

# CEPS POLICY BRIEF



## The New European Framework for Managing Bank Crises

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### Key points

The proposals under discussion for a Single Banking Resolution Regulation establishing a centralised mechanism for countries participating in the Single Supervisory Mechanism and a Resolution Directive are generally well designed and coherent. Yet there is a need to streamline the procedures for deciding the start of resolution and managing the subsequent action, which now entail much overlap in the powers attributed to the institutions involved (the Commission, the Single Resolution Board and the European Central Bank).

Further aspects requiring clarification concern the activation of the bail-in instrument, where there is a need to avoid the potential destabilising effects of an overly rigid approach; the design of the Single Resolution Fund, which must be paid by the financial industry but nonetheless needs a centralised fiscal backstop; and the legal basis of Article 114, which may prove insufficient to support the very intrusive powers attributed to the Single Resolution Board in the management of resolution.

### Recommendations

Our key recommendations are i) that the assessment that a bank is failing or likely to fail and no private or supervisory alternative is available should be left to the ECB, and endorsed by the SRB and Commission with a fast-track procedure for the initiation of resolution completed within a weekend; ii) that bail-in be resorted to parsimoniously in pre-resolution phases, notably when there is need to recapitalise many banks simultaneously; iii) that the ESM should be the first-line backstop for the Resolution Fund, and that the member states should also agree in advance on a 'sharing key' for a last resort backstop by national budgets, albeit only for the extreme case of a systemic crisis affecting large parts of the banking system; and iv) that, should Article 114 appear to offer a weak legal basis for the Single Resolution Mechanism, then the joint resort to Articles 114-cum-352 could also be considered.

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## 1. Introduction

The European Commission proposal for a Regulation establishing a European Single Resolution Mechanism (SRM) for banks is now under consideration before the European Parliament and the Council.<sup>1</sup> The main principles and tools applicable for resolving a failing bank are contained in the June 2012 Commission proposal for a Directive on bank recovery and resolution (BRR), aimed at harmonising crisis management and resolution tools in EU member states, which is also under consideration by the European legislators.<sup>2</sup> Any discussion of the new system must therefore be based on both proposals.

Resolution is an essential complement to the Single Supervisory Mechanism (SSM), whose constitutive Council Regulation was published in the Official Journal of the European Union in October.<sup>3</sup> Supervision and resolution are two main pillars for the creation of a European banking union, the third being the deposit

<sup>1</sup> 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 Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council, COM/2013/0520 final, Brussels, 10 July 2013.

<sup>2</sup> Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM/2012/0280 final, Brussels, 6 June 2012; Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, General approach, Council of the European Union, 28 June 2013.

<sup>3</sup> Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

guarantee system: on this last matter, the Council has not agreed to create a supranational system – mainly due to some member states' reservations about the cross-border pooling of insurance funds – and has asked the Commission to limit itself to a directive harmonising national rules. The proposal, tabled by the Commission in July 2010 (European Commission, 2010), is still pending before legislators.

As proposed by the Commission, the SRM should apply to all banks falling under the SSM, under the principle that all banks should be treated equally. The request by some member states to exempt some banks – thus reopening a discussion that was satisfactorily settled with the SSM Regulation – would create a second tier of banks exposed to supervisory forbearance and, in general, to broader discretion in the application of common rules, and preserve current distortions in the internal market.

Taken together, the legislation adopted or under consideration for the SSM, the SRM, and to an extent also deposit insurance, offers a well designed, comprehensive and coherent framework for banking union that, once fully implemented, should restore the internal market for financial services and go a long way towards eradicating moral hazard and excessive risk-taking in the EU banking and financial system.

This Policy Brief discusses the SRM Regulation and the BRR Directive, drawing attention to certain features that should be improved. They concern notably the initial decision to place an institution under resolution (Paragraph 3), the bail-in tool (Paragraph 4), the resolution fund(s) with attendant fiscal backstop question (Paragraph 5), and the legal basis of the SRM Regulation (Paragraph 6). Paragraph 2 illustrates the main contents of the proposals in order to facilitate the ensuing discussion. Paragraph 7 concludes.

## 2. The three phases of bank crisis management

Banks provide vital services to the economy (the operation of payment systems, deposit-taking and lending). However, since they lend

depositors' money on a fractional reserve or capital basis and transform maturities – and therefore do not have at all times the liquidity required to pay back depositors, should they want to withdraw their money simultaneously – they are exposed to confidence crises that may make them rapidly unviable. A run on a bank may rapidly spread to other banks, due to their close interconnections through the interbank market, and even threaten to bring down an entire financial system.

For this reason, most jurisdictions have special instruments to handle bank insolvencies, which in the main are managed out of court with administrative procedures making it possible to preserve the vital functions of the bank, protect depositors and prevent one bank's crisis from spreading to other banks and destroying confidence in the banking system.

In June 2012, the Eurozone Summit and the European Council<sup>4</sup> decided to launch the banking union project with the aim to break the vicious circle between sovereign debt and national banking crises that threatened the Union's financial stability and the very survival of the euro. Banking union is instrumental in restoring the single market in financial services and combating excessive risk-taking by bankers: notably by eliminating supervisory forbearance by national regulators and their implicit guarantee that banks would not be allowed to fail, which is a major source of moral hazard. To this end, banking supervision and resolution – the endgame once a bank can no longer stand on its own – will be centralised with the SSM and SRM. Against this background, the BRR Directive will ensure that all member states have the harmonised powers and procedures to manage bank crises out of court, while the SRM Regulation will govern decision-making at EU level and the relationships between the Commission, the new agency for bank

resolution – the Single Resolution Board (SRB) – the ECB and national resolution authorities.

