debated at length during the drafting of the Directive and Article 109 was extensively modified in the final version.

A first significant difference between the initial proposal and the final text of the Directive is found in the ranking given to the DGSs in the hierarchy of creditors in ordinary insolvency proceedings. Initially, the DGS was ranked at the same level as unsecured creditors; in the final text of Directive 2014/59/EU, on the contrary, the DGS has been ranked at the same level as covered deposits, which have priority over deposits in excess of €100,000 of some categories of depositors and over all unsecured creditors (Article 108 BRRD).

As a consequence of the ranking given to DGSs, *de facto* their possible involvement in the resolution becomes unlikely, since they would only be liable for the coverage of any losses that remain uncovered after the application of the bail-in and the intervention of the resolution fund.

The double method of calculating the contributions to resolution foreseen in the initial version of the Directive, according to whether or not the DGS was combined with the resolution fund has been replaced in the final text by a univocal indication.[61] Therefore, while the target level of the fund is established in terms of covered deposits both for the

DGS and for the resolution fund, the basis for calculating the contributions from each bank to the scheme is different. This basis is defined, respectively, by the Deposit Guarantee Scheme Directive (DGSD) inArticle 13(1) with reference to covered deposits and by the BRRD (Article 103(2)) with reference to total liabilities, excluding own funds and covered deposits.[62]

Pursuant to Article 109 of the BRRD, the DGS intervenes through provision of cash in the resolution, when the conditions for its involvement occur, as a *loss absorber* in place of covered depositors. The *no creditor worse-off* principle is applied, as well as the quantitative limit on the contribution of the DGS to the resolution, which is 50% of its target level in respect of covered deposits. A key point here is the independent valuation of the bank's assets and liabilities (Article 36 of the BRRD) for the purpose of determining the maximum amount of the contribution.

In particular, provided that ongoing access to deposits by depositors is ensured, if *bail-in* is applied, the DGS must contribute the amount that the secured depositors would have been charged if they were not permanently excluded from application of the bail-in. If one or more of the other tools are applied, the DGS will be liable for the amount of losses that the same depositors would have incurred under national insolvency laws.[63] If *bail-in* is applied, the DGS cannot be required to contribute to the recapitalisation of the bank under resolution or of the bridge bank pursuant to Article 46(1)(b) (conversion into capital of the eligible liabilities to restore the common equity Tier 1 requirement).

The DGSD also regulates (Article 11) the use of DGS funds (see Chapter 5): with regard to their use for resolution financing, it refers to Article 109 of the BRRD and requires the resolution authority to determine, after consulting the DGS, the amount for which the DGS is liable, subject to specific safeguards to preserve its resources.[64]

5.4 Recourse to the *European Stability Mechanism* (ESM)

Another important financial instrument for intervention, especially in cases of banking crises of systemic relevance, is represented by the *European Stability Mechanism* (ESM), the permanent crisis resolution mechanism in Eurozone countries, which provides financial assistance through various tools and procedures in the presence of serious financial and stability problems. Its original mandate was to grant support to Member States; subsequently its mandate was extended to the (direct or indirect) recapitalisation of banks in distress.

The ESM is the ultimate line of defence offered to governments and banks to overcome situations of instability, after recourse to all the other ordinary instruments of intervention. Accordingly, the provision of support measures is subject to a rigorous conditionality regime.

To discharge its mandate, the ESM may raise funding by issuing financial instruments or concluding financial or other agreements with Eurozone countries, financial institutions and third parties. The support instruments include the provision of lending to countries in difficulty, the purchase of financial instruments issued by these countries on the primary or secondary markets, the opening of credit lines and the (indirect) recapitalisation of banks through loans provided to the governments (including those of countries not included in the programme). As to the manner and conditions of ESM intervention, the policy agreed by the Eurogroup was to complete the ESM's operational framework and guidelines on conclusion of the Banking Union approval process.

In particular, once the tool of direct bank recapitalisation becomes operational, the ESM will constitute a further protection of the financial stability of the Eurozone, thus reducing the risk of contagion between the financial sector and the public balance sheets. On 10 June 2014 the Eurogroup reached a political agreement on the operational mechanism for the direct recapitalisation of banks through the ESM, to be activated from 4 November 2014.

Box 2 The European stability mechanism

The European Stability Mechanism

The ESM is the permanent crisis resolution mechanism for Eurozone countries. From an institutional point of view, the ESM is an intergovernmental organisation under international public law, with its registered office and main place of business in Luxembourg. The decision to create the ESM was taken by the European Council in December 2010. The Eurozone countries underwrote the intergovernmental treaty for establishment of the mechanism on 2 February 2012. The ESM became operational on 8 October 2012 following the signing of the Treaty by the then 17 Eurozone countries.

The activity of the ESM consists in collecting funds through the issue of money-market instruments and medium- and long-term debt, with maturity at 30 years, in order to provide loans and other forms of financial assistance to Eurozone Member States.

The financial resources of the Mechanism consist of subscribed capital of about €702 billion, of which €80 billion is paid in by the participating countries, and of the irrevocable and unconditional commitment of the Member States to provide a further €622 billion in case of need. The ESM is able to

issue bonds and other financial instruments to collect about €500 billion on the markets, which constitutes its maximum lending capacity.

The provision of loans is for the benefit of Member States in difficulty, on condition they adopt specific measures. In particular, the ESM:

- grants credit in the framework of macroeconomic adjustment programmes;
- buys debt instruments in the primary and secondary markets;
- provides precautionary financial assistance in the form of credit lines;
- finances the recapitalisation of banks through the provision of loans to the governments of ESM Member States;
- will be able to directly finance the Eurozone banks after the launch of the *Single Supervisory Mechanism*.

Financial assistance can be granted only if the beneficiary State signs a *Memorandum of Understanding* with the European Commission, the ECB and the IMF (where applicable), containing the commitment to adopt a series of economic measures to resolve its balance sheet problems, as well as to ratify the *Fiscal compact.*[65]

On 20 June 2013 the Eurogroup reached an agreement on the main characteristics of the direct recapitalisation of banks through the ESM, with the objective of making available the instrument once the SSM is fully operative. On the basis of the operational *framework* defined in this context, the ESM will be able to perform direct recapitalisation, upon request of a Member State, if:

i) the State is unable to provide full financial assistance to the bank without producing negative effects from the viewpoint of fiscal sustainability and it is demonstrated that recourse to other alternatives would jeopardise the continuity of access to the market of the requesting State;
ii) the financial assistance to the requesting State is indispensable to safeguard the financial stability of the whole Eurozone or that of the States belonging to it;
iii) the bank does not comply (or is likely not to comply in the short term) with the capital requirements established by the prudential regulation and is unable to attract sufficient capital from private sources or to use other instruments to resolve its capital problems;
iv) the bank has a systemic relevance or poses serious threats to the financial stability of the Eurozone as a whole or of the requesting country.

In March 2014 the ESM introduced an *Early Warning System* in order to monitor the capacity of the countries benefiting from financial assistance to reimburse the loans; this implies assessment of the government's short-term liquidity position, its access to the markets, balance sheet position and the sustainability of public debt in the medium-long term.

A limit of €60 billion has been placed on the ESM's capacity to provide financial assistance, in order to balance the objective of risk containment with that of preserving the system's lending capacity. As a general rule,

recapitalisation by the ESM will be carried out against the acquisition of shares of the bank or the underwriting of special shares, hybrid instruments or *contingent capital* in order to lead the bank to comply with the capital requirements established by Basel III (CRD IV and CRR).

Given the conditions for the use of the instrument defined in June 2013, the operational *framework* of the agreement of 10 June 2014 specifies that, in the transitional period until 31 December 2015, direct recapitalisation may be activated only after a *bail-in* of 8% of the bank's liabilities and the use of the resources available in the national resolution funds.

From 1 January 2016 the bail-in rules provided for by the BRRD will apply. The financial assistance will be provided in compliance with State aid rules.

The conditions for access to direct bank recapitalisation – in addition to those established by State aid rules – are defined by the ESM, jointly with the Commission and the ECB. They might consist of rules on governance, management remuneration and bonuses.

A wide debate is currently under way at European level for the transformation of the ESM into an institution having growth and stability among its objectives, through the issue of *eurobonds* for the financing of the economy.

6 A challenge for the future: the harmonisation of insolvency regimes

With the introduction of the new European legal framework for crisis management and the centralisation of resolution within the SRM, the debate on the harmonisation of the national insolvency rules applicable to banks and banking groups remains open. These rules currently differ widely between countries.

The topic is under scrutiny at European level. Precisely as a consequence of the lack of harmonisation of insolvency laws, the resolution framework makes repeated references to the application of national insolvency rules. This occurs when it is necessary to define the participation of creditors in losses or in compensation measures for the benefit of worse-off creditors in the case of bail-in or partial transfer of business. Furthermore, because of this lack of homogeneity, the implementation of resolution action decided at European level is entrusted to national authorities.

Notwithstanding this, significant progress has been made in the direction of harmonisation. The new framework for group resolution based on Resolution Colleges has introduced new binding rules and procedures that are a major step forward in the direction of a unitary approach to crisis management.

The theme under examination becomes even more important when we move from the European dimension to the wider global perspective.

Here the lack of cross-border banking group regulation is a significant shortcoming, if we consider the global scope of financial markets and of many financial intermediaries operating in it (*Systemically Important Financial Institutions*). The failure of *Lehman Brothers*, and the subsequent problems raised by the opening of different insolvency proceedings in all the countries where its subsidiaries were located, offers a strong warning of the need to build harmonised rules and procedures for handling the insolvencies of international banks or banking groups.

The problem comprises two major issues: on the one hand, the applicable insolvency rules (that is, the subjective and objective requirements for opening the insolvency procedure, the treatment of creditors, the rules governing recoveries and distribution of them to creditors); on the other, decision-making competence concerning the position of a group's subsidiaries in the insolvency proceedings and the governance of such proceedings.

This is undoubtedly an ambitious perspective, in view of the complexity of the topic and of the different legal traditions of the countries involved, with consequent significant impacts on institutional arrangements and on company and bankruptcy laws. The practicable solution may well be multiple given the lack of an ideal reference model.

It is worth noting, however, that international insolvency rules for the banking sector are quite advanced compared with those for other commercial enterprises, even though many initiatives have been taken over the last years to strengthen the regulatory framework applicable to those enterprises. At a global level, many efforts have been made to establish a more advanced and comprehensive framework (including principles, objectives, and tools) for improving insolvency law and strengthening cooperation in cross-border insolvency of enterprises or groups of enterprises[66]. These enhancements reflect the importance of an effective insolvency law for the good functioning of the economy and the optimal reallocation of resources. Shortcomings of the EU Regulation (EC) n. 1346/2000 on insolvency proceedings are also well known. It addresses cross-border insolvency through mutual recognition and coordination of national insolvency proceedings. However, it does not harmonize insolvency laws applied to national insolvency cases, leaving substantial differences in national laws with different treatment of creditors.

The existence of stable and structured institutional bodies in the financial sector, which enable a degree of international agreement (Financial Stability Board, Basel Committee on Banking Supervision), facilitates analysis of the problems affecting the sector and the definition of

standards and agreements, also in terms of co-operation and exchange of information between the authorities. In this category we may include the *Key Attributes* of the Financial Stability Board, which establish principles and procedures for the resolution of banking group insolvencies and identify the Crisis Management Groups as the operational and organisational structures for authorities co-operation. However, the principles and standards established are not binding; thus their value is only contractual and, so, limited.

Therefore, substantial legal uncertainties persist as to the effectiveness of cross-border resolution measures, particularly as regards the recognition by host authorities of the measures adopted by the home authority, such as the suspension of payments, the temporary suspension of the anticipated closure of financial contracts (*temporary stay*) and the exercise of bail-in powers.

Legal certainty is fundamental in commercial relationships, all the more so when a firm is in a crisis situation. This requires the definition of rules and procedures, possibly on the basis of a binding international treaty, allowing the immediate recognition of the foreign resolution proceedings.

In theory, two approaches to the regulation of cross-border group insolvency may be identified:

i) the ***universal resolution approach***, which considers the management of a cross-border group insolvency as a "single-entity resolution". Under this model, the insolvent banking group is subject to the laws and rules of the country of the parent bank, which are extended to all the components of the group, including those located in other jurisdictions. This model has certain ambiguities since there can be different ways of applying the scheme. The stronger application of this model may be based on the "pooling of the assets" of the different group entities, considering them as a single economic entity. A weaker, but perhaps more realistic approach, could be strong coordination of the proceedings opened for each legal entity located in different countries, with a primary role in the proceedings being played by the parent bank;
ii) the ***territorial resolution approach*** (or *ring-fencing approach*), based on the application of separate procedures for each legal entity of a banking group located in different jurisdictions. This implies that each national authority is entrusted with the power to manage and resolve the crises of domestic entities. This scheme, in substance, considers the existence of a potential conflict of interests between

home and host authorities, because of the different resolution regimes and the tendency of host authorities to retain their sovereignty in crisis management.

Evidently, this model tends to protect the national stakeholders through the ring-fencing of the assets belonging to local entities. According to this scheme, each national jurisdiction would apply its own domestic legislation and govern the insolvency proceedings for the components and assets located in its jurisdiction.

The territorial model implies that the national authorities will tend to extend the protection of the local entities' assets not only during the resolution process, but also during the "on-going supervision" period, through specific regulatory and supervisory measures, such as asset retention requirements and limits on intra-group transactions including the transfer of assets (supervisory ring-fencing).

Undoubtedly, the ideal approach would be the universal model, in that it tends to handle the banking group as a single entity and to entrust the parent bank's authority with the power to manage and coordinate the crisis. However, this solution requires the definition of a multilateral treaty obliging signatory countries to participate in an international coordination process, and for this reason it might be scarcely practicable at global level in the short term.

It is perhaps more realistic to choose, at least in the short term, the second model, currently in force all over the world, possibly improving it with appropriate measures, for example by strengthening the mechanisms of group crisis management and introducing rules on the mutual recognition of the resolution and insolvency measures adopted. Indeed, for large financial institutions with a cross-border structure, it might well be unrealistic and impracticable to rely on the home supervisor's capacity to control the entire banking group on a consolidated basis or, in the case of insolvency, to confide in the capacity of a single authority to manage a wide-ranging and complex crisis. Furthermore, the recent crisis has shown that these financial institutions, rather than being "*too big to fail*", are "too big to be controlled", even by their parent company. This was the case for the Irish banks, which became so large that the home authorities were unable to carry out effective supervision or to take the necessary actions to manage and resolve the crisis.

As pointed out by the Basel Committee, "*cross-border expansion can create its own risks of unmanaged growth in the absence of effective supervision by home authorities*".[67] The case of the Icelandic banks has also revealed how limited national resources may be with respect to the

financial costs of the crisis. As a consequence, when a crisis is looming, the behaviours of the different entities might be uncoordinated, and this lack of coordination might give rise to distortions and damage for some group entities. In relation to these aspects, the need for careful consideration of the multilateral model for the supervision of the banking group, based on strict coordination entrusted to the *lead supervisor*, has been stressed, considering the useful inputs that can be provided by the host authority.[68]

An "intermediate" approach between the two schemes outlined above could thus consist of the orderly resolution or liquidation of the financial institution by the country in which the institution has its parent bank on a universal basis. Nevertheless the host authorities would maintain a prominent role in the management of the insolvency, co-operating with the home authorities. This could be done through the management of separate insolvency proceedings by host authorities, which might transfer the realization coming from their procedure to the one carried out by the home authority. It would combine the positive aspects of the centralised coordination of the crisis by the parent bank authority with the significant role of the host authorities and, in this way, it would replicate in insolvency management the model created within the Crisis Management Groups for resolution management.

Box 3 Key attributes of effective resolution regimes for financial institutions

The Key Attributes (KA) are 12 principles that form the basis for effective resolution regimes. The KA were issued by the Financial Stability Board (FSB) in October 2011 and can be considered as international standards of general application (soft law). They are not legally binding, but are highly recommended by international financial authorities and forums. Their implementation would allow authorities to keep a bank alive as a going concern or to wind it up in an orderly manner without having to use taxpayer money.

The 12 principles are:

1. **Scope:** resolution regimes should be applied to any systematically significant financial institution;
2. **Resolution authority:** each jurisdiction should have a resolution authority with clear mandates, role and responsibility;
3. **Resolution powers:** resolution authorities should have a broad range of powers, including the transfer of assets and liabilities, the creation of bridge institutions and the carrying out of bail-in;

4. **Set-off, netting, collateralisation, segregation of client assets:** the legal framework governing these arrangements should be clear, transparent and enforceable during a resolution;
5. **Safeguards:** resolution powers may depart from the general principle to respect the hierarchy of claims. Safeguards should ensure the right to compensate creditors in line with the no creditor worse-off principle;
6. **Funding of firms under resolution:** authorities are not constrained to rely on, and should make minimum use, of public ownership or bail-out funds as a means of resolving financial institutions;
7. **Legal framework conditions for cross-border co-operation:** authorities should achieve co-operative solutions with foreign resolution authorities;
8. **Crisis Management Groups (CMGs):** home and host authorities should maintain CMGs to facilitate the management of resolution of cross-border financial institutions;
9. **Institution-specific cross-border cooperation agreements:** home and relevant host authorities should issue specific agreements to clearly define their roles and responsibilities during resolution of Global Sistemically Important Financial Institutions (G-SIFIs);
10. **Resolvability assessments:** resolution authorities should regularly undertake, at least for G-SIFIs, resolvability assessments that evaluate the feasibility and the credibility of resolution strategies;
11. **Recovery and resolution planning:** jurisdictions should require the creation of recovery and resolution plans, at least for home G-SIFIs;
12. **Access to information and information sharing:** financial institutions should maintain the circulation of information among authorities on a timely basis, for recovery and resolution planning.

Appendix 1 gives also general guidance on the implementation of the Key Attributes.

On 15 October 2014, the FSB released a new version of the KA. The 12 principles remained unchanged. The differences are in **Appendix I**, where a new Annex on information sharing for resolution purposes was added; and in a new **Appendix II** on sector-specific guidance, which explains how the Key Attributes should be implemented for insurers, financial market infrastructures (FMIs) and the protection of client assets in resolution.

General guidance on the implementation of the Key Attributes (Appendix I):

I-Annex 1: Information sharing for Resolution Purposes (KAs 7 and 12)
I-Annex 2: Institution-specific Cross-border Cooperation Agreements (KA 9)
I-Annex 3: Resolvability Assessments (KA 10)
I-Annex 4: Recovery and Resolution Plans (KA 11)
I-Annex 5: Temporary Stays on Early Termination Rights (KA 4)

Sector-specific Guidance (Appendix II)

II-Annex 1: Resolution of Financial Market Infrastructures and Financial Market Infrastructure Participants
II-Annex 1: Resolution of Insurers
II-Annex 1: Protection of Client Assets in Resolution.

4
The Second Pillar of the Banking Union: From the National Resolution Authorities to the Single Resolution Mechanism

1 The regulatory path towards the centralisation of crisis management

The Bank Recovery and Resolution Directive (BRRD) is based on a network of national resolution authorities co-operating with each other, a common set of applicable powers and rules and the establishment of national funds for the resolution of bank crises. This marks a major shift away from the previous regulatory and institutional framework; it helps to minimise the differences in national procedures and practices and the fragmentation of the single market.

However, the new overall framework outlined by the Directive has been deemed as not entirely suitable for those Member States that share a common currency and are under the supervision of the same authority, the European Central Bank (ECB). Growing pressure triggered by the financial crisis and, in particular, the vicious circle between sovereign risk and banking risk made it evident that a framework based on the one hand on a centralised European system of banking supervision and, on the other, a crisis management system left in the hands of the National Resolution Authorities, was not the best solution. Inevitably, it would lead to distortions of competition and fragmentation.

This led to growing awareness that a system resting on co-operation and coordination between national authorities was not the best, especially when it came to managing the failure of large cross-border banks.

Thus, similarly to the process that led to the creation of the Single Supervisory Mechanism (SSM), also in the field of bank crises, the idea of developing an architecture matching the new supervisory system started to gain ground.

This led the European Council at its meeting of 14 December 2012, to establish a system where both banking supervision and resolution would be managed at EU level, within the broader objective of a Banking Union. This policy was confirmed by the Council at its meeting of 28 June 2013.[1]

A legislative proposal was submitted by the European Commission on 10 July 2013,[2] after extensive and in-depth debate. The aim was to reach an agreement before the end of the then current term of the European Parliament (plenary of April 2014).

The proposal was to move from a system based on a network of National Resolution Authorities to a Single Resolution Mechanism (SRM). This would centralise decision-making power for the management of failing banks and entrust it to a single European resolution authority. The project also provides for the establishment of an EU-level Single Resolution Fund (SRF). It is the regulators' intention that this crisis management system should be able to address more effectively and rapidly the resolution of a bank than a system in which responsibilities are fragmented among national authorities with more limited resources, capacity and experience.

The path of the proposal for the Single Resolution Fund has been a bumpy one. Difficulties have been experienced in achieving political agreement for the mutualisation of national funds, which would require the transfer of resources between countries, in particular between economically sound and weak ones. On 18 December 2013, the European Council proposed a general approach,[3] and launched the search for a common position with the EU Parliament to resolve the most contentious issues. At the same time, it was decided that an Intergovernmental Agreement (IGA) would establish how the Single Resolution Fund would work from the vpoint of the transferral of contributions and mutualisation of resources.

In the same Plenary, the Eurogroup and the financial ministries signed a declaration on a common backstop for the SRM, in order to address any shortfall scenarios, in the start-up period or in full operation.[4]

The agreement on the SRM Regulation and the IGA package was concluded on 27 March 2014 and signed by 26 EU Member States (with the exception of Sweden and the United Kingdom) on 21 May 2014.[5] On 14 July 2014 the Council approved the Regulation on the Single Resolution

Mechanism.[6] When it is fully operational, the SRM's rules will be based on the Regulation and, for specific matters linked to operation of the Single Resolution Fund, on the IGA. The SRM Regulation will become applicable from 1 January 2016.

The Single Resolution Mechanism establishes a Single Resolution Board (SRB) with the contribution of National Resolution Authorities, accompanied by a Single Bank Resolution Fund.

The SRM will be directly responsible for the restructuring of all the banks of the Member States participating in the SSM (about 6,000 banks).

2 Conferring tasks on the Single Resolution Board: the legal basis

The creation of a single resolution authority was accompanied by intense debates, given the difficulties in identifying the institution to be entrusted with resolution powers. A number of options were considered. One of them was to entrust resolution powers to the ECB on the basis of Article 352 of the Treaty on the Functioning of the European Union (TFEU), without need for any amendments .[7] This option was soon abandoned to avoid excessive concentration of powers within the same institution and possible conflicts with the ECB's performance of its monetary policy and banking supervision tasks. Other institutions considered for this role were the European Banking Authority (EBA), the European Commission and the European Stability Mechanism (ESM).

The final choice was to establish a new *ad hoc* agency: the **Single Resolution Board** (see Articles 42 and 43), entrusted with resolution powers. The Board is responsible for the SRM's effective and consistent operation; it consists of a Chairperson, four full-time members and representatives from those National Resolution Authorities that have voting rights; its meetings are also attended by representatives from the ECB and the European Commission as permanent observers, who are entitled to participate in discussions and access all documents. These extremely complex and sensitive tasks require the highest independence and competence of members, as well as an appropriate decision-making control system.

The legal basis for the resolution mechanism is Article 114 of the Treaty on the Functioning of the European Union, which provides that 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.

The solution proved to be controversial from a legal viewpoint. The Council's legal experts had sent to the national authorities a legal opinion that, referring to the EU's "Meroni" principle (Court of Justice, 1958),[8] raised objections on the possibility of delegating such broad discretionary powers to a body, the Single Resolution Board, which is not an institution of the Union with executive competences; this was with regard both to the drawing up of the resolution plan and to the investments to be made by the Single Resolution Fund associated with the Single Resolution Mechanism.[9] Indeed, some concerns about the establishment of the resolution fund had already been voiced earlier, on account of its potential impact on national fiscal sovereignty.

3 Decision-making process in resolution: a fractious, perhaps inevitable, system

In light of the doubts cast on the legal feasibility of giving the Single Resolution Board the role of authority responsible for managing resolutions, attention was focused on selecting the authority with final decision-making powers and designing the decision-making mechanism.

As to the first matter, the debate within the EU institutions was on whether decision-making powers should rest with the Commission or the Council.

The initial position was that the final decision on implementation of a bank's resolution should be made by the European Commission, a European institution fully empowered to perform this task under the provisions of the Treaty. This choice would also have been in line with the Commission's role as the guarantor of full compliance with the principles underpinning the functioning of the Union and of their uniform application in the Single Market. Another factor, as mentioned, was the experience built by the Commission in bank restructuring, in particular through the approval of State aid to banks and the application of competition rules.

Accordingly, in the initial version of the Regulation the European Commission was given the responsibility for making the final decision as to whether to open the resolution procedure and on use of the resolution tools and of the fund, either on the basis of the investigations and recommendations of the SRB or acting on its own initiative. This solution was opposed by certain countries, which raised concerns about

possible interference and conflicts within the Commission, as a consequence of its regulatory and control powers in the field of State aid.

The alternative option of awarding the decision-making powers to the Council – selected as a general approach at the European Council meeting of December 2013 – was criticised by some who stressed that it would be risky to make the resolution process less independent, as the Council is an authority with strong political connotations.

A compromise solution was reached on 27 March 2014, achieving a delicate balance with a complex decision-making mechanism that involves the SRB, the Commission and the Council.

