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Cross-border supervision and resolution of significant banking groups in the context of the European Banking Union

PhD THESIS

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Abstract

The establishment of the first two (2) pillars of the European Banking Union, namely the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), is a milestone in the process for the Europeanization of banking supervision and resolution. Assigning upon supranational authorities (European Central Bank (ECB) and Single Resolution Board (SRB)), the responsibility for the application of the newly-established Union crisis prevention and crisis management framework is expected to facilitate the effective cross-border supervision and resolution of the largest euro area banking groups. The new institutional and regulatory framework for supervision and resolution aims at promoting financial stability and addressing the financial fragmentation observed in the euro area during the international financial crisis and the euro area fiscal crisis.

The PhD thesis examines extensively and in detail the application of the regulatory framework for supervision and resolution by the ECB and the SRB respectively. The PhD thesis has as an objective to assess whether the new crisis prevention and crisis management framework is suitable to meet the objectives of the Banking Union, i.e. to foster financial stability and promote financial integration. Thus, particular emphasis is placed on whether the new framework is credible and adequate to minimize the risk for Member States to bear the cost of (future) banking failures. In addition, the PhD thesis assesses the contribution of the Banking Union to the integration of the European banking market through the application of uniform supervisory and resolution-related approaches across the euro area, which could incentivize banking groups to expand their operations beyond national borders.

The thesis concludes that significant progress has been made towards meeting the aforementioned objectives. Nonetheless, there is still room for improvement to ensure that the Union crisis management framework will be fit for purpose in addressing potential threats to financial stability, including a new financial system-wide crisis. In particular, at institutional level it is necessary more powers to be transferred from national to supranational level, while at regulatory level, further harmonization of national laws is needed, particularly in the areas of national insolvency laws, and the introduction of arrangements to facilitate cross-border transfer of liquidity and capital is recommended. Lastly, at operational level, Lastly, at operational level, it is necessary the SRB to draw up comprehensive and complete resolution plans the soonest possible, as well as both the ECB and the SRB to improve their cooperation with the respective authorities of non-participating Member States and third countries.

Keywords: resolution, supervision, BRRD, SSM, SRM, ECB, SRB, SRF, CRR, CRDIV, EBA, Banking Union, banking group, bail-in, SREP, recovery plan, MREL, early intervention, state aid, precautionary recapitalization, SPE, MPE

List of Tables

List of figures

List of Abbreviations

AIFs	Alternative Investment funds
BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive (2014/59/EU)
CCP	Central Counterparty
CCyB	Countercyclical Capital Buffer
CDIC	Canada Deposit Insurance Corporation
CDS	Credit Default Swaps
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CET1	Common Equity Tier 1
CMGs	Crisis Management Groups
CoCos	Contingent Convertible bonds
CoE	Cost of Equity
COREP	Common Reporting Framework
CRD IV	Capital Requirements Directive no IV (2013/36/EU)
CRR	Capital Requirements Regulation
DGS	Deposit Guarantee Scheme
DGSD	Deposit Guarantee Scheme Directive (2014/49/EU)
DRI	Direct Recapitalization Instrument
EAD	Exposure At Default
EBA	European Banking Authority
EBU	European Banking Union
ECA	European Court of Auditors
ECB	European Central Bank
ECG	Court of Justice of the European Union
ECOFIN	Economic and Financial Affairs Council
ECON	Economic and Monetary Affairs Committee (European Parliament)
EDIS	European Deposit Insurance Scheme
EEA	European Economic Area
EFSF	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
EMF	European Monetary Fund
EMU	European Monetary Union
ESAs	European Supervisory Authorities
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FINREP	Financial Reporting Framework

FMIs	Financial Market Insrastructures
FROB	Fondo de Reestructuración Ordenada Bancaria
FSB	Financial Stability Board
FX	Foreign Exchange
GDP	Gross Domestic Product
GFSTs	Government Financial Stabilization Tools
G-SII	Global Systemically Important Institution
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IPS	Institutional Protection Scheme
IRB	Internal Ratings-based Approach
IRRBB	Interest Rate Risk in the Banking Book
IRT	Internal Resolution Team
ISDA	International Swaps and Derivatives Association
ITS	Implementing Technical Standards
JST	Joint Supervisory Team
LAA	Loss Absorption Amount
LCR	Liquidity Coverage Ratio
LFAs	Loan Facility Agreements
LGD	Loos Given Default
MCC	Market Confidence Charge
MDA	Maximum Distributable Amount
MLE	Material Legal Entity
MoU	Memorandum of Understanding
MPE	Multiple Point of Entry
MREL	Minimum Requirement for own funds and Eligible Liabilities
M&As	Mergers and Acquisitions
NCB	National Central Bank
NCWO	No Creditor Worse Off (principle)
NDA	National Designated Authority
NPEs	Non-performing exposures
NRA	National Resolution Authority
NSA	National Supervisory Authority
NSFR	Net Stable Funding Ratio
OCR	Overall Capital Requirement
OJ	Official Journal of the European Union
OSI	On-Site Inspection
O-SII	Other Systemically Important Institution
P2G	Pillar 2 Guidance
P2R	Pillar 2 Requirement
PD	Probability of Default
RCA	Recapitalization Amount
RoA	Return on Assets
RoE	Return on Equity
RTS	Regulatory Technical Standards

RWAs	Risk Weighted Assets
SEP	Supervisory Examination Program
SLA	Service Level Agreement
SMEs	Small and Medium Enterprices
SPE	Single Point of Entry
SPEs	Special Purpose Entities
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation
SSM	Single Supervisory Mechanism
SSMFR	Single Supervisory Mechanism Framework Regulation
SSMR	Single Supervisory Mechanism Regulation
TFEU	Treaty on the Functioning of the European Union
TLAC	Total Loss-Absorbing Capacity
TRPs	Transitional Resolution Plans
TSCR	Total SREP Capital Requirement
UCITS	Undertakings for Collective Investment in Transferable Securities
WCCAs	Written Coordination and Cooperation Arrangements

Preface

During the international financial crisis (2007-2009) and the euro area fiscal crisis (2010-2015) failures of banking groups[1] could be addressed with bail-outs with public funds. If there were no private solutions available to prevent such incidents, liquidation under normal insolvency proceedings was the only alternative solution. This option would have severe consequences for the financial stability and the real economy of Members States. This was particularly relevant to the largest European cross-border banking groups, which were considered "too big to fail" due to their size, complexity and interconnectedness. Thus, these crises demonstrated the need to introduce a harmonized Union framework for crisis prevention and crisis management to deal with failures of banking groups without sovereigns bearing the costs of bail-outs.

Against this backdrop, a Union resolution framework was introduced to address the aforementioned problems. Resolution of failing banking groups is a specific procedure introduced as an alternative to national insolvency regimes with the objective to serve the public interest. The term "resolution" involves all the measures taken to resolve problems arising from the exposure of banking groups to insolvency and illiquidity aiming to avoid the initiation of liquidation proceedings or resort to bail-out with public funds. Pursuant to Gortsos "*resolution is a specialized regime for bank failures, since its main objectives are the preservation of financial stability, the protection of depositors (whose deposits are covered by DGSs) and the minimization of resort to bail-out through public funds*."[2] Resolution cannot eliminate the cost from banking failures, but introduces an orderly and fair distribution of costs ensuring that shareholders will bear losses first and creditors will bear losses after shareholders in the order of their priority.

In addition, these crises revealed the negative feedback loop between sovereigns and banking sector, which has significant impact on both the real economy and financial stability. Thus, it was clear that the reform of the EU regulatory framework, though necessary, is not sufficient to address threats to financial stability. The deficiencies of the financial architecture governing supervision and resolution of banking groups had to be addressed. Although coordination among national authorities is important, the crises proved that mere coordination is not enough but a common decision making-process in respect of the euro area is needed. Retaining the existing architecture, where the main role is assigned on national authorities, would not address the risk new crises to break out in the future.

In reaction to the aforementioned crises, in June 2012, the Heads of State and Government of the Euro area decided to establish the European Banking Union (Banking Union), which consists of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Assigning supervisory and resolution tasks upon supranational authorities, namely the European Central Bank (ECB) and the Single Resolution Board (SRB) respectively, is an innovative element in the field of European banking law and is expected to transform drastically the landscape in the areas of banking supervision and resolution. The establishment of the Banking Union aims to promote financial stability and to address the financial fragmentation observed in the euro area during last years. An integrated banking system would promote the effective functioning of the internal market in the area of banking services.

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[1] For the purposes of the present study, cross-border banking groups are defined as groups whose parent entity is either a bank or a financial holding company and their subsidiaries include banks and non-bank (including non-financial) entities located in Member States of the EU and third countries.

[2] See **Gortsos (2018c)**, p. 33.

Thus, over the last years there have been fundamental developments in the area of European banking law. The introduction of a harmonized resolution framework and the establishment of the first two (2) pillars of the Banking Union (i.e. the SSM and the SRM) constitute milestones in this process. Therefore, the PhD thesis examines the application of the newly-established Union framework for crisis prevention and crisis management in relation to the (approximately 100) banking groups whose parent entity is incorporated in the euro area and which are under the remit of the ECB and the SRB.[3] Particular emphasis is placed on the banking groups with cross-border activities not only in Member States participating in the Banking Union, but also in other EU Member States and third countries.

The PhD thesis examines extensively and in detail the Union resolution framework, as it is a new element in the European banking law. The thesis assesses the adequacy and credibility of the new resolution framework from a financial stability perspective.[4] The analysis carried out in this paper is mainly based on the policies, decisions and actions of the ECB and the SRB since the launch of the Banking Union. Leveraging on the way that the ECB and the SRB dealt with the four (4) banking failures that happened in these years, valuable conclusions can be drawn in relation to the completeness and effectiveness of the new regulatory framework.

The PhD thesis has as an objective to assess whether the application of the new crisis prevention and crisis management framework is suitable to meet the objectives of the Banking Union, i.e. to foster financial stability and promote financial integration. Therefore, the thesis examines whether the new financial architecture and the revised regulatory framework limit the role of national authorities both in the decision-making process and in the execution phase and if they minimize the risk for Member States to bear the cost of (future) banking failures. The PhD thesis assesses the contribution of the Banking Union to the integration of the European banking market through the application of uniform supervisory and resolution-related approaches across the euro area by single authorities, which could incentivize banking groups to expand their operations beyond national borders.

Given the nature of the issue under examination, significant part of the thesis is very technical and includes many terms and abbreviations that are difficult for someone not familiar with to comprehend. Nonetheless, the thesis indicates how a very technical issue, as is the case for banking supervision and resolution, paves the way for further Europeanization of the financial architecture and regulatory framework. The thesis highlights the benefits of the establishment of supranational mechanisms, which limit the role of national authorities, and uniform regulatory arrangements across Member States. In that context, the thesis demonstrates that there are still missing elements to ensure that a complete crisis management framework is in place. There is still room for further Europeanization of the framework for banking supervision and resolution.

The European regulatory framework forms the basis for the development of the thesis. The extensive bibliography on this area, which has been developed during the last years, and my interaction and cooperation with the ECB and the SRB under my professional capacity contributed to the analysis and assessment of the framework for the crisis prevention and management. The main constraints in writing the thesis pertained to the

[3] The remaining banking groups/entities under the ECB’s remit refer to banking groups whose parent entity is located in a third country and individual credit institutions (representing only 3% of total assets of banking groups/entities under the ECB’s responsibility). The thesis does not cover also cross-border banking groups which are in the scope of the SRB but are supervised by national supervisory authorities.

[4] Resolution influences also other branches of European and national law, including corporate law, private law and insolvency law, which are not covered in the PhD thesis.

time-limited implementation of the new framework, which does not allow to draw safe conclusions on its capacity to cope with idiosyncratic or system-wide banking crises.

The thesis, updated until 15 December 2018, starts with some **introductory remarks** on the deficiencies of the former financial architecture and regulatory framework relating to crisis prevention and crisis management for cross-border banking groups, as revealed during the crises. Furthermore, it highlights the significance of rules for supervision and resolution of cross-border banking groups in order to promote financial integration and break the nexus between sovereigns and banking groups, preferably through cross-border mergers and acquisitions (M&As).

The thesis is structured in **three (3) Chapters**:

Chapter A is structured in **five (5) Sections**. The **first Section** describes the Union financial landscape which was shaped in the aftermath of the international financial crisis. The establishment of the European Banking Authority (EBA) in the context of the European System Financial Supervision (ESFS) is a milestone in the process for the Europeanization of banking regulation. Particular emphasis is placed on the role and tasks of the EBA both as a European Regulatory Authority and as an actor in the crisis prevention and crisis management framework. The **second Section** presents the process towards the establishment of the Banking Union as a result of the breakout of the euro area fiscal crisis. The **third Section** presents the legal framework and the fundamental elements of the SSM, as well as the tasks and powers of the ECB to carry out micro-prudential supervision of banking groups. The **fourth Section** examines the provisions of the legal framework governing the establishment and functioning of the SRM. In particular, this Chapter outlines the arrangements pertaining to the tasks and powers of the SRB in relation to resolution planning and resolution action. The **fifth Section** examines the arrangements governing the functioning of the Single Resolution Fund (SRF), as well as the procedure for the collection and use of the available financial means of the SRF.

Chapter B constitutes the main part of the thesis, as it includes the analysis of the framework for cross-border supervision and resolution of significant banking groups, which have activities both in the Banking Union and in other EU Member States and third countries.[5] This Chapter is structured in **four (4) sections**. The **first Section** describes the key elements of the micro-prudential supervision carried out by the ECB over significant banking groups. In that context, this Section covers the Supervisory Review and Evaluation Process (SREP), which forms the basis for the supervision of banking groups, and the crisis prevention measures which the ECB may apply upon deterioration of the financial situation of banking groups. The **second Section** examines the key elements of the annual resolution planning process applied by the SRB in relation to significant banking groups. Particular emphasis is placed on the determination of the Minimum Requirement for own funds and Eligible Liabilities (MREL), which is the most significant resolution-related requirement with which banking groups must comply in the following years. The **third Section** describes the conditions and the process for placing a distressed banking group into resolution. Furthermore, it examines the core elements of the resolution framework, which pertain to the application of resolution tools and exercise of resolution powers to significant banking groups. The **fourth Section**

[5] Since the perimeter of the thesis is restricted to banking groups under the ECB's remit, the analysis of the regulatory framework is delineated by the following principles. Firstly, the analysis covers only the provisions relating to banking groups and not individual credit institutions. Secondly, most of the arrangements governing supervision and resolution of banking groups are applied at the (parent) entity level (e.g. Supervisory Review and Evaluation Process, early intervention measures, precautionary recapitalization, resolution tools, liquidity in resolution).

explores the options for providing capital and liquidity support through external sources to banking groups under resolution, including the provision of state aid.

Chapter C contains the concluding remarks of the thesis and an overall assessment of the current crisis management framework. Although there is limited experience from the implementation of the new framework, it can be concluded that this framework promotes the Union financial stability and the integrity of the internal market. However, there is still need for improvements at institutional, regulatory and operational level. In particular, at **institutional level** it is necessary more powers to be transferred from national to supranational level, mainly relating to provision of liquidity in resolution, the deposit guarantee and the enhancement of the SRB's role both in the decision-making process and the implementation of resolution action. At **regulatory level**, further harmonization of national laws is recommended in the areas of liquidation under normal insolvency proceedings, insolvency rankings and crisis prevention tools. At operational level, it is necessary the SRB to draw up comprehensive and complete resolution plans for all banking groups, as well as both the ECB and the SRB to improve their cooperation with the respective authorities of non-participating Member States and third countries.

Lastly, I would like to thank warmly **Professor Christos Gortsos** for his guidance and particularly valuable remarks throughout the period of writing the PhD thesis. Special thanks are extended to **Professor Charisios Tagaras** and **Assistant Professor Christina Livada** for their useful remarks and suggestions. I am also grateful to **Kostas Nakos** for his valuable input and remarks on operational and methodological aspects of banking supervision and resolution.

Table of contents

Chapter A:

The establishment of supranational authorities for banking regulation, supervision and resolution

Chapter B:

Micro-prudential supervision and resolution of significant banking groups

Chapter C:

Assessment of the Union crisis management framework

Introductory remarks

1. The deficiencies of the pre-Banking Union regulatory framework

Since the establishment of the European Economic Communities, national authorities were responsible for the micro-prudential supervision of banking groups. This situation remained unaffected even after the launch of the Economic and Monetary Union (EMU).[6] Home country supervisory authorities were responsible for the supervision of cross-border banking groups at consolidated level, while host supervisory authorities were competent for the supervision of the subsidiaries at individual level.

Aiming to enhance financial integration and create an internal market for banking services, the pre-crisis regulatory framework set out rules on supervision of banking groups operating in more than one (1) Member States. These rules aimed at giving boost to consolidation of the European banking sector through cross-border mergers and acquisitions (M&As), which would allow economies of scale to be achieved and capital to be allocated to its most productive uses at the European level. Under these arrangements, banking groups would have the option to transfer capital and liquidity to their entities needed most, which would imply optimal use of their resources resulting in benefits both for their financial situation and their capacity to finance the European economy.

However, the international financial crisis revealed a number of weaknesses in the supervision of cross-border banking groups, including the lack of effective cooperation among supervisory authorities. The main weaknesses of the previous regulatory framework pertained to:[7]

- the preferential treatment of home country supervisory authorities, which had a leading role in supervision of banking groups, while there were no incentives for enhanced cooperation of supervisory authorities,
- the lack of accountability and power to impose sanctions, where cooperation between supervisory authorities was defective and/or not in line with the regulatory framework,
- the lack of mediation between supervisory authorities which failed to reach joint decisions, particularly in light of the prominent role of home supervisory authorities that was leaving host supervisors with no bargaining power, and
- the lack of a comprehensive and effective framework for crisis management and resolution of failing cross-border banking groups.

When problems started to emerge, interests of home and host authorities became divergent and sometimes conflicting. Host authorities started taking measures within the national borders (ring-fencing measures) to protect their national interests ignoring the implications for the other groups' entities and the relevant Member States.[8] During the international financial crisis, governments rescued with public money failing banking groups and national central banks provided emergency liquidity assistance.[9]

[6] See **Gortsos (2018c)**, pp. 27-28.

[7] See **D' Hulster (2011)**, pp. 5-6.

[8] These ring-fencing measures became increasingly common in emerging EU countries, particularly during 2011. For more on this issue, see **Lehmann** and **Nyberg (2014)**.

[9] See **D'Hulster** and **Ötker-Robe (2014)**, p. 3.

Typically, host authorities tend to take ring-fencing measures when the domestic operations of a foreign banking group are of systemic nature for the host country.[10] Host supervisory authorities may apply ring-fencing measures where a banking group is in financial stress due to problems arisen in the home country (either system-wide or idiosyncratic) or there are doubts about the quality of the supervision carried out by the home supervisory authority. To that end, host authorities aim at preventing domestic entities from providing capital[11] and liquidity to the parent entity or any other entity in distress.[12] For host supervisory authorities, these measures allow greater control on capital, liquidity and risk management to protect national interests (e.g. national depositors, creditors and fiscal sovereignty).

Ring-fencing measures increase the cost of funding for banking groups, as they have to maintain significantly higher capital buffers at the parent and/or subsidiary level than if they were allowed to transfer capital, excess profits and liquidity across borders.[13] Thus, banking groups cannot make optimal use of their funds, which affects their lending capacity with negative implications for the internal market and the European economy. In addition, if such measures are taken amidst a crisis, they result in increase of the stress for the parent entity and the banking group as a whole.[14] Ring-fencing measures taken by (host) supervisory authorities of one country increase stress for the parent entity and the banking group as a whole triggering further defaults and amplification of crisis.

Banking crises affect the public sector directly through the cost incurred on the sovereigns' fiscal position as a result of the measures aiming to support financial system and indirectly due to the negative effect on economic cycle due to the sharp reduction of credit and fall of assets values.[15] These problems may result in sovereign debt restructuring and/or a sharp increase of non-performing exposures (NPEs), which in turn hit the financial situation of banking groups. This negative feedback loop between sovereigns and banking sectors has significant impact on both real economy and financial stability. This became manifest to a significant extent during the euro area crisis, which highlighted the problematic interlinkages between sovereigns and banking groups.

Both the international financial crisis and the euro area fiscal crisis hampered the Union financial integration enhancing the (already existing) fragmentation of the euro area

[10] Supervisory authorities may apply three (3) different types of ring-fencing measures:

a. **Partial ring-fencing measures**, which allow only excess profits of subsidiaries and not the excess capital buffers to be transferred within the group,

b. **Near-complete ring-fencing measures**, which allow transfers only from the parent entity to the subsidiary, and

c. **Full ring-fencing measures**, which do not allow intragroup transfers.

[11] The terms "capital and "own funds" are used interchangeably within this document.

[12] See **D'Hulster** and **Ötker-Robe (2014)**, pp. 7-8.

[13] Based on a study prepared by the **Cerutti, Ilyina, Makarova** and **Schmieder (2010)** for 25 large European banking groups, the adoption of ring-fencing measures results in 1.5-3 times higher capital needs upon materialization of a systemic shock. Therefore, banking groups subject to ring-fencing measures need to have substantially higher capital buffers at the parent and/or subsidiary level given that they are not allowed to transfer capital and/or profits across group's entities

[14] See **D' Hulster (2011)**, p. 6.

[15] See **Baglioni (2016)**, p. 9.

banking system.[16] Financial integration is defined by the ECB as "*the market where all potential participants with the same relevant characteristics:*

1. *face a single set of rules when they decide to deal with financial instruments and/or services,*
2. *have equal access to the above-mentioned set of financial instruments and/or services, and*
3. *are treated equally when they are active in the market.*"[17]

Ideally, in a fully integrated banking market, banking groups, corporates and households should have access to loans under the same credit standards and interest rates. However, this was not the case for the euro area during the crises, where market participants could not enjoy neither the same degree of access to the banking market nor equal terms for banking products and services. Lack of an integrated banking market resulted both in the drop of new loans' origination and in significant divergences in the terms and rates of new loans across Member States. Provision of cross-border loans to banking groups and corporates dropped significantly[18] and corporates and households had to resort almost completely to national banking groups for new loans.

The convergence of interest rates charged by banking groups on loans and deposits to/from corporates and households demonstrates the degree of integration in a banking market.[19] Large loan and deposit interest rate dispersion across Member States is indicative of the different conditions prevailing in national economies and banking systems. At the peak of the euro area crisis (2012), the divergence in loan interest rates exceeded four (4) percentage points, while the deposit interest rate dispersion reached two (2) percentage points.[20]

2. The Banking Union's role in enhancing cross-border supervision and resolution of banking groups

2.1 The Banking Union's objective to foster financial integration

The severe impact of the crises on the Union financial stability and financial integration highlighted the need to adopt harmonized rules on cross-border supervision and resolution of banking groups and assign upon single supranational authorities the responsibility for the enforcement of those rules. Therefore, on 29 June 2012, amidst the euro area fiscal crisis, the Heads of Governments of euro area Member States decided to establish the Banking Union to address the shortcomings which triggered the financial crisis of 2008 and the euro area fiscal crisis. The establishment of the Banking Union is a very ambitious political initiative, which has been called by the President of the ECB,

[16] According to **Gortsos (2013)**, financial integration, which is pursued through the regulatory framework, has two (2) dimensions: a negative and a positive one. The negative dimension of financial integration requires the adoption of rules for the liberalization of trade in financial services and free competition in the financial system. Positive integration aims at achieving the objectives of regulatory intervention in the financial system. In relation to banking system, the main policy objective is to ensure its stability. This objective is more easy to achieve if there is total harmonization of rules and the enforcement of those rules is assigned upon a supranational authority.

[17] See **European Central Bank (2018e)**, p. 3.

[18] *Ibid*., p. 152.

[19] *Ibid*., p. 154.

[20] *Ibid*., p. 155.

Mario Draghi, as the "*greatest step towards deeper economic integration since the creation of Economic and Monetary Unio*n".[21] That statement reflects the magnitude of the political initiative and the benefits expected to be reaped.

The establishment of the Banking Union addresses the question of how we can achieve financial stability in a world of cross-border banking or what Schoenmaker had called "financial trilemma", which states that "*1) financial stability, 2) financial integration and 3) national financial policies are incompatible. Any two of the three objectives but not all three; one has to give*."[22] Thus, European political leaders decided to give up national financial policies and adopt a Europeanized approach in relation to banking regulation, supervision and resolution.

At a first stage, the establishment of the ESFS and subsequently the setup of the Banking Union transferred the competence for banking regulation, supervision and resolution at supranational level. With respect to banking regulation, regulatory convergence is pursued through the adoption of a harmonized prudential regulatory framework (through greater use of Regulations rather than Directives) and the establishment of the EBA, which primarily functions as a European regulatory authority within the ESFS. In the areas of supervision and resolution of banking groups, this political choice is reflected in the establishment of the first two (2) pillars of the Banking Union, namely the SSM and the SRM respectively. The assignment upon supranational authorities of the tasks of supervision and resolution seeks to limit the role of national authorities, which tend to take national interests into account during a crisis and ignore cross-border externalities of bank failures.[23]

This approach accompanied with a Europeanized bank safety net aims at contributing to the creation of an integrated euro area banking market. The conferral upon supranational authorities of the task for banking supervision and resolution seeks to further enhance regulatory convergence. The ECB and the SRB should apply the relevant rules of European banking law (even in areas not totally harmonized) in a uniform way across the euro area, while they should also set common standards of supervision and resolution for all banking groups located in the euro area. Thus, banking groups could expand their activities across the euro area due to reduced compliance costs and achievement of level playing field. Furthermore, supervision and resolution carried out by supranational authorities could address the inefficiencies referred above in relation to the communication and coordination of the national authorities with regard to banking groups located in the euro area.

The introduction of harmonized rules on supervision and resolution of banking groups operating across the EU is expected to contribute to financial integration in various ways. Firstly, it could promote efficient liquidity management by cross-border banking groups through the introduction of liquidity waivers for the groups' entities, which are located in the euro area and are supervised by the ECB.[24] Since groups' entities would no longer be subject to capital and liquidity requirements at individual level, transfer of excess profits and liquidity could be transferred across the groups' entities.[25] Secondly, the enhancement of the framework for cross-border supervision could facilitate the transfer

[21] See **European Central Bank (2015**), p. 3.

[22] See **Schoenmaker (2011)**.

[23] See **Vardi (2017),** p. 2.

[24] Efficient liquidity management across groups' entities is feasible, only if the regulatory framework does not provide Member States with the discretion to set large exposure limits for intragroup exposures.

[25] See **European Central Bank (2018e),** p. 6.

of eligible collateral for central bank operations which was not allowed, where ring-fencing measures were imposed by supervisory authorities. Thirdly, the introduction of harmonized Union rules on banking resolution could address the concerns of national authorities on how to handle the failure of a group's entity. As highlighted amidst the crises, the home resolution authority had no incentive to put into resolution the parent entity of a banking group if a small subsidiary of that entity failed.[26] The failure of that entity would result in upstream of losses to the parent entity, but this was not sufficient to ensure the recapitalization of the entity and the orderly functioning of its operations. This could be achieved only if the parent entity injected fresh capital in its subsidiary. Where the parent entity considered the subsidiary as immaterial for the whole group and decided to not inject capital, the host resolution authority had limited options to deal with this failure, mainly relating to rescuing the entity with public funds. Therefore, the new resolution framework aims at facilitating the orderly recapitalization of subsidiaries through capital and liabilities issued either (internally) to the parent entity or (externally) to external creditors. The establishment of such mechanisms could alleviate the concerns of the host resolution authorities on the way they would deal with a failure minimizing, thus, their incentives to restrict transfer of capital and liquidity across groups' entities.

2.2 The Banking Union's objective to break the nexus between sovereigns and banking system

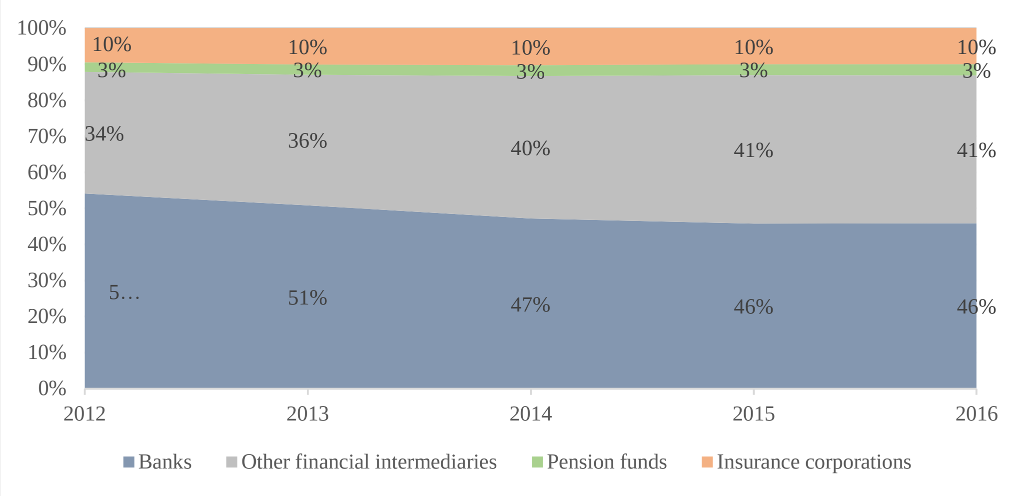
Since the onset of the financial crisis, the role of the euro area banking system has been steadily declining, both for the euro area economy and its financial system (see ***Figure 1*** and ***Figure 2***), further affecting banking groups' profitability and capital adequacy.

Figure 1: Euro area banking groups' assets over euro area GDP

Source: *European Central Bank (2017b), p. 74.*

[26] See **Davies (2016),** p. 11.

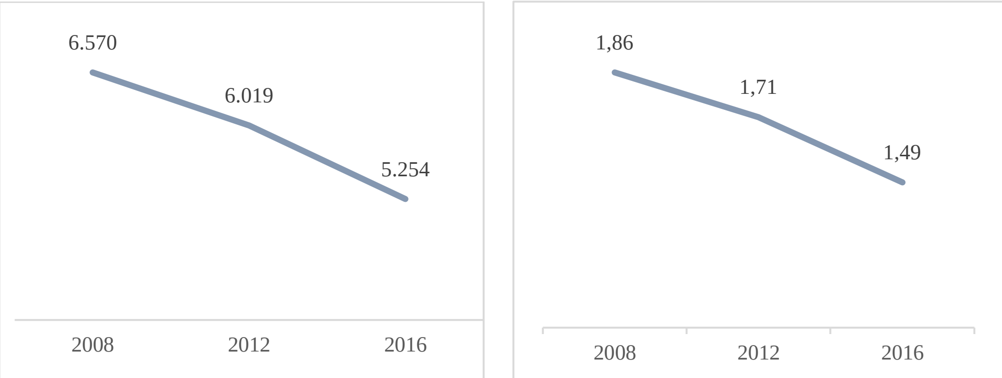
Figure 2: Ratio of assets of sub-sectors to total assets of the financial sector



Source: *Source: European Central Bank (2017b)*

Although the euro area banking system has undergone considerable consolidation since 2008 in terms of operating entities and staff (see ***Figure 3***), it is still considered oversized and fragmented.[27] Overbanking[28] affects banking groups' profitability, as they compete for the same customers, a point raised mainly for countries with banking systems characterized by low market concentration.

Figure 3: Number of banks and employees (in million) in the euro area



Source: *ECB Statistical Data Warehouse*

Despite the significant consolidation that has taken place during the previous years, there is still room for further progress. Further consolidation could benefit the euro area banking system from a financial stability perspective, as it would create economies of scale resulting in increase of revenues and decrease of operating expenses. Hence, banking groups could develop a more sustainable business model, which would strengthen their financial situation.

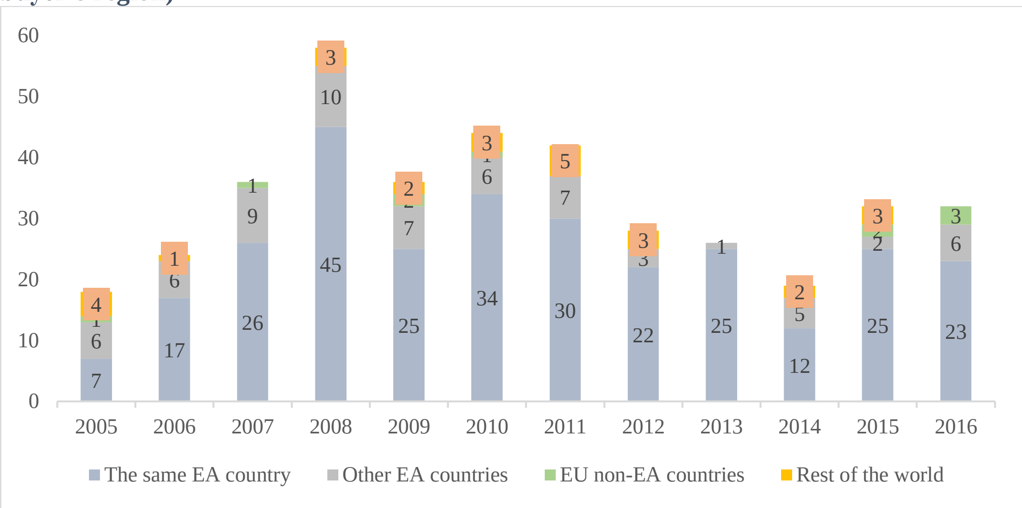
To that end, the adoption of rules for cross-border supervision and resolution of banking groups along with the establishment of the SSM and the SRM could promote further

[27] See **Nouy (2017).**

[28] Although the concept of overbanking is not very clear, according to the ECB, the gap between Return on Equity (RoE) and Cost of Equity (CoE) raises concerns for banking group's long-term health and warrants the argument of overcapacity in the European banking sector.

consolidation, preferably through cross-border M&As. This would be the optimal solution to deal with the overcapacity of the European banking sector. Despite the introduction of the single currency, cross-border M&As remained stagnant in the pre-crisis period. This situation deteriorated after the international financial crisis, as the number of M&As dropped significantly, while the majority of those pertained to transactions made at domestic level. In addition, the majority of the cross-border M&As referred to minority stakes, while controlling stakes accounted for 71% of domestic M&As.

Figure 4: Number of euro area banking groups acquired by other banking groups (by buyer's region)



Source: *Raposo and Wolff (2017)*

M&As are business, rather than supervisory, decisions. Hence, the Banking Union could have a rather supportive role in promoting further banking consolidation, especially through cross-border M&As. In particular, the introduction of single rules across the euro area fosters regulatory certainty and scales down compliance costs for banking groups. Thus, banking groups can do business across the euro area without being in need to comply with different supervisory practices and methodologies. The establishment of the Banking Union seeks to promote harmonized supervisory practices across the euro area, which could lay the ground for banking groups to explore and implement such options.

The main rationale behind the establishment of the Banking Union is summarized in the following sentence of the Statement of the Euro Area Summit of 29 June 2012: "***We affirm that it is imperative to break the vicious circle between banks and sovereigns***". The close link between banking groups and national governments is a remarkable feature of the euro area banking system. Based on a policy paper published by the Bruegel,[29] 64% of the largest banking groups are subject to the control or influence of national governments.[30]

[29] See **Veron (2017):** *The governance and ownership of significant euro-area banks.*

[30] The sample of the exercise consists of 97 entities directly supervised by the ECB, whereas the remaining 29 entities are subsidiaries of other banking groups (data as at November 2016). This category includes:

- public sector entities,
- entities nationalized or with the national government as their single largest minority shareholder as a result of bailouts with public funds,

Banking groups under political influence are widely considered to be prone to low market discipline and have weak incentives to prioritize profitability. Furthermore, banking groups under political influence are largely exposed to sovereign risk, which may have significant impact on their financial performance. This became manifest during the euro area crisis, which highlighted the problematic interlinkages between sovereigns and banking groups. A negative feedback loop was reflected in the fiscal burden that governments took on for bailing out failing banking groups, and, vice versa, in banking groups' troubles created from sovereign debt restructuring and/or a sharp increase of NPLs.

This negative nexus between sovereigns and banking groups can be broken through the consistent application of the crisis prevention and resolution framework, which is expected to minimize the risk for bail-outs with public funds. In addition, cross-border M&As could serve the objective of the Banking Union to break the nexus between banking groups and sovereigns through the reduction of the sovereigns' interference in the ownership and governance structure of banking groups. In that way, both financial stability and financial integration could be promoted.

The present thesis analyzes the role, powers and tasks of the supranational authorities (Chapter A) in the implementation of the new regulatory framework for cross-border supervision and resolution of significant banking groups (Chapter B). This analysis aims to assess whether the Banking Union's objectives could be achieved and what additional improvements are needed (Chapter C).

- entities whose the largest (minority or majority) shareholder is a regional or national foundation, typically controlled or influenced by political interests, and
- cooperative banking groups whose governance models are often politicized.

Chapter A:

The establishment of supranational authorities for banking regulation, supervision and resolution

Section 1: The European System of Financial Supervision (ESFS)

1. The establishment of the ESFS

1.1 The road towards the establishment of the ESFS

The international financial crisis (2007-2009) demonstrated the need to review the Union financial regulatory and supervisory framework. For that reason, the European Commission (Commission) assigned that task on a high-level group of experts, chaired by Jacques de Larosiere, known as the **High-Level Group on Financial Supervision in the EU** (Group). In February 2009, the Group submitted a report ("Larosiere report") that contained recommendations in order to harmonize to the extent possible the Union regulatory framework and to fill regulatory gaps identified during the crisis.[31] The report suggested also the amendment of the Union supervisory architecture by establishing the ESFS.

The ESFS would be an integrated network of European supervisory authorities, which would continue to carry out day-to-day supervision over financial institutions. In the context of the ESFS, there should be a consistent effort to promote harmonization of rules applicable to financial institutions.

The Commission welcomed the recommendations included in the Larosiere report and in its Communication of 4 March 2009 entitled "*Driving European Recovery*", proposed an ambitious program of reforming the EU financial sector. The Commission supported the Group's idea to establish a European body to oversee the stability of the Union financial system as a whole. In addition, the Commission agreed with the conclusion of the Group that "*the structure of the (then) existing Committees*[32] *is not sufficient to ensure financial stability in the EU and its Member States*". The Commission also considered that there are merits in introducing a system that combines certain centralized responsibilities at the European level and conduct of day-to-day supervision at national level.

Considering that action was urgently needed, the Commission proposed to expedite the implementation of the Group's recommendations by combining the two (2) phases proposed by the Group. That policy action aimed at improving the quality and coherence of supervision in the EU and transforming the three (3) Committees into Authorities within a European financial supervision system. Thus, the Commission proposed to put forward draft legislation creating a European system of financial supervision and a European Systemic Risk Board (ESRB). Discussions in the European Council, the Council and the European Parliament demonstrated a broad consensus about the need for reform and the objectives to be achieved in line with the Larosière report.[33]

[31] On the proposals of the La Larosière Group, see **Gortsos (2010).**

[32] This term refers to the "*Committee of European Banking Supervisors*" (CEBS), the "*Committee of European Insurance and Occupational Pensions Supervisors*" (CEIOPS) and the "*Committee of European Securities Regulators*" (CESR).

[33] See **Communication for the** "*European financial supervision*", p. 2.

In its Communication of 27 May 2009, the Commission provided more details on the architecture of the new European financial supervisory framework.[34] The broad consensus on the initiative to transform the Union financial supervisory framework is depicted by the consent of the European Council on the necessity for a European System of Financial Supervisors to be established, as referred to in the conclusions of the Summit of 19 June 2009.[35]

1.2 The components of the ESFS

The Larosiere report demonstrated that macro-prudential oversight[36] is not meaningful unless it can somehow impact on supervision at the micro level, whilst micro-prudential supervision[37] cannot effectively safeguard financial stability without adequately taking account of macro-level developments.[38] Based on the aforementioned remarks of the Larosiere report, it was deemed necessary to establish the ESFS consisting of:

a. the three (3) European Supervisory Authorities (ESAs), namely the **European Banking Authority** (EBA), the **European Insurance and Occupational Pensions Authority** (EIOPA) and the **European Securities and Markets Authority** (ESMA), and

b. the **European Systemic Risk Board** (ESRB).

The three (3) ESAs were established based on the following Regulations of the European Parliament and of the Council of 24 November 2010:

a. the **Regulation (EU) No 1093/2010** "*establishing a European Supervisory Authority (European Banking Authority)(…)*";[39]

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[34] *Ibid*.

[35] See **Council of the European Union (2009).**

[36] Macro-prudential oversight of the financial system by central banks is gradually becoming a common instrument to achieve financial stability. It is aimed at limiting distress for the financial system as a whole and, thus, protect the overall economy against significant losses in real output.

[37] Micro-prudential supervision aims at:

- assessing the quality of banking groups' portfolios, and
- ascertaining compliance with the applicable regulatory framework in order to prevent exposure to exceptional, unmanageable risk levels.

[38] **Regulation 1092/2010**, recital (13).

[39] Further minor amendments to the founding EBA Regulation followed with the adoption of the following legislative acts:

a. the **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" ("Bank Recovery and Resolution Directive", "BRRD"),*

b. the **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" (Single Resolution Mechanism Regulation", "SRMR")*, and

c. the **Directive 2014/17/EU** of the European Parliament and of the Council of 4 February 2014 "*on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010*".

b. the **Regulation (EU) No 1094/2010** "*establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority*)(…)", and

c. the **Regulation (EU) No 1095/2010** "*establishing a European Supervisory Authority (European Securities and Markets Authority)(…*)".

The ESFS, which entered into operation on 1 January 2011, is an integrated network of national and Union authorities. Within the ESFS, the former are competent for the day-to-day supervision of financial institutions, whilst the latter are responsible for conducting the macroprudential oversight of the financial system (i.e. ESRB) and ensuring the convergence of regulatory rules applicable across the EU (i.e. EBA, ESMA, EIOPA). The creation of the ESFS did not lead to the establishment of supranational supervisory authorities for the Union financial system. Micro-prudential supervision remained national, although financial regulation is developed at the European level.

Each of the ESAs (EBA, ESMA, EIOPA) is responsible for one of the three (3) sectors comprising the Union financial system, namely the banking sector, the securities sector and the insurance and occupational pensions sector. Given that they are entrusted mainly with regulatory tasks, these Authorities should be called European Regulatory Authorities, instead of **European Supervisory Authorities**, as referred to in the aforementioned founding Regulations.[40]

2. The European Banking Authority (EBA)

2.1 The scope of application and objectives of the EBA

Divergent regulatory frameworks and different supervisory approaches among the EU Member States could pose a risk of fragmentation of the single market, as banking groups could take advantage of the existing differences to pursue regulatory arbitrage. Therefore, the establishment of the EBA[41] aims to deliver the objective of coherent and convergent supervision across the whole Union by promoting a uniform legal framework and supervisory culture across the EU through a single rulebook and a single supervisory handbook.[42]

Based on the **Regulation 1093/2010** (**EBA Regulation**), the objective of the EBA is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses. The EBA can meet that objective by:[43]

a. improving the functioning of the internal market, including, in particular, a sound, effective and consistent level of regulation and supervision,

b. ensuring the integrity, transparency, efficiency and orderly functioning of financial markets,

[40] Supervision of Credit Rating Agencies and trade repositories by the ESMA is the sole exception from this norm.

[41] Concerning the legal status, the EBA is a Union body with legal personality. It enjoys in each Member State the most extensive legal capacity accorded to legal persons under national law. Particularly, it may acquire or dispose of movable and immovable property and be a party to legal proceedings.

[42] **Communication from the Commission** "*to the European Parliament and the Council: A Roadmap towards a Banking Union*", p. 5.

[43] **EBA Regulation**, Article 1(5).

c. strengthening international supervisory coordination,

d. preventing regulatory arbitrage and promoting equal conditions of competition,

e. ensuring that the taking of credit risk, as well as of other risks, are appropriately regulated and supervised, and

f. enhancing customer protection.

The scope of EBA's action is delimited by the following legislative acts:[44]

a. **Directive 2002/87/EC** of the European Parliament and of the Council of 16 December 2002 "*on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate*",

b. **Regulation (EC) No 1781/2006** of the European Parliament and of the Council of 15 November 2006 "*on information on the payer accompanying transfers of funds*",

c. **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*" (known as '**CRD IV**'),

d. **Regulation (EU) No 575/2013** of the European Parliament and of the Council of 26 June 2013 "*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*" (known as '**CRR**'),

e. **Council Regulation (EU) No 1024/2013** of 15 October 2013 conferring specific tasks "*on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*" (known as '**SSMR**'),[45]

f. **Directive 2014/49/EU** of the European Parliament and of the Council of 16 April 2014 "*on deposit guarantee schemes*" (known as '**DGSD'**),

g. **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 (…)*" (known as '**BRRD**').

In addition, the EBA acts within the scope of all Directives, Regulations and Decisions that have been issued based on the aforementioned legislative acts, and of any further legally binding Union act that confers tasks on the EBA. In addition, the EBA may act in the field of activities of credit institutions, financial conglomerates, investment firms, payment institutions and e-money institutions in relation to issues not covered by those legislative acts, including matters of corporate governance, auditing and financial reporting.

[44] *Ibid.*, Article 1(2).

[45] Also, the scope of action of the EBA is delimited by the following acts to the extent that they apply to credit institutions and financial institutions, as well as to the competent authorities that supervise them: ***Directive 2002/65/EC, Directive 2005/60/EC, Directive 2007/64/EC and Directive 2009/110/EC***.

2.2 The role and tasks of the EBA

2.2.1 An overview of the EBA's tasks and powers

As referred above, the EBA acts mainly as a regulatory authority, which entails that the tasks assigned upon it are related to drafting single regulatory and supervisory handbooks. These handbooks lay down rules applicable to banking groups and competent authorities[46] seeking to ensure a level playing field among market participants across the EU. A second dimension of the EBA's role as an EU authority is related to **promoting cooperation among competent authorities** either in going-concern situations or during crises.

Thus, the core tasks conferred upon the EBA pertain to:[47]

a. contribution to the establishment of a Single Rulebook, in particular by developing draft Regulatory Technical Standards (RTS), Implementing Technical Standards (ITS), Guidelines and Recommendations,

b. development and maintenance of a European supervisory handbook on the supervision of banking groups by setting out supervisory best practices on methodologies and processes, and

c. contribution to the consistent application of legally binding Union acts by:

    i. ensuring efficient and effective application of the acts included in the scope of the EBA,

    ii. mediating and settling disagreements between competent authorities,

    iii. ensuring a coherent functioning of colleges of supervisors, and

    iv. taking action in emergency situations.

For the purposes of achieving the aforementioned tasks,[48] the EBA is assigned with the power:[49]

a. to develop draft Regulatory and Implementing Technical Standards,

b. to issue Guidelines and Recommendations,

c. to take individual Decisions addressed to competent authorities and banking groups, in cases concerning directly applicable Union law,

d. to issue opinions to the European Parliament, the Council or the Commission, and

e. to collect the necessary information concerning banking groups.

Assessing the powers referred above, it is evident that the EBA is assigned with "soft" powers related particularly to issuing non-binding acts for the configuration of a uniform set of rules.

[46] For the purposes of this study, the term competent authorities covers supervisory authorities, resolution authorities and the authorities administering deposit guarantee schemes.

[47] **EBA Regulation**, Article 8(1).

[48] For an overview of the tasks and powers assigned upon the EBA, see **Gortsos (2011)**.

[49] **EBA Regulation**, Article 8(2).

2.2.2 The development of draft Regulatory and Implementing Technical Standards

Financial regulation is heavily detailed, complex and full of technical issues and terminology. These specificities are taken into account in the law-making process and, thus, extensive use of the provisions of the **Articles 290** and **291 of the TFEU** is made.

Article 290 of the TFEU introduced an innovative element in the Union legislative procedure allowing the European Parliament and the Council to delegate power to the Commission to adopt Delegated acts (along with the Commission Implementing acts adopted under **Article 291 of the TFEU**, collectively known as '**Level 2 acts**'). The objective of those acts regards the specification of basic provisions laid down in legislative acts.

The rationale behind delegating to the Commission the power to adopt Level 2 acts is associated with practical impediments that do not allow legislative acts to cover the full spectrum of technical issues that are necessary to be addressed. Legislative acts should constitute the framework reflecting the core political choices of the co-legislators leaving the technicalities to be resolved at by competent authorities and the EBA.[50]

The role of the EBA is critical in the procedure governing the adoption of Commission Delegated and Implementing acts in the field of financial regulation, given that it is competent for drawing up draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS) respectively and submitting them to the Commission for endorsement. The solution of the Commission Delegated and Implementing acts, which are based on RTS and ITS drafted by the EBA respectively, has been established because the EBA (the same applies to the ESMA and the EIOPA) does not have the power to issue legally binding acts. Such a power could only be conferred upon them by amending the TFEU, which is not an option for the time being.[51]

RTS and ITS are appropriate means both for specifying the principles and core provisions laid down in legislative acts and for establishing technical arrangements. They have certain characteristics, namely they are **technical**, **do not imply strategic decisions or policy choices** and **their content is delineated by the legislative acts on which they are based**. [52]

Though RTS are of technical nature, quite often legislative acts provide key political and strategic decisions to be taken with the means of technical standards. This is because a certain degree of political content is inevitable or because they use RTS as a means to break political deadlocks and postpone to a later stage the political solution of the issues at stake.[53]

Technical arrangements established under RTS and ITS would be impossible to be adopted within the legislative procedure due to lack of time and expertise on behalf of the co-legislators. The length of the legislative procedure relating to the adoption of the main legislative acts which have been issued within the crisis period did not exceed two (2) years. On the contrary, the necessary period for the adoption of the full set of RTS and ITS provided for in those legislative acts may exceed five (5) years. The heavy

[50] Although legislative acts should be framework-legal acts, in certain cases, they cover extensively and excessively detailed the arrangements laid down therein, which seem to fit appropriately in the scope of RTS, given the technical knowledge they require and the procedural aspects they cover.

[51] See **Gortsos (2015a)**, p. 40.

[52] **EBA Regulation**, Article 10(1).

[53] See **Cappiello (2015)**, p. 7.

workload for drawing up legal acts of such large scale justify the time delay, which would be even longer should those arrangements had to be adopted under the Level 1 procedure.

The content of ITS is more technical than that of RTS. In most cases, ITS establish uniform templates and formats, which are used by banking groups in order to provide supervisory authorities with information and data (i.e. supervisory reporting).

2.2.3 Guidelines and Recommendations issued by the EBA

The Level 3 of the EU financial law-making process provides for the issuance of Guidelines and Recommendations by the EBA. Although Guidelines and Recommendations are not legally binding instruments, they promote the consistent and uniform application of the EU banking law. Guidelines and Recommendations are considered "soft law", since there is no legal obligation for addressees to comply with the provisions included therein. Effective application of Guidelines and Recommendations is promoted by the **"comply or explain"** principle that urges the addressees concerned to implement the relevant arrangements.

Guidelines provide guidance to competent authorities and/or banking groups on the application of the arrangements laid down in legislative acts, thus, allowing them to adjust these arrangements to national specificities. Recommendations are addressed to all or some of the competent authorities or banking groups located in the EU requesting them to take specific action in order to ensure level playing field across the EU.

In contrast to Level 1 and Level 2 legal acts, the European Commission, the European Parliament and the Council cannot influence the decision-making process for Level 3 acts. These acts are adopted by the EBA's Board of Supervisors, which consists of the representatives of national supervisory authorities. Hence, Guidelines and Recommendations are issued by competent authorities and typically are addressed to competent authorities.

The addressees of Guidelines and Recommendations (i.e. competent authorities and banking groups) must make every effort to comply with those acts.[54] The "comply or explain" principle is exercised based on a specified process. Where a competent authority has no intention to comply with, it must inform the EBA stating its reasons for such inaction.

2.2.4 EBA's action in case of breach of Union law

The EBA is also assigned with the task to ensure that competent authorities and banking groups comply with the provisions laid down in the legal acts included in the scope of the EBA Regulation. In case that a competent authority has not applied the provisions included in a legal act or has applied them in a way which appears to be a breach of Union law, the EBA may exercise the powers conferred upon it by **Article 17 of the EBA Regulation**.

The EBA may investigate the alleged breach or non-application of Union law, upon request from one or more competent authorities, the European Parliament, the Council, the Commission or on its own initiative. In that case, the EBA may issue a Recommendation addressed to the competent authority concerned setting out the action necessary to comply with Union law. The addressee is obliged to inform the EBA of the steps it has taken or intends to take to ensure compliance with Union law. Where the competent authority has not complied with Union law within one (1) month from receipt of the EBA's Recommendation, the Commission may issue (either on its own initiative

[54] **EBA Regulation**, Article 16(3).

or after having been informed by the EBA) a formal Opinion requiring the competent authority to take the action necessary to comply with Union law. The Commission's formal opinion must take into account the EBA's Recommendation.[55] The competent authority must inform the Commission and the EBA of the steps it has taken or intends to take to comply with that formal Opinion.

Without prejudice to the powers of the Commission pursuant to **Article 258 of the TFEU**, in case of non-compliance of a competent authority with the Commission's formal Opinion, the EBA may adopt an individual decision addressed to a banking group requiring it to take the necessary action to comply with its obligations under Union law, including the cessation of any practice. The EBA may exercise that power only in respect of violations of requirements directly applicable to financial institutions.[56]

Based on the procedure described above, the EBA contributes to the consistent application of Union law by forcing competent authorities to execute their tasks in conformity with the arrangements established in legal acts. Thus, national competent authorities have limited discretion to apply divergent supervisory practices and to avoid ensuring compliance of banking groups with the directly applicable prudential requirements.