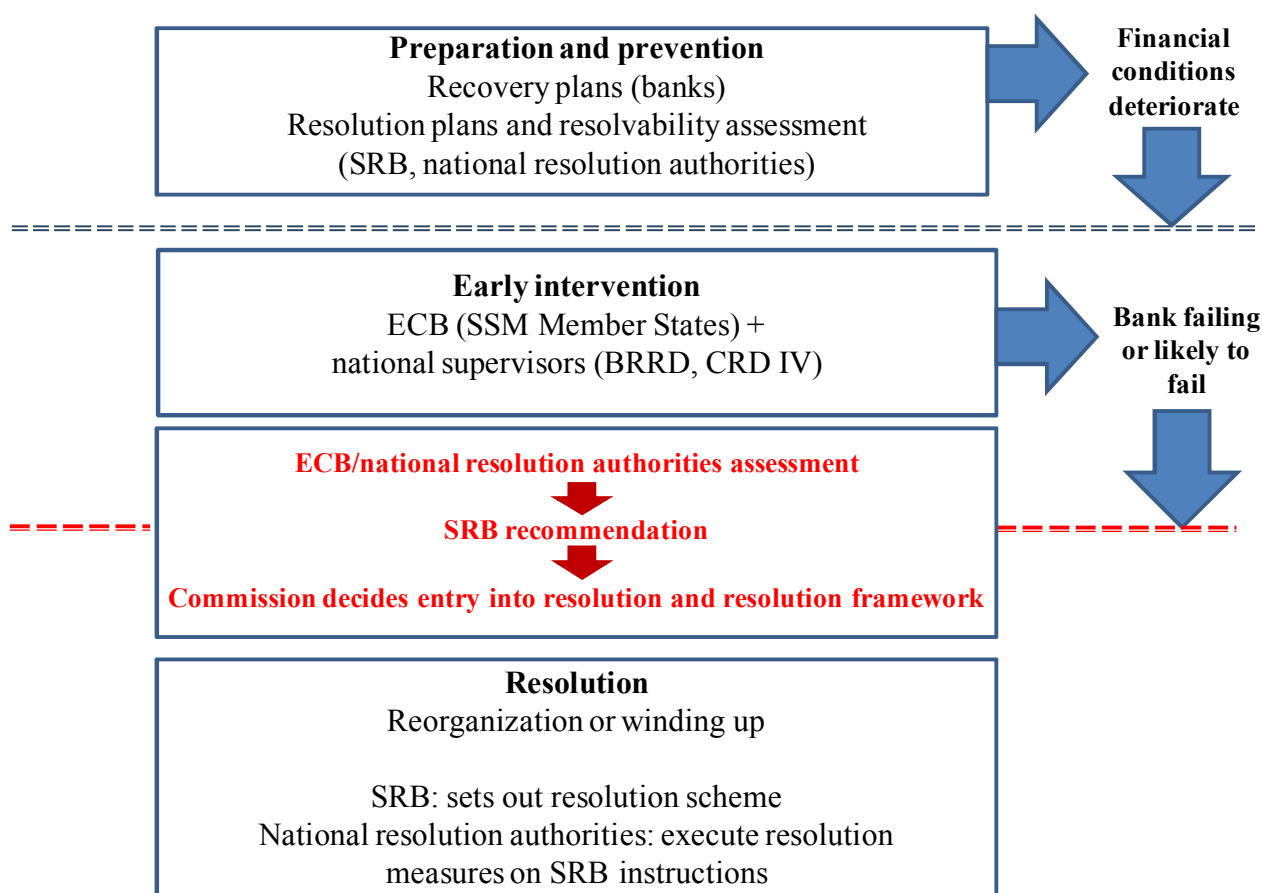
Thus, **resolution** is an administrative procedure to manage bank crises out of court so as to protect financial stability, preserve vital systemic functions and protect depositors, while minimising any adverse impact on taxpayers. It normally entails the resolution authority taking full control of the failing bank's assets, liabilities and operations, with all the means and tools to reorganise it or wind it down. Key principles in the European legislation under discussion are that no creditor should find himself worse off than under a normal insolvency procedure; and that all decisions taken by resolution authorities should be subject to judicial review. These principles guarantee that the Union procedure will not infringe fundamental rights under national and European law.

In the SRM Regulation and the BRR Directive, there are three phases to bank crisis management (see Figure 1): i) preparation and prevention; ii) early intervention; and iii) resolution.

Under **preparation and prevention**, banks will be required to draw up **recovery plans** detailing measures and actions that they will adopt to restore viability when in distress; these plans must be assessed and approved by supervisors. In turn, the resolution authorities (at EU and national level) will have to prepare **resolution plans**, explaining how a bank will be resolved while protecting systemic functions and financial stability and minimising the potential burden for taxpayers. Resolution authorities are also required to identify **impediments to resolvability** and adopt measures that can facilitate it, including changes in banks' structure to reduce complexity; limits to maximum individual and aggregate exposures; reporting requirements; limitations or prohibition of activities, products and business lines; requirement to issue additional convertible capital instruments.

<sup>4</sup> Euro Area Summit Statement, 29 June 2012; European Council (2012), "Towards a genuine monetary and economic union", Report by the Presidents of the European Council, the European Commission, the Eurogroup and the European Central Bank, Brussels, 26 June.

Figure 1. The new EU framework for bank crisis management



In this domain, the European Banking Authority (EBA) will develop technical standards to ensure consistency across member states in the parameters considered to assess resolvability and in the use of preventative powers. For member states that will participate in the SRM, the tasks related to resolution plans are assigned to the Single Resolution Board established by the SRM Regulation.

**Early intervention** envisages a range of powers and tools that should be available to supervisors in the early stage when a bank's financial position starts to deteriorate. Under the BRR Directive, national supervisors must have the power to require the bank: to adopt measures outlined in the recovery plan; to draw up an action programme and timetable for its implementation; to convene a shareholders' meeting, proposing the agenda or the adoption of certain measures; and to prepare a plan for debt restructuring. Moreover, when the supervisor determines that the bank's solvency may be at risk, it can appoint a special manager

for a limited period of time who will take up all management powers (under the constraint of no prejudice to ordinary shareholders' rights) with the objective of restoring the viability of the institution.

The SSM Regulation attributes strong early intervention powers to the ECB (Article 16) which are more pervasive than those assigned by the BRR Directive to national supervisors and basically coincide with those assigned to national supervisors by the CRD IV (Article 104)<sup>5</sup>. They include, among others: the request to hold own funds in excess of minimum capital requirements; the request to apply a specific provisioning policy; the restriction of activities and operations, including the request to divest

<sup>5</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

activities posing excessive risks; the reduction of risks related to assets, products and systems; the restriction or prohibition of dividend distributions; the removal of management. These powers will apply to credit institutions (as well as financial holding companies comprising credit institutions and mixed financial holding companies) legally residing in member states participating in the SSM. All early intervention actions, taken by the ECB or national supervisors, must be communicated to the national resolution authorities and the SRB, which in turn must notify the Commission.

**Resolution** begins when a bank is failing or likely to fail without any possibility of restoring its viability with a private sector or supervisory action, and when a resolution action is necessary in the public interest, i.e. basically to preserve financial stability and vital systemic functions. Given the specific nature of the banking business and the risk of contagion spreading to other banks, the procedure for resolving banks must act swiftly to protect systemic functions and reassure depositors. Ordinary insolvency proceedings normally cannot guarantee this result, which is why most countries already have special administrative (out of court) procedures to handle bank resolution (FSB, 2013). Specific principles and tools to guide these procedures were developed by the Basel Cross-Border Bank Resolution Group (BCBS, 2010) and the Financial Stability Board (FSB, 2011).

Competent resolution authorities, including the SRB at Union level, must be entrusted with administrative resolution tools including, as a minimum: the **sale of business**, enabling authorities to sell an institution or part thereof without shareholders' approval; the setting up of a **bridge institution**, allowing authorities to transfer an institution or part thereof to a publicly controlled entity, with the view to sell it to the private sector when market conditions are appropriate; **asset separation**, to be applied in combination with the other tools and entailing the transfer of impaired assets to an asset management vehicle, which will then sell them to the market; and **bail-in**, giving resolution authorities the power to convert debt

instruments into equity or to write down claims of unsecured creditors.

Under the BRR Directive it falls to national resolution authorities to initiate the resolution phase. For countries participating in the SSM and the SRM, the national resolution authorities and the ECB may indicate to the SRB the need to resolve a bank (Article 16); the SRB, in turn, would present a recommendation to the European Commission, containing the draft resolution framework. The decision to place the bank in resolution is then taken by the Commission, which must also set out the framework for the use of resolution tools. Various provisions regulate possible disagreements between the SRB and the Commission, as well as the possibility for the Commission to decide on own initiative when the SRB does not act (with an ECB opinion). The SRB will then determine the precise use of resolution tools – the resolution scheme – and instruct national authorities to implement it under national laws. Should a national resolution authority not comply with SRB decisions, the SRB can directly address executive orders to the troubled banks.

In the Commission proposal, a Single Bank Resolution Fund will be set up under the control of the SRB, to ensure the availability of medium-term funding support while the bank is restructured, and will be funded *ex ante* through risk-based contributions by the banks included in the SSM, in line with the rules set by the BRR Directive for national resolutions funds. For member states in the SRM, the resolution fund will replace the national resolution funds provided for by the BRR Directive. The Fund will be allowed to intervene only after shareholders and creditors have contributed to loss absorption and recapitalisation for an amount of at least 8% of total liabilities; the maximum amount it can make available to an individual bank is capped at 5% of total liabilities (Article 24.7).