Under the chosen solution, the decision to place a bank in resolution is entrusted to the SRB, acting on a recommendation from the ECB in its capacity as supervisory authority, or acting on its own initiative after giving advance notice to the ECB. Thus the ECB in its capacity as supervisor – that is, on account of its knowledge of the bank's situation by virtue of its role – is the body empowered to launch the resolution procedure; accordingly, the ECB alerts the Single Resolution Board when a bank is failing or likely to fail and is thus in need of a resolution measure.[10]

The SRB is responsible for the preparation of the resolution, which include the drafting of resolution plans and assessing the bank's resolvability. The Board is also empowered to analyse and identify the methods for a bank's resolution and the modalities of intervention of the Single Resolution Fund. The SRB will apply the rules on resolution laid down in the BRRD to the banks of participating Member States in the same manner as they are applied by the National Resolution Authorities.

Thus, the Board is responsible for the functioning of the SRM in respect of "significant" banks and groups (those that are systemically important and operate on a cross-border basis) and for those banks under the ECB's direct supervision (Article 7 of the SRM Regulation). All the other banks remain under the care of the National Resolution Authorities, unless recourse to the Single Resolution Fund becomes necessary: in this case the decision must be made by the SRB.

The National Resolution Authorities are involved to a significant extent in a bank's resolution: they assist the SRB in drawing up and implementing resolution plans, under the SRB's supervision. When performing the tasks conferred on them by the Regulation, the Board and the National Resolution Authorities act independently and in the public interest (Article 47). If a National Resolution Authority fails to conform to the SRB's decision, the latter may impart executive orders directly to the failing bank.

The decision-making process of the resolution action is highly structured and complex, reflecting the Board's design and manner of operation.

The Board's structure varies according to its decision-making competences: plenary session and executive session.

The **executive session** is composed of the Chair and four members designated on the basis of a selection procedure that takes into account their specific competences and experience in the fields of supervision, financial regulation and bank resolution. Decisions on cross-border banks and groups are taken with the participation of the representatives of the resolution authorities of the countries affected by the crisis. The executive session is competent for the preparatory and operational decisions concerning bank restructuring, including use of the resolution fund, and for the decisions addressed to Member States concerning enforcement of the approved resolution measures. The executive session draws up most of the draft resolution decisions and, as a rule, takes its decisions by a simple majority. In the event of a tie, the Chair has the casting vote.

The **plenary session** is competent for general and budgetary matters, and for adopting the rules of procedure for the executive session as well. The plenary session is also responsible for: (1) resolution decisions above the threshold of €5 billion of capital, or double that amount in the form of liquidity support from the SRF; (2) if the net accumulated use of the Fund in the last consecutive 12 months has reached the threshold of €5 billion, evaluation of the application of the resolution tools, in particular the use of the SRF, and provision of guidance to the executive session for subsequent resolution decisions and (3) deciding on the necessity to raise extraordinary ex-post contributions in accordance with Article 71, on the voluntary borrowing between financing arrangements in accordance with Article 72, on alternative financing means in accordance with Articles 73 and 74 and on the mutualisation of national financing arrangements in accordance with Article 78, involving support of the Fund above the threshold of €5 billion.

The resolution scheme adopted by the Board – including the tools to be adopted and, in particular, any optional exclusions from the bail-in and use of the SRF – becomes fully effective 24 hours after approval.[11]

The draft proposal does not become definitive if the Council, acting on the Commission's proposal within 12 hours of the adoption of the scheme by the SRB, objects to the scheme on grounds of public interest or with regard to the amount of the funds provided for by the resolution scheme (Article 18(7) of the Regulation). In particular,

where the resolution scheme provides for the exclusion of certain liabilities and this requires a contribution from the SRF or an alternative financing source, in order to protect the integrity of the internal market the Commission may prohibit this or require amendments to the proposed exclusion setting out adequate reasons. Under Article 18(8), if the Council objects on the grounds that the scheme is not in the public interest, the bank must be wound up in accordance with the applicable bankruptcy procedures.

If this is the case, the Board must within eight hours make amendments to the resolution scheme on the basis of the reasons set out in the objection.

In any case, the Commission is always involved whenever the resolution involves the granting of State aid or use of the SRF (Article 19(1) of the Regulation). In this regard, Article 19(3) provides that, when the proposed resolution scheme involves use of the SRF, the Board must so inform the Commission, including all the information necessary to enable the Commission to make its assessments, specifically to verify that use of the Fund is not ultimately incompatible with the internal market by altering or distorting competition or by favouring the beneficiary or other entities. To perform its assessment, the Commission will apply to use of the SRF the criteria established by TFEU Article 107 for State aid.

4 The setting-up of a Single Resolution Fund

The centralisation at the EU level of decision-making powers in the resolution of crises under the Single Resolution Mechanism – consistent with the scheme established by the BRRD at the national level – requires, for its effective implementation, the availability of adequate financial resources to support the resolution process of a failing bank. The clear concern was that EU-level management of resolution might be affected if use of the resolution funds introduced by the BRRD was left to the national authorities.

For that reason, it was decided to establish, under the SRM Regulation, an EU-level "Single Bank Resolution Fund" (Article 67 *et seq.*) to be activated under the control of the Single Resolution Board to ensure the availability of financial support to banks under resolution. The Fund, to be financed through contributions from the banking sector, will gradually replace the National Resolution Funds of the Eurozone Member States and of those participating in the Banking Union.

The creation of a European-level Single Resolution Fund has been one of the most hotly debated issues in the preparatory works for the BRRD

and the SRM; several EU Member States have raised significant difficulties and resistance as they were unwilling to establish a loss mutualisation mechanism immediately. So, an attempt was made to overcome the controversial issues relating to functioning of the Fund via an Intergovernmental Agreement (IGA).

The mutualisation of the national crisis resolution funds is undoubtedly the most advanced and significant target of the new rulebook. It embodies the principle that the resolution fund steps in irrespective of the location of the bank and the structure of the failing banking group, thus establishing a solidarity mechanism within the EU banking system. This effectively breaks the link between the failing entity and the nationality of the sources of funding for resolution, a link that could have been a real obstacle to a bank's recovery if the Member State concerned lacked sufficient resources for the operation. As stated, this solution, too, was opposed by certain countries, which feared that it could threaten national fiscal sovereignty by requiring Member States to step in to rescue banks established in other countries.

The solution set out in the Agreement is to establish from the start a single European fund, managed by the SRB, consisting initially of **national compartments** to be gradually merged over a period of eight years. The Board will be able to use the SRF in order to ensure the efficient application of resolution tools and powers, to the extent necessary and in accordance with the objectives and principles of resolution.

The Regulation confirms as a matter of principle for the SRF the forms of intervention by national resolution funds set out in the BRRD,[12] as well as the cases in which the Board, in drafting a resolution scheme, may use the Single Resolution Fund; it also specifies in Article 77 that the use of the Fund is contingent on the Intergovernmental Agreement (IGA), whereby the participating Member States agree to transfer to the SRF contributions raised at national level in accordance with Regulation no. 806/2014 and Directive 2014/59/EU, and that this use must comply with the principles laid down in the same Agreement.

In any case, the Fund cannot be used directly to cover the losses of the bank under resolution or to recapitalise it. If the use of the Fund, to the extent necessary to ensure the effective application of the resolution tools and for the purposes set out in Article 76, leads indirectly to the transfer of losses from the entity under resolution to the Fund, the applicable rules are similar to those set out in the BRRD in the case of total or partial exclusion of an eligible liability from the bail-in (see Article 27(6)).[13]

4.1 Financial resources and the funding mechanism of the Single Resolution Fund

The resources of the Single Resolution Fund will come from **ex-ante annual contributions** of the banks: the aim is to reach a target-level of at least 1% of the amount of covered deposits of all credit institutions authorised in all the Member States participating in the SRM (hence a target-level of about €55 billion) by the end of an initial period of eight years starting from 1 January 2016 (Article 69).[14] Par. 5 letter a) of the same Article empowers the Commission to adopt delegated acts, in order to specify the criteria for the spreading out in time of the contributions to the Fund[15].

The available financial means to be taken into account in order to reach the target level may include a share (up to 30%) of irrevocable payment commitments backed by collateral of low-risk assets unencumbered by any third-party rights, at the free disposal of the Board for resolution purposes.

Under the IGA, the transfer of the ex-ante contributions to the SRF must take place by 30 June of each year, starting from 30 June 2016. Consequently, for 2015, the contributions must be collected at national level under the rules of the BRRD, and transferred to the Single Resolution Fund by the end of January 2016 at the latest.[16]

During the Fund's initial period, contributions should be spread out over time as evenly as possible, taking into account the phase of the business cycle and the impact that pro-cyclical contributions might have on the financial position of contributing banks.

Where the available financial means are insufficient to cover the losses, costs or other expenses incurred by the use of the Fund in resolution actions, **extraordinary ex-post contributions** (Article 71), calculated and allocated between the banks of participating Member States will be raised. These extraordinary contributions will be raised in the same manner as the ex-ante contributions and shall not exceed three times their annual total.[17]

The Fund may also use **alternative funding means**, in the event that ex-ante and ex-post contributions are not immediately available or do not cover the expenses incurred by using the SRF in resolution actions. In this case, the Board may contract for the Fund borrowings or other forms of support from those institutions, financial intermediaries or third parties that offer the best financial terms at the most appropriate time so as to optimise the cost of funding and preserve its reputation.

The Single Resolution Board may also decide to make a request to **borrow voluntarily** for the Fund from resolution financing arrangements

within non-participating Member States (Article 72) when the following conditions occur: the ex-ante contributions are insufficient; the extraordinary contributions are not immediately accessible and the alternative funding means provided for in Article 73 are not immediately accessible on reasonable terms. Under this voluntary mechanism, the SRB may also decide to lend resources to National Resolution Funds established within Member States not participating in the SRM, subject to the rules set out in the BRRD.

The Regulation provides that the Fund may access financial facilities. The relevant provision is Article 74, which allows the Board to contract for the Fund **financial arrangements**, including, where possible, public financial arrangements, necessary for the resolution action. Again, access to financial facilities is allowed only if the ex-ante and ex-post contributions are insufficient to meet the Fund's obligations in resolution.

The resources of the SRF are managed by the Board and must be invested following a prudent and safe strategy, in line with the general principles and criteria set out in the delegated acts adopted by the Commission in this area.[18]

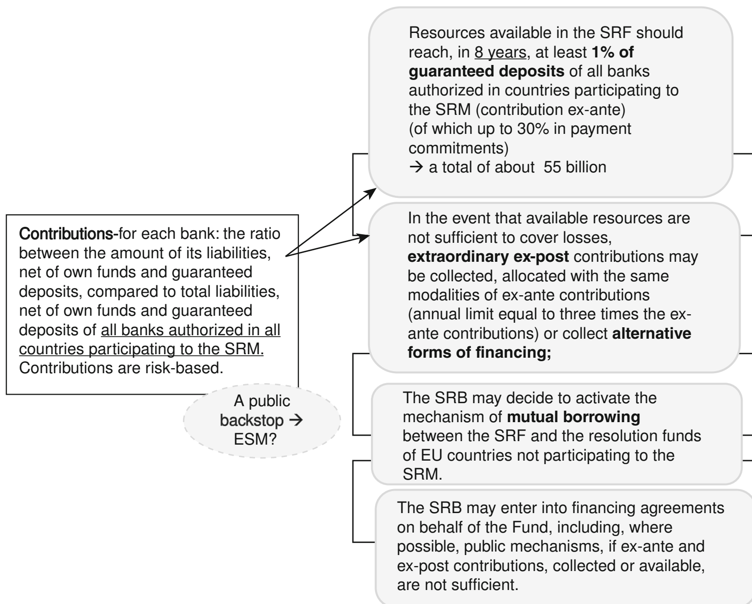

Figure 4.1 Single Resolution Fund: the funding mechanism

During the transitional period, that is, until the SRM and the BRRD become fully operational, failing banks will continue to be managed on the basis of the national arrangements, which will undergo a progressive merger toward the resolution principles agreed at EU level, especially as concerns the allocation of losses to the shareholders and creditors of the failing bank instead of to taxpayers; as noted, this principle is laid down both in the new *Guidelines on State Aid to Banks* (see Chapter 6) and in the rules on the direct recapitalisation of banks by the ESM, which require an appropriate level of burden-sharing by private investors as a condition for access to public support through national or ESM resources.

4.2 The Intergovernmental Agreement on transfer and mutualisation of resources to the Single Resolution Fund

The Intergovernmental Agreement (IGA) governs the phase of the transfer of resources to the SRF, a competence accomplished by participating Member States, which are required to collect the contributions from the banks established in their respective territories in accordance with the BRRD.[19]

Under the Agreement, participating Member States make an irrevocable commitment to transfer to the Single Fund the contributions made by authorised banks in their respective territories. To this end, the IGA lays down uniform criteria, modalities and conditions for the transfer of resources. In particular, it provides that the funds will be allocated to national compartments for the eight-year transitional period established for the creation of the Fund; it establishes progressive mutualisation in the use of the compartments and their merger into the SRF at the end of the transitional phase. Thus, contributions collected in 2015 by national resolution authorities (calculated on the basis of covered deposits of the single country), will be transferred to the SRF by 31 January 2016. The SRF is composed, for the first year (2016), by the financial resources collected in the participating countries, which are allocated to the extent of 60% to their respective national compartments and to the extent of 40% to the Single Fund. In the second year (2017) of the transitional period, the annual contribution to the national compartments will be 40% and the one to the Single Fund will be 60%. From the third year onwards, the pooling of resources will increase by a constant rate (6.7% per annum) until the completion of the SRF in 2024, when the national compartments will definitively cease to exist.

To ensure a sufficient flow of financial means during the transitional period, the Member States concerned in a resolution action may use

bridging loans of national or ESM funds following agreed procedures, including temporary transfers between compartments. Moreover, during the transitional period a common backstop must be developed to facilitate borrowing by the SRF, to be reimbursed through the contributions – including ex-post contributions – of the banks of participating Member States (to ensure the tax neutrality of the financing arrangement).

Over the transitional period, a mechanism is in place to involve national compartments in the resolution progressively:

i) the costs of resolution will be initially borne by the national compartment of the Member State where the bank or group under resolution is established or authorised. In the case of cross-border groups, the costs will be distributed among the compartments of the Member States concerned proportionally to the amounts of the contributions paid by each group entity into its respective national compartments, compared to the total amount of the contributions by all group entities to their respective national compartments. In the first year, all the resources of the compartments concerned by the crisis will be used, 60% will be used in the second year, 40% in the third and constant percentages in the years thereafter;
ii) only if the use of compartments concerned is insufficient, the resources of all other compartments will be used (40% the first year, 60% the second year and constant percentages in the years thereafter);
iii) in the third alternative, if the use of resources under point (ii) is still insufficient, all the remaining resources of the national compartments affected by the crisis will be used;
iv) furthermore, where felt necessary, ex-post contributions may be raised from authorised banks in the Member States whose national compartments are directly concerned by the resolution;
v) last, if the compartment's ex-ante resources are insufficient and ex-post contributions are not immediately accessible (even for stability reasons), the SRB may exercise its power to contract borrowings or other forms of support in line with Articles 72 and 73 of the SRM Regulation, or provide for the temporary transfer of resources between the different compartments. The compartments will repay any amount received in the form of loan, support or transfer between compartments by means of ex-post contributions.

Since the Banking Union is also open to Member States not belonging to the Eurozone, even if it refers directly to Eurozone countries, the SRM

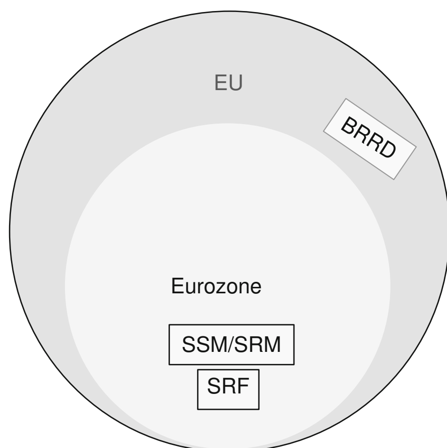

Figure 4.2 Resolution in the EU and in the Eurozone

Regulation has the same scope of application as the SSM and, thus, also extends to countries participating in it on a voluntary basis. The integrity of the Single Market is preserved by the fact that the same rules laid down in the BRRD are applicable to all Member States.

For the resolution of cross-border banks established in both participating and non-participating Member States, the Resolution Colleges and the related procedures (for example, the EBA acting as mediator) provided for by the BRRD would apply. *Ad hoc* procedures have been designed to coordinate the action of the colleges with the Single Resolution Board, involving the EBA, too, where necessary.

4.3 Contribution mechanism to the Fund

The contribution of individual banks to the Fund is determined by considering the various types of banks, their business models and risk profiles. The amount of each bank's contribution to the Fund is calculated, in line with the BRRD's approach, by applying criteria that take into account the amount of liabilities, net of each bank's own funds and covered deposits, adjusted in proportion to the risk profile.

In particular, each bank is required to make a contribution consisting of the ratio of its liabilities, excluding own funds and covered deposits, over the total liabilities, excluding own funds and covered deposits, of all the authorised banks in the Member States participating in the SRM. This means following a Europe-wide approach to calculating the contributions to the Single Resolution Fund, different from the system under

the BRRD for the national resolution financing arrangements, where calculation of the contributions is linked to the set of authorised banks in each country.[20]

The individual contribution is calculated annually on the basis of the above-mentioned proportional criterion (flat contribution) plus a risk-based component, in line with the criteria of BRRD Article 103(7),[21] taking into due account the principle of proportionality and the need to avoid creating distortions in the structures of the participating Member States' banking systems.

4.4 Relations between the SRF and the Deposit Guarantee Schemes

Particularly relevant is the issue of the relationship between the SRM and national Deposit Guarantee Schemes. In particular, as a consequence of creation of the SRM, the Deposit Guarantee Schemes will continue to perform the functions assigned to them by the DGS Directive and the BRRD. They would be called upon to reimburse depositors in the event of a bank wind-up, while, in the event of resolution, they would contribute the amount of losses depositors would have incurred in a wind-up under normal insolvency proceedings.

The SRM Regulation is in line with that provision and, with regard to the use of DGS in resolution, Article 79 refers to the provisions of Article 109 of the BRRD. It should be noted that the SRM would have no impact on the Institutional Protection Schemes (IPSs) or the other intra-group support schemes in place within specific groups of credit institutions. The SRM may step in only when those private solutions are unable to avert the failure of a bank. Indeed, similarly to the BRRD, the final condition for resolution is, in addition to the assessment that the bank is failing or likely to fail and to the public interest test, the absence of any reasonable prospect that any alternative private sector measure (including measures by an IPS) would prevent the bank's failure in the short term.

5
The Third Pillar of the Banking Union: The Pan-European Deposit Guarantee Scheme

1 The role of deposit guarantee schemes

Deposit Guarantee Schemes (DGSs) play a crucial role in banking crisis management. In cases of bank insolvency, DGSs intervene to reimburse depositors who are the weakest subjects in the creditor category and often do not possess adequate information tools to assess how robust their bank might be.

DGSs play a fundamental role in the safety net established for financial stability.[1] Depositor protection reinforces confidence in the banking system. It tells depositors that whatever happens a certain amount of their deposit is protected and will be paid out in a short time. There is, consequently, no fear for their savings and no cause for a panic withdrawal of funds, the classic "run on the bank" or contagion spread to other financial intermediaries, and no systemic crisis is triggered.

Since the onset of the financial crisis, the role and the mandate of DGSs have been significantly expanded. However, we do not yet have a standard "best model" for DGSs, since each has its own national peculiarities.

A DGS may have a simple pay-box function; it may act as a pay-box plus if it is involved in resolution financing; it may act as a loss minimiser, that is, determining and funding resolution measures in accordance with the least-cost principle or, finally, it may be a risk-minimiser, assessing and managing risk and having early intervention and resolution powers, and in some cases even supervisory powers.[2]

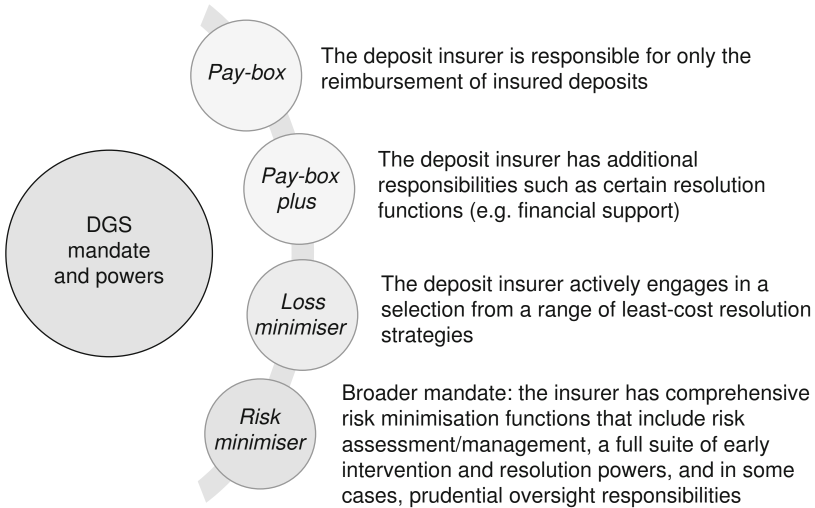

Figure 5.1 DGS mandates

In some jurisdictions, the DGS is also the resolution authority. This has many advantages. It gives flexibility, a more efficient management of funds and synergies, a mitigation of forbearance risk, incentives for the application of least-cost solutions, and the resolution fund and may DGS be used as complementary funding resources, if they are separate.[3]

In the European legislative framework, the DGS "*constitutes an essential instrument for the achievement of the internal market from the point of view of both the freedom of establishment and the freedom to provide financial services in the field of credit institutions, while increasing the stability of the banking system and the protection of depositors*" (Directive 2014/49/EU, Recital 3).

Italy has two DGSs: the Interbank Deposit Guarantee Fund (*Fondo Interbancario di Tutela dei Depositi, FITD*) and the Deposit Protection Fund for Co-operative Banks (*Fondo di Garanzia dei Depositanti del Credito Cooperativo*). The two Deposit Guarantee Schemes were created voluntarily by the Italian banking system well before Directive 94/19/EC. The two DGSs were introduced as self-protection tool from insolvencies, and each has its own Statute.[4] The Italian DGSs can be defined as loss-minimisers, that is, they act not only in the case of payouts but

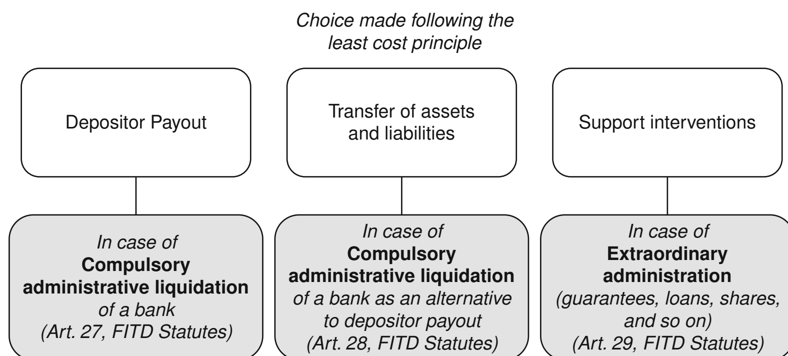

Figure 5.2 The current Italian DGS intervention system

can also provide, in their decisional autonomy, supporting measures to prevent or avoid the traumatic effects of bank insolvencies.

Both schemes are private law consortia among banks and are administered by banks' representatives. The governance is basically similar to that of any corporate enterprise. They have an Annual Shareholders Meeting, a Board of Directors and Executive and Audit bodies. They do not exercise supervisory powers on banks. They play a central role in bank crisis management under the oversight of the Bank of Italy, which is the National Supervisory Authority.

2 Directive 94/19/EC

The 94/19/EC Directive (the Deposit Guarantee Scheme Directive, DGSD) was a milestone in DGS regulation. It aimed at harmonising the fundamental aspects of DGS activity, on the basis of a minimum harmonisation and mutual recognition principles. These principles were typical of the EU banking regulation in those years.

Since then, participation in a DGS has become mandatory for banks and a prerequisite for carrying out banking activity. The Directive requires Member States to create DGSs to protect depositors and reimburse them if needed to the guaranteed extent. With participation mandatory for banks, some argue that this implies an implicit government guarantee.[5]

3 DGSD reform: from minimum to maximum harmonisation

3.1 The reform process and general lines of regulatory intervention

Following the numerous banking bankruptcies and some "bank runs" during the 2007–09 international financial crisis, a wide debate opened at the European level on the need to strengthen Deposit Guarantee Schemes.[6] The case of Northern Rock in the UK in September 2007 illustrated well the disruptive impact of a panicky "run", with widespread media coverage and a major loss of confidence in banks.

Directive 2009/14/EC of 11 March 2009 was the first step towards a comprehensive reform of the system. It remedied certain critical profiles of the 1994 Directive and achieved greater convergence between Deposit Guarantee Schemes.

The international debate on further strengthening DGSs and possibly establishing a centralised DGS at a European level increased with the deepening of the crisis. There is widespread support at the doctrinal level for a pan-European system.[7] It would imply significant savings in administrative costs, better banking crisis management, reduced impact from a bank failure on a system larger than its domestic one. In addition, the centralisation of decisions and the consequent equality of treatment, among EU countries, would be further major benefits.

The idea of establishing a single EU Deposit Guarantee Scheme was felt to be less urgent than the other components of the Banking Union and has been postponed for the time being.[8] However, it remains on a back burner, along with other important features of the European safety net. The choice was made to proceed for the moment, with a network of harmonised national Deposit Guarantee Schemes[9].