2.2.5 Action in emergency situations

As referred above, the EBA is assigned with the power to require banking groups to implement obligations established under directly applicable Union legal acts should the relevant competent authorities have not complied previously with the Commission's formal Opinion. Therefore, Commission's actions are prerequisite for the EBA to undertake initiatives towards ensuring banking groups' compliance with Union law.

This condition does not apply during emergency situations, where the EBA may act faster and directly in order to ensure that competent authorities execute their tasks in line with Union law. In such cases, the whole procedure is shortened, since Commission's intervention is not prerequisite for the EBA to take action. Specifically, the EBA is empowered to act in emergency situations by facilitating and, where deemed necessary, coordinating any actions undertaken by the relevant competent authorities.

The Council, in consultation with the Commission and the ESRB, may adopt a decision addressed to the EBA determining the existence of an emergency situation. Based on the Council's decision, the EBA may adopt individual decisions requiring competent authorities to take the necessary action to address any such adverse situation. These decisions aim to ensure that both competent authorities and banking groups act in accordance with the requirements laid down in Union law.

Without prejudice to the powers of the Commission pursuant to **Article 258 of the TFEU**, if a competent authority does not comply with the aforementioned decision taken by the EBA, the latter may adopt an individual decision addressed to a banking group requiring the necessary action to be taken in order to comply with its obligations, including the cessation of any practice. These powers may be exercised only in respect of requirements directly applicable to banking groups and only in situations in which a competent authority does not apply the legal acts included in the scope of the EBA Regulation or applies them in a way, which appears to be a breach of those acts.[57] The EBA's decision prevail over any previous decision adopted by the competent authorities on the same matter.

[55] *Ibid.*, Article 17(4).

[56] *Ibid.*, Article 17(6).

[57] *Ibid.*, Article 18(4).

The arrangements described above promote the role of the EBA as an authority competent for enforcing Union law during crises.

2.2.6 Mediation in settlement of disagreements between competent authorities

2.2.6.1 Binding mediation

Disputes among national competent authorities, mainly during crisis situations, render necessary the intervention and mediation of an independent authority to contribute to the settlement of such disputes. Therefore, the EBA Regulation has conferred upon the EBA the task to mediate among competent authorities, either on a binding or on a non-binding manner, should disagreements arise.

With respect to binding mediation, under **Article 19 of the EBA Regulation,** the EBA has the power to resolve disputes among competent authorities provided that certain conditions are met. Firstly, at least one of the competent authorities concerned has requested the EBA mediation.[58] Secondly, the option for mediation is permitted in any of the legislative acts included in the scope of the EBA Regulation. Under these conditions, a competent authority may request EBA's mediation, only if a legislative act (e.g. CRR, CRD IV, BRRD) provides that a disagreement on a specific issue can be settled under that way. In many cases, disagreements between competent authorities arise, when supervisory authorities or resolution authorities are going to take decisions in respect of a cross-border banking group. Such decisions may pertain to the level of capital requirements to apply to the banking group (at consolidated level) or to some of its entities (at individual level), as well as to the possibility to put a banking group into resolution.

Pursuant to **Article 19 of the EBA Regulation**, in case that a competent authority disagrees with the procedure or content of an action or inaction of another competent authority, the EBA may assist the competent authorities in reaching an agreement, upon request from one of them.[59] Following the receipt of request for mediation, the EBA sets a timeframe for conciliation between the competent authorities. During the conciliation period, an independent mediator brings the two (2) parties in the table trying to make them reach an agreement and end their dispute. If the two (2) parties do not reach an agreement, then the EBA has the role of an arbiter requiring the involved parties to take specific action or to refrain from any action in order to settle their agreement, with binding effects for the competent authorities concerned, in order to ensure compliance with Union law.[60]

Without prejudice to the powers of the Commission pursuant to **Article 258 of the TFEU**, if a competent authority does not comply with the aforementioned decision taken by the EBA, the latter may adopt an individual decision addressed to a banking group requiring the necessary action to comply with its obligations, including the cessation of any practice.

[58] *Ibid.*, Article 19(1).

[59] The EBA Regulation provides also that the EBA may undertake mediating action on its own initiative, where disagreement between competent authorities from different Member States can be determined. Nonetheless, the relevant arrangement is still inactive, as such provision is not included in a legislative act included in the EBA scope.

[60] See **European Banking Authority (2018a)**, p.74.

2.2.6.2 Non-binding mediation

In accordance with **Article 31(c) of the EBA Regulation,** the EBA may mediate in a non-binding way by assisting competent authorities to reach an agreement on a dispute having arisen. Similar to the arrangements governing binding mediation, the EBA may contribute to the settlement of a dispute, only upon request from an involved competent authority where such option is provided for in a legislative act included in the scope of the EBA Regulation. In this process, the EBA does not impose solutions or even find them for the parties, but it rather expresses its informal view.[61] Non-binding mediation has solely a consultative function, as competent authorities are not obliged to comply with the EBA's position.

The EBA has dealt with disputes relating to the joint decision procedure, which pertain mainly to capital requirements, liquidity, recovery planning and supervisory measures.[62] In addition, the EBA has helped supervisory authorities to resolve disputes about the need for ring-fencing measures imposed by host authorities.[63]

Nonetheless, competent authorities have resorted in few only cases to (binding and non-binding) mediation.[64] Limited resort to the mediation procedure may be attributed to the aversion of competent authorities to the role of the EBA and the uncertainty on the outcome of a binding decision taken by the EBA.

2.2.7 Coordination of EU-wide stress tests

The EBA, in cooperation with the ESRB, is responsible for the coordination of the Union-wide stress tests to assess the resilience of banking groups to adverse market developments.[65] The EBA's EU-wide stress tests are conducted every two (2) years in a bottom-up fashion, using consistent methodologies, scenarios and key assumptions developed in cooperation with the ESRB, the ECB and the Commission.

The EBA carried out its first EU-wide stress test exercise in 2011,[66] while the following stress test exercises took place in 2014, 2016 and 2018.

3. The European Systemic Risk Board (ESRB)

3.1 The rationale for establishing the ESRB

The international financial crisis revealed that the arrangements governing Union financial architecture placed too little emphasis on macro-prudential oversight of the financial system[67] and on interlinkages between developments in the broader

[61] *Ibid.*, p.74.

[62] *Ibid.*, p. 56.

[63] *Ibid.*, p. 93.

[64] See **European Banking Authority (2015b)**, p. 56.

[65] **EBA Regulation**, recital (43).

[66] In 2009, the CEBS conducted the first stress-test exercise, which did not disclose quantitative results. A year later, the CEBS carried out the second stress test exercise. For more on these exercises, see **Veron (2018).**

[67] Macro-prudential oversight aims to limit the distress of the financial system as a whole in order to protect the overall economy against significant losses in real output. This aim is achieved by adopting macro-prudential policies, which refer to the set of (mainly preventive) policies adopted and implemented to limit the financial system's exposure to systemic risk arising from factors not

macroeconomic environment and the financial system. During the crisis, significant drawbacks in financial supervision were revealed, which failed to detect adverse macro-prudential developments and prevent the accumulation of excessive risks in the financial sector.

Hence, it was necessary to take prompt action to address those deficiencies identified. Following the proposals of the Larosiere report, which recommended the establishment of a Union level body charged with the task of macro-prudential oversight of the EU financial system, European Parliament and Council adopted the **Regulation 1092/2010** "*on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board"*.

The macro-prudential oversight of the Union financial system became the first –and single until 2014- component of the Europeanized bank safety net.[68] In the context of the ESRB, macro-prudential tasks have been assigned upon the ECB in accordance with Council Regulation 1096/2010, which constitutes the first legal act issued based on **Article 127(6) of the TFEU**.

3.2 The role and tasks of the ESRB

The ESRB forms part of the ESFS and has been assigned with the task to monitor and assess systemic risk during normal times for mitigating the exposure of the financial system to the risk of failure and enhancing its resilience to systemic shocks. Thus, the ESRB contributes to the prevention or mitigation of the systemic risks to Union's financial stability. Such risks arise from developments within the financial system and macroeconomic developments.[69] Systemic risks are defined as risks of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy.

In that context, the ESRB has been assigned with the following tasks:[70]

- identification and prioritization of systemic risks,
- issuance of warnings, where such systemic risks are deemed to be significant and, where appropriate, making those warnings public,
- issuance of recommendations for remedial action in response to the risks identified and, where appropriate, making those recommendations public,
- when the ESRB determines that an emergency situation may arise, issuance of a confidential warning addressed to the Council accompanied with an assessment of the situation in order to enable the Council to assess the need to adopt a decision addressed to the ESAs determining the existence of an emergency situation, and
- close cooperation with all the other parties to the ESFS, and, where appropriate, provision of the ESAs with information on systemic risks and development of adverse scenarios for stress-tests exercises.

The main task of the ESRB is to identify systemic risks in the Union financial system and take the necessary measures to address them, mainly by issuing warnings and

associated with individual financial firms or individual markets and structures of the financial system, but of a more general nature.

[68] See **Gortsos (2015a),** p. 14.

[69] **Regulation 1092/2010**, Article 3(1).

[70] *Ibid.*, Article. 3(2).

recommendations for remedial action, including for legislative measures.[71] Warnings or recommendations may be of general or specific nature and can be addressed to the Union as a whole, one or more Member States, one or more of the ESAs (i.e. EBA, ESMA, EIOPA) and one or more of the competent authorities.

A warning seeks to raise awareness or draw attention of the addressee to a systemic risk. A recommendation is a more far-reaching policy tool, which specifies recommended remedial action. The ESRB decides, on a case-by-case basis, whether a warning or a recommendation should be made public, bearing in mind that disclosure can help to foster compliance.

[71] *Ibid.*, Article 16(1).

Section 2: The European Banking Union

1. The establishment of the Banking Union

1.1 The main pillars of the Banking Union

The international financial crisis (2007-2009) demonstrated that banking groups suffered from a series of weaknesses, namely low quality and quantity of capital, poor governance arrangements, overreliance on short-term funding and lack of macroprudential tools to address macroeconomic and cyclical dimensions of systemic risk. In 2010, the Basel Committee on Banking Supervision (BCBS) adopted the "**Basel III"** framework ("*A global regulatory framework for more resilient banks and banking systems*") to address these weaknesses of the former regulatory framework.[72]

The revised international regulatory framework was introduced into the European law through:

- the **Regulation (EU) No 575/2013** "*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*" (known as '**Capital Requirements Regulation**' or '**CRR**'), and
- the **Directive 2013/36/EU** "*on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (…)*" ('**Capital Requirements Directive no IV**' or '**CRD IV**').

The establishment of a single European regulatory authority (i.e. EBA) and the adoption of more rigorous rules relating to capital, liquidity and governance were in the right direction. Nonetheless, addressing the deficiencies of the regulatory framework would not be adequate to promote financial stability, unless a coherent and effective supervisory framework was established to ensure consistent enforcement of banking rules. Therefore, tightening the prudential requirements had to be accompanied with a radical modification of the institutional landscape in the area of banking supervision and resolution in the context of the Banking Union.

The establishment of the Banking Union would create a '**Europeanised bank safety net**' consisting of:[73]

a. a **Single Supervisory Mechanism (SSM)** that would be competent for supervising banking groups located in the Banking Union,

b. a **Single Resolution Mechanism (SRM)**, which would be responsible for executing the resolution tasks in respect of the banking groups included in the perimeter of the SSM,

c. a **Single Resolution Fund (SRF)** funded by contributions paid by banking groups to cover the costs arising from the implementation of resolution decisions taken in the context of the SRM,

d. a **Single Deposit Guarantee Scheme**, which would guarantee covered deposits of banking groups located in the Banking Union, and

[72] A revised version of the rules was adopted in June 2011, see **Basel Committee on Banking Supervision (2011)**.

[73] For an overview of the "Europeanized Bank Safety Net", see **Gortsos (2015b)**.

e. a **Single Rulebook** containing substantive rules on the previous areas (i.e. micro-prudential supervision, banking resolution, deposit guarantee[74]) aiming at a "total harmonization approach', as part of the single market for financial services.[75]

It is notable that except for the establishment of the Single Deposit Guarantee Scheme, all the other components of the Banking Union have been established.

1.2 The procedure towards establishing the Banking Union

1.2.1 First calls for setting up a Banking Union

The fiscal crisis that hit the euro area in 2010 sparked the debate about the need to set up a supranational institutional framework, upon which supervision and resolution of banking groups would be assigned, breaking, thus, the close links between sovereigns and banking systems. Towards that direction, at the Euro Area Summit of 29 June 2012 the political leaders decided that setting up the Banking Union is prerequisite for enhancing the Union financial stability and addressing fragmentation of the single market for financial services.

Prior to the Euro Area Summit of 29 June 2012, the President of the ECB, Mario Draghi, and the European Commission paved the way for a political discussion on the need to move forward and adopt significant changes in the architecture governing banking supervision and resolution. On 25 April 2012, Mario Draghi referred to the strengthening of banking supervision and resolution at the European level. At that period, the euro area crisis had reached its peak, as the Spanish banking sector was facing significant solvency problems. In specific, in his introductory statement at the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, he highlighted that:[76]

"*I see financial stability clearly as a common responsibility in a monetary union. During the crisis, we have observed strong negative spill-over effects across euro area countries and between the banking sector and its respective sovereign. National supervisors and Treasuries are also confronted with the well-known problem that during good times, large banks work as European institutions but in bad times fall on national shoulders. Ensuring a well-functioning EMU implies strengthening banking supervision and resolution at European level.*

European integration has brought peace and prosperity. While I hesitate to sketch out the long-term end point of the integration process, I am convinced that we need to actively step up our reflections about the longer-term vision for Europe as we have done in the past at other defining moments in the history of our union."

Under that statement, Mario Draghi called the euro area leaders to take initiatives in order to address the problems arising from the close connection of the banking systems with sovereigns. This statement is of particular importance, as the euro area political leaders also recognized this finding as the main source of risks for the banking system at the Euro Area Summit of 29 June 2012.

A few days after the speech of Mario Draghi, the European Commission published a Communication "*on action for stability, growth and jobs*" addressed to the EU institutions. In that Communication, the Commission proposed a number of elements that could form part of an initiative to enhance EU growth and create jobs. Among others, the Commission referred to the establishment of the Banking Union as one of the main

[74] The terms "deposit guarantee" and "deposit insurance" are used interchangeably within this document.

[75] See **Gortsos (2015b)**, p. 4.

[76] See **Draghi (2012)**.

building blocks for a deeper Economic and Monetary Union (EMU). The core objective of such an initiative was focused on promoting the single market for financial services under which banking groups, enjoying rights of free establishment and free provision of services, are subject to equivalent and proper supervision across the EU.[77]

In particularly, the Commission's Communication stated:

"*Looking beyond the immediate horizon, a longer-term perspective on the future of the EU's economic and monetary union is needed. The Commission will advocate an ambitious and structured response. Building on what has been achieved to date a process will be needed to map out the main steps towards full economic and monetary union. Showing our clear determination to go further, demonstrating the political commitment of Member States to the euro will be part of restoring confidence in the euro area and our ability to overcome current difficulties. This will require a wide-ranging process that will take account of legal issues. It must include a political process to give democratic legitimacy and accountability to further integration moves.* ***Mapping out the main building blocks could include, among other, moving towards a banking union including an integrated financial supervision and a single deposit guarantee scheme***."[78]

1.2.2 The European Council's report towards a genuine Economic and Monetary Union

In view of the European Summit of 28/29 June 2012, which was held concurrently with the Euro Area Summit of 28 June, the President of the European Council, Herman Van Rompuy, delivered a report that was prepared in collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB.[79] That report aimed at setting out a vision for the future of the EMU and how it can best contribute to growth, jobs and stability. The report proposed "*a vision for a stable and prosperous EMU*" based on four (4) building blocks:

a. an **integrated financial framework** to ensure financial stability in particular in the euro area and minimize the cost of banking failures to European citizens. Such a framework would elevate responsibility for supervision to the European level and provide for common mechanisms to resolve banking groups and guarantee customers' deposits,

b. an **integrated budgetary framework** to ensure sound fiscal policy applied at the national and European levels, encompassing coordination, joint decision-making, greater enforcement and commensurate steps towards common debt issuance,

c. an **integrated economic policy framework**, which would have sufficient mechanisms to ensure that national and European policies are in place to promote sustainable growth, employment and competitiveness, and are compatible with the smooth functioning of the EMU, and

d. ensuring the **necessary democratic legitimacy and accountability** of decision-making within the EMU, based on the joint exercise of sovereignty for common policies and solidarity.

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[77] **Communication from the Commission** "*to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the regions and the European Investment Bank, Action for stability, growth and jobs*", p.4.

[78] *Ibid.*, p. 5.

[79] See **European Council (2012b)**.

With regard to the first building block (i.e. the integrated financial framework), the report underlined the need to proceed to a single European banking supervision system and requested to explore the possibility to assign upon the ECB supervisory tasks based on **Article 127(6) of the TFEU**. Furthermore, the Rompuy report called for the establishment of a European resolution scheme and a European deposit insurance scheme. The European resolution scheme funded primarily by banking groups' contributions would provide financial support to the application of resolution measures to unviable banking groups. The European deposit insurance scheme would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible covered deposits[80] are sufficiently guaranteed.

The report called for submission by December 2012 of an additional report with detailed proposals for a stage-based approach towards a genuine EMU.

1.2.3 The Euro area Summit of 28 June 2012

In June 2012, at the peak of the euro area fiscal crisis, when Spanish banking sector was facing significant capital shortfalls, the euro area political leaders agreed on the necessity to promote the establishment of a Single Supervisory Mechanism in which the ECB would play a crucial role. Thus, they affirmed that "***it is imperative to break the vicious circle between banks and sovereigns***".[81] Furthermore, they called on the Commission to present proposals for the setting up of a Single Supervisory Mechanism based on **Article 127(6) of the TFEU**, which contains an enabling clause (known as the 'sleeping beauty clause')[82] that reads as follows:

"*The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings*".

That would be the second time that the aforementioned provision would serve as a legal basis for a Union legislative act. This Article had been also used as the legal basis for the **Council Regulation 1096/2010** "*conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board*."

The European Summit held at the same day invited the President of the European Council to develop, in collaboration with the President of the Commission, the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine EMU.[83] The deadline for submission of the report was set at the end of 2012.

1.2.4 The Commission's proposals on the establishment of the Single Supervisory Mechanism

Acting swiftly in response to the mandate given by the European Council and the Heads of State and Government of the Euro area, on 12 September 2012, the European Commission issued:

[80] Covered deposits are defined as deposits guaranteed by the Deposit Guarantee Scheme of the jurisdiction in which the banking group is located. Covered deposits amount up to €100,000 per depositor per banking group.

[81] See **Euro area Summit (2012)**.

[82] See **Gortsos (2015a),** p.53.

[83] See **European Council (2012a),** p. 4.

- a **Communication** concerning "*A roadmap for the Banking Union*",
- a **proposal for a Council Regulation** "*conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*", and
- a **proposal for a Regulation** of the European Parliament and of the Council "*amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*".

In the Communication, the Commission called on the European Parliament and the Council to reach an agreement on the aforementioned legislative proposals by the end of 2012,[84] as well as to examine, in the medium term, how to shape the conditions for the establishment of:[85]

- a supranational authority for the resolution of unviable banking groups,
- a supranational resolution fund to cover resolution costs incurred from the implementation of resolution decisions, and
- a supranational deposit guarantee scheme.

The Commission's proposal envisaged a 'vertical' transfer from the Member States to the ECB of specific tasks regarding micro-prudential supervision of banking groups.[86] The transfer of prudential supervision at supranational level would promote high standards of supervision and limit competitive distortion among Member States.[87]

The Commission's proposal provided that the ECB would be responsible for supervising all banking groups located in the Banking Union under a gradual staged approach.[88] The specific tasks conferred upon the ECB would be carried out within the framework of the Single Supervisory Mechanism, where National Supervisory Authorities (NSAs) would function as the ECB's executive arm.

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[84] Moreover, the Commission asked the European Parliament and the Council to reach an agreement before the end of 2012 on the following –pending- legislative proposals:

- the **proposal for a Directive** "*on access to the activity of credit institutions and investment firms*",
- the **proposal for a Regulation** "*on prudential requirements for credit institutions and investment firms*",
- the **proposal for a Directive** "*establishing a framework for the recovery and resolution of credit institutions and investment firms*", and
- the **proposal for a Directive** "*on deposit guarantee schemes*".

[85] See **Gortsos (2015a)**.

[86] See **Gortsos (2012)**, p. 12.

[87] See **Baglioni (2016)**, p. 8.

[88] Based on that proposal, the ECB would become competent for the supervision:

a. of banking groups having received or requested to receive state aid as of 1 January 2013,
b. of systemically important banking groups as of 1 July 2013, and
c. of the remaining banking groups as of 1 January 2014.

Section 3: The Single Supervisory Mechanism (SSM)

1. The legal framework of the SSM

1.1 The negotiations for the adoption of the SSM Regulation

Within fourteen (14) months from the submission of the Commission's legislative proposal on the establishment of the Single Supervisory Mechanism (SSM), the Council adopted the **Regulation 1024/2013** of 15 October 2013 "*conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*" (**SSM Regulation** or **SSMR**) on the basis on the **Article 127(6) of the TFEU**.[89] Taking into account the normal timeline for the EU law-making process, in that case the European institutions acted in an exceptionally short timeframe.

Although the role of the European Parliament is merely advisory under the special legislative procedure provided for in **Article 127(6) of the TFEU**, this did not apply to the adoption of the SSMR. In this case, the role of the European Parliament was more critical, since this Regulation was adopted along with the **Regulation 1022/2013** "*amending the Regulation 1093/2010*" (EBA Regulation). The latter was adopted under the ordinary legislative procedure, which means that both the European Parliament and the Council played a decisive role in adopting the act. Under these circumstances, the European Parliament could leverage more on the content of the SSMR asking for substantial amendments, given that setting impediments to the adoption of the Regulation 1022/2013 would delay the adoption of the SSMR. The interrelation between the two (2) legislative acts arose due to the fact that the legislative proposal amending the EBA Regulation included important changes to the voting modalities of the EBA's decision-making body (i.e. Board of Supervisors). These changes pertained mainly to the establishment of the necessary safeguards for Member States whose currency is not the euro to form a blocking minority in decisions taken by the EBA.

Having at its disposal such political leverage, the European Parliament achieved to reach an agreement with the ECB on the accountability obligations of the latter towards the former. Thus, based on **Article 20(8) of the SSMR**, in October 2013, the two (2) institutions signed an **Interinstitutional Agreement** "*on the practical modalities of the exercise of democratic accountability and oversight over the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism*" (2013/694/EU). Pursuant to that agreement, the ECB undertook enhanced cooperation and accountability obligations, related mainly to the provision of information to the European Parliament and the recognition of enhanced role for the European Parliament in the selection procedures for the Chair and Vice-Chair of the Supervisory Board (i.e. the decision-making body of the ECB for supervisory issues).

1.2 The legal acts on the establishment and functioning of the SSM

The SSMR laid down the objective of the SSM and the basic arrangements governing the micro-prudential supervision of banking groups located in the Banking Union. The objectives of the SSM are associated with the Union financial stability and integration of the internal market. That can be clearly identified in **Article 1 of the SSMR**, which reads as follows:

"*This Regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State, with full regard and duty of care for the unity and integrity of*

[89] For an analysis of the provisions of the SSMR, see **Gortsos (2015a)** and **Wymeersch (2014)**.

the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage".

Based on the provision above, it is assumed that the establishment of the SSM seeks to:

- enhance the Union financial stability by minimizing the risks that banking groups pose to it, and
- promote the internal market by ensuring that banking groups would no longer take advantage of the loopholes existing in the Union and national legislation under the implicit forbearance of NSAs.

The SSMR contains provisions relating to the establishment and functioning of the SSM, namely the scope of application, the cooperation between the ECB and NSAs, as well as the tasks conferred on them. In addition, the SSMR governs the investigatory and supervisory powers of the ECB and the organizational arrangements of the SSM. These arrangements have been further developed and specified in the **Regulation 468/2014 of the ECB** "*establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities"* (**SSM Framework Regulation** or **SSMFR**).

The SSMFR adopted under **Article 6(7) of the SSMR** specifies rules, among others, on the following aspects:[90]

- the methodology for the assessment and review of whether a banking group is classified as significant or less significant,
- the procedures concerning the cooperation between the ECB and NSAs regarding the micro-prudential supervision of significant and less significant banking groups,
- the procedures governing the cooperation between the ECB, NSAs and National Designated Authorities (NDAs)[91] regarding the execution of macro-prudential tasks,
- the procedures on the cooperation between the ECB and NSAs relating to the exercise of investigatory powers stipulated in **Articles 10-13 of the SSMR**, and
- the procedures applicable to the sanctioning powers of the ECB and NSAs in the context of the SSM.

Several legal acts adopted by the ECB have also established arrangements relating to the functioning of the SSM and operational framework for carrying out supervision.

1.3 Applicable law

The ECB under its supervisory function is responsible for the enforcement of Union law related to the supervisory tasks conferred upon it. Pursuant to **Article 4(3) of the SSMR,** the ECB applies all relevant Union law, and where this Union law is composed of Directives, the national law transposing those Directives. Based on that provision, the ECB ensures compliance of banking groups with:

- the **directly applicable legislative acts**, namely Regulations adopted by the European Parliament and the Council (Level 1 acts),

[90] **SSMFR**, Article 1(1).

[91] National Designated Authorities (NDAs) are defined as the national authorities assigned by Member States with the tasks relevant to application of macro-prudential tools adopted based on the CRD IV and CRR.

- the **directly applicable rules adopted by the Commission**, namely Commission Delegated and Implementing Regulations (Level 2 acts),
- the **national law transposing Directives**, and
- the **legal acts adopted by the ECB**, such as Regulations, Decisions and Recommendations.

In addition, the ECB is addressee of the Guidelines and Recommendations issued by the EBA (Level 3 acts) being subject to the "comply or explain" principle, as it holds for other supervisory authorities.

With respect to the aforementioned principles some considerations are raised. In respect of **Directives**, the ECB is obliged to implement the provisions included in the national law of the 19 participating in the Banking Union Member States. Although Directives are binding as to the result to be achieved, any discrepancies related to transposition into national law enhance the regulatory divergence among jurisdictions.

In some cases, Regulations and Directives grant **options to Member States** allowing them to retain in place some national arrangements (e.g. supervisory reporting requirements) in parallel with the Union requirements. Such provisions impede the ECB's work to promote a harmonized framework of supervision, since it is obliged to apply the national legislation exercising those options.[92]

Furthermore, certain Union legislative acts (e.g. CRR, CRD IV) **provide supervisory authorities with options and discretions** to have the necessary flexibility to address national specificities and idiosyncrasies of their national banking systems. In these cases, the ECB is not obliged to follow the arrangements adopted by NSAs prior to the establishment of the SSM but it may apply a single approach across the Banking Union. To that end, the ECB has issued the **Regulation 2016/445** "*on the exercise of options and discretions available in Union law*", the **Guide** "*on options and discretions available in Union law*" and the **Addendum to the ECB Guide** *"on options and discretions available in Union law*".

Lastly, since the SSMR provides that the **ECB applies only Union law and not the national law** related to the scope of its supervisory tasks, the ECB must require NSAs to apply the relevant provisions to banking groups.

1.4 The types of legal acts adopted by the ECB

In the context of exercising its supervisory tasks, the ECB adopts different types of legal acts based on the type of addressees (NSAs or banking groups), the number of addressees (general application or bank-specific) and whether the relevant legal act is issued based on a legislative act (e.g. CRR, CRD IV) or on the ECB's initiative to address an issue not covered by a legislative act. Since 2014, the ECB has issued the following types of legal acts relating to supervisory issues:[93]

(A) Regulations: legally binding acts of general application, which are issued by the ECB to organize or specify arrangements for the execution of its supervisory tasks (e.g. SSM Framework Regulation).

(B) Supervisory Decisions: legally binding acts addressed to specific banking groups granting rights or imposing obligations to the addressees. Decisions may include ancillary provisions, such as time limits, conditions, obligations or non-binding recommendations. Unless adopted by means of delegation, a draft decision is approved

[92] **SSMR**, Article 4(3).

[93] See **ECB SSM Supervisory Manual**, pp. 19-21.

by the Supervisory Board and subsequently submitted to the Governing Council for adoption under the non-objection procedure[94] (e.g. annual SREP decisions).

(C) Decisions of general application: the ECB may issue such decisions for binding procedural requirements which are applicable to all banking groups, subset thereof or NSAs. The core objective of these decisions is to make clear the ECB's supervisory expectations against banking groups (e.g. Decision ECB 2014/5 "*on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro*").

(D) Guides/Guidances: although non-binding acts, the ECB expresses its supervisory expectations from banking groups in relation to areas, such as options and discretions available in Union law, fit and proper assessments, leveraged transactions and the treatment of non-performing loans. Banking groups may explain their deviation from the rules included in these acts (e.g. ECB Guidance "*to banks on non-performing loans*").

(E) Recommendations: legal acts that express the ECB's non-binding supervisory expectations either to banking groups or relevant third parties, or to NSAs. The ECB may issue non-binding Recommendation to NSAs, as an alternative to binding Guidelines, in order to provide more flexibility.

(F) Instructions: the ECB may use this tool to instruct NSAs to make use of their powers under national law to execute tasks conferred upon the ECB under the SSMR. In addition, the ECB may issue general instructions to NSAs regarding the execution of tasks in relation to banking groups under their remit.

(G) Guidelines: binding legal acts addressed to NSAs specifying the results that need to be achieved, though allowing for flexibility in terms of execution. Guidelines play a significant role in ensuring common standards of supervision.

Albeit non-binding, Guides and Guidances constitute a significant policy tool for the ECB to set out prudential requirements beyond those prescribed in legislative acts. The ECB uses this option to address issues inadequately covered or not covered at all by Legal 1 acts and foster supervisory convergence. In this regard, it is worth mentioning that the ECB has chosen to address the problem of non-performing loans through the issuance of the **Guidance** *"to banks on non-performing loan*" and the **Addendum to the ECB Guidance** *"to banks on nonperforming loans: supervisory expectations for prudential provisioning of non-performing exposures*".

Both acts are not legally binding, but the ECB expects that banking groups should explain and substantiate any deviation from their provisions. Compliance with the arrangements established under these acts is taken into consideration in the annual SREP and non-compliance may trigger supervisory measures. Hence, banking groups have no other option than to comply with the ECB's expectations, as non-compliance with them would

[94] Taking into account the legal limitations on assigning upon the Supervisory Board decision-taking powers, as well as the aim to avoid conflict of interests between monetary and supervisory functions, the SSMR introduced a non-objection procedure for decisions relating to the ECB's supervisory tasks. The non-objection procedure involves both the Supervisory Board and the Governing Council. The Supervisory Board is competent for preparing and submitting to the Governing Council draft decisions. Draft decisions are considered adopted, unless the Governing Council raises objections within a (maximum) period of ten (10) working days. Should an emergency situation arise, the aforementioned period must not exceed 48 hours. The Governing Council may object to draft decisions. Nevertheless, it must justify the reasons for doing so in writing, mainly when concerns regarding monetary policy arise. It is worth mentioning that the Supervisory Board prepares approximately 1,500 draft decisions annually. The Governing Council has not declined yet any draft decision of the Supervisory Board.

trigger supervisory measures, including, but not limited to, the imposition of increased capital requirements.

2. The institutional arrangements of the SSM

2.1 The fundamental elements of the SSM

2.1.1 The perimeter of the SSM

Euro area Member States participate mandatorily in the Banking Union and, therefore, the SSM's perimeter contains mainly and in principle all banking groups incorporated in those Member States (participating Member States). In addition, Member States whose currency is not the euro may decide to participate in the Banking Union under the regime of the 'close cooperation' between the ECB and their NSA. In such case, the banking groups located in those Member State are also included in the scope of the SSM.

The scope of the SSM encompasses entities established in participating Member States, namely credit institutions,[95] financial holding companies,[96] **mixed financial holding companies**[97] and **branches of credit institutions** located in non-participating Member States.

For the purposes of the present study, the aforementioned entities will be called collectively 'banking groups' or 'groups', unless otherwise stated.

Branches of banking groups established in third countries, as well as the institutions referred to in **Article 2(5) of the CRD IV** are not included in the perimeter of the SSM.[98]

2.1.2 The structure of the SSM

The SSM is a system of micro-prudential supervision of banking groups located in participating Member States. The SSM is neither an authority nor an agency and has no legal personality. With respect to its components, the SSM is composed of the ECB and the NSAs of the participating Member States. Until the commencement of the SSM, each Member State assigned the responsibility for banking supervision either on its National Central Bank (NCB) or on an administrative authority. Currently, the majority (11 out of 19) of the Member States have authorized their NCBs to act as supervisory authority (see ***Table 1***).

[95] In accordance with Article 1(1)(1) of the CRR, the '**credit institution**' is defined as "*an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*".

[96] Under Article 1(1)(20) of the CRR, the '**financial holding company**' is defined as "*a financial institution, the subsidiaries of which are exclusively or mainly institutions or financial institutions, at least one of such subsidiaries being an institution, and which is not a mixed financial company*".

[97] Under Article 2(15)(21) of the ***Directive 2002/87/EC***, the '**mixed financial holding company**' is defined as "*a parent undertaking, other than a regulated entity, which together with its subsidiaries, at least one of which is a regulated entity which has its head office in the Community, and other entities, constitutes a financial conglomerate*".

[98] Indicatively, central banks, post office giro institutions, the 'Tamio Parakathikon kai Danion' (Greece), the 'Cassa depositi e prestiti' (Italy).

Table 1: National Supervisory Authorities (NSAs) in euro area

Country	National Supervisory Authority (NSA)
Austria	Finanzmarktaufsicht
Belgium	Nationale Bank van België/Banque Nationale de Belgique (NCB)
Cyprus	Central Bank of Cyprus (NCB)
Estonia	Finantsinspektsioon
Finland	Finanssivalvonta
France	Autorité de contrôle prudentiel et de résolution
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht
Greece	Bank of Greece (NCB)
Ireland	Central Bank of Ireland (NCB)
Italy	Banca d'Italia (NCB)
Latvia	Finanšu un kapitāla tirgus komisija
Lithuania	Lietuvos bankas (NCB)
Luxemburg	Commission de Surveillance du Secteur Financier
Malta	Malta Financial Services Authority
Netherlands	De Nederlandsche Bank (NCB)
Portugal	Banco de Portugal (NCB)
Slovakia	Národná banka Slovenska (NCB)
Slovenia	Banka Slovenije (NCB)
Spain	Banco de España (NCB)
Note: NCB stands for National Central Bank	

It is worth mentioning that the SSM has a different institutional architecture from the Eurosystem,[99] which operates under the principle of decentralization.[100] In the Eurosystem, NCBs constitute the executive arms of the ECB being responsible for the implementation of the decisions taken by the latter as a monetary authority. On the contrary, within the SSM, NSAs cooperate with the ECB, but retain their role to act autonomously, at least in respect of some areas, which will be described below in ***3.1***.

Assigning on the ECB the full responsibility for supervising all banking groups located in participating Member States would be a huge task for the ECB to cope with. Should such a decision had been taken, it is plausible to assume that the SSM would be in a very difficult position to accomplish its objectives. This assumption is mainly based on the following considerations:

- the magnitude of the task (supervision of 4,000 banking groups) assigned upon a newly established supervisory authority (ECB) with limited expertise on banking supervision,

[99] The Eurosystem comprises the ECB and the National Central Banks of those countries that have adopted the euro.

[100] See **Gortsos (2015a)**, p. 88.

- the divergent supervisory practices applied to 19 Member States that would have be unified within a very short timeframe, and
- the obligation of the ECB to execute its tasks not only in accordance with Union law but also under the national legal framework applied across participating Member States.

Therefore, the Council considered appropriate to adopt a functional approach based on which the ECB would be responsible for direct supervision of the largest and most significant banking groups. In principle, NSAs are responsible for the supervision of less significant banking groups, albeit subject to the ECB's instructions. Furthermore, the ECB may assume direct supervision of a less significant banking group, where appropriate.

As of 1 September 2018, the ECB was responsible for the supervision of 118 significant banking groups (see ***Table 2***) that own and control more than 1,100 entities, whereas NSAs were competent for supervising the remaining (above 3,000) banking groups located in participating Member States.[101]

Table 2: Banking groups directly supervised by the ECB

Country	Number of the ECB-supervised banking groups
Austria	6
Belgium	7
Cyprus	3
Estonia	3
Finland	3
France	12
Germany	21
Greece	4
Ireland	5
Italy	12
Latvia	3
Lithuania	3
Luxemburg	6
Malta	3
Netherlands	6
Portugal	3
Slovakia	3
Slovenia	3
Spain	12
TOTAL	**118**

Source: *European Central Bank, List of supervised entities (Cut-off date: 1 September 2018)*

[101] The list of supervised entities is available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.list_of_supervised_entities_201810.en.pdf

2.1.3 Criteria for the determination of significant banking groups

The SSMFR established certain criteria for the classification of banking groups into two (2) categories, namely significant and less significant banking groups. In particular, a banking group is considered significant, where it fulfils one of the following criteria:[102]

a. the total value of the group's assets exceeds €30bn (**size criterion**),

b. the total value of the group's assets exceeds both €5bn and 20% of the GDP of the participating Member State where it is located (**criterion of importance for the economy of the Union or any participating Member State**),

c. the banking group has significant cross-border activities (**criterion of significant cross-border activities**), namely:

   - the ratio of its cross-border assets to its total assets is above 20%,[103] or
   - the ratio of its cross-border liabilities to its total liabilities is above 20%,[104]

d. the participating Member State, where the banking group is incorporated, has submitted a request for direct public financial assistance from the European Stability Mechanism (ESM) in respect of the group,[105]

e. the banking group is among the three (3) most significant banking groups of a participating Member State in terms of assets.[106]

Article 57 of the SSMFR provides that the ECB, either on its own initiative or upon request from the NSA concerned, may take into account the following criteria for the assessment of the significance of a banking group, for reasons other than those set out in point b) above:

a. the significance of the banking group for specific economic sectors in the EU or in a participating Member State,

b. the interconnectedness of the banking group with the economy of the EU or a participating Member State,

c. the substitutability of the banking group as both a market participant and client service provider, and

d. the business, structural and operational complexity of the banking group.

2.1.4 Derogations from the procedure for the assessment of significance

The legal framework provides the ECB with the discretion to undertake direct supervision of banking groups, even if they do not satisfy the criteria referred above. Thus, the ECB may decide at any time, either on its own initiative or upon request from

[102] **SSMFR**, Article 39(3).

[103] Cross-border assets are defined as the part of the total assets in respect of which the counterparty is a banking group or other legal or natural person located in a participating Member State other than the Member State in which the parent undertaking of the relevant supervised group has its head office.

[104] Cross-border liabilities are defined as the part of the total liabilities in respect of which the counterparty is a banking group or other legal or natural person located in a participating Member State other than the Member State in which the parent undertaking of the relevant supervised group has its head office.

[105] **SSMFR**, Article 61.

[106] *Ibid.*, Article 65.

the NSA concerned, to exercise directly the supervision of a less significant banking group based on the following criteria:[107]

a. whether or not the less significant banking group is close to meeting one of the criteria referred above,

b. the interconnectedness of the less significant group with other banking groups,

c. the fact that the ECB's instructions have not been followed by the NSA concerned,

d. the fact that the NSA concerned has not complied with the acts included in the scope of the SSMR, or

e. the fact that the less significant banking group has requested or received indirectly financial assistance from the ESM.

On the other hand, the supervision of a banking group classified as significant may be assumed by the NSA of the participating Member State where it is located if particular circumstances exist that justify such an ECB decision.[108]

2.2 Cooperation arrangements

2.2.1 Cooperation within the SSM in respect of exchange of information

In spite of the clear allocation of tasks between the ECB and NSAs, the SSMR provides for certain areas of cooperation and cases where the ECB may substitute NSAs in the execution of their tasks.[109] Aiming to achieve a harmonized framework of supervision, the ECB is empowered to exercise the following powers in respect of less significant entities:[110]

- issue Regulations, Guidelines or general instructions to NSAs according to which the latter carry out their tasks and take supervisory decisions,
- exercise oversight over the functioning of the SSM,
- make use of the investigatory powers conferred upon it pursuant to **Articles 11-13 of the SSMR** in respect of less significant banking groups,
- request, on an ad hoc or continuous basis, information from NSAs on the performance of their tasks.

Article 21 of the SSMFR lays down an obligation for the ECB and NSAs to cooperate effectively and exchange information. In particular, without prejudice to the ECB's power to receive directly information from banking groups, NSAs are obliged to provide the ECB in a timely and accurate manner with all the necessary information to carry out its supervisory tasks. Respectively, the ECB must transmit to the NSAs concerned information received from legal or natural persons. That holds mainly for information necessary for NSAs to carry out their role in assisting the ECB.[111]

[107] *Ibid.*, Article 67(2).

[108] Particular circumstances must be strictly interpreted and are considered as specific and factual circumstances that make the classification of a banking group as significant inappropriate, taking into account the objectives and principles of the SSMR and, in particular, the need to ensure the high application od standards. The assessment of an entity falling within this case must be made on a case-by-case basis and specifically for the banking group concerned and not for categories of banking groups.

[109] **SSMR**, Article 6(2).

[110] *Ibid.*, Article 6(5).

[111] **SSMFR**, Article 21(2).

The cooperation arrangements between the ECB and NSAs reflect the primary role of the former in the functioning of the SSM. In addition to holding the responsibility for supervising directly the largest banking groups, the ECB is empowered to provide NSAs with instructions in respect of supervision of less significant banking groups with which NSAs are obliged to comply.

Although NSAs do not function as executive arms of the ECB, it is obvious that their actions are subject to the binding rules and guidance issued by the ECB. NSAs enjoy a significant grade of autonomy in executing their tasks, being though under the oversight of the ECB, which may start supervising directly any less significant banking group, should the NSA concerned underperform or execute its tasks beyond the limits set by the ECB.

Under the arrangements referred above, the ECB promotes the establishment of a harmonized framework of supervision applied across the Banking Union.

2.2.2 NSAs' contribution to supervision of significant banking groups

Although the ECB carries the responsibility for supervising the significant banking groups, NSAs assist the ECB in performing this task. Activities performed by NSAs, in each case under the ECB's instructions, are constrained to operational arrangements and the enforcement of ECB's decisions.[112] Pursuant to **Article 90 of the SSMFR**, NSAs assist the ECB in carrying out its supervisory tasks by submitting draft decisions to the ECB in respect of significant banking groups and assisting the ECB in the enforcement of its decisions. Furthermore, NSAs assist the ECB in the preparation and implementation of acts relating to the exercise of its supervisory tasks, including in assisting in verification activities and the day-to-day assessment of the situation of significant banking groups. NSAs may submit draft decisions to the ECB concerning the exercise of supervisory tasks either upon request from the ECB or on their own initiative.

Furthermore, close cooperation between the ECB and NSAs is necessary in case that a significant banking group is under severe stress situation. **Article 92 of the SSMFR** provides that the ECB and NSAs must exchange information relating to significant banking groups where there is a serious indication that those groups can no longer be relied on to fulfil their obligations towards their creditors and cannot provide security for the assets entrusted to them by their depositors, or there are circumstances that could lead to a determination that the banking group concerned is unable to repay its depositors.

2.2.3 Cooperation between the ECB and other agencies

Based on the legal framework of the SSM, the ECB must cooperate closely and effectively with other authorities of the international and European financial system. In that context, the ECB must cooperate with:

- **supervisory authorities of non-participating Member States** by concluding Memorandum of Understanding (MoUs) that describe in general terms how they cooperate with one another in the performance of their supervisory tasks, while specific MoUs must be concluded with the supervisory authority of each non-participating Member State in which is located at least a Global Systemically Important Institution (G-SII),

[112] For a more thorough analysis of the cooperation of the ECB with the NSAs, see **Tröger (2013).**

- **the authorities consisting the ESFS**, namely the EBA, the ESMA, the EIOPA and the ESRB,
- **resolution authorities**, mainly with regard to the preparation of resolution plans,[113]
- **competent authorities of Member States responsible for markets in financial instruments** through signing MoUs,[114] and
- any **public financial assistance facility**, including the ESM, in particular where such a facility has granted or is likely to grant direct or indirect financial assistance to a banking group included in the scope of the SSM.[115]

In 2016, the ECB initiated overall 24 negotiations for the conclusion of cooperation agreements with supervisory authorities from non-participating Member States, third countries and EU market supervisory authorities. In December 2016, the ECB concluded MoUs with the supervisory authorities of Sweden, Norway, Denmark and Finland with regard to supervising branches that are considered significant **under Article 51 of the CRD IV**. The MoUs cover matters related to ongoing supervision, such as participation in supervisory colleges, the exchange of information and on-site inspections.[116] Also, the ECB has concluded MoUs with the EBA, the SRB and the ESMA. So far, the ECB has signed two (2) MoUs with supervisory authorities from third countries, while it is expected shortly to sign MoUs with other eight (8) supervisory authorities. These MoUs will facilitate the supervision of banking groups with presence in third countries or groups whose parent entity is located in third countries covering issues relating to information exchange, cooperation in ongoing supervision as well as in crises and conduct of on-site inspections and internal models' investigations.[117]

2.3 The close cooperation procedure

2.3.1 The establishment of a close cooperation procedure

The Banking Union, though primarily consists of euro area Member States, gives the opportunity to Member States whose currency is not the euro also to participate in. For that purpose, a close cooperation must be established between the ECB and the NSA of such a Member State.[118]

The close cooperation procedure is established by an ECB decision, where the following conditions are met:

a. the Member State concerned notifies the other Member States, the Commission, the ECB and the EBA of its request to enter in a close cooperation with the ECB in which the latter will be responsible for exercising its supervisory powers over the banking groups established in its territory,

b. in the notification, the Member State concerned commits:

   i. to ensure that its NSA or NDA will abide by any guidelines or requests issued by the ECB,

[113] **SSMR**, Article 3(4).

[114] *Ibid.*, Article 3(1).

[115] *Ibid.*, Article 3(5).

[116] See **European Banking Authority (2017a)**, p. 43.

[117] *Ibid.*, p. 44.

[118] **SSMR**, Article 7(1).

ii. to provide all the necessary information on the banking groups incorporated in its jurisdiction that the ECB may require for the purpose of carrying out a comprehensive assessment[119] of those groups,

c. the Member State concerned has adopted relevant national legislation to ensure that its NSA will be obliged to adopt any measure requested by the ECB in relation to banking groups.

2.3.2 Supervisory arrangements under a close cooperation procedure

The framework governing micro-prudential supervision and execution of macro-prudential tasks over banking groups located in Member States which have established close cooperation is identical to that applied to banking groups located in euro area. However, given that the ECB does not have directly applicable powers over banking groups located in those Member States, the procedural arrangements governing the enforcement of ECB's decisions differ.

Since the ECB is not empowered to issue legally binding acts addressed to natural or legal persons located in Member States whose currency is not the euro, the SSMR established a procedure that includes the relevant NSA as an intermediate between the ECB and the significant banking groups. Instead of addressing decisions directly to those banking groups, the ECB may give instructions, make requests or issue guidelines to the NSA of the Member Stare concerned.[120] That NSA is responsible for addressing those decisions to the banking groups in accordance only with the ECB's instructions.

The same process is applied with regard to the ECB's investigatory powers stipulated in **Articles 10-13 of the SSMR (**see below, under **3.5.2**). The NSAs of non-euro area Member States must make use of those investigatory powers in accordance with the ECB's instructions. Hence, the framework governing close cooperation assigns upon the ECB the task of substantive supervision over significant banking groups located in those Member States, while the NSAs act as executive arms of the ECB in the enforcement of its decisions.

Consequently, NSAs are obliged to apply the ECB's decisions in respect of supervision of significant banking groups without having the right to deviate from them, while they remain competent for supervising less significant banking groups, as holds for the NSAs of euro area Member States.

2.3.3 Suspension or termination of close cooperation upon determination of non-compliance with accession requirements

Article 7 of the SSMR contains provisions enabling the ECB to terminate a close cooperation agreement, where it determines non-compliance of the Member State or the NSA concerned with the entry requirements described above (see above, in ***2.3.1***). At first stage, the ECB may issue a warning to the Member State concerned that the close cooperation will be suspended or terminated if no decisive corrective action is undertaken, where it considers either that the aforementioned conditions for the

[119] The Comprehensive Assessment is a fully-fledged exercise conducted by supervisory authorities, which includes an Asset Quality Review and a stress-test exercise. The Comprehensive Assessment aims to identify deficiencies in the balance sheet of banking groups (e.g. non-performing loans, overestimated values of collateral) and capital shortfalls might arise in the medium term (i.e. the next 3 years) under both a baseline and adverse macroeconomic scenario.

[120] **SSMFR**, Article 108(1).

establishment of the close cooperation are no longer met by the Member State concerned or that the NSA concerned does not act in accordance with the ECB's decisions and instructions.[121]

The addressee of the notification must take the necessary action within fifteen (15) days to address the concerns raised by the ECB. Should the ECB demonstrate that no appropriate action has been taken in response to its warning, it may suspend or terminate the close cooperation with that Member State. The decision must indicate the date from which it applies, taking account of supervisory effectiveness and legitimate interests of banking groups.

2.3.4 Termination of the close cooperation on Member State's own initiative

The SSMR contains provisions allowing a Member State whose currency is not the euro, and has established a close cooperation, to leave the SSM on its own initiative. Such a decision may be taken in case that the Member State concerned:

- triggers the clause included in the SSMR to terminate its participation in the SSM after three (3) years from its entry,
- disagrees with an objection of the ECB's Governing Council to a draft decision of the Supervisory Board, and
- disagrees with a draft decision of the Supervisory Board.

Article 7(6) of the SSMR provides a Member State whose currency is not the euro with the option to leave the SSM by abolishing close cooperation between the ECB and its NSA. Thus, the Member State concerned may request the ECB to terminate the close cooperation at any time after a lapse of three (3) years from the date of the publication of the ECB's decision on the establishment of the close cooperation in the Official Journal (OJ) of the EU. This request must explain the reasons for the termination, including any potential significant adverse consequences regarding the fiscal responsibilities of the Member State. In that case, the ECB is obliged to adopt immediately a decision terminating the close cooperation and indicating the date from which it applies within a maximum period of three (3) months.

Furthermore, a Member State whose currency is not the euro may leave the SSM in case that it notifies the ECB of its reasoned disagreement with an objection of the Governing Council to a draft decision of the Supervisory Board. The SSMR provides Member States whose currency is not the euro with that option, since they do not participate in the decision-making in the Governing Council, where only euro area Member States participate in. In that case, the Governing Council must, within a period of thirty (30) days, give its opinion on the reasoned disagreement expressed by the Member State and confirm or withdraw its objection.[122] If the Governing Council insists on its objection, the Member State concerned may notify the ECB that it will not be bound by the potential decision related to a possible amended draft decision by the Supervisory Board. Following that, the ECB must consider the possible suspension or termination of the close cooperation with that Member State and take a decision in that respect. In particular, the ECB must take into account two (2) factors. Firstly, whether the absence of such suspension or termination could jeopardize the integrity of the SSM or have significant adverse consequences on the fiscal responsibilities of the Member State concerned. Secondly, whether or not it is satisfied that the NSA concerned has adopted measures, which, in the ECB's opinion:

[121] **SSMR**, Article 7(5).

[122] *Ibid.*, Article 7(7).

- ensure that banking groups established in the Member State concerned are not subject to a more favorable treatment than banking groups in the other participating Member States, or
- are equally effective as the decision of the ECB's Governing Council with which the Member State concerned disagrees, in achieving the objectives of the SSM and in ensuring compliance with relevant Union law.

If a participating Member State whose currency is not the euro disagrees with a draft decision of the Supervisory Board, it must inform the Governing Council of its reasoned disagreement within five (5) working days from the receipt of that draft decision. The Governing Council must then decide about the matter within a specific timeframe (five working days), taking fully into consideration those reasons, and explain in writing its decision to the Member State concerned. The Member State concerned may request the ECB to terminate the close cooperation with immediate effect and will not be bound by the ensuing decision.[123] **Article 7(9) of the SSMR** contains a clause, which prohibits a Member State that has terminated the close cooperation with the ECB, from entering into a new close cooperation before a lapse of three (3) years from the date of the publication of the ECB's decision terminating the close cooperation in the OJ of the EU.

3. Micro-prudential supervision carried out by the ECB

3.1 Allocation of tasks within the SSM

3.1.1 Tasks related to micro-prudential supervision

Within the SSM there is a clear allocation of tasks between the ECB and NSAs in respect of conducting micro-prudential supervision, since the ECB is responsible for significant banking groups, whilst NSAs are competent for less significant banking groups. Nonetheless, that distinction does not apply to tasks concerning common procedures[124] and macro-prudential tasks, as a special decision-making procedure is envisaged providing both the ECB and NSAs with relative powers.

The SSMR assigned upon the ECB specific supervisory tasks and rendered it the sole competent for the execution of micro-prudential supervision in respect of significant banking groups. Thus, the supervisory tasks of the ECB can be grouped into three (3) categories:

i. **ensuring compliance of banking groups with the prudential requirements** laid down in Union law, particularly with regard to capital requirements, securitisations, large exposure limits, liquidity, leverage, supervisory reporting, disclosure, internal governance and remuneration policies,[125]

ii. **carrying out the Supervisory Review and Evaluation Process (SREP)**, including supervisory stress-tests at SSM level (or at Union level in collaboration with the EBA) and taking supervisory (Pillar II) measures provided for in **Articles 104-105 of the CRD IV** (see below, under **3.3**), and

[123] *Ibid.*, Article 7((8).