Whenever resolution measures entail financial support with national resources, the Commission will assess them under the criteria for state aid control of Article 107 TFEU. In order to avoid distortions in the internal market,

these criteria will also be applied when the financial support is granted by the Single Resolution Fund. The Commission decision on the resolution framework and the SRB decision on the resolution scheme will be conditional on a positive (and separate) decision by the Commission on the compatibility of public aid with the internal market.

Under the Treaty, the European Court of Justice will have jurisdiction over the legality of decisions taken by the Commission and the SRB (Article 263 TFEU). For certain Board decisions an appeal panel will operate as a first instance chamber (Article 37c of the November 4 Presidency compromise text). Since resolution measures will be implemented through legal acts adopted by national resolution authorities, these acts will be subject to judicial review by national courts. National courts will also be entitled to request preliminary rulings of the Court of Justice on the validity and interpretation of the acts of the Commission and SRB (Article 267 TFEU). The Regulation sets out the competence of the Court of Justice for the determination of non-contractual liabilities of the Commission and the Board stemming from the exercise of the powers under the SRM Regulation.

The SRB will be established as a special Union agency and will comprise an executive body charged with decisions in individual cases and a plenary session including representatives of national resolution authorities of all participating member states. The ECB will designate one representative in the executive body as a “permanent observer”. A key issue still under discussion in the Council is whether to grant a special role in the resolutions decisions to the national representative of the institution home country, at least in an initial phase (cf. Presidency General Approach of November 11, 2013). Of course, there is a great danger here that national forbearance, pushed out through the door, re-enters the room through an open window.

### 3. Resolution initiation

The start of the resolution procedure entails the transfer of the control of the failing bank to the

resolution authority, with a significant compression of shareholders’ rights: were this crucial step to be mishandled, the initiation of resolution could become a source of instability as investors and creditors scramble for the door. Therefore, it is of the essence that the procedure for placing a financial institution in resolution is rapid and effective while ensuring water-tight confidentiality. The procedures envisaged by the SRM Regulation, depicted in Figure 1, may fall somewhat short of these requirements.

Under the draft SRM Regulation,<sup>6</sup> the procedure for placing a bank into resolution starts with an assessment by the ECB, or a national resolution authority after consulting the ECB, that i) a bank is failing or likely to fail (Article 16.2a), and ii) there is no reasonable prospect that any alternative private sector or supervisory action would prevent its failure within a reasonable timeframe (Article 16.2b). Were this to be the case, the finding must be communicated without delay to the Commission and the SRB (Article 16.1). The conditions under which a bank may be judged to be “failing or likely to fail” are listed in Article 16.3: the bank is in breach of requirements for authorisation (e.g. insufficient capital); its net worth is negative; it is or will soon be unable to pay its debts; and there is a need for extraordinary public support.<sup>7</sup> Any one of these circumstances is sufficient to justify the communication to start the resolution procedure.

The Regulation then requires that, upon receiving the communication, the Board shall verify again the existence of the conditions of Article 16.2.a and 16.2b as well as assess whether a resolution action is necessary in the public interest (Article 16.2c): where “public interest” means that the resolution action achieves, and is proportionate to the achievement of one or more of the resolution objectives – i.e. ensure critical functions, preserve financial stability, minimise taxpayers’ exposures and protect depositors – and that

<sup>6</sup> In this analysis we refer to the Presidency compromise text of the Regulation of 4.11.2013.

<sup>7</sup> Public support may not always mean that the bank is failing or likely to fail (Article 16.3d). We return later to this issue.

normal insolvency procedures would not meet those objectives to the same extent (Article 16.4). If the Board finds that all conditions are met, it will then send out a recommendation to the Commission that should include a draft decision to start the resolution procedure, along with the draft 'framework' of the resolution tools to be utilised and the draft 'framework' for the use of the Single Bank Resolution Fund (Article 16.5).

These frameworks define and limit the actions to be undertaken by the SRB, and thus the scope of the resolution measures, including the conversion or write down of credits; the possible exclusion of certain liabilities from the bail-in tool, and the conditions for the intervention of the resolution fund. These being the decisions that produce the largest interference with private rights, it seems appropriate that they are formally taken by the Commission, as discussed further in Paragraph 5.

Upon receipt of the Board recommendation, in order to take its decisions the Commission must again, and in full independence, assess whether all the conditions for starting resolution are met (Article 16.6). It may decide not to adopt the SRB recommendation and send it back with requests for amendments. If the Board does not comply by a deadline set by the Commission (normally, no fewer than five working days), then the Commission may adopt the decision with its own amendments. The Commission would also possess a right of initiative: after receiving the communication from the ECB or national resolution authorities, or even without such communication, the Commission may require the Board to submit a recommendation and draft decision. If the Board does not comply, the Commission may nonetheless go ahead and take the decision. The Board is also entitled to ask the Commission to amend the frameworks for the resolution tools and the use of the Fund (Article 16.12). If the Commission decides not to place the entity under resolution, then the national insolvency law will apply.

The Commission decision is addressed to the SRB; the latter, in turn, will draw up the resolution scheme (Article 20), and instruct national resolution authorities to proceed accordingly. For example, with regard to the

bail-in tool, the scheme must establish the amount by which eligible liabilities must be reduced or converted, the objectives and minimum content of the business reorganisation plan required by the bail-in framework, and the like (Article 24.1). National resolution authorities are then responsible for the adoption of resolution measures within their jurisdiction, and the SRB will monitor their behaviour in the execution of the resolution scheme (Article 16.8).

This cumbersome apparatus clearly reflects the attempt to establish a balance between the main interests involved: the ECB, the national resolution authorities, the SRB and the Commission. However, it does not only seem overly complex but also incompatible with the requirements of speed, decisiveness and confidentiality needed to move from the early intervention phase to resolution. The intervention of multiple actors entitled to participate in the decisions, the passage of information and documentary material between them, and the complex procedural steps are bound to take time and generate leaks and rumours, notably when there are different views on whether and how to proceed. Any leak of sensitive information could destroy confidence and result in a run on the bank before the entity is placed into resolution, thus frustrating the very aim of the procedure. It would be advisable, in this regard, to strengthen the provisions on professional secrecy and confidentiality of information contained in the proposal (Article 79) with adequate sanctions so as to ensure effective deterrence.

As for the complexity of the institutional architecture, in its legal opinion on the SRM the ECB stresses the importance of avoiding any overlap of supervisory powers and, to this end, they claim sole responsibility of the supervisor both in regard of early intervention measures and in the assessment that an institution is failing or likely to fail (ECB 2013).<sup>8</sup> In this manner, the transition from early intervention to resolution would be free of political interference

<sup>8</sup> The ECB also proposes to eliminate the proposed duty for the ECB or national supervisors to consult the resolution authorities before taking additional early intervention measures.

and taken far out of sight of banking markets. Any ‘threshold’ effect of the decision to start resolution would thus be minimised.

The twin goals of simplifying and streamlining the procedure and constraining it within a tighter timeframe could be achieved by leaving resolution entirely in the hands of the SSM at the ECB, as a natural extension of the early intervention phase. This unitary approach has been adopted in the US with the FDIC, and by a number of European countries (e.g. Italy, Germany and the UK), but is not acceptable to other member states, which consider resolution a separate function requiring their direct involvement. A solution entrusting this competence to the ECB would also require a change in the Treaty, to the extent that resolution cannot be seen as an integral part of supervision as referred to by Article 127.6 of the TFEU.

An alternative, which would be easier to implement, is to let the ECB, and national supervisors for countries not in the SSM, indicate when resolution must start, as the last act of early intervention, and then transfer the resolution procedure to the SRB.