At the wider international level, too, many initiatives were taken to strengthen deposit insurance systems. In 2009 the International Association of Deposit Insurers (IADI) released the *"Core Principles for Effective Deposit Insurance Systems"*. These Principles were endorsed by the Basel Committee on Banking Supervision (BCBS). The Core Principles (CPs) are a set of standards to be applied on a voluntary basis; they help jurisdictions to establish and assess their deposit insurance systems and identify areas for improvement. In 2010, an *Assessment Methodology* was issued to help evaluate compliance with the Core Principles.

The continued deepening of the crisis led to a revision of the Core Principles. It was essential to: (1) improve the effectiveness of DGSs;

(2) ensure that the CPs be adaptable to a wide range of country circumstances, settings and structures; (3) reduce moral hazard and (4) reflect the greater role to be played by DGSs in resolution regimes. It was also important to ensure consistency with the Financial Stability Board's (FSB) Key Attributes.

In the autumn of 2014 the new revised version of the CPs was released. It includes 16 Principles (against the previous 18). Each Principle is now integrated with Essential Criteria, included in the Assessment Methodology. The Essential Criteria explain each principle and give operational guidance. In November 2014, the Revised Core Principles were communicated to the Financial Stability Board for inclusion in the FSB Compendium of Key International Standards of Financial Stability[10].

A DGS can measure its compliance with the CPs in a number of ways:

i) self-assessment;
ii) IMF and World Bank assessments in the context of the *Financial Sector Assessment Program* (FSAP);
iii) reviews conducted by private third parties (that is, consulting firms); and
iv) peer reviews (conducted, for example, within IADI regional committees).

At European level, in July 2010 the EU Commission presented a new directive proposal aimed at amending the 1994 Directive.[11] The aims were to enhance consumer protection and boost confidence in financial services.[12] The legislative intervention was based on a maximum harmonisation approach.

The original text of the proposal had been the object of a long and complex discussion, even in relation to the interactions with the concomitant EU legislative proposal on the recovery and resolution of banks. A compromise was reached at the Ecofin meeting on 17 December 2013. The final text of the Directive was approved at the plenary meeting of the European Parliament on 15 April 2014.[13] Member States had to transpose the Directive within one year of its entry into force (3 July 2015).[14]

The Directive aims at:

- simplifying and harmonising the scope of coverage and the provisions on depositors' payout;

- reducing the payout timeframe;
- improving DGSs access to information on member banks;
- making DGSs more robust and credible through a more harmonised and adequate funding;
- establishing a funding model based on a mixed approach (ex-ante and ex-post), including mutual borrowing between DGSs;
- introducing risk-based contributions;
- regulating the use of DGS funds for purposes other than payout, such as bank restructuring interventions;
- establishing co-operation mechanisms between DGSs operating in different countries, in order to facilitate the payout in the event of a cross-border failure.[15]

3.2 Main aspects of the reform

3.2.1 Scope of guarantee, payout procedures and timeframe

The new Directive confirms protection per depositor rather than per deposit and the 100,000-Euro level of coverage already provided for by Directive 2009/14/EC. The level of guarantee decided on ensures the repayment of a very considerable share of deposits at the European level.[16]

In the Directive, a "depositor" is defined as the account holder and, in case of a joint account, each of the account holders. A "per depositor" protection implies that all accounts of the same holder at the same bank (irrespective of the currency of the deposit and its location within the Union) are aggregated before the coverage level up to 100,000 Euros is applied.[17] In the case of a joint account, the balance of the account is shared between co-holders in equal parts and contribute to the reimbursable amount.

The Directive explicitly excludes the need for a depositor to submit a specific claim for reimbursement to the DGS; this marks a clear difference from Directive 94/19/EC, which left discretion on the matter to the Member States.

A particular rule is established for "dormant accounts"; in the DGSD, these are the accounts (regardless of the amount held) on which no transaction has been carried out in the previous 24 months. The legislation provides for a wider protection to the depositor holding a dormant account, establishing the possibility of extending the payout timeframe to up to three months (Article 8, paragraph 5). However, if the amount of the deposit is such that the administrative costs of refunding it would exceed the amount to be repaid, the Directive excludes reimbursement (Article 8, paragraph 9). However, the practical application of this

second provision would require a cost/benefit analysis, since excluding an account from the payout procedure (because of its small amount and in the absence of movements in the period of time considered) might be in reality more expensive for the DGS than simply reimbursing the deposit. Article 8, paragraph 9, however, can be seen as an exception (under specified circumstances) to the general principle of reimbursement to a not financially sophisticated depositor.

A payout is triggered when a deposit is unavailable. It is considered unavailable when "*the deposit that is due and payable but that has not been paid by a credit institution under the legal or contractual conditions applicable to it*", when:

- the administrative authorities have determined that the credit institution, for reasons that are directly related to its financial circumstances, is unable to repay the deposit and has no current prospect of being able to do so;
- a judicial authority takes a decision that has the effect of suspending the rights of depositors towards the credit institution.

The Directive increases the level of harmonisation for subjective and objective requirements. The eligibility criteria for payout are simplified and harmonised in terms of eligibility of depositors, through a system of exclusions from guarantee. The new Directive makes mandatory the transition from a regime with few mandatory and many optional exclusions (Directive 94/19/EC) to one in which all exclusions are mandatory (Article 5, paragraph 1). Namely, these exclusions are: deposits of other banks and financial institutions, investment firms, insurance companies, collective investment companies, pension funds; deposits of public authorities; debt securities issued by banks and liabilities arising out of own acceptances and promissory notes; deposits arising out of transactions where there has been criminal conviction for money-laundering or the depositor has never been identified.

However, the Directive allows a few limited exceptions. Member States can include in the guarantee, up to the level of coverage, deposits held by personal and professional pension schemes of small and medium-sized enterprises and deposits of local authorities with a budget of up to €500,000.

Conversely, they may exclude from guarantee deposits that could be released, in accordance with domestic law, only to pay off a loan on immovable property if the loan is made by the credit institution or another institution holding the deposit. These are funds that are not

available to the depositor because they are earmarked to pay a loan contracted for the purchase of a private property.

From the point of view of the object of the guarantee, the Directive defines the deposit as a *"credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit"*.

A credit balance is excluded from the definition of deposit when:

- its existence can only be proven by a financial instrument (pursuant to the Markets in Financial Institutes Directive, MiFID), unless it is a savings product evidenced by a certificate of deposit related to a name and that has existed in a Member State since 2 July 2014;
- its capital is not repayable at par;
- its capital is repayable at par only on the basis of a specific guarantee or a specified agreement provided by the credit institution or by a third party.

There are interpretative doubts on the treatment of the certificates of deposit issued after the entry into force of the Directive. However, DGS guarantee extends to nominative certificates of deposit, intended as a traditional product representative of a savings deposit and, as such, widely used in many countries, including Italy.

Other mandatory exclusions are bank's own funds; deposits arising out of transactions in relation to which there has been a criminal conviction for money-laundering; certain financial products, such as structured products, debt certificates and bonds; repurchase agreements; deposits of investment firms; accounts of depositors not identified and electronic money. The deposits of executives, directors and shareholders of a bank are no longer in the exclusion list, in contrast to the provision of Annex I (optional exclusions) of Directive 94/19/EC.

A cardinal principle of the new legislation is the strengthening of bank *transparency* towards depositors. It regards a *standardised information model*, which could form part of deposit contracts, both at the time the contract is being agreed and in periodic statements. The regular disclosure of information by guarantee schemes (ex-ante funds available, ex-post funding capacity and the results of regular Stress Testing) ensures transparency and credibility. This strengthens financial stability and at minimal costs.

The payout timeframe is to be reduced to seven working days. A transitional period of ten years (until 31 December 2023) is allowed, which could best be used with greater coordination and information sharing among DGSs, supervisors and member banks. The choice about whether to use the transitional period or not is left to the discretion of Member States. When supervisors inform a DGS as soon as bank problems that could lead to guarantee scheme intervention are perceived, the DGS can take action to make the payout in due time.

The Directive (Article 8, paragraph 4) provides for emergency payments (*interim payments*). If, during the transitional period, the DGS cannot pay out within seven working days, it must ensure that depositors have access to an appropriate amount of their covered deposits for daily living within five working days of the depositor claim. This quota, received in advance, will be deducted from the total amount repayable to the depositor. This provision could create problems in application. Making a payment in five days from the request of a depositor is likely to make the process more expensive for the DGS and expose it to having perhaps to activate the same procedure many times while the preparation of the overall repayment is under way. Further, there is the problem of identifying the amount needed to meet the needs of everyday life.

Reimbursement within seven working days implies that the DGS needs to have rapid access to the aggregate position of each depositor (Single Customer View, SCV). The Directive requires DGS member banks to mark eligible deposits for their immediate identification (Article 5, paragraph 4) and to give to the deposit guarantee system, at any time and at the DGS's request, an information flow that contains the set of depositor aggregate positions (Article 4, paragraph 8, and Article 7, paragraph 6). The DGS will provide in advance appropriate instructions to standardise the process and the information flow.

In determining the Single Customer View, another problem is *temporary high balances* (THB), (Article 6, paragraph 2). Under that provision, the DGS ensures that some deposits are protected over 100,000 Euros, for at least 3 months but no longer than 12, after the amount has been accredited, or from the time such deposits become legally transferable. The THB provision applies to deposits:

i) resulting from real estate transactions relating to private residential properties;
ii) that serve social purposes laid down in national law and are linked to particular life events of a depositor such as marriage, divorce, retirement, dismissal, redundancy, invalidity or death;

iii) that serve purposes laid down in national law and are based on the payment of insurance benefits or compensation for criminal injuries or wrongful conviction.

The applicative problem is linked to the identification of the accounts where the THB is recorded. In fact, banks are not required to know why there are high balances in customer accounts. Maintenance of an updated information file on THB cases adds further difficulties. It would be appropriate to take account of THB only in the liquidation and in payout. Repayment could be made up to €100,000; the remaining part would be paid during the course of the procedure. This would mean that the Temporary High Balances are not taken into account in the SCV information flow that the DGS requires under ordinary business conditions.

Set-off is yet another issue. This is the practice of compensating the deposit amount with any depositor liabilities against the bank. Directive 94/19/EC left the matter to national discretion. The new Directive (Article 7, paragraph 4), on the other hand, provides for the non-application of set-off in calculating the refundable amount, unless (1) depositor liabilities, against the bank, are due on the date of the unavailability of deposits and (2) the compensation is permitted by law or by a contract that regulates the relationship between the bank and the depositor. It should be noted that Italian bankruptcy law expressly regulates such compensation in its Article 56.[18] It is a provision inspired by the need for equity. It allows those who are in a creditor-debtor position the right to compensate: on the one hand, they do not have to pay their debt in full, while on the other, they are not subject to a haircut deriving from the bankruptcy procedure. The compensation is applicable only if both claims have arisen prior to the declaration of bankruptcy, regardless of being payable before that date.

3.2.2 Stress testing of deposit guarantee systems

Article 4, paragraph 10 requires that Member States ensure that DGSs perform regular Stress Tests of their systems to verify whether they have procedures and processes to fulfil the obligation to repay depositors of a failing bank in the time required by law. These tests should take place at least every three years (the first within three years after the entry into force of the Directive). In addition, the DGS should be informed as soon as the competent authorities detect problems in a credit institution that could give rise to a DGS intervention.

Based on the results of the Stress Tests, the EBA is called to lead, at least every five years, peer reviews in order to assess the DGS's resilience.

3.2.3 Financial means and funding mechanism of DGSs

For a DGS to be credible it must have available adequate financial resources for interventions. In principle, each DGS should have the financial capacity to meet its potential liabilities. Directive 2014/49/EU introduces a more complex funding mechanism than the previous unharmonised one that left the choice to the discretion of Member States. They could adopt either ex-ante funding (having a fund in place already) or ex-post funding (calling in the funds as required).

The new approach is more complex mixed funding mechanism, combining both ex-ante and ex-post contributions. It is a four-step approach set out in Article 10 of the DGSD. The aim is to ensure that the DGSs have funding proportionate to their liabilities

The first step is to have a solid reserve based on regular contributions by the member banks. It should reach a target level (available funds) of at least 0.8% of covered deposits by 3 July 2024.[19] Part of the available financial means, equal to a maximum of 30%, can be represented by payment commitments (fully collateralised). The Directive is precise on the payment commitments (Article 2, paragraph 1, point 13): the collateral shall consist of low-risk assets, is unencumbered by any third-party rights and is at the disposal of the DGS. To ensure consistent application of this provision, the EBA issued appropriate guidelines.[20] In calculating the regular contributions of member banks, collected at least annually, DGSs must take account the economic cycle and pro-cyclicality.

Apart from the general rule, Article 10, paragraph 6, permits the target level to be set lower (subject to the approval of the EU Commission), that is, at a level of at least 0.5% of covered deposits, under certain conditions. These conditions are not defined in absolute terms, but allow some flexibility. There are two conditions:

i) When it is unlikely that a significant share of the available financial means would be employed in measures other than resolution or the transfer of guaranteed deposits and assets and liabilities in insolvency proceedings as an alternative to reimbursement of depositors. The reasoning seems to be linked to the probability that crisis management is carried out through the repayment of depositors and alternative measures (paragraph 3).
ii) When the banking sector, in which the credit institutions affiliated to the DGS operate, is highly concentrated with a large quantity of assets held by a small number of credit institutions or banking groups, subject to supervision on a consolidated basis which, given their size, are likely, in case of failure, to be subject to resolution proceedings.

Once the target level is reached for the first time, its maintenance is ensured by having a mechanism to rebuild resources used for interventions; if "*the financial capacity falls short a target level, the payment of contributions shall resume until the target level is reached again. And, if the available financial means have been reduced to less than two-thirds of the target level, the regular contributions shall be set at a level allowing the target level to be reached within six years*".

The second form of DGS financing is *extraordinary contributions* (ex-post), which banks are committed to pay when the available financial means are insufficient to reimburse depositors. These contributions shall not exceed 0.5% of covered deposits per calendar year. Only in exceptional circumstances, and with the consent of the supervisory authority, may DGSs require higher contributions. However, the supervisory authority may authorise a bank to defer a contribution payment to the DGS for a period of six months, renewable upon application by the bank, if the contribution would jeopardise the solvency and liquidity of the bank.

Moreover, when the DGS's financial means are used to finance alternative measures, banks are required to transfer immediately the means to be used to the DGS, again in the form of extraordinary contributions, when (1) there is a need to repay depositors and the DGS's available means are less than two-thirds of the target level or (2) the available financial means are less than 25% of the target level.[21]

The third form of financing is *alternative funding arrangements*. These enable the DGSs to get short-term funding on financial markets, or by issuing bonds, to meet intervention needs not covered by other funding sources.

Finally, Article 12 provides that, if the funding resources prove to be insufficient, DGSs may have access to a *mutual and voluntary borrowing facility*. Using this facility, a DGS may borrow funds from other European DGSs under certain conditions and up to 0.5% of its covered deposits. The European DGS could loan an amount proportional to its total covered deposits. The interest rate would be equivalent to the rate of the ECB marginal lending facility in force during the life of the loan. It should be repaid in five years.

DGSs collect financial resources for interventions. Investing these resources (Article 10, paragraph 7) has to be carefully addressed. The DGS Directive stipulates that the investments should be in low-risk and well diversified assets.

Banks make risk-based contributions to DGSs. These are calculated using basic business models, on the basis of the indicators normally

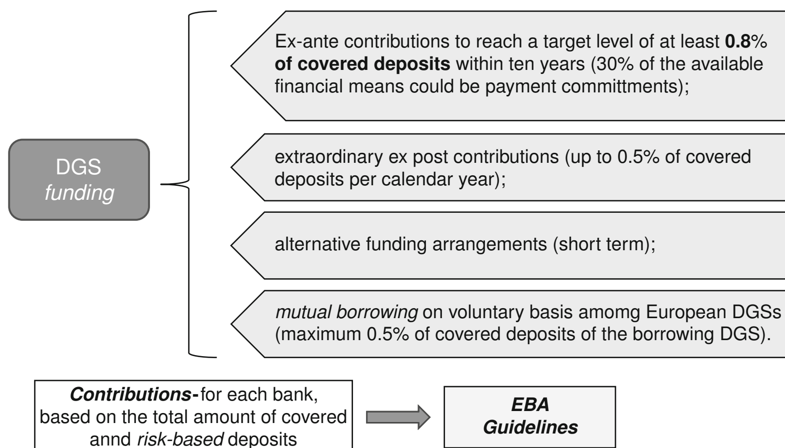

Figure 5.3 Funding of deposit guarantee schemes

used in supervisory evaluations (capital adequacy, asset quality, profitability, liquidity and leverage). The Directive, in this way, also encourages banks to have in place effective risk management. Lower contributions can be set for low-risk sectors governed by national law and for banks belonging to Institutional Protection Schemes (IPSs).

The Directive leaves Member States free to decide their own contribution systems and allows the application of those already existing.[22] These should be approved at the national level and communicated to the EBA. On 28 May 2015, the EBA issued guidelines for calculating contributions to the DGSs (formula calculation, specific indicators, risk classes for members and thresholds for risk weights assigned to specific risk classes) and will review periodically these guidelines (every five years).

In November 2014, the EBA issued a consultation paper containing guidelines for calculating contributions to Deposit Guarantee Schemes.[23]

3.2.4 Use of funds

The use of the available funds for interventions can be gleaned by a combined reading of DGSD and BRRD, albeit at times with some difficulty and careful interpretation.

Article 11 of the DGSD states the mandate and provides indications on measures for crisis interventions. Some of these indications are

compulsory (paragraphs 1 and 2); others are left to the discretion of the Member States (paragraphs 3 and 6). The following is a brief summary:

i) DGS funds should be used primarily to fulfil the payout mandate (paragraph 1), that is, depositor reimbursement (Article 2, paragraph 1, lett. h (*pay-box functions*). If payouts are made, the DGS then "inherits" the rights of reimbursed depositors in liquidation proceedings and shall participate in liquidation allotments;
ii) As an alternative (paragraph 6), in the same liquidation context, the DGS can adopt measures to preserve depositors' access to covered deposits (including transfer of assets and liabilities and deposit book transfers), in accordance with national insolvency proceedings, provided that the costs borne by the DGS do not exceed the amount that the DGS would be required to pay to reimburse covered depositors, net of any possible recoveries (*least-cost principle*);
iii) The financial resources can also be used to finance resolutions (paragraph 2), in accordance with Article 109 of the BRRD (see Chapter 3). This can be done in many ways to cover losses arising from the resolution (*loss absorber function*). The resolution authority, after consultation with the DGS, and in accordance with an evaluation conducted by the independent evaluator, determines the amount due to the DGS (Article 36 of the BRRD);
iv) The resources can be used to prevent bank insolvency and avoid the cost of depositor reimbursement and other possible adverse effects. In principle, these measures should be applied in a "clearly defined framework" and in accordance with State aid rules (Recitals 3 and 16 of the DGSD), even in the absence of an explicit reference in the relevant provision of the Directive.

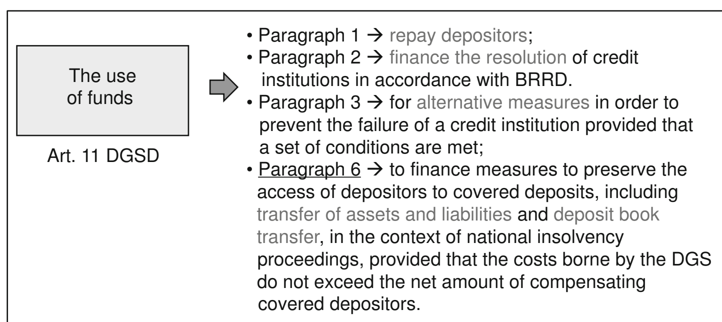

Figure 5.4 Use of deposit guarantee schemes in the new directive

Figure 5.4 shows the actions of DGSs as outlined in the Directive. Case 1, depositor reimbursement, does not pose particular applicative or interpretative problems. This is a DGS's traditional activity, its institutional mandate, which is to reimburse depositors of banks in liquidation, within the limit of the established coverage, with subrogation in the rights of reimbursed depositors towards the bank in liquidation and subsequent participation in the liquidation allotments.

The other two types of interventions appear more complex.

The role of the DGS in resolution deserves more in-depth analysis, given the articulated mechanisms to cover the expected losses related to these types of interventions, including the prior use of the bail-in and the resolution fund. In this regard, Article 11, paragraph 2, of the DGSD refers to the provisions contained in Article 109 of the BRRD.

In these cases, the contribution to cover losses – to be made in cash – cannot be more than 50 percent of the target level of available financial means (Article 109, paragraph 5).[24] The DGS, however, cannot be called on to cover losses greater than of those to which it would be exposed in the event of liquidation (*no creditor worse-off principle*). If such an event were to materialise (in which the difference in treatment is determined by the assessment conducted after the resolution, pursuant to BRRD Article 74), the DGS would be entitled to a refund of the difference by the resolution fund (BRRD Article 75), like any other creditor exposed to greater losses than in ordinary insolvency proceedings.

BRRD Article 109 refers to two possible situations in which a DGS can be called upon to contribute to the resolution:

i) in the case of bail-in, the DGS is required to pay the same amount that depositors would have been exposed to in case of haircuts, according to the priority order specified by national insolvency laws;
ii) in case of application of other resolution instruments, the DGS shall contribute the amount of losses to which covered depositors would have been exposed, according to the priority order specified by national insolvency laws.

The BRRD introduces *depositor preference,* giving covered depositors and the DGS a higher ranking than some eligible depositors and the other unsecured creditors (Article 108). This is important in identifying the circumstances and the probability of DGS intervention in resolution, in which the DGS is called upon to contribute only after all other creditors

of lower grade have contributed to cover the losses of the bank and only for the residual part.

This "residual" nature of DGS intervention results primarily from (i) when the resolution tool applied is the bail-in. Given the priority granted to protected depositors and to the DGS – which on their behalf (since depositors are excluded from the bail-in) is called to contribute to the bank losses – the intervention of the DGS can only take place when certain conditions have been met: (1) after a bail-in at least equal to 8% of the bank liabilities; (2) after an intervention of the resolution fund up to 5% of the same aggregate and (3) after all other creditors with a lower priority level than the DGS (the so-called "bail-in virtual" DGS) have borne losses.

The second intervention case (ii), related to resolutions carried out using tools other than bail-in, raises interpretative doubts and does not appear to be clearly delineated. The individuation of the DGS intervention trigger seems more complex.

In particular, even in the absence of bail-in, DGS intervention should take place with loss absorber functions in accordance with the priority ranking. Respecting such ranking would seem to favour, even in this case, DGS intervention only in residual terms, limited to the case in which the contributions of other creditors are insufficient to cover the capital needs.

In the presence of a bridge bank, the DGS might also be called upon to intervene in order to contribute to the transfer of deposits, as an alternative to capitalisation or in some combination, always taking into account the ranking established by the insolvency rules.

For the other two instruments of resolution, sale of assets/liabilities and asset separation, the second of which is applicable only in combination with other tools, a similar mechanism would seem conceivable, but is made more complex if these tools are used in conjunction with the bail-in.

Article 9 paragraph 2 of the DGSD provides that a DGS, when it intervenes in the context of resolution procedures (including the application of crisis resolution instruments or the exercise of resolution powers pursuant to Article 11), has a claim against the bank that has benefited from the intervention, for an amount equal to the payments made (subrogation right). This credit is considered to be at the same level as covered deposits under the national law governing the normal insolvency proceedings.

Finally, the third case of intervention, governed by Article 11, paragraph 3, provides that DGSs can use the available financial means as

"alternative measures" designed to prevent the failure of a bank, provided that:

- a resolution procedure has not been opened;
- the DGS has appropriate systems and procedures in place for selecting and implementing alternative measures and monitoring affiliated risks;
- the cost of alternative measures does not exceed the costs that would be borne by the DGS in the fulfilment of its regulatory or contractual mandate (*least-cost principle)*;
- the use of alternative measures by the DGS is linked to conditions imposed on the credit institution that is being supported, involving at least more stringent risk monitoring and wide verification rights for the DGS;
- the use of alternative measures by the DGS is linked to commitments by the credit institution being supported with a view to securing access to covered deposits;
- the ability of the bank to pay the ex-post extraordinary contributions is confirmed in the assessment of the competent authority.

The possibility to use DGS resources for "alternative measures" is undoubtedly the aspect of highest concern at national level. It is a sphere of action left to the discretion of Member States and could also have different configurations depending on the approaches chosen in the Directive transposition process and the specificities of national systems.

The peculiarity lies in the fact that, while the context of DGS interventions both in depositor reimbursement and in resolution is clear, there are still some difficulties in identifying the areas of DGS intervention in the context of alternative measures. Alternative measures are "early intervention" tools, adopted when a bank is in a state of financial difficulty closely supervised by the competent authority.

Article 11 of the DGSD provides that the financial means of Article 10 are primarily used to repay depositors (paragraph 1). However, Recitals 3 and 16 of the DGSD allow sufficient flexibility and seem to favour the use of DGSs that goes beyond the mere function of depositor repayment. The DGS function aims to avoid a bankruptcy while reducing the likelihood of an expensive payout and other adverse effects at a lower cost. However, these Recital highlight that these types of intervention should be in compliance with State aid rules; this raises concerns over the operative configurability of these measures.

The European Commission Communication of 30 July 2013 (see Chapter 7),[25] refers explicitly to DGS interventions. It excludes any possibility that depositor repayment, in accordance with the DGSD, can constitute State aid. However, using DGS resources for restructuring a member bank could be assessed as State aid, when the funds, even if from the private sector, come under State control and the decision to use them could be linked to the State.