[124] Common procedures refer to the procedure for granting authorization to take up the business of a credit institution, withdrawal of an authorization to pursue such business and decisions with regard to qualifying holdings.

[125] These prudential requirements are set out in the CRR and CRD IV, in Commission Delegated and Implementing Regulations and in EBA Guidelines.

iii. **tasks relating to crisis prevention**, such as tasks pertaining to recovery planning and taking early intervention measures in accordance with the provisions of the BRRD (see below, under **3.4**).[126]

All the aforementioned micro-prudential tasks are executed both at consolidated level (i.e. for each banking group as a whole) and at individual level (i.e. for each of the group's entities separately).[127] Consolidated supervision applies both to banking groups located only in participating Member States and to banking groups with entities also in non-participating Member States. In the latter case, consolidated supervision is carried out in the context of colleges of supervisors (see below, under **3.2**). The SSMR has conferred upon the ECB specific supervisory and investigatory powers to execute effectively the aforementioned tasks (see below, under **3.5**).

In addition to the micro-prudential tasks, the ECB is responsible for acting as the home Member State's supervisory authority with regard to banking groups established in participating Member States, which wish to establish a branch or provide cross-border services in non-participating Member States, as well as acting as the host Member State's supervisory authority with regard to banking groups established in non-participating Member States, which wish to establish a branch or provide cross-border services in participating Member States.[128]

With regard to less significant banking groups, the aforementioned tasks are executed by the NSAs of the Member States where they are incorporated.

In addition, the ECB is responsible for carrying out the tasks relating to common procedures in respect of both significant and less banking groups. These tasks pertain to granting and withdrawing authorization and assessing notifications of the acquisition and disposal of qualifying holdings in banking groups.

3.1.2 The role of the Joint Supervisory Teams in micro-prudential supervision

The day-to-day supervision of significant banking groups is executed by the Joint Supervisory Teams (JSTs). The ECB has set up a JST for each banking group under its remit. The size, overall composition and organization of a JST is tailored to the size, business model and risk profile of the banking group it supervises. Each JST is composed of staff members from the ECB and from the NSAs of the participating Member States where entities of the group are established.

A designated ECB staff member is assigned with the task of coordinating the JST, assisted by one or more sub-coordinators appointed by NSAs.[129] The JST coordinator, who is generally not from the Member State where the banking group is located,[130]

[126] **SSMR**, Article 4

[127] The ECB participates also in supplementary supervision of a financial conglomerate in respect of the credit institution included in it and assuming the tasks of a coordinator where appropriate.

[128] **SSMR**, Article 4(2).

[129] **SSMFR**, Article 3(1).

[130] Although the **ECB Guide** "*to banking supervision*" determines that the JST coordinator should not be a national of the Member State in which is located the group concerned, the ECB has not met fully this obligation. According to a report prepared by the European Court of Auditors, at the end of 2015, there were 18 JSTs whose coordinator was coming from the Member State in which the corresponding banking group was incorporated. That report identified also that JSTs are heavily reliant on NSAs' staff, since the majority of employees is coming from the same country as the relevant banking groups.

coordinates the work within the JST, while the other members of the JST must follow his instructions.[131] Sub-coordinators assist the coordinator as regards the organization and coordination of the tasks in the JST, particularly with regard to staff members appointed by the same NSA. Sub-coordinators may give instructions to the members of the JST appointed by the same NSA, provided that these do not conflict with the instructions given by the JST coordinator.

Tasks conferred upon the JSTs include:[132]

- the execution of the SREP for the significant banking groups,
- the participation in the preparation of a Supervisory Examination Program (SEP)[133] to be proposed to the Supervisory Board, including an On-Site Inspection (OSI) plan and the coordination with the OSI team on the implementation of the plan, and
- the implementation of the SEP and any other ECB decision.

3.1.3 Execution of macro-prudential tasks within the SSM

The application of macro-prudential policy within the SSM is subject to different procedures and arrangements compared to micro-prudential policy. Pursuant to **Article 5 of the SSMR**, the competence for executing macro-prudential tools lies primarily with NSAs or NDAs, which are competent for deciding for the timing and selection of macro-prudential tools to be activated in order to mitigate systemic risk and address macro-prudential concerns.

Article 104 of the SSMFR specifies the arrangements governing the exchange of information and cooperation between the ECB and NSAs/NDAs with regard to the application of macro-prudential tools. In particular, where an NSA/NDA deems appropriate the introduction of a macro-prudential tool, it communicates to the ECB the identification of a macro-prudential or systemic risk for the financial system and the details of the intended tool and the scheduled date of application.

Where the ECB objects to the intended measure of the NCA/NDA concerned, it must state the reasons for supporting that position. The dissent of the ECB must be taken into account by the relevant NSA/NDA before taking the decision concerned.[134] However, the ECB has the ultimate authority to decide on the necessity and the level of the macro-prudential tools to be applied.[135] In that context, **Article 5(2) of the SSMR** provides the ECB with the power to apply higher requirements for capital buffers or to apply more stringent measures aimed at addressing systemic or macro-prudential risks, where it considers that is necessary for the purposes of financial stability.[136]

[131] **SSMFR**, Article 6(1).

[132] *Ibid.*, Article 3(2).

[133] The Supervisory Examination Program (SEP) includes a list of items scheduled to be examined by the JST within the following year informing, thus, the banking group concerned of the content and timeline of the supervisory activities.

[134] **SSMFR**, Article 104(3).

[135] For a comprehensive overview of the exercise of macro-prudential tasks in the context of the SSM, see **Gortsos (2015c)** and **Tröger (2015).**

[136] **SSMFR**, Article 105(1).

In the context of the SSM, NSAs/NDAs have the primary responsibility to decide on the application of the following macro-prudential tools:[137]

- the **capital buffers** laid down in the CRD IV, namely:
  - the **institution-specific countercyclical capital buffer**,[138]
  - the **Global Systemically Important Institution buffer** (G-SII buffer),[139]
  - the **Other Systemically Important Institution buffer** (O-SII buffer),[140] and
  - the **systemic risk buffer**,[141]
- measures provided for in **Article 458 of the CRR**, and
- any other measures provided for in the CRR and CRD IV, which aim at addressing systemic or macro-prudential risks (e.g. higher risk weights (**Article 124 of the CRR**) or higher minimum LGD values[142] (**Article 164 of the CRR**) for exposures secured by property).

The ECB has set up a Macro-prudential Forum to facilitate the exercise of the macro-prudential tasks. This Forum serves as a platform for members of the Governing Council and Supervisory Board to bring together micro-prudential and macro-prudential perspectives from the jurisdictions across the SSM.[143]

3.1.4 Tasks not conferred upon the ECB

The establishment of the SSM does not entail that the full set of tasks carried out until then by NSAs has been assigned upon the ECB. Therefore, the tasks not conferred explicitly on the ECB are still exercised by NSAs. Indicatively, these tasks include:[144]

[137] *Ibid.*, Article 101(1).

[138] The Countercyclical Capital Buffer (CCyB) is a macro-prudential tool and aims to mitigate the procyclicality of economic cycle of growth and recession. During the build-up phase of the credit cycle the CCyB is activated and an additional capital requirement of up to 2.5% of RWAs is set. During recessions, where credit defaults rise and losses materialize, the CCyB is released. The CCyB is part of the combined buffer requirement and consists of CET1 capital.

[139] Capital buffer applied to the banking groups which have been determined as systemically important at global level (G-SIIs). This buffer ranges from 1%-3.5% of RWAs and is met with CET1 capital.

[140] Capital buffer applied to the banking groups which have been determined as systemically important as national or European or national level (O-SIIs). This buffer may reach 2% of RWAs and is met with CET1 capital.

[141] The systemic risk buffer is imposed to the whole national banking sector or subset thereof to address a systemic risk to the domestic financial stability. This buffer starts from 1% of RWAs and must be met with CET1 capital.

[142] The Loss Given Default (LGD) is used to measure credit risk. LGD is one risk parameter among others (Probability of Default (PD), Exposure at Default (EaD), time to maturity) to calculate the risk of an exposure (RWA). The determination of the loss rate in the event of default is based on the concept of economic loss. A simplified definition of economic loss is the difference between the outstanding amount and the economic value of the risk exposure at the time of a default event (minus the utilization costs). The LGD is used for the Internal Ratings-Based Approach (IRB), which determines capital requirements for credit risk.

[143] See **European Central Bank (2018b)**, p. 44.

[144] **SSMR**, recital (28).

- receipt of notifications from banking groups in relation to the right of establishment and the free provision of services,
- supervision of bodies which are not covered by the definition of credit institutions under national law,
- supervision of banking groups from third countries establishing a branch or providing cross-border services in the EU,
- supervision of payment services,
- carrying out day-to-day verifications of banking groups,
- carrying out the function of competent authorities over banking groups in relation to markets in financial instruments,
- combat against the use of the financial system for the purpose of money maundering and terrorist financing, and
- protection of consumer interests in respect of financial services.

Consequently, the ECB has been authorized to execute the tasks relevant to micro-prudential supervision of (significant) banking groups and not all the tasks exercised by NSAs until the establishment of the SSM. NSAs continue being competent for the execution of the aforementioned tasks both for significant and less significant groups.

3.2 The role of the ECB within the colleges of supervisors

Colleges of supervisors promote cooperation and coordination among the supervisory authorities involved in the consolidated supervision of cross-border banking groups. Colleges of supervisors function as a forum for planning and execution of key supervisory tasks during normal times, as well as for preparation and handling of emergency situations. This enhanced cooperation among supervisory authorities both at international and EU level is crucial to enhance the supervision of cross-border banking groups.

Colleges of supervisors provide a framework for involved parties (i.e. supervisory authorities and EBA) to carry out the following tasks:

- consistent application of the prudential requirements across all groups' entities,
- execution of the SREP assessment on a group-wide basis,
- implementation of crisis prevention measures to avoid the failure of a banking group as a whole, and
- exchange of information between each other and with the EBA.

In relation to significant banking groups,[145] the ECB may act as:[146]

[145] If the consolidating supervisor of a banking group is located in a non-participating Member State, the ECB participates in the supervisory college:

- as member, if the group's entities in participating Member States are all significant, while the NSAs participate as observers,
- as member for the group's entities in participating Member States considered to be significant, while the NSAs participate as members for the less significant entities.

[146] See **ECB SSM Supervisory Manual**, p. 31.

- consolidating (home) supervisor for colleges which include supervisory authorities from non-participating Member States or third countries, or
- host supervisor for colleges in which the consolidating supervisor is from a non-participating Member State.

Where the parent entity of the significant banking group is incorporated in a participating Member State, the ECB is the consolidating supervisor, while NSAs of participating Member States in which the banking group has its parent entity, subsidiaries or significant branches participate as observers (see ***Table 3***). Thus, NSAs contribute to the college's tasks and activities and receive all the relevant information but do not participate in the decision-making process.[147]

The ECB chairs the meetings of supervisory colleges and decides which supervisory authorities should participate in meetings. In addition, the ECB is obliged to keep all members of the colleges fully informed of the organization of such meetings, the main issues to be discussed and the activities to be considered.

Table 3: Consolidating supervision – Participation in colleges of supervisors

	Consolidating supervisor	Supervisory college - Members	Supervisory college - Observers
Significant banking group	**ECB**	**NSAs** (non-participating Member States)	**NSAs** (participating Member States)
Less significant banking group	**NSA** (participating Member State)	**NSAs** (participating Member States) **NSAs** (non-participating Member States)	

The ECB, in its capacity as consolidating supervisor, carries out the following tasks:[148]

- coordinates the gathering and dissemination of information both in going concern and crisis situations,
- plans and coordinates supervisory activities in going-concern situations in cooperation with the supervisory authorities involved, and
- plans and coordinates supervisory activities in preparation and during emergency situations.

Where the ECB fails to execute the aforementioned tasks or the supervisory authorities involved do not cooperate with the ECB, any of the supervisory authorities concerned may refer the issue to the EBA in accordance with **Article 19 of the EBA Regulation**.

The ECB chairs 34 supervisory colleges, including four (4) international colleges that do not include any other European supervisory authority.[149] Effective cooperation between the members of supervisory colleges presupposes that Written Coordination and

[147] *Ibid.*, p. 31.

[148] **CRD IV**, Article 112(1).

[149] See **European Court of Auditors (2018)**, p. 21.

Cooperation Arrangements (WCCAs) have been put in place.[150] In that context, in June 2017, the ECB had signed WCCAs for five (5) colleges, while it was in the process of signing WCCAs for the remaining ones.

3.3 The Supervisory Review and Evaluation Process (SREP) under the ECB

In addition to the minimum prudential requirements established under the CRR and the CRD IV, the ECB may impose to banking groups additional requirements of quantitative and qualitative nature based on their riskiness. Such supervisory measures aim at addressing the risks inherent in the business model, internal governance and balance sheet of banking groups, which are identified through the implementation of a thorough and comprehensive supervisory exercise, the Supervisory Review and Evaluation Process (SREP).

Article 97 of the CRD IV established the obligation for supervisory authorities to perform the SREP in order to review the arrangements, strategies, processes and mechanisms applied by banking groups. The arrangements governing the implementation of the SREP are specified in Guidelines issued by the EBA in December 2014[151] and revised in July 2018.[152]

In the SSM context, the SREP is the core supervisory exercise which the ECB carries out on an annual basis in order to identify and evaluate the deficiencies and risks threatening the viability and solvency of banking groups.[153] In particular, the ECB evaluates the risks to which banking groups are or might be exposed, including the risks revealed by stress test exercises, and determines whether the capital and liquidity held by banking groups ensure a sound management and coverage of their risks.

Aiming to ensure level playing field in the Banking Union, the ECB applies the SREP in a uniform way facilitating peer comparisons and large-scale transversal analyses.[154] In that context, the ECB allocates banking groups into certain peer groups based on their business model, in particular based on the products and business lines targeting the same source of profits/customers. Thus, each banking group's financial situation is compared with the respective performance of its peers.

The ECB has developed a common methodology for the assessment of banking groups' profitability, governance arrangements and capital and liquidity situation. Specifically, as shown in ***Figure 5***, the SREP consists of the following four (4) building blocks:

i. assessment of business model,

ii. assessment of internal governance and institution-wide controls,

iii. assessment of risks to capital and adequacy of capital to cover these risks, and

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[150] **CRD IV**, Article 115(1).

[151] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP)*", EBA/GL/2014/13, December 2014.

[152] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing, consolidated version*", EBA/GL/2014/13, July 2018.

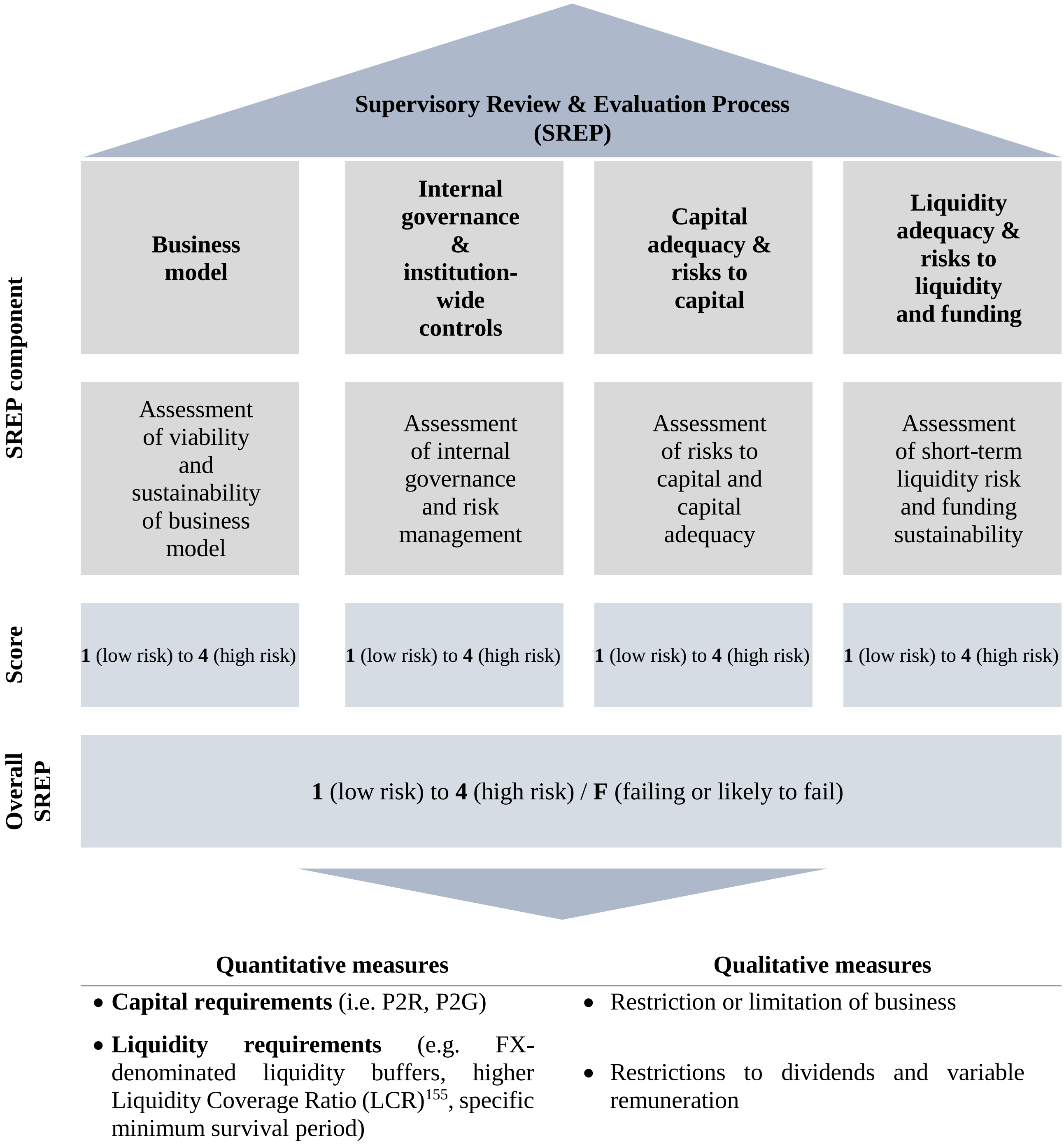
[153] The SREP assesses the risk management arrangements and risks to which banking groups might be exposed, including credit and counterparty risk, residual risk, concentration risk, securitization risk, market risk, interest rate risk arising from non-trading activities, operational risk and liquidity risk.

[154] See **ECB SSM Supervisory Manual**, p. 43.

iv. assessment of risks to liquidity and adequacy of liquidity resources to address such risks.

The implementation of the SREP to significant banking groups is analyzed in detail in **Chapter B, Section 1,** under **1**.

Figure 5: Overview of the SREP



[155] The Liquidity Coverage Ratio (LCR) aims to enhance banking groups' resilience against an acute liquidity stress. This requirement aims to ensure that a banking group maintains an adequate stock of unencumbered High Quality Liquid Assets, which should enable the banking group to survive for 30 days under stressed conditions.

The JSTs assess the arrangements, strategies, processes and mechanisms implemented by banking groups in these areas.[156] The assessment is made in a structured way and results in assigning a score of "1" (best score) to "4" (worst score) to banking groups. At the end of this assessment, the ECB takes supervisory decisions establishing quantitative and qualitative prudential requirements. Quantitative measures refer mainly to the level of the capital requirements applied to banking groups, namely the Pillar 2 Requirement (P2R) and Pillar 2 Guidance (P2G). Qualitative measures pertain to additional obligations, including enhanced disclosure and reporting requirements, changes in the internal governance and restrictions to dividends and variable remuneration.

3.4 The crisis prevention measures applied by the ECB

The new Union framework for crisis prevention, crisis management and resolution (**BRRD**) established a series of arrangements that intend to limit the possibility of banking failures. These measures aim to ensure that banking groups can address timely and effectively any deterioration of their financial situation before entering into the resolution zone.

The crisis prevention measures include:

a. the development of **group recovery plans**,

b. the establishment of **intragroup financial support agreements**,

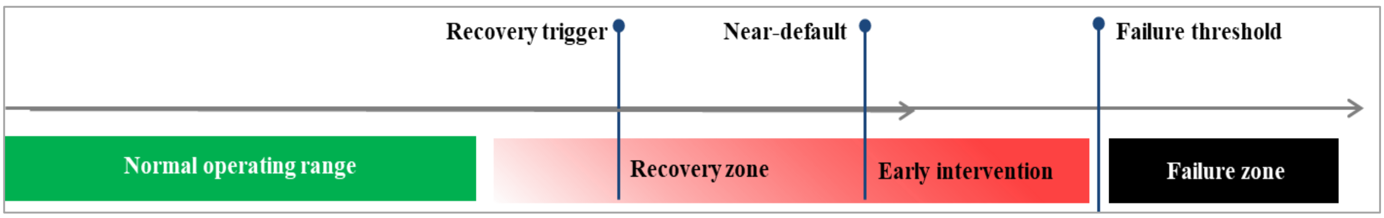
c. the **early intervention measures**, and

d. the **precautionary recapitalization** instrument.

The first two (2) crisis prevention measures are developed during the business-as-usual phase and are activated by the banking groups themselves upon deterioration of their financial situation. The other two (2) crisis prevention measures are closely related to the SREP assessment and intend to limit the possibility of failure by requiring banking groups to implement capital-accretive actions (e.g. share capital increase) and other measures that will fix any deficiencies identified.

The crisis prevention measures are designed to be implemented in a progressive manner, once the financial position of a banking group starts deteriorating. As shown in ***Figure 6***, recovery plan is activated when a banking group enters the recovery zone whereas early intervention measures, including provision of intragroup financial support, are to be taken in a near-default situation.

Figure 6: Crisis prevention measures upon deterioration of financial situation



The crisis prevention measures taken with respect to significant banking groups are analyzed in **Chapter B, Section 1, under 2.**

[156] The ECB has deployed different levels of supervisory engagement for each banking group based on its size, complexity and riskiness. This results in a differentiated frequency and intensity of supervision for banking groups with different characteristics. For each significant banking group, the overall engagement level is determined based on the size and the riskiness, as reflected in its SREP score. Thus, larger and riskier banking groups have a more intense supervisory engagement with the ECB compared to smaller and less risky banking groups.

3.5 The powers of the ECB under its supervisory function

3.5.1 Key remarks for the ECB's powers

For the purposes of executing its supervisory tasks, the ECB has at its disposal extensive powers. Pursuant to **Article 9(1) of the SSMR**, the ECB has all the powers which supervisory authorities and designated authorities have under the relevant Union law. In addition, the ECB may require NSAs to make use of their powers, under the conditions provided for in national law, in case that the SSMR does not confer upon the ECB such powers.

Thus, the ECB may exercise directly or indirectly all the powers provided for in the Union law and in the national law of the participating Member States. These powers pertain to both **investigatory** and **supervisory powers**, which are analyzed below.

Assigned with investigatory powers, the ECB may acquire from banking groups and natural persons related to the banking groups all the necessary information to execute its tasks. In respect of the supervisory powers, the ECB may require a banking group to implement stringent measures aiming to ensure that the group will not enter into a stress situation threating its viability.

3.5.2 Investigatory powers

3.5.2.1 Request for information and execution of general investigations

The ECB may require banking groups, natural persons belonging to banking groups and other relevant third parties to provide the necessary information to carry out its supervisory tasks.[157] Under the principles governing the cooperation between the ECB and NSAs, information obtained by the ECB directly from the above-mentioned persons must be made available to the NSAs concerned.

In addition, the ECB may carry out all necessary investigations of any legal or natural person referred above that is established in a participating Member State. In that context, the ECB is authorized to:[158]

- require the submission of documents,
- examine the books and records of the persons concerned and take copies or extracts from such books and records,
- obtain written or oral explanations from any person or their representatives or staff, and
- interview any other person who consents to be interviewed for the purpose of collecting information relating to the subject matter of an investigation.

In case that a person obstructs the conduct of the investigation, the SSMR provides that the NSA of the participating Member State where the relevant premises are established must provide the necessary assistance, including to facilitate the ECB's access to the business premises of the banking group concerned.

3.5.2.2 On-Site Inspections (OSIs)

In parallel with the day-to-day supervision under the JST, the ECB conducts also OSIs to banking groups. OSIs are in-depth investigations focused on risks, risk controls and governance issues. Inspections are conducted at a specific point in time by a team, which is led by a head of mission, who is independent from the JST.

[157] **SSMR**, Article 10(1).

[158] *Ibid.*, Article 11(1).

OSIs contribute to the work of the JSTs as they provide them with valuable information on the operational situation of the banking group and the extent of its riskiness. Ongoing supervision by the JST and OSIs are complementary. Supervisors have up-to-date, in-depth knowledge of banking groups, obtained through ongoing supervision, which mainly relies on the information reported by the groups. OSIs check the accurateness of the information used in the ongoing supervision and may identify shortcomings in the operations of the groups. After the end of the OSI, a report is sent to the banking group concerned, which includes the inspections' findings, requiring the group to take any necessary action to address the identified weaknesses.

The ECB conducts OSIs at the business premises of the banking groups with or without prior announcement to those groups.[159] ECB's staff may enter into business premises of the legal persons subject to an investigation decision adopted by the ECB and has all the powers to conduct general investigations. **Article 13 of the SSMR** provides that authorization for a judicial authority must be granted in case that it is necessary for the conduct of an OSI.[160]

OSIs are carried out in cooperation with staff from NSAs who may participate also. Officials and other accompanying persons authorized or appointed by the NSA concerned must assist the ECB staff. Furthermore, NSAs are responsible for providing ECB's staff with the necessary assistance in accordance with national law to cope with persons who oppose to an OSI. To that end, the assistance may include the sealing of any business premises and books or records. [161]

In contrast to the provisions laid down in **Article 12(1) of the SSMR**, which assign to the ECB critical role in carrying out OSIs, the experience from the OSIs carried out shows that the ECB's involvement is extremely low and not in keeping with the spirit of the SSMR.[162] By October 2015, 235 OSIs had been carried out, of which twenty-nine (29) were led by ECB staff, while the majority were led by NSA staff. Also, 8% of the inspections' members came from ECB and the rest (92%) from NSAs.[163]

In 2017, the ECB launched a system-wide approach with the objective of increasing the number of cross-border and mixed-team inspections.[164] 29 out of the 157 OSIs planned for 2017 staffed by mixed/cross-border teams, while in 2018 about 25% of OSIs were conducted by such teams.[165]

[159] *Ibid.*, Article 12(1).

[160] *Ibid.*, Article 13(1).

[161] In July 2017, the ECB issued a consultation paper on the execution of on-site inspections (OSIs) and internal model investigations. This guide aims to explain how OSIs are conducted and to provide a useful reference for inspected banks

[162] **European Court of Auditors (2016)**, p. 70.

[163] During 2017, 57 credit risk inspections were completed, of which six (6) were led by the ECB and 51 by NSAs. In 54 out of 57 on-site inspections the management and valuation of NPEs was the key issue. In addition, 157 inspections were approved for 2017 (compared with 185 in 2016. As at 31 December 2017, all but one of the planned inspections had been launched. Of these, 64 inspections were completed in 2017.

[164] Teams are considered to be "cross-border" when the head of mission and at least one team member do not come from the relevant home/host NSA, while a team is considered to be "mixed" when the head of mission comes from the relevant home/host NSA and at least two other members do not come from the relevant home/host NSA.

[165] See **European Central Bank (2018a)**, p. 62.

3.5.3 Supervisory powers

Article 16 of the SSMR confers upon the ECB certain supervisory powers necessary to carry out its supervisory tasks. The ECB may require from any banking group located in a participating Member State to take action, including at an early stage, to address risks that may threaten its viability in any of the following circumstances:[166]

- the banking group does not meet the prudential requirements,
- the ECB has evidence that the banking group is likely to breach the prudential requirements within the next twelve (12) months,
- the arrangements, strategies and mechanisms implemented by the banking group, as well as the capital and liquidity held by it, do not ensure a sound management and coverage of its risks.

Under those circumstances, the ECB has the following (extensive) powers:[167]

- to impose additional capital requirements related to risks not covered by Pillar 1 capital requirements,[168]
- to require the reinforcement of the arrangements, mechanisms and strategies (e.g. governance and internal control functions),
- to require banking groups to submit a plan to restore compliance with supervisory requirements and set a deadline for its implementation,
- to require banking groups to apply a specific provisioning policy or treatment of assets in terms of capital requirements,
- to restrict or limit the business, operations or network of banking groups or to request the divestment of activities that pose excessive risks to the soundness of the groups,
- to require the reduction of the risk inherent in the activities, products and systems of banking groups,
- to require banking groups to limit variable remuneration as a percentage of net revenues when it is inconsistent with the maintenance of a sound capital base,
- to require banking groups to use net profits to strengthen their capital,
- to restrict or prohibit distributions by banking groups to shareholders or holders of additional Tier 1 instruments where the prohibition does not constitute a default event,
- to impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions,
- to impose specific liquidity requirements, including restrictions on maturity mismatches between assets and liabilities,
- to require additional disclosures, and
- to remove at any time members from the management body who do not fulfil the requirements set out in Union law.

[166] **SSMR**, Article 16(1).

[167] *Ibid.*, Article 16(2).

[168] Pillar 1 capital requirements intend to cover banking groups against credit risk, market risks and operational risk.

The ECB is equipped with a full set of powers that covers all items included in the scope of its supervisory scrutiny, namely capital adequacy, liquidity availability, risk management, supervisory reporting, governance arrangements, disclosures. Supervisory powers allow the ECB to go beyond the borders set by the rules laid down in legal acts and require banking groups to comply with more stringent requirements, where necessary. Such powers provide the ECB with unlimited discretion to require banking groups to do whatever it takes in order to remedy any deterioration of their financial situation.

As referred above, the ECB is assigned with specific supervisory powers described in the SSMR and other Union legal acts, which are complemented by additional powers conferred upon NSAs under national law. Given that the ECB cannot exercise those powers on its own, it may require, by way of instructions, from NSAs or NDAs to make use of those powers in accordance with the conditions set out in national law.[169]

[169] **SSMFR**, Article 22(1).

Section 4: The Single Resolution Mechanism (SRM)

1. The key elements of the SRM

1.1 The rationale for establishing an EU resolution framework

The need for the Union banking system to have an effective resolution framework for banking groups became evident during the international financial crisis (2007-2009), as many countries had no resolution regime in place. The need to avoid the consequences of bankruptcy resulted in imposing the costs of rescuing failing banking groups on sovereigns rather than on shareholders and creditors who had benefited from the groups' profits prior to the crisis. This is particularly relevant to the largest and more complex banking groups, which were rescued by governments, as they were considered "too big to fail".[170]

During the period from September 2008 to December 2010, the European Commission approved state aid of €4.3 trillion to 215 banking groups,[171] while until 2017 the relevant approved amount reached €5.1 trillion, of which €2 trillion was used for capital and liquidity purposes.[172]

State aid to the financial sector resulted in increase of the cumulative state budget deficit by €200bn (2% of GDP) and increase of government debt by 18%.[173] However, there was significant divergence of the fiscal impact across Member States. Ireland incurred the greatest cost (28% of GDP) followed by Greece (17% of GDP), Slovenia (14% of GDP) and Cyprus (9% of GDP).[174]

Prior to the international financial crisis, banking groups were subject to normal insolvency proceedings in case of failure, which provide for either a reorganization of the company through an agreement with the creditors to reduce the debt burden or a liquidation and allocation of the losses to the creditors.[175] Liquidation under normal insolvency proceedings results in infringements of the rights of two (2) groups of actors, namely the shareholders who lose their economic and legal stakes and creditors whose claims are (partially or fully) written down or are restructured in terms of maturity.[176]

[170] See **European Central Bank (2015)**, p. 81.

[171] See **Millarueno** and **Del Rio (2017)**, pp. 3-4.

[172] For more information on the amounts of state aid approved and used in the EU over the period 2008-2017, see the State Aid Scoreboard, which is available at: http://ec.europa.eu/competition/state_aid/scoreboard/index_en.html

[173] In accordance with a study published from the **International Monetary Fund (2015)**, during this period the impact on euro area public finances was considerably greater than in other banking crises in the past. The median increase in government debt was 18% of GDP, of which 4.2% was caused by the provision of financial support to the financial sector, while euro area government debt was increased by 22% of GDP, of which 4.6% was due to direct support to the financial sector. These figures indicate that the indirect macroeconomic costs of the financial crisis have been more pronounced compared to previous banking crises.

[174] See **Millarueno** and **Del Rio (2017)**, p. 10.

[175] For an overview of the rationale for the introduction of resolution framework, as well as its objective, limitations and implications, see **Hadjiemmanuil (2014)**.

[176] For more on the implications of normal insolvency proceedings, see **Binder (2017)** and **Ringe (2017)**, pp. 5-7.

However, the experience from the crisis indicated that the normal insolvency procedure is inappropriate to deal with failures of significant banking groups, as it:[177]

- triggers disruptions to financial stability and the provision of critical services,
- does not fully protect depositors, and
- is a lengthy procedure, particularly in the case of reorganization that requires complex negotiations and agreements.[178]

Therefore, international authorities decided that the optimal solution is to resort to resolution of failing banking groups. Resolution is an alternative to the traditional form of dealing with insolvent banking groups seeking to avoid implications that might arise from liquidation under normal insolvency procedures and respecting the general principles of loss distribution under insolvency law.[179] Thus, in November 2011, the G20 Heads of States and Government endorsed the FSB's "*Key Attributes of Effective Resolution Regimes for Financial Institutions*",[180] which set out the key elements that are necessary for an effective resolution regime.

The FSB's "*Key Attributes of Effective Resolution Regimes for Financial Institutions"* were introduced in Union law with the BRRD, which established for first time uniform rules for crisis prevention and resolution of failing banking groups. The BRRD aims to enable resolution authorities to allow a distressed banking group to continue operating as a going-concern, while its stakeholders (i.e. shareholders, creditors, senior management) bear the cost of failure. The adoption of the BRRD addresses the lack of trust in traditional forms of insolvency procedures, as referred to in the Commission's proposal on the BRRD:

"*In most countries, bank and non-bank companies in financial difficulties are subject to normal insolvency proceedings. These proceedings allow either for the reorganization of the company (which implies a reduction, agreed with the creditors, of its debt burden) or its liquidation and allocation of the losses to the creditors, or both. In all the cases creditors and shareholders do not get paid in full. However, the experience from different banking crises indicates that insolvency laws are not always apt to deal efficiently with the failure of financial institutions insofar as they do not appropriately consider the need to avoid disruptions to financial stability, maintain essential services or protect depositors. In addition, insolvency proceedings are lengthy and in the case of reorganization, they require complex negotiations and agreements with creditors, with*

[177] See **Hadjiemmanuil (2015b)**, p. 231.

[178] Pursuant to **Cassesse (2017)** (p. 244), the introduction of a Union resolution framework that confers upon administrative authorities (i.e. resolution authorities) is warranted by the following reasons:

- courts are reactive and not proactive, while the modern financial system requires early action to avoid insolvency of banking groups and prevent potential disruption in the financial system, and
- courts cannot deal with insolvency problems that have a systemic nature, as the failure of a banking group may trigger the failure of other groups.

[179] For a thorough presentation of banking resolution from an insolvency law perspective, see **Haentjens (2014), Haentjens** and **Wessles (2016)** and **Binder (2015).**

[180] In October 2014, the FSB adopted additional guidance pertaining to information sharing for resolution purposes. The guidance has been incorporated as annex into the 2014 version of the 2014 Key Attributes document. No changes were made in the twelve (12) Key Attributes of 2011.

some potential detriment for the debtors and the creditors in terms of delay, costs and outcome."

Nonetheless. resolution action is not the default option. Resort to resolution is permitted, only if recourse to liquidation under normal insolvency procedures is inappropriate. In other words, resolution should be applied only to prevent the failure of banking groups, which perform critical functions whose discontinuance would pose material threat to the real economy and the financial system.

1.2 The objectives of the SRM

The BRRD established minimum harmonization rules and common resolution tools available to resolution authorities providing them with the discretion to apply these tools, where necessary. The BRRD is a minimum harmonization Directive that allows Member States to introduce additional crisis management tools, provided that they are compatible with the resolution principles and objectives established under the BRRD.[181] The principles governing the new resolution framework are centered on the idea of shifting the cost of banking crises from the public to the private sector.[182]

However, the BRRD did not centralize the decision-making process. The BRRD relies on a network of National Resolution Authorities (NRAs) and national resolution funds to ensure efficient resolution of ailing banking groups. The BRRD is a major step towards eliminating variant national rules related to resolution and protecting the integrity of the internal market, but it is insufficient for the Banking Union where banking groups are supervised by a single authority (SSM). In the absence of a single resolution mechanism within the Banking Union, coordination between NRAs would be challenging and unlikely to achieve timely and cost-effective resolution decisions, particularly for cross-border banking groups.

The political request for the establishment of the second pillar of the Banking Union, the SRM, was acknowledged by the Commission, which submitted on 10 July 2013 a 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*".

The adoption of the SSMR in November 2013 accelerated the negotiations during the trialogue phase. Thus, on 20 March 2014, after fast, but intense and heavy, negotiations a political agreement between the European Commission, the European Parliament and the Council was reached. On 30 July, the Regulation 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 1093/2010*" (known as **SRMR**) was published in the OJ of the EU. Article 114 of the TFEU is the legal basis of the SRMR.[183]

The CJEU case-law[184] provides significant guidance as to the use of **Article 114 of the TFEU** as a legal basis "*only where it is actually and objectively apparent from the legal*

[181] See **Freudenthaler (2017)**, p. 31.

[182] See **Vardi (2017),** p. 9,

[183] Article 114 of the TFEU has been used as legal basis also for the establishment of other EU agencies, namely the EBA, the ESMA and the EIOPA.

[184] The Court held in the Case C-66/04 (United Kingdom vs Parliament and Council) that "*by the expression 'measures for the approximation' in Article 95 EC the authors of the Treaty intended*

act that its purpose is to improve the conditions of the establishment and functioning of the internal market".[185] In that context, the adoption of the SRMR can be considered as a measure aiming at complementing the already (minimum) harmonization measures included in the BRRD to ensure that Member States do not adopt and implement divergent approaches regarding resolution.[186]

The objective of the SRM is to achieve convergence in resolution procedures with respect to euro area banking groups and ensure the consistent application of the rules laid down in the BRRD through a centralized decision-making procedure.[187] This applies mostly in cases of cross-border resolution, where potentially inconsistent and biased decisions taken by NRAs could threaten the financial stability.

1.3 The perimeter of the SRM

The SRMR forms the basis for the establishment and functioning of the SRM by introducing uniform rules and a uniform procedure for the resolution of the following entities:[188]

- **credit institutions** established in participating Member States,
- **parent undertakings**, including **financial holding companies** and **mixed financial holding companies**, established in participating Member States, where these undertaking are subject to the ECB's supervision,
- **investment firms** and **financial institutions** established in participating Member States, where they are covered by the consolidated supervision of the ECB.

Hence, the perimeter of the SRM highlights two (2) discrepancies with the scope of the BRRD and the SSM. Firstly, the scope of the SRM does not include branches of third-country banking groups, which means that NRAs remain responsible for executing the resolution tasks in relation to those branches in accordance with the BRRD. Secondly, the SRM's scope is broader than the respective of the SSM, as the former includes also investment firms and financial institutions, provided that they are included in a banking group whose parent entity is subject to ECB's supervision.

The banking groups included in the SRM's scope are located in participating Member States (as holds also for the SSM), namely euro area Member States and any other EU Member State that decides to establish close cooperation between its supervisory authority and the ECB.[189] Upon suspension or termination of close cooperation between

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to confer on the Community legislature a discretion, depending on the general context and the specific circumstances of the matter to be harmonized, as regards the harmonization technique most appropriate for achieving the desired result, in particular in fields which are characterized by complex technical features." The Court confirmed this judgement in the Case C-270/12, (United Kingdom of Great Britain and Northern Ireland v European Parliament, Council of the European Union).

[185] See **Zavvos and Kaltsouni (2015),** p. 10.

[186] *Ibid*., p. 12.

[187] See **Gortsos (2018c),** p. 66.

[188] **SRMR**, Article 2.

[189] *Ibid.,* Article 4(1).

a Member State and the ECB, the banking groups located in that Member State will not be covered by the provisions of the SRMR from the date of application of that decision.[190]

2. The role of the SRB within the SRM

2.1 The legal status of the SRB

The uniform rules and procedures established under the SRMR are applied by the SRB together with the ECOFIN, the Commission and the NRAs of the participating Member States. The SRB, which was established based on **Article 114 of the TFEU**,[191] is a Union agency with legal personality that has a specific structure corresponding to its tasks. In each Member State, the SRB enjoys the most extensive legal capacity accorded to legal persons under national law. In particular, it may acquire or dispose movable and immovable property and be a party to legal proceedings.[192]

The complex structure of the SRM is owed to two (2) reasons, namely **a compromise to strike a balance** between the interests of individual euro area Member States and the interests of the euro area as a whole[193] and the **constraints posed by the Meroni doctrine**.[194] The idea for establishing a specialized EU agency solely responsible for resolution tasks was also considered, but it was dismissed given the extensive powers that such an agency would have and the conflict with the Meroni doctrine.[195] Pursuant to the Meroni doctrine, discretionary decisions of political nature can only be taken by institutions of the EU and delegation of powers to an EU agency can only refer to clearly defined powers.[196] In line with the Meroni doctrine, the SRB could not be authorized to take decisions to put banking groups into resolution, which entail excessive margin of discretion.[197] Therefore, the legislators adopted this complex structure by assigning upon the Commission[198] and the ECOFIN the power to raise objections to a resolution scheme

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[190] *Ibid.,* Article 4(2).

[191] This Article has been used as a legal basis also in the case of the establishment of the European Network and Information Security Agency (ENISA). In that case (C-217/04), the United Kingdom requested for the annulment of the Regulation (EC) No 460/2004 of the European Parliament and of the Council, which established the ENISA. The United Kingdom supported that Article 95 of the EC did not provide for an appropriate legal basis for the adoption of that Regulation, as the power conferred on the Community aims at harmonizing national laws and not at setting up bodies and conferring tasks upon those bodies (par. 11). The fact that the establishment of the body "*may be beneficial to the functioning of the internal market does not mean that it constitutes a harmonization measure within the meaning of Article 95 EC*." The Court recognized that Article 95 of the EC (current Article 114 of the TFEU) is a solid legal basis for the establishment of an Agency to prevent the emergence of disparities likely to create obstacles to the smooth functioning of the internal market (par. 62 and 67).

[192] **SRMR**, Article 42(1)-(2).

[193] The involvement of the Council in the SRM can be attributed to the governments' need to keep a political control over resolution actions, which may require use of the SRF.

[194] See **Busch (2017)**, p. 2.

[195] See **Zavvos** and **Kaltsouni (2015)**, p. 20. Alternatively, the Bundesbank had argued that a Treaty amendment would be necessary to confer more powers on the SRB. For more information, see **Deutsche Bundesbank (2014),** p. 52.

[196] See **Vardi (2017)**, p. 16.

[197] In the Meroni case, the Court held that the powers delegated by the High Authority to the bodies in question gave those bodies "*a degree of latitude which implies a wide margin of discretion" which could not be considered compatible with the "requirements of the Treaty*".

[198] See **Wymeersch (2015)**, p.4.

(i.e. decision to place a banking group into resolution) adopted by the SRB.[199] Although the resolution schemes (adopted by the SRB) are finally endorsed by the Commission and the ECOFIN, the SRB is empowered to exercise a range of potentially intrusive powers, including the power to instruct NRAs (**Article 28 of the SRMR**) and require banking groups to take specific action in case of inaction or non-compliance of NRAs.[200]

The 2014 Short Selling case (C-270/12) made clear the ability of EU agencies to take direct measures over entities. In this litigation, the UK challenged the validity of supervisory powers conferred upon the ESMA in relation to short selling under **Article 28 of the Regulation 236/2012** (Short Selling Regulation). Pursuant to these powers, the ESMA may require entities to take specific actions overriding, thus, national competent authorities.[201] The ESMA decision narrowed down the Meroni doctrine,[202] as it demonstrated that "*the consequences resulting from a delegation of powers are very different depending on whether it involves clearly defined executive powers […], or whether it involves a discretionary power implying a wide margin of discretion which may, according to the use which is made of it, make possible the execution of actual economic policy*". In the ESMA case, the Court concluded that "*the powers available to ESMA under Article 28 of Regulation No 236/2012 are precisely delineated…*".[203]

The ESMA case has significantly stabilized the constitutional basis of the SRB by determining that supervisory powers conferred upon agencies under **Article 114 of the TFEU** can override national competent authorities in exceptional circumstances and under pre-defined conditions, where necessary for the orderly functioning and integrity of financial markets.[204] Furthermore, the Court's decision highlighted the particular role of technical expertise and speedy reaction on supporting financial stability and the single financial market.[205]

Given that resolution schemes, which place significant banking groups in resolution, entail a significant margin of discretion, once adopted by the SRB are put under the Commission's scrutiny. These schemes are endorsed unless the Commission raises objections to any discretionary aspects of them. However, in line with the Meroni doctrine, as revisited in the ESMA case, in exceptional cases the SRB may use its executive powers to instruct banking groups in resolution, where NRAs fail to comply with its instructions and certain pre-defined conditions are met (see below, under **4.3.1**).[206]

[199] The ECB could not become resolution authority, since it has not been granted with the relevant powers under **Article 127(6) of the TFEU**, whereas there could be conflicts of interest given that the ECB is responsible also for conducting monetary and supervisory tasks.

[200] See **Moloney (2014)**, p. 40.

[201] The Advocate General argued that the ESMA's powers could not be considered as a measure for approximation of Member States' law under **Article 114 of the TFEU**. The ESMA's powers allowed it to intervene in the conditions of competition in financial markets overriding national competent authorities. Such powers did not resemble to the agency powers which had been recognized by the Court as compliant with **Article 114 of the TFEU**.

[202] See **Chamon**, p. 247.

[203] Case C-270/12, par. 53.

[204] *Ibid*., par. 114-115.

[205] See **Lintner (2017)**, p. 604 and **Moloney (2014)**, p. 39.

[206] See **Moloney (2014)**, p. 42.

2.2 Applicable law and legal acts adopted by the SRB

For the purpose of exercising the tasks conferred upon it under the SRMR, the SRB applies the relative provisions of:[207]

- the **SRMR** and the **national law transposing the BRRD**,
- the **Commission Delegated Regulations** and **Commission Implementing Regulations** issued on the basis of the BRRD and the SRMR, and
- the **Guidelines and Recommendations issued by the EBA**, where the SRB has decided to comply with them ("comply or explain principle").

The SRMR is consistent with the BRRD and adapts the rules and principles of the BRRD to the specificities of the SRM. Many significant provisions of the SRMR are almost identical to those of the BRRD in order to ensure that the SRM functions under a common legal framework and that it would not have to apply solely the national laws transposing the BRRD, which, as a Directive, leaves the option to Member States to adopt different approaches.[208]

In addition, the SRB is empowered to issue certain legal instruments, mainly addressed to NRAs, in order to ensure the effective implementation of its resolution decisions, as well as the efficient cooperation with NRAs. These legal instruments refer to:

(A) Guidelines and general instructions: Pursuant to **Article 31(1)(a) of the SRMR**, the SRB in its Executive Session may issue **guidelines** and **general instructions** to NRAs in respect of tasks performed and resolution decisions adopted by them.[209] Guidelines set the operational details as regards the tasks performed by the SRB and NRAs, while general instructions have the objective to give further details concerning specific tasks. Guidelines and general instructions may be issued for the preparation of resolution plans, adoption of measures to address or remove impediments to resolvability and the determination of the MREL. NRAs must follow and comply with the guidelines and general instructions. Should an NRA not comply with guidelines and general instructions, it must explain the reasons for that non-compliance.

(B) Warnings: Based on **Article 7(4)(a) of the SRMR**, the SRB may issue a warning to the relevant NRA where it considers that the draft decision with regard to a banking group does not comply with the SRMR or with the general instructions issued by the SRB.[210] Warnings are issued by the Executive Session of the SRB and are related to a specific banking group.

(C) Specific instructions: The SRB may issue specific instructions addressed to an NRA with respect to a specific banking group. Indicatively, the Executive Session of the SRB may address specific instructions to NRAs with respect to:

- the preparation of draft group resolution plans,
- measures to effectively address or remove impediments to resolvability,
- the determination of the MREL,

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[207] **SRMR**, Article 5(1)-(2).

[208] See **Zavvos** and **Kaltsouni (2015)**, p. 15.

[209] **SRB Decision** of the Plenary Session of the Board of 28 June 2016 "*establishing the framework for the practical arrangements for the cooperation within the Single Resolution Mechanism between the Single Resolution Board and national resolution authorities (SRB/PS/2016/07)*", Article (1)-(2).

[210] *Ibid.*, Article 12(3).

- the write-down and conversion of capital instruments,
- the application of resolution tools and the exercise of resolution powers, to inform and consult employee representatives of the banking group concerned.

(D) Recommendations: Pursuant to **Article 33(2) of the SRMR**, the SRB in its Executive Session may issue recommendations to NRAs on the recognition and enforcement of resolution proceedings conducted by third-country resolution authorities in relation to a third-country banking group which has either one or more subsidiaries established in participating Member States or it has assets, rights or liabilities located in participating Member States or governed by the law of participating Member States.[211] NRAs must inform the SRB without undue delay whether and how they are going to comply with that recommendation. NRAs must either follow the SRB's recommendations and ask for the recognition and enforcement of the resolution proceedings in their respective jurisdictions or must explain to the SRB why they do not comply with its recommendation.[212]

2.3 The tasks and powers conferred upon the SRB

2.3.1 The resolution tasks of the SRB

The SRM consists of the SRB and the (19) NRAs of the participating Member States (see ***Table 4***) and functions in a decentralized manner. In the context of the SRM, the SRB is responsible for executing tasks related to resolution with respect to **significant banking groups** subject to the ECB's supervision and other **cross-border banking groups**, which are defined as groups with entities located in more than one participating Member States.

The **less significant banking groups** located in the participating Member States remain under the NRAs' remit. However, the SRB may take on the responsibility for exercising resolution tasks for less significant banking groups either on its own initiative or upon request from the relevant NRA.[213] Alternatively, the relevant participating Member State may request for this transfer of responsibility.[214]

Hence, the SRB's remit is slightly wider than the ECB's one, since it includes also some less significant cross-border groups which are subject to the supervision of NSAs. Thus, as of September 2018, the ECB was responsible for 118 banking group and entities, while the SRB for 127 banking groups, of which 13 are considered as 'other cross-border groups'.[215]

In accordance with **Article 7 of the SRMR**, the SRB is responsible for executing resolution-related tasks, which can be grouped into two (2) categories, **resolution planning** and **resolution action**.[216] The tasks pertaining to **resolution planning** include:

- the development and adoption of resolution plans (see below in **Chapter B, Section 2,** under **3.1**),

[211] *Ibid.*, Article 8.

[212] *Ibid.*, Article 13.

[213] **SRMR**, Article 7(4)(b).

[214] *Ibid.*, Article 7(5).

[215] The list of banking groups under SRB's remit is available at: https://srb.europa.eu/en/content/banks-under-srbs-remit

[216] **SRMR**, Article 4(3).

- the determination of the level of the Minimum Requirement of Eligible Liabilities and own funds (MREL) (see below in **Chapter B, Section 2,** under **3.2**),

The SRB's tasks relating to **resolution action** cover:

- the implementation of preparatory measures relating to resolution upon adoption of early intervention measures by the ECB (see below in **Chapter B, Section 2,** under **4.1**),
- the adoption of a resolution scheme or a decision for write-down and conversion of capital instruments (see below in **Chapter B, Section 2**, under **4.2**), and
- the monitoring of the implementation by the NRAs of resolution action in order to ensure that it is in line with the resolution scheme (see below in **Chapter B, Section 2**, under **4.3**).

Table 4: National Resolution Authorities (NRAs) participating in the SRM

Member State	National Resolution Authority (NRA)
Austria	Austrian Financial Market Authority
Belgium	National Bank of Belgium
Cyprus	Central Bank of Cyprus
Estonia	Finantsinspektsioon (Estonian Financial Supervision and Resolution Authority)
Finland	Finnish Financial Stability Authority
France	Autorité de contrôle prudentiel et de résolution
Germany	Bundesanstalt für Finanzmarktstabilisierung
Greece	Bank of Greece
Ireland	Central Bank of Ireland
Italy	Banca d'Italia
Latvia	Financial and Capital Market Commission
Lithuania	Bank of Lithuania
Luxemburg	Commission de Surveillance du Secteur Financier
Malta	Malta Financial Services Authority
Netherlands	De Nederlandsche Bank
Portugal	Banco de Portugal
Slovakia	Slovak Resolution Council
Slovenia	Banka Slovenije
Spain	FROB (Spanish Executive Resolution Authority)

2.3.2 The role of Internal Resolution Teams (IRTs) in performing resolution tasks

The day-to-day performance of resolution tasks with respect to significant banking groups is responsibility of the Internal Resolution Teams (IRTs). The SRB has established 76 IRTs for the banking groups under its remit. The scope of activity of each IRT is determined based on the complexity, risk profile, size, place of establishment and interconnectedness of each banking group. Where appropriate, several banking groups can be allocated to the same IRT.

The coordinator of the IRT is a designated SRB staff member, while the sub-coordinator comes from the relevant NRA. The IRT coordinator along with the sub-coordinator coordinate the work within the IRT.[217] The IRT members must follow the instructions of the coordinator and sub-coordinator as regards their tasks in the IRT.