More precisely, one may envisage the following steps:

- (i) Since in reality only the ECB and national supervisors (which at national level mostly coincide with the resolution authorities; cf. FSB, 2013) possess all the information required to start the procedure, the assessment by the ECB and national resolution authorities that a bank is failing or likely to fail should normally be taken for granted and not repeated by the SRB and the Commission; the initial assessment could only be overturned in narrowly defined, exceptional circumstances (a gross error of fact); any separate initiative by the Commission to place an entity in resolution should also be excluded;
- (ii) Under the proposed procedures, it is already envisaged that the SRB and the national resolution authorities (for non-SRM members) are alerted to the difficulties of a bank or banking group as soon as the ECB, or national supervisors, activate early

intervention measures. Article 11 of the SRM Regulation already prescribes that, after receiving such information, the Board “may prepare” for the resolution of the entity: this provision could be strengthened by requiring the SRB “to prepare immediately” for the resolution of the entity, so that they will be able to react instantaneously and send their recommendation to the Commission within hours of receiving the ECB communication.<sup>9</sup> It would also be useful to clarify that the SRB and national resolutions authorities should make reference, in this activity, to the bank’s resolution plan (which, as may be recalled, is an official document prepared by the resolution authorities);<sup>10</sup>

- (iii) As to the Commission, clearly their intervention in the procedure cannot be reduced to rubberstamping, since the final decision of legality and conformity with the Treaty can only be taken by them; what can be done is to concentrate their assessment on the criteria of “public interest” required for placing a bank in resolution, and for the rest the Commission should ascertain that all requirements for the decision, as reflected in the SRB recommendation, have been respected.

With this simplified procedure, the decision to place the entity in resolution may be taken within a very short time span – thus also shutting the door to political negotiations. The Commission decision on the frameworks for the use of resolution tools and recourse to the Fund may well be taken at a later stage, also in conjunction with the separate decision to be taken under the state aid rules. The maximum

<sup>9</sup> On this, the ECB legal opinion stresses the need that, during the early intervention phase, the SRB avoid any direct activities in contact with third parties, to avoid undermining market confidence and aggravating the institution’s conditions.

<sup>10</sup> In line with the ECB legal opinion, the actions that the SRB and national resolution authorities may undertake in preparation for resolution should not include the possibility to contact potential purchasers of the bank’s assets and business lines (Article 11.3c of the Regulation and 23.1a of the Directive), since such an initiative is bound to destabilise investors and creditors.



time lapse between the initial ECB or national resolution authority communication and the decision by the Commission, should in no event exceed 48 hours. Whenever possible, the procedure should be started after the close of business on Friday afternoon.

A related, but separate problem concerns the criteria to be considered when deciding the point of entry into resolution, and specifically whether the institution entrusted with the power to start resolution should be bound to act by objective indicators of distress. As has been described, the BRR Directive and the SRM Regulation indicate that resolution should start when “a bank is failing or likely to fail”, and placing it into resolution is “necessary in the public interest”. This assessment shall be conducted by the ECB supervisory Board for banks subject to the SSM and by national resolution authorities for banks in non-participating countries.

Taking the latter first, leaving full discretion to national authorities would not guarantee the eradication from the system of supervisory forbearance, which was rampant in the events leading to the financial crisis. Therefore, there is merit in providing the ECB and other interested parties with objective triggers for starting resolution, as this may limit the room for disagreement and political meddling within the SSM and SRB supervisory boards (which are mainly made up of national representatives) and the Commission.

An objective trigger may only work if it is timely, easy to read, and unambiguous in signalling fundamental distress. Based on extensive empirical evidence collected since the financial crisis erupted in 2008, the metric that best meets these criteria is (the inverse of) absolute leverage, that is the ratio of bank capital – with equity valued at market prices – to total assets or liabilities (Calomiris & Herring 2011, Carmassi & Micossi 2012).

Following the system of Prompt Corrective Action (PCA) pioneered by the FDIC, the EBA and SRB should be asked to identify a set of “capital zones” corresponding to a presumption of corrective action of increasing intensity by supervisors, from various measures of early

intervention down to resolution. Capital thresholds should be public, thus allowing financial markets to fully exercise Basel “Pillar Three” market discipline on banks.<sup>11</sup> Under this system, banking supervisors may still decide that they do not want to act but would have to explain their decision.

Any injection of public funds into a bank by the resolution authority will trigger a separate procedure for the examination of its compatibility with internal market rules under the state aid policy; the evaluation of compatibility with internal market rules will be undertaken more generally, also when there is an injection of funds not involving state aid (Recital 18). This activity will remain separate from the resolution decisions and the Commission decision on the resolution framework shall not be taken until the decision under the state aid policy has been adopted (Article 16a.1).

#### 4. The bail-in tool

The approach to banking rescues in the EU has evolved remarkably since the financial crisis hit European banks in 2008. Initially, under the shock of the dramatic failure of Lehman Brothers, European governments and especially the ECB held the view that no losses should be imposed on bank creditors, let alone depositors, for fear the financial system would collapse. A main argument in favour of this approach was that the authorities did not have resolution tools permitting those financial institutions fail while limiting systemic repercussions on financial markets. Thus it was that creditors were by and large – albeit not always – shielded from losses in large banking groups rescues, e.g. in Germany, Ireland and the UK in 2008-09.

<sup>11</sup> The Basel II framework (BCBS, 2006), which revised the Basel I rules, envisaged three “pillars” of discipline, the first being the minimum capital requirements, the second, the principles for the supervisory review, and the third, market discipline and transparency through disclosure requirements. The Basel III framework, adopted at the end of 2010, has maintained the three-pillar system.

Attitudes started to change in 2011, following the second rescue package for Greece, which entailed substantial losses for holders of Greek government bonds, including banks and their shareholders, under the new Private Sector Involvement (PSI) approach decided by the European Council. In October 2011, the Financial Stability Board recommended that ‘bail-in’ of private creditors be explicitly included among resolution tools in all jurisdictions (FSB, 2011). And indeed in 2012-13 bank rescues have been characterised by increasing participation in the losses by subordinated and junior creditors, even if not always and with considerable variation of approach in different cases (cf. Dübel, 2013, and Veròn, 2013). In the Cyprus banking rescue, in the spring of 2013, the Troika required that losses be inflicted not only on unsecured senior creditors but, more poignantly, on uninsured depositors at Laiki Bank and Bank of Cyprus. This last step was later regretted for its potentially disruptive impact on depositor confidence throughout the Union, and numerous official statements tried to assure that it would not happen again.

By now, involving shareholders and creditors first, whenever public funds are deployed to avoid a bank failure or, at any rate, when a bank enters a resolution procedure, has become an official Union policy – enshrined in the draft resolution Regulation and Directive, the European Stability Mechanism (ESM) rules for the recapitalisation of financial institutions, and the Commission Guidelines on state aid to banks.

The resolution Directive and Regulation empower the resolution authorities to write down or convert debt instruments into equity as soon as a bank is placed in resolution, regardless of whether the bail-in instrument is activated (respectively, Articles 51 and 18 in the two draft proposals). The resolution Directive and Regulation list the classes of liabilities always excluded from the scope of the bail-in tool, which include guaranteed deposits and secured liabilities, as well as interbank liabilities with original maturities of less than seven days (cf.

respectively Articles 38.2 and 24.3);<sup>12</sup> deposit guarantee schemes will bear losses *in lieu* of guaranteed deposits, but shall not be required to make any contribution for the recapitalisation of a bridge bank (Article 99 of the Directive); non-guaranteed deposits will be included only after all other eligible creditors have been hit. Derivatives are not automatically exempted but may be excluded from the application of the bail-in tool (Articles 38 and 44 of the Directive).<sup>13</sup> Non-excluded liabilities will be bailed-in on the basis of their pecking order in national insolvency laws, which the Directive purports to harmonise. The same pecking order for bail-in is present in the SRM Regulation (Article 15):<sup>14</sup> Common Equity Tier 1 comes first, followed by additional Tier 1 and Tier 2 instruments, subordinated debt, unsecured claims and finally uncovered deposits, and the deposit guarantee scheme *in lieu* of guaranteed depositors, which are therefore excluded.