DGSs in the EU can be structured and classified in many different ways, organisationally and legally. In some cases, they are an integral part of public authorities (ministries, central banks) or banking associations; in others, they are independent entities with a private nature, albeit performing a public function – the protection of savings. They are funded through private sector resources and they come under the control of a supervisory authority (the "designated authority" in Article 2, paragraph 1, r.) of the DGSD).

The State aid law may, therefore, be considered applicable only to the alternative measures of Article 11, paragraph 3, depending on the specific institutional features of each system (see Chapter 6).

It would seem vital to have a clear line of demarcation between DGS interventions in resolution and "alternative measures". The latter measures can be used only in the absence of a resolution process, in a phase of early intervention (BRRD). It is important to identify what tools would apply (would constitute) the alternative measures and what would be the modalities of DGS interventions.

3.2.5 Institutional Protection Schemes

The Directive continues to recognise the mutual guarantee schemes (Institutional Protection Scheme). These are systems for indirect depositor protection, by preventing a bank's insolvency. Because all banks must adhere to a DGS, IPSs can also be recognised as deposit guarantee systems and, in that case, they must also comply with DGSD provisions and the IPS Capital Requirements Regulation (CRR, Article 113, paragraph 7).[26] The latter, in particular, requires that IPSs should have adequate tools for monitoring and classifying risk, which must be communicated to member banks. These banks can then provide a full picture of their risk positions and their institutional protection scheme.

Alternatively, IPSs can be established separately. As the bank would now adhere to both schemes, this must be taken into account for the purpose of the guarantee-schemes funding since an additional guarantee is provided by the IPS.

The alternative measures of Article 11, paragraph 3, in some respects, can make the DGS, authorised to adopt them, look like the IPSs governed by Article 113 of the CRR, which, however, fixes criteria and constraints that are much more stringent than the conditions mentioned in the Directive.

3.2.6 Co-operation and exchange of information between DGSs and other authorities within the safety net

This topic is a key aspect of the role assigned to the deposit guarantee systems in the new regulatory framework.

In the wake of the recent financial crisis, co-operation between the different actors of the safety net has become a fundamental principle, considered a crucial element for a successful crises resolution.

In the BCBS-IADI Core Principles, co-operation between the authorities and DGS is the object of specific recommendations. CP6 prescribes close coordination and exchange of information, even in specific cases, between DGSs and the other safety net participants. CP15 sets out the need for DGSs to participate in resolution processes. It provides that DGSs should be part of a framework within the safety net of the financial system for the early detection of, and timely intervention in, troubled banks. The decision and recognition of when a bank is, or is deemed to be, in serious financial difficulty should be made in a timely manner and on the basis of clearly defined criteria by participants in the safety net who possess operational independence and the power to act.

The Revised Core Principles establish that the DGS should be independent in the performance of its mandate.[27] The DGS should be operationally independent (CP3) and it should not have interference from other parties (government, central bank or the financial industry). CP4 requires close coordination and exchange of information on an ongoing basis in the safety net; this should be formalised through legislation, regulation, memoranda of understanding and legal agreements. CP6 establishes the central role of the DGS in crisis management: it should participate in defining the system-wide preparation of strategies and management policies, such as the common responsibility of all participants in the safety net. The DGS, together with the other safety net players, should participate on a regular basis in contingency planning and simulation exercises for the preparation and management of systemic crises.

DGSD legislated the principles above: it explicitly highlights the need for collaboration and exchange of information, both in Recital 51 and Articles 3 and 4. Article 4, paragraph 10, states that DGSs should do Stress Sests of their systems and that the authorities should inform the

relevant DGS as soon as problems are identified that are likely to give rise to a DGS intervention. Specific provisions govern the exchange of information in cases of cross-border crises.

However, a number of issues are still open: DGS participation in the decision-making process of the resolution, specifically in Resolution Colleges, where according to BRRD the authority responsible for the supervision of Deposit Guarantee Schemes participates and not the DGSs themselves. Some perplexities arise from this provision since DGS interventions in resolution can assume different configurations and only guarantee schemes can properly carry out evaluations of interventions. Also, direct DGS participation, even though privately administered, does not preclude confidentiality profiles, given the principle of professional secrecy imposed by the Directive on all those who work in Deposit Guarantee Schemes. In addition, with the gradual extension of the DGS mandate, collaboration and exchange of information, also within colleges, cannot be limited only to the payout case, but should be closely related to the extension of the mandate itself.

3.2.7 Cross-border co-operation

Article 14 of the Directive sets out of the principle of co-operation between the European DGSs in facilitating the process of depositor repayment in the case of cross-border insolvency. In this case, the host DGS acts as a single point of contact for depositors of branches operating in another Member State, not only with regard to communications with depositors in that country, but also for reimbursement on behalf of the home system. To strengthen co-operation, guarantee systems must exchange relevant information such as: elaboration of payment instructions in accordance with the Single Customer View, modalities of transmission of the payment instructions, payment currency, modalities of communication among home and host DGSs and towards depositors (language, use of mass-media and social networks) and the contractual framework in which home and host will co-operate.

The Directive also sees the possibility of a merger between DGSs of different States or the establishment of a cross-border guarantee system. This probably leaves the door open to a possible future pan-European system.

The new legal framework envisages a supervisory role over guarantee schemes for the EBA. The EBA collects information on the amount of deposits and available resources;[28] conducts peer review analysis on the basis of the stress tests results carried out by DGSs on their own systems; defines guidelines; receives briefings on mutual borrowing from the borrower DGS on the compliance with loan conditions and from the

lender DGS on the initial interest rate and loan duration; resolves disputes that may arise between DGSs (DGSD Recital 49). It also issues guidelines to ensure the uniform application of the Directive; in particular, it can specify the methods for calculating contributions to, and the characteristics of the payment commitments computable within, the available financial means of the DGS.

With the DGSD and CPs, DGSs have strengthened co-operation and information sharing in order to find common solutions at both European and international levels. To this extent, it is important to highlight the activities of the European Forum of Deposit Insurers (EFDI) at the European level and those of the International Association of Deposit Insurers (IADI) at the global level. Currently EFDI is working on DGSD implementation with a special focus on home and host DGS co-operation and is engaged in a survey that monitors the modalities by which European countries are implementing the new Directive. EFDI is also committed to a general analysis of the Banking Union regulation and its repercussions on DGS functions. Meanwhile IADI is engaged in a worldwide promotion of the Core Principles and conducts researches on relevant DGS issues (see the following boxes).

Box 1 International Association of Deposit Insurers (IADI): the role of International Standard Setter

IADI is the worldwide association of deposit insurers.

It currently has 79 deposit insurers from 76 jurisdictions. IADI is a non-profit organisation, established in May 2002 under Swiss Law. It is domiciled at the Bank for International Settlements in Basel, Switzerland.

Its mandate is to promote international co-operation and provide guidance on DGS establishment and development. It organises research and analyses into related topics, as well as international conferences and other forums.

The governing bodies of the Association are the General Meeting and the Executive Council (25 members). The IADI Executive Council has established seven Standing Committees, as well as Regional Committees for Africa, Asia-Pacific, the Caribbean, Eurasia, Europe, Latin America, the Middle East and North Africa and North America. The Standing Committees analyse specific issues while the regional committees provide a forum for issues, information and ideas of common interest affecting members in those regions.

IADI, from being a "pure" international association, is becoming a standard setter. The revised IADI Core Principles for Effective Deposit Insurance Systems are becoming a single set of principles for guidance globally. In fact, since November 2014, the Revised Core Principles have been included in the FSB's Compendium of Standards, which "lists the various economic and financial standards that are internationally accepted as important for sound, stable and well-functioning financial systems".

Box 2 Core principles for effective deposit insurance systems

Principle 1 – Public Policy Objectives

The principal public policy objectives for deposit insurance systems are to protect depositors and contribute to financial stability. These objectives should be formally specified and publicly disclosed. The design of the deposit insurance system should reflect the system's public policy objectives.

Principle 2 – Mandate and Powers

The mandate and powers of the deposit insurer should support the public policy objectives and be clearly defined and formally specified in legislation.

Principle 3 – Governance

The deposit insurer should be operationally independent, well-governed, transparent, accountable, and insulated from external interference.

Principle 4 – Relationships with other Safety-Net Participants

In order to protect depositors and contribute to financial stability, there should be a formal and comprehensive framework in place for the close coordination of activities and information sharing, on an ongoing basis, between the deposit insurer and other financial safety-net participants.

Principle 5 – Cross-border Issues

Where there is a material presence of foreign banks in a jurisdiction, formal information sharing and coordination arrangements should be in place among deposit insurers in relevant jurisdictions.

Principle 6 – Deposit Insurer's Role in Contingency Planning and in Crisis Management

The deposit insurer should have in place effective contingency planning and crisis management policies and procedures to ensure that it is able to effectively respond to the risk of, and actual, bank failures and other events. The development of system-wide crisis preparedness strategies and management policies should be the joint responsibility of all safety-net participants. The deposit insurer should be a member of any institutional framework for ongoing communication and coordination involving safety-net participants related to system-wide crisis preparedness and management.

Principle 7 – Membership

Membership in a deposit insurance system should be compulsory for all banks.

Principle 8 – Coverage

Policymakers should define clearly the level and scope of deposit coverage. Coverage should be limited, credible and cover the large majority of depositors but leave a substantial amount of deposits exposed to market discipline. Deposit insurance coverage

should be consistent with the deposit insurance system's public policy objectives and related design features.

Principle 9 – Sources and Uses of Funds

The deposit insurer should have readily available funds and all funding mechanisms necessary to ensure prompt reimbursement of depositors' claims, including assured liquidity funding arrangements. Responsibility for paying the cost of deposit insurance should be borne by banks.

Principle 10 – Public Awareness

In order to protect depositors and contribute to financial stability, it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

Principle 11 – Legal Protection

The deposit insurer and individuals working both currently and formerly for the deposit insurer in the discharge of its mandate must be protected from liability arising from actions, claims, lawsuits or other proceedings for their decisions, actions or omissions taken in good faith in the normal course of their duties. Legal protection should be defined in legislation.

Principle 12 – Dealing with Parties at Fault in a Bank Failure

The deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.

Principle 13 – Early Detection and Timely Intervention

The deposit insurer should be part of a framework within the financial safety-net that provides for the early detection of, and timely intervention in, troubled banks. The framework should provide for intervention before the bank becomes non-viable. Such actions should protect depositors and contribute to financial stability.

Principle 14 – Failure Resolution

An effective failure-resolution regime should enable the deposit insurer to provide for protection of depositors and contribute to financial stability. The legal framework should include a special resolution regime.

Principle 15 – Reimbursing Depositors

The deposit insurance system should reimburse promptly depositors' insured funds promptly, in order to contribute to financial stability. There should be a clear and unequivocal trigger for insured depositor reimbursement.

Principle 16 – Recoveries

The deposit insurer should have, by law, the right to recover its claims in accordance with the statutory creditor hierarchy.

Box 3 European Forum of Deposit Insurers (EFDI)

EFDI is the Association of the Deposit Guarantee Schemes of the European Area. It is composed of 56 Members (DGS) representing 44 countries and of 10 Associates representing some European Investor Compensation Schemes.

EFDI was first established in 2002 by 25 founder members whose intention was to create an association for the mutual exchange of information and expertise. In June 2007, EFDI adopted the legal status of an International Non-profit Association under Belgian Law (INPA – AISBL).

Its registered office is in Brussels hosted by the European Banking Association. The governance of the Association reflects its private nature. The bodies of the Association are the General Assembly, the Board of Directors, the Chairman, the Vice-Chairman, the Treasurer, the EU Committee and the person(s) entrusted with the daily management of the Association.

EFDI has relations with major European and International organisations, benchmark setters and academia. EFDI acts to promote European and International co-operation in deposit insurance, crisis resolution and investor compensation. It serves as a forum for discussions and information sharing on common issues, such as cross-border problems. It links European and non-European DGSs for the study and practical implementation of the EU Directive on Deposit Guarantee Schemes.

To carry out its mission, EFDI has set up an EU Committee, which also is a body of the Association, comprising all its members from the EU Member States. The EU Committee deals with EFDI policy concerning European Union legislation on deposit insurance. Currently, the EU Committee has several subgroups to analyse various aspects of implementation of Directive 2014/49/EU.

EFDI also has other Working Groups for further analysis of issues of interest to the members of the Association.

Each year EFDI organises seminars, workshops and conferences to tackle matters of common interest.

6
Banking Crises and State Aid Discipline

1 State aid general rules

During the financial crisis, State interventions to rescue ailing banks were justified by the need to preserve financial stability and led the EU authorities to revise their policy and methodological approach to State aid, whilst maintaining consistency with the provisions of the Treaty on the Functioning of the EU (TFEU). More precisely, the general principles and rules in this area have undergone extensive adaptation to meet the needs resulting from the systemic bank failures that occurred at that time, unprecedented in the history of the European banking sector.

This innovative approach led to recognition of the special nature of the banking sector with regard to State aid rules, on account of the primary need to preserve financial stability, which is the overarching objective of the new framework. Before the crisis, assessment of recovery and rescue actions in the banking sector was subject to the extensive and detailed general rules applicable to other business undertakings. The reason for this was that in the past, when bank failures did not have system-wide impacts, no need had been felt to introduce *ad hoc* rules for the banking sector. In this area, similarly to other financial sectors, the financial crisis marked a turning point or watershed in the Commission's approach to the assessment of restructuring operations.

The extensive recourse to public intervention during the crisis marked the shift from a system in which bank rescues with public money were considered inadmissible events that could not be declared expressly ex ante but could be implemented in practice in case of need (a sort of *constructive ambiguity*) to one whereby the adoption of public measures to resolve crises was recognised in law as an exceptional solution

permissible under certain circumstances, after all private courses of action available had been exhausted. The conditions for the permissibility of State aid are designed to minimise the negative impacts of State aid on the ex ante conduct of intermediaries in terms of moral hazard and distortion of market competition.

The relevant general rule is Article 107 of the TFEU. It prohibits State aid for the recovery and rescue of ailing undertakings because, by favouring certain undertakings or the production of certain goods, such aid is liable to distort competition. However, this general prohibition is subject to certain exceptions in particular cases:

i) TFEU Article 107(3)(c) considers compatible with the internal market *"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";*
ii) TFEU Article 107(3)(b) considers compatible measures to *"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".*

Specific rules and procedures are contained in the Commission Communication of 1994,[1] which sets out the procedure for the Commission's assessment of the compatibility of public measures and draws a distinction between restructuring aid and rescue aid.[2] Thus, the implementing rules were not adopted through legislative acts but through Communications from the Commission laying down principles and rules for assessing the compatibility of State aid with the internal market. At the time, the EU guidelines applied to the banking sector classified State aid as support measures for undertakings in difficulty, applying the criteria laid down in Article 107

2 The special discipline for the financial sector

As stated, the financial crisis and its system-wide proportions prompted an overhaul of the EU policy on State aid to the banking sector and the adoption of special regulations, through application of the criteria laid down in TFEU Article 107(3)(b).

The Commission has issued a number of specific Communications laying down guidelines on the criteria for assessing the compatibility of State aid in the banking sector, establishing different methods according to the nature and size of the entities and the objective characteristics of the failure. The series of measures issued by the Commission

was opened by the Banking Communication of 25 December 2008. This was followed by the Communication on the recapitalisation of financial institutions in the current financial crisis (15 January 2009), the Communication on the treatment of impaired assets (26 March 2009), the Communication on the assessment of restructuring measures (19 August 2009) and two Communications, in 2010 and 2011, extending the application of State aid rules to support measures in favour of banks in the context of the financial crisis (*Prolongation Communications*).

Through the guidelines contained in the Communications, a regulatory framework was consolidated over time, aimed at ensuring that the application of public instruments to safeguard financial stability would be such as to keep to a minimum any distortions of competition between banks and Member States within the single market. These guidelines set out the conditions for access to State aid and the mandatory requirements for making such aid compatible with the internal market in the light of the principles enshrined in the Treaty.

3 The 2013 Communication of the European Commission

At the height of the financial crisis – a time marked by persisting pressures on financial markets and sovereign debt and by the evolution of State interventions in support of ailing banks, in connection with significant changes underway in the EU rules on bank restructuring and resolution and on Deposit Guarantee Schemes – at the end of July 2013 the Commission issued a further Communication. It entered into force on 1 August 2013.[3]

The Communication rewrote the rules on State aid by repealing the 2008 Communication, updating other previous Communications and introducing new principles and cases. One of the main overarching objectives of the revised policy is financial stability: this is seen not only as the need to prevent major negative spillover effects on the rest of the financial system from the failure of a bank, but also as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy. This marks an innovation in the EU's approach, in the sense that the bank failures are seen not only in terms of instability in the banking market but also in terms of their impact on the real economy; the revised policy would also seem to reconsider and rebalance the relationship between stability policy and competition policy.

In the new strategic framework, the Communication lays down more precise criteria and conditions for the compatibility of the public measures applied by States for bank rescues, defines the procedures to be followed to submit the measures to the Commission and in some cases simplifies such procedures. One of the innovations found in the Communication is that it does not set time limits on derogations, but provides that they remain possible (only) *"as long as the crisis situation persists, creating genuinely exceptional circumstances where financial stability at large is at risk"* (point 6).

3.1 The burden-sharing principle and the need for a bank restructuring plan

One of the mainstays of the EU's State aid rules, also applied during the financial crisis, is that State aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary, that is, by the bank and its capital holders, as much as possible with their own resources. Consequently, State support should be granted on terms that allow adequate burden-sharing by those who invested in the bank (point 15).

From the early phases of the crisis, when examining the compatibility of State aid to banks, the Commission introduced a minimum burden-sharing requirement to cover losses with available capital and payment of an adequate remuneration for the financial resources supplied by the State. Furthermore, to prevent outflow of funds, the Commission introduced rules on the buyback of hybrid instruments, as well as bans on the payout of coupons and dividends (point 16). At the time, creditors were not required to contribute to rescuing banks by participating in the coverage of losses.

As the crisis evolved and the link between banking crisis and sovereign crisis emerged, similarly to the approach adopted in some countries, the need was felt to enforce stricter burden-sharing requirements, by bailing in the bank's investors and creditors; consequently, any granting of aid for bank restructuring must be preceded by a contribution to cover losses by shareholders and junior creditors (that is, subordinated debt instruments).

Thus, the legal framework assumed the existence of an inverse correlation between the measures required to contain competition distortion and the degree of burden-sharing: the higher the burden-sharing requirement, the lower the need to put in place measures to limit distortions of competition.

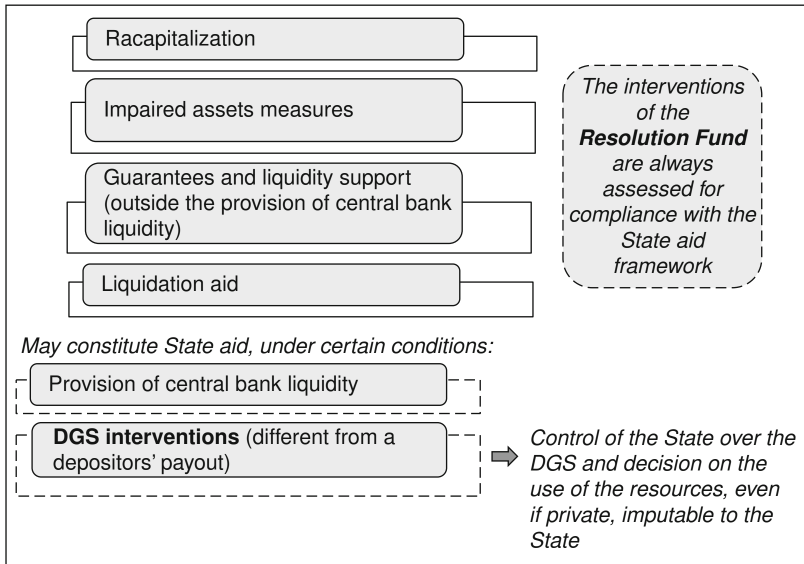

Figure 6.1 Forms of state aid in the 2013 communication

Another pillar of the Communication, which innovates on the practices adopted in the course of the financial crisis, is that recapitalisation and impaired asset measures can be authorised only after the bank's restructuring plan has been approved by the Commission.

3.2 Recapitalisation and impaired asset measures

These public support measures are typically granted when there is a capital shortfall, which for the purposes of State aid rules means a capital shortfall established in a Stress Test or asset quality review (point 28) or an equivalent exercise at Union, Eurozone or national level.[4] The regulatory basis for this provision is the Article 32(4) of the Bank Recovery and Resolution Directive (BRRD) (*precautionary recapitalisation* – see Chapter 3, Section 4.3.4).

Public measures to address capital shortfalls may consist of recapitalisation or impaired asset measures, including the issue of guarantees on those assets. In the light of the scope of these measures and their impact on the States' budgets, the Commission can authorise them only once the Member State concerned has demonstrated that all the other options to limit State aid to the minimum necessary have been exploited to the maximum extent.

To that end, as a precondition for obtaining authorisation for State aid, the Member State concerned must submit a capital-raising plan as part of the submission of a bank restructuring plan. The capital raising-plan should contain both the capital-raising measures implemented by the bank itself and the burden-sharing measures – that is, those measures ensuring participation of the bank's shareholders and subordinated creditors in the bank's losses – in order to determine the residual capital shortfall of a bank which needs to be covered with State aid.[5]

In particular, the Communication provides that the burden-sharing should entail, after losses are first absorbed by equity, contributions by hybrid-capital holders and subordinated debt holders, in order to help to reduce the capital shortfall to the maximum extent. These contributions can take the form of a conversion into Common equity Tier 1 or a write-down of the principal of the instruments.

Thus, the burden-sharing approach taken by the Commission does not require participation in losses by senior debt holders, such as deposits and bonds. In this respect, it differs from the notion of the BRRD, which instead includes unprotected depositors and senior creditors in the scope of the bail-in referred to in Article 44.[6] Thus, in the future, the Commission might well decide to align the two notions, by extending the rules set out in the BRRD to the provisions on State aid.

The new EU rules distinguish two scenarios (points 43 and 44):

- Where the capital ratio of the bank that has the capital shortfall remains above the EU regulatory minimum, the bank should be able to restore its capital position on its own; therefore before approving the State aid scheme the Commission requires the bank to take capital-raising measures, and only once all such initiatives have been explored, must subordinated debt be converted into equity;
- In cases where the bank's capital ratio is below the minimum regulatory capital requirements, subordinated debt must be converted or written down before State aid is granted.

In the former case, the approach is clearly more favourable for the holders of subordinated instruments.

It is worth noting that two derogations are foreseen. The application of the burden-sharing principle can be avoided if it would endanger financial stability or lead to disproportionate results, in particular where the amount of aid to be received is small in comparison to the bank's risk-weighted assets and the capital shortfall has been reduced significantly through capital-raising measures (point 45).

In the framework of the support measures, a particular procedure is established whereby the Commission may exceptionally authorise a Member State to grant State aid on a temporary basis as rescue aid before a restructuring plan is approved, if such measures are required by the need to preserve financial stability. In these cases, the supervisory authority must confirm that a capital shortfall does in fact exist and must demonstrate that it cannot be covered by private capital within a short period of time or by any other less distorting measure such as a State guarantee.

In line with the principle of proportionality of administrative action, the Commission has introduced a simpler authorisation procedure for recapitalisation and restructuring schemes concerning small banks, if these schemes have a clear remit and are limited to a six-month period. Application of the simpler procedure is limited to banks having a balance sheet total of not more than €100 million. Moreover, the sum of the balance sheets of the banks that receive aid under the scheme must not exceed 1.5% of the total assets held by banks in the domestic market of the Member State concerned.

3.3 Guarantees and liquidity support

Guarantees and liquidity support are designed to stabilise temporarily the liability side of the balance sheet of banks experiencing liquidity problems but not a capital shortfall. These measures can be covered by the special procedure for rescue aid, whereby the Commission approves the aid temporarily, pending approval of a restructuring plan.

The authorisation procedure may be the ordinary one, with individual notification of the aid measure, or may concern schemes of liquidity measures for a maximum period of six months. However, if the bank also has a capital shortfall, the ordinary procedure is applied, requiring the submission of a restructuring or wind-down plan, unless the aid is reimbursed within two months.

In exceptional cases, the Commission may authorise guarantees covering exposures of the European Investment Bank towards banks, for the purpose of restoring lending to the real economy in countries with severely distressed borrowing conditions compared to the EU average. Such guarantees may cover a period of up to seven years and do not involve the obligation for the bank to present a restructuring plan.

Liquidity interventions to be considered separately are those of the central banks, such as open market operations and standing facilities, which are related to monetary policy and thus do not fall within the scope of State aid rules. However, if the action of the central bank targets

an individual bank specifically, this constitutes an emergency liquidity assistance operation and might constitute State aid unless a number of cumulative exempting conditions are met (the bank is illiquid but solvent, the facility is adequately secured by collateral, a penal interest rate is applied and the measure is taken at the central bank's own initiative and is not backed by any counter-guarantee of the State).

3.4 Intervention of Deposit Guarantee Schemes (DGSs)

This is the most questionable part of the whole State aid discipline. The Communication provides that in principle interventions using deposit guarantee funds to reimburse depositors of failed banks do not constitute State aid. However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid to the extent that such use comes within the control of the State and the decision as to the funds' application is imputable to the State. The Commission will assess the compatibility of State aid in the form of such interventions (point 63).[7]

The latter category of State aid, which occurs where the intervention of Deposit Guarantee Schemes is aimed at restructuring the failing bank through measures other than reimbursement of depositors, seems likely to give rise to interpretation problems.[8]

The specific issue is to identify when there is the control by the State and when the decision to intervene is imputable to it.