The tasks carried out by IRTs include, among others, contribution to:[218]

- the examination of recovery plans in order to identify any recovery options which may adversely impact the banking groups' resolvability,
- the drawing up group resolution plans,
- the application of simplified obligations,
- the conduct of the resolvability assessment and determination of the measures to address or remove impediments to resolvability,
- the determination of the MREL,
- the monitoring of the compliance with early intervention measures,
- the preparation of resolution schemes,
- the monitoring of the execution of resolution schemes,
- the coordination with the OSI team and assistance in carrying out an OSI or a general investigation, and
- the cooperation with the JSTs.

2.3.3 The investigatory powers of the SRB

2.3.3.1 Requests for information

The SRMR conferred upon the SRB strong investigatory powers to execute its resolution tasks. The investigatory powers, which are analyzed below, are similar to those assigned on the ECB under the SSMR. In that context, the SRB may require banking groups to provide it with the necessary information to conduct its tasks. after making full use of the information available to the ECB or to NSAs through the established channels of communication. For that purpose, the SRB and the ECB have signed an MoU, which governs, among others, the exchange of information between them.[219]

However, if the cooperation with the ECB or NSAs is not efficient and cannot warrant the smooth flow of information in a timely manner, the SRB may require banking groups to provide it directly with the necessary information. This power can be exercised in

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[217] Pursuant to **European Court of Auditors (2017)** (p. 38), the legislative framework does not make clear the extent of the SRB's and NRAs' involvement in IRTs. Hence, the SRB does not control the composition, seniority, expertise or performance evaluation of the staff assigned by NRAs. The SRB can only request for a minimum number of staff belonging to NRAs that should join IRTs.

[218] **SRB Decision** of the Plenary Session of the Board of 28 June 2016 "*establishing the framework for the practical arrangements for the cooperation within the Single Resolution Mechanism between the Single Resolution Board and national resolution authorities (SRB/PS/2016/07)*", Article 24.

[219] **SRMR**, Article 34(5).

relation to the banking groups under its remit, persons belonging to those groups and third parties to whom those groups have outsourced activities. [220]

Such actions are appropriate during crisis situations, when it may be time-consuming for the SRB to receive the necessary information through the ECB. Information obtained by the SRB under the aforementioned way must be made available to NRAs. Without prejudice to the right of the SRB to require information from legal or natural persons directly, NRAs may also require information from groups located within their jurisdictions, the groups' employees and third parties to whom those groups have outsourced functions or activities.[221] NRAs must immediately submit any information received to the SRB.

2.3.3.2 General investigations conducted by the SRB

The SRB may carry out general investigations, either directly or through the NRAs, with respect to the legal and natural persons referred above. For that purpose, the SRB may:[222]

- require the submission of documents,
- examine the books and records of legal or natural person referred above,
- obtain written or oral explanations from any legal or natural person, and
- interview any other natural or legal person who consents to be interviewed for the purpose of collecting information relating to the investigation.

2.3.3.3 On-site inspections (OSIs)

For the purpose of executing its tasks, the SRB may conduct OSIs at the business premises of the banking groups under its remit or of other related natural or legal persons.[223] Such OSIs can be carried out following a notification to the relevant NRAs and NSAs and, where appropriate, in cooperation with them.

The members of the OSI team are authorized to enter any business premises and land of the legal persons subject to the investigation. The OSI teams may consist of staff members of the NRA concerned and other accompanying persons (e.g. staff from advisory firms), which must provide assistance in the execution of the OSIs.[224]

Where a banking group or a related legal or natural person opposes to an OSI, the NRA concerned may provide any necessary assistance for the completion of the OSI, including the sealing of any business premises and books or records. The SRB may also apply for authorization by a judicial authority to carry out the OSI in accordance with national rules, where it is required for the execution of an OSI.[225]

[220] *Ibid.*, Article 34(1).

[221] **SRB Decision** of the Plenary Session of the Board of 28 June 2016 "*establishing the framework for the practical arrangements for the cooperation within the Single Resolution Mechanism between the Single Resolution Board and national resolution authorities (SRB/PS/2016/07)*", Article 39.

[222] **SRMR**, Article 35(1).

[223] *Ibid.*, Article 35(1).

[224] *Ibid.*, Article 36(4).

[225] *Ibid.*, Article 37(1).

Until the end of 2018, the SRB had neither conducted an OSI nor participated in an OSI carried out by the ECB.[226] In 2019, the SRB is expected to draft an operational guidance for conducting OSIs for resolution purposes.[227]

2.4 The governance arrangements of the SRB

2.4.1.1 Plenary session of the SRB

The governance structure of the SRB consists of the **plenary session** and the **executive session**. The plenary session of the SRB is composed of the **Chair**, **four (4) further full-time members** and **a member appointed by the NRA of each participating Member State**. Where a Member State has more than one (1) NRA, a second representative is allowed to participate as observer without voting rights.[228]

Each member, including the Chair, has one vote. In the meetings of executive and plenary sessions of the SRB participate a representative from each of the Commission and the ECB under the capacity of permanent observer.

The plenary session of the SRB is competent for executing, among others, the following tasks:[229]

a. taking decisions on the use of the SRF, where in a specific resolution action the required recourse to SRF's available financial means exceeds the sum of €5bn or €10bn in terms of liquidity,

b. providing guidance to the executive session on the selection of resolution tools and the use of the SRF that must follow in subsequent resolution decisions, once the net accumulated use of the SRF in the last twelve (12) months reaches the threshold of €5bn, and

c. taking decisions on whether it is necessary to raise extraordinary ex-post contributions or to resort to voluntary borrowing between financing arrangements, alternative funding means and mutualization of national financing arrangements, involving support of the SRF above the threshold referred to in point a).

Furthermore, the SRB in its plenary session takes decisions on financial and administrative issues related to the function of the SRB (e.g. adoption of annual work program, annual budget, annual activity report, financial rules and anti-fraud strategy).

The SRB in its plenary session holds at least two (2) ordinary meetings per year, as well when the Chair or at least one-third of its members or the representative of the Commission deems it appropriate. The decisions are taken by a simple majority of the members, except for the following cases:[230]

- a simple majority of the members representing at least 30% of contributions to the SRF is required, when the decision pertains to points a) and b) referred above and mutualisation of national financing arrangements limited to the use of financial means available to the SRF,
- a majority of two thirds of the members representing at least 50% of contributions to the SRF (for the period until 2023) or at least 30% of contributions (as of 2024)

[226] See **European Court of Auditors (2017),** p. 40

[227] See **Single Resolution Board (2018c)**, p. 16.

[228] **SRMR**, Article 43(1).

[229] For an overview of the tasks of the Plenary Session, see **Gortsos (2018c),** pp. 83-86, and **Busch (2017)**, p. 14.

[230] **SRMR**, Article 52(2)-(3).

is required, when the decision pertains to raising ex-post contributions, voluntary borrowing between financing arrangements, alternative financing means, as well as on the mutualisation of national financing arrangements exceeding the use of the financial means available to the SRF.

In any of these cases, each voting member has one vote and in the event of a tie, the Chair has a casting vote.

2.4.1.2 Executive session of the SRB

The SRB in its executive session is composed of the Chair, the four (4) full-time members, and

- when deliberating on a banking group established only in a participating Member State, the representative on the NRA concerned, or
- when deliberating on a cross-border group, the representatives of the NRAs of the participating Member States, where the parent entity and other group's entities covered by consolidated supervision are located.

The executive session of the SRB is competent for taking the important decisions relating to exercise of resolution tasks. These decisions cover the development and approval of resolution plans, the **determination of the MREL**, as well as the **preparation and submission to the Commission of resolution schemes** accompanied with all relevant information allowing in due time the Commission to assess and decide or, where appropriate, propose a decision to the Council.[231]

Furthermore, the SRB's executive session prepares all the decisions to be adopted by the the plenary session.

2.5 Cooperation arrangements

2.5.1 The cooperation between the SRB and NRAs

The resolution framework established under the SRMR is a combination of centralized decision-making and decentralized implementation, as the SRB is competent for taking decisions, while NRAs function as executive arms of the SRB being entrusted with the implementation of its decisions. Under this cooperation mechanism, the SRB ensures that the resolution framework is applied consistently across the participating Member States. This is particularly relevant for resolution schemes adopted by the SRB, which set out the resolution tools and powers that must be applied by the NRAs.

Therefore, ensuring efficient and effective cooperation between the SRB and NRAs is prerequisite for the achievement of the SRM's objectives. To that end, a detailed and comprehensive framework for cooperation within the SRM has been established under **Articles 30-33 of the SRMR**, as well as by a Decision adopted in June 2016 by the Plenary Session of the SRB. This Decision established a framework to organize the practical arrangements for the cooperation between the SRB and NRAs in accordance with **Article 31(1) of the SRMR**. This framework includes rules concerning the following issues:[232]

- the issuance by the SRB of guidelines and general instructions addressed to NRAs, which provide guidance on the execution of tasks performed by NRAs,

[231] *Ibid.*, Article 54(1)-(2).

[232] **SRB Decision** of the Plenary Session of the Board of 28 June 2016 "*establishing the framework for the practical arrangements for the cooperation within the Single Resolution Mechanism between the Single Resolution Board and national resolution authorities (SRB/PS/2016/07)*", Article 1(1).

- the exercise by the SRB of the investigatory powers referred to in **Articles 34 to 37 of the SRMR**,
- the requests for information, either on an ad hoc or on a continuous basis, sent from the SRB to NRAs on the performance of their tasks,
- the preparation and submission of draft decisions by NRAs to the SRB on which the latter may express its views,
- the composition, functioning and coordination of IRTs,
- the relations between the SRB and NRAs when cooperating within the framework of Resolution Colleges or European Resolution Colleges,
- the procedures governing the cooperation between the SRB and NRAs regarding their respective resolution responsibilities, including the exchange of information and the preparation and submission of draft decisions from NRAs to the SRB,
- the cooperation between the SRB and NRAs regarding the exercise of powers concerning resolution planning, including determination of the MREL, and measures to address or remove impediments to resolvability and the application of simplified obligations,
- the cooperation of the SRB and NRAs concerning the implementation and monitoring of decisions taken by the SRB, and
- the cooperation regarding the SRF.

As referred above, the SRB is the decision-making body for the SRM for all issues related to significant banking groups. Nonetheless, the SRMR provides that SRB should consult on NRAs prior to taking decisions. Thus, the legal framework determines the following cases where prior consultation between the SRB and NRAs should be made:[233]

- the drawing up of resolution plans, including determination of impediments to resolvability and MREL,
- the decision to apply simplified obligations or to waive the obligation of drafting resolution plans,
- the decision to exercise directly all the relevant powers in relation to less significant banking groups,
- the decision that the MREL is partially met on a consolidated or on an individual basis through contractual bail-in instruments, and
- the decision to defer, in whole or in part, the payment of extraordinary ex-post contributions if it is necessary to protect the financial position of banking groups.

2.5.2 Cooperation with the ECB

Efficient cooperation between the ECB and the SRB is of critical importance for the orderly functioning of the Banking Union and the safeguard of financial stability. Both authorities must ensure a smooth cooperation and exchange of information during going-concern and crisis situations.

To that end, on 22 December 2015, the ECB and the SRB signed an MoU for **cooperation and information exchange**. The MoU facilitated the cooperation of the two (2) parties in resolution planning, early intervention and resolution phases. However, during the first years of the SRM there have been some deficiencies in the cooperation

[233] *Ibid.*, Article 9(1).

of the two authorities, which were identified also by the European Court of Auditors (ECA). In the context of an inspection relating to the functioning of the SRM, the ECA identified deficiencies in the process for exchange of information, including critical information on capital adequacy and liquidity availability of the banking groups. The SRB had to make specific requests to the ECB for this information, which was time- and resource consuming.[234] The ECB and the SRB acknowledged the need to address these deficiencies and facilitate further the exchange of information. Therefore, on 30 May 2018, they revised the MoU to improve the exchange of information and decision-making process in respect of normal situations and crisis situations.

In relation to the **exchange of information**, the revised MoU provides that the ECB communicates promptly to the SRB any change with respect to a banking group that necessitates the revision or update of the resolution plan.[235] To that end, the ECB and the SRB agreed to share automatically, without any explicit request or justification, information relating to:[236]

- any material changes to the legal or organization structure or to the business or the financial position of banking groups,
- the banking groups' capital, liquidity and asset quality,
- the composition of banking groups' liabilities and loss absorbing capacity,
- the banking groups' critical functions and core business lines,
- any supervisory or resolution reviews or analyses, stress-tests, OSIs, comprehensive assessments or valuations,
- any supervisory or resolution requirements, and
- the banking groups' business model, strategies, risk management, governance, contingency or crisis management procedures.

In addition to the aforementioned information, which is automatically shared between the two (2) parties, more information may be transmitted upon specific request.

The SRMR provides that the ECB may participate in the SRB's sessions as observer. However, the SRB did not enjoy the same benefit, as the Chair of the Supervisory Board had to invite the SRB's Chair to participate in meetings with resolution interest. The MoU resolved this issue by making clear that the Supervisory Board of the ECB will invite the Chair of the SRB to participate as an observer in the meetings relating to deliberations on group recovery plans, group financial support, rapid deterioration of the financial situation of a banking group and any "failing or likely to fail" determination.[237] In addition, the Chair of the SRB may be invited in the Supervisory Board if the latter has been informed of the SRB's intention to make a "failing or likely to fail" determination in accordance with **Article 18(1) of the SRMR**.

The MoU covers the cooperation and exchange of information between the ECB and the SRB for all banking groups directly supervised by the ECB. However, it does not cover the less significant banking groups, which are under the SRB's remit though are supervised by NSAs. The ECB has some supervisory information on all euro area banking groups, part of which it receives from NSAs. However, the ECB does not

[234] See **European Court of Auditors (2017),** p. 40.

[235] **Memorandum of Understanding** *between the Single Resolution Fund and the European Central Bank in respect of cooperation and information exchange*, par. 7.1.1.

[236] *Ibid*., par. 7.2.2.

[237] *Ibid.*, par. 5.

provide the SRB with access on this information.[238] Hence, the SRB must conclude separate MoUs with all NSAs of the participating Member States.[239]

2.5.3 Cooperation with resolution authorities of non-participating Member States

Resolution action with respect to banking groups operating both in participating and non-participating Member States may encounter difficulties, as it requires cooperation of different resolution authorities, while it is also affected by the (not fully harmonized) national legal frameworks. Therefore, the BRRD laid down arrangements to facilitate the cooperation of NRAs and to ensure that any decision taken will give due account to the interests of both the Union and Member States.

In accordance with **Article 88 of the BRRD**, if and when the SRB is the group-level resolution authority, it must establish resolution colleges to carry out resolution tasks and ensure cooperation and coordination with resolution authorities of non-participating Member States. Resolution colleges function as fora for cooperation and decision-making with respect to resolution decisions applied to banking groups with activities both in participating and non-participating Member States.

In a resolution college participate:[240]

- the **SRB**, as the group-level resolution authority, representing also the NRAs of the participating Member States where entities of the group concerned are located,
- the **relevant NRAs of participating Member States** in which the group's entities under the SRB's remit are located (observer status),[241]
- the **NRAs of the non-participating Member States**, where entities (and significant branches) of the banking group are located,
- the **consolidating supervisory authority (ECB**) and the **supervisory authorities of the non-participating Member State**s where entities of the group concerned are incorporated,
- the **competent ministries** and the **authorities responsible for the deposit guarantee schemes** of the Member States where the group's entities are located, and
- the **EBA**.

Third-country resolution authorities may, at their request, be invited to participate in the resolution colleges as observers, provided that confidentiality arrangements have entered into force.

The group-level resolution authority in its capacity as chair of the resolution college coordinates the activities of the college and decides which members will be invited to

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[238] See **European Court of Auditors (2017),** p. 41.

[239] **Memorandum of Understanding** *between the Single Resolution Fund and the European Central Bank in respect of cooperation and information exchange*, par. 2(1)

[240] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p. 17.

[241] **SRB Decision** of the Plenary Session of the Board of 28 June 2016 "*establishing the framework for the practical arrangements for the cooperation within the Single Resolution Mechanism between the Single Resolution Board and national resolution authorities (SRB/PS/2016/07)*", Article 36a.

attend specific meetings taking into account the issues to be discussed.[242] Detailed arrangements governing operational functioning of the resolution colleges are set out in the **Commission Delegated Regulation 2016/1075**.

Resolution colleges provide a framework for the participating authorities to cooperate effectively in the execution of the following resolution tasks:[243]

- the development of group resolution plans,
- the assessment of the resolvability of banking groups,
- the exercise of the powers to remove or address impediments to resolvability,
- the determination of the MREL at consolidated and individual level,
- the decision on the need to draw up a group resolution scheme,
- the agreement on a group resolution scheme,
- the coordination of public communication of group resolution strategies and schemes, and
- the coordination of the use of resolution financing arrangements.

Where resolution action is likely to impact one or more other Member States, the decision for such action should be taken in accordance with the following principles:[244]

- resolution authorities, supervisory authorities and other involved authorities must cooperate with each other to ensure that the decision is made in a coordinated and efficient manner,
- due consideration must be given to the interests of the Member States where the parent entity and the other group's entities are incorporated, in particular with regard to the impact of any decision or action or inaction on the financial stability, fiscal resources, resolution funds, deposit guarantee schemes or investor compensation schemes of the Member States concerned, and
- due consideration must be given to the objectives of balancing the interests of the various Member States involved and avoid unfair burden allocation across Member States.

Currently, the SRB chairs resolution colleges for 25 banking groups and seeks to further facilitate its cooperation with resolution authorities of non-participating Member States.[245] Therefore, there are ongoing negotiations with the objective of reaching an agreement before the end of 2019 on multilateral MoUs between the SRB, the ECB and the NRAs and NSAs of each of the nine (9) non-participating Member States.[246]

2.5.4 Cooperation with resolution authorities of third countries

2.5.4.1 Agreements with third countries on cooperation for resolution purposes

The Commission may submit to the Council proposals for the negotiation of agreements with one or more third countries covering the cooperation between the European

[242] **BRRD**, Article 88(5).

[243] *Ibid.*, Article 88(2).

[244] *Ibid.*, Article 87.

[245] See **Single Resolution Board (2018a)**, p. 13.

[246] See **Single Resolution Board (2018c)**, p. 17.

resolution authorities, including the SRB, and the relevant third-country authorities, among others, for the purposes of information sharing for recovery and resolution planning. Such agreements may cover the following situations:[247]

- where a third-country parent entity has subsidiaries in two or more Member States,
- where a parent entity established in a Member State and which has a subsidiary in at least one other Member State has one or more third-country subsidiaries, and
- where an entity located in a Member State and which has a parent entity or a subsidiary in at least one other Member State has one or more branches in one or more third countries.

The agreements with third countries must aim to ensure the establishment of processes and arrangements between resolution authorities and the relevant third-country authorities for cooperation in the execution of the following tasks:

- the development of resolution plans,
- the assessment of resolvability,
- the application of powers to address or remove impediments to resolvability,
- the application of early intervention measures, and
- the application of resolution tools and exercise of resolution powers.

Until the entry into force of such agreements, Member States may enter into bilateral agreements with third countries concerning the issues mentioned above.[248]

2.5.4.2 EBA Framework Cooperation Agreements with third-country authorities

Up till now, no international agreement between the EU and a third country has been concluded. By the time that such an agreement will be signed, the EBA may conclude non-binding Framework Cooperation Agreements with third-country authorities in the following cases:[249]

- where a third-country parent entity has subsidiaries in two or more Member States,
- where a parent entity established in a Member State and which has a subsidiary in at least one other Member State has one or more third-country subsidiaries, and
- where an entity located in a Member State and which has a parent entity or a subsidiary in at least one other Member State has one or more branches in one or more third countries.

The Framework Cooperation Agreements must establish processes and arrangements between the participating authorities governing exchange of information necessary for carrying out resolution-related tasks. Supervisory authorities or resolution authorities, where appropriate, must conclude non-binding cooperation arrangements with the relevant third-country authorities in line with the EBA framework arrangement. The SRB (and NRAs) may conclude cooperation arrangements with resolution authorities of third countries, which may include provisions on the following matters:[250]

[247] **BRRD**, Article 93(1).

[248] *Ibid.*, Article 93(4).

[249] *Ibid.*, Article 97(2).

[250] *Ibid.*, Article 97(5).

- the exchange of information necessary for the development and maintenance of resolution plans,
- the exchange of information necessary for the application of resolution tools and the exercise of resolution powers,
- any early warning to or consultation of parties to the cooperation arrangement before taking any significant action under the BRRD or third-country law affecting the banking group to which the arrangements apply,
- the coordination of public communication in case of joint resolution action, and
- the procedures and arrangements for the exchange of information and cooperation, including the establishment of crisis management groups.

2.5.4.3 Framework Cooperation Agreement between the EBA and the U.S. Authorities

In September 2017, the EBA signed a Framework Cooperation Agreement with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the U.S. Securities and Exchange Commission, and the New York State Department of Financial Services (collectively called 'U.S. Authorities').[251] The Framework Cooperation Agreement lays out the basis for subsequent cooperation arrangements on crisis management and resolution between any of the EU supervisory or resolution authorities and any of the participating U.S. authorities. This Agreement seeks to promote cooperation on resolution planning and resolution action for cross-border banking groups.

Furthermore, this Agreement sets principles for future Cooperation Arrangements between any EU authority and U.S. authority in order to support information sharing and cooperation on cross-border crisis management. Such Cooperation Arrangements, which are not legally binding, should cover:[252]

- the cooperation and interaction among participating authorities both on business-as-usual periods and stress periods,
- all the banking groups under the remit of participating authorities, a subset of them or a specific banking group,
- one or more of the following areas of information sharing and cooperation:
  - resolution planning,
  - resolvability assessment,
  - early intervention measures,
  - crisis management and application of resolution tools and powers, and
  - sharing of confidential information.

[251] The EBA is in the process to conclude framework cooperation agreements with other third-country authorities, such as the FINMA (Switzerland), the HKMA (Hong Kong) and the FSA (Japan).

[252] **Framework Cooperation Arrangement** "*between the European Banking Authority ('EBA') and the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the U.S. Securities and Exchange Commission, and the New York State Department of Financial Services (collectively, 'U.S. Authorities,' and, together with the EBA, 'the Parties')*", pp. 4-5.

The SRB is currently in negotiations with the Australian Prudential Regulation Authority, the Japan's Financial Services Authority, the Hong Kong Monetary Authority and the Swiss Financial Market Supervisory Authority to sign bilateral arrangements.[253]

2.5.4.4 Cooperation Arrangements between the SRB and resolution authorities of third countries

In line with the EBA Framework Cooperation Agreements described above, the SRB may conclude non-binding Cooperation Arrangements.[254] Thus, based on the Framework Cooperation Agreement signed by the EBA and the U.S. Authorities in September 2017, three (3) months later the SRB signed the first two (2) Cooperation Arrangements with the Federal Insurance Deposit Corporation (FDIC) and the Canada Deposit Insurance Corporation (CDIC). The SRB signed Cooperation Arrangements also with the National Bank of Serbia and the Banco Central do Brasil.[255]

These Arrangements do not create any legally binding obligations, or confer any rights, or modify or supersede any domestic laws. These Cooperation Arrangements are identical and lay the ground for efficient exchange of information and cooperation between the contracted parties in relation to resolution planning and implementation of resolution tools and powers. The Cooperation Arrangements are primarily focused on Global Systemically Important Institutions (G-SIIs) seeking to ensure that limited systemic consequences will occur upon their failure.

In accordance with the Cooperation Arrangements, the contracted parties commit to:[256]

- consult on approaches and strategies related to resolution planning,
- designate a contact person who will be involved in resolution action in respect of failing banking groups and crisis management,
- discuss and agree on the information which each authority should provide to the other in the context of resolution planning and resolution action, and
- ensure confidentiality of information exchanged.

2.5.4.5 Establishment of Crisis Management Groups (CMGs)

The "*Key Attributes for Effective Resolution Regimes*" adopted in 2011 set out the obligation for home and key host authorities of G-SIIs to establish and maintain Crisis Management Groups (CMGs), which aim at enhancing resolution preparedness and facilitating the management of resolution actions in case of failure of a G-SII. CMGs involve the representatives of the relevant supervisory authorities, central banks, resolution authorities, finance ministries and the authorities responsible for the deposit guarantee schemes.

In 2010, the FSB issued the paper "*Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*", which recommended, among others, the conclusion of

[253] See **Single Resolution Board (2018c)**, p. 27.

[254] **SRMR**, Article 32(4).

[255] See **Cooperation Arrangement** *between the Banco Central do Brasil and the Single Resolution Board* and **Cooperation Arrangement** *between the National Bank of Serbia and the Single Resolution Board.*

[256] **Cooperation Arrangements** "*concerning the resolution of insured depository institutions and certain other financial companies with cross-border operations in the United States and the European Banking Union*"**)**, pp. 6-9.

banking group-specific crisis cooperation agreements for each G-SII.[257] These agreements:[258]

- establish the processes for cooperation through CMGs,
- define the responsibilities and roles of the authorities both in going-concern and resolution stages,
- describe the process for information-sharing before and during crises, and
- set out the procedure for coordination in the development of recovery and resolution plans for G-SIIs, including for the parent entity and significant subsidiaries.

As of November 2018, CMGs have been established for all G-SIIs,[259] of which eight (8) are chaired by the SRB. Also, 25 cross-border cooperation agreements had been implemented by home and host authorities in CMGs.[260]

2.5.4.6 European resolution colleges

The BRRD introduced the obligation for resolution authorities of two or more Member States to establish a European resolution college where the parent entity of a banking group is established in a third country and has subsidiaries in two or more Member States. European resolution colleges aim to facilitate the cooperation between European resolution authorities and third-country resolution authorities. In case that the Union subsidiaries are held by a financial holding company, the European resolution college is chaired by the resolution authority of the Member State where the holding company is incorporated.[261]

European resolution colleges are responsible for carrying out the tasks conferred upon resolution college with respect to the subsidiaries located in the EU. The SRB chairs European resolution colleges for five (5) banking groups.[262]

2.5.4.7 Confidentiality arrangements

Effective cooperation between the SRB and resolution authorities of third countries presupposes the introduction of confidential arrangements between the involved parties to ensure that necessary safeguards apply. To that end, the BRRD provides that resolution authorities, supervisory authorities and competent ministries can exchange information with relevant third-country authorities if two (2) conditions are met.[263] Firstly, third-country authorities are subject to requirements and standards of professional secrecy at least equivalent to confidentiality arrangements applicable at EU level. Secondly, the information is necessary for the performance by the relevant third-country resolution authorities of their resolution functions.

For confidential information originating in another Member State, the resolution authority of that Member State is obliged to request the resolution authority concerned

[257] See **Financial Stability Board (2010)**, p. 2.

[258] See **Financial Stability Board (2014),** pp. 14-15.

[259] See **Financial Stability Board (2018d)**, p. 12.

[260] See **Financial Stability Board (2018c),** p.1.

[261] **BRRD**, Article 89(3).

[262] See **European Banking Authority (2018)**, p. 13.

[263] **BRRD**, Article 98(1).

to permit the disclosure of information to third-country resolution authority and only for the purposes permitted.

2.5.5 Cooperation with the European Parliament

In December 2015, the SRB signed an **Interinstitutional Agreement** with the European Parliament on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the SRB within the framework of the SRM. In accordance with this Agreement:

- the SRB must submit to the European Parliament every year a report on the execution of its tasks, which should be presented by the SRB's Chair at a public hearing,
- the SRB's Chair must participate in ordinary public hearings, ad hoc exchanges of views with the ECON Committee and confidential meetings with the Chair and the Vice-Chairs of the ECON Committee,
- the SRB must reply in writing to written questions raised by the European Parliament, and
- the SRB must provide the European Parliament an annotated list of decisions of the Executive and Plenary Sessions, as well as with non-confidential information relating to resolution of banking groups.

In addition, the Interinstitutional Agreement covers the selection procedure of the members of the SRB's Executive Session, as well as the relevant investigations carried out by the European Parliament.

3. Resolution planning under the SRB

3.1 Development and approval of group resolution plans

3.1.1 Objectives and key elements of resolution planning

The international financial crisis and the euro area fiscal crisis showed that authorities lacked the necessary tools and powers to wind down failing banking groups in an orderly manner. Enhanced preparedness is prerequisite for effective resolution action. Therefore, the Union resolution framework introduced the obligation for resolution authorities to develop during the good times comprehensive resolution plans for banking groups.

In the Banking Union, the SRB carries out the resolution planning process for (significant) banking groups under its remit. The SRB draws up and reviews at least annually the group resolution plans or after any material changes to the legal and organizational structure or financial position of banking groups.[264] The key objective of resolution plans is to enhance the preparedness of the SRB to carry out resolution of banking groups, where necessary, by:[265]

- obtaining comprehensive understanding of the legal, financial and operational structure of banking groups,
- identifying and addressing any impediments to resolvability, and

[264] **SRMR**, Article 10(6).

[265] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p. 21.

- enhancing resolution preparedness by setting a preferred resolution strategy and the resolution actions to be implemented should banking groups meet the conditions for resolution.

The group resolution plan is a fully-fledged and comprehensive document whose key outcomes pertain to:

- the designation of the critical functions performed by banking groups, as well as their core business lines,
- the determination of the preferred resolution strategy, including the resolution tools to be applied upon resolution,
- the development of an information and communication plan,
- the identification of impediments to resolvability and the determination of the measures to address such impediments, and
- the determination of the MREL.

The group resolution plan consists of the following chapters:[266]

- a **summary** of the key elements of the plan,
- a **strategic business analysis**, which describes the legal, financial and operational structure of the banking group,
- a **preferred resolution strategy**, which provides whether the group will be liquidated under normal insolvency proceedings or will be resolved,
- an assessment of the **financial and operational continuity upon resolution**,
- an **information and communication plan**, and
- a **resolvability assessment** to identify potential barriers to resolution, and
- a list of **measures to address or remove impediments to resolvability** and facilitate the implementation of the preferred resolution strategy.

The content and outcomes of the group resolution plans developed by the SRB are described in detail in **Chapter B, Section 2**, under **1**.

3.1.2 The internal process for the development and approval of resolution plans

The starting point for the resolution process is the assessment of the group recovery plans. Group recovery plans are important not only for the ECB to assess the adequacy of the recovery capacity of banking groups but also for the SRB, as they include valuable information also for resolution purposes. In that context, the SRB assesses the group recovery plans aiming to identify the critical functions and the core business lines designated by the banking groups themselves and to make recommendations to the ECB regarding recovery options which may adversely impact the groups' resolvability.[267]

The second stage of the resolution process is related to the collection by the SRB of useful information for the development of resolution plans. For the purposes of resolution planning, the SRB uses information derived from the following sources:

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[266] For more information on the contents of a group resolution plan, see **SRB Decision** "*on Banco Popular Group Resolution Plan".*

[267] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning"*, p. 23.

- publicly available information (e.g. financial statements, Pillar III reports),
- information already submitted by banking groups to the ECB under the standard supervisory reporting process (e.g. FINREP, COREP), and
- additional reports and templates that the SRB requires from banking groups to submit at least on an annual basis.

With respect to the latter point, the SRB requires from banking groups to submit on an annual basis the following templates:

- the standardized templates established under the **Commission Implementing Regulation (EU) 2018/1624** "*laying down implementing technical standards with regard to procedures and standard forms and templates for the provision of information for the purposes of resolution plans for credit institutions and investment firms*", known as "**EBA templates**",[268]
- the **Liability Data Report**, under which the SRB collects data on the liability side of the banking groups' balance sheet,
- the **Critical Functions Template**, and
- the **Financial Markets Infrastructure template** (**FMI template**).

The decision-making process for the adoption of resolution plans differs depending on whether there is a need for a joint decision to be taken by a resolution college, which is the case for banking groups with entities located both in participating and non-participating Member States.

Thus, for banking groups without resolution college, the IRT prepares the draft resolution plan, which is submitted to the ECB and the relevant NSAs for consultation. Subsequently, the Executive Session of the SRB adopts the resolution plan and the SRB communicates the outcome of the resolution planning process and the MREL target to the banking group concerned. For banking groups with a resolution college, the process described above is slightly different, since the draft resolution plan, which is preliminary endorsed by the Executive Session of the SRB, is submitted to the resolution college for approval. In this case, the timeline and arrangements on functioning of resolution colleges apply, as per the Commission Delegated Regulation 2016/1075.

3.1.3 Resolution planning templates

3.1.3.1 Liability Data Report

The Liability Data Report (LDR) is the most significant set of templates for resolution planning purposes, as it provides the SRB with necessary information both for the determination of the MREL and for any resolution action it may take. Banking groups submit the LDR both at consolidated level and at individual level with respect to Relevant Legal Entities. For the purposes of this report, Relevant Legal Entities are defined as the entities that either **represent more than 5% of the group's RWAs**, leverage exposure or total operating income or **provide critical functions**.[269]

[268] This Regulation repealed the Commission Implementing Regulation 2016/1066 of 17 June 2016 *"laying down implementing technical standards with regard to procedures, standard forms and templates for the provision of information for the purpose of resolution plans for credit institutions and investment firms pursuant to Directive 2014/59/EU of the European Parliament and of the Council"*.

[269] See **Single Resolution Board (2017c)**, p. 2.

Through the LDR, banking groups provide detailed and granular information on:[270]

- both **liabilities excluded from bail-in** (e.g. covered deposits, liabilities towards employees) and **liabilities not excluded from bail-in** (e.g. uncovered deposits, derivatives, senior unsecured liabilities, subordinated liabilities),
- the **types of counterparties / creditors** (e.g. natural persons, micro & SME, corporates, governments),
- the remaining **maturity of liabilities**,
- the **intragroup liabilities** and **guarantees** provided to and received by other groups' entities,
- the **counterparties for derivatives transactions** and **secured finance** (e.g. repo transactions), and
- the **ranking of the liabilities in the national insolvency hierarchy** of each entity.

The information obtained through the LDR enables the SRB to calculate the amount of liabilities excluded from bail-in, the amount of liabilities not excluded from bail-in but subject to the SRB's discretion to exclude them in accordance with **Article 44(3) of the BRR**D and the amount of MREL-eligible liabilities.

3.1.3.2 Critical Functions Template

One of the core objectives of resolution pertains to ensuring continuity of critical functions, which are defined as those functions whose discontinuance would disrupt the provision of services that are essential for the real economy and the financial stability at national and/or EU level.

Group resolution plans determine how critical functions and core business lines could be legally and economically separated from other functions to ensure continuity upon resolution.[271] The SRB obtains a clear picture of the critical functions performed by banking groups both by the self-assessment exercise conducted by banking groups in their group recovery plan, as well as by additional quantitative and qualitative information obtained through the Critical Functions Template.

Banking groups report quantitative data and qualitative information per entity-level for each of the applicable functions performed by them, namely i) deposits, ii) lending, iii) payment, cash, settlement, clearing and custody services, iv) capital markets, and v) wholesale funding.

Quantitative data pertain to the national market share of the banking group in each function, as well as:

- the outstanding value of deposits/loans,
- the number of accounts and clients both at national and cross-border level,
- the number of (payments) transactions,
- the size of derivatives portfolio, and
- the number and value of repurchase agreements (repo transactions).

This data is accompanied with a qualitative assessment performed by banking groups concerning the anticipated impact on the market in case of failure. Thus, banking groups assess the impact that any discontinuity of the critical functions could have on the

[270] See **Single Resolution Board (2017d)**.

[271] **Commission Delegated Regulation 2016/778**, recital (5).

financial stability and real economy, given the market concentration and the ability and timing needed to be substituted by another market participant. This assessment is determined to a significant extent by the operational and legal impediments which exist in the national market, which may prevent other competitors from taking on the business of the failed banking group within a short timeframe.

Based on the Critical Functions Template, each banking group conducts a self-assessment to determine the critical functions performed. Subsequently, based on the self-assessment and other relevant data, the SRB determines the critical functions performed by the banking group's entities.

3.1.3.3 FMI templates

In the context of the information collection process, the SRB requires from banking groups to submit the FMI report for all Relevant Legal Entities. This report provides the SRB with information on the banking groups' exposure to FMIs and other intermediaries providing payment, clearing, settlement and custody services. In addition, the SRB obtains a clear view of the potential impact of resolution proceedings on the access to each FMI and the likely impact on critical functions' continuity.[272]

In the FMI report, banking groups report all direct and indirect participation in FMIs, namely payment systems,[273] clearing[274] and settlement systems[275], central counterparties,[276] and trade repositories.

The FMI report contains quantitative data to measure the exposure to each FMI and qualitative information on the FMIs and their transactions with reporting entities, such as governing law, currency used in transactions, ancillary services received from the FMI, service providers needed to access FMI. Moreover, the report includes qualitative information for the contractual consequences of resolution proceedings, such as whether there is a termination trigger in the contract with the FMI which provides for termination of the services upon resolution. Also, it requires information on the possibility to

[272] See **Single Resolution Board (2017e)**, p. 5.

[273] The term 'payment system' has two meanings: 1) in some cases, it refers to the set of instruments, banking procedures and interbank transfer systems which facilitate the circulation of money in a country or currency area, and 2) in most cases, it is used as a synonym for "funds transfer system". The funds transfer system is defined as "*a formal arrangement based on a private contract or legislation, with multiple membership, common rules and standardized arrangements, for the transmission, clearing, netting and/or settlement of monetary obligations arising between its members. Payments systems reported in the FMI cover both large-value and retails systems. Large-value are mostly used to settle interbank or wholesale transactions and are often operated by central banks (e.g. TARGET2, EURO1). Retail systems are used to settle retail transactions, including Point-of-Sale and other card transactions, direct debits and credit transfers (e.g. STEP2)*."

[274] The term 'clearing system' is defined as "*a set of rules and procedures whereby financial institutions present and exchange data and/or documents relating to transfers of funds or securities to other financial institutions at a single location (e.g. a clearing house). These procedures often include a mechanism for calculating participants' mutual positions, potentially on a net basis, with a view to facilitating the settlement of their obligations in a settlement system*."

[275] The term 'settlement system' is defined as "*a system used to facilitate the settlement of transfers of funds, assets or financial instruments*."

[276] The term 'central counterparties' (CCPs) is defined as "*the entities that interpose themselves between counterparties to contracts listed in one or more financial markets. CCPs are used for transactions for securities and derivatives*."

substitute the FMI concerned with another FMI and the time required for such a transition.

3.1.4 Simplified obligations for resolution planning

The BRRD provides supervisory and resolution authorities with the ability to grant -in certain cases- simplified obligations and waivers for recovery and resolution plans. Pursuant to **Article 4(1) of the BRRD** supervisory authorities and resolution authorities may apply simplified obligations on:

- the content and details of recovery and resolution plans,
- the date by which the first recovery and resolution plans will be drafted, as well as the frequency of their update,
- the level and granularity of the information requested from banking groups, and
- the level of the resolvability assessment.

The SRB can decide to waive the obligation of drafting resolution plans only in relation to banking groups not subject to the ECB's supervision (i.e. other less significant cross-border banking groups within its remit).[277] In addition, the SRB may apply simplified obligations in relation to the content of resolution plans and the level of detail for the resolvability assessment. Such decision may be taken by the SRB either on its own initiative or upon request by an NRA, based on the following criteria:[278]

- the nature of the banking group's business, shareholding structure, risk profile, size and interconnectedness,
- whether the banking group has joined an Institutional Protection Scheme (IPS) or other cooperative mutual solidarity systems,
- any exercise of investment activities by the banking group, and
- whether the failure and liquidation under normal insolvency proceedings of the banking group would be likely to have adverse impact on financial system.

Based on data as of 30 April 2017, half of the EU supervisory and resolution authorities had granted waivers and simplified obligations to banking groups in their jurisdictions. According to estimations, only 420 out of the 6,000 EU-based entities are expected to be subject to full development of resolution plans.[279] Thus, it is expected that in the following years, supervisory and resolution authorities will resort to a greater extent to this discretion provided by the BRRD.

However, until today neither the ECB has granted waiver or simplified obligations to any banking group under its remit for recovery planning purposes[280] nor the SRB has applied simplified obligations or waiver to any banking group for resolution planning purposes.[281] The approach adopted by both the ECB and the SRB is in line with the EBA Guidelines "*on the application of simplified obligations*", which provide that such beneficial treatment is not allowed to G-SIIs and O-SIIs, which constitute the bulk of the banking groups under the ECB's and SRB's remit. G-SIIs and O-SIIs cannot enjoy this

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277 **SRMR**, Article 11(8).

278 *Ibid*., Article 11(3)

279 See **Merc (2017)**, p. 75.

280 See **European Banking Authority (2017c)**, par. 25.

281 *Ibid.*, par. 34.

benefit, as their failure and subsequent liquidation would have adverse impact on the financial stability.[282]

3.2 The Minimum Requirement for own funds and Eligible Liabilities (MREL)

3.2.1 The key principles for the MREL

The last step of the annual resolution planning process is the determination of the Minimum Requirement for Own funds and Eligible Liabilities (MREL) which is applied both at consolidated and individual level. The MREL is a new prudential requirement introduced with the BRRD and seeks to facilitate the resolution of banking groups. The MREL is designed to ensure that each banking group has a sufficient amount of loss-absorbing capacity and can be recapitalized in an orderly manner through the write-down or conversion of its capital instruments and eligible liabilities avoiding a bail-out with public funds and limiting the possibility to resort to the SRF. Hence, building the MREL is key to improving the resolvability of banking groups.

Article 45 of the BRRD established the obligation for resolution authorities to determine MREL targets for banking groups. In addition, this Article set out the key principles governing this new prudential requirement, such as the eligibility criteria for MREL instruments and the joint decision-making process for the determination of MREL targets for banking groups with entities both in participating and non-participating Member States. The key provisions regarding the approach for the determination of the MREL are specified in the **Commission Delegated Regulation 2016/1450** (EU) 2016/1450 of 23 May 2016 "*supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities*".[283]

The MREL is calculated as a percentage of the group's own funds and eligible liabilities (nominator) over its total own funds and eligible liabilities (denominator). Although there are similarities with capital requirements, what differentiates the MREL in relation to capital requirements is the fact that it:

- **is determined on a case-by-case basis**, as there is no single requirement applicable to all banking groups, as holds for minimum capital requirements in accordance with **Article 92(1) of the CRR**, but resolution authorities determine the MREL based on the specific features of each banking group,
- **is calculated over the total amount of consolidated own funds and total liabilities**, whereas the basis for capital requirements is RWAs, and

[282] *Ibid.*, par. 20.

[283] This Regulation is based on a revised EBA RTS, as the Commission raised objections to the initial draft RTS submitted by the EBA on 3 July 2015. In particular, the Commission objected to the EBA's proposal to establish a harmonized minimum MREL level of 8% of total liabilities and own funds for all banking groups determined as G-SIIs and O-SIIs. In addition, the Commission disagreed with the provisions of the EBA RTS on MREL with respect to the transitional period of 48 months to reach the MREL target. The Commission amended Article 8 of the draft RTS in such a way to allow resolution authorities to set an appropriate transitional period as short as possible. On 9 February 2016, the EBA issued an Opinion addressed to the Commission in which it insisted on the arrangements included in its draft RTS. On 23 May 2016, the Commission adopted the Delegated Regulation without incorporating the comments of the EBA.

- **is covered both with capital instruments and eligible liabilities** that meet specific criteria (e.g. senior unsecured bonds), whereas capital requirements can be met only with capital instruments (i.e. CET1, AT1, T2 instruments).

3.2.2 The key elements of the MREL

3.2.2.1 Liabilities eligible to count towards the MREL

Banking groups can meet the MREL with own funds and liabilities which fulfil the following conditions:[284]

- the liabilities are issued and fully paid up,
- the liabilities are not owed to, secured by or guaranteed by the banking group,
- the purchase of the liabilities was not funded directly or indirectly by the banking group,
- the liabilities have a remaining maturity of at least one (1) year and where the liabilities confer upon the owner a right to early reimbursement, the maturity date of those liabilities is the first date where such a right arises,
- the liabilities do not arise from derivatives, and
- the liabilities do not arise from deposits of natural persons, micro, small and medium-sized enterprises (SMEs).

With respect to liabilities governed by third-country law, the SRB may require the banking group to demonstrate that the application of the write-down and conversion powers would be effective under the law of that country. This requirement can be met in two ways. Under the first way, the relevant issuance contains contractual clauses that recognize the resolution authorities' power to exercise the write-down and conversion powers in relation to those liabilities in line with **Article 55 of the BRRD**. Alternatively, an international agreement between the EU and the relevant third country must have been signed.[285] If none of the aforementioned conditions is met, the SRB must not count those liabilities toward s the MREL.

According to **Article 45(13) of the BRRD**, the SRB may allow a banking group to meet partially the MREL at consolidated or individual level through contractual bail-in instruments if they meet the following conditions:

- the instruments contain a contractual term providing that, where the SRB decides to apply the bail-in tool to that banking group, the instrument must be written down or converted to the extent required before other eligible liabilities are written down or converted, and
- the instrument is contractually subordinated, under normal insolvency proceedings, to other eligible liabilities and cannot be repaid until other eligible liabilities outstanding at the time have been settled.

3.2.3 The MREL components

Pursuant to the Commission Delegated Regulation 2016/1450, the MREL consists of the **Loss Absorption Amount** (LAA) and the **Recapitalization Amount** (RCA). The Loss Absorption Amount functions as a capital cushion seeking to absorb losses. Typically, it is determined based on the currently applicable capital requirements set for a banking

[284] **BRRD**, Article 45(4).

[285] *Ibid.*, Article 45(5).

group (default Loss Absorption Amount), while the Recapitalization Amount reflects the capital requirements that the "new" banking group must meet after resolution.

Thus, the default Loss Absorption Amount is the sum of the following capital requirements:[286]

- the **minimum capital requirements** set out in **Article 92(1) of the CRR** (i.e. 8% of RWAs),
- the **Pillar 2 Requirement (P2R)** imposed by the ECB in the context of the SREP, and
- the **combined buffer requirement** set out in **Article 128 of the CRD IV.**

However, the SRB may adjust the default Loss Absorption Amount:

- **upwards** if it assesses that the need to absorb losses in resolution is not fully reflected in the capital requirements set by the ECB, or it is necessary to reduce or remove impediments to resolvability, or
- **downwards** if it considers that the P2R or the combined buffer requirement is not relevant to apply to the post-resolution banking group.

The Recapitalization Amount is defined as the pre-resolution amount of own funds and eligible liabilities, not used for the purposes of the Loss Absorption Amount, over the post-resolution RWAs.[287] The Recapitalization Amount is determined on the basis of the preferred resolution strategy and resolution tool. In particular, if the SRB concludes that the preferred resolution strategy is the liquidation of the banking group's entities under normal insolvency proceedings, it may not set a recapitalization amount, which implies that the MREL would be equal to currently applicable capital requirements.[288] On the contrary, if the SRB determines that resolution is the preferred strategy, it must set a recapitalization amount whose level should reflect the capital requirements and the level of RWAs of the post-resolution banking group.

Pursuant to **Article 2(6) of the Commission Delegated Regulation 2016/1450**, the recapitalization amount is the sum of the following components:

- an amount of capital and eligible liabilities which would be necessary for the banking group to meet the capital requirements applicable after its resolution, and
- an additional amount of capital and eligible liabilities that, if written down or converted into equity, would provide the post-resolution banking group with additional capital to maintain sufficient market confidence.

The first component of the recapitalization amount consists of:[289]

- the **minimum capital requirements** set out in **Article 92(1) of the CRR** (i.e. 8% of RWAs), and

[286] **Commission Delegated Regulation 2016/1450**, Article 1(5).

[287] For a detailed presentation of the MREL framework, see **Maragopoulos (2016).**

[288] **Delegated Regulation 2016/1450**, Article 2(2).

[289] Based on the Commission Delegated Regulation 2016/1450, for the determination of the Loss Absorption Amount and the Recapitalization Amount, resolution authorities should take into account also the Basel I floor (Article 500 of the CRR) and any applicable leverage ratio requirement. However, currently none of these requirements is in force, as the former expired in 2017 and latter is expected to be introduced in EU law with the CRR II.

- the **Pillar 2 Requirement (P2R)** that should be applied to the banking group after its resolution.

The SRB may decide, after consultation with the ECB, to determine a P2R rate for the Recapitalization Amount different from the respective one set for the Loss Absorption Amount if it assesses that the banking group after resolution will be less (or more) risky than currently is. To that end, the SRB must take into account any SREP-related information received from the ECB.

The additional amount of capital required for the banking group to maintain sufficient market confidence may not exceed the combined buffer requirement applicable to it after resolution action. The additional amount required by the SRB may be lower than the currently applicable combined buffer requirement if the SRB considers that a lower amount would be sufficient to sustain market confidence.

The determination of the additional amount of capital needed for market confidence purposes should take into account the capital position of peer banking groups and the capital resources in the entities of the banking group, which would credibly and feasibly be available to support market confidence in the banking group, in case that these entities:[290]

- were subsidiaries of the banking group and continue to be after the implementation of the preferred resolution strategy, and
- are not expected to access market funding on an individual basis after the implementation of the preferred resolution strategy.

For the estimation of the recapitalization amount, the SRB must take into account the most recent reported values for the relevant RWAs or leverage ratio denominator, unless the resolution plan identifies and quantifies any change in the regulatory capital needs immediately after the resolution action and this change is considered both feasible and credible without adverse impact on the critical functions performed by the banking group.

Consequently, the regulatory framework provides resolution authorities with the power to adjust the RWAs basis for the recapitalization amount if they consider possible that there will be a balance sheet depletion due to resolution that would drive down the RWAs of the post-resolution banking group.

3.2.4 The ‘no-creditor-worse-off principle’ adjustment of the MREL

In the context of the resolvability assessment, the SRB must identify the liabilities which are explicitly excluded from bail-in under **Article 44(2) of the BRRD** (mandatory exclusions) or that may be excluded on its discretion under **Article 44(3) of the BRRD** (discretionary exclusions). This information is useful for the SRB also for MREL purposes and, in particular, to determine:

- if these liabilities rank equally or junior in the insolvency ranking to any class of liability qualifying for inclusion in the MREL, and
- if the amount of these liabilities exceeds 10% of any class of liabilities, which includes also MREL-eligible liabilities.

Should the SRB conclude that the amount of liabilities that is likely to be excluded from bail-in exceeds the 10% threshold, it must assess whether the other MREL-eligible

[290] **Commission Delegated Regulation 2016/1450**, Article 2(8).

instruments can contribute to loss absorption and recapitalization without breaching the “no-creditor-worse-off” principle.[291]

This case is relevant to Member States whose insolvency ranking provides that senior unsecured bonds rank *pari passu* with other senior unsecured liabilities (e.g. operating liabilities, derivatives, uncovered deposits), which are amongst the mandatory or discretionary exclusions from bail-in. In the case of banking groups located in these Member States, there is a significant risk to breach the “no-creditor-worse-off” principle, where senior unsecured bonds, which typically represent the bulk of the MREL instruments, do not exceed the 90% of the total amount of liabilities within the same class. In such case, the SRB may require from the banking groups concerned to issue a larger amount of senior unsecured bonds in order to exceed the relevant threshold and avoid any legal challenges.

3.2.5 Downwards adjustment of the MREL due to the DGS contribution

Pursuant to **Article 109(1) of the BRRD**, the DGS of the home country of the parent entity may contribute to the financing of resolution action under very strict conditions. Although this option is not very likely to happen, the SRB may take it into account in the determination of the MREL target and reduce the MREL target by the amount of the DGS’s contribution to resolution financing. The size of any such reduction must be based on a credible assessment of the potential contribution of the DGS and must be ensured that it is:

- less than a prudent estimate of the potential losses which the DGS would have had to bear, had the banking group been wound up under normal insolvency proceedings in accordance with the insolvency ranking,
- less than 50% of the DGS’s target level (i.e. 0.4% of covered deposits of banking groups located in the relevant Member State),
- based on the overall risk of exhausting the available financial means of the DGS due to the contribution to multiple concurrent banking failures, and
- consistent with any other relevant provisions in national law and the duties of the authority responsible for the DGS.

Hence, the reduction of the MREL due to the possible contribution of the DGS ranges:

- **from zero**, if the SRB concludes that the DGS is not likely to contribute to resolution costs or because there is a high risk of exhaustion of the available financial means of the DGS in case of a systemic crisis,
- **to maximum of an amount of 0.4% of covered deposits of domestic banking groups** (i.e. 50% of the DGS’s target level).

3.2.6 The “8% of total liabilities and own funds” constraint

Pursuant to **Article 5 of the Commission Delegated Regulation 2016/1450,** the SRB may determine higher MREL target for G-SIIs and O-SIIs and any other banking group that poses a systemic risk in case of failure. In relation to these banking groups, the SRB may set an MREL target of not lower than 8% of its total liabilities and own funds, even if the determination formula described above (under ***3.2.3***) would lead to a lower MREL target.

The “8% of total liabilities and own funds” cap is consistent with **Article 44(5) of the BRRD** that allows the use of the SRF provided that a contribution to loss absorption and

[291] *Ibid.,* Article 3(3).

recapitalization of at least 8% of total liabilities and own funds has been made. Given that G-SIIs and O-SIIs are most likely to be resolved due to their systemic relevance, the regulatory framework seeks to ensure that their resolution costs will be borne to the maximum extent possible by their shareholders and bondholders limiting, thus, the possibility to resort to the SRF's available financial means.

3.2.7 Transitional period to meet the MREL target

The obligation of banking groups to meet the MREL target is definitely a heavy burden for them, since it requires the issuance of a large volume of MREL-eligible liabilities, mainly senior unsecured bonds. This problem is particularly relevant for deposit-funded banking groups, which do not need senior unsecured bonds for funding purposes.