A question that may deserve clarification in the legal texts is the hierarchy for the exercise of the write-down and conversion of creditor claims. On this, the proposals do not clarify whether and under what circumstances one tool would apply rather than the other, leaving *de facto* the decision to the resolution framework; but one cannot overlook the need for a general rule to preserve equal treatment of creditors of different banks that may fall under resolution.<sup>15</sup>

<sup>12</sup> Other exempted instruments are: liabilities to employees of failing institutions, such as fixed salary and pension benefits; commercial claims relating to goods and services critical for the daily functioning of the institution; liabilities arising from a participation in payment systems, which have a remaining maturity of less than seven days.

<sup>13</sup> If they are not excluded, resolution authorities can apply the bail-in only upon or after closing out the derivatives. Upon entry into resolution, resolution authorities shall be empowered to terminate and close out any derivative contract for this purpose (Article 44 of the BRR Directive).

<sup>14</sup> In its legal opinion, the ECB maintains that there remain differences between the Regulation and the Directive that must be eliminated.

<sup>15</sup> In its State Aid Guidelines, the Commission has indicated that conversion alone may apply when there is a capital shortfall but the bank meets minimum capital requirements (Paragraph 43).

A further question concerns the inclusion of uncovered deposits in the list of ‘bail-inable’ instruments. The EU approach contrasts with the US system where depositor preference applies to both insured and uninsured deposits. Systematically, the approach taken in the EU proposals appears logically inconsistent as non-guaranteed deposits would be the only liabilities redeemable on demand which could be called in to cover emerging losses (sight interbank liabilities are excluded, as was recalled). Deposits are also not considered among bail-inable resources under the state aid policy. On the other hand, large deposits would only come in last, after tapping all other eligible creditors; substantial eligible liabilities would in all cases be available before calling in uncovered deposits, following the provision requiring a minimum amount of bail-inable liabilities (see below). In any event, a likely effect of this provision would be to encourage depositors to split up their holdings in below-threshold deposits at different banks, making it *de facto* irrelevant. All in all, full depositor preference appears to be a preferable solution.

An important element of flexibility is introduced by the provision allowing national authorities and the SRB to exclude liabilities, entirely or partially, in certain special circumstances: if they cannot be bailed-in within a reasonable time; to ensure continuity of critical functions; to avoid contagion; to avoid value destruction that would raise losses borne by other creditors (Articles 38.3c of the Directive and 24.5 of the Regulation).

The principle that shareholders and creditors should be the first in line to bear bank losses is also included in the ESM framework for direct bank recapitalisation, whose operational details are still under negotiation: capital injection by the ESM into distressed banks can only take place after an adequate capital contribution by shareholders (capital write-down) and creditors (debt conversion into equity or write-offs) of the beneficiary institution, in line with state aid rules and the BRR Directive (ESM, 2013a). Moreover, a significant participation in the capital injection of the member state where the bank is established is required as a condition for ESM recapitalisation. Specifically:

- a) if the beneficiary institution has a capital level lower than the legal minimum Common Equity Tier 1 of 4.5%, the requesting ESM member will be required to make a capital injection to reach this level, as a precondition for the ESM intervention;
- b) if the beneficiary institution already meets the capital ratio mentioned above, the requesting country will have to make a capital contribution alongside the ESM of 20% of the total public contribution in the first two years after bank recapitalisation and 10% in following years.

The resolution Directive and Regulation entrust the resolution authorities with the power to determine the minimum level of ‘bail-inable’ liabilities that each bank must hold (respectively Articles 39 and 10), measured as a proportion of total liabilities excluding those arising from derivatives and covered bonds issued by non-depository institutions. The provision aims to ensure that banks have a sufficient cushion of loss-absorbing liabilities at their disposal and avoid an excess of unencumbered liabilities jeopardising their loss-absorbing capacity.

In this regard Calomiris and Herring (2011) recommended that each bank or banking group be required to issue debt instruments that convert automatically into equity when certain predetermined market triggers – identified under a PCA approach as has been recalled – are hit, for an amount equal to at least 10% of total book value assets. The automaticity of conversion into equity of a substantial share of bail-inable liabilities would greatly strengthen market discipline on managers and shareholders through a credible promise of dilution as operating losses dent capital (cf. also Carmassi and Micossi, 2012). This approach may usefully complement the proposed approach in the various EU proposals under discussion where bail-in is activated by a discretionary decision taken on a case by case basis.

An important question arises in connection with the activation of the bail-in tool when there is an injection of public funds into an ailing bank by national authorities or the ESM before resolution is opened, in order to keep the bank afloat and possibly engineer its recovery. This may soon

become a hot issue, should the asset quality review and stress tests to be undertaken by the ECB and EBA before the start of the SSM lead to ascertain significant and widespread capital shortfalls in the eurozone banking system.

The question arises because there is a risk that the principles developed for resolution by the Directive and the Regulation are extended to pre-resolution interventions somewhat a-critically. On this, the Directive and the Regulation provide that an injection of public funds into a bank is one of the circumstances indicating that the bank is failing or likely to fail (Article 16.3d of the SRM Regulation and Article 27.2d of the BRR Directive), opening the way to debt write-down or compulsory conversion. However, even in these extreme circumstances the current texts recognise that public support may not always entail that the bank is failing or likely to fail, notably when, in order to remedy a serious disturbance in the economy and preserve financial stability, it concerns a solvent institution and takes the form of:

- (i) a state guarantee to back liquidity facilities provided by central banks;
- (ii) a state guarantee of newly issued liabilities;
- (iii) an injection of own funds or purchase of capital instruments whose terms and conditions do not confer an advantage upon the entity.

The room for flexibility in imposing losses on private creditors takes on enhanced importance when a bank needs public help but is not in resolution. Indeed, while in the resolution phase the bank is in public hands and creditors' claims are handled under predetermined principles and procedures for loss allocation, making the write-down or conversion of debt automatic in the earlier stage of crisis management is liable to generate a run on a solvent bank and make it insolvent, possibly destabilising other banks and the banking system as a whole.

According to press reports (Christie et al., 2013), this is precisely the question raised by the ECB President Draghi in a confidential letter sent last summer to Competition Commissioner Almunia, in response to the new Commission guidelines on state aid rules for banks

(European Commission, 2013). These guidelines require member states to submit a capital-raising plan before or as part of the submission of a restructuring plan for an ailing bank. The plan should contain burden-sharing measures by the shareholders and subordinated creditors of the bank.<sup>16</sup> As was recalled, these rules would also apply to injections of public funds into ailing banks by the ESM. In this letter, President Draghi reportedly said that those rules needed to be clarified so as to make it possible for regulators to order technically solvent banks to strengthen their balance sheets without scaring off investors; and that public capital needs to be available – without wiping out subordinated debt holders or forcing them to convert to equity – if a bank's holdings are above regulatory minimums but below what supervisors deem necessary in a particular case, e.g. as a result of a stress test, which he dubbed 'precautionary recapitalisation'.