According to the Commission guidelines, instances in which a DGS is acting under a public mandate or when the banks' contributions to the DGS are mandatory, – as well as when it intervenes for an orderly resolution of a bank crisis (instead of liquidating it) – could be extensively interpreted as State aid.

To some extent, the situation may be considered contradictory, with the whole EU crisis management framework – which is aimed at avoiding public interventions – providing for the use of resolution funds and DGSs (private resources). So, how might private financial means become public resources and give rise to State aid?

This interpretation does not seem to be fully acceptable, especially where the Deposit Guarantee Schemes are of a private legal nature and decisions to use the resources for alternative interventions are made by the governing bodies of the guarantee schemes themselves, applying the least-cost principle to these interventions vis-à-vis paying out to depositors. In these cases, indeed, the schemes are fully private, with regard both to the source of the financial resources used and to the decision-making mechanism.

But national conditions and, within countries, the characteristics of the various schemes do not always allow a clear-cut classification between entirely public or entirely private; therefore the applicability of the rules on State aid might be debatable. This is the case for instance when the alternative measures by DGSs, decided upon by their governing bodies, are subject to administrative control by the banking supervisory authority (authorisations, consents, etc.). These interventions should not qualify as being made under the public authority's direct "control", nor should the public authority be held responsible for the decision to use the funds, since such kind of involvement of authorities is due only to the role of Deposit Guarantee Schemes in banking crisis management, which is necessarily in coordination with the other safety-net players. This does not change the real nature of the funds or who made the decision. Therefore, the authorisation granted by the authority should not be designed so as to leave to itself the decision as to whether or not the DGS should intervene.

3.5 Aid to bank liquidation

The case of liquidation aid is special in that in this case the failing bank is unable to return to viability and is doomed to exit the market no matter what. In itself, therefore, the operation is fully consistent with competition rules.

Implications in terms of State aid can occur only when, for the purpose of preserving financial stability, it is not feasible to liquidate the bank under ordinary insolvency proceedings and it becomes necessary to use public support tools to enable an orderly market exit process by the failing bank. To this end, the Communication requires the Member State to provide a plan for the orderly liquidation of the failing credit institution (point 69), through measures minimising distortions of competition, including withdrawal of the banking licence and interruption of activities, except for those necessary to realise assets.

If the State aid measures are in favour of the buyer of the assets of the bank under resolution, the Commission will assess their compatibility in the light of the actual procedure applied in the asset sale process, checking that this has been organised in an open and transparent manner, via a competitive procedure and on market terms, in order to maximise the sale price.

If, instead, the aid is granted to the economic activity to be sold as part of the liquidation, the Commission will assess the need for measures to limit distortions of competition, considering, *inter alia*, the market share held by the economic activity being sold and the viability of

the entity resulting from the sale, having regard to the size of the assets acquired.

The Communication provides for a specific authorisation procedure for liquidation aid schemes for banks of limited size in accordance with the requirements on burden-sharing for shareholders and subordinated debt holders. However, aid measures under an approved scheme in favour of a bank with total assets of more than €3 billion must be individually notified to the Commission for approval.

4 The rationale for EU action: the growth target

The regulatory framework outlined above shows how the rules on State aid have evolved steadily in response to the issues generated by the financial crisis. This evolution takes into account the specific function played by the banking sector in the economy, the need for public intervention under certain circumstances to avert undesired system-wide effects on both the financial system and the real economy and the variety of operational forms in which support may be provided.

However, the EU rulebook in this field has not yet taken its final shape. In the short term, as already noted, the cases identified in the 2013 Communication may require technical adjustments to adapt them to the final set-up of the legal frameworks introduced by the three pieces of legislation on bank crises (the DGSD, BRRD and Single Resolution Mechanism (SRM)). It is worth noting that, pursuant to Article 3 of the SRM Regulation and to Article 2 of the BRRD, any extraordinary public financial support provided to preserve or restore a bank's viability, liquidity or solvency constitutes State aid within the meaning of TFEU Article 107(1).[9]

From a broader viewpoint, a further wide-ranging overhaul in EU policies in this area would appear to be in the making. As noted by a commentator, the 2013 Communication "marks the last phase of the extraordinary aid linked to the crisis but at the same time and in many respects it also prefigures a fourth phase, that of 'modernisation' of the financial sector aid policy which is linked in turn to broader modernisation of the general State aid policy as an aspect of the EU institution's competition policy".[10]

In this sense, the Communication on State aid modernisation opens up new perspectives on the regulatory framework and control activity on State aid that, without prejudice to competition policy, consider re-oriented public spending as one of the tools for designing growth-promoting policies.[11] This foreshadows reinterpretation of State

aid policies in the light of the need to remedy "market failures" through appropriate public interventions to safeguard market efficiency and function.

These new targets may also be pursued through material and procedural changes in order to rationalise overall action in this field by the EU authorities – with a stronger focus on the cases having the greatest incidence on the internal market – and at a national level, as well as to speed up the decision-making process. Thus, the emerging policies seem to target an incentive effect by inducing the aid beneficiaries to undertake activities that they would not have done without the aid, so as to avoid useless waste of public resources and to remove brakes on growth (point 12 of the 2012 Communication).

7
Conclusions

1 The implantation of the new European regulations on banking crisis management in national legislations

The European legal framework on supervision and banking crisis management is now completed. New tools and rules are in place. The main element of the new institutional set-up is the centralisation at EU level of many functions, implying more advanced balances between European and national authorities.

The Directives on Bank Recovery and Resolution (BRRD) and the Deposit Guarantee Schemes (DGSD) are to be transposed in national jurisdictions: the hard work of transposition is ongoing. Implementation will cut across national borders, impacting commercial, banking, bankruptcy and administrative laws. The task is almost herculean and the time in which to carry it out is limited. The devil, in this case, is certainly in the detail.

First, the text of the Directives often leaves room for interpretation and can be ambiguous in the systematic position of the various provisions. The Directives were obviously affected by time pressures during the discussions on the new European legal framework. This had some impact on the consensus around regulatory intervention. Inevitably, interpretative guidelines and secondary regulations will need to be issued by the Commission and the European Banking Authority (EBA). Contents and methods will have to be clarified.

The innovative nature of many legal instruments and institutions being introduced by the European discipline require careful consideration. Can the old and new arrangements be adequately and consistently blended?

European national laws for dealing with crises are often very complex and can be difficult to piece together into a single European jigsaw. From a technical legislative point of view, the EU framework is extremely detailed in its prescriptions[1], while national legislations are in many cases based on principles and allocation of powers. This is the case for Italy, as for other EU Member States. Legislators will have to decide on modalities of implementation for the new rules, identify the new institutions and tools provided by EU framework and clarify the decision-making powers, in the light, too, of the Single Resolution Mechanism (SRM) Regulation, which is immediately applicable. Undoubtedly, things would be easier if legislators drew up just one an autonomous legislative corpus to discipline all the matter relating to banking crisis management.

A second problem relates to the need to strike the right balance between the legislation and the secondary administrative regulations that could import further (devilish) details into national law.

Finally, implementation of numerous provisions of prudential regulation, such as the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV), which in many aspects are connected to the BRRD, has altered the environment into which the new crisis regulation is to be transposed. This also is no small complication.

2 The identification of the resolution authority

The first task is the identification of the resolution authority and the allocation of resolution powers. Here, the European regulation voices a preference for assigning the powers to an administrative authority in order to ensure speed in resolution. However, the Directive does not indicate which authority should be entrusted with resolution powers because it does not want to be seen to trespass into national institutional arrangements.

Neither does the Directive regulate how non-judicial administrative proceedings (in which decisions on interventions should be taken in the different phases of a bank crisis) should be grown and managed because receivership, administration, direct executive powers, etc. are so different in the various countries. Europe leaves the decision on the resolution mechanisms to the Member States. The alternative – the harmonisation of processes – would have resulted in more complex work on substantive and procedural rules on insolvency of banks.

The Directive makes ample use of the principle of subsidiarity, as enshrined in the European Treaty, to skirt around many of these dilemmas.

By contrast, the Directive appears more prescriptive when delineating organisational solutions for cross-border issues. It identifies "Resolution Colleges" as the appropriate forums to achieve the necessary coordination among the authorities of the various countries involved in the resolution of a cross-border group. The EBA is also given a significant role.

European Member States have numerous institutional alternatives for establishing the resolution authority. Two models that seem to fit the current institutional arrangement best can be theoretically taken as benchmarks:

- assignment of the role to the supervisory authority, considering its powers in crisis management and drawing on its consolidated experience and practices; this is particularly important when the supervisory authority is the central bank, which has other tools for intervention in crisis situations;
- creation of an *ad hoc* resolution authority, following the EU model. In this case, however, appropriate coordination procedures between the two authorities should be in place, as provided by the SRM Regulation, with the involvement of the supervisory authority, especially in the starting phase of the resolution.

Specifically, when the supervisory authority also has responsibilities for resolution, operational and functional separation should be established between crisis management and supervisory functions, in compliance with Article 3 of the BRRD. The investigative phase, conducted by the technical offices of the supervisory authority, should also be separate from the decisional phase. Decisions should be carried out by a Board having an appropriate composition to reflect the different institutional components that can play a role in the bank insolvency management.

Identifying the institutions that should be part of the resolution authority is a key issue. Specifically, if and in what ways should treasuries and DGSs take part in the definition of the various crisis management and resolution activities? This depends on many factors, such as the legal features and the role of the various authorities in each institutional set-up.

National legislations should clearly define the powers and responsibilities for the main phases in crisis management: (1) prevention and preparation measures (in particular, recovery and resolution plans) and

early intervention; (2) resolution measures, managed by the resolution authority, in co-operation and coordination with the supervisor, as provided for by the Directive, and (3) liquidation measures, as an alternative to resolution, to be entrusted to the resolution authority.

Where administrative management and the powers of the resolution authority are increased, resolution principles and objectives (Articles 34 and 31 of the BRRD, respectively) and the use of tools and transparency procedures must be clearly located in national legislations so as to provide a framework of responsibilities for the competent authorities and set limits for their discretionary actions.

3 The scope and the use of tools: the flexibility of the Directive and the left to Member States for discretionary measures

The new European framework on banking crises is based on minimum harmonisation of intervention tools. Member States may integrate these new tools into their legislation. Alternatively, they may continue using instruments already existing in their national experience. In this, wide areas of discretion and autonomy are permitted to national legislations, provided that they do not conflict with the principles and objectives of the Directive.

In fact, many BRRD tools are already present in national jurisdictions, such as transfers of assets and liabilities, sale of business, mergers and acquisitions (M&A) and good bank-bad bank separation. Other provisions may be innovative, such as preventative recovery and resolution plans, removal of management, resolution through *bail-in* and *bridge-bank* and the discipline on the ways and procedures for public intervention. For these new legal instruments, an appropriate legal framework should be drawn and it should be in line with the overall regulatory framework.

The Directive gives the authorities the power to activate directly early intervention and resolution tools and to appoint special administrators. The mandate can vary depending on the circumstances.

Specifically, the BRRD provides for the possibility to appoint a temporary administrator as an early intervention measure, under the responsibility of the supervisory authority, and a special manager in resolution, under the control of the resolution authority. The temporary administrator and special manager have different mandates and objectives: the first might work with the bank's management body or replace it with the purpose of reaching a reorganisation solution and of re-establishing

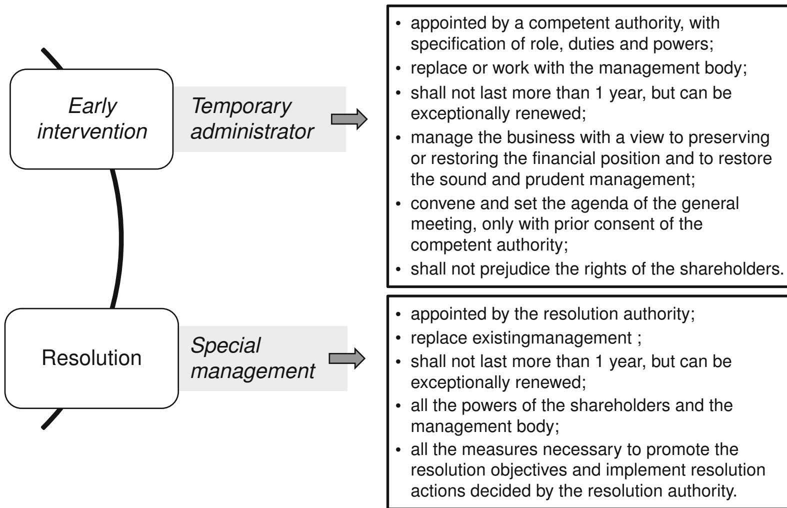

Figure 7.1 Temporary administrator and special management

the safe and prudent management of the bank; in the resolution, the special manager has the function of executing the resolution measures taken by the resolution authority.

The relationship between liquidation and resolution is more complex. In the new regulatory framework, these are two distinct proceedings. The matter is of key importance and the implications for the operational level in banking crisis management are delicate and need careful consideration. Specifically, can resolution be considered as prior proceedings over liquidation as a means for intervention in the case of insolvency? Yes could be the best answer, given the disruptive effects that liquidation normally entails. According to this view, liquidation should be activated only when a restructuring operation is not feasible. It should be a last resort solution.

However, the Directive leaves the question somewhat open. Article 42, for example, says that "Resolution authorities may exercise the power specified in paragraph 1 to transfer assets, rights or liabilities only if: (a) the situation of the particular market for those assets is of such a nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on one or more financial markets".[2] SRM Regulation (Recital 59) and BRRD (Recitals 45–46) seem to lead in the same direction.[3]

These provisions seem to say that the hypothesis of liquidation should be considered first; only if there were a negative assessment of its impact on the markets, could the resolution option be adopted instead.

Further, the EBA, in the Regulatory and Technical Standards [RTS] on Resolution Planning and the guidelines on measures to reduce or remove impediments to resolvability.[4] proposes that resolution authorities consider bank resolvability but verify if liquidation is feasible, credible and consistent with the public interest.

Then, what is the discriminating criterion? Undoubtedly, in the Directive the two procedures are intimately connected. Both are similar as to their starting requirements (Article 32), to wit, the severity of the crisis situation of the bank (the bank is failing or likely to fail) and the lack of alternative solutions to remedy it. The distinctive element, then, seems to be the presence or absence of the "public interest". Where the public interest exists, resolution may be activated. Otherwise, liquidation should be started.

The interpretation, then, has to qualify what is the public interest that justifies applying a resolution action. In this respect, the BRRD Explanatory Memorandum states: "a resolution action shall be treated as in the public interest if it achieves and is proportionate to one or more of the resolution objectives as specified in Article 31, among which to ensure the continuity of essential financial services, to maintain the stability of the financial system, to protect depositors and investors – and winding up of the institution or parent undertaking under normal insolvency proceedings would not meet those resolution objectives to the same extent".

However, how do these objectives operate? Is there a hierarchy between them? An answer to this question could begin with the consideration that the objectives set by the EU legislature can be pursued in many different types of resolution. For example, the reference to the effects on financial stability could suggest that the size of a bank might be a condition for whether or not to start resolution. However, this interpretation does not appear exhaustive. The other objectives, which are not necessarily associated with the systemic importance of the bank, are also of significance and can be crucial for small and medium-sized banks that have strong roots in local areas or provide essential functions in a given economic environment. Thus, "public interest" can be more broadly interpreted and at the discretion of the administrative authority, albeit on the basis of pre-determined technical requirements.

However, liquidation can be "special" and work differently from "ordinary" liquidation proceedings oriented to the minute realisation of assets. As a result, a bank liquidation could have a double function. It could aim purely at the disposal of assets (piecemeal liquidation), but at the same time constitute the legal instrument by means of which it is possible to realise the various forms of resolution. Currently, in fact, in many jurisdictions (such as Italy) the resolution measures envisaged by the BRRD (bad bank-good bank separation, transfer of assets and liabilities) are carried out within liquidation procedures.

Therefore, liquidation does not necessarily involve the disintegration of the bank. Both in theory and in practice it is structured as a procedure that is largely used as a resolution tool (in the literal sense of the word). In fact, liquidation can also imply the sale "*en bloc*" of the business or vital parts of it in addition to the extinction of the credit institution. In particular, the transfer of assets and liabilities in Italian legislation is specifically to be used within administrative compulsory liquidation. The liquidator transfers the business of the insolvent bank to another bank in order to avoid the disruptive effects of liquidation. In the new BRRD framework, however, the transfer of assets and liabilities is also possible outside of the liquidation procedure: the transfer can be activated in the resolution procedure on the basis of the power given to the resolution authority.

The choices that national lawmakers make on this issue are crucial. However, there seems to be no doubt about the possibility that the sale of business can be used both in resolution and in liquidation, as expressly stated in Article 11 of the DGSD. They have different meanings and effects: in resolution, the sale of business is a way to restructure the bank; in liquidation, it is a means for the best realisation of the assets of the failed bank in the interest of creditors and safeguarding viable business lines.

4 The safeguards for subjects affected by resolution measures

The main objectives of resolution are the protection of financial stability and the continuity of the essential functions of banks, through the use of a wide range of tools. In the pursuit of these objectives, shareholders' and creditors' rights may be affected; furthermore, specific general principles may be impacted, such as: freedom of business conduct, credit and savings protection and judicial protection rights.

Powers given to the resolution authority should be consistently framed in national banking and company laws. In particular, shareholders' rights must be taken into consideration in the case of a sale of business and creditors' rights in the case of a transfer of assets and liabilities. Reference should be made to the cardinal principle of the equal treatment of creditors established by bankruptcy law. In case of a bridge bank, issues linked to the authorisation given by the supervisory authority should be raised. Namely, it is important to establish if the licence granted to the bridge bank has the same content and scope as that of an ordinary bank, or if some constraints should be imposed given the mandate of the bridge bank. If the bridge bank is controlled by the resolution authority, there could be a conflict of interest between the exercise of the control and the involvement of the resolution authority in the management and the supervision of the bridge bank. Again, given the for-profit nature of the limited company corporate form, how can this be reconciled with the purely conservative (from a risk-taking point of view) approach of the bridge bank?

The bail-in tool or, as it is called, the "internal rescue" of the bank done through the write-down of credits and their conversion into capital, needs special consideration. This is a form of intervention done outside of an insolvency procedure and it raises delicate issues of compatibility with the protection of creditor rights. Creditors should accept as normal the loss of all or part of their credit following a formal liquidation procedure in accordance with bankruptcy rules. However, they might consider excessive a reduction of their credit rights, through an administrative measure, outside bankruptcy proceedings.

Creditor participation in bank recovery, even at the expense of the principle of equal treatment of creditors, is a common element in many insolvency laws. In insolvency procedures, this still requires the creditors' consensus. In resolution, on the other hand, creditor participation in the recapitalisation of the insolvent bank is executed by an authoritative decision.[5]

Bail-in raises, too, the problem of the treatment of property rights of old shareholders (for the residual value of their shares) and new shareholders following the conversion of credits into shares and particularly with reference to the governance of the bailed-in entity.

During the debate on bail-in, consideration was given to attributing special categories of shares without voting rights to converted creditors. However, this would have had the disadvantage of leaving the voting rights in the hands of the previous shareholders and could have caused the inevitable consequence of moral hazard.

In the logic of corporate restructuring, it would be more appropriate and fairer for the bank management to be appointed by the new shareholders. However, it cannot be excluded that the new shareholders – previously creditors – might have no interest in being involved in strategic decision-making or in radically changing the nature of their participation in financing the bank.

A model has been developed that could avoid such a result. "Converted" creditors would be given securities issued by a special-purpose vehicle that – following the transaction – would acquire full control of the bank in resolution. The bank, now adequately recapitalised as a result of the bail-in, would be sold on the market within a reasonable time. In consequence, the value obtained from the sale would be distributed among the securities holders of the holding company (that is, converted creditors) by the liquidation of the holding company itself. The repayment of financial instruments attributed to the different categories of stakeholders would take place according to the established order required by insolvency law. In this way, the market would determine the amount of the loss to be borne by creditors affected by the bail-in.

From another point of view, the introduction of bail-in, with different levels of priority assigned to the various classes of creditors (depending on the manner of their participation in the write-down and capital conversion), implies a revision of the current creditor hierarchy in liquidation, with regard to the new rule of *depositor preference* and the *no creditor worse-off* principle introduced by the BRRD.

5 DGSD implementation: national legislative choices

The transposition of the new Directive on Deposit Guarantee Schemes into the national legislation is a matter of great delicacy. The DGSD is a maximum harmonisation directive. However, there is some room for national discretion. Choices have to be made with regard to the object of the guarantee and to certain types of reimbursement and, above all, to the use of DGS funds in the three different areas of intervention provided for by the Directive (alternative measures, resolution and liquidation).

In this regard, the central point is that of the *alternative measures*. These interventions are already in place in many European jurisdictions. They give the DGSs the possibility to intervene in order to resolve banking crises in an orderly manner and to prevent insolvency, in the context of a set of measures taken or authorised by the supervisory authority. Deposit guarantee is a crisis management tool aimed at

protecting significant interests and contributing to the stability of the financial system.

However, rigidities and constraints are a feature of the alternative measures in the new Directive and they call into question the experience and practice accumulated by many jurisdictions. The application of State aid rules is one such element of complexity.

If the DGSD provision is interpreted in too restrictive a way, reducing the room for *manoeuvre* for the alternative measures, a new scenario would open up. The focus would be on the alternative, resolution or liquidation: the first would be financed by the resolution fund and the second via intervention of the Deposit Guarantee Scheme for the payout of depositors, without prejudice to the possibility of realising the transfer of covered deposits or of assets and liabilities to another bank.

The debate around the new Directive is still ongoing. Legislators have to deal with complex choices on DGS functions. In particular, they should clarify if they intend to continue with the current ample mandate, which over the years has made it possible to prevent insolvencies and resolve problematic cases by means of a wide range of tools; it has given protection to depositors and helped banks to remain in business. If so, it must be fitted into the new system of banking crisis management, of which the DGSs are an essential component.

In the new regulatory framework, collaboration between supervisory and resolution authorities and DGSs has to be strengthened. This point is emphasised by international standard setters. The perspective is for an even wider involvement of DGSs in banking crisis management. For this, the exchange of information has to be improved, becoming more timely and effective; ways and means of co-operation will require formal Memoranda of Understanding.

Banking Union is very likely to change the background and operational scenarios for the Deposit Guarantee Schemes, too. The effects could potentially be different in the Eurozone from those in other EU countries, given the different areas of application of the new EU legislations. The financial safety net of the non-Eurozone countries is basically domestic, while in the Eurozone it is both domestic and centralised. Banking Union could be still a “work in progress”. It already has two of its “legs”. The third, the pan-European DGS, has been postponed.

The issue of the coexistence of “domestic interests” and “European interests” will have to be faced and tackled appropriately. Many questions arise. Could crises in small banks similarly be managed in a standard way throughout the EU? Could the proceedings and tools provided for in the new framework also become standards? Are the adopted

solutions sufficiently effective and adequate? Will they lead to achieving the objective of a uniform application of rules in Europe? Only time can tell and provide the answer to these questions.

There is no doubt that financial market stability should greatly benefit from the centralisation of supervision and crisis management. Significant improvements in dealing with problematic situations are envisaged, especially with regard to large banks and those with cross-border projection. It is expected to strengthen the confidence and the stability of the financial system, which represent essential preconditions for the economic growth and the progress of the European society.

In this perspective, further enhancements may derive from the EU Commission's project to create a *Capital Market Union*, aimed at establishing an ample and diversified European capital market.[6] Along with the Banking Union, this is yet another important step towards a single European financial market. The goals are to revitalise the placement of securities issued by enterprises and diversify their financing sources, in a context in which banks are required to operate with a lower leverage. In this field, too, the role of the banking system is essential leading non-financial firms towards the market.

Notes

Introduction

1. I. Visco, *The financial sector after the crisis*, Lecture at Imperial College London, 5 March 2013.
2. Between 1 October 2008 and 1 October 2014, the Commission authorised a total aid of EUR 3,892.6 billion (29.8% of EU Gross Domestic Product (GDP) in 2013) for guarantees on liabilities. The outstanding amount peaked in 2009 at EUR 835.8 billion (6.39% of EU 2013 GDP), and has decreased since. In 2013, outstanding guarantees amounted to EUR 352.3 billion (2.7% of EU 2013 GDP). Recapitalisation is the second most used instrument to support the financial sector after the guarantees on liabilities. The Commission has authorised an overall aid amount of EUR 821.1 billion (6.3% of EU 2013 GDP) in the last six years. In addition to guarantees on liabilities, some Member States have provided direct short-term liquidity support to banks and other troubled financial institutions (EUR 379.9 billion, corresponding to 2.9% of EU 2013 GDP, since 2008). However, Member States have, in practice, used only a very small amount in comparison to the total approved. The outstanding liquidity measures peaked in 2009 reaching EUR 70.1 billion (0.5% of EU 2013 GDP). http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html.
3. The Si*ngle Rulebook is composed of* 28 adopted legislations and other important draft reforms aimed at better regulation and supervision of the financial system (particularly with reference to risks resulting from shadow banking), security and transparency of financial markets and reduced reliance on credit agencies. European Commission, *Banking union: restoring financial stability in the Eurozone*, Memo, Brussels, 15 April 2014.
4. The Basel Committee on Banking Supervision (BCBS) developed "Basel III" as a comprehensive set of reform measures, including new rules on capital, liquidity and leverage, aimed to strengthen the regulation, supervision and risk management of the banking sector.