Therefore, under **Article 8 of the Commission Delegated Regulation 2016/1450**, the SRB may require banking groups to meet gradually the MREL by setting a transitional period, which should be "*as short as possible*".[292] This provision gives the SRB wide discretion on the transitional period it can provide to banking groups to satisfy the MREL. For each twelve (12) months during the transitional period, the SRB must communicate to banking groups a planned MREL target along with the deadline by which they must comply with. In any case, the SRB can revise the transitional period or any planned MREL target.

The SRB's approach for the determination of the MREL target, as well as the revised regulatory framework for the MREL are further analyzed in **Chapter B, Section 2,** under **2**.

4. Resolution action taken by the SRB

4.1 Implementation of preparatory measures related to resolution

4.1.1 Preparatory action upon adoption of early intervention measures

The SRB may start preparing for the resolution of a banking group upon receipt of information from the ECB that it has exercised any of its supervisory powers referred to in Article 16 of the SSMR (see above in **Chapter A, Section 1**, under **3.5.3**) or has taken any Pillar II measures (see below in **Chapter B, Section 1**, under **1.4**) or early intervention measures (see below in **Chapter B, Section 1**, under **2.3**).[293] In that context, the ECB and the SRB should monitor the financial situation of the banking group concerned and its compliance with the early intervention measures. The ECB must provide the SRB with the necessary information to update the resolution plan and prepare for the possible resolution of the group.

In light of the severe deterioration of the financial situation of the banking group and its possible resolution, the SRB should take action to perform valuation of the assets and liabilities of the group. In addition, the SRB may require the parent entity of the banking group concerned to contact potential purchasers in order to prepare for the application of the sale of business tool. The SRB may also require the NRA concerned to draft a preliminary resolution scheme for the banking group.

4.1.2 Resolution-related valuations

Valuations are critical for any resolution action taken. A successful resolution requires timely and robust valuation to determine the level of recapitalization required, the scope

[292] *Ibid.*, Article 8(2).

[293] **SRMR**, Article 13(1)

of the liabilities to be subject to bail-in and the exchange terms for bailed-in liabilities. Aiming to ensure that the power of NRAs to intervene in the rights of shareholders and creditors is exercised in a manner that both achieves resolution objectives and respects the rights of shareholders and creditors, the following valuations are carried out in three (3) phases of the resolution process: [294]

1. the **"failing or likely to fail" valuation** (**Valuation 1**), which is an assessment of the banking group's financial position aiming to contribute to the determination of the group as "failing or likely to fail",
2. the **"ex-ante valuation"** (**Valuation 2**), which is carried out prior to taking resolution action and aims at informing the SRB's understanding on the value of the group's assets and liabilities and allowing the SRB to choose the appropriate resolution tool, and
3. the **"ex-post valuation"** (**Valuation 3**), which seeks to ensure that shareholders and creditors of the banking group have not received worse treatment than they would have received if the group's entities had been wound up under normal insolvency proceedings.[295]

The process and key elements for each of the aforementioned valuations are described in detail in **Chapter B, Section 3,** under **1.1**.

4.2 Adoption of resolution schemes or decisions for write-down or conversion of capital instruments

4.2.1 Conditions for resolution and resolution procedure

The decision for taking resolution action in relation to a significant banking group is taken based on a complex process which includes many actors. The determination that a banking group must be put into resolution is made by the ECB and the SRB, subject to the Commission's and ECOFIN's consent. Nonetheless, the SRMR laid down a tight timeframe (maximum within 48 hours) in which the relevant decision must be taken.

Within the framework of the SRM, the SRB adopts a resolution scheme (i.e. a decision to activate the resolution procedure) in respect of a banking group, only when it assesses in its executive session, either on receiving a communication by the ECB or on its own initiative, that the following conditions are met:[296]

a. an assessment that the **banking group is "failing or is likely to fail**" is made,
   i. either by the ECB, after consulting the SRB, or
   ii. by the SRB's executive session, only after informing the ECB of its intention and only if the ECB, within three (3) calendar days of having been informed, does not make such an assessment.[297]

b. the SRB's executive session assesses, in close cooperation with the ECB, or the ECB on its own assesses that having regard to timing and other relevant circumstances, there is **no reasonable prospect that any alternative private**

[294] See **De Nederlandsche Bank (2017)**, p. 5.

[295] For more information on the ex-post valuation (Valuation 3 report), see **Deloitte and Single Resolution Board (2018).**

[296] **SRMR**, Article 18(1).

[297] The SRB can make the determination that a banking group is "failing or is likely to fail", only if the ECB without delay provides it with any relevant information that the latter requests in order to assess its assessment.

sector measures taken in respect of the banking group, including early intervention measures or the write-down or conversion of relevant capital instruments, **would prevent its failure within a reasonable timeframe**,

c. **resolution action is necessary in the public interest**, where that action is prerequisite for the achievement of one or more of the resolution objectives which cannot be met through liquidation under normal insolvency proceedings.

Once the aforementioned conditions for resolution are met (further analysis below in **Chapter B, Section 3,** under **2.2)**, the SRB adopts a resolution scheme in respect of the banking group concerned. The resolution scheme places the banking group under resolution and determines the resolution tool(s) to be applied in the parent entity and any liabilities that should be excluded from the scope of bail-in. Where necessary, the resolution scheme determines the amount and the purpose of possible use of the SRF for covering resolution costs and whether the NRA of the Member State where the parent entity is located must appoint a special manager to the entity under resolution. [298]

In addition, the resolution scheme describes the banking group under resolution and the national insolvency proceedings of the Member State where the parent entity is located. The resolution scheme presents the core elements of the resolution plan drawn up for the banking group concerned and the reasons for any deviation of the resolution scheme, as well as the difficulties which the banking group was facing and the measures taken by the group to cope with those difficulties. Lastly, the resolution scheme describes the resolution process and the argumentation supporting the SRB's assessment that the conditions for resolution are met.[299]

Upon adoption of the resolution scheme, the SRB transmits this scheme to the Commission, which has to take one of the following decisions:[300]

a. to endorse the resolution scheme, within 24 hours from its transmission, or to not raise any objection within that timeframe,

b. to object to the scheme, within 24 hours from its transmission, in relation to discretionary aspects of it (e.g. selected resolution tool, liabilities subject to the scope of NRA's resolution powers),

c. to propose to the Council to object to the scheme because it does not fulfil the criterion of the public interest, or

d. to propose to the Council a material modification of the amount that the SRF will contribute for financing resolution costs, which is defined as a change of 5% or more to the amount of the SRF's contribution compared to the original proposal of the SRB.[301]

In the first case (point a), the resolution scheme is adopted and the NRA of the Member State where the parent entity is located is competent for its application. In the second case (point b), the SRB must modify the scheme within eight (8) hours based on the remarks made by the Commission. Where the Commission considers that the resolution of the banking group concerned does not meet the criterion of public interest (point c),

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[298] **SRMR**, Article 23.

[299] For a more detailed presentation of the resolution scheme's content, see **SRB Decision** of the Single Resolution Board in its Executive Session of 7 June 2017 "*concerning the adoption of a resolution scheme in respect of Banco Popular, S.A., (the "Institution") with a Legal Entity Identifier: 80H66LPTVDLM0P28XF25, Addressed to FROB*", **Single Resolution Board (2017b)** and **FROB (2017)**.

[300] **SRMR**, Article 18(7).

[301] *Ibid.,* recital (26).

the Council **either agrees with the Commission**, a decision that triggers the liquidation of the group's entities in accordance with the respective national insolvency law, **or disagrees with the Commission's proposal**, which means that the resolution scheme submitted by the SRB is adopted as such.

In the latter case (point d), if the Council approves the Commission's proposal on the necessity to amend the SRF's contribution, the SRB must modify the resolution scheme within eight (8) hours in accordance with the Commission's remarks. On the contrary, where the Council disagrees with the Commission proposal, the resolution scheme submitted by the SRB is adopted.

Upon determination by the ECB (or the SRB in exceptional circumstances) that a banking group is "failing or is likely to fail", the SRB must assess whether it is likely to prevent the failure of that group in case of application of private sector measures or any supervisory measures, including the **write-down or conversion of capital instruments** into equity. If the application of the write-down and conversion of capital instruments is adequate to restore the capital adequacy of the group, resolution action is not taken. Thus, the write-down or conversion of capital instruments can be applied before the resolution action or in combination with the resolution action if this supervisory measure is inadequate to prevent the failure of the banking group.[302]

The complexity of the resolution procedure is justified by the need to ensure control and supervision over the discretionary powers of the SRB in line with the Meroni doctrine.[303] This applies mainly to aspects of the resolution scheme that pertain to the need to put a banking group into resolution (public interest criterion) or the use of the SRF. Since the adoption of resolution schemes entails a margin of discretion, the legislators considered necessary to provide for the involvement of the Council and the Commission in this decision-making process.[304] As referred to in **recital 26 of the SRMR** " *the procedure relating to the adoption of the resolution scheme, which involves the Commission and the Council, strengthens the necessary operational independence of the Board while respecting the delegation of powers to agencies as interpreted by the Court of Justice of the European Union."*

In any case, resolution schemes adopted under the above procedure are addressed to the NRAs concerned, which must take all the necessary measures for the application of the schemes by exercising the resolution powers conferred upon them.[305] However, the lengthy decision-making procedure (may last up to 48 hours) leaves only six (6) to twelve (12) hours to NRAs for the implementation of the resolution schemes. This timeframe is not enough, particularly if the banking group has operations also in non-participating Member States, let alone in third countries. In this case, it would be likely that the NRAs of non-participating Member States could take resolution action before the adoption of the resolution scheme by the SRB.[306]

In **Chapter B, Section 3,** under **2.3,** the implementation of the write-down and conversion of capital instruments issued by the parent entity and/or subsidiaries of banking groups is analyzed in detail.

[302] **BRRD**, Article 59(1).

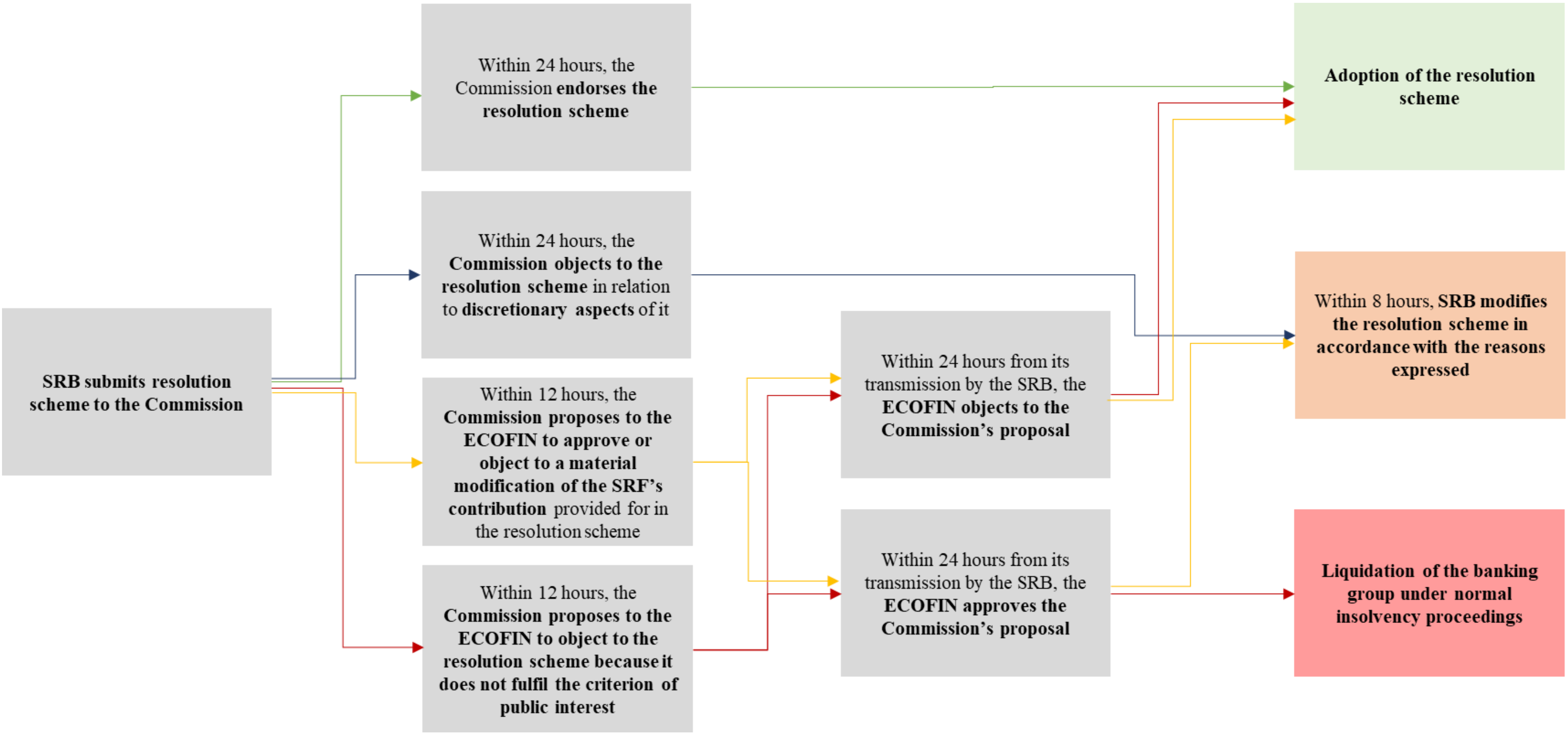
[303] See **Busch (2017)**, p.39.

[304] **SRMR**, recital (2).

[305] *Ibid.,* Article 18(9).

[306] See **Huertas (2016)**, p. 14.

Figure 7: Resolution procedure under Article 18 of the SRMR



4.2.2 Resolution objectives

The SRMR laid down a set of resolution objectives that must be considered by the SRB, the Council, the Commission and the NRAs, when they decide on the need to take resolution action and the resolution tool(s) to apply. These objectives pertain to:[307]

a. ensuring continuity of critical functions,

b. the avoidance of significant adverse impact on financial stability, mainly by preventing contagion and maintaining market discipline,

c. the protection of public funds by minimizing reliance on extraordinary public financial support,

d. the protection of depositors covered by the DGSD and investors covered by the Directive 97/9/EC, and

e. the protection of client funds and client assets.

The resolution objectives relating to resolution action for banking groups are analyzed in **Chapter B, Section 3,** under **2.4**.

4.2.3 Resolution principles

The introduction of the resolution framework aims to ensure that the rescue of failed banking groups will minimize the burden upon taxpayers' shoulders and henceforth shareholders, creditors and senior management will bear the consequences of their choices and actions or inaction. In that context, the SRMR laid down specific principles which must govern resolution decisions seeking to ensure that resolution action will be in line with the rationale of introducing the resolution framework. Hence, the SRB, the Commission and the Council must ensure that resolution action is taken in accordance with the following principles:[308]

a. the shareholders of the parent entity of the group under resolution bear first losses,

b. the creditors of the parent entity of the banking group under resolution bear losses after the shareholders in accordance with the order of priority of their claims,

c. the management body and senior management are replaced, except in those cases where the retention of the management body and senior management, in whole or in part, is necessary for the achievement of the resolution objectives,

d. the management body and senior management must provide all necessary assistance for the achievement of the resolution objectives,

e. natural and legal persons are made liable, subject to national law, under civil or criminal law, for their responsibility for the failure of the banking group concerned,

f. except where otherwise provided in the SRMR, creditors of the same class are treated in an equitable manner,

g. no creditor shall incur greater losses than would have been incurred if the entities constituting the banking group had been wound up under insolvency proceedings,

h. covered deposits are fully protected, and

i. resolution action is taken in accordance with the safeguards stipulated in **Articles 73-80 of the BRRD**.

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[307] **SRMR**, Article 14(2).

[308] *Ibid.,* Article 23(1).

4.3 Implementation of resolution action

4.3.1 Allocation of responsibilities within the SRM

Under the SRMR, NRAs are responsible for implementing the decisions taken by the SRB and exercising the resolution powers in accordance with the resolution scheme, including the power to appoint temporary administrator to a banking group under resolution (see below in **Chapter B, Section 3,** under **2.5**) and to write down capital instruments and other eligible liabilities, as well as to ensure that the resolution action complies with the safeguards provided for in the BRRD.[309] To that end, NRAs exercise their powers in accordance with national law transposing the BRRD.[310] The adoption of a decentralized approach for the implementation of resolution schemes is plausible, particularly in light of the divergences existing in national company, insolvency, contract and property laws across Member States.[311]

The effective implementation of resolution decisions can be ensured, only if timely and sound information is provided to the SRB. For that purpose, NRAs must cooperate with and assist the SRB in the performance of its monitoring duty and provide accurate and reliable information on the execution of the resolution schemes, the application of the resolution tools and the exercise of the resolution powers.[312] The information provided from NRAs should cover:

- the operation and financial situation of the banking group under resolution, the bridge institution and the asset management vehicle,
- the treatment that shareholders and creditors would have received in the liquidation of the banking group, where it had been put under normal insolvency proceedings,
- any ongoing court proceedings relating to the liquidation of the assets of the banking group under resolution, to challenges to the resolution decision and to the valuation,
- the appointment, removal or replacement of evaluators, administrators, accountants, lawyers and other professionals that may be necessary to assist the NRAs, and on the performance of their duties,
- any other matter that is relevant for the implementation of the resolution scheme including any potential infringement of the safeguards provided for in the BRRD, and
- the economic viability, feasibility, and implementation of the business reorganization plan.

Based on the information received, the SRB may instruct NRAs as to any aspect of the implementation of the resolution scheme and the exercise of the resolution powers.[313] Where the SRB identifies that NRAs have not implemented its decision or have applied it in a way that threatens the achievement of the resolution objectives, the SRB in its Executive Session may exercise its powers under **Article 29(2) of the SRMR**.

Specifically, in the event of resolution action, the SRB may order an entity under resolution to **transfer to another entity specific rights, assets or liabilities** and/or to **convert into equity any debt instruments**, which contain a contractual term for

[309] *Ibid.,* Article 29(1).

[310] See **Wymeersch (2015)**, p. 5.

[311] See **Binder (2016)**, p. 14

[312] **SRMR**, Article 28(1).

[313] *Ibid.,* Article 28(2).

conversion. Furthermore, the SRB may order an entity under resolution to **adopt any other necessary measure to comply with the decision in question**, only if the measure significantly addresses the threat to the achievement of the relevant resolution objective.

Before deciding to impose any measure, the SRB must notify, at least 24 hours earlier, of its intention the NRA concerned and the Commission. The notification must include details of the envisaged measures, the reasons for those measures and details of when the measures are intended to take effect. The banking group under resolution must comply with the decision taken by the SRB, which prevails over any previous decisions adopted by the NRA concerned on the same matter.[314]

4.3.2 Resolution tools

4.3.2.1 General principles governing the application of resolution tools

The new Union resolution framework introduced four (4) resolution tools that can be applied by resolution authorities, where conditions for resolution are met.[315] These resolution tools are classified into two categories: the **going-concern tools**, which aim at preserving the group's entities autonomous legal existence and the **gone-concern tools**, which dissolve the group's entities' legal existence aiming at minimizing the negative effects of insolvency on the different stakeholders.[316] The **bail-in tool** is the sole going-concern resolution tool, while the second category (gone-concern tools) includes the **sale of business tool**, the **bridge institution tool** and the **asset separation tool**. [317]

The SRB must decide on the resolution tool to be applied in case of resolution by taking into account several factors, such as the assets and liabilities of the banking group based on the outcome of the ex-ante valuation, the liquidity position of the group, the marketability of its franchise value, as well as the time available to implement the resolution scheme.[318] For instance, if the banking group is put into resolution due to liquidity reasons (e.g. breach of liquidity requirements), the bail-in tool will be ineffective to address the reasons which triggered the failure of the group. Therefore, it is more appropriate for the SRB to select the sale of business tool and to transfer the assets, rights and liabilities of that group to another banking group which would have liquidity surplus.

Resolution tools may be applied individually or in combination. The only exception is the asset separation tool which can be applied only together with another resolution tool. Where the SRB adopts a resolution scheme that provides for the application of the sale of business tool or the bridge institution tool and the transfer only part of the assets, rights or

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[314] *Ibid.*, Article 29(3).

[315] Since the BRRD is a minimum harmonization legislative act, it does not prevent Member State from introducing additional resolution tools and powers in their national legal framework, which can be applied to failing entities, provided that:

- they do not pose obstacles to effective resolution of cross-border banking groups, and
- they are consistent with the resolution objectives and the general principles governing resolution.

However, in the context of the SRM, the SRB may apply only those resolution tools provided for in the BRRD.

[316] See **Vardi (2017)**, p. 10.

[317] **BRRD**, Article 37(3).

[318] **SRMR**, Article 22(3).

liabilities of the banking group under resolution, the residual entity is wound up under normal insolvency proceedings.

The use of the resolution tools and powers may entail expenses for the SRB and the NRA concerned and the SRF which must be recovered in three (3) ways. Firstly, as a deduction from any consideration paid by a recipient to the banking group under resolution or to the shareholders. Secondly, from the banking group under resolution, as a preferred creditor, and, thirdly, from any proceeds generated as a result of the termination of the operation.[319]

4.3.2.2 The gone-concern resolution tools

Prior to the international financial crisis, the **sale of business tool** (and the bridge institution tool also) had been extensively used in the United States and Canada as effective tools to deal with banking failures. These resolution tools were subsequently introduced in certain EU jurisdictions, such as the UK, Denmark, Germany and Greece, before the adoption of the BRRD.[320]

Following the introduction of the BRRD, the sale of business tool can be applied in a uniform way across the EU. Thus, if the SRB decides that the selection of a gone-concern tool is the most preferred option to deal with a failing banking group, the sale of business tool is definitely the most feasible and efficient solution to proceed, provided that there is a willing buyer to acquire the assets, rights and liabilities of the banking group under resolution. The successful implementation of the sale of business tool largely depends on the availability of a private-sector investor that is financially and operationally capable to complete the transfer of assets and liabilities. This availability is subject to a series of variables, such as the complexity and size of the failing banking group, the amount of capital and liquidity needed to restore the capital and liquidity ratios of the acquired banking group and the prevailing macroeconomic and market conditions both at national and Union level.[321]

Where the application of a transfer tool is considered the most credible option to cope with the underlying reasons for the failure of a banking group, but no private sector purchaser has shown interest for that purpose, the SRB may resort to the **bridge institution tool**. The SRB may select this resolution tool to ensure transfer of critical functions performed by the banking group under resolution to another group avoiding any adverse impact on the financial system and the real economy. Upon adoption of a resolution scheme by the SRB, which provides for the application of the bridge institution tool, the NRA concerned is responsible for transferring to a bridge institution the shares issued by the parent entity of a group under resolution and/or all or any assets, rights or liabilities of the group under resolution.

Impaired assets and depreciation triggered many cases of financial distress during the international financial crisis. Against that backdrop, many Member States established asset management vehicles (known as “bad banks”) to relieve banking groups’ balance sheets of these depreciated assets and the risks linked to them.[322] The “bad bank” model was introduced in the new resolution framework through the **asset separation tool**. This tool enables resolution authorities to transfer the assets, rights or liabilities of a banking group under resolution to one or more asset management vehicles seeking to wind these

[319] *Ibid.*, Article 22(6).

[320] See **Binder (2018a)**, p. 21 and **Gordon** and **Ringe (2014)**, pp. 1305-1306, 1335-1336.

[321] See **Binder (2018b),** p. 11.

[322] **EBA Guidelines** “*on 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*”, p. 4.

activities down in an orderly manner. The objective of the asset separation tool is the maximization of the value of the assets transferred to it through eventual sale or orderly wind down.[323]

The asset separation tool is the optimal solution to cope with many failing banking groups that face similar problems relating to the quality of their portfolio (e.g. high volume of non-performing loans). Thus, the SRB may decide the application of the asset separation tool, along with the bail-in tool or the sale of business tool, and the transfer of problematic assets to an asset management vehicle. Under this way, the SRB can achieve a more efficient and effective work out of bad loans and promote the maximization of the value of the assets under disposal.

4.3.2.3 The going-concern (bail-in) tool

Bail-in is a statutory power of resolution authorities that permits them to write-down or convert into equity part of the liabilities of the parent entity of the group in order to preserve the banking group into a going-concern status.[324] Therefore, the bail-in tool is considered as the only going-concern resolution tool, the application of which seeks:[325]

- to recapitalize a banking group under resolution that meets the conditions for resolution to the extent sufficient to restore its capital ratio above the minimum regulatory threshold and sustain market confidence, or
- to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
    - to a bridge institution in order to provide capital to that institution, or
    - to another entity under the sale of business tool or the asset separation tool.

The recapitalization of a banking group through the use of the bail-in tool is the only available option which does not result in change of the legal form of the group concerned. The SRB may recourse to that option only if there is a reasonable prospect that this option, accompanied with the implementation of other relevant measures under the reorganization plan, will both meet the resolution objectives and restore the financial soundness and long-term viability of the banking group.

Thus, the SRB should first assess whether the application of the bail-in tool can ensure the achievement of the resolution objectives. Where the SRB concludes that the conditions for the application of solely the bail-in tool are not met, then it may apply the other resolution tools individually or in combination with the bail-in tool. Consequently, upon determination that the conditions for resolution are met, the bail-in tool should be the first option for the SRB to examine.

The procedural arrangements governing the implementation of resolution tools with respect to banking groups are described in detail in **Chapter B, Section 3,** under **3.1**.

4.3.3 Public financial support in resolution

The resolution framework requires shareholders and creditors to bear losses and contribute to the recapitalization of a banking group under resolution. However, within the resolution framework there is still the option for capital contribution from Member States through

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[323] **BRRD**, Article 42(3).

[324] See **Lambrecht and Tse (2018)**, p. 2.

[325] **BRRD**, Article 43(2).

the use of the **Government Financial Stabilization Tools (GFSTs)** or the **Direct Recapitalization Instrument** (DRI) of the European Stability Mechanism (ESM).

Under the GFSTs, Member States may request from the SRB to contribute to the recapitalization of a banking group, where a systemic crisis has sparked, under the following strict conditions:[326]

- the conditions for resolution of the banking group are met,
- shareholders, holders of capital instruments and other creditors have contributed to loss absorption and recapitalization of the parent entity of the banking group with an amount not less than 8% of total liabilities and own funds, and
- the Commission has granted approval to the use of the state aid.

The government's contribution to the recapitalization of the parent entity is feasible through resort to the **public equity support tool** and/or the **temporary public ownership tool**. In the first case, the government acquires a stake (and not full control) in the parent entity under resolution, while in the second case the government takes the temporary public ownership and control of the parent entity under resolution.

Where a Member State encounters difficulty in contributing to the recapitalization of a banking group exclusively with its own means due to fiscal constraints, resort to the DRI is an option, though under very strict conditions. Direct recapitalization through the ESM requires higher (than in the case of GFSTs) contribution of creditors to losses, use of the available funding means of the SRF, as well as contribution from the Member State where the parent entity is located.

The arrangements relating to the GFSTs and the DRI are analyzed in **Chapter B, Section 4,** under **1**.

4.3.4 Safeguards

4.3.4.1 No-creditor-worse-off principle

Resolution powers conferred upon NRAs enable them to interfere with the property rights of shareholders, creditors and counterparties without their consent. However, such powers are subject to some safeguards, which are designed to achieve a balance between providing a degree of certainty to those stakeholders about the treatment they would receive in resolution and providing NRAs with the necessary flexibility to give effect to an orderly resolution as quickly as necessary.

Upon application by an NRA of the sale of business tool, bridge bank tool or asset separation tool, only part of the rights, assets and liabilities of the group under resolution are transferred. The shareholders and creditors whose claims have not been transferred, must receive in satisfaction of their claims at least as much as they would have received if the group's entities had been wound up under normal insolvency proceedings.[327] This safeguard is applied also in case of application of the bail-in tool. Thus, the shareholders and creditors whose claims have been written down or converted into equity must not incur greater losses than they would have incurred if the group's entities had been wound up under normal insolvency proceedings.

To that end, the NRA carries out an ex-post valuation to determine whether shareholders and creditors would have received better treatment if the group under resolution had entered into normal insolvency proceedings (see below in **Chapter B, Section 3,** under **1.1.3**). The ex-post valuation must determine:

[326] *Ibid.,* Article 37(10).

[327] *Ibid.,* Article 73.

- the treatment that shareholders, creditors, as well as the relevant DGS, would have received if the group's entities had entered normal insolvency proceedings,
- the actual treatment that shareholders and creditors received in the resolution of the group concerned, and
- if there is any difference between the treatment referred in the points below.

Where the ex-post valuation determines that any shareholder or creditor or the DGS has incurred greater losses than it would have incurred in case of liquidation, the SRB has to pay the difference by using the available funding means of the SRF.[328] In that context, it is necessary national insolvency rankings to be modified in such a way to avoid the breach of the "no-creditor-worse-off" principle, as will be further analyzed in **Chapter C, Section 2**, under **3.3**.

4.3.4.2 Safeguard for counterparties in partial transfers

The BRRD has introduced additional safeguards for counterparties of banking groups under resolution in which partial transfers are carried out. The same protection is applied when an NRA forcibly modifies the terms of a contract to which the group under resolution is party. This protection seeks to prevent, when a partial transfer or contractual modification is effected, the splitting of assets, rights or liabilities which are linked to each other by virtue of those arrangements.[329]

In particular, this protection is applied in two (2) cases. Firstly, where the NRA transfers some but not all of the assets, rights or liabilities of the parent entity of a banking group under resolution to another entity or from a bridge institution or asset management vehicle to another person, Secondly, if the NRA cancels or modifies the terms of a contract to which the parent entity under resolution is a party or substitute a recipient as a party. [330]

Thus, the protection covers the following arrangements and the corresponding counterparties:

- **security arrangements**, under which a person has by way of security an actual or contingent interest in the assets or rights that are subject to transfer, irrespective of whether that interest is secured by specific assets or rights or by way of a floating charge or similar arrangement,
- **title transfer financial collateral arrangements**, under which collateral to secure or cover the performance of specified obligations is provided by a transfer of full ownership of assets from the collateral provider to the collateral taker,
- **set-off arrangements**, under which two or more claims or obligations owed between the parent entity under resolution and a counterparty can be set off against each other, and
- **netting arrangements**, **covered bonds**, and **structured finance arrangement**, including securitizations.

The requirement to provide protection, as described above, is applied irrespective of the number of parties involved in the arrangements and of whether the arrangements are created by contract, trusts or other means, or arise automatically by operation of law or

[328] *Ibid.*, Article 75.

[329] **Commission Delegated Regulation 2017/867**, recital (1).

[330] **BRRD**, Article 76(1).

are governed in whole or in part by the law of another Member state or by third-country law. [331]

The aforementioned classes of arrangement falling within the scope of protection are specified in the Commission Delegated Regulation 2017/867.

4.3.4.3 Protection for financial collateral, set-off arrangements and netting arrangements

Netting arrangements allow banking groups to have a single net claim by offsetting the value of multiple positions, or payments to be exchanged, between two or more parties.[332] Netting and set-off result in the same economic effect, but they work in a different way. Under a netting arrangement, two parties agree that to the extent that they transact between each other, there will be just one amount owed by the party whose notional cross-claims are worth less that of its counterparty, while a set-off arrangement has a narrower scope given that it discharges cross-claims between the counterparties only if the amounts are equivalent.[333]

In accordance with **Article 77 of the BRRD**, title transfer financial collateral arrangements and set-off and netting arrangements must enjoy the appropriate protection ensuring that NRAs will not transfer some, but all of the rights and liabilities that are protected under such arrangements between the parent entity under resolution and another person or will modify or terminate rights and liabilities that are protected under such arrangements through the use of ancillary powers. To that end, rights and liabilities are to be treated as protected under such an arrangement if the parties to the arrangement are entitled to set-off or netting those rights and liabilities.

Set-off arrangements entered into between the parent entity of a banking group and a single counterparty enjoy protection, where they relate to rights and liabilities arising from financial contracts or derivatives and in any of the following circumstances:[334]

- where the arrangements are linked to the counterparty's activity, in particular for the activity covered by a default fund as referred to in **Article 42 of the Regulation 648/2012**,[335] or
- where the arrangements are related to rights and obligations towards payment and securities settlement systems, as defined in **Directive 98/26/EC**.

NRAs may decide on a case-by-case basis that set-off arrangements entered into between an entity under resolution and one or more counterparties related to other types of rights and liabilities than those referred above may qualify as set-off arrangements eligible for protection. These arrangements should be recognized for risk mitigation purposes under the applicable prudential rules and the protection.[336]

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[331] *Ibid.*, Article 76(3).

[332] See **Pompei (2017)**, p. 2.

[333] *Ibid.*, p. 3.

[334] **Commission Delegated Regulation 2017/867**, Article 3(1)-(2).

[335] **Regulation (EU) No 648/2012** of the European Parliament and of the Council of 4 July 2012 "*on OTC derivatives, central counterparties and trade repositories*".

[336] **Commission Delegated Regulation 2017/867**, Article 3(3).

The aforementioned provisions apply also to netting arrangements.[337] For example, all individual derivative transactions that are subject to the same netting master agreement must be transferred together.[338]

However, where necessary to ensure availability of covered deposits, NRAs may transfer covered deposits which are part of any of the arrangements mentioned above without transferring other assets, rights or liabilities that are part of the same arrangement. In addition, NRAs may transfer, modify or terminate those assets, rights or liabilities without transferring covered deposits.[339]

4.3.4.4 Protection for security arrangements

Security arrangements eligible for receiving protection include:[340]

- arrangements stipulating guarantees, personal securities and warranties,
- liens and other real securities interests,
- securities lending transactions, which do not imply a transfer of full ownership of the collateral and which involve one party (the lender) lending securities to the other party (the borrower) for a fee or interest payment and in which the borrower provides the lender with collateral for the duration of the loan.

Security arrangements qualify for protection, only if the rights or assets to which the security interest is attached or would attach upon an enforcement event are sufficiently identified in accordance with the terms of the arrangement and the applicable national law. Protection for liabilities secured under a security arrangement is necessary so as to prevent one of the followings:[341]

- the transfer of assets against which the liability is secured, unless this liability and the benefit of the security is also transferred,
- the transfer of a secured liability, unless the benefit of the security is also transferred,
- the transfer of the benefit of the security, unless the secured liability is also transferred, or
- the modification or termination of a security arrangement through the use of ancillary powers, if the effect if that modification or termination is that the liability ceases to be secured.

Where necessary to ensure availability of covered deposits, NRAs may transfer covered deposits which are part of any of the arrangements mentioned above without transferring other assets, rights or liabilities that are part of the same arrangement, and transfer, modify or terminate those assets, rights or liabilities without transferring the covered deposits. [342]

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[337] *Ibid.*, Article 4

[338] See **Pompei (2017)**, p. 5.

[339] **BRRD**, Article 77(2).

[340] **Commission Delegated Regulation 2017/867**, Article 2.

[341] **BRRD**, Article 78(1).

[342] *Ibid.*, Article 78(2).

4.3.4.5 Protection for structured finance arrangements and covered bonds

Appropriate protection is also provided for structured finance arrangements, including covered bonds and (synthetic and true sale securitizations) in order to prevent either of the following:[343]

- the transfer of some, but not all, of the assets, rights and liabilities which constitute or form part of a structured finance arrangement to which the group under resolution is party,
- the termination or modification through the use of ancillary powers of the assets, rights and liabilities which constitute or form part of a structured finance arrangement to which the group under resolution is a party.

Respectively, where necessary to ensure availability of covered deposits, NRAs may transfer covered deposits which are part of any of the arrangements mentioned above without transferring other assets, rights or liabilities that are part of the same arrangement. For the same reason, NRAs may transfer, modify or terminate those assets, rights or liabilities without transferring the covered deposits. [344]

4.3.4.6 Protection of trading, clearing and settlement systems

The application of resolution tool(s) must not affect the operation of systems and rules of systems covered by the Directive 98/26/EC, where the NRA concerned transfers some but not all the assets, rights or liabilities of an entity under resolution or uses powers to cancel or amend the terms of a contract to which the group under resolution is a party or to substitute a recipient as a party.

[343] *Ibid.*, Article 79(1).

[344] *Ibid.*, Article 78(2).

Section 5: The role of the Single Resolution Fund (SRF) in the Banking Union

1. The rationale for establishing the Single Resolution Fund

The adoption of a Union resolution framework aimed at ensuring that taxpayers would no longer be liable for covering the costs arising from failures of banking groups. Therefore, having as objective to break the vicious circle between sovereigns and banking systems, it was prerequisite to ensure that such costs would be borne by the banking sector.

To that end, the BRRD laid down the obligation for Member States to establish national resolution funds.[345] National resolution funds are governed by public administrative authorities, which are responsible for deciding if the available funding means will be used for the purpose of covering resolution costs.

National resolution funds raise contributions from banking groups during normal periods (ex-ante contributions) and, if necessary, also during crisis periods (ex-post contributions). Such contributions may be used only for resolution-related purposes in accordance with **Article 101 of the BRRD**. National resolution funds can fulfil effectively the tasks conferred on them on condition that they have the necessary firepower in terms of available funds. To that end, each national resolution fund must reach a target level of at least 1% of covered deposits of all the banking groups authorized in the Member State concerned.[346] The BRRD sets the minimum level of available funding means (target level) which a national resolution fund must reach providing Member States with the discretion to determine a higher target level. The target level must be reached within a 10-year period (i.e. by 2024) providing, thus, banking groups with an adequate timeframe to meet their obligations without threatening their financial position.

The establishment of a supranational authority (i.e. SRB) that is competent for taking resolution decisions for banking groups located in the participating Member States had to be accompanied with the creation of a Single Resolution Fund (SRF). If the resolution funding was to remain national, the link between sovereigns and banking sector would not be fully broken.[347] Assigning resolution tasks upon a supranational authority, while retaining the existing regime of national resolution funds with different target levels would impede the orderly functioning of the SRM.

Therefore, **Article 67 of the SRMR** established the SRF and laid down the arrangements related to the calculation and use of the contributions raised from banking groups, as well as other funding means available to the SRF to cover resolution financing. The SRF, which started operating on 1 January 2016, is owned by the SRB and, where necessary, may be used to ensure the efficient application of resolution tools and the exercise of the SRB's resolution powers.[348] The SRF pools significant resources from all banking groups located in participating Member States and, therefore, protects taxpayers more effectively than national resolution funds would do. Thus, the SRF contributes to achieving a uniform administrative practice in resolution financing and avoiding distortion of competition in the internal market due to divergent national practices.

[345] *Ibid.*, Article 100(1).

[346] *Ibid.*, Article 102(1).

[347] **SRMR**, recital (19).

[348] *Ibid.*, Article 67(2).

2. The funding means of the SRF

2.1 The target level of the SRF

The financial capacity of the SRF, which is critical for the achievement of its objectives, can be ensured only if a sufficient amount of contributions is raised. **Article 69 of the SRMR** has set the target level for the SRF at the level of at least 1% of covered deposits of banking groups located in the participating Member States. This amount is expected to reach €60bn until 2023. Although it would be ideal for the SRF to reach this target level sooner, the long transitional period limits the negative implications in the financial situation of banking groups. Should euro area banking groups had been obliged to pay an amount of €60bn at a short notice (e.g. within a year), significant impact on its profitability and solvency would have arisen.

During the last years, there has been an intense debate on the appropriate target level of the SRF, as there are studies that doubt on the capacity of the SRF to meet its objectives with a target level of approximately €60bn. In 2015, **De Groen and Gros (2015)** published a study, which was based on the capital support (state aid) provided to 72 banking groups in the euro area during the period 2007-2014. These banking groups experienced losses of €313bn and the study assumes that the SRF would have contributed €58bn or €101bn if these banking groups had to be recapitalized through bail-in up to the minimum capital requirement (8% of RWAs)[349] or even higher (12% of RWAs) respectively.[350] Given that the needed amount exceeds the target level of the SRF (€60bn), the study concludes that the current target level is insufficient to cover possible capital gap that might arise upon occurrence of a systemic crisis.

However, this argument does not take into account that banking groups have materially improved their capital adequacy during the past years as a result of the new regulatory framework and the pressure exercised by the ECB towards that direction through various initiatives (e.g. Asset Quality Review, On-Site Inspections on performing and non-performing loans). Thus, the average CET1 ratio of the ECB-supervised banking groups stands at 14.1% (as of Q2 2018), which is significantly higher than the respective one in the pre-crisis period,[351] indicating that banking groups have larger loss absorbing capacity to withstand capital troubles. Hence, most likely the SRF's available funding means are adequate to meet its aforementioned objectives, except for those relating to the provision of guarantees and loans to banking groups under resolution. This issue will be further analyzed below, in **Chapter C, Section 2**, under **2.1**.

Lastly, the SRMR includes provisions on the replenishment of contributions in case of disbursements made during the transitional period to cover resolution costs. Where, during the transitional period, the SRF has made cumulative disbursements in excess of 0.5% of the amount of covered deposits (50% of the target level), the timeframe to reach the target level will be extended for a maximum of four (4) years. If, after 2023, the available financial means of the SRF fall below the target level, banking groups must pay

[349] The term "Risk Weighted Assets" (RWAs) was developed as the basis for the calculation of the capital adequacy ratio. To determine the minimum amount of capital that must be held to reduce the risk of insolvency, assets are weighted by asset class, on the basis of factors representing their riskiness. The risk weighting varies assuming that not every loan or investment bears the same inherent risk: assets considered less risky require less capital to match the risk and vice versa.

[350] See **De Groen and Gros (2015)**, p. 22.

[351] See **European Central Bank (2018d)**, p. 45.

contributions until the target level is reached again. In case that the SRF's funds diminish below two-thirds of the target level, the target level must be reached within six (6) years.[352]

2.2 Ex-ante contributions

The SRF is financed from ex-ante contributions paid annually by all banking groups which are incorporated in participating Member States. Within the SRM, the SRB is responsible for the calculation of contributions in accordance with the methodology provided for in the **Commission Delegated Regulation 2015/63** and the **Council Implementing Regulation 2015/81.** NRAs are responsible for the collection of contributions and their transfer to the SRF in accordance with the provisions of the Intergovernmental Agreement.

The amount of contributions differs between small, non-risky banking groups and large, risky banking groups. In particular, banking groups whose total liabilities (excluding own funds and covered deposits) are below €300m and total assets below €1bn are liable to pay annually a lump-sum that ranges from €1,000 to €50,000.[353] On the contrary, a more complex and risk-based approach is applied to large banking groups, given that their annual contribution is calculated based on:

- a **flat contribution**, which is calculated pro-rata to the amount of each banking group's liabilities (excluding own funds) less covered deposits over the aggregate liabilities (excluding own funds) less covered deposits of all banking groups located in the participating Member States, and
- a **risk-adjusted contribution** that is based on the risk profile of each banking group.[354]

During the 8-year transitional period (2016-2023), contributions paid to the SRF are spread out as evenly as possible, but with due consideration to the phase of the business cycle and the impact that pro-cyclical contributions may have on the financial position of banking groups.[355] In any case, annual contributions must not exceed 12.5% of the target level.[356] The available financial means may include irrevocable payment commitments, which are fully backed by collateral of low-risk assets unencumbered by any third-party rights, at the free disposal of and earmarked for the exclusive use by the SRB. The share of the irrevocable payment commitments must not exceed 30% of the total amount of contributions raised.

As of June 2018, the SRB had collected an amount of contributions reaching €24.9bn,[357] while the following years this amount is expected to reach €60bn (see ***Figure 8***).

[352] The Commission Delegated Regulation 2017/747 specifies the aforementioned provisions on the criteria for the spreading out in time of the contributions to the SRF and the replenishment of contributions both during and after the transitional period.

[353] **Commission Delegated Regulation 2015/63**, Article 10.

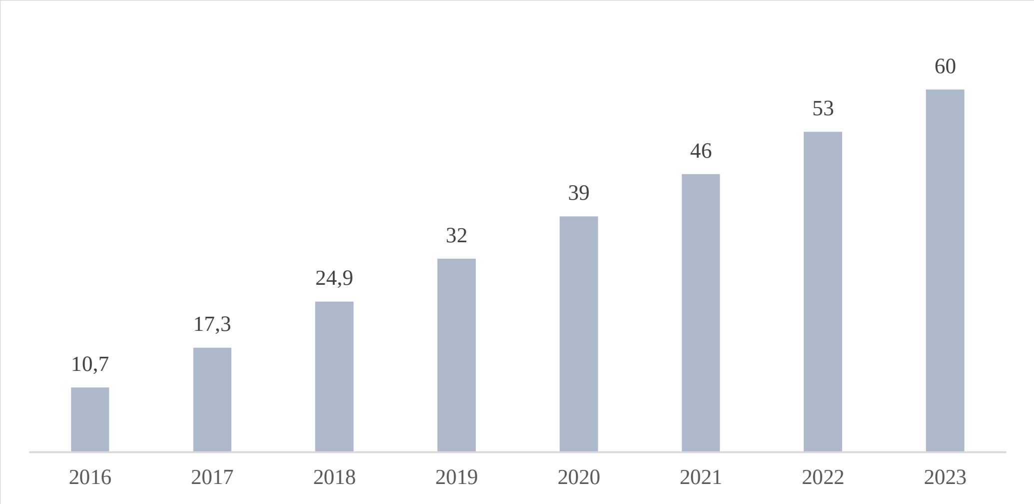
[354] For the determination of the risk-adjusted contribution of each banking group, several risk metrics (e.g. capital adequacy, liquidity, trading activities) are taken into account. Based on these metrics, which are provided for in **Article 6 of the Commission Delegated Regulation 2015/63**, the riskier a banking group is, larger contributions is liable to pay.

[355] **SRMR**, Article 69(1)-(2).

[356] *Ibid.*, Article 70(2).

[357] See **Single Resolution Board (2018b).**

Figure 8: SRF's available funding means (in €bn)



Source: *Single Resolution Board (2018b) and own estimates*

2.3 Extraordinary ex-post contributions

Where the available financial means of the SRF are insufficient to cover the losses or costs incurred, additional ex-post contributions are raised by banking groups. Ex-post contributions must be calculated and allocated among banking groups based on the methodology described above with regard to the calculation of the ex-ante contributions. The SRMR has set a cap on the amount of the ex-post contributions which can be raised on an annual basis so as to mitigate the burden on banking groups' profitability and capital adequacy. Thus, the total amount of the ex-post contributions per year must not exceed three (3) times the annual amount of the ex-ante contributions that would pay, if necessary.

The obligation of banking groups to pay ex-post contributions may be deferred, in whole or in part, after relevant decision of the SRB, either on its own initiative or upon proposal from the relevant NRA, where such a decision is necessary to protect the banking groups' financial position. That deferral must not exceed a period of six (6) months, which can be renewed on request of the banking group(s) concerned. These contributions must be paid later, when permitted by the financial situation of the banking group(s).[358]

2.4 Alternative funding means

During systemic crises, the available funding means of the SRF may be not be adequate to cover costs for resolution of large banking groups, particularly with respect to provision of liquidity. In such cases, where the ex-ante contributions, as well as the ex -post contributions are not immediately accessible or do not cover the resolution costs required, the SRB may contract for the SRF borrowings or other forms of support from **institutions, financial institutions or other third parties**, which offer better financial terms.[359] Repayment of loans must be fully recouped with contributions raised by banking groups within the maturity period of the loan.

[358] **SRMR**, Article 72(2).

[359] *Ibid.*, Article 73(1).

Furthermore, the SRB may decide to **voluntarily borrow for the SRF from national resolution funds of non-participating Member States**, in the event that:

- the ex-ante contributions raised are not sufficient to cover the resolution costs arisen,
- the amount of ex-post contributions is not immediately accessible, and
- the alternative funding means are not immediately accessible on reasonable terms.

National resolution funds take decisions on whether they would lend the SRF based on the provisions of **Article 106 of the BRRD**. Specifically, an agreement must be reached between the two parties on the rate of interest, repayment period and other terms and conditions of the loan. Reciprocally, the SRB may decide to lend SRF's available financial means to national resolution funds of non-participating Member States, if requested.[360]

2.5 Public bridge financing arrangement for the SRF

2.5.1 Key elements for the Loan Facilities Agreements

The SRMR does not require Member States to grant access to public funds, as this would impinge on Member States' fiscal sovereignty that cannot be encroached upon **Article 114 of the TFEU**.[361] Therefore, the SRMR laid down a generic reference to the obligation of the SRB to contract public financial arrangements, where possible. Pursuant to **Article 74 of the SRMR**, the SRB must contract for the SRF financial arrangements including public financial arrangements, to deal with the risk of unavailability of adequate funding means (ex-ante and ex-post contributions) to meet the SRF's obligations. Notably, this risk holds for the transitional period (2016-2023), when the SRF's target level is still being built.

To address this problem, on 8 December 2015, the ECOFIN adopted the **public bridge financing arrangement** for the SRF, which provides that Member States should sign Loan Facility Agreements (LFAs) with the SRB.[362] Through the LFAs, which is a last resort option, each participating Member State provides a bridge financing in the form of a national credit line to the SRB for the respective national compartment within the SRF during the transitional period, until the SRF is fully mutualized by 1 January 2024. The LFAs make the SRF's capacity fully available in the build-up phase of its existence.

The overall amount of the (19) credit lines of all participating Member States amounts to €55bn, which was the initial target level of the SRF (calculated based on data as of 2014).[363] Each Member State provides a credit line equal to the amount of contributions which the banking groups of its jurisdiction are expected to pay until the end of the transitional period (Fixed Individual Amount).

Table 5 includes Information on the Fixed Individual Amount per participating Member State.

[360] *Ibid.*, Article 72(2)-(3).

[361] See **Busch (2017)**, p. 24.

[362] See **Single Resolution Board (2017a).**

[363] This amount will be adjusted during the transitional period to the level of €60bn to correspond to the 1% of covered deposits of banking groups located in the Banking Union.

Table 5: Fixed Individual Amount of Credit line per participating Member State

Member State	Share	Amount (in €m)
Austria	2.86%	1,573
Belgium	3.40%	1,870
Cyprus	0.20%	110
Estonia	0.04%	22
Finland	1.97%	1,083.5
France	27.79%	15,284.5
Germany	27.56%	15,158
Greece	1.13%	621.5
Ireland	3.30%	1,815
Italy	10.46%	5,753
Latvia	0.07%	38.5
Lithuania	0.06%	33
Luxemburg	1.97%	1,083.5
Malta	0.12%	66
Netherlands	7.57%	4,163.5
Portugal	1.55%	852.5
Slovakia	0.20%	110
Slovenia	0.13%	71.5
Spain	9.62%	5,291
TOTAL	**100%**	**55,000**

Source: *Council of the European Union (2015), p. 11.*

At any point of time, the available amount of each credit line is equal to the Fixed Individual Amount minus the amount of contributions raised until that time by the banking groups located in the Member State concerned. Hence, the available amount is reduced annually by the contributions raised by banking groups and may be increased by the amount that the SRF uses for the purpose of contributing to resolution costs of a banking group located in that Member State.[364]

Recourse to the credit line facility should be the last resort option for the SRB, where the following sources of funding have been used and there is still need for funds:

1. the available ex-ante contributions raised in the affected national compartment which are not subject to mutualization,
2. the available ex-ante contributions raised in all the national compartments which are subject to mutualization,
3. the remaining ex-ante contributions in the affected national compartment,

[364] See **Term sheet for national Credit Lines provided by the participating Member States to the Single Resolution Board (SRB)**, p. 3.

4. any borrowing from national resolution funds of non-participating Member States, institutions, financial institutions or other third parties or temporary transfers between national compartments of the SRF.

2.5.2 Procedural arrangements

On 8 February 2017, the SRB announced that it has signed LFAs with all the participating Member States based on a term sheet, which sets out the terms and conditions for the use of the credit lines. The LFAs are binding for each party and constitute a legally binding commitment to activate the credit line in accordance with the conditions referred therein.[365]

If the SRB determines that it is necessary to resort to the credit line facility, it has to make a request to the Member State concerned and the latter must make available the requested amount, subject to prior national approval, where relevant. In accordance with the respective LFA, the Member State concerned must make the loan in full or in staggered payments.[366] The loan granted by the Member State concerned to the SRB is unsecured and has a tenor of 24 months, unless the repayment after a period of 24 months is not possible. In this case, the Member State must agree on an extension of the loan term by an additional 12-month period.[367]

The loans granted by Member States must be fiscally neutral for them, as they are ultimately repaid by extraordinary ex-post contributions collected from the banking groups located in the territories of the affected Member States, after borrowings and temporary transfers between compartments, where relevant, have been repaid. Furthermore, the loans are given at an interest rate representing the funding cost of the Member State concerned at that time.

If a euro area Member State is unable to make the payment requested by the SRB, it may request stability support from the ESM by the Financial Assistance Instruments that are subject to eligibility criteria. If the Member States is not a euro area Member State, it may access to the European Union’s medium-term facility for Balance of Payment assistance provided that the eligibility criteria are met.[368]

2.6 Arrangements on the transfer and mutualization of contributions

The adoption of the SRMR was accompanied with an **Intergovernmental Agreement on “*the transfer and mutualisation of contributions to the Single Resolution Fund*”**. The EU Member States, except for the UK and Sweden, signed the Intergovernmental Agreement as a result of the persistent objection of Germany to transfer the contributions raised at national level to the SRF based on a Union legislative act (SRMR). In particular, its main concerns related to the fact that SRMR’s arrangements governing resolution

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[365] *Ibid.*, p. 6.