The approach that is being developed in Europe may be usefully compared with that followed by the US authorities in the 2008 financial crisis with the Capital Purchase Program (CPP, under the broader TARP program), which has been successful in restoring the viability of much of the US banking system through the provision of abundant and cheap 'bridge financing'. The CPP was designed to bolster the capital of ailing institutions, in extremely adverse economic conditions, so as to release the flow of credit to the economy and restore confidence. To this end, the US Treasury initially committed \$250 billion, and eventually invested about \$205 billion, to provide capital to 707 financial institutions throughout the country. Against the capital injections, the Treasury received preferred (non-voting) stock yielding a 5% dividend for the first five years and 9%

<sup>16</sup> The private sector contribution can take the form of either a conversion into Common Equity Tier 1 (the highest quality capital) or a write-down of the debt principal. Senior creditors, insured as well as uninsured deposits, bonds and all other senior debt are explicitly excluded from the scope of application of this requirement. The 'no creditor worse off' principle has to be respected, i.e. "subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted" (paragraph 46).

thereafter, but there was no deadline for the investment and little intrusion into the banks' business decisions. As of 30 September 2013, the Treasury has recovered more than \$225 billion from CPP from dividend income and repayments and expects to recover additional funds.

Clearly, there is here a difficult balancing act to undertake. On the one hand, the expectation that public support will be available may keep moral hazard alive among bankers; the issue is aggravated, in the EU context, by the presence of multiple regulatory and resolution authorities side by side with those of the Union. Experience has shown that, especially when a large banking institution is concerned, national regulators are all too willing to protect national champions and forbear their sins. On the other hand, a generalised promise that financial support may always be preceded automatically by activation of the bail-in instrument may be destabilising.

On this, the new Commission guidelines on state aid already contain a safeguard clause that may be activated to suspend bail-in "where implementing such measures would endanger financial stability or lead to disproportionate results" (paragraph 45). The new Presidency compromise text of November 4 goes one step further by recalling how in the past the Commission was able to find an appropriate balance between the potentially conflicting goals of financial stability and competition (Recital 18b of the SRM Regulation).

## 5. Resolution fund and fiscal backstop

Even if the system is designed to ensure that losses fall entirely on shareholders and creditors, it must nonetheless be backed up by adequate financial resources to support resolution actions and lend credibility to the resolution goals. For this purpose both the SRM Regulation and the BRR Directive provide for resolution funds to back their activities. At the end of the road, there is also a need for last resort fiscal backstop to cover residual losses, notably in the case of systemic crises.

The establishment of the Single Bank Resolution Fund (SBRF) and attendant fiscal backstop remain contentious issues in the negotiations under way in the European Parliament and Council. Some member states would still prefer, at least for an initial transitional phase of extended duration, to set up a network of national resolution funds. There is little doubt that such a solution would not guarantee the availability of resources and the effective operation of the Fund in case of need, as individual national funds could refuse participation in individual operations when they disagreed. Not only the required mutualisation of risk, but also the subtraction of decision from national interests would be utterly compromised. Without these features, the SRM would lack effectiveness and credibility; while, on the other hand, the issues to be resolved in order to have a strong and credible system are in substance less contentious than commonly perceived.

The tasks of the SBRF are spelled out in Article 71.1 of the SRM Regulation and they include the following:

- (a) guarantee assets or liabilities or make loans to the bank under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- (b) purchase the assets of the institution under resolution;
- (c) contribute capital to a bridge institution or an asset management vehicle;
- (d) compensate shareholders and creditors in case they have received less than under normal insolvency proceedings;
- (e) make a contribution to the institution *in lieu* of bail-in-able creditor resources when certain creditors have been excluded from bail-in for reasons of systemic stability; the fund contribution may not exceed 5% of total liabilities and only after shareholders and creditors have contributed at least 8% of total liabilities to the costs related to loss absorption or recapitalisation (Article 24.7).

The Commission framework for resolution is required to specify "any use of the Fund in accordance with the provisions above, as well as

the maximum amount that may be used (Article 16.5 of the Regulation). The SRB will further decide the specific amounts and purposes for use of the Fund (Article 20). As may be seen from the list above, all functions performed by the Fund are strictly meant to facilitate the application of resolution tools and manage resolution effectively. With the narrow exceptions of points (d) and (e), any intervention by the SBRF aimed at shielding shareholders and creditors from losses is ruled out: “the Fund shall not be used directly to absorb losses ... or recapitalise the bank” (Art. 71.3).

It is envisaged that the Fund resources will be provided by the financial sector with *ex ante* annual contributions (Article 66); in case of need these may be supplemented by extraordinary *ex post* contributions once the fund resources have been depleted (Article 67). Banks’ contributions will be calculated with reference to liabilities, excluding capital and guaranteed deposits, and the risk profile of the institution. The timescale for fund-raising (at least 0.8% of guaranteed deposits within ten years) and the criteria for the determination of the contributions by financial institutions will be determined by the Commission with a delegated act under Article 82 of the Regulation, and will be enacted by the SRB. A two-thirds majority decision by the Board is necessary to decide *ex post* contributions when they exceed three times the amount of annual contributions. Were funds raised *ex ante* and *ex post* to prove insufficient or not immediately available, the Regulation permits the SRB to tap alternative sources, e.g. by borrowing from financial institutions or other third parties (Article 69)<sup>17</sup> and, as a last resort, from national resolution funds of EU member states not participating in the SRM (Article 68).

These funding arrangements are very close, in nature, to those envisaged for funding the deposit insurance schemes; they share with them the fundamental nature of a mutual insurance arrangement by the financial institutions, where the commitment of public

money may only be envisaged in extreme circumstances.

The system cannot do away with the availability of a suitable fiscal backstop mechanism to ensure that resolution is completed in the public interest, after all other available means have been exhausted, notably following a systemic crisis threatening to bring down the entire banking system.

The first line of defence may well be performed by the ESM, which is a strongly capitalised institution already empowered to assist its member states, and their banks, in need of financial assistance. The ESM may grant financial assistance to its members for the specific purpose of re-capitalising financial institutions, with appropriate conditionality (Article 15 of the ESM Treaty), “including through schemes to support asset separation and disposal” (ESM 2013b, Article 2). It will also be empowered to recapitalise directly ailing banks in its member states, once the SSM is fully operational, a decision taken to help break the vicious circle between banks and sovereigns (cf. Euro Area Summit Statement, 29 June 2012).

While the operational rules for these interventions are yet to be finalised, it has been agreed that they shall abide by the state aid rules, including associated rules for national contributions and bail-in of private creditors (ESM 2013a). Therefore, the ESM is already entrusted with powers of intervention in bank crisis management: the function of absorbing residual losses in resolution in case of a systemic crisis would represent but a natural extension of these powers, fully in line with its constitutive goals. The decision to let the ESM intervene should of course be taken according to its general decision-making mechanisms.

In order to let the ESM play this role, its scope of operation must be expanded to cover all SSM members, both as regards the recapitalisation of SSM banks in non-euro countries and the residual fiscal backstop: an issue that requires modification of the ESM statutes under which at present only eurozone members may join the ESM and benefit from its operations (Article 2). As an intermediate arrangement, one may explore the possibility that the ESM signs

<sup>17</sup> The ECB legal opinion considers that the formulation of Article 69 is too vague, and fails to spell out clearly that third parties could include temporary access to public funds.

contractual arrangements with SSM members not using the euro in order to regulate their contribution to, and participation in, financial support operations for banks in the SSM area and the fiscal backstop, alongside statutory contributions by ESM members (cf. in the same line Asmussen, 2013). The financial contributions of non-members would only cover interventions related to ailing banks, and not the general operations of the ESM. The key for these contributions would thus be determined with reference to the total amount of funds committed for these specific purposes.