   These measures aim to: (i) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (ii) improve risk management and governance; (iii) strengthen banks' transparency and disclosures.
   The reform is based on two complementary approaches to supervision: bank-level (or microprudential) and macroprudential. Greater resilience at the individual bank level reduces the risk of system wide shocks.
   See: Basel III: *A global regulatory framework for more resilient banks and banking systems*, December 2010 (rev. June 2011); *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013; *Basel III: the net stable funding ratio*, October 2014.

5. Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience 1980–1994*, Washington, D.C., August 1998.
6. In Italy, at the end of 1996, as part of the restructuring and privatisation plan for the *Banco di Napoli* (Law no. 588/1996) the *"Società per la Gestione delle Attività SpA* (SGA)" was created as a special-purpose vehicle that received all non-performing credits and other abnormal assets of the group, for the purposes of their recovery. Thus, the reorganisation and restructuring of the healthy part of the bank was made possible, together with its subsequent sale on the market.
7. EBA Proportionality Workshop*: The application of the principle of proportionality in the context of Institutional and Regulatory Reforms,* 3 July 2015, EBA premises, London.
8. *The Volcker Rule*, Paragraph 619 of *Dodd-Frank Wall Street Reform* in the USA, aimed at allowing banks to carry out retail and investment activities, provided that these are not speculative, such as proprietary trading, commodities, hedge funds and private equity funds. These activities should be transferred to asset management non-banking companies that are specifically regulated. See also M. Richardson, R.C. Smith, I. Walter, "Large Banks and the Volcker Rules", in Acharya, Cooley, Richardson, Walter, *Regulating Wall Street. The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley & Sons, Inc., Hoboken, New Jersey, 2011; *The Vickers Commission*, Independent Commission on Banking, *Final Report Recommendations*, September 2011; *High-level Expert Group on reforming the structure of the EU banking sector*, chaired by Erkki Liikanen, *Final Report*, Brussels, 2 October 2012.
9. Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions - Confirmation of the final compromise text with a view to an agreement,* Brussel, 12 June 2015, 9579/15.
10. The *Glass-Steagall Act* was cancelled by the *Gramm-Leach-Bibley Act* of 1999. See also, J.R. Barth, R.D. Brumbaugh Jr., J.A. Wilcok, *The Repeal of Glass-Steagall Act and the Advent of Broad Banking*, Economic and Policy Analysis Working Paper, 5 April 2000; G. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*, New York, Oxford University Press, 1989; R.J. Phillips, A. Roselli, "Narrow Banking: a Proposal to Avoid the Next Taxpayer Bailout of the Financial System", in *ApertaContrada, Riflessioni su Società, Diritto, Economia*, available on: www.apertacontrada.it, 2009.

1 The Financial Crisis and the Banking Union Project

1. M. Draghi, *Financial stability in the global environment? Learning the lessons from the market crisis*, Keynote Speech at IOSCO's Annual Conference, 10 June 2009; R. Masera, *The Great Financial Crisis. Economics, Regulation and Risk*, Bancaria Editrice, 2009; R.A. Posner, *The Crisis of Capitalist Democracy*, Harvard University Press, 2010; N. Roubini-S. MIHM, *Crisis Economics. A Crash Course in the Future of Finance*, Penguin Audiobooks, 2010; R. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about it*, Princeton University Press, 2008; J. Stiglitz, *Freefall,*

America, Free Market, and the Sinking of the World Economy, W.W. Norton & Co., 2010; A. Turner, *What banks do? Why do credit booms and busts occur and what can public policy do about it?*, in *The Future of Finance*, The London School of Economics and Political Science, 2010.

2. Dating back to the early years of this decade, some important initiatives for the establishment of a framework of principles for the management of banking crises may be outlined. These include: the Financial Stability Forum, *Guidance for Developing Effective Deposit Insurance System*, 24 September 2001, www.fsforum.org.; Basel Committee on Banking Supervision, *Supervisory Guidance on Dealing With Weak Banks*, March 2002, www.bis.org.; World Bank-IMF, *Global Bank Insolvency Initiative: Legal, Institutional, and Regulatory Framework to Deal With Insolvent Banks,* 2009; Group of Ten, *Report on Legal and Institutional Underpinnings of the International Financial System*; on the same issue, R.B. Leckow, *The IMF/World Bank Global Bank Insolvency Initiative – Its purposes and Principal Features*, Presented at the Congreso Internacional de Derecho Mercantil, 8–10 March 2006, Juridicas.unam.mx; E. HUPKES, *Insolvency – why a special regime for banks?*, in *Current Developments in monetary and financial law*, Vol. 3, 2003; C.A. Goodhart, P. Hartmann, D.T. Llewellyn, M. Rojas-Suarez, and S. Weisbrod, *Financial Regulation: Why, How and Where Now?*, London, Routledge, 1999; D.T. Llewellyn, *The Economic Rationale of Financial Regulation*, FSA, Occasional Paper No. 1, London, Financial Services Authority, 1999.
3. G. Boccuzzi, *European Community Directive on Reorganization and Winding-up of Credit Institutions: Comments to Titles I, II, III, IV (art. 28–29–33)*, 15 *European Business Law Review*, Issue 4. M. Pellegrini, *European Community Directive on Reorganization and Winding-up of Credit Institutions: Introduction to Title IV (art. 20-27-30-32),* 15 *European Business Law Review,* Issue 4, 2004; R. Cercone, *European Community Directive on Reorganization and Winding-up of Credit Institutions: Exceptions to the Application of lex concursus (Title IV, Articles 20–27 and 30–32)*, 15 *European Business Law Review*, Issue 4, 2004; J.P. Deguee, *The Winding up Directive Finally Establishes Uniform Private International Law for Banking Insolvency Proceedings*, in *European Business Review*, 2004, 1, pp. 99 ss.; E. Fernandez-Bollo-C. Arnaud, *Défaillance des établissements de crèdit*, in *Rev. Droit banc. Et finance*, 2000, pp. 369 ss.; A. Campbell, *Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding-Up of Credit Institutions*, in www.imf.org/external/np/leg/sem/2002/cdmfl/eng/campb.pdf.
4. Essentially coeval with the Banking Directive is EC Regulation n. 1346/2000, governing the insolvency proceedings of commercial companies operating cross-border. This differs from the pattern for banks some aspects, including, in particular, the prediction of the possibility of opening secondary proceedings in other countries in which the company is established with branches (this case is not included in the Banking Directive).
5. Basel Committee on Banking Supervision – International Association of Deposit Insurers, *Core Principles for Effective Deposit Insurance Systems, June* 2009. The principles have been defined on the base of a methodology jointly developed by the following organisations: Basel Committee on Banking Supervision (BCBS), International Association of Deposit Insurers, European

Forum of Deposit Insurers (EFDI), European Commission, International Monetary Fund and World Bank.

6. Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 2008.
7. Basel Committee on Banking Supervision, *Core principles for effective deposit insurance systems. A proposed methodology for assessment*, 28 May 2010. The methodology was defined in cooperation with IADI, EFDI, the European Commission, The International Monetary Fund and the World Bank.
8. European Commission, Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes (recast), {COM(2010) 369}{SEC(2010) 834}{SEC(2010) 835}, Brussels,12 July 2010; Id., Impact Assessment, Commission Staff Working Document, accompanying document to the Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes (recast), Brussels, Sec(2010) 834/2.
9. Under these agreements, in the event of an enforcement event, all the debt-credit relations between the two parties are resolved and obligations become immediately due. Then, the debt of each party to the other is calculated with respect to individual transactions and a net sum is determined resulting from the balance due on the side where the debt is higher, producing the extinction of legal relations.
10. For a clear description of the process that led to the Banking Union, see Christos Hadjiemmanuil, *Bank Resolution Financing in the Banking Union*, LSE Law, Society and Economic Working Papers 6/2015 – London School of Economics and Political Science Law Department.
11. See also *ECB Banking Supervision and beyond. Report of a CEPS Task Force*, Centre for European Policy Studies, Brussels, December 2014.
12. I. Visco, *The exit from the euro crisis. Opportunities and challenges of the Banking Union*, Speech at the workshop "*Europe and the Future of Global Governance*", organised by *the Institute of International Affairs* and the *Council on Foreign Relations*, Rome, 10 September 2013; President of the European Council, *Towards a Genuine Economic and Monetary Union*, June 2012, updated in December 2012; European Commission, *Blueprint for a Deep and Genuine Economic and Monetary Union*, November 2012. In June 2015 the "Five President's Report" outlined a roadmap towards a complete Economic and Monetary Union, in terms of economic, fiscal union, as well as democratic accountability and financial and institutional strengthening. See European Commission*, Completing Europe's Economic and Monetary Union*, 22 June 2015.
13. See F. Breuss, and W. Roeger, J. In 'T Veld, *The stabilization properties of a European Banking Union in case of financial shocks in the Euro Area*, European Commission Economic Papers, n. 550
14. European Commission, *A comprehensive EU response to the financial crisis: a strong financial framework for Europe and a banking union for the eurozone*, MEMO, Bruseles, 10 July 2013. Commission document "*Banking Union: restoring financial stability in the Eurozone*" (MEMO/14/294), 15 April 2014. See also: European Commission, "*Communication from the Commission to the European Parliament,* the Council, *the European Economic and Social Committee of the Regions – A reformed financial sector for Europe*", COM(2014) 279 final, del. 15 May 2014).

15. CCR (EU Regulation n. 575/2013 of 26/6/2013) and CRD IV (Directive 2013/36/CE of 26/6/2013). In Italy the European framework was transposed by the Circular n. 285/13 of the Bank of Italy, *Disposizioni di vigilanza per le banche*. With specific reference to supervisory reports, according to the CRR, acting on a proposal of EBA, the Commission adopts a regulation establishing the binding ITS on supervisory reporting for banks and investment firms (Common Reporting (COREP)).

2 The First Pillar of the Banking Union: The Single Supervisory Mechanism

1. *Final Report of the Committee of Wise Men on the regulation of European securities markets*, February 2001. The Report was endorsed by the EU Council in the meeting held in Stockholm, March 2001.
2. There are two legislative procedures: co-decision and consultation. The procedure of co-decision was introduced by the Maastricht Treaty in 1992 and was widened and amended by the Amsterdam Treaty (1999) in order to strengthen its efficacy. Following the Lisbon Treaty entering into effect as from 1 December 2009, such procedure was renamed "ordinary legislative procedure" and is now the main EU decisional procedure, giving the Parliament and the Council the same weight in many issues. The consultation procedure (Article 289 of the Treaty on the Functioning of the EU - TFEU) is a special legislative procedure that is used in a few cases; in it, the Parliament is called to vote on a legislative draft before it is adopted by the Council. The EU Parliament may approve or reject a draft or propose amendments; the Council is not legally bound to take the Parliament's opinion into account, although it cannot decide before having received such opinion (according to the Court of Justice). Today this procedure is applied to a limited number of legislative issues.
3. The Commission regularly publishes statistical information about the situation of implementation among Member States, in particular with regard to First-Level and Second-Level directives; based on transposition tables that Member Steter send to the commission. In case of delays in transposition, infringement proceedings are carried out under Article 226 of the EC Treaty.
4. M. Cihak and E. Nier, *The Need for Special Resolution Regime for Financial Institutions: The Case of the European Union*, IMF Working Paper 09/200, International Monetary Fund, Washington, D.C., 2009.
5. Report of *"The High-Level Group on Financial Supervision in the EU"*, Brussels, 25 February 2009. In October 2008, the Commission gave the High Level Group the mandate to make proposals to strengthen financial supervision in Europe. The report identifies, primarily, the fundamental components of the global financial system and the main factors in the financial crisis, and recommends ways to improve regulations, institutional structures of European supervisory bodies and the protection of financial stability at the global level. On the issue, L. Bini Smaghi, Introductory remarks at the Roundtable discussion *"How to strengthen Europe's financial stability framework"*, CFS-IMF Conference *"A financial stability framework for Europe:*

managing financial soundness in an integrated market", Frankfurt am Main, 26 September 2008; Forum on Financial Cross-Border Group, *Cross-border banking in Europe: what regulation and supervision*, Unicredit Group, Discussion Paper, no. 1, March 2009.

6. Regulations (EU) of the European Parliament and of the Council of 24 November 2010, published in the EU Official Journal of 15 December 2010 (L.331/1): no. 1093/2010 establishing the European Banking Authority (EBA), no. 1094/2010 establishing the European Insurance and Occupational Pensions Authority (EIOPA), no. 1095/2010 establishing the European Securities and Markets Authority (ESMA) and no. 1092/2010 on the European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB).
7. As said, the other two authorities are the *European Insurance and Occupational Pensions Authority* (EIOPA) and the *European Securities and Market Authority* (ESMA). EIOPA has the function of supporting the stability of the financial system, the transparency of markets and financial products and the protection of the holders of insurance policies and members and beneficiaries of pension schemes. ESMA has the primary responsibility of ensuring the integrity, transparency, efficiency and orderly functioning of the securities markets, as well as increasing the protection of investors.
8. EU Regulation no. 1024/2013 of the Council of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, Official Journal of the European Union, 29.10.2013, L 287/63.
9. With reference to the debate on conferring supervisory tasks on the ECB: P.G. Teixeira, *The Single Supervisory Mechanism: Legal and Institutional Foundations*, in *From the Consolidated Law on Banking to the Single Supervisory Mechanism: legislative tools and powers allocation*, Legal Research, Bank of Italy, March no. 75, 2014.
10. The ECB shall levy an annual supervisory fee on banks established in the participating Member States and branches established in a participating Member State by banks established in a non-participating Member State. The fees shall cover expenditure incurred by the ECB in relation to its tasks. The fees is calculated at the highest level of consolidation within participating Member States, and shall be based on objective criteria relating to the importance and risk profile of the credit institution concerned, including its risk weighted assets. On 27 May 2014, the ECB launched a consultation period on the draft regulation concerning the contributions to the supervisory activities. The responses to the public consultation were published on 30 October 2014.
11. I. Visco, *Final remark for 2013*, Rome, 30 May 2014.
12. On 27 June 2013 EU Regulation no. 575/2013 and Directive 2013/36/EU on prudential supervision were published in the Official Journal of the European Union, to implement the rules defined by the Basel Committee of Banking Supervision (Basel III) in the EU. The regulatory framework on prudential supervision is a key component of the project defined by the European Council in June 2009 on the establishment of a single rulebook for financial institutions within the European Single Market. The regulatory framework also encompasses the ITS (Implementing Technical Standards)

and the RTS (Regulatory Technical Standards) issued by EBA and adopted by the European Commission with EU Regulation directly binding in all member states.

From 1 January 2014, the new regulatory framework replaces Directive 2006/48/EC related to the activity of credit institutions and its exercise and Directive 2006/49/EC on capital adequacy of investment companies and credit institutions, thus constituting the new prudential regulatory framework for EU banks and investment institutions.

13. European Central Bank, *SSM Framework Regulation: REGULATION (EU) No 468/2014 OF THE EUROPEAN CENTRAL BANK of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities* (L 141/1 of May 2014).
14. The final list of "Significant Credit Institutions" was published by the ECB on 4 September 2014, exactly two months before it took on the tasks of direct supervision. The assessment of significance was conducted on the data of banks' balance sheets by the end of 2013; it will be updated on a regular basis at least once a year and in the case of mergers. On the same date, the ECB also published the list of "Less Significant Institutions" as required by the Framework Regulation.
15. From the quarterly report of ECB on the progress made in the operative implementation of the SSM regulation, it is evident that, in the period under review, the work on the Supervisory Manual, intended for those involved in the Single Supervisory Mechanism, has continued. The Manual reflects the supervisory model of the SSM. It illustrates the processes and procedures, the methodology applicable to More Significant and Less Significant Institutions and specifies the roles and responsibilities of the Joint Supervisory Teams at the different stages of the supervisory process, defining also the organisational structure and its needs in terms of staff. The Manual is subject to refinement, based on the observations of the National Supervisory Authorities and will continue to be subject to regular updates.
16. The *Guide to Banking Supervision* was published by the ECB on 30 September 2014. The guide explains the principles of the SSM, provides guidance on the operation of SSM (distribution of powers between the ECB and national authorities, decision-making processes, operational structure and supervisory cycle) and regulates the procedures for the conduct of supervision. The procedures may be adapted to specific circumstances or to the need to set priorities. In fact, the guide is a practical tool that will be developed through regular updates in order to reflect new empirical experiences. Finally, it does not constitute a legally binding document and does not replace the regulatory requirements set out in applicable EU law, which prevail in case of divergence. ECB, *Guide to Banking Supervision*, September 2014.
17. The Panel is composed of one member per participating State, chosen by each country among the members of the board and of the Supervisory Poard and decides by simple majority. Each member has one vote. The founding texts and scope of action have been adopted and published by the ECB.
18. Regulation (EU) no. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) no. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as

regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013 (L. 287/5 of 29.10.2013).

19. Article 44 of the EBA Regulation is amended as follows: paragraph 1: "Decisions of the Board of Supervisors shall be taken by a simple majority of its members. Each member shall have one (...)"; paragraph 4: "The non-voting members and the observers, with the exception of the Chairperson and the Executive Director, shall not attend any discussions within the Board of Supervisors relating to individual financial institutions, unless otherwise provided for in Article 75(3) or in the acts referred to in Article 1(2)"; it is added in paragraph 4-bis: "The Authority's Chair shall have the prerogative to call a vote at any time. Without prejudice to that power and to the effectiveness of the Authority's decision-making procedures, the Board of Supervisors of the Authority shall strive for consensus when taking its decisions."
20. As noted, "The eventual assignment to the ECB, for the Eurozone alone, of also the regulatory powers of completion of the Single Rulebook would interfere with the production, for the whole Union, of operating rules for the internal market in the banking sector. Therefore, the decision was made to preserve the EBA's power to compete with the Commission in the production of rules." In this sense, S. ROSSI, Speech at the Conference *"From the consolidated law on banking to a banking union: regulation and allocation of responsibilities",* Bank of Italy, 16 September 2013.
21. C. BRESCIA MORRA *"From the Single Supervisory Mechanism to the Banking Union. The role of the ECB and the EBA"*, Working Paper 2/2014 - LUISS Guido Carli - School of European Political Economy.
22. European Court of Auditors, *European banking supervision taking shape - EBA and its changing context*, Special report, no. 05, 2014.
23. Joint supervisory teams are governed by Article 3 of the Framework Regulations. Each team is composed of staff of the ECB and national supervisors. The tasks of the Joint Supervisory Team include, among others: creating the process of review and evaluation (supervisory review and evaluation process - SREP); taking SREP into account, contributing to the preparation of a supervisory examination programme to be proposed to the Supervisory Board, including a plan for on-site inspections of the supervised party; implementing the supervisory examination programme approved by the ECB and all its decisions related to supervision with the supervised institutions; ensuring coordination of the group in charge of on-site inspections and liaising with the National Supervisory Authorities, if appropriate.
24. Supervisors examine the arrangements, strategies, processes and mechanisms implemented by the banks to comply with CRD IV and the CRR, with the frequency and intensity of such inspections determined by the ize, systemic importance, nature, breadth and complexity of the activities of the institution in question, taking into account the principle of proportionality. The assessment and review refer to matters such as: (1) the risks to which the institutions are or might be exposed; (2) the risks that an institution poses to the financial system, taking into account the identification and measurement of the systemic risk set out in Article 23 of Regulation (EU) no. 1093/2010 or – where appropriate – the recommendations of the ESRB and (3) the risks revealed by Stress Tests, taking into account the nature, scale and complexity of the activities of the bank. Based on the assessment

conducted, the authorities determine whether the arrangements, strategies, processes and mechanisms implemented by banks, their own funds and their liquidity are such as to ensure management and coverage of their risks. Where the results of the SREP indicate that a bank poses serious risks of systemic nature, the supervisory authority must inform the EBA without delay.

On 19 December 2014, the EBA published the final version of the guidelines related to procedures and common methodologies for the SREP (EBA/GL/2014/13), after a consultation period opened in the summer. The guidelines are addressed to the EU supervisory authorities, including SSM; they recognise the principle of proportionality and the importance of the judgement of the supervisory authority, providing a framework that is, at the same time, both flexible and binding. They refer to four main areas: (1) analysis of the business model, (2) evaluation of internal governance, (3) risk assessment for capital adequacy and (4) assessment of liquidity risk and adequacy of resources to cover this risk. The evaluations are to be summarised according to a common method of scoring and will lead to a consistent approach in the determination of additional requirements related to capital and liquidity

25. The contents of the full evaluation and the methodological issues are contained in the notes on the Comprehensive Assessment of October 2013, which were followed by a note on the Comprehensive Assessment of February 2014. On 8 August 2014, the ECB published a manual for Stress Tests covering the scope of an in-depth evaluation; the document sets out in detail the arrangements for integration of the projections of the Stress Test with the results of the Asset Quality Review (AQR) and describes the process for ensuring the quality of the results of the Stress Test, which is essential for the soundness and credibility of the business.
26. European Central Bank, press release, 29 April 2014. Capital adequacy of banks will be evaluated at the end of the Comprehensive Assessment taking as a benchmark a capital requirement of 8% (Common Equity Tier 1 – CET1) for AQR and the baseline scenario of the Stress Test; instead, the benchmark for the adverse scenario is equal to 5.5% (CET1 ratio). It is determined that the deficiencies of capital arising from AQR and from the base scenario of the Stress Test should be covered by banks within six months and with Common Equity Tier 1, while those resulting from the adverse scenario should be covered within nine months even with different instruments, since the use of convertible equity instruments is subject to limits. The ECB published the results of the Comprehensive Assessment in October 2014, before assuming responsibility for the SSM.

3 The European Reform of the Rules for Banking Crisis Management: The Bank Recovery and Resolution Directive

1. 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 and amending Council Directive 82/891/

EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council. The Directive was published in the Official Journal of the European Union (EC) of 12 June 2014.

2. Financial Stability Board, *Key Attributes of effective resolution regimes for financial institutions (KAs)*. The KAs (see Box 4) represent non-binding international standards and identify the fundamental elements that the FSB deems necessary for an effective resolution system; once implemented, this system will allow the pursuit of the orderly resolution of a financial intermediary without negative effects and will avoid recourse to public money. The KAs consist of 12 principles that should constitute the resolution framework at international level, and focus on four main aspects: the strengthening of national resolution regimes, the arrangements for international co-operation, the improvement of recovery and resolution planning and, finally, the elimination of practical barriers to co-operation. In particular, the KAs strongly support the necessity to have independent resolution authorities with clear mandates, roles and responsibilities and with increased powers and instruments at their disposal. The KAs also foster co-operation between home and host resolution authorities; in this regard, crisis management groups play a role of fundamental importance, especially for the reviewing and reporting of resolvability procedures of systematically important banks. Finally, the KAs encourage jurisdictions to eliminate impediments to the domestic and cross-border exchange of information between authorities, both in normal times and during crises. In August 2013, the FSB proposed, with a consultation paper, a methodology for the assessment of compliance with the principles (FSB, *Assessment Methodology for the compliance to Key Attributes of effective resolution regimes of financial institutions, 29 August 2013)*. In October 2014, the FSB published a new version of the KAs confirming the principles without changes, while adding a general guidance on the implementation of Key Attributes (Appendix I) and sector-specific guidance (Appendix II), in order to determine the conditions of application of KAs to insurance companies, financial market infrastructures (FMIs) and for the protection of client assets during resolution.
3. P. White and T. Yorulmazer, *Bank Resolution Concepts, Tradeoffs, and Changes in Practices*, Economic Policy Review, Federal Reserve Bank of New York, March 2014.
4. European Commission, *Statement of Commissioner Barnier following agreement in ECOFIN on bank recovery and resolution*, 27.6.2013.
5. The composition of the Resolution Colleges reflects the set-up outlined by *Key Attributes* (KA 8.1) for the *Crisis Management Group* (CMG). According to the FSB *standards*, indeed, "Home and key host authorities of all G-SIFIs should maintain CMGs with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm. CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for the guarantee schemes of jurisdictions that are home or host to entities of the group that are material to its resolution, and

should cooperate closely with authorities in other jurisdictions where firms have a systemic presence".

6. Pursuant to Article 88(7) the EBA shall develop draft regulatory standards and shall submit them to the Commission. On 3 July 2015 the EBA published its final draft RTS on resolution colleges, after a consultation period of three months, that ended in March 2015. "*The EBA's standards focus on the operational organization of resolution colleges and describe the resolution planning process - from the assessment of the resolvability of an institution to the setting up of minimum requirements for own funds and eligible liabilities (MREL) - and give detail on how the resolution of a cross-border group should be carried out. These RTS also cover situations of disagreement, so as to ensure that transparency is given to decisions taken on individual basis and cooperation and interaction between resolution authorities continues also in such cases. The involvement of resolution authorities of third countries, both in resolution planning and in group resolution, is also foreseen by these RTS, which require EU resolution authorities to develop and specify a framework covering this third country resolution authorities' involvement.*".
7. Article 90(4) states: "*Resolution authorities shall share information with the competent ministry when it relates to a decision or matter which requires notification, consultation or consent of the competent ministry or which may have implications for public funds*".
8. The BRRD, in the determination of the MREL requirements for groups, adopts a top-down approach (See recital 80 of the BRRD and 84 of the SRM Regulation). The minimum requirement should reflect the resolution strategy that is appropriate to a group, in accordance with the resolution plan. In particular, the MREL requirements should be required at the appropriate level in order to reflect the approach of the resolution strategy (*single-point-of-entry* – SPE or *multiple point of entry* - MPE).
9. On the concept of banking crisis, see G. BOCCUZZI, *Towards a new framework for banking crisis management*, cit., pp. 15–21;
10. The rationale of the Directive reflects a framework that has been proposed for some years by doctrine and the international regulatory bodies. See, in this regard, the recent work carried out within the Basel Committee, which updated the guidance issued in 2002 in the light of the lessons learned from the 2007–09 financial crisis and development in the regulatory landscape, identifying new policies, tools and practices for effective management of banking crises for banks and authorities; see: Basel *Committee on Banking Supervision, Supervisory Guidelines for Identifying and Dealing with Weak Banks*, July 2015. With respect to the 2002 version of the Guidelines, key changes include: (i) emphasised need for early intervention and use of recovery and resolution tools; (ii) further guidance for improving supervisory processes (i.e. incorporating macro-prudential assessments, stress testing and business model analysis) and reinforcing the importance of sound corporate governance at banks; (iii) stressed importance of liquidity shortfalls, excessive risk concentrations, misaligned compensation and inadequate risk management; and, (iv) expanded guidelines for information-sharing and cooperation among relevant authorities.