[366] Under this option, at least 50% of the fixed individual amount should be provided under the first request within four (4) working days, followed by a maximum of three subsequent disbursements provided every five (5) business days, unless exceptional circumstances apply. The exceptional circumstances pertain to the entry into force of a resolution scheme, which provides for the application of a resolution tool requiring a payment above 50% of the fixed individual amount in order to avert the immediate default of the entity under resolution.

[367] See the **Term sheet for national Credit Lines provided by the participating Member States to the Single Resolution Board (SRB)**, p. 5.

[368] **Loan Facility Agreement** *between [Member State] as lender and [National Resolution Fund] and the Single Resolution Board as Borrower*, p. 4.

funding must not require budgetary liability for Member States. Resolution schemes adopted by the SRB, and subsequently endorsed by the Council and the Commission, may not require Member States to provide extraordinary public financial support or impinge on the budgetary sovereignty and fiscal responsibilities of the Member States.[369]

The European Parliament was opposed to the solution of the Intergovernmental Agreement, over which it has no influence, and considered that **Article 114 of the TFEU** is an appropriate legal basis for that purpose.[370] Finally, the European Parliament stepped back and accepted the adoption of the Intergovernmental Agreement to allow the finalization of the negotiations on the adoption of the SRMR.[371]

The Intergovernmental Agreement is an instrument of public international law. The rights and obligations laid down therein are subject to the principle of reciprocity,[372] namely the equivalent performance of the rights and obligations by all Contracting Parties.[373] Should a Member State not transfer to the SRF the contributions raised at national level, the banking groups located in that Member State will be excluded from access to the funds of the SRF.[374] The Intergovernmental Agreement laid down rules on the **transfer of the contributions raised at national level to the SRF**[375] and the **allocation of the contributions collected to different national compartments** during the transitional period to reach the target level of 1% of covered deposits of banking groups located in the Banking Union (2016-2023).[376]

During the transitional period, the SRF is divided into 19 national compartments, one for each participating Member State. Contributions raised at national level are transferred to the respective national compartment. For instance, contributions raised by Greek banking groups are transferred to the Greek compartment of the SRF. This transitional arrangement was adopted in order to mitigate the risk for healthy banking systems to incur the resolution cost for banking groups located in high-NPE jurisdictions (e.g. Greece, Cyprus, Italy, Ireland, Portugal).

Recourse to the SRF's funds is made in the following order:[377]

1. the available financial means of the national compartment of the Member State where the banking group is located,
2. the available financial means of all the national compartments, including the national compartment of the Member State where the banking group concerned is located,
3. any remaining financial means of the national compartment concerned,

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[369] See **Gortsos (2018c)**, p. 70.

[370] See **Committee on Economic and Monetary Affairs (2014)**, Letter to the Greek Presidency of the EU.

[371] See **Busch (2017)**, pp. 21-22.

[372] See **Intergovernmental Agreement** of 14 May on "*the transfer and mutualisation of contributions to the Single Resolution Fund"*, recital (20).

[373] See **Gortsos (2018c)**, p. 77.

[374] See **Intergovernmental Agreement** of 14 May on "*the transfer and mutualisation of contributions to the Single Resolution Fund,* Article 10(2).

[375] *Ibid*., Article 1(1).

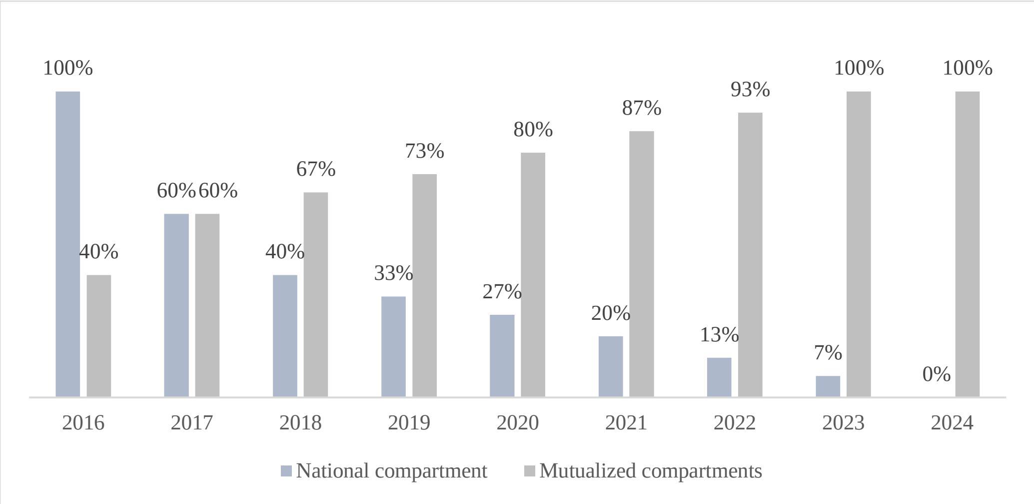
[376] See **König (2018b)**.

[377] See **Intergovernmental Agreement** of 14 May on "*the transfer and mutualisation of contributions to the Single Resolution Fund,* Article 5(1).

4. extraordinary ex-post contributions raised from the banking groups located in the Member State concerned, and
5. if extraordinary ex-post contributions are not immediately accessible, the SRB may contract borrowings or other forms of support or temporary transfers between compartments.

The mutualization of the available funding means of the national compartments will be increased in a progressive manner during the following years, as shown in ***Figure 9***. As of 2024, no recourse to national compartments will be made and resolution costs will be covered fully by the mutualized funds of the SRF.

Figure 9: Use of SRF's funding means during the transitional period



Source: *Intergovernmental Agreement of 14 May on "the transfer and mutualisation of contributions to the Single Resolution Fund"*

When a cross-border group is put into resolution, costs are distributed between the different national compartments where the parent entity and subsidiaries are incorporated in proportion to the relative amount of contributions that each of the group's entity has paid to the relevant compartment over the aggregate amount of contributions that all the entities of the group have paid to their national compartments.[378]

3. The mission of the SRF

The funding means of the SRF are available only for covering costs relating to resolution action taken with respect to failing banking groups. The SRF's funding means must not be used to absorb the losses of a banking group or for its recapitalization (i.e. bail-out).[379] **Article 76 of the SRMR** sets out a list of objectives for the use of the SRF. In particular, the SRF may:

- make contribution to the parent entity of a banking group under resolution in lieu of the write-down or conversion of liabilities of certain creditors, when the SRB decides to exclude partially or fully certain liabilities from the write-down or conversion,

[378] *Ibid*., Article 5(1)(a).

[379] **SRMR**, Article 76(3).

- to guarantee the assets or the liabilities of the parent entity of a banking group under resolution, its subsidiaries, a bridge institution or an asset management vehicle,
- to grant loans to the parent entity of a banking group under resolution (including its subsidiaries), a bridge institution or an asset management vehicle (for more details see **Chapter B, Section 4**, under **2**),
- to purchase assets of the banking group under resolution,
- to make contributions (e.g. capital increase, cover funding gap) to a bridge institution and an asset management vehicle,
- to pay compensation to shareholders or creditors if, following a post-resolution valuation, they have incurred greater losses than they would have incurred upon liquidation under normal insolvency proceedings, and
- to take any combination of the aforementioned actions.

The SRF may be used to take the aforementioned measures also with respect to the purchaser in the context of the sale of business tool.

Based on the tasks listed above, it is presumed that recourse to the SRF is more likely, where resolution action provides that certain liabilities must be excluded from the application of the bail-in tool or the ex-post valuation demonstrates that there has been a breach of the "no-creditor-worse-off" (NCWO) principle. This mainly holds for the following liabilities:[380]

- **uncovered deposits held by natural persons and micro, small and medium-sized enterprises**, where non-exclusion would give rise to widespread contagion and cause disturbance in the financial system and the real economy,
- **liabilities that are not possible to be bailed-in within a reasonable timeframe**,
- **liabilities to critical service suppliers whose exclusion is strictly necessary in order to achieve the continuity of critical functions** and core business lines and ensure that the banking group under resolution would continue operating without problems, and
- **liabilities that would have not been excluded from bail-in, such a destruction in value would be caused** that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in (e.g. derivatives).

Where an eligible liability or class of eligible liabilities is excluded from the bail-in and the losses that would have been borne by those liabilities have not been passed on fully to other creditors, the SRB may make a contribution under the following restrictions:[381]

- write-down or conversion of capital instruments and other eligible liabilities of at least 8% of total liabilities including own funds of the parent entity of the banking group under resolution, measured at the time of resolution action, has been made prior to the SRF's contribution, and
- the SRF's contribution does not exceed an amount of 5% of total liabilities including own funds, unless all unsecured, non-preferred liabilities (other than eligible deposits) have been written down or converted in full.[382]

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[380] *Ibid.*, Article 27(5).

[381] *Ibid.*, Article 27(7).

[382] See **Busch (2017)**, p. 15.

Chapter B:
Micro-prudential supervision and resolution of significant banking groups

Section 1: Micro-prudential supervision of significant banking groups

1. The application of the SREP on a group-wide basis

1.1 The decision-making process for the SREP assessment

With respect to banking groups whose parent entity is located in participating Member States, the ECB performs the SREP process for the group (consolidated level) and the parent entity and any other entity located in the participating Member States (at individual level), while the NSAs of non-participating Member States are responsible for carrying out this assessment for the entities under their remit (at individual level).

At the supervisory college, deliberations between the involved supervisory authorities take place and the ECB and the NSAs concerned must make every effort to reach a joint decision on the Overall SREP assessment for a banking group, the adequacy of the consolidated capital held by the banking group, as well as the additional capital (P2R and P2G) and liquidity requirements to be applied to each group's entity. Joint decision on additional capital requirements must be reached within four (4) months from the submission by the ECB of a risk assessment report, while the timeline for reaching a joint decision on liquidity requirements is limited to one (1) month.[383]

In the absence of a joint decision, the ECB may take a decision on the relevant measures to be applied on a consolidated basis, after taking into account the risk assessment carried out by the NSAs of non-participating Member States for the entities within their responsibility. Upon request from an involved supervisory authority for a binding mediation by the EBA in accordance with **Article 19 of the EBA Regulation**, the EBA must take a decision, which is binding for the involved parties.

Respectively, the NSA of a non-participating Member State may take a decision in respect to a subsidiary, after taking into account the views and reservations expressed by the ECB. Upon request from an involved supervisory authority, the EBA must take a decision, which is binding for the involved parties in accordance with **Article 19 of the EBA Regulation**.

1.2 The SREP components

1.2.1 Assessment of business model

As referred above in **Chapter A, Section 1**, under **3.3**, the SREP consists of the following four (4) components:

i. the assessment of business model,
ii. the assessment of internal governance and institution-wide controls,
iii. the assessment of risks to capital and adequacy of capital to cover these risks, and
iv. the assessment of risks to liquidity and adequacy of liquidity resources to address such risks.

In the context of the business model analysis, the ECB assesses the viability and sustainability of the business model of the parent entity and any other entity located in participating Member States. In particular, the ECB assesses the **viability of the business**

[383] **CRD IV**, Article 113(2).

model based on its ability to generate sufficient returns over the following twelve (12) months, while the **sustainability of the business model** is assessed based on its ability to produce acceptable returns over a forward-looking period of at least three (3) years.

For the assessment of the business model, the ECB deploys the following internal and external sources of quantitative and qualitative information.[384] The internal sources of information include the business plan, financial reporting (e.g. balance sheet and income statement disclosures), regulatory reporting (e.g. COREP[385], FINREP), internal reporting (e.g. capital planning, liquidity reporting) and recovery and resolution plans. External sources of information include, among others, reports from the external auditor.

In addition, the ECB places emphasis on the following areas of the entities' financial performance:

- **profit and loss**, with particular focus on the underlying profitability, the breakdown of income streams and costs, impairment provisions and key ratios (e.g. cost-to-income, net interest margin),
- **the balance sheet**, in particular the asset/liability mix, the funding structure, the RWAs movement and the trend of the capital ratios, and
- **concentrations** on specific customers, sectors and jurisdictions.

The **business model viability** is determined on the basis of the following criteria:

- whether the business model generates profits above cost, namely through a comparison of Return on Equity (RoE) against Cost of Equity (CoE),
- whether the funding mix is suitable to the business model and strategy, as volatility of mismatches in the mix may imply that the returns are not viable, and
- whether the business model relies on a high-risk appetite that generates profits but may incur losses in the future.

The **business model sustainability** is assessed based on the following characteristics:[386]

- the plausibility of the assumptions for the future financial performance,
- the impact on the projected financial performance of the business environment, and
- the risk level of the business strategy and the execution capabilities of the entities.

Based on the assessment described above, the ECB may identify risks and vulnerabilities relating to the business model, including poor expected financial performance, reliance on unrealistic strategy, excessive concentrations or volatility, excessive risk-taking and funding structure concerns.[387]

[384] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, par. 66.

[385] The COREP is the standardized EBA reporting framework covering credit risk, market risk, operational risk, capital and capital adequacy ratios.

[386] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, par. 84.

[387] *Ibid.*, par. 85.

1.2.2 Assessment of the internal governance and institution-wide controls

The second pillar of the SREP focuses on the governance arrangements and the internal control framework of the entities constituting the banking group. Additional areas reviewed under this SREP element include:[388]

- the internal governance framework and arrangements,
- the composition, organization and functioning of the management body and its committees,
- remuneration policies and practices,
- the second and third lines of defense, namely the risk management, the compliance and the internal audit functions,
- the new product approval process,
- outsourcing arrangements, and
- the consistency and credibility of recovery planning.

1.2.3 Assessment of risks to capital and capital adequacy

1.2.3.1 Areas assessed by the ECB

The third pillar of the SREP plays a critical role in the determination of the Overall SREP score. This pillar covers the material risks to which the group's entities are exposed in terms of both risk exposure and quality of mechanisms, processes and arrangements used to mitigate these risks. In that context, the ECB examines particularly the risks to capital, namely **credit and counterparty risk**, **market risk**, **operational risk** and **interest rate risk from the banking book** (IRRBB). Furthermore, the ECB assesses other risks material to each entity, such as pension risk, insurance risk or structural foreign exchange (FX) risk. For each material risk, the ECB assesses both the inherent risk and the quality and effectiveness of risk management mechanisms and controls employed by the group's entities.[389]

In the context of the assessment of credit risk, which is the most material risk to which most of the EU banking groups are exposed, the ECB assesses all the elements that determine potential credit losses, namely the probability of borrowers' default (PD), the amount of exposures subject to credit risk (Exposure at Default) and the recovery rate of credit exposures in the event of borrowers' default (Loss Given Default).[390]

During the last years, the ECB's assessment is mainly focused on the quality of credit portfolio, particularly with regard to the volume of non-performing exposures (NPEs) and the losses that may stem from these exposures. The ECB's approach can be attributed to the fact that the high stock of NPEs across euro area puts in risk the solvency of banking groups and, hence, the overall financial stability. Therefore, the ECB places emphasis on:

- the non-performing ratio in total and per portfolio, industry, geographies and changes over time,
- the distribution of the exposures across classes of non-performing assets (e.g. unlikely to pay, past due),

[388] *Ibid.*, par. 89.

[389] *Ibid.*, par. 149.

[390] *Ibid.*, par. 155.

- the types and level of residual collateral, as well as the time needed to liquidate collateral,
- the migration rates from non-performing classes to performing, forborne exposures and across non-performing classes, and
- historical recovery rates by portfolio, industry and type of collateral.

Credit risk may be mitigated effectively if sufficient, credible and prudently valuated guarantees, mainly real estate collateral, have been received by banking groups. Therefore, the ECB assesses:[391]

- the cash coverage (i.e. provisions) by portfolio, borrower type and industry, and
- historical recovery ratios by type and amount of collateral and guarantees,
- the timing and the ability to realize collateral under the national legal framework, and
- the liquidity and volatility in asset values for collateral (e.g. residential property).

In certain jurisdictions the time needed to repossess and liquidate collateral comes to many years (e.g. six or seven years) due to deficiencies in the legal and judicial system. Such deficiencies render doubtful the ability of banking groups to receive in cash the amount written in their books as coverage for the loan granted. In these cases, the ECB considers the collateral received as inadequate and requires banking groups concerned to increase the provision coverage. The same approach applies to the ECB's assessment on whether the level of loan loss provisions is consistent with the level of risk in different portfolios and whether accounting loss provisions are in line with applicable accounting principles and are assessed as sufficient to cover expected losses.

1.2.3.2 Determination of the Pillar 2 Requirement (P2R)

After the assessment of the material risks to capital, the ECB determines whether the capital held by the banking group (at consolidated level) and the group's entities (at individual level) is sufficient to ensure appropriate coverage against those risks. The ECB determines the amount and composition of additional capital that the entities are required to hold against risks not covered by minimum capital requirements (Pillar 1). Thus, the ECB determines the P2R and the P2G. [392]

The P2R is determined based on:

- the risk of unexpected losses and expected losses insufficiently covered by provisions over a 12-month period,
- the risk of underestimation of risk due to model deficiencies, and
- the risk from other deficiencies identified, including those related to internal governance and internal controls.

Based on the 2017 SREP cycle, the P2R assigned by the ECB on the banking groups under its remit ranged from 1% to 4% with the median average at the level of 2%. Although the CRD IV provides that the P2R may be covered by at least 56% CET1 capital[393] and by at

[391] *Ibid.*, par. 194.

[392] *Ibid.*, par. 347.

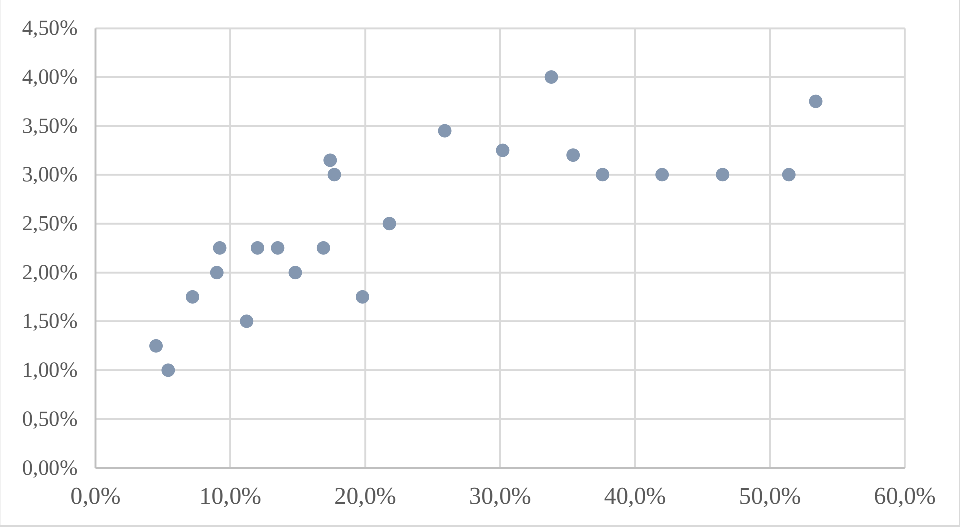
[393] Common Equity Tier 1 (CET1) has the best loss-absorbing capacity. CET1 capital consists of the common shares issued, the stock surplus (share premium), retained earnings and accumulated other comprehensive income and other disclosed reserves.

least 75% Tier 1 capital,[394] the ECB has adopted a stringent approach and requires banking groups to meet the P2R fully with CET1 capital. [395]

Given that the ECB has not disclosed its approach for determination of the P2R, it is not clear which are the key drivers behind setting the P2R. Therefore, we made an analysis which covers 23 ECB-supervised banking groups located in high-NPE jurisdictions, namely Greece, Cyprus, Italy, Ireland and Portugal. Based on data from the 2017 SREP cycle, we examined the relationship between the level of the P2R assigned on the relevant banking groups[396] and their financial situation as measured based on certain significant variables (i.e. NPE ratio, NPE provision coverage, CET1 ratio, Total Capital ratio, Cost-to-Income ratio).[397]

Statistical analysis among the sample banking groups indicates strong positive correlation between the P2R and the NPE ratio (see ***Figure 10***). Such link does not exist for other variables examined. Hence, this analysis shows that for the ECB the NPE ratio is key determinant of the P2R.

Figure 10: 2017 SREP cycle - Correlation of P2R and NPE ratio



Source: *Data on P2Rrates and NPE ratios is available in the Annex*

For more information on the other variables, see the **Annex**.

[394] Tier 1 capital consists of CET1 capital and Additional Tier 1 (AT1) capital. AT1 consists of deeply subordinated debt instruments combined with equity features. They have perpetual maturity and may only be terminated, repaid or repurchased after a minimum of five (5) years after issue, with prior supervisory approval.

[395] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, par. 372.

[396] Banking groups themselves disclose the P2R rate assigned by the ECB through their disclosures to investors (i.e. Pillar 3 disclosures, financial statements, investors presentations).

[397] Data on variables have been derived from the 2017 EBA Transparency Exercise. The data is available at: https://eba.europa.eu/-/eba-sees-a-more-resilient-eu-banking-sector-but-challenges-in-npls-it-security-and-long-term-profitability-remain

1.2.3.3 Capital requirements in stressed conditions

In the context of the assessment of capital adequacy, the ECB also evaluates whether the quantity and composition of capital held by banking groups is adequate upon occurrence of stressed conditions. This assessment is feasible through the use of the outcomes of the Internal Capital Adequacy Assessment Process (ICAAP)[398] and supervisory stress tests.

Stress tests are designed to provide supervisory authorities with a common analytical framework to consistently compare and assess the resilience of banking groups to economic shocks. In line with **Article 100 of the CRD IV**, supervisory stress tests are carried out annually on a group-wide basis and their results are incorporated into the SREP assessment. In the SSM context, the ECB conducts a comprehensive and rigorous stress-testing exercise every two (2) years. In between, the ECB performs a simplified stress test exercise with a focused scope.[399] In relation to the largest banking groups under the ECB's remit, the full-scope stress test is carried out under the coordination of the EBA, while for the remaining banking groups the ECB coordinates the exercise and applies the EBA methodology, albeit with reduced complexity for reasons of proportionality.

Stress tests examine the expected profitability, as well as the credit risk, market risk and operational risk to which banking groups are expected to be exposed in the following three (3) years under both a baseline and an adverse scenario. The baseline scenario is developed based on the macroeconomic forecasts published by the Commission and the ECB (in terms of GDP growth, unemployment rate, inflation rate, prices of residential and commercial real estate), while the adverse scenario assumes the materialization of worse macroeconomic conditions.

The ECB's stress tests seek to assess whether the quantity and quality of capital is sufficient to cover the applicable capital requirements, and in particular:

- the **Total SREP Capital Ratio** (**TSCR**)[400] under the adverse scenario over a period of at least two (2) years,[401] and
- the **Overall Capital Requirement** (**OCR**) under the baseline scenario over a period of at least two (2) years.

Where the adverse scenario of a stress test indicates that a banking group is likely to breach its TSCR within the following twelve (12) months, the ECB may require the group concerned to submit a capital plan that would provide for means to cover any capital shortfall (e.g. share capital increase, assets disposals, divestments, reduction of dividends).

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[398] The ICAAP is undertaken by banking groups themselves. The purpose of the internal process is to ensure that banking groups identify their risks, as well as adequately supporting their different business activities with internal capital.

[399] In 2017, the ECB executed a sensitivity analysis of interest rate risk in the banking book (IRRBB), while in 2019 it will perform a liquidity stress test exercise.

[400] The Total SREP Capital Requirement (SREP) is the sum of:

- minimum capital requirements (8% of RWAs) set out in **Article 92 of the CRR**, and
- the Pillar 2 Requirement (P2R).

[401] Alternatively, the ECB may set predefined target ratios (fixed thresholds) in the context of system-wide scenarios.

1.2.3.4 Determination of the Pillar 2 Guidance (P2G)

Where the ECB has concerns about the ability of banking groups to withstand adverse scenarios, as shown by the quantitative outcomes of stress tests, and to meet capital requirements under stressed conditions, it determines an additional capital buffer, the P2G.[402] This is particularly relevant when banking groups are expected to breach the TSCR under the adverse scenario.[403] The P2G is a non-legally binding expectation which the ECB communicates to banking groups and expects to be met with CET1 capital held over and above the OCR.[404]

The P2G should be set at such a level to cover at least the anticipated maximum stress impact, as calculated based on the changes in the CET1 ratio in the worst year of stress test and taking into account the TSCR. In particular, the determination of the P2G takes into consideration the following factors:

- the year when the maximum stress impact occurs in relation to the starting point and the time horizon of the scenarios used,
- the outcome of the ICAAP stress test, and
- any relevant mitigating actions that the group's management intends to take to limit the impact of potential adverse effects on capital adequacy.

When capital ratio drops or is likely to drop below the P2G, the banking group concerned must submit a capital plan to restore compliance with the P2G. The supervisory reaction to the breach of the P2G is dependent on the reasons behind this event, and in particular:[405]

- where capital ratio drops below the P2G (while remaining above the OCR) due to banking group-specific or external circumstances in which risks that the P2G was aimed at covering have materialized, the banking group may temporarily operate below that threshold until the application of the actions included in the capital plan restore its capital ratio above the P2G,
- where capital ratio drops below the P2G (while remaining above the OCR) due to banking group -specific or external circumstances in which risks that the P2G was not aimed at covering, the group must increase its own funds above the P2G within an appropriate timeline, and
- where the banking group disregards the P2G, does not incorporate it into its risk management framework or does not implement capital action within the timeframe provided by the ECB, the later may take supervisory measures, including increase of the P2R.

Given that the determination of the P2G is the outcome of the full-scope supervisory stress tests carried out (typically) once every two (2) years, the ECB may set the P2G rate every second year. In the other year, the ECB assesses all relevant information, including outcomes of past supervisory stress tests together with additional sensitivity analysis (e.g. sensitivity analysis on Interest Rate Risk in the Banking Book (IRRBB)) to decide whether P2G is still relevant or update is necessary.

[402] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, p. 13.

[403] *Ibid.*, par. 386.

[404] *Ibid.*, par. 398.

[405] *Ibid.*, par. 545.

1.2.4 Assessment of risks to liquidity and funding and liquidity capacity

The fourth SREP pillar is focused on liquidity and funding of banking groups. The ECB assesses the liquidity risk, the funding risk and the risk management processes and arrangements concerning these two (2) types of risks. As far as the liquidity risk in concerned, the ECB assesses the entities' short- and medium-term liquidity risk over an appropriate set of time horizons to ensure that banking groups maintain sufficient liquidity buffers to withstand potential liquidity stress under normal and extreme situations.[406]

In addition, the ECB evaluates the funding risk and whether the medium- and long-term obligations of the group's entities can be met by funding resources both under normal and stressed conditions. For that purpose, the ECB assesses the funding profile and the risks posed to it, the access to (secured and unsecured) interbank market and wholesale market, as well as the expected change in funding risks based on the funding profile. The last component of this assessment pertains to the evaluation of the liquidity risk strategy and the organizational framework, policies and procedures for liquidity risk management.

The ECB assesses whether the liquidity resources held by the group's entities ensure appropriate coverage against identified risks to liquidity and funding. The ECB may decide to impose specific liquidity requirements, if necessary. These liquidity requirements can be either of quantitative nature (i.e. held over and above minimum liquidity requirements) or of qualitative nature. Indicatively, the ECB may require from the entities whose liquidity position and funding profile pose high risk to their viability any of the following obligations:[407]

- to meet an LCR higher than the regulatory minimum threshold (100%),
- to meet a minimum survival period of such a length that identified shortcomings are mitigated, or
- to hold a minimum total amount of liquid assets or counterbalancing capacity that allow a banking group to withstand significant liquidity outflows.

1.3 Overall SREP assessment

Taking into account the individual SREP elements, the ECB assesses the overall risk profile and viability of the banking group as a whole and each group's entity located in participating Member States. The ECB determines the Overall SREP assessment, which reflects any supervisory findings identified in the course of the SREP, including information obtained through On-Site Inspections and thematic reviews.

The Overall SREP assessment results in assigning:

- **Risk scores** to 1) risks to capital and 2) risks to liquidity and funding, which reflect the likelihood that these risks will have material impact (e.g. potential loss) prior to taking into account the entities' ability to mitigate these risks through available capital and liquidity resources respectively,[408] and
- **Viability scores** to the four (4) SREP elements (i.e. business model, internal governance, capital adequacy and liquidity adequacy) and an Overall SREP score,[409] which reflect the risk to the entities' viability from an individual SREP

[406] *Ibid.*, par. 418.

[407] *Ibid.*, par. 485.

[408] *Ibid.*, par. 28.

[409] Overall SREP score is defined as the numerical indicator of the overall risk to the viability of the banking group based on the overall SREP assessment.

element. The scores to capital and liquidity adequacy represent the ECB's assessment on the available capital and liquidity resources to cover risks to capital and liquidity.

The Overall SREP score reflects:[410]

- the risks to the entities' viability stemming from these SREP elements,
- the likelihood that Pillar 2 measures may need to be taken to address these risks,
- the possibility for taking a decision on whether to apply early intervention measures, and
- the prioritization of supervisory resources and the supervisory priorities with respect to banking groups.

The score assigned for each SREP element and the Overall SREP score ranges from "1" (low risk) to "4" (high risk) with intermediate scores "2" (medium-low risk) and "3" (medium-high risk), while score "F" denotes that the banking group is in a "failing or likely to fail" situation.

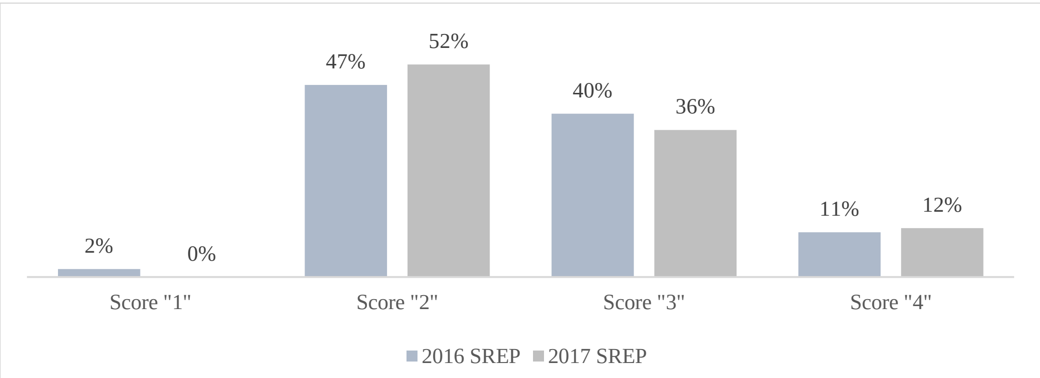
Table 6: Supervisory views for assigning the Overall SREP score

Score	Supervisory view
1	The risks identified pose a **low level of risk** to the viability of the group
2	The risks identified pose a **medium- low level of risk** to the viability of the group
3	The risks identified pose a **medium-high level of risk** to the viability of the group
4	The risks identified pose a **high level of risk** to the viability of the group
F	The group is considered to be "**failing or likely to fail**", as there is an **immediate risk** to the group's viability

Source: ***EBA Guidelines*** *"*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing, consolidated version, *pp. 184-185*

Figure 11 shows the allocation of ECB-supervised banking groups in clusters based on their Overall SREP score for the 2016 and 2017 SREP cycles. This figure shows that the majority of banking groups is assigned with Score "2" or "3", while very few banking groups are assessed as having high level of risk (Score "4").

Figure 11: Overall 2016 SREP score vs Overall 2017 SREP score



Source: *SSM 2017 SREP Methodology Booklet*

[410] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, par. 38.

Following the completion of the SREP assessment, the ECB issues a draft decision addressed to each banking group, providing it with a timeframe of two (2) weeks to reply in written to its remarks (right to be heard process). At the end of the supervisory dialogue, the ECB issues the final SREP decision, which defines the risks and deficiencies identified during the SREP and determines:[411]

- the **capital requirements**, which will apply to the banking group and each entity the next year, consisting of
  - a **total SREP capital requirement (TSCR)** composed **of minimum capital requirements** of 8% which must be met with CET1 capital instruments (4.5%), AT1 instruments (1.5%) and Tier 2 instruments[412] (2%) and the P2R which must be covered only with CET1 capital,
  - the **combined buffer requirement[413]** that must be met only with CET1 capital, and
  - the **P2G** also met only with CET1 capital,
- the **liquidity requirements** to be applied both at consolidated and individual level, and
- **other qualitative supervisory measures**, which are analyzed below.

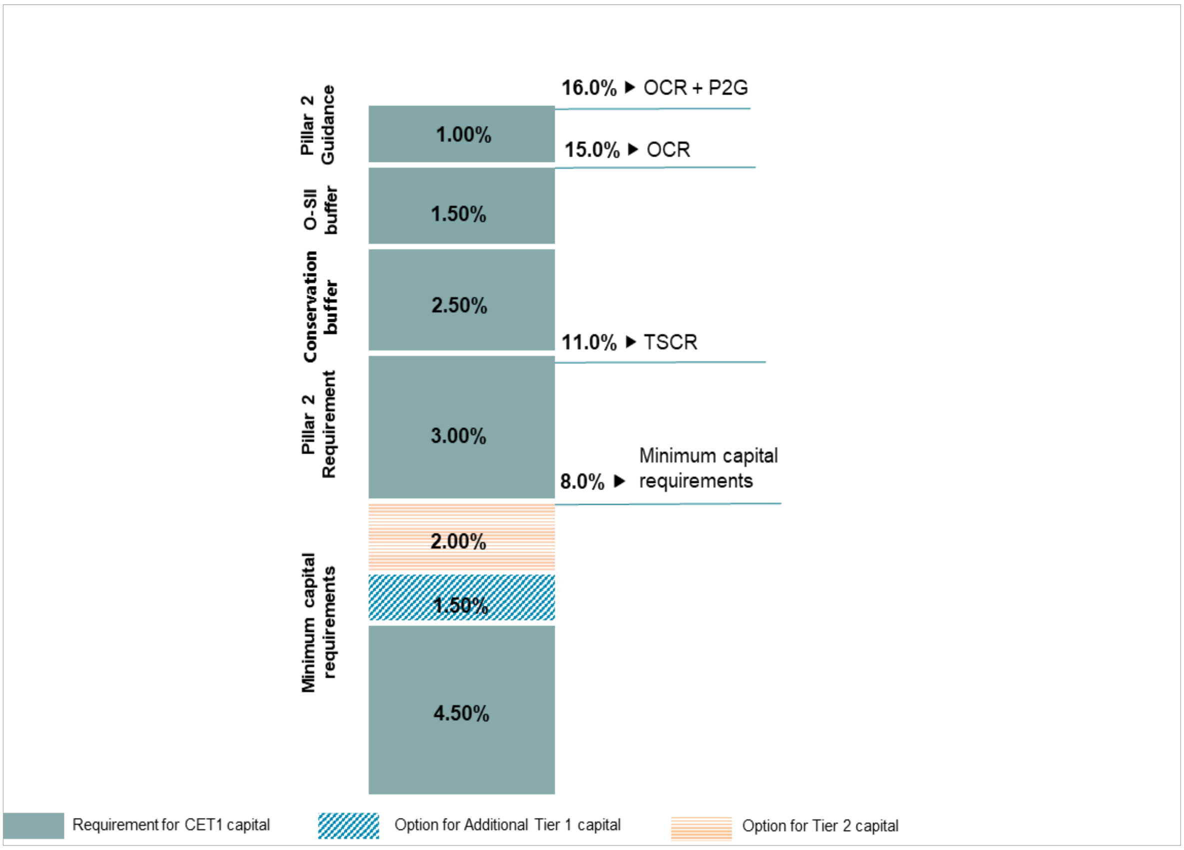
Figure 12 depicts an indicative example of the capital requirements set by the ECB for a high-risk banking group (SREP score: 4) and the type of capital required to cover these capital requirements.

[411] See **ECB SSM Supervisory Manual**, p. 86.

[412] Tier 2 instruments are deeply subordinated debt instruments (which are, however, senior to Tier 1 capital) with an original maturity of at least five (5) years. Tier 2 instruments do not absorb losses on a going-concern but only on a gone-concern basis.

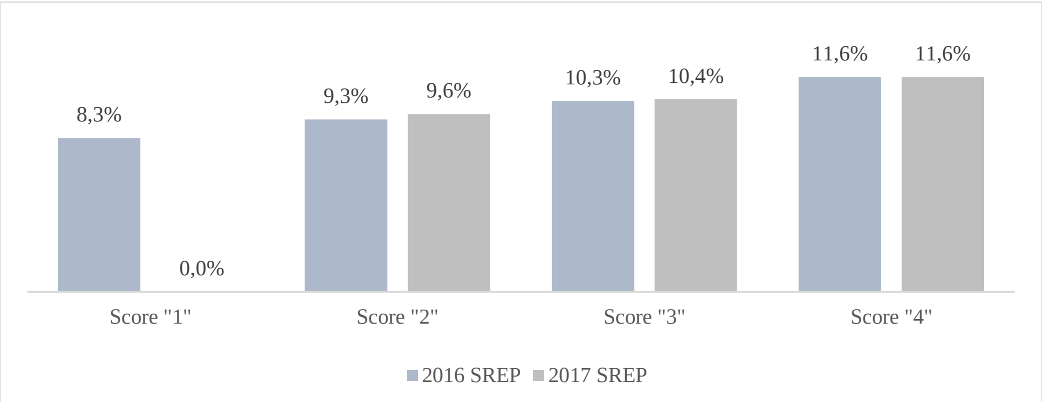
[413] The combined buffer requirement is the sum of: 1) the capital conservation buffer, 2) the countercyclical capital buffer, where applicable, and 3) the highest of the i) systemic risk buffer, ii) the G-SII buffer or iii) the O-SII buffer.

Figure 12: Indicative capital requirements stacking order



Capital requirements are closely linked to the Overall SREP score assigned on banking groups. Specifically, Overall SREP score reflects the riskiness of banking groups and is translated into different capital requirements with which each banking group must comply. A shown in ***Figure 13***, high-risk banking groups must meet stricter CET1 requirements as a result of higher P2R and P2G rates compared to banking groups with a SREP score of “2” or “3”.

Figure 13: CET1 requirement per SREP score cluster (2016 vs 2017 SREP cycle)



Source: *SSM 2017 SREP Methodology Booklet*

1.4 Supervisory measures

Based on the individual SREP elements and the Overall SREP assessment, the ECB may take **supervisory measures**, such as capital measures, liquidity measures and any other measures considered necessary to address supervisory concerns,[414] or it may decide whether it should apply **early intervention measures** pursuant to **Article 27 of the BRRD** or it may **determine the banking group as "failing or likely to fail"**.

In addition to the imposition of additional capital requirements (P2R) and capital expectations through the P2G, the ECB may decide due to the identified vulnerabilities and deficiencies to impose **capital-related measures.** Indicatively, the ECB may:[415]

- require the group's entities to use net profits to strengthen their capital base in accordance with **Article 104(1)(h) of the CRD IV**,
- restrict or prohibit distributions or interest payments to shareholders or holders of AT1 instruments provided that this measure does not constitute an event of default in accordance with **Article 104(1)(i) of the CRD IV**, and
- require the application of a specific treatment of assets in terms of capital requirements in accordance with **Article 104(1)(d) of the CRD IV**.

Furthermore, the ECB may require the group's entities to apply stricter measures for addressing credit risk. Indicatively, the ECB may require:[416]

- the application of a specific provisioning policy to increase provisions,
- application of floors (or caps) to internal risk parameters and risk weights used to calculate risk exposure amounts for specific products, sectors or types of products,
- application of higher haircuts to the value of collateral, and
- additional capital to compensate for the difference between the accounting value of provisions and a prudent valuation of assets reflecting expected losses not covered by the accounting provisions.

Also, the ECB may take measures relating to large exposures, market risks, operational risk and interest risk from non-trading activities.

In addition to the additional liquidity measures referred above, the ECB may impose **specific quantitative liquidity requirements** aiming to address the deficiencies identified. In that context, the ECB may impose restrictions on maturity mismatches between assets and liabilities or other administrative measures (e.g. prudential charges).[417] For the purpose of addressing **liquidity risk** and in accordance with **Article 104(1)(k) of the CRD IV**, the ECB may impose requirements on the concentration of the liquid assets held, including caps, limits or restrictions on funding concentrations. Furthermore, the ECB may impose restrictions on short-term contractual or behavioral maturity mismatches between assets and liabilities.[418] With respect to **funding risk**, the ECB may require measures to improve the group's entities funding profile, including reduction of the dependency on certain (volatile) funding markets (e.g. wholesale funding) or reduction of the concentration of the entities' funding profile to specific counterparties. In any case,

[414] **EBA Guidelines** "*on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing"*, par. 24.

[415] *Ibid*., par. 503.

[416] *Ibid*, par. 520,

[417] *Ibid.*, par. 505.

[418] *Ibid.*, par. 535.

the ECB may require increased reporting frequency on the trend in LCR, NSFR and other liquidity indicators.

Furthermore, the ECB may require the group's entities to take **additional measures to address deficiencies related to business model internal governance and controls**, where necessary (see ***Table 7***).

Table 7: Supervisory measures related to business model and internal governance

Measures related to business model
Adjustments to the financial plan if it is not supported by internal capital planning or credible assumptions
Changes to organizational structures, reinforcement of risk management and control functions and arrangements to support the implementation of the business model or strategy
Changes to and reinforcement of the IT systems to support the implementation of the business model or strategy
Reduction of risk inherent in the products distributed, including improvements to the governance and control arrangements for product development and maintenance
Reduction of risk inherent in IT systems
Measures related to internal governance and institution-wide controls
Changes to the overall governance arrangements and organization
Changes to the organization and composition of the management body
Enhancement of the overall risk management arrangements, including changes in the risk appetite, improvements to the ICAAP or the Internal Liquidity Adequacy Assessment Process (ILAAP)[419] and enhancement of stress-testing capacity
Enhancement of internal control arrangements and functions
Enhancement of information systems and business continuity arrangements
Changes to the remuneration policies
Limitation of variable remuneration as a percentage of net revenues

1.5 Supervisory Examination Program (SEP)

Furthermore, the SREP assessment functions as input to the design of the next year's Supervisory Examination Program (SEP). The ECB gives due consideration to the risks and weaknesses revealed during the annual SREP cycle in order to set a SEP that would allow the monitoring and assessment of the remedial actions taken by banking groups to address these weaknesses.

Pursuant to **Article 99 of the CRD IV**, the ECB adopts a SEP, which contains an indication of how the ECB intends to carry out its supervisory tasks and allocate its resources, as well as an identification of which banking groups are intended to be subject to enhanced supervision.

[419] The Internal Liquidity Adequacy Assessment Process (ILAAP) is defined in **Article 86 of the CRD IV** as one of the key risk management instruments for credit institutions (as well as ICAAP). The ILAAP entails robust strategies, policies, processes and systems implemented by banking groups for the identification, measurement, management and monitoring of liquidity.

At the beginning of each year, the ECB communicates to each banking group a specific SEP, which covers both the supervisory activities planned for the following twelve (12) months, including a plan for On-Site Inspections and thematic reviews to be carried out at the premises of banking groups. [420]

2. The application of crisis prevention measures to significant banking groups

2.1 Development and assessment of group recovery plans

2.1.1 Rationale for establishing group recovery plans

The BRRD requires banking groups to plan in advance for restoration of their financial position, once a significant deterioration occurs, by developing and submitting to supervisory authorities the group recovery plans. The aim of recovery plans is for banking groups to establish a credible governance framework based on which they can identify any deterioration of their financial position and take prompt action to address it. To that end, banking groups are obliged to establish and maintain (on an annual basis) effective recovery arrangements to ensure that they will take action early enough to avoid the further worsening of their financial position (in terms of capital adequacy, liquidity availability, profitability, asset quality) that would make supervisory action unavoidable.

The group recovery plan establishes measures which the banking group would take in order to restore in a timely manner its long-term viability should it come under severe stress.[421] The objective of a recovery plan is not to forecast the factors that could prompt a crisis, but rather to identify the options that might be available to counter both an idiosyncratic and a system-wide crisis and to assess whether these options are robust enough and sufficiently varied to deal with a wide range of shocks of different natures. The ultimate aim of the group recovery plan is the stabilization of the group as a whole, when it is in a situation of stress so as to address the causes of the distress.

Pursuant to **Article 7(1) of the BRRD**, the parent entity draws up and submits to the consolidating supervisory authority (the ECB for significant banking groups) a group recovery plan. The group recovery plan must be updated at least annually or after a significant change to the legal or organizational structure of the group, its business or its financial situation.[422] The NSAs of non-participating Member States may require groups' entities located in their jurisdictions to draw up recovery plans on an individual basis.

The consolidating supervisory authority and the relevant NSAs of the non-participating Member States assess jointly the group recovery plan within the context of the supervisory college.

[420] See **ECB SSM Supervisory Manual**, pp. 61-62.

[421] See **EBA Final draft Regulatory Technical Standards** *"on the content of recovery plans under Article 5(10) of Directive2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms",* p. 6.

[422] **BRRD,** Article 5(2).

2.1.2 Content of group recovery plans

2.1.2.1 General information

Group recovery plans must be detailed and based on realistic assumptions applicable in a range of robust and severe scenarios. The content of the group recovery plan must take account of the nature of the group's sources of funding and the degree to which group's support would credibly be available.[423]

The group recovery plan:

- determines the **recovery indicators** which should be monitored by the group in order to assess if the recovery measures must be activated,
- provides for a range of hypothetical **scenarios of severe macroeconomic and financial stress** that may threaten the financial situation of the group and is likely to activate the recovery plan,
- includes a range of **recovery options** setting out actions to restore group's viability should the scenarios lead recovery indicator(s) to be breached,
- includes appropriate **conditions and procedures to ensure the timely implementation of the recovery options**, and
- includes, where applicable, **arrangements for intragroup financial support** adopted in accordance with an agreement for intragroup financial support.

The **Commission Delegated Regulation 2016/1075**, which was based on RTS adopted by the EBA, elaborates the above-mentioned requirements and the information necessary to be included in group recovery plans.

2.1.2.2 Governance arrangements

Group recovery plans should include a section that sets out the process for development and ongoing maintenance of the document and the respective **escalation process and decision-making process** for the activation of the recovery phase. Furthermore, this section should describe the integration of recovery indicators within the group's risk management framework.

The ECB places emphasis on the escalation process for the activation of recovery plans. Therefore, recovery plans must set out a time-detailed plan for the implementation of the escalation process both in case of breach of an early warning threshold and/or a recovery trigger. Upon breach of a recovery trigger, the ECB requires:

- the parent entity to inform the JST concerned on the incident at the latest within one (1) business day,
- the relevant competent body (e.g. Executive Committee) of the parent entity to decide on whether the recovery plan will be activated within a short timeframe (2-3 business days), and
- the management body of the parent entity to be informed of the decision on the activation (or not) of the recovery plan.

Furthermore, the group recovery plan should identify the **Material Legal Entities** (**MLEs**) of the banking group, which are defined, pursuant to **Article 7(2) of the Commission Delegated Regulation 2016/1075**, as the entities and branches that:

- substantially contribute to profit or funding, or hold an important share of assets, liabilities or capital of the banking group,

[423] *Ibid.*, rec. 21.

- perform key commercial activities,
- centrally perform key operational, risk or administrative functions,
- bear substantial risks that in a worst-case scenario could jeopardize the viability of the banking group,
- could not be disposed of or liquidated without likely triggering a major risk for the banking group, or
- are important for the financial stability of at least one of the Members States they operate in.

The identification of the group's MLEs should be accompanied with the determination of the critical functions performed by the relevant entities. Typically, for most of the MLEs the critical functions pertain to deposit-taking, loan servicing and payments and cash services.[424]

Drafting a recovery plan document should be accompanied with preparatory work from banking groups to test their ability to implement recovery arrangements, once a stressed situation arises. Aiming to promote the operationalization of recovery plans, the ECB has identified the best practices from recovery plans drawn up by banking groups and has requested banking groups to adopt two (2) additional measures, the **development of Playbooks** and the **execution of dry runs**.

Given that some group recovery plans have more than 1,000 pages, their implementation from senior management during crisis situations is barely difficult. Therefore, the adoption of Playbooks, which function as concise implementation guides (not more than 50 pages) for recovery plans, can facilitate swift and effective decision-making by the management body of the parent entity, the selection of the suitable recovery option(s) to address a crisis situation and the application of the communication strategy towards internal and external stakeholders.[425]

The operationalization of recovery plans can be further enhanced by the execution of dry run exercises. Dry runs are simulation exercises that aim at testing whether the processes for the implementation of recovery plans can work when needed. The dry runs seek to test and assess whether specific parts of the recovery plans could be implemented effectively and timely upon occurrence of a crisis situation and to train relevant staff to achieve and maintain proficiency in reacting to crisis situations using the recovery plans.[426] Potential areas of group recovery plans that may be tested by a dry run include, among others, the functioning of the escalation and decision-making procedures operational aspects of the group recovery plan (e.g. testing if assumed timeframes for implementation of most relevant options are plausible).

2.1.2.3 Recovery indicators

Setting strong and trustworthy recovery indicators is the cornerstone for having an effective recovery plan, as they constitute the basis for identifying risks to a banking group's viability and activating the necessary measures to restore its financial situation. To that end, banking groups must establish a set of recovery indicators that are monitored on a regular basis seeking to ensure that significant deterioration of the group's financial situation will be captured in a timely manner.

The EBA developed, in accordance with **Article 9(2) BRRD**, *Guidelines "on the minimum list of qualitative and quantitative recovery plan indicators",* which specify the

[424] See **European Banking Authority (2015a)**, p. 11.

[425] See **European Central Bank (2018c)**, pp. 33-36.

[426] *Ibid*., pp. 36-39.

minimum list of categories that should be included in all group recovery plans, namely indicators relating to capital, liquidity, profitability and asset quality, as well as market-based indicators and macroeconomic indicators.

For each category of indicators, the EBA Guidelines determine specific indicators that should be included in group recovery plans.[427] Indicatively, group recovery plans may include, *inter alia*, the following indicators:

- **capital indicators**: CET1 ratio, total capital ratio, leverage ratio,
- **liquidity indicators**: Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR),[428]
- **profitability indicators**: Return on Assets (RoA), Return on Equity (RoE),
- **asset quality indicators**: growth rate of gross non-performing loans, coverage ratio,
- **market-based indicators**: CDS spread, stock price variation, and
- **macroeconomic indicators**: GDP variations, CDS of sovereigns.

Recovery indicators should be adapted to the banking group's size, business model, strategy and risk profile and should define the point at which a decision on activation of the recovery plan may be taken. Moreover, recovery indicators should be aligned with the risk management framework of the banking group concerned, namely with the ICAAP, ILAAP, and Risk Appetite Framework.

Banking groups should employ the traffic light approach using progressive metrics in order to signal to the senior management that recovery triggers might be breached.[429] Under the traffic light approach, for each recovery indicator an early warning threshold and a recovery trigger is set.

Figure 14: Traffic light approach

Level of risk			
Level of recovery indicator	Better than early warning threshold	Early warning threshold breached	Recovery trigger breached
Banks' reaction	Steady state; no action taken	Awareness raised; Preparatory measures for corrective action	Escalation procedure enacted; decision on recovery plan activation

Early warning thresholds can be used as early warning signals that capture an undesired development or event which (if not appropriately managed) could result in a deterioration of the financial position of the banking group and could eventually force it into the recovery zone. Setting early warning thresholds aims at raising awareness of adverse developments and allowing adequate preparation time for corrective actions. The breach

[427] The EBA Guidelines are in line with the FSB's Guidance on "*Recovery Triggers and Stress Scenarios*".

[428] The Net Stable Funding Ratio (NSFR) aims to limit excessive maturity transformation. The NSFR therefore requires banking groups to maintain a minimum number of stable funding sources in relation to the terms and maturity of their assets, as well as the potential to deal with contingent liquidity needs arising from off-balance sheet commitments.

[429] See **European Banking Authority (2016)**, p. 29.

of an early warning threshold should initiate a more detailed assessment and careful monitoring of the situation.

Recovery triggers constitute the points at which the escalation process is enacted and a decision on the activation (or not) of the recovery plan is taken. Recovery triggers should be calibrated in such a way to ensure that they are set sufficiently above the minimum regulatory thresholds. For instance, capital indicators (e.g. Total Capital ratio) should be set above both the minimum capital requirements and the Pillar II requirements determined by the ECB after the conduct of the SREP. For instance, if the Pillar 1 and Pillar 2 requirements (i.e. TSCR) account for 11% of group's RWAs,[430] then the relative indicator could be set at the level of 13.0%. If the Total Capital ratio falls below that level, the escalation process must be activated so as the banking group's competent body decides on the need to implement recovery measures.

Table 8 is an indicative example of recovery indicators along with the relevant early warning thresholds and recovery triggers.

[430] Capital adequacy is measured on the basis of the riskiness of the assets. Therefore, based on the inherent risk of each class of assets, a different risk factor is applied. For instance, since consumer loans are riskier than mortgages, they are assigned with a higher risk factor (i.e. 75% vs 35% for mortgages). As a result, banking groups must hold more capital to cover against risks arising from consumer loans.