The preservation of financial stability may still require the intervention of national budgets to stabilise the banking system – of course, once all other sources have been exhausted. These contributions should be agreed in advance by the Council according to some predetermined key (Goodhart & Schoenmaker, 2011; Carmassi et al., 2010); the Council should also specify in advance the procedure for this decision, so as to avoid creating unnecessary uncertainty in case of need (as happened repeatedly until the establishment of the ESM for national support for countries under adjustment programmes). In order to maintain the principle of fiscal neutrality, as well as eliminate any pro-cyclical effects of the intervention, these contributions should be made available through credit lines granted by member states to the SRM, and be subsequently recouped from the financial sector after the crisis subsides, as in the FDIC system (this solution is also advocated by the ECB legal opinion on the SRM).

## 6. The legal basis of the SRM Regulation

The SRM Regulation establishes a centralised decision-making process; its rules and procedure will be applied by the European Commission together with a new EU Agency (the SRB) and the resolution authorities of the participating member states. The SRB will implement its decisions by instructing national resolution authorities, which are legally obliged to comply; its decisions are liable to impinge profoundly on property rights of shareholders and creditors within the member states.

The legal basis of the proposal is Article 114 TFEU, enabling the European Parliament and the Council to adopt measures for the approximation of national provisions aimed at the establishment and functioning of the internal market. As may be recalled, two notable features of Article 114 are co-decision by the European Parliament, which strengthens legitimacy, and majority voting within the Council.

The adequacy of this legal basis was discussed in an opinion of the Legal Service of the Council of September 2013 which supported the choice but made some suggestions to strengthen the argument, leading in turn the Presidency to a number of changes and clarifications in the original text of the proposal.

The main issue is whether the envisaged centralisation of decision-making is strictly functional to the harmonisation process to which Article 114 refers. The arguments supporting this view are illustrated in Recitals 1 to 12 of the proposal: the functioning of the internal market for banking services is under threat; there is a growing risk of financial fragmentation due to fears of contagion and a lack of confidence in other national banking systems and in member states' capacity to support their banks; divergences in national resolution rules and the absence of a unified decision-making process at EU level may further weaken confidence; resolution decisions taken at the national level entail a risk of regulatory forbearance and may undermine the functioning of the internal market, leading to distortions of competition.

The application of the SRM to only a subset of Union member states may be "objectively" justified as strictly related ("imbricated", as characterised by Recital 6a of the Regulation) to the scope of application of the SSM; the centralisation of supervision and resolution may thus be seen as closely complementary and mutually dependent.

On the legal basis of the Regulation, two further issues have been discussed within the Council. First, with reference to the creation of the SBRF, levies payable by credit institutions for financing the fund are not to be regarded as taxes, but as consideration for (compulsory)

insurance against the risk of resolution. The provision whereby the criteria for establishing the annual contribution of institutions will be set by the Commission taking into account their risk profiles (Articles 65-66 of the SRM Regulation) adds weight to this interpretation. Moreover, Article 114 has been used as a legal basis also for setting the fees that financial institutions must pay to the new European Supervisory Agencies for their services.

A second issue is that, in order to use article 114 TFEU as a legal basis, the funding of resolution should under no circumstance entail member state budgetary liability, also throughout the transitional period during which the target funding level will be achieved. Accordingly, the proposal under discussion states that no decision of the Board shall require member states to provide extraordinary public support, and that one main objective of resolution is to protect public funds by minimising reliance on extraordinary financial support. As a consequence, the fiscal back up will have to be set up as a separate legal arrangement between the participating member states, since voluntary participation on a case by case basis could prejudice the confidence stabilising effects of the SRM.<sup>18</sup>

While these are clear and convincing arguments, the question remains as to whether Article 114 offers a proper legal basis for the far-reaching powers attributed to the Commission and the SRB. Indeed, under the Regulation, the Commission decision to start resolution *de facto* places the bank administration in public hands and excludes shareholders and management from all decisions. Once that decision is taken, the SRB will have extended discretionary powers to steer the resolution process, including the power to instruct national resolution authorities on the specific actions required to implement the resolution scheme, and to intervene directly in their place when it considers that national resolution authorities are not complying with the Board instructions, in breach of Union law.<sup>19</sup> In this regard, it is legitimate to ask whether the principle of Article

345 TFEU, whereby the Treaty shall in no way prejudice the rules in the member states governing the system of property ownership, is consistent with the SRM power to overcome property rights of shareholders and creditors.

The political sensitivity of the issue, covered by constitutional rules in several member states, cannot be underestimated, even though it may be mitigated by consideration of the counterfactual: as we have illustrated, the SRM is governed by the principle whereby creditors cannot incur greater losses than they would suffer under the ordinary national insolvency procedure.<sup>20</sup>

Historically, few EU agencies have been established on the legal basis of Article 114 (ENISA and the new European financial supervisory authorities, EBA, ESMA and EIOPA). Some scholars consider it to be a shaky legal basis for radical institutional reform,<sup>21</sup> and the first case concerning the ESMA Regulation has already been brought before the European Court of Justice (ECJ) by the United Kingdom.<sup>22</sup>

In his opinion on this matter, delivered on 12 September 2013, Advocate General Jääskinen of the European Court of Justice, while in general supporting the choice of Article 114 as a legal basis, has argued that this is not the case for specific powers attributed to ESMA by Article 28 of the Regulation, whereby ESMA may overrule national authorities in the decision to ban short selling when there is a disagreement between ESMA and the competent national authority, or between national authorities. On this AG Jääskinen considers that we are not confronted with harmonisation but rather with a replacement of national decision-making with EU level decision-making – something for which Article 114 does not provide an adequate legal basis.

Similar questions are likely to be raised with regard to the SRM Regulation, since the SRB will be a distinctively powerful Union agency which, as acknowledged by Recital 19 of the SRM

<sup>18</sup> On this, cf. also the ECB legal opinion.

<sup>19</sup> Article 26 of the SRM Regulation.

<sup>20</sup> Article 16.1.f. of the Regulation.

<sup>21</sup> Moloney (2010); see also Busuioc (2013).

<sup>22</sup> Case C-270/12, *United Kingdom v. Council of the European Union and European Parliament*.



Regulation, “departs from the model of all other agencies in the Union”. One might ask, therefore, whether Article 352 TFEU, the residual clause for Union competence, would not have provided a stronger legal basis for the radical change in policies and power brought about by the Regulation. The use of Article 352 would require the Commission to draw national parliaments’ attention to the proposal, under the subsidiarity monitoring procedure. Moreover, Article 352 would require unanimity in the Council, which would have the advantage of symmetry with the procedure based on Article 127.6 TFEU, used for the establishment of the Single Supervisory Mechanism.

The main weakness of solutions centred on Article 352 is the absence of the European Parliament as a co-legislator, which would weaken legitimacy (although, since the Lisbon Treaty, the European Parliament is not merely consulted but must give its consent). Should use of Article 352 prove necessary, one possibility to maintain the role of Parliament as co-legislator would be to resort to a double legal basis (Article 114 and Article 352), with use of the latter to strengthen the legal basis for the more intrusive provisions – which according to the ECJ is feasible, albeit not without difficulties.<sup>23</sup> Should it eventually prove necessary to use both Articles 114 and 352 as legal bases, the decision-making procedure could be designed so as to preserve an adequate role for Parliament alongside unanimity voting in the Council.

<sup>23</sup> The ECJ has accepted the use of multiple legal bases when a legislative act pursues several goals or has several components that cannot be separated, conditional on the decision procedures being “mutually compatible” (cf. C-155/07 of 6 November 2008). In case C-338/01 of 29 April 2004, which referred to the joint application of Article 95 TEC (now Article 114 TFEU) and Articles 93 and 94 TEC (now Articles 113 and 115 TFEU, i.e. special rules with respect to Article 114), the ECJ considered that procedures with different voting thresholds (QMV v. unanimity) and entailing a different involvement of the European Parliament could not be applied together (paragraph 58). On the other hand, in case 165/87 of 27 September 1988 the ECJ accepted the use of a double legal basis for a Council decision, despite the two legal bases involving different voting majorities.