    Consultative Document, June 2014, available on the BIS website (www.bis.org). The final document was released in June 2015.

11. On this issue, see the document of the Senior Supervisors' Group, *Observations on Development in Risk Appetite Framework and IT infrastructure*, 23 December 2010, according to which: "RAFs help firms prepare for the unexpected. Firms with a more developed RAF set an expectation for business line strategy review and conduct regular discussion about how to manage unexpected economic or market events in particular geographies or products".
12. See Annex – Section A to Directive 2014/59/EU "Information to be included in recovery plans". See also recommendations issued by the EBA in 2013: *EBA Recommendation on Development of Recovery Plans* (EBA/2013/1) and EBA Technical advice on the resolution framework for EU banks. The advice covers the definition of critical functions and core business lines (EBA/Op/2015/05, 6 March 2015) and rules for the exclusion of liabilities from the application of the bail-in tool (EBA/Op/2015/07, 6 March 2015). The EBA stresses the fact that the bail-in aims at ensuring the legislative principle that shareholders and creditors of a failing institution have to bear its losses; therefore, exemptions should be applied cautiously. In particular, the EBA's advice on critical functions is based on its work on rules for recovery planning and on a comparative analysis of the recovery plans of 27 European cross-border banking groups. This comparative analysis was published together with the advice and identifies key strengths and weaknesses in the approaches of banks (EBA Report, 6 March 2015).
13. On 6 May 2015, the EBA issued guidelines specifying the minimum set of indicators, both qualitative and quantitative, that banks are to include in the recovery plans. In this regard, the Guidelines on the minimum list of qualitative and quantitative recovery plan indicators, (EBA/GL/2015/02) state that the indicators should be established by each bank, in order to identify the critical moments at which to activate the process for implementing the most appropriate actions defined in the recovery plan. Since the level of risk of each bank depends on various factors, including the business model, the funding, the activities and the structure adopted, overall size and interconnections with other banks, the EBA's guidelines provide the basic requirements to be met in the development by the banks of a set of quantitative and quantitative indicators to be included in recovery plans; they also define the minimum list of the categories of ratios to be considered: capital, liquidity, profitability and asset quality, plus two additional categories (market-based indicators and macroeconomic indicators) that should be included in the recovery plans, unless the bank explains their exclusion to the supervisory authority, with reference to their own characteristics in terms of legal structure, size, risk profile or complexity. However, it remains possible to use additional indicators concerning core profiles and other profiles deemed relevant for determining the overall risk of the bank.
14. See Articles 19–26 of the Directive. Article 23, in particular, identifies the conditions for intra-group financial support. According to this Article, financial support measures by a group entity (1) must be able to redress the financial difficulties of the group entity receiving the support; (2) must be suitable to preserve or restore the financial stability of the group and must be in the interests of the entity providing the support; (3) must be provided

on condition that the loan will be reimbursed and interest will be paid and (4) must not jeopardise the liquidity or the solvency of the group entity providing the support. Finally, the Directive provides that the entity providing the support will comply with the prudential requirements at the time when the support is provided. On the issue, on 9 July 2015, EBA published the final draft Regulatory Technical Standards (EBA/RTS/2015/08) and the Guidelines (EBA/GL/2015/17) on the provision of group financial support, as well as final draft Implementing Technical Standards (EBA/ITS/2015/07) detailing the disclosure requirements of these activities.

15. EBA *Final draft Regulatory Technical standards on the content of resolution plans and the assessment of resolvability,* 19 December 2014 (EBA/RTS/2014/15). As to the content of the plans, EBA identifies eight categories of information for which there are specific requirements, and applies the general rule of including in the plans all of the information necessary to allow the adoption of the resolution strategy indicated as preferred for each category. The categories of information are the following: summary of the plan; description of the resolution strategy; agreement for information; agreement for operational continuity; financing; communication; conclusions of the resolvability assessment and answers from the bank or the group.
    With reference to the resolvability assessment, the *draft* RTS proposes an approach divided into stages, in which the resolution authorities should *in primis* assess the feasibility and credibility of liquidation according to ordinary proceedings. Where the outcome of this assessment is negative, a resolution strategy should be identified (*"single-point-of-entry"* or *"multiple-point-of-entry"*, chosen on the basis of the criteria identified in the RTS), evaluating its feasibility and credibility. A categorisation of problems and criteria for the evaluation allotted to each stage has been proposed: (1) criteria for evaluating the feasibility and credibility of the liquidation; (2) criteria for identifying an appropriate resolution strategy; (3) criteria for assessing the feasibility of a resolution strategy, with reference to structure and operations, financial resources, information, cross-border issues, legal issues and 4) criteria for assessing the credibility of a resolution strategy.
16. EBA *Final guidelines on the specification of measures to reduce or remove impediments to resolvability,* 19 December 2014 (EBA/GL/2014/11). The proposed guidelines provide additional details on the list of measures that the resolution authorities can adopt to reduce or remove the obstacles to the resolvability of a bank (or group), specifying the circumstances in which such measures can be adopted.
17. In this regard, despite the wide consensus achieved in the debate on financial reform and on structural interventions on banks (*Volcker rule*, *Vickers Commission*) rather than just on prudential rules, in the early phase of the reform process the option of requiring by law changes in bank organisation and business set-up was put aside. It was decided that any such changes would be required by the authorities, on a case-by-case basis, depending on the outcome of the resolution plan.
    The European Commission, following the Liikanen Report of October 2012, made a legislative proposal for the structural reform of the European banking system (COM(2014) 43 of 29 January 2014), with the aim of preventing more complex banks from carrying out trading activities on their own,

considering the particular riskiness of such activity. The new rules would entrust to the supervisory authorities the powers (and even the obligation in specific circumstances) to impose on such banks the separation of trading activities potentially at risk from deposit-taking, where trading activities might jeopardise financial stability. High-risk activities would be transferred to distinct legal trading entities within the group. However, banks would be allowed not to separate their activities if they could prove to the supervisory authorities that the dangers connected to their risky activities are attenuated through other means. Furthermore, specific rules are provided covering the economic, legal, operational and governance relationships between the distinct trading entity and the rest of the banking group. In order to prevent any attempt by the banks to circumvent these rules by transferring parts of their business to the less regulated "shadow banking system", the proposal for structural reform is accompanied by rules aimed at improving the transparency of this business sector.

18. On the definition of the *triggers* for applying *early intervention* measures, see EBA, *Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU*, EBA/GL/2015/03, 8 May 2015.
19. The term "resolution" has been considered "elusive" by L. Stanghellini, *La disciplina delle crisi bancarie: la prospettiva europea*, in VV.AA., *From the Consolidated Law on Banking to the Single Supervisory Mechanism: legislative tools and powers allocation, Legal Research, Bank of Italy, March, no. 75,* 2014.
20. In this sense, see also Stanghellini. *La disciplina delle crisi bancarie: la prospettiva europea,* in VV.AA*., From the Consolidated Law on Banking to the Single Supervisory Mechanism: legislative tools and powers allocation, Legal Research,* Bank of Italy, March, no. 75, 2014*,* cit., p. 155.
21. The issue of *burden-sharing* was discussed well before the financial crisis, in consideration of the integration process underway in the banking market and of the development of banks having systemic relevance. For a vision anticipating the settings that were to be outlined in the following years, see Goodhart and Schoenmaker, *Burden sharing in a banking crisis in Europe*, LSE Financial Markets Group, Special Paper No 164, March 2006.
22. P. Calello and W. Ervin, *From bail-out to bail-in*, *The Economist*, 28 January 2010, available at: www.economist.com/node/15392186;
23. With regard to the independence requirements of the valuer, see EBA, *Final Report Draft Regulatory Technical Standards on independent valuers under Article 36(14) of Directive 2014/59/EU*, EBA/RTS/2015/07, 6 July 2015..
24. Before reaching the agreement on the BRRD the possibility was also discussed of including among the alternative actions of the private sector for avoiding bank failure, the *Institutional Protection Scheme*, now included in the provision of Article 32(1)(b). An IPS is an agreement among banks, of a statutory and contractual nature, aimed at protecting the participating banks and ensuring their liquidity and solvency for the purpose of avoiding failure, where necessary. In order to qualify as such, an IPS must have specific characteristics. The Deposit Guarantee Schemes Directive (DGSD) is applicable to an IPS that is recognised as a DGS (if it meets the criteria specified in Article 113(7), of Regulation (EU) No 575/2013 and if it complies with the same DGSD). On this issue, see Chapter 5, section 4.2.5.

25. On 26 May 2015, EBA published the final Guidelines (EBA/GL/2015/07) on the circumstances under which an institution shall be considered as "failing or likely to fail" (triggers for resolution). The final report is the result of a public consultation, which lasted for three months and ended on 22 December 2014. "*The Guidelines lists under one single section all objective elements for determining whether an institution is failing or likely to fail. These elements are applicable to both supervisors and resolution authorities. In addition, the Guidelines specify different sets of procedural rules addressed to each of these authorities, and establish the link between the supervisory review and evaluation process (SREP) and failing or likely to fail determination made by the supervisors. The Guidelines also provide additional guidance on the consultation and exchange of information between these authorities when deciding if an institution is failing or likely to fail*".
26. As already anticipated, in the *Final Draft Regulatory Technical Standards on the content of resolution plans and the assessment of resolvability* (EBA/RTS/2014/15), the EBA states in Article 5 the conditions that must be verified by the resolution authority in the assessment of the *feasibility* and *credibility* of the liquidation; among these, the resolution authority shall assess the impact of liquidation on the following elements: the functioning of the financial market and, in particular, market confidence; the functioning of financial market infrastructures; the interconnections between banks (with risk of contagion); the cost of funding and, in more general terms, the effects on the real economy.
27. Differently, the temporary administrator provided for in the *early intervention* phase (Article 29) is appointed by the supervisory authority, which specifies his or her powers, roles and functions, whether to replace the management of the bank or to work temporarily with it. The temporary administrator carries out management functions aimed at preserving or restoring the financial viability of the bank and its safe and prudent management; he or she may convene the shareholders' meeting and draw up its agenda, with the consent of the supervisory authorities. Shareholders' rights are not prejudiced. In this case, too, the term of office is of one year, renewable only in exceptional circumstances if the supervisory authority establishes that the conditions for temporary administration are still present and provides the reasons for this decision to the shareholders.
28. See the EBA, *Guidelines on the minimum list of services or facilities that are necessary to enable a recipient to operate a business transferred to it under Article 65(5) of Directive 2014/59/EU*, EBA/GL/2015/06, 20 May 2015.
29. The suspension of payments is regulated by Article 69 of the BRRD. Methods of communication are laid down in Article 83(4), according to which the resolution authority shall publish a copy of the order by which the resolution action was taken or a summary notice of the effects of that action (in particular on *retail* customers), as well as the terms and length of the suspension of payments. The publication may be effected on the website of the resolution authority, or of the supervisory authority (where different), of EBA and of the bank under resolution.
30. *Investor Compensation Scheme* (ICS), established and operating under Directive 97/9/EC.

31. The Directive provides that the application of the instruments and the exercise of resolution powers may interfere with the rights of shareholders and creditors only if this becomes necessary in the public interest and the interference is compatible with the Charter of Fundamental Rights of the European Union. In particular, where creditors of the same class are treated differently in the context of a resolution action, the differences should be justified by public interest and proportionate to the risk incurred and should not lead to direct or indirect discrimination on the grounds of nationality.

    The same principle is repeated with reference to the power to require the bank to submit a recovery plan and redress any deficiency, which might affect the freedom to conduct a business guaranteed by Article 16 of the Charter. In this case, the limitation of this fundamental right is justified by (and proportionate to) the need to meet the objectives of financial stability.

    Another case consists of the power to impose changes to the structure and organisation of the institution and to take necessary and proportionate measures to reduce or remove substantial impediments to the application of resolution tools and ensure the possibility of resolution of the bank concerned. In this regard, it is expected, among other things, that the measures imposed should comply with EU law, should not lead to discrimination, either direct or indirect, because of nationality and should be justified by the overriding reason that they should be applied in the public interest of financial stability. In addition, intervention should be limited to the minimum necessary to achieve the desired objectives. In determining the measures to be taken, the resolution authority should also take into account the reports and recommendations of the European Systemic Risk Board established by Regulation (EU) No 1092/2010 of the European Parliament and of the Council.

    Another important principle is that the limitations of the rights of shareholders and creditors should be in accordance with Article 52 of the Charter, so that the resolution tools should be applied only to banks that are failing or likely to fail and only when this is necessary to pursue the goal of financial stability in the general interest. When applying tools and exercising resolution powers, both the principle of proportionality and the specific legal status of the bank should be considered.

    Finally, under Article 47 of the Charter, the parties concerned have the right to a fair trial and effective remedies against the measures affecting them. Therefore, provision should be made for the right to challenge decisions taken by the resolution authority.
32. According to the EU Directive, national resolution authorities can make use of these additional tools only with adequate reasons and if those provided by the framework (alone or jointly) do not allow the reaching of an effective resolution.
33. P. Tucker, *Resolution of large and complex financial institution – the big issue*, European Commission Conference *"Building a Crisis Management Framework for the Internal Market"*, 19 March 2010.
34. Article 59(4) specifies that an institution or an entity or a group shall be deemed to be no longer viable only if both of the following conditions are met: (a) the institution or the entity or the group is failing or likely to fail;

(b) having regard to timing and other relevant circumstances, there is no reasonable prospect that any action, including alternative private sector measures or supervisory action (including early intervention measures), other than the write-down or conversion of capital instruments, independently or in combination with a resolution action, would prevent the failure of the institution or the entity or the group within a reasonable timeframe. As can be seen, these are the first two conditions for resolution; the third one referring to the public interest is not mentioned.

35. C. Pazarbasioglu, J. Zhou-V.Le Leslé and M. Moore, *Contingent Capital: Economic Rationale and Design Feature*, IMF Staff Discussion Note, 25 January 2011; M. Moore, *Contingent Capital and Statutory Bail-in Within a Crisis Prevention/Crisis Resolution Framework*, Speech held at the Workshop *"How promising are contingent capital instruments and bail-ins to strengthen financial stability?"*, Brussels: Bruegel, 11 February 2011; P. Melaschenko and N. Reynolds, *"A Template For Recapitalising Too-Big-To-Fail Banks", in BIS Quarterly Review,* June 2013.
36. M. King, Speech to Scottish Business Organisation, Edinburgh, 20 October 2009; G. De Martino, M. Libertucci, M. Marangoni, and M. Quagliariello, *Countercyclical contingent capital (CCC): possible use and ideal design*, Questioni di Economia e Finanza (*Occasional Papers*), Banca d'Italia, No 71, September 2010.
37. EBA, *Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of Directive 2014/59/EU*, (EBA/RTS/2015/06), 3 July 2015. "*The final draft RTS determine the cases in which the requirement to include the contractual term does not apply. In particular, the requirement is displaced where an adequate statutory regime in the relevant third country or an international agreement exists which provides for an administrative or judicial procedure to secure recognition of the application of the write-down and conversion powers by an EU resolution authority. In addition, the final draft RTS specify that liabilities that are fully secured in accordance with EU regulatory requirements or equivalent third country law need not include the contractual term. Importantly, the final draft RTS specify the minimum contents of the contractual term*".
38. European Commission, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution, DG Internal Market*, Working Document, 2010, p. 89.
39. According to Article 45(6) of the BRRD, the minimum requirement should be determined for each bank by the resolution authority, in consultation with the supervisory authority, taking into account: (1) the need to ensure that the bank can be resolved by the application of the resolution tools including, where appropriate, the bail-in tool, in a way that meets the resolution objectives; (2) the need to ensure, in appropriate cases, that the institution has sufficient eligible liabilities to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised and to sustain sufficient market confidence in the institution or entity; (3) the need to ensure that, if the resolution plan anticipates that certain classes of eligible liabilities might be excluded from bail-in or that certain classes of eligible liabilities might be

transferred to a recipient in full under a partial transfer, the institution has sufficient other eligible liabilities to ensure that losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised; (4) the size, the business model, the funding model and the risk profile of the institution; (5) the extent to which the Deposit Guarantee Scheme could contribute to the financing of resolution and (6) the extent to which the failure of the institution would have adverse effects on financial stability.

40. In the sense that the sum of the total regulatory capital and bail-inable liabilities must exceed a certain percentage of total liabilities of the bank. Indeed, Article 39(1) of the initial proposal referred to a sufficient amount of equity capital and bail-inable liabilities, expressed as a percentage of total liabilities not classified as equity; the Impact Assessment published in conjunction with the Directive in June 2012, based on simulation models and data related to the financial crisis, was based on the hypothesis of a LAC of 10%, to take into account the capital requirements of Basel. In the final version of the BRRD, there is no reference threshold, but the assessment must be made on a case-by-case basis and the minimum requirement of own funds and eligible liabilities for bail-in (MREL) is expressed as a percentage of the bank's total liabilities and own funds. In practice, there is convergence between MREL and LAC as additional capital.
41. EBA, *Final draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU*, (EBA/RTS/2015/05), 03 July 2015.
42. Eligible liabilities, including subordinated instruments not qualified as Tier 1 or Tier 2, must be included in the amount to be considered for the requirement only if they meet the following conditions: (1) the instrument is issued and paid; (2) the liability is not owned, insured or guaranteed by the bank; (3) the purchase of the instrument has not been funded, directly or indirectly, by the bank; (4) the liability has a remaining maturity of at least one year (or, if it provides for the right to early repayment, the first date on which the right may be exercised); (5) the liability does not arise from a derivative and (6) the liability is not a deposit subject to priority in the hierarchy of creditors established in the legislation in accordance with Article 108 of the BRRD.
43. With regard to the interrelation between the *sequence* in which the liabilities should be written off or converted in case of application of *bail-in* and the hierarchy of capital instruments in the Capital Requirements Regulation (CRR), see EBA guidelines, under public consultation: EBA, *Draft Guidelines concerning the interrelationship between the BRRD sequence of write-down and conversion under CRR/CRD IV* – consultation paper (EBA/CP/2014/29), 1 October 2014, updated on 10/02/2015.
44. Fondo Interbancario di Tutela dei Depositi: *DGS and depositor preference: implications in light of the upcoming reforms at an EU level*, *Working Paper* no. 11, 2013, which contains analysis of the problem of privilege and discusses its possible application to DGSs, in the light of European legislation sub-

mited for approval at that time; research is accompanied by a statistical analysis at European level.

45. EBA, *Technical advice on the delegated acts on the circumstances when exclusions from the bail-in tool are necessary*, EBA/Op/2015/07, 6 March 2015.
46. Article 44(8) provides that, notwithstanding the 8% threshold, the resolution fund can intervene if: (1) the contribution to loss absorption and recapitalisation is equal to not less than 20% of the risk-weighted assets of the institution concerned; (2) the resolution financing arrangement of the Member State concerned has at its disposal, by way of ex-ante contributions, an amount which is at least equal to 3% of the covered deposits of all the credit institutions authorized in the territory of that Member State and (3) the institution concerned has assets below EUR 900 billion on a consolidated basis.
47. The prudent and realistic valuation is carried out by an independent expert before starting the resolution action or exercising the power to write down and convert capital instruments, with the aim of estimating the value of assets and liabilities of the bank under resolution. If this is not possible, the resolution authority may conduct a transitional valuation. In any case, the valuation aims at (1) verifying that the conditions for resolution or for the write-down/conversion of capital instruments are met; (2) informing the decision on the appropriate resolution action or on extension of the write-down/conversion to capital instruments; (3) informing the decision on the extension of the write-down/conversion of the eligible liabilities in the case of application of *bail-in* and (4) verifying the conditions for the application of other resolution tools. In any case, the evaluation must ensure that losses of the bank under resolution are correctly and entirely recorded when the resolution instruments are applied or the powers of write-down/conversion of capital instruments are exercised.
48. "*When issuing bonds, banks should pay particular attention to investor protection, since they may be asked to bear the costs of resolution. Thus, banks should provide to their clients extensive information on the characteristics of the different instruments. The riskier ones should be explicitly reserved for institutional investors*". I. Visco, *Address by the Governor Ignazio Visco at the Annual Meeting of the Italian Banking Association*, Italian Banking Association Annual Meeting, Rome, 8 July 2015.
49. Fondo Interbancario di Tutela dei Depositi, *La gestione delle crisi delle banche e i ruoli dei fondi di garanzia: casistica europea e inquadramento degli interventi di sostegno del FITD*, Working Paper n. 13, January 2014.
50. Temporary public ownership is implemented in favour of a person on behalf of the State or of a company with total public capital, with the aim of managing the acquired bank under resolution and transferring ownership back to the private sector as soon as the economic and financial situation makes this possible.
51. European Banking Authority, Consultation Paper, *Draft Guidelines on the types, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive*, EBA/CP/2014/17, 9 July 2014. Extraordinary public financial support, disbursed in the form of additional capital in favour of an insolvent bank and subsequent to the recognition of a shortage of capital due to periods of stress or revision of

capital, cannot be considered a resolution trigger if it is granted to remedy a condition of economic difficulties in a Member State and to maintain financial stability. EBA guidelines specify the main features of Stress Tests or capital adequacy reviews that can lead to support measures, such as the time horizon, the object, the reference date, the quality review process, the common methodology and, where relevant, the macroeconomic scenario, the minimum rates of return and the period of time to correct the shortage of capital. The *Final guidelines* were published on 22 September 2014: EBA – *Final Guidelines specifying the type of tests, review or exercises that may lead to extraordinary public support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive,* EBA/GL/2014/09.

52. The valuation shall: (1) assume that the institution under resolution would have entered normal insolvency proceedings at the time when the resolution decision was taken; (2) assume that the resolution action had not been effected and (3) disregard any provision of extraordinary public financial support to the institution under resolution. The EBA may develop draft regulatory technical standards specifying the methodology for carrying out the valuation, in particular the methodology for assessing the treatment that shareholders and creditors would have received if the institution under resolution had entered insolvency proceedings. The Commission is empowered to adopt regulatory technical standards.
53. EBA, *Final draft Regulatory Technical Standards on procedures and contents of notifications referred to in Article 81(1), (2) and (3) and the notice of suspension referred to in Article 83 of Directive 2014/59/EU,* EBA/RTS/2015/04, 3 July 2015.
54. In this sense, the EBA's *Final draft Regulatory Technical standards on the content of resolution plans and the assessment of resolvability.*
55. The regulatory process started in 2010 with a Commission Communication: EUROPEAN COMMISSION, *Bank Resolution Funds, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Brussels*, 26.5.2010, COM (2010) 254 *final*.
56. For the 19 Eurozone countries participating in the SSM (and for the other countries adhering on a voluntary basis), the resolution fund regulation is applied, *based on the SRM Regulation,* and, for aspects related to the transfer of contributions and to the mechanism of mutualisation of resources, an Intergovernmental Agreement is applied (see Chapter 4).
57. Differently, the Directive on DGS awards to to EBA the task of issuing guidelines on risk-based contributions.
58. The Delegated Regulation was adopted in October 2014: COMMISSION DELEGATED REGULATION (EU) 2015/63 of 21 October 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to ex ante contributions to resolution financing arrangements (L 11/44 of 17 October 2014). In this regard, art. 16 of the Regulation specifies that the DGS should communicate to the resolution authority the average of covered deposits in the previous year. In addition, the calculation methodology provided for by the delegated regulation 2015/63 is also referred to in art. 4 of the Council Implementing Regulation (EU) 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation

(EU) No 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the Single Resolution Fund.

59. In the first version of the Directive, borrowing arrangements between funds were mandatory and not voluntary. A similar compulsory arrangement was also foreseen for DGSs in the 2010 proposal; now it is provided on a voluntary basis in Directive 2014/49/EU.
60. Unless agreed differently in the financial plan, the basis for calculating the contribution of each national fund must take into account the proportion of *risk weighted assets*, of group assets and of losses pertaining to the group banks established in the territory of the resolution fund and of the parts of the total resources that are expected go to the direct benefit of such group components.
61. In the regulatory framework initially proposed by the European Commission, the calculation basis varied depending on whether or not the State had decided to unify the resolution fund and the DGS, using the latter's resources for resolution purposes. If the two funds were unified, the contribution of the individual bank was calculated in proportion to the amount of its liabilities, excluding covered deposits and capital, with respect to the same aggregate referred to the whole banking system. Instead, in the case of separation between the resolution fund and DGS, the calculation basis for the resolution fund consisted of the amount of liabilities of the bank, excluding capital, out of the whole value of the same aggregate at system level.
62. This calculation method is further modified in the shift to the *Single Resolution Mechanism*, for participating countries and, hence primarily for the Eurozone, by virtue of the European approach to the determination of the reference total amount. As a matter of fact, Article 66 of the SRM regulation requires that, for each bank, the contribution is given by the ratio of its liabilities, net of own funds and covered deposits, to the total of the same aggregate of all banks authorised in all the countries participating in the Single Resolution Mechanism.
63. Notice how the BRRD extends the possibility of intervention of the DGS with respect to the original version of the DGSD presented in July 2010, which considered the possibility of using the financial means of the DGS not only for reimbursement, but also to fund the transfer of deposits to another credit institution, provided that the costs incurred by the guarantee scheme did not outweigh the amount of covered deposits of the bank in crisis. In the BRRD (and in the DGSD that refers to it in Article 11(2)), the DGS might be liable for all instruments in the framework, thus, even in scenarios of continuation of the bank resolution (subject to bail-in and recovery).
64. As already stated, the main safeguards are compliance with the "no creditor worse-off" principle (Article 109(1)) and the quantitative limit of 50% of available resources (Article 109(5)). Moreover, Article 109 also provides other safeguards. If the resources of the DGS have been used in the resolution and, as a result, have been reduced to less than two-thirds of the target level, regular contributions to the DGS should be set so that the target level is reach once again in six years, taking into account the impact of the economic cycle and pro-cyclical contributions (paragraph 5); if the DGS

has incurred higher losses than in the case of liquidation, it is entitled to refund of the difference from the resolution fund (based on the provisions of Article 75 for shareholders and creditors of the bank in resolution).