Table 8: Indicative example of recovery plan indicators

#	Name	Category	Early warning threshold	Recovery trigger	Monitoring frequency	Remarks
1	CET1 ratio	Capital	10%	9.5%	Monthly	Assuming SREP CET1 requirement at 7.5%
2	Total capital ratio	Capital	13.5%	13.0%	Monthly	Assuming SREP capital requirements at 11%
3	Leverage ratio	Capital	4.5%	3.5%	Quarterly	The minimum regulatory threshold is 3%
4	Liquidity Coverage Ratio (LCR)	Liquidity	125%	110%	Monthly	The minimum regulatory threshold is 100%
5	Net Stable Funding Ratio (NSFR)	Liquidity	120%	110%	Quarterly	The minimum regulatory threshold is 100%
6	Return on Equity (RoE)	Profitability	4%	2%	Quarterly	Assuming current level of the indicator at 8%
7	Cost-to-income ratio	Profitability	65%	70%	Quarterly	Assuming current level of the indicator at 55%
8	Non-Performing Exposures ratio	Asset quality	18%	20%	Quarterly	Assuming current level of the indicator at 15%
9	Provision coverage ratio	Asset quality	45%	40%	Quarterly	Assuming current level of the indicator at 50%
10	CDS spread	Market-based	+250 bps	+400 bps	Daily	Change compared to previous week
11	Stock price variation	Market-based	+20%	+25%	Daily	Assuming current level of the indicator at 6%
12	GDP growth rate	Macroeconomic	+0.5%	+0.0%	Quarterly	GDP growth rate on a quarterly basis
13	Spread of Government 10-yr bond over German Bund	Macroeconomic	+150 bps	+350 bps	Daily	Change compared to previous week

2.1.2.4 Stress scenarios

Article 5(6) of the BRRD requires banking groups to consider a range of scenarios of severe macroeconomic and financial stress when developing their recovery plans. Scenarios of severe macroeconomic and financial distress should be designed in a way that they would threaten the failure of the banking group if recovery measures were not implemented timely. However, since the aim of a recovery plan is to prove the group's capacity to restore its viability, these scenarios should be designed as 'near-default' situations, namely they should bring a banking group close to failure but no further.

The range of the scenarios that should be provided for in group recovery plans are specified in the EBA Guidelines *"on the range of scenarios to be used in recovery plans"*. In particular, recovery plans must include at least three (3) scenarios to ensure coverage of a system-wide event, an idiosyncratic event and a combination of system-wide and idiosyncratic events.[431] Recovery plans for G-SIIs and O-SIIs should include at least four (4) stress scenarios, including both slow-moving and fast-moving adverse events. Stress scenarios should be designed to effectively highlight potential crises that can be capital- or liquidity-driven, fast- or gradually-evolving and of idiosyncratic or systemic nature (or both).

Table 9 provides an example of stress scenarios that fulfil all the requirements set out in the aforementioned EBA Guidelines.

Table 9: Characteristics of stress scenarios

Characteristics		Scenario 1	Scenario 2	Scenario 3	Scenario 4
Scenario type	Idiosyncratic		√	√	
	System-wide	√			
	Combined (idiosyncratic and system-wide)				√
Impact	Liquidity			√	√
	Capital	√	√		√
Speed with which scenarios develop	Fast			√	√
	Slow	√	√		√

Table 10 shows the impact of hypothetical stress scenarios which lead the recovery indicators below the respective recovery triggers (13% for Total Capital ratio, 110% for LCR).

Table 10: Example of stress scenarios' impact

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Recovery indicator breached	Total capital ratio	Total capital ratio	LCR	Total capital ratio / LCR
Starting point	16%	16%	135%	16% / 135%
Ending point	12%	12.1%	102%	12% / 102%

[431] See **EBA Guidelines** "*on the range of scenarios to be used in recovery plans*", p. 8.

2.1.2.5 Recovery options

Each group recovery plan must include a list of recovery options and a description of each option. Recovery options are designed to respond to financial stress scenarios and are expected to contribute to the restoration of the viability and financial position of the banking group.[432] Recovery options indicate a range of capital and liquidity actions required to maintain or restore the viability of the group's entities.[433]

Indicatively, recovery options that can be included in group recovery plans include:

- share capital increase,
- no distribution of dividends to shareholders,
- reduction in personnel,
- reduction in marketing expenses,
- cancellation of bonus payments,
- sale of loan portfolios,
- sale of subsidiaries, and
- issuance of covered bonds.

The recovery plan should assess whether each recovery option meets the criteria listed below.

(A) Feasibility: assessment of whether the option is considered possible to be executed.

(B) Suitability: relevance of the option's benefits to the particular stress scenario under consideration.

(C) Valuation: range of potential valuations under different stress conditions.

(D) Speed & timing: the time that will be required to implement the recovery option, considering the time necessary to decide, prepare, announce and execute the option.

(E) Potential counterparties: the counterparties that are considered likely to support the recovery option or transaction.

(F) Financial impact: impact of the option on the group after the execution of the option (e.g. preparation / execution costs, profitability impact, capital and liquidity impact).

(G) External impact: potential systemic or other consequences along with competition and regulatory considerations.

(H) Risk assessment: obstacles anticipated to be faced during option execution, which may lead the recovery option to not be implemented or be less successful than expected given the stress conditions, and ways in which these can be mitigated beforehand.

Should the competent body (e.g. Executive Committee or management body) of the parent entity decide to activate the group recovery plan, it may implement one of the recovery options included in the recovery plan to restore the breached recovery indicator to a level sufficiently above the recovery trigger.

[432] **BBRD**, Article 8(2).

[433] *Ibid.*, Article 9(1).

2.1.3 Enhancing the group-wide perspective of group recovery plans

Group recovery plans are often drafted from the perspective of the Union parent entity, and do not include adequate information at the level of the group's entities. This shortcoming impacts the credibility and effectiveness of the proposed recovery measures and the overall recoverability of the banking group, since recovery indicators, stress scenarios and recovery options are primarily focused on the parent entity. Insufficient elaboration of recovery planning at the level of the group's entities leave the NSAs of non-participating Member States without adequate information on recovery planning for the entities under their supervisory remit.

Hence, NSAs have no option but to require entities located in their jurisdictions to draw up recovery plans on an individual basis. Such a development enhances the recoverability of the entities concerned but promotes ring-fencing as it treats banking groups as the sum of entities. Therefore, the EBA has issued **Recommendations** "*on the coverage of entities in a group recovery plan*" urging parent entities to cover more extensively their groups' entities in the group recovery plans. The aim of the EBA Recommendations is to avert NSAs from requesting the submission of individual recovery plans for groups' entities.

Pursuant to the EBA Recommendations and based on the criteria laid down in **Article 7(2) of the Commission Delegated Regulation 2016/1075**, a banking group's entities should be designated as **relevant for the banking group**, or **relevant for the local economy**, or **not relevant neither for the Group nor for the economy**.

Based on their classification, the relevant group recovery plan should envisage different extent of coverage for the group's entities. The entities relevant for the group should be covered in an extensive and detailed manner, whilst the entities relevant for the local economy should be covered in a way that ensures operational continuity, thereby ensuring that critical functions are preserved in case of distress.

2.1.4 Assessment of group recovery plans

2.1.4.1 Joint decision on the assessment of group recovery plans

Following the submission of the group recovery plan by the parent undertaking to the ECB, the latter must transmit the plan to the SRB and the NSAs and NRAs[434] of the non-participating Member States, where the group's entities are located.[435] The SRB may examine the plan in order to identify any actions referred to, which may adversely impact the resolvability of the banking group and make recommendations to the ECB with regard to those matters.

The ECB along with the NSAs of non-participating Member States, where subsidiaries are located, review the group recovery plan and assess the extent to which it satisfies certain requirements and criteria. That assessment must take account of the potential impact of the recovery measures on financial stability in all the Member States where the group operates.[436] The ECB and the NSAs of non-participating Member States must endeavor to reach a joint decision on the **review and assessment of the group recovery plan** and **whether an individual recovery plan must be drawn up for any group's entities**.

[434] Pursuant to **Article 3 of the BRRD**, Member States must designate an administrative authority with the task to apply resolution tools and exercise resolution powers.

[435] **BRRD**, Article 7(3).

[436] *Ibid.,* Article 8(1).

Upon request from an involved supervisory authority, the EBA may assist –in the context of a non-binding mediation- the parties to reach a joint decision in accordance with **Article 31(c) of the EBA Regulation**. Where within four (4) months a joint decision is not reached, the ECB and the NSAs must decide on their own with regard to the assessment of the recovery plan and the need to require an individual plan to be drawn up for each group's entity. These decisions must be made after having taken into consideration the views and reservations expressed by the other involved parties during the four-month period.[437]

On the contrary, a specific procedure is applied if, at the end of the four-month conciliation period, any of the involved supervisory authorities has referred, based on **Article 19(3) of the EBA Regulation**, any of the aforementioned matters to the EBA. In that case, the interesting parties defer their decision and await any decision that the EBA may take. The EBA must decide within one (1) month, otherwise in the absence of such a decision, the decisions of the involved parties (i.e. ECB and/or NSAs) apply. The matter must not be referred to the EBA after the end of the four-month period or after a joint decision has been reached. Following a failure to reach a joint agreement, the ECB takes decisions in respect of the parent undertaking and other entities located in participating Member States, whilst the NSAs of non-participating Member States decide on the group's entities incorporated in their jurisdictions.

From a national interest perspective, individual recovery plans satisfy NSAs, since they are confident that there is a recovery plan to address any crisis situation which might arise. However, this approach is damaging for the internal market, as individual plans treat banking groups as a sum of entities resulting in the fragmentation of the banking market. Therefore, it is critical a joint decision to be reached in order to ensure that the banking group has a consistent group-wide recovery plan that can be activated under stress situations and not a sum of individual recovery plans (one for each entity).

2.1.4.2 Criteria for the assessment of group recovery plans

The ECB assesses the group recovery plans mainly on the basis of whether the implementation of the arrangements proposed in the recovery plans is reasonably likely to maintain or restore the viability and financial position of banking groups. The ECB's assessment is focused on whether specific options within the plans are reasonable likely to be implemented quickly and effectively in situations of financial stress avoiding to the maximum extent possible any important adverse impact on the financial system.[438]

Furthermore, the ECB assesses the group recovery plans in order to ensure that they satisfy the requirements provided for in **Article 7 of the BRRD** and reviews the completeness of the plans based on the following:[439]

- whether the recovery plan adequately reflects an appropriate range of scenarios of severe macroeconomic and financial stress relevant to the specific conditions of the entities covered by the plan,
- whether the plan contains a framework of indicators which defines the points at which appropriate recovery actions may be applied, and
- whether for each of the scenarios of severe macroeconomic and financial stress which is reflected in the plan pursuant to **Article 7(6) of the BRRD**, the plan

[437] *Ibid.*, Article 8(3).

[438] *Ibid.*, Article 6(2).

[439] **Commission Delegated Regulation 2016/1075**, Article 16.

identifies if there are impediments to implementing recovery measures within the group, including at the level of individual entities covered by the plan.

2.1.4.3 Procedure for the assessment of group recovery plans

Article 8 of the BRRD determines a specific procedure for the assessment of group recovery plans. This procedure is applied by the ECB where a joint decision is reached for the group recovery plan, as well as in case of disagreement among involved supervisory authorities. In the latter case, the procedure described below is applied by the ECB in respect of the individual recovery plan of the parent entity and by the NSAs of non-participating Member States for the individual recovery plans of the group's entities located in their jurisdictions.

In case of a joint decision on the assessment of the group recovery plan, the ECB (consolidating supervisory authority) notifies the parent entity with regard to the assessment conducted and the weaknesses identified in the group recovery plan. If the weaknesses are immaterial, the ECB requires from the banking group to take them into consideration in the next recovery plan submission. On the other hand, if the weaknesses are material, the parent entity is required to resubmit a revised plan demonstrating how these impediments or deficiencies have been addressed.[440]

In case that the ECB assesses that the revised plan is inadequate to remedy the deficiencies identified in its original assessment, it requires the parent entity to identify changes to its business in order to address the identified deficiencies. Where the parent entity is unable to identify such changes within the time limits set or if the ECB deems that the proposed measures do not remedy the identified deficiencies, the ECB may require the parent entity to:[441]

- reduce the risk profile of the banking group, including liquidity risk,
- enable timely recapitalization measures,
- review the group's strategy and structure,
- make changes to the funding strategy so as to improve the resilience of the core business lines and critical functions, and
- make changes to the governance structure of the parent entity.

2.2 Intragroup financial support

2.2.1 Core elements of the intragroup financial support

Under the existing regulatory framework, individual capital and liquidity requirements can be waived allowing the free flow of funds between group's entities but only under strict conditions. In accordance with **Article 7 of the CRR**, capital waivers may be granted, where certain requirements are met, including the fact that both the parent and the subsidiary are located in the same Member State.[442] In relation to liquidity waiver, it

[440] **BRRD**, Article 6(6).

[441] *Ibid.*, Article 6(6).

[442] The remaining conditions refer to the following ones:

a. there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities by the parent entity,

b. either the parent entity satisfies the supervisory authority regarding the prudent management of the subsidiary and has declared, with the permission of the supervisory can be applied also to group's entities located in different Member States, provided that a joint decision between the relevant supervisory authorities is taken.[443] Hence, providing financial support from one group entity to another located in different Member States is restricted and subject to a number of provisions laid down in national law of Member States (i.e. ring-fencing measures). Such provisions aim at protecting the creditors and shareholders of each entity from the risk of failure.[444] This approach results in treating the group's entities from a national perspective without considering the interdependencies between them.

Until this issue is addressed in an effective manner (see below, in **Chapter C, Section 2**, under **3.1**), **Articles 19-26 of the BRRD** established the **intragroup financial support**, which is an innovative element in the crisis prevention framework aiming to ensure that entities belonging to a banking group may assist each other in times of stress through providing financial support. The parent entity and its subsidiaries in other (participating and non- participating) Member States or third countries may enter into an agreement to provide financial support to any other party to the agreement. That agreement is activated when both the conditions for early intervention and the conditions referred below (in section ***2.2.3***) are met. The group financial support agreement cannot be concluded, when any of the parties meets the conditions for early intervention at the time the proposed agreement is reached.

An intragroup financial support agreement is not a prerequisite to provide financial support to any entity of the group that experiences financial difficulties if the entity decides to do so, on a case-by-case basis.[445] The intragroup financial support agreement may cover one or more subsidiaries of the group and provide for financial support:

- from the parent entity to subsidiaries,
- from the subsidiaries to the parent entity,
- between subsidiaries of the group that are party to the agreement, or

authority, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest,

c. the risk evaluation, measurement and control procedures of the parent entity cover the subsidiary, and

d. the parent entity holds more than 50 % of the voting rights attached to shares in the capital of the subsidiary or has the right to appoint or remove a majority of the members of the management body of the subsidiary.

[443] Pursuant to Article 8(3) of the CRR, the involved supervisory authorities should agree on the following issues:

a. their assessment of the compliance of the organisation and of the treatment of liquidity risk with the conditions set out in Article 86 of Directive 2013/36/EU across the single liquidity sub-group

b. the distribution of amounts, location and ownership of the required liquid assets to be held within the single liquidity sub-group;

c. the determination of minimum amounts of liquid assets to be held by institutions for which the application of Part Six will be waived;

d. the need for stricter parameters than those set out in Part Six; (e) unrestricted sharing of complete information between the competent authorities; (f) a full understanding of the implications of such a waiver.

[444] **BRRD**, recital (38).

[445] *Ibid.*, Article 19(3).

- any combination of those entities.

Furthermore, the intragroup financial support agreement provides for financial support, including between the beneficiary of the support and a third party, in the form of loans, guarantees, assets for use as collateral, or any combination of those forms of financial support.

Financial support may be transferred among the entities of a cross-border banking group in order to safeguard the group's financial position without putting in danger the solvency or liquidity of the entity providing the support.[446] For the determination of whether the provision of financial support seeks to preserve the financial health of the banking group as a whole, the ECB and the providing entity should analyze and compare:[447]

- the **overall benefits for the group** as a whole resulting from the restoration of the financial situation of the receiving entity and the overall risks for the group should the support not be provided, and
- the **risks for the group** as a result of the provision of financial support.

2.2.2 Ex-ante approval of the proposed agreement by supervisory authorities and shareholders

An intragroup financial support agreement may enter into force, only if both the involved supervisory authorities and the shareholders of the entities concerned have provided an ex-ante approval. With regard to supervisory authorities, the proposed intragroup financial support agreement must be reviewed by the ECB, which is the consolidating supervisory authority, and the NSAs which are responsible for the group's entities located in non-participating Member States. **Article 20 of the BRRD** provides that the parent entity submits to the ECB an application for authorization of any proposed intragroup financial support agreement. The involved supervisory authorities must do everything within their power to reach a joint decision on whether the terms of the proposed agreement are consistent with the conditions for financial support. The timeframe for reaching joint decision cannot exceed four (4) months from the date of receipt of the application by the ECB.[448]

Upon request from an involved supervisory authority, the EBA may assist -within the context of a non-binding mediation- the supervisory authorities in reaching an agreement in accordance with **Article 31 of the EBA Regulation**. If, at the end of the four-month period, any of the involved supervisory authorities has referred the matter to the EBA pursuant to **Article 19 of the EBA Regulation** (binding mediation), the ECB must defer its decision and await any decision that the EBA may take in accordance with **Article 19(3) of the EBA Regulation** and, subsequently, it must decide in accordance with the decision of the EBA.

As mentioned above, the approval of the proposed agreement by shareholders is prerequisite for it to enter into force. The agreement is valid only in respect of those parties whose shareholders have approved the agreement and have authorized the management body of that entity to make a decision that the group entity must participate in the proposed agreement. The management body of the entity providing the support is responsible for taking the decision to provide group financial support, while the

[446] *Ibid.*, rec.38

[447] **EBA Guidelines** "*specifying the conditions for group financial support under Article 23 of Directive 2014/59/EU*", par. 3.

[448] **BRRD**, Article 20(5).

management body of the receiving entity decides to accept intragroup financial support in accordance with the agreement.

2.2.3 Conditions for provision of intragroup financial support

Article 23 of the BRRD lays down certain requirements which intragroup financial support agreements must meet. In specific, the following conditions must be satisfied cumulatively:[449]

- there is a reasonable prospect that the support provided significantly redresses the financial difficulties of the group's entity receiving the support,
- the provision of financial support has the objective of preserving or restoring the financial stability of the group as a whole or any of the group's entities,
- the financial support is provided on reasonable terms,
- there is a reasonable prospect that the reward for the support will be paid and, if the support is given in the form of the loan, that the loan will be reimbursed, by the entity receiving the support,
- the provision of the financial support would not jeopardize the liquidity or solvency of the entity providing the support,
- the provision of the financial support would not create a threat to financial stability, particularly in the Member State where the entity providing the support operates,
- the entity providing the support complies, at the time the support is provided, with the capital and liquidity requirements,
- the entity providing the support complies, at the time when the support is provided, with the requirements relating to large exposures, and
- the provision of the financial support would not undermine the resolvability of the entity providing the support.

The conditions for intragroup financial support are specified in the **Commission Delegated Regulation 2016/1075** and in Guidelines issued by the EBA, while the **Commission Implementing Regulation 2016/911** defines in detail the form and the content of the description of group financial support agreement.

2.2.4 Right of opposition to the provision of intragroup financial support

Taking ex-ante approval of the intragroup financial support agreement is not adequate in order to activate the agreement and provide funding to an entity in need of it. Thus, prior to the provision of support, the management body of the entity providing support must notify its supervisory authority, as well as the other involved supervisory authorities.

The supervisory authority of the group's entity that provides the financial support may agree with the provision of financial support or may prohibit or restrict it, where it assesses that the conditions for intragroup financial support have not been met. In such a case, should the supervisory authority (of the receiving entity) have objections regarding the decision to prohibit or restrict the financial support, it may refer the matter to the EBA and request its assistance pursuant to **Article 31 of the EBA Regulation** (non-binding mediation).

Based on the aforementioned process, it can be reasonably stated that the significance of the intragroup financial support agreement is limited, given that the supervisory authority of the entity providing the funding may prohibit the activation of the agreement and, thus,

[449] *Ibid.*, Article 23(1).

the provision of the assistance. Furthermore, the supervisory authorities of the entities receiving the assistance have limited tools at their disposal to ensure that the entities under their remit will have the necessary funding at the early intervention stage. It is notable that the relative BRRD provisions do not envisage the possibility for the involved supervisory authorities to resort to binding EBA mediation under **Article 19 of the EBA Regulation**, but only to non-binding mediation, limiting, thus, their available options.

2.3 Early intervention measures in respect of significant banking groups

2.3.1 An overview of the early intervention measures

For the purpose of preserving financial stability, it is important that supervisory authorities are able to remedy the deterioration of a banking group's financial situation before it reaches a point at which there is no other option than to resolve it.[450] The new crisis management framework confers upon supervisory authorities extended powers to address stress situations in which banking groups have come. In the context of an escalation procedure, supervisory authorities have extensive early intervention powers to exercise in a sequential manner, commencing from simple corrective measures and ending to the appointment of a temporary administrator in the banking group under stress. Initiating from milder to more intrusive measures, there is a continuous line of **preventive measures** (Pillar 2 capital and liquidity requirements), **corrective measures** (changes in the internal organization) and **extraordinary measures** (appointment of temporary administrator).[451]

Pillar 2 measures can be applied both as an outcome of the SREP process and during the early intervention phase, which creates ambiguity over the content and the conditions for the application of such measures. This overlap between Pillar 2 measures and early intervention measures reveals the need for more clarity in the regulatory framework, as will be further analyzed in **Chapter C, Section 2**, under **3.4.3**.

Determining deterioration of the financial position of a banking group entails significant degree of discretion. Therefore, the EBA has issued Guidelines setting out common criteria based on which supervisory authorities should take decisions on early intervention measures (EBA Guidelines "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail*").

Where the situation of a banking group is deteriorating rapidly in terms of capital adequacy, liquidity, asset quality and results in infringing, or being likely to infringe in the near future, the applicable prudential requirements, the ECB has at its disposal several powers to address this situation:[452]

- to require the banking group to implement the measures provided for in its recovery plan,
- to require the banking group to identify measures to overcome the problems having arisen and draw up a relative action plan to address,
- to require a meeting of the shareholders of the parent entity to be convened and certain decisions to be considered for adoption by the shareholders,
- to require one or more members of the management body or senior management of the parent entity to be replaced should they be unfit to perform their duties,

[450] With the term "resolve" is denoted the application of a resolution tool (i.e. sale of business tool, bridge bank tool, asset separation tool, bail-in tool) in order to restore the solvency and viability of a failed banking group without triggering the normal insolvency proceedings.

[451] See **Psaroudakis (2018)**, p. 14.

[452] **BRRD**, Article 27(1).

- to require the management body of the parent entity to draw up a plan for negotiation on restructuring of debt with some or all of its creditors,
- to require changes in the banking group's business strategy and legal or operational structure, or
- to contact potential purchasers in order to prepare for the resolution of the banking group.

The BRRD confers upon supervisory authorities even more extended and radical (than the aforementioned) powers to address worse situations. Such powers may end up to the **removal of the senior management and management body** of the parent entity. The ECB may take such a decision where it considers that the aforementioned early intervention measures are not sufficient to remedy a rapidly deteriorating banking group or identifies serious infringements of law or administrative irregularities. In particular, the ECB may decide to require the removal of the senior management or management body in its entirety or with regard to individuals aiming to cope with the issues threating the viability of the banking group.

If the replacement of the senior management or the management body is deemed insufficient to address the situation, the ECB may appoint one or more **temporary administrators** to the banking group. The temporary administrator will be entrusted with the task either to replace the management body or to work temporarily with it.[453] The role of the temporary administration pertains to ascertaining the financial position of the banking group, managing the business and taking the necessary measures to restore its financial position.[454]

In respect of banking groups with operations inside and outside the Banking Union, prior consultation among supervisory authorities in the context of the supervisory college must take place before deciding on early intervention measures, including temporary administration. The ECB should consider the potential impact of early intervention measures on the group's entities located in other Member States, but not on third countries. The ECB must notify the NSAs of non-participating Member States and the EBA of such measures. In any case, the decision is taken by the ECB without being obliged to reach an agreement with the relevant NSAs.

The same process applies to the application of early intervention measures by the NSA of a non-participating Member State to the group's subsidiary under its remit. Before taking the relative decision, notification of its intention and consultation with the other supervisory authorities must precede. However, the NSA concerned is the sole responsible for taking the relative decision.

2.3.2 Triggers for the use of early intervention measures

2.3.2.1 Key early intervention triggers

The ECB may take early intervention measures based on certain triggers envisaged in the relevant EBA Guidelines. These triggers are closely, though not solely, linked to the outcome of the annual SREP assessment. Early intervention measures can also be triggered upon occurrence of other circumstances which might not be immediately factored into the SREP outcome. In accordance with the EBA Guidelines, the ECB may apply early intervention measures based on the following triggers:

[453] Shareholders retain full responsibility and control of the banking group concerned except when a temporary administrator has been appointed by the supervisory authority.

[454] **BRRD**, Article 29(2).

- the **Overall SREP score** and any **combination of the overall SREP score and individual scores for SREP components**,
- any **material change** identified **in the monitoring of key financial and non-financial indicators** which reveals that the conditions for early intervention are met, or
- any **significant event** which indicates that the conditions for early intervention are met.

However, in accordance with the report of the European Court of Auditors (ECA) on "*the operational efficiency of the ECB's crisis management for banks",* the ECB's "*guidance for early intervention assessments is underdeveloped*", while it has not yet determined "*objective criteria or indicators for determining that a bank has entered a crisis situation*". Therefore, the ECA concluded that the ECB should define indicators for the identification of a potential deterioration in the financial situation of a banking group and link them to clear escalation processes.[455]

2.3.2.2 Triggers based on the SREP outcome

The annual SREP assessment is a holistic exercise within which the ECB examines all key sources of risks for banking groups. Thus, when the ECB assigns to a banking group an overall SREP score of "4", this implies that the banking group concerned faces significant problems that may threaten its viability.[456] The same applies in case that the ECB assigns to a banking group:[457]

- an overall SREP score of "3" and an individual score of "4" for the **business model**,
- an overall SREP score of "3" and an individual score of "4" for the **internal governance and institution-wide controls**,
- an overall SREP score of "3" and an individual score of "4" for the **capital adequacy**,
- an overall SREP score of "3" and an individual score of "4" for the **liquidity adequacy**.

Consequently, in all these cases the ECB should examine the possibility to take a decision on the application of early intervention measures.

2.3.2.3 Monitoring key financial and non-financial indicators under the SREP

Within the SREP process, the ECB monitors key financial and non-financial indicators. For these indicators, the ECB may set thresholds above the minimum capital requirements (TSCR) and liquidity requirements (LCR, NSFR). For instance, the ECB may set a threshold for CET1 ratio at the level of 1.5% above the TSCR. Upon identification of a breach of that indicator by the banking group concerned, the ECB should investigate further the situation. In this case, the ECB should either update the overall SREP score or the individual score for this SREP component (risks to capital) or use this incident as a trigger for taking a decision on the application of early intervention

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455 See **European Court of Auditors (2018)**, p. 48.

456 See the **EBA Guidelines** "*on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU*", par. 13.

457 *Ibid*., par. 15.

measures. This determination should be based on the causes and materiality of the potential prudential impact on the banking group.

2.3.2.4 Significant events that may trigger early intervention measures

Upon occurrence of severe events that impact the banking group's financial situation, the ECB should investigate further the situation to decide whether it is necessary to take early intervention measures. Such events could include:[458]

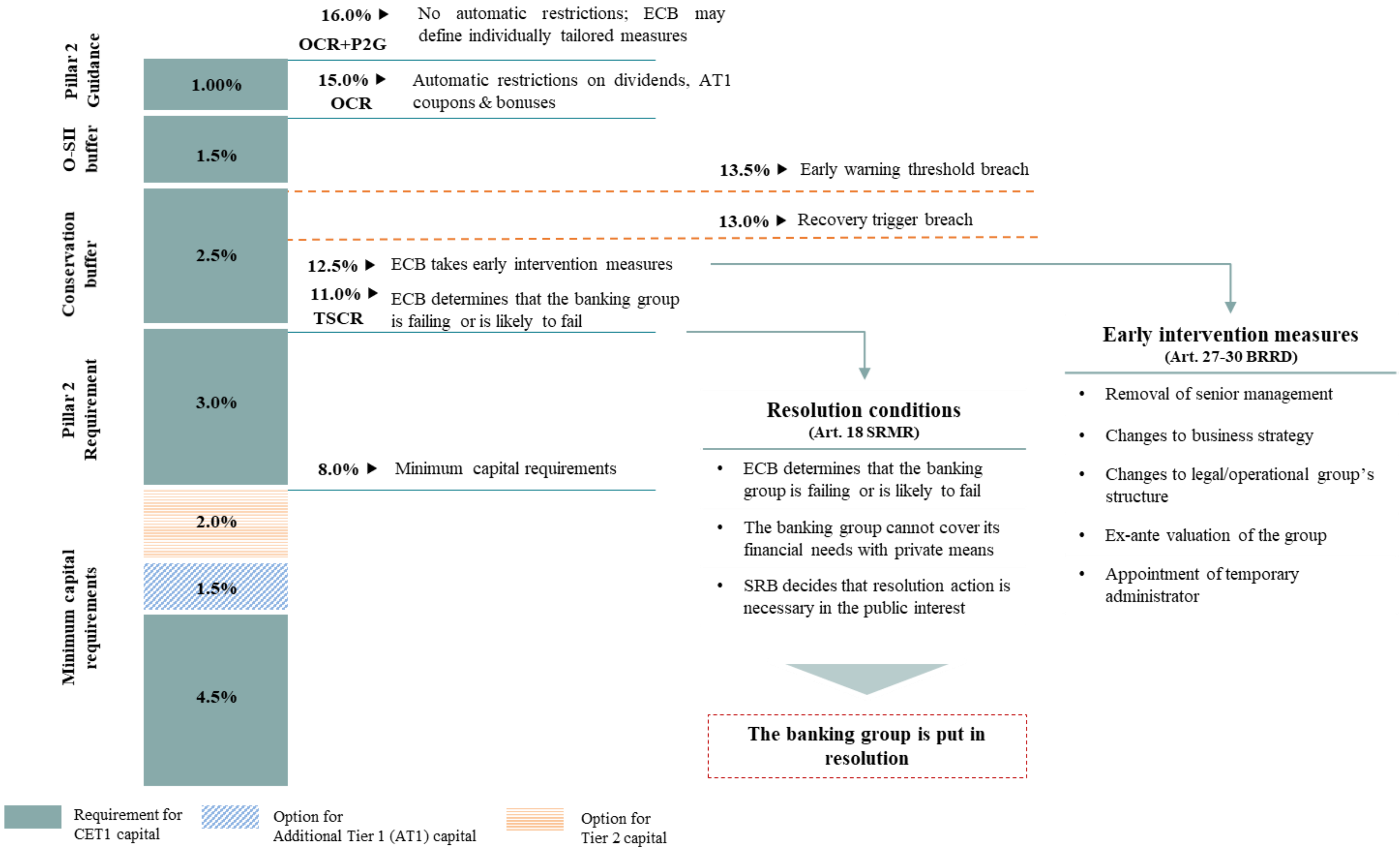
- major operational risk events (e.g. fraud, fines imposed by public authorities),
- significant deterioration in the amount of MREL-eligible liabilities held by the banking group,
- signals that the quality of assets has been deteriorated and an independent valuation is needed,
- significant outflow of funds, including retail deposits,
- unexpected loss of senior management or key staff who have not been replaced, or
- significant rating downgrades, which may lead to substantial outflow of funds.

In light of any of the aforementioned findings, the ECB must update the score of the respective SREP element. If this update results in an Overall SREP score of "F" or any of the aforementioned combinations of the Overall SREP score and of the SREP elements score, the ECB may decide to take early intervention measures.[459] Nonetheless, significant events may trigger directly the decision for taking early intervention measures depending on the magnitude of the significant event and the materiality of the impact on the group's financial situation.

[458] *Ibid*., par. 24.

[459] *Ibid*., par. 26.

Figure 15: Interaction of capital requirements with supervisory measures



2.4 The precautionary recapitalization as a crisis prevention measure

2.4.1 Key principles for the precautionary recapitalization instrument

The core objective of the BRRD is to avoid the need to resort to taxpayers' money as far as possible to rescue failing banking groups. Within the BRRD framework, resolution should be primarily and almost exclusively financed by private resources. Within the boundaries of resolution framework, state aid can be granted through the use of the Government Stabilization Financial Tools (see below in **Section 3,** under ***1.1***) only under very strict conditions, including prior bail-in of 8% of total liabilities and own funds of the ailing parent entity of the banking group.

However, there is still room to circumvent the resolution framework and use public funds to enhance the capital base of distressed banking groups and prevent their failure. This can be achieved through the use of the precautionary recapitalization instrument. Based on **Article 32 of the BRRD**, the need for extraordinary public financial support for a banking group is amongst the criteria for the determination that a banking group is "failing or is likely to fail" triggering, thus, the need for resolution action. However, the provision of extraordinary public financial support can be considered compatible with the resolution framework, where it takes the form of an injection of capital to or purchase of capital instruments issued by a banking group in order to address a capital shortfall arisen from stress-tests,[460] asset quality reviews[461] or equivalent exercises. This capital support must be provided to remedy a serious disturbance in the economy of a Member State and to preserve financial stability.

Precautionary public support can be provided only if neither the conditions for determination of a banking group as "failing or likely to fail" (**Article 32(4) of the BRRD**) nor the conditions for exercise of the write-down and conversion powers are met. Recourse to the precautionary recapitalization instrument is governed by certain principles, namely it:[462]

- is provided at prices and terms that do not confer a competitive advantage upon banking groups,
- is granted to solvent banking groups, namely groups that satisfy the minimum (Pillar I and Pillar II) capital requirements,
- is temporary and proportionate to address the consequences of a serious disturbance in the economy of a Member State,
- aims to safeguard the financial stability,
- is not used to cover losses that banking groups have incurred or there are objective elements to assess that will incur in the near future, and

[460] Pursuant to the **EBA Guidelines** "*on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive*", 'stress tests' are defined as "*tools, coordinated at the national, SSM or Union level, designed to assess the resilience of a group against hypothetical adverse market developments*".

[461] Pursuant to the **EBA Guidelines** "*on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive*", 'asset quality reviews' are defined as "*assessments, coordinated at the national, SSM or Union level, of the quality of the accounting or prudential framework applied by a group of institutions, including an assessment of the risk management framework, loan classification, collateral valuation and loan origination and arrears management*".

[462] See the **EBA Guidelines** "*on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive*", par. 8.

- is subject to final approval under the state aid rules.[463]

With respect to the first condition, where provision of financial support is given in the means of CET1 instruments, the issuance of new shares must imply that existing shares will be diluted to the same extent as would happen if the new shares were issued to private purchasers. Moreover, precautionary recapitalization through the issuance of Additional Tier 1 and/or Tier 2 instruments has to be provided with a coupon rate not lower to that applied if these instruments were sold to private sector investors.

Based on the conditions referred above, it is assumed that precautionary recapitalization is not eligible for banking groups failing to pass the threshold of an AQR or of the baseline scenario of a stress-test exercise (e.g. CET1 ratio of 8% of RWAs).[464] Where a banking group does not pass the AQR threshold, it has to increase its provision coverage, which implies losses driving the group below the minimum capital requirements threshold. Hence, the banking group is considered to be "failing", as it meets the criterion of breaching the minimum capital requirements.

The same applies to banking groups falling below the threshold of the baseline scenario of a stress-test. The objective of such a scenario is to assess the financial situation of banking groups within a 3-year horizon under a base-case scenario. Thus, if a banking group falls below the "pass/fail" threshold, the banking group is considered as very "likely to fail" in the near future.

Consequently, when a capital shortfall is identified, the ECB requires the banking group concerned to cover this shortfall via private means within a specific timeframe. Depending on the component of the exercise where the group failed, a different procedure applies (see ***Figure 16***). Specifically:[465]

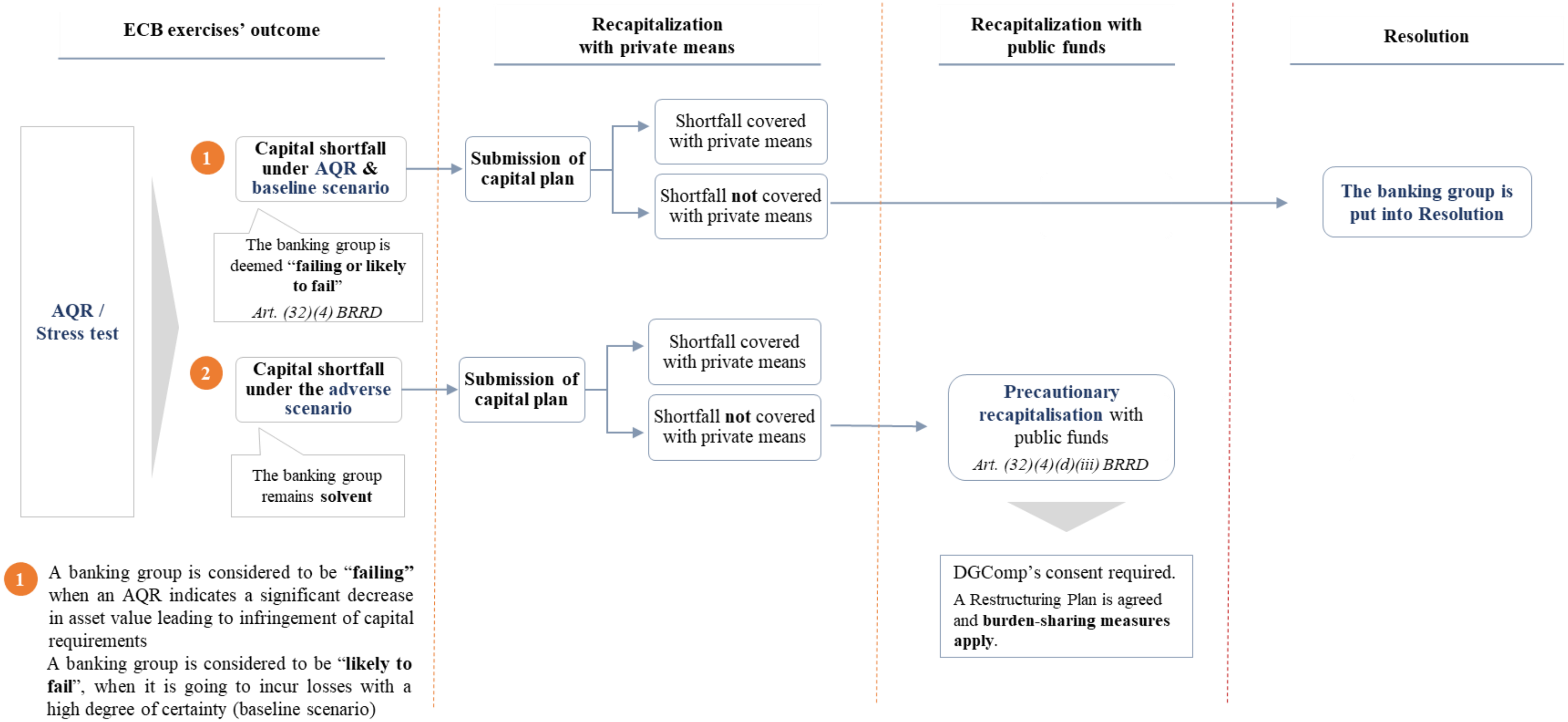
- if the banking group fails to cover with private means the capital shortfall identified in an AQR, the ECB determines the group as "failing or likely to fail",
- if the banking group fails to cover with private means the capital shortfall under the baseline scenario of a stress-test, the group is determined as "failing or likely to fail",
- if the banking group fails to cover with private means the capital shortfall of the adverse scenario of a stress-test, the group is eligible to request for precautionary recapitalization support with public funds.

[463] Before granting precautionary recapitalization to an ailing banking group, the Commission should be informed by the ECB that the beneficiary is solvent, namely it fulfils the minimum capital requirements (total capital ratio of 8%) in accordance with **Article 92 of the CRR**.

[464] A stress-test exercise is not necessary to have an explicit "pass or fail" threshold. This approach is followed by the ECB since the 2016 stress-test exercise. In particular, the ECB determines whether a banking group is in need of additional capital, after taking into account both the outcome of the stress-test and the management actions taken by the banking group to improve its financial position.

[465] This procedure was applied in the three (3) most remarkable cases of use of the precautionary recapitalization instrument after the entry into force of the BRRD, namely in the bail-out cases of National bank of Greece (2015), Piraeus Bank (2015) and Monte dei Paschi Di Siena (2017). For a critical assessment of the precautionary recapitalization of the Monte dei Paschi di Siena, see **Hadjiemmanuil (2017b)** and **Götz, Krahnen** and **Tröger (2017a).**

Figure 16: Potential capital implications of the AQR/stress-test results



1. A banking group is considered to be "**failing**" when an AQR indicates a significant decrease in asset value leading to infringement of capital requirements
A banking group is considered to be "**likely to fail**", when it is going to incur losses with a high degree of certainty (baseline scenario)

2. Should a banking group not pass the adverse scenario's threshold, the "failing or likely to fail" procedure is not activated and the bank may resort to the **precautionary recapitalization instrument**

2.4.2 Compatibility of the precautionary recapitalization instrument with the state aid framework

Starting from the breakout of the crisis in 2008, the Commission adopted during the years of crisis eight (8) "Crisis Communications" to formulate a framework governing the provision of state aid to ailing banking groups.[466] The last Communication was adopted on 30 July 2013 and replaced the 2008 Banking Communication setting out the principles governing the provision of state aid to banking groups. The 2013 Banking Communication provides guidance on the compatibility criteria for liquidity support and liquidation aid, as well as on burden-sharing applied to shareholders and junior bondholders in case of capital support. In addition, the Communication stipulates that no recapitalization or asset protection measure can be granted without prior approval of a restructuring plan by the Commission.

Communications are acts of soft law that determine how the Commission is going to apply **Article 107(3)(b) of the TFEU**, which provides that state aid may be considered to be compatible with the internal market if it is necessary in order "*to remedy a serious disturbance in the economy of a Member State*".[467] Based on these Communications, the Commission approved massive state interventions in the banking sector, mainly through government financial sector stabilization measures, namely **recapitalization** of banking

[466] The Crisis Communication adopted by the European Commission are the following:

- Communication "*on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*" (2008),
- Communication "*on the recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*" (2009),
- Communication "*on the temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis*" (2009),
- Communication "*on the treatment of impaired assets in the Community banking sector*" (2009),
- Commission "*on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules*" (2009),
- Communication "*on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis*" (2010),
- Communication "*on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis*" (2011), and
- Communication "*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).

[467] In the Kotnik case (Case C-526/14), the court recognized the non-binding legal nature of the Communication, as this is an instrument setting out the criteria used by the Commission to assess the compatibility of state aid with the Treaty provisions on state aids. In particular, the court emphasized that "*the effect of the adoption of the guidelines contained in that communication is equivalent to the effect of a limitation imposed by the Commission on itself in the exercise of its discretion, so that, if a Member State notifies the Commission of proposed State aid which complies with those guidelines, the Commission must, as a general rule, authorise that proposed aid. On the other hand, the Member States retain the right to notify the Commission of proposed State aid which does not meet the criteria laid down by that communication and the Commission may authorise such proposed aid in exceptional circumstances*" (par. 43).

groups, **asset relief interventions** (e.g. support for impaired assets in asset support programs, "bad banks" schemes), **guarantees** and other **liquidity support measures**. [468]

The total amount of state aid to EU banking groups which was used for recapitalizations over the period 2008-2017 was approximately €475bn, of which 95% covers the period until the entry into force of the BRRD (see ***Table 11***). The introduction of the BRRD changed the landscape relating to the government intervention in the banking sector, as it set limitations to capital injections with public funds. Since 2015, the use of state aid for bank recapitalizations has been limited at c.€23bn, mainly related to the use of the precautionary recapitalization instrument in respect of National Bank of Greece (2015), Piraeus Bank (2015) and Monte dei Paschi di Siena (2017).[469] Hence, since 2014 the significance of the 2013 Banking Communication has been reduced, being still relevant mainly to the use of the precautionary recapitalization instrument.[470]

Table 11: Amount of state aid granted to banking groups in the period 2008-2017

Aid instrument (amounts in €bn)	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**Total**
Recapitalizations	115.2	90.7	93.5	35	90.8	20.5	7.6	11.3	0	11.3	475.9
Impaired asset measures	9.8	79.5	54	0	35.4	9.5	0.3	0.3	0.5	0	189.2
Capital-like aid instruments	125	170.2	147.4	35	126.3	30	7.9	11.6	0.5	11.3	665.1
Guarantees	400.4	835.8	799.8	589	492.1	352.3	204.5	170.6	126.1	110.8	1,188.1
Other liquidity measures	22.2	70.1	62.6	60.6	44.3	34.6	31.6	21.8	12.4	10.9	108.4
Liquidity-like aid instruments	422.6	906	862.5	649.5	536.4	336.9	236.2	192.4	138.5	121.7	1,296.5
TOTAL	547.6	1,076.2	1,009.7	684.5	662.7	366.9	244.1	204	139	133	1,961.6

Source: *European Commission, State Aid Scoreboard*

The other option for state aid to banking groups (i.e. Government Financial Stabilization Tools) is governed by the BRRD framework and presupposes the application of burden-sharing measures (prior bail-in of 8% of total liabilities and own funds), removal of senior management and other measures taken through the reorganization plan relating to cost reduction and scaling down business activities.

As referred above, the precautionary recapitalization tool is valid for capital shortfalls having arisen from the adverse scenario of a stress-test exercise. In such a case, the banking group concerned must submit to the ECB for approval a capital raising plan that demonstrates how it will cover the capital shortfall. This plan should contain capital raising measures and potential burden-sharing measures to the shareholders and

[468] See **Lanoo (2015)**, p. 144.

[469] For more information, see **Commission Decision** "*on State Aid SA.43364 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank*", **Commission Decision** "*on State Aid SA.43365 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece*" and **Commission Decision** on "*State Aid SA. 47677 (2017/N) – Italy, New aid and amended restructuring plan of Banca Monte dei Paschi di Siena*".

[470] See **Lucchini, Moscianese, De Angelis** and **Di Benedetto (2016)**, p. 10.

subordinated creditors.[471] This capital plan should enable the Member State concerned to determine the residual capital shortfall (after the implementation of the actions provided therein) to be covered by state aid.

In line with the 2013 Banking Communication, prior to granting restructuring aid (i.e. recapitalization or impaired asset measure) all measures that result in capital generation must be exhausted, namely capital raising measures and burden sharing measures.[472] Thus, at first stage banking groups must implement capital raising measures, such as:[473]

- share capital increase,
- voluntary conversion of subordinated debt into equity based on a risk-related incentive,
- liability management exercises, which should be 100% capital generating,
- capital-generating sales of assets, subsidiaries and portfolios,
- securitization of portfolios in order to gain capital from non-core activities,
- earnings retention, or
- other measures reducing capital needs.

Following the application of capital raising measures, the Member State concerned must adopt a legal act to impose burden-sharing measures to shareholders, hybrid capital holders and subordinated debt holders in order to cover the remaining capital shortfall. Thus, hybrid capital and subordinated debt must be written down or converted into equity. Senior liabilities, including covered and uncovered deposits and senior debt, are excluded from the scope of burden-sharing measures.[474]

In the initial phases of the crisis, the Commission did not require from banking groups any burden-sharing measures, except for absorbing past losses with available capital and paying an adequate remuneration to the state for receiving state aid.[475] This stance, which is plausible to assume that was attributed to concerns that such requirement would destabilize further the financial system, changed with the adoption of the 2013 Banking Communication.[476]

[471] **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')*", par. 29.

[472] See **Lucchini, Moscianese, De Angelis** and **Di Benedetto (2016)**, p. 20.

[473] **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')*", par. 35.

[474] *Ibid.*, par. 42.

[475] See **Hadjiemmanuil (2017a)**, p. 7.

[476] The application of the precautionary recapitalization instrument to the National Bank of Greece, Piraeus Bank and Monte dei Paschi di Siena was accompanied with the implementation of burden sharing measures. For more information, see **Commission Decision** "*on State Aid SA.43364 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank"*, **Commission Decision** "*on State Aid SA.43365 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece"* and **Commission Decision** on "*State Aid SA. 47677 (2017/N) – Italy, New aid and amended restructuring plan of Banca Monte dei Paschi di Siena"*.

The burden-sharing principle that governs the Commission's Communication aims at limiting the distortions of competition between banking groups and across Member States and addressing moral hazard. To that end, the Banking Communication stipulates that state aid should be limited to the extent possible, while the aid beneficiary should contribute to restructuring costs also with its own means.[477] Burden-sharing measures entail reduced need for state aid.[478]

However, the 2013 Banking Communication acknowledges that the application of burden-sharing measures is subject to some limitations.[479] In particular, the fundamental rights, such as property rights, must be respected, while burden-sharing measures cannot be applied, where such measures could threaten financial stability or lead to disproportionate results.[480] Lastly, the "no-creditor-worse-off" principle must be respected, which means that subordinated bondholders must not receive lower compensation for their claims than they would have received if no state aid had been granted.[481] In the case of the precautionary recapitalization of Banca Monte dei Paschi di Siena, burden-sharing measures were applied to shareholders and holders of subordinated debt instruments.[482] In particular, all outstanding Additional Tier 1 and Tier 2 capital were converted into shareholders' equity.

In the Kotnik case (Case C-526/14), the Court of Justice found that **Articles 107-109 of the TFEU** do not preclude burden-sharing measures to shareholders and junior debtholders as a condition for granting state aid. Pursuant to the Court's judgment (par. 56-57), burden-sharing measures aim to ensure that banking groups with a capital shortfall take steps by raising capital and by obtaining a contribution from subordinated creditors to reduce that shortfall and limit the amount of state aid granted. In addition, the Court recognized that burden-sharing measures do not violate the protection of legitimate expectations or the right of property, at least as long as these measures do not exceed what is necessary to overcome the capital shortfall of the banking groups concerned.[483]

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[477] **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')*", par. 15.

[478] The approval of state aid should be accompanied with the replacement of the Chief Executive Officer and board members of the beneficiary entity, where recourse to State aid could have been averted through appropriate and timely management action. In addition to capital raising measures, the restructuring plan should provide for the application of strict remuneration policy applicable to staff, including board members and senior management. The total remuneration of any such individual may not exceed 15 times the national average salary in the Member State concerned or 10 times the average salary of employees in the beneficiary banking group.

[479] See **Micossi, Bruzzone** and **Cassella (2016**, p. 4.

[480] This is related to cases where the state aid is relatively small in relation to beneficiary's RWAs and the capital shortfall has been reduced significantly through capital generating measures. Pursuant to point 45 of the Banking Communication, burden-sharing measures to subordinated bondholders should be excluded when their implementation "*would endanger their financial stability or lead to disproportionate results*".

[481] **Commission Decision** on "*State Aid SA. 47677 (2017/N) – Italy, New aid and amended restructuring plan of Banca Monte dei Paschi di Siena"*, point 61.

[482] *Ibid*., point 60.

[483] See **Hadjiemmanuil (2017a)**, p. 8

Section 2: Resolution planning in respect of significant banking groups

1. Development of group resolution plans

1.1 Strategic business analysis

1.1.1 Legal ownership and governance structure

The strategic business analysis forms the basis of resolution plans as it presents a detailed overview of banking groups. This chapter includes information on the legal, ownership and governance structure of banking groups, as well as on the business model and critical interdependencies.

Based on the information provided by banking groups with the means of the EBA templates, this chapter presents the legal structure of the banking group concerned detailing, *inter alia*, all legal entities and branches consisting the group, their legal form, the location (i.e. either located in an EU Member State or in a third country), the business purpose (e.g. credit institution, investment form, special purpose vehicle, etc), as well as the intragroup ownership structure. Since resolution tools are applied to individual legal entities, the mapping of banking groups is very useful for the SRB to decide on the preferred resolution strategy, namely whether resolution action can be implemented at the parent entity level or at sub-consolidated level.

This chapter contains also financial information regarding the banking group as a whole, as well as each entity alone, including information on the balance sheet, income statement and regulatory requirements. Specific attention is given to collateralized positions and encumbered and unencumbered assets that can be used for generating liquidity in resolution.

1.1.2 Business model analysis

1.1.2.1 Determination of Material Legal Entities and Core Business Lines

In the context of resolution planning, the SRB determines, among others, the **Material Legal Entities** (MLEs) of banking groups. Pursuant to **Article 7(2) of the Commission Delegated Regulation 2016/1075,** an entity is considered material if it is significant for the banking group or the Member State in which it is located. The SRB determines the MLEs of a banking group for resolution planning purposes, after considering the self-assessment conducted by the banking group in the context of recovery planning.

The next step pertains to the description of the banking group's business model and business lines, which explain the core elements of the business and risk strategy, the funding sources, the main sources of risk and revenues within the group, as well as the position of the parent entity and the MLEs in the market (e.g. market share, significant competitors).[484] This description is the basis for the identification of the **core business lines** and **critical functions** of the group's entities.

The main difference between critical functions and core business lines lies in the impact of the activities performed. Critical functions are assessed from a financial stability perspective, namely whether they are important for the functioning of the real economy and financial markets, while core business lines are assessed on the basis of their importance for the banking group itself (e.g. contribution to revenues and profits of the banking group).[485]

[484] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p.26.

[485] **Commission Delegated Regulation 2016/778**, recital (11).

For the determination of core business lines, the SRB considers the following indicators:[486]

- revenues generated by the core business line as percentage of the overall revenues,
- profit generated by the core business line as percentage of the overall profits,
- return on capital or assets,
- total assets, revenue and earnings,
- the customer base, geographic footprint, brand and operational synergies of the business with other group businesses,
- impact of ceasing the core business line on costs and earnings, where it is a source of funding or liquidity,
- the growth outlook of the core business line,
- the attractiveness of the business to competitors as a potential acquisition, and
- market potential and franchise value.

Retail and corporate banking are the most common core business lines for EU banking groups, while **asset & wealth management** and **investment banking** are typically the core business lines of banking groups with a universal business model.