A separate legal issue is whether the powers granted to the Commission, the Board and national resolution authorities by the regulation are compatible with the EU Treaty, notably as regards the institutional balance of powers.

The bulk of resolution actions is performed by the SRB, an independent agency whose decisions should be shielded from all political interference (but on this negotiations in the Council are not over yet). Beyond preparing the draft decisions for the Commission, the Board draws up resolution plans and identifies measures to remove impediments to resolvability, which will be implemented by national resolution authorities; sets minimum requirements for own funds and eligible liabilities; adopts schemes for the use of resolution tools, within the framework established by the Commission.

National resolution authorities participate as auxiliary bodies with the twofold task of cooperating with the Board in the exercise of its duties and implementing the decisions of the Board. The Board “closely monitors” the execution of resolution schemes at national level and may intervene directly with respect to third parties when national authorities have not implemented decisions following EU rules.

However, the Commission, invested with political and institutional strength from its formal status of Union institution under Articles 13 and 17 TEU, has the task of adopting the most intrusive decisions: whether or not to put an entity under resolution, the framework for the use of resolution tools and the framework for the use of the Fund (normally, on the basis of drafts prepared by the Board); upon recommendation of the Board or on its own initiative, whether the power to write down or convert capital instruments should be exercised, singly or together with a resolution action; and direct application, with no involvement of the Board, of Treaty rules on state aid.

Assessing this system within the strict framework of the Meroni doctrine (delegation of powers from the Commission to other bodies)<sup>24</sup>

<sup>24</sup> ECJ, case 10/56, 13 June 1958, *Meroni v. High Authority of the European Coal and Steel Community*.

may be misleading. As clearly explained by AG Jääskinen in his opinion on the ESMA case, under Article 291 of the TFEU the competences of agencies – and therefore also the SRB – may derive directly from a legislative act; and the Treaty expressly provides for judicial review of their acts by the ECJ.<sup>25</sup> EU legislation has already granted significant implementing powers to agencies and this course of action appears particularly appropriate when “complex technical assessments” are needed in order to implement an EU measure.

What remains a fundamental requirement is that the powers granted to the SRM by the regulation are sufficiently well defined so as to preclude not only an arbitrary exercise of power, but more generally that the Board takes “economic policy” decisions – notably including the decisions to open resolution, in light of the public interest to preserve financial stability, and to establish the frameworks for the use of resolution tools and of the Fund. In this regard, more precise legislative constraints on implementing powers have been advocated within the Council.<sup>26</sup> The subsequent versions of the Regulation have specified the criteria for

<sup>25</sup> In his opinion, AG Jääskinen underscores that agencies necessarily have to be precluded from Article 290 delegations of powers “because the exercise of such powers changes the normative content of legislative acts, albeit with respect to their non-essential elements”, and agencies cannot participate in the system of inter-institutional checks and balances established by Article 290(2). Delegated powers can only be exercised by an EU institution that is democratically accountable, in other words by the Commission, which is ultimately accountable to the European Parliament. A similar restriction does not apply to Article 291 TFEU implementing powers. Although agencies are not expressly mentioned as subjects to whom implementing powers can be conferred at the EU level, there are no fundamental constitutional principles preventing the legislator from conferring such powers on agencies “as a midway solution between vesting implementing authority in either the Commission or the Council, on the one hand, or leaving it to the Member States, on the other”. See also Repasi (2013).

<sup>26</sup> The original proposal already contained a number of principles and criteria to be respected by the Commission and the Board in the exercise of their implementing powers (see, in particular, Articles 6, 12, 13, 14, 15 and 16) and, more specifically, the use of resolution tools.

implementing actions in several aspects of the proposal.

Of course, it would be unrealistic to imagine that the resolution mechanism can operate without the exercise of discretionary powers, both by the Commission and the Board; but in the recent Presidency compromise text discretion has been more precisely limited to what is required to achieve the resolution objectives, and has been allocated between the Commission and the Board in a manner that seems in line with the Treaty. A critical provision in this regard is that only the Commission shall balance the objectives of resolution “as appropriate to the nature and circumstances of each case” (Article 12.3 of the Regulation).

The balance of the system is completed by the provisions ensuring on the one hand the political accountability of the SRM to the European Parliament and national parliaments<sup>27</sup> and, on the other hand, the judicial review of all decisions affecting individual rights.

## 7. Conclusions

The SRM Regulation and BRR Directive offer a comprehensive framework for the resolution of banks and banking groups at EU level, which complements the SSM to ensure that moral hazard is eradicated from European banking and financial markets. Critical aspects to this end are the transfer of resolution decisions from national supervisory authorities to a Single Resolution Mechanism that should operate in full independence from national authorities and all political interference at Union level. Any direct role of the Council of the Union in resolution decisions should be excluded as it would utterly destroy the credibility of the SRM.

The proposed system appears to be well designed on the whole and respectful of the institutional balance of powers dictated by the Treaty. However, some specific aspects may be improved with a view to ameliorating the effectiveness and legal strength of the SRM. In

<sup>27</sup> Articles 41 and 42.

particular, we have argued that the following changes are desirable:

On the **initiation of resolution**, in order to streamline and speed up the procedure, the assessment that a bank is failing or likely to fail, and that no private or supervisory alternative is available, should be left to the ECB (in its supervisory role) and national resolution authorities, as the last act of early intervention. Accordingly, the Commission should in practice focus its intervention on verifying the existence of the public interest conditions that are required to open resolution. The decision to start resolution should normally be initiated after the close of business on Friday afternoon and be completed before markets reopen.

On **bail-in**, we have proposed that the requirement for banks to have sufficient bail-inable liabilities could in part be translated into an obligation to issue debentures automatically convertible into equity when capital (evaluated at market price) falls below certain thresholds. This would greatly strengthen market discipline on shareholders and management. We have also underscored the need for flexibility in the application of bail-in where there is an injection of public funds into a solvent financial institution, be that by national authorities or the ESM, so as to avoid unwanted destabilising effects when a capital shortfall is ascertained and becomes known to the public. This will be especially important in view of the comprehensive and ambitious asset quality review that the ECB and EBA will launch in the coming months, possibly leading to the conclusion that a major ‘precautionary’ injection of funds may be needed in parts of the EU banking system.

On the **Resolution Fund**, our main proposition is that it must be supranational and that a collection of national funds would not do. The Fund would be paid by financial institutions participating in the SRM and would not require any support from national budgetary resources. This, however, does not eliminate, for the sake of the very credibility of the SRM, the need to establish a last-resort fiscal backup for the Fund, to be activated in exceptional circumstances such as a systemic shock affecting large parts of

the Union banking system. In this regard, the first line of defence can be provided by the ESM, with appropriate changes in its membership, and subsequently, in extreme cases of systemic banking crisis, by national budgets. The rules for tapping these backstops and the contribution keys by the member states should be agreed in advance, lest they become the subject of frantic and divisive negotiations should a major financial shock materialise. These funds should be repaid by financial institutions as soon as the crisis subsides. The SRM credibility requires that the system be completed by a **fiscal backstop**, which may be guaranteed in the first place by the ESM and as a last resort by national budgets.

Finally, we have discussed two **legal aspects of the SRM design**, and notably its legal basis and the balance of powers between the different bodies involved in the resolution procedures. On the first aspect, were Article 114 to prove an inadequate legal basis for the exercise of centralised resolution powers deeply impinging on individual property rights, it might be necessary to consider, only in this respect, the joint resort also to Article 352. On the second aspect, we have stressed the critical role of the Commission, which must be preserved as proposed, in taking the key decisions affecting property rights in the procedure, thus better underpinning their legality and political accountability under the Treaty.

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