65. The Fiscal Compact is the Treaty on Stability, Coordination and Governance of Economic and Monetary Union signed by 25 countries on 2 March 2012 (excluding the UK and the Czech Republic), which entered into force on 1 January 2013. It sets out certain targets for the participating countries, including: the constitutional requirement of a balanced budget; the constraint of a 0.5% structural deficit relative to Gross Domestic Product (GDP); the obligation to keep the ratio of deficit to GDP below 3%; for countries with high debt, the obligation gradually to reduce (within 20 years) the debt /GDP ratio in order to return to the 60% threshold required by the Maastricht Treaty; the obligation to activate correction mechanisms in the case of significant deviations from the medium-term objective or the adjustment path towards this objective for each country; the commitment to coordinate plans for debt issuance with the Council of the Union and with the European Commission.
The reference to the *Fiscal Compact* is made in Recital 5 of the ESM Treaty: *"This Treaty and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("TSCG") are complementary in fostering fiscal responsibility and solidarity within the economic and monetary union. It is acknowledged and agreed that the granting of financial assistance in the framework of new programmes under the ESM will be conditional, as of 1 March 2013, on the ratification of the TSCG by the ESM Member concerned and, upon expiration of the transposition period referred to in Article 3(2) TSCG, on compliance with the requirements of that article*".
66. See UNCITRAL, *Legislative Guide on Insolvency Law, Parts One and Two, 25 June 2004; part three, 1 July 2010; part four, 18 July 2013*. Also at EU level, important improvements are under way, aimed at passing through the shortcomings of the EU Regulation (EC) n. 1346/2000 on insolvency proceedings.
See *Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)*, L 141/19.
Moreover, EC, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, A new European approach to business failure and insolvency, Strasbourg*, 12/12/2012, COM (2012) 742 final.
67. Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Bank Resolution Group*, Bank for International Settlements, March 2010.
68. J. Limpsky, *Towards an International Framework for Cross Border Resolution*, delivered at the ECB and its Watchers Conference XII Frankfurt, Germany, 9 July 2010. According to the author, "*We would envisage establishing an international framework under which countries would agree to cooperate with each other if certain conditions are met. The establishment of such a framework may involve changes to legislation at the national level that would enable such cooperation to take place. The framework would consist of four principal elements: (i) countries would amend their domestic legislation to permit their own authorities to cooperate in an international resolution whenever they view such cooperation as being consistent with the interests of creditors and financial stability; (ii) participating*

countries would adhere to "core coordination standards" that ensure that their national supervisory and insolvency frameworks are sufficiently robust; (iii) they would agree on the criteria and parameters that would guide the burden sharing process among the members of the coordination framework; (iv) finally, they would agree on procedures for coordinating resolution measures across borders, including the cross-border recognition of measures taken in other countries".

4 The Second Pillar of the Banking Union: From the National Resolution Authorities to the Single Resolution Mechanism

1. Towards a Genuine Economic and Monetary Union, Report by President of the European Council (26 June 2012). As stressed in the report, in the short term completing the Banking Union is confirmed as the key priority to ensure financial stability, reduce fragmentation of the financial system, restore normal availability of loans to the economy and break the vicious circle between banks and governments.
2. European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (Brussels, 10.7.2013, COM (2013) 520 *final*, 2013/0253 (COD).
3. The European Parliament's Economic Affairs Committee (ECON) also voted its Report with the amendments to the proposal for a Regulation on 20 December 2014. These amendments were also voted by Parliament in the plenary of 6 February 2014. On that occasion, Parliament voiced certain doubts on the need for an Intergovernmental Agreement for the SRF and stated its view that the State backstop is a key element to make the SRM credible, but not if funded with taxpayers' money.
4. The declaration states: "In order to ensure sufficient funding, the Eurogroup and Ecofin Ministers agreed for Member States participating in the SSM/SRM to put in place a system by which bridge financing would be available as a last resort and in full compliance with State aid rules. In the transition period, bridge financing will be available either from national sources, backed by bank levies, or from the ESM in line with agreed procedures. The arrangements for the transition period will be operational by the time the SRF is established, including the setting up of possibilities for lending between national compartments.

   A common backstop will be developed during the transition period. Such a backstop will facilitate borrowings by the SRF. The banking sector will ultimately be liable for repayment by means of levies in all participating Member States, including ex post. The backstop will be fully operational at the latest after ten years. Progress shall be reviewed soon after entry into force of the SRF. These arrangements will be activated according to their agreed rules and be fiscally neutral over the medium term so that taxpayers will be protected. The arrangements will ensure equivalent treatment

across all Member States participating in the SSM/SRM, including Member States joining at a later stage, in terms of rights and obligations and both in the transition period and once a common backstop has become fully operational. They will respect a level playing field with non-participating Member States, take full advantage of synergies with existing frameworks and safeguard the Internal Market. Non-euro area Member States that consider participating in the Single Supervisory Mechanism are invited to take part in the negotiations".

5. EU Council, Press release of 21 May 2014 "*Member States sign agreement on bank resolution fund*"; *Legislative acts and other instruments – "Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund*" of 14 May 2014 (no. 8457/14).
6. Regulation (EU) no. 806/2014 of the European Parliament and of the Council of 15 July 2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L. 225/1 of 30 July 2014). The SRM may be compared in some respects to other central authorities for the resolution of banking crises such as the Federal Deposit Insurance Corporation in the USA. Unlike the FDIC, however, the SRM – while taking the key decisions on bank resolution – would not be responsible for the management of the failed bank, because of the different national legal systems and traditions. Consequently, the SRM would have no power to liquidate the assets of the failing bank: this power would remain the purview of the national authorities in accordance with national legislation. For an initial analysis of the European regulatory framework, with proposals for improving processes and tools, see MICOSSI-BRUZZONE-CARMASSI, *The New European Framework for Managing Bank Crises*, CEPS Policy Brief, no. 304, 21 November 2013, available on CEPS website (www.ceps.eu).
7. Article 352 of the Treaty on the Functioning of the European Union (TFEU) has a flexibility clause on the areas under the European Union's competence, which allows the Union's competences to be adjusted to the objectives laid down by the Treaties when the latter have not provided the powers of action necessary to attain them. In other words, TFEU Article 352 can serve as a legal basis if the following conditions are met: (1) the action envisaged is "necessary to attain, in the context of the policies defined by the Treaties (with the exception of the Common Foreign and Security Policy), one of the Union's objectives"; (2) no provision in the Treaty provides for action to attain the "objective" and (3) the action envisaged must not lead to the Union's competences being extended beyond those provided for by the Treaties. The decision on whether this provision should be used is for the Council of the European Union, acting unanimously on a proposal from the Commission and after approval by the European Parliament. The European Commission, in accordance with the procedure for monitoring subsidiarity provided by Article 5 of the Treaty on European Union (TEU), must inform national parliaments of the initiatives taken on the basis of TFEU Article 352.
8. Judgment of the Court of Justice of 13 June 1958, according to which it is not permissible to delegate broad discretionary powers to an agency not

provided for by the Treaties. In the case at issue, the Commission cannot confer on another agency greater powers than those it possesses itself.

9. On this issue, we should also mention the recent judgment of the Court of Justice of 22 January 2014 (C-270/12) that, while addressing a different matter, is very useful for the purposes of interpreting the EU legal order. By this judgment, the Court rejected the action lodged by the United Kingdom of Great Britain and Northern Ireland for annulment of Article 28 of Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 (adopted on the basis of TFEU Article 114), which grants the European Securities and Market Authority (ESMA) intervention powers such as prohibiting or imposing conditions on the entry by natural or legal persons into a short sale in exceptional circumstances (threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union). The Court upheld the positions put forward by the Commission, the Council and the European Parliament and held that ESMA's assessments pursuant to Article 28 of Regulation No 236/2012 are technical in nature and are linked to exceptional circumstances and therefore do not involve a "very large measure of discretion"; these powers are precisely delineated and amenable to judicial review in the light of the objectives established by the delegating authority. The Court's conclusion was that the regulatory provision at issue complied fully with the conditions laid down in the Meroni's judgment.
10. Under Article 18 of the SRM Regulation, the ECB's communication must concern assessment of whether the following conditions for the resolution are met: the bank is failing or likely to fail; there is no reasonable prospect that any alternative private sector measures – including measures by an IPS – or supervisory action including early intervention measures or the write-down or conversion of relevant capital instruments in accordance with Article 21 – taken in respect of the entity would prevent its failure within a reasonable timeframe and a resolution action is necessary in the public interest. In particular, the assessment that the bank is failing or likely to fail will be made by the ECB after consulting the SRB. The Board itself may make such an assessment (in its executive session) after informing the ECB of its intention and only if the ECB, within three calendar days of receipt of that information, does not make such an assessment. This provision replicates the mechanism of the BRRD, with regard to the same assessment (see Article 32(2)).
11. The content of the resolution scheme is specified in Article 23 of the Regulation, while the tools are regulated by Articles 24–27, following the same model as the BRRD.
12. Article 76 sets out the following cases in which the Fund may be used: to guarantee the assets or the liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle; to make loans to the same entities; to purchase assets of the institution under resolution; to make contributions to a bridge institution or an asset management vehicle; to pay compensation to shareholders or creditors if they have incurred greater losses than they would have incurred in a winding down under normal insolvency proceedings; to make a contribution to the institution under resolution in the event of optional exclusions from bail-in, as

to the part that would have derived from inclusion of those positions, or any combination of those actions. Article 77 governs use of the resources in the transitional period of establishment of the SRF and of its coexistence with the national compartments corresponding to the participating Member States, with reference to the IGA.

13. In the event of total or partial or exclusion of certain liabilities from the bail-in, use of the SRF to cover any losses that have not been absorbed or to purchase shares in the institution in order to recapitalise it is possible only after a bail-in equal to not less than 8% of liabilities (including own funds) of the bank under resolution. Such funding provided by the Fund may not exceed 5% of total liabilities including own funds.
14. The starting date of 1 January 2016 for reaching the target level may be deferred pursuant to Article 99(6): from 1 January 2015, the Board must submit a monthly report (approved in its plenary session) to the European Parliament, the Council and the Commission on whether the conditions for the transfer of contributions to the SRF have been met. If these reports show that those conditions have not been met, the start date of 1 January 2016 may be postponed by a month at a time. At the end of that month, the Board must submit a new report.
15. *Council Implementing Regulation (EU) 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation (EU) No 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the Single Resolution Fund*. On the issue, see also the EBA *technical advice on the delegated acts regarding the initial period of the single resolution fund*, (EBA/Op/2015/11, 10 June 2015).
16. By expressed provision of the IGA, these time limits may be amended according to the entry into force of the IGA itself, linked to the ratification by the Member States participating in the SSM-SRM, representing at least 90% of votes.
17. In particular, Article 71(2) provides that the Board may, on its own initiative after consulting the National Resolution Authority or upon the latter's proposal, defer, in whole or in part, an institution's payment of extraordinary ex-post contributions by up to six months, if this is necessary to protect the bank's financial position. The contributions may be made later at a point in time when the payment no longer jeopardises the bank's financial position.
18. On this point, Article 75(3) of the Regulation provides that the resources of the Single Resolution Fund must be invested in obligations of the Member States or inter-governmental organisations, or in highly liquid assets of high credit-worthiness, taking into account the provisions of the Capital Requirements Regulation (CRR). Furthermore, investments must be sufficiently diversified (sector, geographic and proportional diversification).
19. Article 67(4) of the Regulation provides that ex-ante contributions for reaching the target level and ex-post contributions must be raised at national level by the National Resolution Authorities and transferred to the SRF in accordance with the IGA. Article 68 requires the Member States participating in the SRM to establish financing arrangements in accordance with Article 100 of the BRRD and with the Regulation.

20. Every year, the SRB, after consulting the ECB and the National Supervisory Authorities, and in close co-operation with the National Resolution Authorities, must calculate the contribution from each bank to ensure that the amounts to be paid by all the authorised banks in all participating countries do not exceed 12.5% of the target level (corresponding to a contribution of 0.125% per year (Article 70(2)).
21. Art. 103(7) BRRD empowers the European Commission to adopt a delegated regulation, in order to specify the calculation of risk-based contributions, issued on October 2014. *Commission Delegated Regulation (EU) 2015/63 of 21 October 2014 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to ex ante contributions to resolution financing arrangements* (L 11/44 of 17 October 2014).

5 The Third Pillar of the Banking Union: The Pan-European Deposit Guarantee Scheme

1. On objectives, purposes and diffusion of deposit guarantee see, D. Diamond and P. Dybvig, Banking Theory, Deposit Insurance, and Bank Regulation, The Journal of Business, 1986, Vol. 59, No. 1, pp. 55–68; A. Demirgüç-Kunt and E.J. Kane. Deposit Insurance Around the Globe: Where Does It Work?, Journal of Economic Perspectives, 2002, 175–95.
2. Financial Stability Board, *Thematic Review on Deposit Insurance Systems – Peer review report*, 8 February 2012; IADI Data and Survey Committee presentation, IADI Annual Survey Key Results, October 2014.
3. J. Pruski, *The role of the deposit insurer in bank resolution*, speech at the "FSI-IADI Seminar on Bank Resolution, Crisis Management and Deposit Insurance Issues", Basel, 9–11 September 2014.
4. G. Boccuzzi, La *crisi dell'impresa bancaria. Profili economici e giuridici, cit.*, pp. 423 ff. (in Italian only).
5. Some clarification on this point could derive from Recital 45 of the Directive 2014/49/EU on DGS, which states that "*This Directive should not result in the Member States or their relevant authorities being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized*".
6. For an overview of Deposit Guarantee Schemes in the European Union, F. Arnaboldi, Deposit Guarantee Schemes: A European perspective, Palgrave Macmillan, 2014.
7. D. Schoenmaker and D. Gros, A European Deposit Insurance and Resolution Fund: An Update, DSF Policy Paper Series, September 2012.
8. V. Constancio, Banking Union and European Integration, Speech held at the OeNB Economics Conference, Vienne, 12 May 2014; I. Visco, Il completamento dell'Unione Bancaria e il finanziamento dell'economia reale, (in Italian only) - translation of the title "The completion of the Banking Union and the financing of the real economy"), according to which "the decision to harmonise the deposit guarantee schemes adopted by the various Member States is a step in the right direction, even if only with the

creation of a single deposit guarantee scheme for the Banking Union countries, can you really ensure equal treatment of depositors, regardless of their residence, and the residence of the banks to which they decide to entrust their savings".

9. Please, see J.C. Juncker, in close cooperation with D. Tusk, J. Dijsselbloem, M. Draghi, M. Schulz; The Five Presidents Report: Completing Europe's Economic and Monetary Union; European Commission, 22 June 2015. In the report, the five presidents propose the launching of a European Deposit Insurance Scheme (EDIS), as a re-insurance system at the European level for the national DGSs. Just like the Single Resolution Fund, the common EDIS would be privately funded through ex-ante risk-based contributions paid by all the participating banks. Its scope should coincide with that of the Single Supervisory Mechanism.
10. International Association of Deposit Insurers, Core Principles for Effective Deposit Insurance Systems, November 2014.
11. European Commission, Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes (recast), {COM(2010) 369} {SEC(2010) 834}{SEC(2010) 835}, Brussel, 12.7.2010; European Commission, *Impact Assessment, Commission Staff Working Document, Accompanying document to the Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes* (recast), Brussels, SEC(2010) 834/2.
12. The Directive proposal also contains a specific section governing the protection of investors of investment firms, amending Directive 97/9/EC, in order to harmonise the types of protected financial instruments, to increase the coverage, speed up the reimbursement and adjust the "funding" of the systems, to improve the disclosure towards investors significantly.
13. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on Deposit Guarantee Schemes (recast), Official Journal of the EU 173/149 of 12 June 2014. The Directive innovates in many ways compared to the initial proposal of the Commission, including the target level of resources (from 1.5% to 0.8%), the basis for calculation of contributions (from "eligible" deposits to "covered" deposits), the setting of a risk-based correction system (no longer completely harmonised, but defined in terms of principles) and the extension of the possibilities of DGSs' use of funds.
14. The Directive provides a broader term (31 May 2016) for the implementation of the provisions relating to the interim payments pursuant to Article 8, paragraph 4. The same broader term is applied to the calculation of contributions, if, in the opinion of the Authority, the deposit guarantee systems are unable to comply with the provisions of Article 13 before 3 July 2015. The EBA Final Guidelines on risk-based contributions were released on 28 May 2015.
15. For a detailed analysis of the policy and regulatory aspects of the new directive, C.V. Gortsos, *The new EU Directive (2014/49/EU) on Deposit Guarantee Schemes*, ECEFIL (European Center of Economic and Financial Law), Working Paper Series, no. 10, October 2014.
16. The Directive has a transitional provision (Article 19), under which Member States that at 1 January 2008 had a level of coverage between €100,000 and €300,000 may continue to apply the highest level of coverage until

31 December 2018. In this case, however, the target level and the contributions of the banks must be adjusted accordingly.

17. Article 6, paragraph 4 of the Directive provides that repayments may be made, in Euros, the currency of the Member State in which the DGS or the account is located, the currency of the Member State where the account holder is resident or the currency of the account. The exchange rate used is that of the date on which the unavailability of deposits has been defined in the relevant forums.
18. Pursuant to Article 56 of the Bankruptcy Law: "The creditors have the right to compensate with their debts towards the bankrupt the credits they have towards the same, even if they are not expired before the declaration of bankruptcy. Compensation, however, does not take place for non-expired loans if the creditor has purchased the credit after the declaration of bankruptcy or a year before".
19. The initial term of ten years for the establishment of the fund may be extended for a maximum of four years in the event that the DGS has made cumulative interventions of more than 0.8% of covered deposits.
20. On 28 May 2015, EBA published the final Guidelines on payment commitments: EBA, Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes, EBA/GL/2015/09, 28 May 2015. The Guidelines are addressed to DGSs and designated and supervisory authorities and they find application in accordance with the internal transposing rules of the directive that qualify payment commitments as integral part of the financial available means of the DGS for the purposes of calculating the target level. The 30% limit shall be deemed applicable to the ex-ante contribution of each member bank. The eligibility of the payment commitment is subject to written individual agreement between the DGS and the member banks (payment commitments arrangements), which must include, among other elements, the amount of commitments, the irrevocable bank obligation to pay in cash corresponding to the commitment after the DGS request, and do so without delay and not more than two days after the request and the signing of a Security Financial Collateral Arrangement, in which the collateral characteristics are defined.
21. Article 19, paragraph 3, states that until the target level has been reached for the first time, Member States may apply these thresholds in relation to the available financial means.
22. JRC (Joint Research Centre, European Commission), Possible models for risk-based Contributions to EU Deposit Guarantee Schemes, June, 2009. This study was the basis of the proposal of a fully harmonised system of contribution contained in the Commission's original text, then deleted in the final text in favour of an approach in which it states only the principle of risk-based contributions.
23. EBA, *Guidelines on methods for calculating contributions to Deposit Guarantee Schemes*, EBA/GL/2015/10, 28 May 2015.
24. In view of national banking system particularities, Member States may set a percentage level for DGS contribution to the resolution of more than 50% of its available financial means. In any case, if due to the intervention in a resolution the DGS size falls below two thirds of the target level, it should be rebuilt in six years.

25. European Commission, "Communication from the Commission on the application, from 1 August 2013, of t State aid rules to support measures in favour of banks in the context of the financial crisis", published in the EU Official Journal 30 July 2013. A reference to DGS in connection to State aid can also be found in Recitals 47 and 55 of the BRRD. The Recital 47 states: "State aid may be involved, inter alia, where resolution funds or deposit guarantee funds intervene to assist in the resolution of failing institution". Recital 55 provides: "Save as expressly specified in this Directive, the resolution tools should be applied before any public sector injection of capital or equivalent extraordinary public financial support to an institution. This, however, should not impede the use of funds from the deposit guarantee schemes or resolution funds in order to absorb losses that would have otherwise been suffered by covered deposits or discretionarily excluded creditors. In that respect, the use of extraordinary public financial support, resolution funds or deposit guarantee schemes to assist in the resolution of failing institutions should comply with the relevant State aid provisions".
26. This rule provides: "The exception of exposures giving rise to Common Equity Tier 1, Additional Tier 1 and Tier 2 items, institutions may, subject to the prior permission of the competent authorities, not apply the requirements of paragraph 1 of this Article to exposures to counter parties with which the institution has entered into an institutional protection scheme that is a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary. Competent authorities are empowered to grant permission if the following conditions are fulfilled: (...) "
27. At the end of August 2014, the IADI launched a new consultation on the Core Principles for Effective Deposit Insurance Systems among the deposit guarantee systems of its participating countries. The revision was necessary to strengthen certain areas (governance, reimbursement of depositors, coverage of deposits and funding) and to add further guidance on the role of Deposit Guarantee Schemes in the preparation and management of crises, in the light of the increasing role that DGSs are called upon to have in the resolution. It emphasises, therefore, the relevance of DGSs within the safety net. The Revised Core Principles have been submitted to the Financial Stability Board (FSB) for inclusion in the FSB's Compendium of Key International Standards of Financial Stability.
28. The reference is to Article 10, paragraph 10, under which the guarantee schemes are required to forward to the EBA, by March 31 of each year, information on guaranteed deposits and available financial means as of 31 December previous year.

6 Banking Crises and State Aid Discipline

1. Communication from the Commission, *Community guidelines on State aid for rescuing and restructuring firms in difficulty*; Official Journal of the Commission, 368, 23.12.1994, pp. 12–20.
2. For an analysis of the criteria set out in the Communication and their application to the banking sector, too, see G. Boccuzzi, *La crisi dell'impresa*

bancaria. Profili economici e giuridici, Milan, 1998, p. 487 *et seq.*; ID., *Gli assetti proprietari delle banche. Regole e controlli*, Turin, 2010, p. 153 *et seq.*

3. European Commission, *Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis* ("Banking Communication"), 2013/C 216/01, 30.7.2013.
4. On this point, we should recall the difference in the qualification and amount of capital requirements measured by a Stress Test with respect to those emerging from an Asset Quality Review (AQR). As specified (Bank of Italy, Financial Stability Report, no. 6, November 2013, p. 13), an AQR performed in the framework of a supervisory action assesses losses; actual (incurred) losses must be recorded in the financial reports by the company's governance bodies. On the other hand, capital requirements as assessed by a Stress Test refer to a purely potential loss, which, by definition, has a low probability of occurring and does not reflect fair value impairment or loan impairment charges and therefore must be recognised in the accounts under the current international accounting standards.
5. The Communication lists as capital-raising measures the issue of new shares, the voluntary conversion of subordinated debt instruments into equity, liability management exercises that should be able to generate capital and sales of assets and portfolios, as well as in order to generate capital, earnings retention and any other measures reducing capital needs.
6. For a comparison between EU State aid policies and the BRRD, see, S. Micossi, G. Bruzzone, and M. Cassella, *Bail-in Provision in State Aid and Resolution Procedures: Are they consistent with systemic stability?*, CEPS Policy Brief, no. 318/2014.
7. Point 64 makes similar provision for the interventions of resolution funds.
8. The Court of Justice has several times intervened on interpretation issues.
9. "Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."
10. See, S. Fortunato, 2013, Gli aiuti di stato alle banche in crisi, in Crisi Bancarie e Diritto Comunitario, Diritto della Banca e del Mercato Finanziario, n. 4.
11. European Commission, *Communication on State aid modernisation*, COM (2012) 209 *final*, 5 May 2012.

7 Conclusions

1. The BRRD consists of 132 articles, 133 Recitals and an Attachment. The DGSD consists of 23 articles, 56 Recitals and 3 attachments. Certain aspects covered by the SRM Regulation will also be incorporated in national legislations.
2. As regards to the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets under Article 42(14) of Directive 2014/59/EU,

the EBA on 24 September 2014 launched public consultation on the Draft Guidelines and the final document will soon be issued.

3. In this sense, Christos Hadjiemmanuil, *Bank Resolution Financing in the Banking Union*, p. 23.
4. European Banking Authority, final draft *Regulatory Technical Standards (RTS) on resolution planning and final Guidelines on measures to reduce or remove impediments to resolvability* (19 December 2014).
5. The same considerations can arise with reference to the forced transfer of shares or assets, rights and liabilities of the company, as well as to cases of their partial transfer.
6. EU Commission, *Building a Capital Market Union*, Green Paper, COM (2015), February 2015.

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