1.1.2.2 Determination of Critical Functions

Ensuring continuity of critical functions is one of the objectives of resolution action. Therefore, within the resolution planning process the SRB should identify the groups' critical functions and take all the preparatory measures to ensure that these functions will continue operating during and after resolution. The determination of critical functions is important for the selection of the preferred resolution strategy and the conduct of the separability analysis and the loss-absorbing capacity analysis.[487]

Pursuant to **Article 6(1) of the Commission Delegated Regulation 2016/778**, a function is considered critical, where the function is provided by a group's entity to third parties not affiliated to that entity and the sudden disruption of that function would likely have a material negative impact on third parties and give rise to contagion or undermine the general confidence of market participants due to the systemic relevance of that function.

Taking into account the functions and sub-functions listed in ***Table 12***, the SRB identifies which organizational units perform any of these functions and determines the critical ones based on a two-step approach. Firstly, it performs an impact analysis to assess the impact on third parties from the sudden disruption of the function, and, secondly, it carries out a substitutability analysis to assess whether other market participants can replace the entity concerned in an acceptable manner and within a reasonable timeframe.

The SRB assesses the criticality of each economic function based on the information reported by banking groups (i.e. through the Critical Functions Template), comparisons with peers and expert judgement.[488]

[486] *Ibid*., Article 7(2).

[487] **SRB Policy** "*on Critical Functions: SRB Approach"*, p. 2.

[488] *Ibid.*, p. 3.

Table 12: List of critical functions and sub-functions

Functions	Sub-functions
Deposits	Households
	Non-financial corporations – SMEs
	Non-financial corporations – non-SMEs
	General Governments
Lending	Households – lending for house purchase
	Households – other lending
	Non-financial corporations – SMEs
	Non-financial corporations – non-SMEs
	General Governments
Payment, Cash, Settlement, Clearing, Custody	Payment services to Monetary Financial Institutions (MFIs)
	Payment services to non-MFIs
	Cash services
	Securities settlement services
	CCP clearing services
	Custody services
Capital markets	Derivatives held for trading -OTC
	Derivatives held for trading – non-OTC
	Secondary markets/trading (held-for-trading only)
	Primary markets/underwriting
Wholesale funding	Borrowing
	Derivatives (assets)
	Lending
	Derivatives (liabilities)

Source: SRB Policy *"on Critical Functions: SRB Approach""*

The SRB makes the impact analysis to assess the impact on the national and EU economy and financial system from a discontinuation of provision of critical functions on the basis of the following considerations:[489]

- the analysis is focused on the impact of a sudden disruption of a specific function (e.g. lending to SMEs) and not on the failure of the whole group,
- for deposits, the SRB does not place emphasis on the value of deposits covered by the DGSs, as the latter is not going to replace the group's entity in the provision of the function,
- with respect to lending, the SRB considers that the impact of potential new lending is more significant than the current stock of outstanding loans of the group's entity,

489 *Ibid.*, p. 4.

- for capital markets, the SRB gives due consideration to the role of the group's entities as liquidity providers, and
- for wholesale funding, the SRB assesses the role of the group's entities in the smooth functioning of interbank funding markets.

The SRB's approach for the assessment of the deposit-taking function is inappropriate, given that the amount of covered deposits should be considered as a significant factor in the determination of the criticality of the deposit-taking function. This remark is based on the fact that the liquidation of the group's entity that has a large amount of covered deposits, which cannot be compensated by the available means of the DGS concerned, is likely to trigger systemic implications and threaten the financial stability. This is owed to two (2) reasons. Firstly, covered depositors are highly unlikely to be compensated, as the available financial means of the DGS concerned would not be sufficient for that purpose, Secondly, the other banking groups located in the same Member State would have to pay ex-post contributions to the DGS to cover the compensations required, which could pose risks to their financial situation.

Lastly, once the SRB has identified the critical functions, it assesses whether these functions can be separated from the rest of the banking group and under what cost. This analysis is very important, where the preferred resolution strategy provides for the application of an asset transfer tool (e,g, sale of business tool, bridge institution tool).[490]

1.1.3 Internal and external interdependencies

The internal and external interdependencies among the banking group's entities, in particular between the parent entity and the subsidiaries, are critical elements in the determination of the preferred resolution strategy. Depending on the loss absorbing capacity and separability of the group, the SRB decides on the type of the **preferred resolution strategy**, namely between a **Single Point of Entry** (**SPE**) and a **Multiple Point of Entry** (**MPE**) approach, as well as on the **preferred resolution tool** (i.e. bail-in tool, sale of business tool, bridge institution tool, asset separation tool).[491]

At first stage, the SRB assesses and analyzes the internal financial, legal and operational interdependencies between the group's entities in respect of the following elements:

- capital allocation,
- intragroup liquidity and funding,
- off balance-sheet risk positions,
- derivative positions,
- other material financial interdependencies, such as mutual guarantee commitments, back-to-back transactions, cross-default clauses, cross-collateralization agreements, and
- legal interdependencies, such as guarantee obligations, profit-and-loss transfer agreements, dependency agreements.

Furthermore, the SRB looks for any internal operational interdependencies focusing on critical interdependencies between organizational units, which could be considered as

[490] *Ibid.*, pp. 9-10.

[491] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning"*, p. 25.

impediments to resolvability. To that end, the SRB collects information to determine the **essential internal services** and the **critical internal services**.

Essential internal services are service relationships within the parent entity and its material legal entities, which are important for the performance of the core business lines. **Critical internal services** are defined as "*the operations, activities and services performed for one (dedicated) or more business units or legal entities (shared services) within the group which are needed to provide one or more critical functions*."[492] Critical services can be performed by the banking group itself or by an external party through an outsourcing arrangement.

1.2 Preferred resolution strategy

1.2.1 Procedure to determine the preferred resolution strategy

The group resolution plan determines a preferred resolution strategy, which is considered (at the time when the plan is developed) suitable and credible to implement upon resolution. The first step of the process (see ***Figure 17***) is to decide whether winding up the group's entities under normal insolvency proceedings is credible and feasible, as this is the default option to cope with a failing banking group.

A banking group is deemed to be resolvable if it is feasible and credible for the SRB:

- to liquidate its group's entities under normal insolvency proceedings, or
- to put into resolution the banking group through the implementation of resolution tools at the parent entity level, while avoiding any significant adverse consequences for the financial system and the real economy of the Member States where they are incorporated.[493]

In that context, the process applied for the determination of the preferred resolution strategy is as follows:[494]

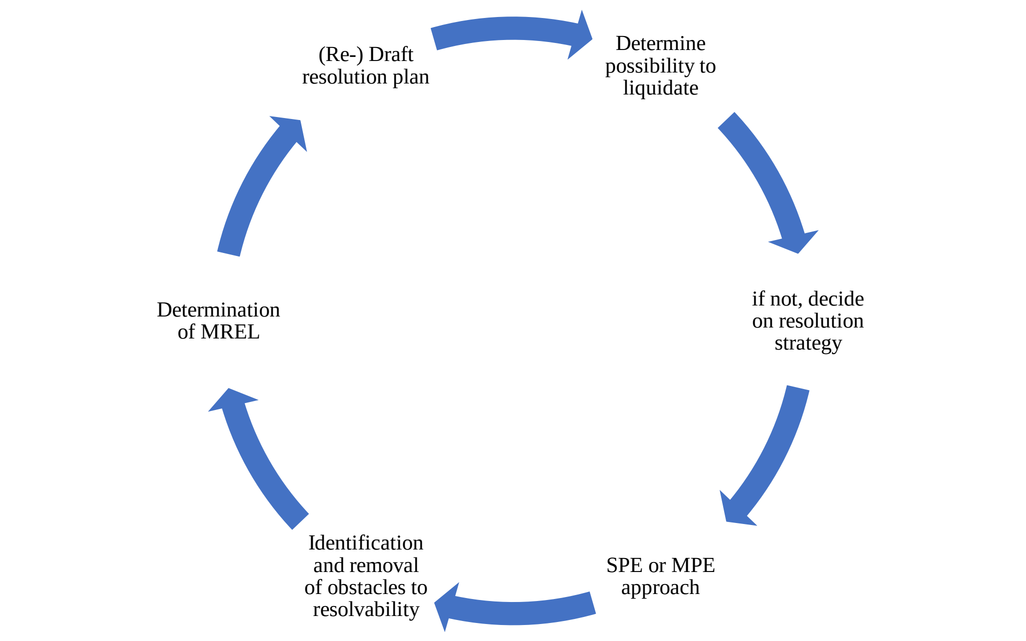
- firstly, the SRB explores the **feasibility** and **credibility** of **liquidating** the group's entities under normal insolvency proceedings,
- in case that the SRB ascertains that liquidating the group's entities is neither feasible nor credible, it **selects the resolution strategy** which considers appropriate in order to resolve the group in an orderly manner without disrupting its operations, and
- lastly, the SRB assesses the **feasibility and credibility of the preferred resolution strategy**.

[492] **Commission Delegated Regulation 2016/778**, recital (8).

[493] Significant adverse consequences for the financial system or threat to financial stability refer to a situation where the financial system is actually or potentially exposed to a disruption that may give rise to financial distress liable to jeopardize the orderly functioning, efficiency and integrity of the internal market or the economy or the financial system of one or more Member States. In determining the significant adverse consequences, the SRB must take into consideration the relevant warnings and recommendations of the ESRB and the relevant criteria developed by the EBA in considering the identification and measurement of systemic risk.

[494] **Commission Delegated Regulation 2016/1075**, Article 23(1).

Figure 17: Annual resolution planning cycle



1.2.2 Assessment of the feasibility and credibility of liquidation under normal insolvency proceedings

In the context of the resolvability assessment, the SRB assesses the feasibility and credibility of liquidating the group's entities under normal insolvency proceedings, as well as the impact on the financial stability. Initially, the SRB assesses the credibility of liquidation by considering its likely impact on the financial system of any Member State or of the Union, with a view to ensuring continuity of access to critical functions carried out by the banking group and achieving the resolution objectives of **Article 31 of the BRRD**. To that end, the SRB takes account of the functions performed by the group's entities and assesses if liquidation is likely to have a material adverse impact on any of the following:

- **financial market functioning**, and in particular the impact on market confidence,
- **financial market infrastructures**, and in particular:
  - ➢ whether the sudden cessation of activities would constrain the normal functioning of financial market infrastructures in a manner which impacts adversely the financial system as a whole, and
  - ➢ whether and to what extent financial market infrastructures could serve as a contagion channel in the liquidation process,
- **other financial institutions**, and in particular:
  - ➢ whether the liquidation would raise the funding costs or reduce the availability of funding to other financial institutions in a manner which presents a risk to financial stability,
  - ➢ the risk of direct and indirect contagion and macroeconomic feedback effects,
- **the real economy** and in particular on the availability of critical financial services.

If the SRB determines that the liquidation is credible, it subsequently assesses the **feasibility of the liquidation** which is verified,[495] provided that the following conditions are fulfilled:[496]

- the banking group's systems are able to provide the information required by the relevant DGSs for the purposes of compensating covered depositors in the amounts and timeframes provided for in the DGSD, and
- the banking group has the capability of supporting the DGSs' operations, in particular by distinguishing between covered and non-covered balances on deposit accounts.

1.2.3 Determination of the preferred resolution strategy

If the SRB concludes that the liquidation of the banking group's entities is neither credible nor feasible, it determines the resolution strategy that considers appropriate for the achievement of the resolution objectives taking into account the structure and business model of the group and the resolution regimes applicable to the legal entities consisting of the banking group. In addition, the SRB assesses whether it would be more appropriate to apply a **Single Point of Entry** (**SPE**) strategy or a **Multiple Point of Entry** (**MPE**) strategy. [497] The selection between the SPE and the MPE strategy should be based on the following elements:[498]

- what resolution tools would be used under the preferred resolution strategy and whether these resolution tools are available for legal entities to which the resolution strategy proposes to apply them,
- the amount of eligible liabilities under the proposed resolution strategy, the risk of not contributing to loss absorption and recapitalization and the legal entities issuing these eligible liabilities,
- the contractual or other arrangements for losses to be transferred between the group's entities,
- the operational structure and business model of the group and, in particular, whether it is highly integrated or has decentralized structure with a high degree of separation between different parts of the group,
- the enforceability of resolution tools particularly if these are to be applied in third countries, and
- whether the resolution strategy requires supporting action by other authorities, particularly in third countries, or requires such authorities to refrain from independent resolution action.

The **SPE strategy** is defined as a resolution strategy that involves the application of resolution powers at the level of the parent entity.[499] The SPE strategy contributes to the resolution of failing banking groups avoiding legal risks and potential dislocation of critical functions. The SPE strategy is more likely to be appropriate if a banking group

[495] See **European Court of Auditors (2017)**, p. 4.

[496] **Commission Delegated Regulation 2016/1075**, Article 24(4).

[497] *Ibid.*, Article 25(2).

[498] *Ibid.*, Article 25(3).

[499] *Ibid.*, Article 2, point (d).

operates in a highly integrated manner, including where there are centralized liquidity management, treasury functions or IT and other critical shared services.[500]

On the contrary, the **MPE strategy**, in accordance with **Article 2, point (6) of the Commission Delegated Regulation 2016/1075,** is a resolution strategy which involves the exercise of resolution powers by two or more resolution authorities to regional or functional resolution groups of the banking group. Under the MPE approach, the parent entity is resolved, walks away from its subsidiaries and the group is separated. The MPE strategy is credible to be applied to banking groups whose operations are divided into two or more clearly identifiable subgroups, each of which is to a significant extent independent (financially, legally or operationally) from other parts of the group and any other critical dependencies on other parts of the group are based on robust arrangements that ensure their continued operation in the event of resolution.

The choice of the preferred resolution strategy is important also for the amount, composition and internal allocation of the MREL. According to **Article 25(3), point (b) of the Commission Delegated Regulation 2016/1075**, the SPE strategy is more appropriate if sufficient externally issued eligible liabilities that are expected to contribute to loss absorption and recapitalization have been issued by the parent entity. In contrast, the MPE strategy is more appropriate if the group's eligible liabilities have been issued by more than one entity or regional sub-groups.

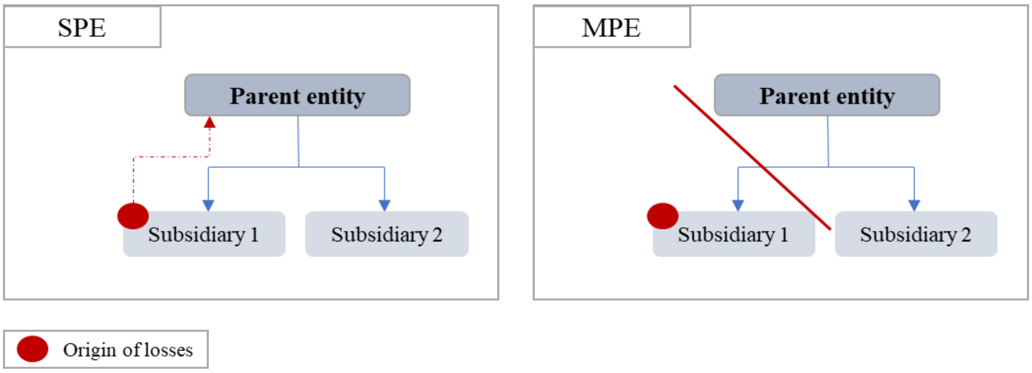
Table 13: Key characteristics of the SPE and MPE approaches

SPE approach	MPE approach
Resolution powers are applied at parent entity level by a single resolution authority in case of failure of a banking group	Resolution powers are applied to each point of entry by different resolution authorities
Sufficient loss absorption capacity at the single point of entry for the whole group	Ensuring that the group can be divided in two or more separate parts without a significant cessation of the critical functions
Arrangements to ensure that losses incurred at subsidiary level can be absorbed by the parent entity	A degree of legal, financial and operational separation within the group which may require changes to the current structure
A degree of certainty for host authorities that resources generated at parent entity level can be down-streamed to the subsidiaries	Sufficient external loss absorption capacity at each point of entry

Under the SPE approach, losses incurred in any subsidiary will be upstreamed to the parent entity (see ***Figure 18***) through a decline in the value of its equity holdings in the subsidiary concerned. If these losses drive the parent entity to a "failing or likely to fail" situation, the group-level resolution authority will apply resolution tools to the parent entity. Upstream of losses is not adequate to avert the failure of the subsidiary, as the parent entity will have to inject fresh capital to the subsidiary to restore capital ratios above the minimum levels. Therefore, the effective implementation of the SPE approach presupposes that the parent entity holds sufficient amount of equity and debt instruments issued by its subsidiaries, which can be written down or converted into equity upon resolution.

[500] *Ibid.*, Article 25(3), point (d).

Figure 18: Upstream of losses under SPE vs MPE approach



The SPE approach is more efficient than the MPE, as it facilitates cross-jurisdictional transfer of capital and funding and, as a result, requires less loss-absorbing capacity to achieve the same result. Also, the SPE approach minimizes the number of the parties that are involved in resolution and reduces coordination costs and risks, as only one resolution authority takes resolution action.[501] The SPE approach requires from host resolution authorities to refrain from taking uncoordinated resolution action in respect of the subsidiaries under their remit. Hence, the SPE approach is preferable for complex banking groups that are costly to restructure. Therefore, the US, UK and Swiss authorities prefer the SPE approach.[502]

1.3 Assessment of the financial and operational continuity in resolution

1.3.1 Assessment of financial continuity

Under this chapter of the resolution plan it is examined whether the financial and operational arrangements in place ensure an effective implementation of the preferred resolution strategy. The financial arrangements must ensure that during and after resolution action, the banking group maintains access to funding and liquidity to perform its critical functions. The same condition must be met in case that the banking group's critical functions are transferred to another entity under the sale of business tool or to a bridge institution under the bridge institution tool.

After the entry of a banking group into resolution, even if it has been recapitalized to an adequate degree, the banking group may face liquidity constraints given that market participants may hesitate to provide funding, mainly on an unsecured basis, as a result of the asymmetry of information concerning the viability of the group.[503] Therefore, it is necessary for the SRB to take measures in the context of resolution planning to ensure that banking groups have the necessary arrangements in place to cover their liquidity needs during and after resolution action.

Resolution plans must assess the amount and timing of the required liquidity during and after resolution action.[504] This estimation should be deployed on the basis that prior to and during resolution, access to liquidity and funding will be deteriorated. Therefore, the amount of liquidity needed during and after resolution must take into account adverse circumstances, such as the potential inability to roll-over maturing unsecured debt,

[501] See **Davies (2016)**, p. 10.

[502] See **Schoenmaker (2016)**, p. 7.

[503] See **Financial Stability Board (2018a)**, p. 13.

[504] *Ibid.*, p. 5.

deposit outflows and deterioration of credit ratings.[505] Resolution planning seeks to ensure, among others, that a banking group has in place the necessary systems to calculate accurately and credible funding needs and allocate funding resources to the group's MLEs. Therefore, banking groups should be in a position to:[506]

- have contingency plans to deal with severe liquidity needs in resolution,
- estimate the nature and extent of the funding needs,
- identify assets that could be rapidly mobilized as collateral or sold, where appropriate,
- identify and measure for each MLE the intraday liquidity needs, operating expenses and working capital needs,
- estimate the liquidity needed to meet obligations related to payment, clearing and settlement services, and
- ensure that temporary funding is available.

Based on the FSB's Guiding principles *"on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB")*", upon resolution the funding needs of a banking group should be covered with the following order:

1. use of **internal liquidity resources** (e.g. cash and other liquid assets available for sale or use as collateral),
2. if this source is insufficient, recourse to **private markets**, and,
3. resort to a **public sector backstop mechanism** should be the last option.

Thus, the SRB should identify the types of assets that could be pledged as collateral for repurchase transactions with other financial institutions or for standard monetary policy facilities, as well as the private sources of funding and the extent to which such sources can meet potential funding needs in resolution. In addition, the SRB should identify the public sector backstop funding arrangements that could be used, where necessary. The SRB should also determine the preferred funding sources given the preferred resolution strategy, including an assessment of potential obstacles.[507]

Following the determination of the above elements, the SRB should draft a funding plan to determine:

- whether liquidity and funding sources within the banking group can generate internal liquidity,
- which external private sources may remain open, and against which conditions, and which sources are expected to close and how they can be replaced, and
- whether the banking group may apply for the use of central bank facilities and identify those assets that are expected to qualify as collateral.

Recovery planning arrangements, particularly with respect to liquidity recovery options, could serve as valuable input in resolution funding plan. Resolution authorities may take into account recovery options (e.g. assets disposal, use of standard monetary facilities) into their assessment of the available means at group's disposal to cover its funding needs.

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[505] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p. 32.

[506] See **Financial Stability Board (2018a)**, p. 3.

[507] See **Financial Stability Board (2016b)**, pp. 15-16.

Banking groups can raise liquidity through external private sector sources and/or a public sector backstop mechanism only via secured funding. Therefore, resolution plans should assess the assets' encumbrance and may require from banking groups to take measures in order to ensure that there is adequate collateral to pledge and receive funding. The level of asset encumbrance is a significant factor also for the determination of the preferred resolution strategy. The SRB should understand how much of the group's assets can be separated under the sale of business tool, bridge institution tool or asset separation tool.[508]

In any case, the resolution strategy must not assume any of the following:[509]

- any extraordinary public financial support besides the use of the SRF,
- any central bank emergency liquidity assistance (ELA), or
- any central bank liquidity assistance provided under non-standard collateralization, tenor and interest rate terms.

Furthermore, in the context of the development of the resolution funding plan, the SRB should identify the public sector backstop mechanism that could be used by the banking group and assess the operational requirements and eligibility criteria that must be met in order to have access to that mechanism, such as maximum capacity, constraints on access and pricing. Furthermore, the SRB should develop the exit strategies from the mechanism that will be implemented upon normalization of the conditions, including the determination of actions to restore market confidence and encourage prompt return to private sector funding. [510]

The SRB should also assess whether the use of public sector backstop funding mechanism is compatible with the preferred resolution strategy (SPE or MPE). For instance, in case of an MPE approach, such mechanisms should be in place in the jurisdictions where the point of entry of the regional resolution subgroup is located. In addition, the SRB should examine the time needed for the banking group to access to that mechanism and if this timeframe allows the orderly implementation of the resolution action.

1.3.2 Operational continuity

In addition to financial continuity, it is necessary for the preferred resolution strategy to ensure the operational continuity of the banking groups' critical functions. Based on the FSB's Guidance on "*arrangements to support operational continuity in resolution*", operational continuity is defined as "*the ability to continue critical shared services*[511] *which are necessary to maintain the provision or facilitate the orderly wind down of an entity's critical functions in resolution*."[512]

[508] See **Financial Stability Board (2018a)**, p. 8.

[509] **SRMR** Article 8(6).

[510] See **Financial Stability Board (2018a)**, p. 15.

[511] Critical shared services refer to "*an activity, function or service by either an internal unit, a separate legal entity within the group or an external provider, performed for one or more business units or legal entities of the group, the failure of which would lead to the collapse of critical functions*". The two main categories of critical shared services in the banking system are finance-related and operational shared services. The former refers to treasury-related services, trading, asset management, cash handling, risk management and valuation, while the latter includes IT infrastructure, software-related services, personnel, procurement and facilities management.

[512] See **Financial Stability Board (2016a),** p. 5.

Operational continuity may be disrupted in any of the following cases:[513]

- high interconnectedness and complexity of the group's entities accompanied with a lack of clear mapping of the business lines and critical shared services,
- vague and insufficient contractual arrangements for intragroup and third-party service provision, and
- contractual arrangements that permit the service provider to terminate the provision of services upon entry of the group into resolution.

Typically, banking groups employ one of the following three (3) different service delivery models to provide operational services. In particular, they may choose provision of services by a **division within the entity** (e.g. IT division), an **intragroup service company** or a **third-party service provider**. [514]

Provision of services within a regulated entity: operational services are provided "in-house" from the parent entity either to other group's entities ("inter-entity") or within itself ("intra-entity"). Upon entry of the entity into resolution, this model may impede the legal and operational separation of critical functions and create uncertainty for service recipients.[515] The SRB can deal with this problem if it requires the parent entity to ensure that the provision of services is based on adequate and transparent documentation and at arm's length pricing mechanisms.

Provision of services by an intragroup service company: a banking group may decide to establish a subsidiary dedicated to providing IT services based on intragroup Service Level Agreements (SLAs) and a defined fee charging mechanism. This company owns the assets (including intellectual property rights) and infrastructure required to run the services. However, even if the SLAs are clear and well-defined, the SRB may face difficulties in enforcing SLAs if this service company is outside the prudential scope of the banking group or if it is located in a third country.

Provision of services by a third-party service provider: under this model, a banking group outsources operational services to an external service provider. This model is more suitable for resolution events that provide for transfer of assets, rights and liabilities. The SRB should require banking groups that have chosen this delivery model to introduce specific contractual clauses in the relevant SLAs to ensure provision of critical services in resolution.[516] In addition, the SRB should require the adoption of SLAs whose terms and pricing will not alter as a result of the entry of the banking group into resolution and should explicitly provide that the service provider cannot terminate provision of services as long as payments and other obligations continue to be met. In addition, SLAs designed to provide services to a banking group should have clauses that allow for the continued provision of services by (former) group's entities for a reasonable period of time following the divestment or separation of an entity as a result of resolution action.[517]

The aforementioned delivery models are not mutually exclusive and many banking groups have employed a **mixed service delivery model** that combines different models. The SRB should examine the delivery model adopted by each banking group from a resolvability perspective to ensure that it is appropriate to specific shared services that

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[513] *Ibid.,* pp. 5-6.

[514] *Ibid.,* p. 9.

[515] *Ibid.,* p.9.

[516] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning"*, p. 33.

[517] See **Financial Stability Board (2016a)**, p.14.

can support critical functions in resolution. In addition, banking groups must take all the necessary measures to ensure that staff, IT systems, facilities and other critical services provided by internal and external parties will remain in place upon resolution.[518]

1.3.3 Ensuring access to FMIs

Continuous access to FMIs is critical for a banking group to provide cash, payment and settlement services to its clients. Access to such payment and settlement systems is possible, only if the group's entities meet the entry requirements set by each system, such as requirements related to the solvency and liquidity of the banking group (consolidated level) or the entity concerned (individual level), as well as any other condition that the system may consider appropriate.

Therefore, banking groups should take measures to ensure continued access to FMIs upon entry in resolution, including through the preparation of contingency plans. As part of contingency plans, banking groups must develop arrangements that would facilitate how their entities would meet the financial requirements necessary to maintain access to critical FMI services.[519] In that context, banking groups should engage with FMIs to understand how they would react upon application of resolution tools and assess the nature and extent of any additional requirements which FMIs could raise. FMIs may take a decision to suspend or terminate access even if the banking group concerned meets all the payment and delivery obligations. Such cases refer to breach of another condition of access (e.g. credit rating downgrade) or if the parent entity or other affiliate of the banking group has entered resolution.[520]

Once banking groups have identified the conditions that ensure access to FMIs upon resolution, they must take all the necessary measures to address the legal, financial and operational issues which could impede access to FMIs, including through renegotiation of the contracts with FMIs.[521]

1.4 Information and communication plan

This section of the resolution plan describes the governance arrangements for the provision of information from the banking group to the IRT, as well as the management information systems used by the banking group for that purpose, particularly with regard to its capability to provide timely, up-to-date and accurate information for the relevant valuations.

The SRB requires from banking groups to establish specific governance structures to facilitate the provision of information in the context of resolution planning and resolution action.[522] For that purpose, each banking group must designate specific persons responsible for communicating to the IRT information necessary to prepare the annual resolution plan and to draft a resolution scheme, where required. Banking groups should have in place a crisis management function able to support resolution-related issues. This function should coordinate the actions of internal units in order to facilitate resolution action. In addition, upon resolution this function should handle the communication with

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[518] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p. 33.

[519] See **Financial Stability Board (2017)**, pp. 12-13.

[520] *Ibid.*, p. 15.

[521] *Ibid.*, p. 16.

[522] **SRB Policy** "*on the Single Resolution Mechanism, Introduction to resolution planning*", p. 34.

the SRB, the ECB, the Ministry of Finance and the DGS concerned providing them with all the necessary information.

The financial situation of a banking group may deteriorate within a very short timeframe activating the resolution procedure and the "failing or likely to fail" determination. Hence, the management information systems must be able to provide at a very short notice the information necessary to prepare and implement a resolution scheme and to perform the necessary ex-ante valuations, mainly with respect to deposits covered and not covered by a DGS.[523] The description of the management information systems and the relevant arrangements should be described in this section of the resolution plan.

1.5 Assessment of resolvability

1.5.1 Assessment of the feasibility of the preferred resolution strategy

A critical stage of the resolution planning process regards the power of the SRB to conduct a resolvability assessment of banking groups. This assessment seeks to examine whether the preferred resolution strategy is feasible and credible to apply without the assumption of any extraordinary public financial support besides the use of the SRF, any central bank emergency liquidity assistance or any central bank liquidity assistance provided under non-standard collateralization, tenor and interest rate terms.[524]

The SRB assesses whether it is **feasible to apply the selected resolution strategy** both effectively and in an appropriate timeframe and identify any potential impediments to the implementation of this strategy. Within this context, the SRB examines if there are any impediments to the short-term stabilization of the banking group and any foreseeable impediments to a business reorganization, as provided for in **Article 52 of the BRRD**, or likely to be required if the resolution strategy envisages all or part of the banking group being restored to long-term viability.

Specifically, the SRB must examine whether the preferred resolution strategy faces any impediments, which fall into any of the following categories, namely **structure and operations**, **financial resources**, **information**, **cross-border issues**, and **legal issues**.

Undoubtedly, the most crucial aspects of the selected resolution strategy are associated with issues concerning **financial resources.** Thus, the SRB must identify and quantify the amount of liabilities, which are likely not to contribute to loss absorption or recapitalization, considering at least the following factors:[525]

- maturity,
- subordination ranking,
- the types of holders of the instrument or the instrument's transferability,
- legal impediments to loss absorbency, such as lack of recognition of resolution tools under foreign law or existence of set-off rights,
- the amount and issuing legal entities of qualifying eligible liabilities or other liabilities which would absorb losses,
- the size of funding needs in the run-up to and during resolution, the availability of sources of funding, and any impediments to the transfer of funds within the group, and

[523] *Ibid.*, p. 35.

[524] **SRMR**, Article 10(1).

[525] **Commission Delegated Regulation 2016/1075**, Article 28, point (2).

- the extent to which intragroup guarantees and back-to-back transactions increase contagion across the banking group.

Furthermore, the SRB must assess the following issues related to the **structure and operations** of banking groups:

- the extent to which banking groups can map core business lines and critical operations to their entities,
- the extent to which there are arrangements in place to provide for essential staff, infrastructure, funding, liquidity and capital to support and maintain the core business lines and the critical functions,
- the extent to which the service agreements with the critical service providers are fully enforceable in the event of resolution,
- the extent to which banking groups have a process for transitioning the services provided under SLAs to third parties in the event of the separation of critical functions or core business lines, and
- whether there are contingency plans in place to ensure continuity in access to payment and settlement systems.

Information systems constitute another area examined by the SRB in the resolvability assessment. Thus, the SRB assesses:[526]

- the capability of banking groups to provide information on the amount and location within the groups of assets which are expected to qualify as collateral for central bank facilities,
- the capability of banking groups to provide information to carry out a valuation for the determination of the amount of write-down or recapitalization required,
- the adequacy of the management information systems to provide the SRB with accurate and complete information which is essential for effective resolution action,
- the extent to which banking groups can ensure the continuity of the management information systems both for the affected entities and the new entity in case that the critical functions and core business lines are separated from the rest of the banking group and are transferred to a new entity, and
- the extent to which banking groups can provide the SRB with the information necessary to identify depositors and the amounts covered by the DGSs.

Furthermore, the SRB examines the following aspects related to **cross-border issues** and in particular:

- whether there are adequate arrangements and processes for coordination and communication on actions to be taken between home and host authorities, including in third countries, to ensure the implementation of the resolution strategy,
- whether the applicable law in relevant home and host jurisdictions overrides contractual termination rights in financial contracts that are triggered solely by the failure and resolution of an affiliated entity,
- whether third-country resolution authorities have at their disposal the resolution tools which are necessary to support resolution action taken by the SRB.

[526] *Ibid.*, Article 29.

Lastly, under the resolvability assessment the SRB examines other **legal issues**, namely:

- whether requirements for regulatory approvals or authorizations necessary to deliver the resolution strategy can be met in a timely manner,
- whether significant contractual documentation permits termination of contracts upon entry into resolution, and
- whether contractual obligations which cannot be disapplied by the SRB prohibit any transfer of assets and/or liabilities envisaged in the resolution strategy.

1.5.2 Assessment of the credibility of the preferred resolution strategy

After the assessment of the feasibility of the preferred resolution strategy, the SRB assesses the **credibility** of the strategy, considering the likely impact of its implementation on the financial systems of any Member State or of the Union. For that purpose, the SRB assesses:

- the credibility of using resolution tools in such a way that meets the resolution objectives,
- the extent to which the group's structure allows the SRB to resolve the whole group or one or more of the group's entities without causing a significant direct or indirect adverse effect on the financial system or the economy,
- the credibility of using resolution tools in a way which meets the resolution objectives, given possible impact on creditors, counterparties, customers and employees,
- the extent to which the resolution of the banking group could have a significant direct or indirect adverse impact on the financial system, market confidence or the economy, and
- the extent to which contagion to other banking groups or to the financial markets could be contained through the application of the resolution tools and powers.

1.6 Measures to address or remove impediments to resolvability

1.6.1 Process to address or remove impediments to resolvability

The SRB applies a structured and escalated approach in the determination of impediments to resolvability. Where the SRB determines, after consulting the ECB, that there are substantive impediments to the resolvability of a banking group, it notifies in writing that determination to the banking group and to the ECB. As a first step, the banking group must propose within a four-month period to the SRB measures to address or remove the identified impediments to resolvability.[527] Subsequently, if, according to the SRB, the proposed measures do not effectively reduce or remove the identified impediments, it must require the banking group to take any of the measures provided for in **Article 17(5) of the BRRD**, which can be grouped under three (3) categories:[528]

1. **structural measures** associated with the organizational, legal and business structure of the banking group,
2. **financial measures** related to the group's assets, liabilities and products, and

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[527] **BRRD**, Article 17(3).

[528] See the **EBA Guidelines** "*on the specification of measures to reduce or remove impediments to resolvability and the circumstances in which each measure may be applied under Directive 2014/59/EU*", pp. 4-6.

3. **information requirements**.

The SRB must demonstrate how the proposed by the banking group measures would not be appropriate for addressing or removing the impediments to resolvability and how that matter would be addressed with the measures proposed by the SRB itself. When deciding on the measures to be taken by the banking group, the SRB must take account of the need to avoid any impact on the group concerned that would go beyond what is necessary to remove the impediments.

In case of a banking group with entities located both in participating and non-participating Member States the procedure described above can be implemented only if a joint decision is reached by the involved resolution authorities. The SRB in its capacity as a group-level resolution authority and the NRAs of non-participating Member States concerned must do everything within their power to reach a joint decision on the way that impediments to resolvability will be addressed by the banking group.

The resolution authorities have four (4) months at their disposal to reach a decision during which the EBA may assist them for that purpose under the non-binding mediation provided for in **Article 31(c) of the EBA Regulation**. In the absence of a joint decision the SRB (group-level resolution authority) may take the appropriate measures to address impediments to resolvability at group level.

Nonetheless, the legal framework provides resolution authorities with the option to request EBA's binding mediation under **Article 19 of the EBA Regulation**, only with respect to measures related to change of the group's structure or organization. This option is available at the end of the four-month period if the group-level resolution authority and the other involved resolution authorities have not reached an agreement on either the **change of the legal or operational structure of the banking group** or the **establishment of a parent financial holding company**.

Following the receipt of the request to mediate in the dispute, the EBA asks for parties' written statements of position and supporting documentation. Then, the EBA holds a conciliation meeting between the parties to settle the dispute within the four-month conciliation period.[529] If the parties fail to reach an agreement within the conciliation period, the EBA takes a decision with binding effect on the parties.[530]

The resolution authorities must take their decision based on the relevant EBA's decision, while in absence of a decision by the EBA within the envisaged timeframe of one (1) month, the resolution authorities can make their own decisions on the appropriate measures to be taken by the group's entities at individual level.

1.6.2 Structural measures to improve banking groups' resolvability

1.6.2.1 An overview of the structural measures

Since the legal, operational and financial structure of a banking group may impede the implementation of resolution powers, the BRRD has provided resolution authorities with the power to take structural measures to address possible impediments to resolvability. Such measures pertain to the change of the legal structure of the banking group aiming to improve the feasibility and credibility of the preferred resolution strategy.

[529] **EBA Decision** "*on the settlement of a disagreement*", pp. 2-3.

[530] The EBA's decision is taken on the basis of a proposal by a Panel convened by the EBA's Chairperson. The Panel sets a short time limit to the two parties to comment its proposal and, then, it submits its proposal to the Standing Committee on Resolution for final adoption by the Board of Supervisors.

In that context, the SRB may require the parent entity of the banking group:

a. to **revise any intragroup financing agreements** or **review the absence thereof** or **draw up service agreements** (either intragroup or with third parties) to cover the provision of critical functions,

b. to **change the legal or operational structure of the banking group** so as to reduce complexity in order to ensure that critical functions may be legally and operationally separated from other functions through the application of the resolution tools, and

c. to **set up a parent financial holding company**.

The first two (2) measures aim at facilitating the resolution of the banking group in different ways. The first measure allows the SRB to apply the sale of business tool or the bridge institution tool effectively and in a timely manner. In particular, the SRB may require a banking group to transfer its core business lines and critical functions (e.g. lending in natural persons and SMEs) to a separate entity, which could be separated easily upon resolution.

The third measure seek to facilitate the application of the bail-in tool by addressing the subordination issue. Financial holding companies are not permitted to accept deposits and their liabilities consist only of equity and (subordinated and senior) unsecured debt. Thus, the SRB can resolve the banking group effectively by applying the bail-in tool to the liabilities of the financial holding company. In this way, no material operational, legal and financial stability implications would arise, which could happen if the SRB had to bail-in deposits and derivatives, which are the most typical liabilities of credit institutions.

1.6.2.2 Revision of intragroup financing agreements

Where the SRB reviews the existing financing agreements and concludes that the type of provision of support or the absence thereof impedes the achievement of the resolution objectives, it may require banking groups to revise these financing agreements. This is an appropriate measure for the reduction of the financial and operational interconnectedness of a banking group, when the preferred resolution strategy provides for separation of its group's entities.

If the resolution strategy envisages the breakup and restructuring of the banking group, the SRB may require the MLEs of the group to draw up SLAs with other entities within the group and third parties to ensure that they are operationally independent. This measure is suitable to address cases where there are no written service agreements or the level of documentation of service agreements is deemed insufficient or vague regarding the ability of the counterparty to terminate the provision of services due to resolution action.

The SRB should also require the intragroup financing agreements and SLAs to be transferrable to a bridge institution (under the bridge institution tool) or to any private sector purchaser (under the sale of business tool). In this way, the SRB would be confident that the application of the sale of business tool or the bridge institution tool is both feasible and credible.[531]

[531] See the **EBA Guidelines** "*on the specification of measures to reduce or remove impediments to resolvability and the circumstances in which each measure may be applied under Directive 2014/59/EU*", par. 7(d).

1.6.2.3 Change of legal or operational structure of banking groups

Aiming to ensure that critical functions can be legally and economically separated from other (non-critical) functions, the SRB may require the parent entity of a banking group to implement some measures which would reduce the group's complexity and heavy interconnectedness. These measures aim to ensure continuity of access to critical functions in resolution under a break-up of the banking group and transfer of assets and liabilities.

This requirement is of particular importance for banking groups for which the SRB has adopted an MPE resolution strategy based on which each banking group is organized in regional blocks (e.g. European resolution group, resolution group in Brazil, Chile, Turkey, etc). Each regional block would have its own core business lines and critical functions and should operate orderly without any material dependency on the parent entity or any other regional block. To that end, each regional resolution group should have autonomous functions regarding hedging and risk management, trading, liquidity management, collateral management, other treasury and finance functions.

Therefore, the SRB may require the parent entity to put in place effective standalone governance, control and management arrangements in each resolution group.[532] In that way, the SRB would prevent extensive cross-entity booking and hedging and ensure that the banking group can be broken up in case of resolution and the regional resolution groups can be resolved separately.

Appropriate action is required also under an SPE resolution strategy which may envisage the break-up of the banking group or a change of ownership by sale or transfer of assets and liabilities. Business lines which perform non-critical functions should be legally and operationally possible to be separated through either winding down or sale to private sector purchasers. To that end, the SRB may require the parent entity to take measures to minimize the dependency between material entities of the group, among others, on key infrastructure, IT, facilities and personnel. In addition, the effective implementation of an SPE resolution strategy can be ensured if the funding provided by the parent entity to subsidiaries is adequately subordinated, is not subject to set-off and provides for appropriate arrangements for the upstreaming of losses (i.e. transfer of losses from subsidiaries to parent entity).

Ensuring orderly separability of material entities or subgroups is critical, where the SRB has determined the sale of business tool or the bridge institution tool as preferred resolution tool. Therefore, the SRB may require banking groups to change their structure in third countries from branches to subsidiaries or to internally segregate all or certain functions and business lines in these branches to prepare carve-out of these functions and facilitate the transfer to a separate entity.[533]

Lastly, if the preferred resolution strategy provides for the use of the bail-in tool, the SRB may require the reduction of the complexity and size of the trading book, in particular if it holds for large portfolios of derivatives and other financial contracts. Inadequate action may result in impediments to accurate measurement and valuation of the products and portfolios in the trading book.[534]

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[532] *Ibid.*, par. 13(b).

[533] *Ibid.*, par. 13(g).

[534] *Ibid.*, par. 13(n).

1.6.2.4 Establishment of a parent financial holding company

The application of resolution tools to a banking group is likely to be subject to significant challenges, mainly with regard to potential exclusion of certain liabilities from the scope of the bail-in tool (e.g. uncovered deposits from SMEs and natural persons). If the SRB intends to address such an impediment prior to taking resolution action, it may ask for the establishment of a parent financial holding company to which resolution tools will be applied. Upon resolution, the SRB will exercise its resolution powers to capital instruments and eligible liabilities issued by that holding company ensuring effective implementation of the resolution tools avoiding, thus, material legal challenges. The SRB may also set limitations to prevent that holding company from performing critical functions or providing services to other group's entities.[535]

Where the SRB assesses that it is not feasible or credible to resolve the EU part of a banking group whose parent entity is located in a third country, it may require the establishment of a parent financial holding company. Then, this holding company would be required to issue sufficient amount of capital instruments and eligible liabilities expected to contribute to loss absorption and recapitalization in case of resolution action. This measure would facilitate the application of resolution powers to the parent holding company ensuring absorption of losses at the level of operating subsidiaries (i.e. credit institutions).[536] Furthermore, this measure is suitable for third country-based entities with significant branch activity in the EU which perform critical functions whose continuance is not adequately provided for in the resolution plan drafted by the resolution authority of the third country.

1.6.3 Financial measures to improve banking groups' resolvability

1.6.3.1 An overview of the financial measures

For the purpose of addressing finance-related impediments to resolvability, the SRB may require a banking group to take any of the following measures:

a. to restrict or prevent the development of new or existing business lines or sale of new or existing products,

b. to limit its maximum individual and aggregate exposures,

c. to divest specific assets,

d. to limit or cease specific existing or proposed activities,

e. to issue eligible liabilities to meet the MREL, or

f. to take other measures to comply with the MREL, including in particular to renegotiate any eligible liability, Additional Tier 1 instrument or Tier 2 instrument it has issued, with a view to ensuring that any decision to write down or convert that liability or instrument would be effected under the law of the jurisdiction governing that liability or instrument.

1.6.3.2 Requirement to limit maximum and aggregate exposures

If the SRB has determined an MPE resolution strategy for a banking group, which involves separation of legal entities within the group, it may require the parent entity to tighten intragroup exposure limits seeking to contain internal financial interconnectedness between the group's entities.

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535 *Ibid.*, par. 14(b).

536 *Ibid.*, par. 14(a).

Furthermore, the SRB may consider requiring the parent entity to limit any exposures to special purpose entities with which the latter has significant undrawn commitments, material guarantees or letters of comfort.[537] These off-balance sheet exposures are not within the scope of resolution powers as long as they are not consolidated in the balance sheet, but may impair the resolvability of the group if they relate to significant amounts and the receiver decides or is obliged to call on them.

1.6.3.3 Disposal of specific assets

If the resolution strategy envisages sale of assets and this sale is expected to have significant adverse impact on the implementation of resolution tools, the SRB may require the banking group to divest those assets prior to resolution. This measure should apply to assets whose sale within a short timeframe would result in pressure on assets' prices (i.e. fire-sale), destruction of value and additional uncertainty and vulnerability of financial markets.[538]

In addition, the SRB may require a banking group to proceed to disposal of assets if its current asset structure is likely to impair the feasibility and credibility of the preferred resolution strategy. For instance, if the resolution strategy relies on liquidation of assets to generate liquidity for the performance of critical functions, the SRB may require from a banking group to divest assets which are likely to be illiquid at the point of resolution action and to increase the proportion of assets which are expected to be liquid instead. In this respect, if the SRB assesses that a banking group has insufficient amount of unencumbered eligible collateral to receive liquidity via the standard ECB's monetary policy operations, it may require the banking group to divest assets that are non-eligible for such operations and to invest in assets that can be accepted by the ECB as eligible collateral.

1.6.3.4 Limitation or cessation of existing activities carried out by banking groups

Another measure to reduce or remove obstacles to resolvability pertains to the limitation of complex products and/or activities related to how trading and hedging operations are marketed, booked, funded and risk-managed and to their location within the group. These activities may undermine the feasibility and credibility of the preferred resolution strategy, especially if they are performed in third countries which have an insufficient resolution regime and cannot ensure the continuity of activities therein during a resolution underpinning, thus, the ability of the SRB to maintain the continuity of critical functions within the Banking Union.[539]

The SRB may also ask the banking group to limit services which are provided to other entities or participants in the financial markets if it considers that these services could not be continued in resolution and their discontinuance may threaten the stability of the recipients of these services.

1.6.3.5 Prevention of development or sale of new business lines

The SRB may apply restrictions to the development or sale of products that are structured in a way that impedes the application of resolution tools. This is applicable to products governed by third-country law or instruments issued from any group's entities located in third countries (e.g. third-country branch, special purpose vehicle incorporated in a third country) if the law of that third country does not give effect to the use of resolution powers envisaged by the resolution strategy. Moreover, the SRB may restrict or prevent

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[537] *Ibid.*, par. 8(d).

[538] *Ibid.*, par. 10(a).

[539] *Ibid.*, par. 11(b).

the development or sale of products whose sale is likely to have significant adverse impact on the exercise of resolution powers. These restrictions may be applied also to products whose complexity is likely to impede the conduct of the ex-ante valuation.

1.6.3.6 Requirement to issue capital instruments and eligible liabilities

Based on the preferred resolution strategy, the SRB may require the parent entity of a banking group which is the point of entry (i.e. entity to which resolution tools will be applied) to issue a sufficient amount of eligible liabilities expected to contribute to loss absorption and recapitalization.

For an SPE resolution strategy, eligible liabilities expected to contribute to loss absorption and recapitalization should be sufficient to absorb losses across the entire banking group, and, in accordance with the resolution strategy, to ensure the integrity and operability of those parts of the group where critical functions are performed. Hence, the SRB may require the parent entity to provide funding to subsidiaries in subordinated form to facilitate the upstreaming of losses from subsidiaries to the parent entity. A set-off between subsidiaries' claims against the parent entity and vice versa should not be available.[540] In this way, the SRB can ensure the orderly implementation of the resolution strategy without putting the subsidiaries into resolution.

On the contrary, under an MPE resolution strategy, the SRB must ensure that liabilities contributing to loss absorption and recapitalization have been issued at each point of entry of the regional resolution groups to absorb losses across the entities included in their perimeter.

1.6.3.7 Renegotiation of the terms and conditions of capital instruments and eligible liabilities

The SRB should assess the risk of exclusion of capital instruments and eligible liabilities from the scope of the bail-in tool, after taking into account certain characteristics of those liabilities relating to the maturity, the subordination ranking, the types of holders and transferability, the risk that the liabilities would be exempted from loss absorption in resolution and other legal obstacles, such as the absence of recognition of third-country law or the existence of set-off rights.[541]

In this case, the SRB may require the banking group which has issued those capital instruments and eligible liabilities to attempt to renegotiate the terms and conditions constituting potential impediments to resolvability to ensure that any decision to write down or convert these instruments and liabilities would be enforceable under their governing law.

1.6.4 Measures related to information requirements

The SRB may require banking groups to provide on an ad hoc basis specific information for resolution purposes. Such information requirements may be imposed if the SRB assesses that they are necessary to apply the resolution tools more effectively or to draw up an efficient resolution plan.

Thus, the SRB may require the parent entity of a banking group:

- to produce information to inform the senior management about the group's financial situation, including financial statements and information on capital and subordinated debt,

[540] *Ibid.*, par. 15(b).

[541] *Ibid.*, par. 16.

- to clarify the structure of arrangements governing operational interconnectedness, particularly if the banking group has complicated intragroup operational services arrangements, and
- to ensure that it is in a position to produce up-to-date information which is critical to implement the resolution strategy and to support a credible ex-ante valuation in a particularly short timeframe before resolution action is taken. In particular, the parent entity must ensure that it can provide the SRB with information on:
  - the critical functions performed,
  - the creditors or types of creditors most likely to absorb losses during resolution,
  - the creditors who are related to critical functions (e.g. suppliers, IT systems providers) and other creditors of particular importance for the implementation of the resolution strategy, such as covered depositors and non-covered but preferential depositors (i.e. SMEs and natural persons), and
  - positions, services and functions essential for the risk management of the banking group which must be maintained to ensure the continuation of critical functions.

Furthermore, banking groups should be capable to produce credible and accurate data for valuation purposes at short notice. Insufficient and inaccurate valuations would result in delays in resolution action, insufficient action being taken and legal risks that could lead to the breach of the "no-creditor-worse-off" principle.

Therefore, banking groups should establish the necessary valuation processes, mechanisms and arrangements to facilitate valuations within two (2) months in the lead-up to resolution.[542] Thus, banking groups should take measures to ensure the production of robust valuations of the banking group's loan portfolios and trading positions, as well as the production of detailed business forecasts. Furthermore, banking groups should establish a Virtual Data Room to maintain and update this data regularly.[543]

Resolution-related information requirements are considered very demanding for many banking groups which have legacy IT systems that must be updated to produce reliable information on a short timeframe. Hence, banking groups should invest money and human resources in IT projects that would deliver the requirements of resolution authorities.

2. Determination of the MREL for significant banking groups

2.1 The decision-making process for the determination of the MREL

The MREL target is determined based on the joint decision process for banking groups with cross-border activities both in participating and non-participating Member States. The SRB, in its function as group-level resolution authority, and the NRAs of non-participating Member States concerned are responsible for the determination of the MREL target at consolidated level.

[542] This timespan refers to end-to-end valuation process, which covers collection of data and information, provision of this data to an independent valuer, review of data and models, calibration of models, running models, review of model outputs and preparation of a final valuation report.

[543] See **Bank of England's policy on valuation capabilities to support resolvability**, pp. 13-14.

The MREL target is set in accordance with the approach described below and whether any third-country subsidiaries of the banking group are to be resolved separately according to the resolution plan.[544] The involved resolution authorities must do everything within their power to reach a joint decision on the consolidated MREL target. If a joint-decision is not reached within four (4) months, the SRB may adopt a decision on the consolidated MREL target, after taking into account the assessment of subsidiaries carried out by the relevant NRAs of non-participating Member States.

The EBA may contribute to the resolution of the dispute among the involved parties if any of the resolution authorities refers the issue to the EBA before the end of the four-month period. In this case, the EBA may require involved parties to refrain from any action until it adopts a binding decision in accordance with **Article 19 of the EBA Regulation**. The SRB's decision on the MREL target must be in line with the EBA's decision.

The procedure and the arrangements described above apply also to the determination of MREL targets at the subsidiary level. In particular, if the involved parties do not reach a joint decision within a fourth-month period, the resolution authorities concerned may determine the MREL targets for the entities under their remit at individual level. If the SRB has referred the issue to the EBA, the latter may issue a binding decision in accordance with **Article 19 of the EBA Regulation**.[545]

2.2 The SRB's policy on MREL for significant banking groups

2.2.1 The key elements of the SRB's policy on MREL

Leveraging on the provisions stipulated in the BRRD and the Commission Delegated Regulation 2016/1450 (see above in **Chapter A, Section 2**, under **3.2**), the SRB has adopted its own MREL policy that governs the approach for the determination of the MREL and the eligibility criteria of MREL instruments.

This policy is still under development and the SRB enhances further its provisions on an annual basis based on the past experience and the regulatory developments. The SRB has decided to apply this policy in a gradual manner within a multi-year timeframe (2016-2020). Starting from the determination of informative MREL targets in the 2016 resolution planning cycle, in the 2017 resolution planning cycle the SRB moved to banking group-specific binding targets at consolidated level for most of the banking groups. Thus, the SRB set binding MREL targets for 76 banking groups representing approximately 80% of total assets of the banking groups under its remit. These MREL targets were equal to 26% of RWAs and resulted in an MREL shortfall of €47bn. For the other banking groups, the SRB set informative targets.

In the 2018 resolution planning cycle (expected to be completed within 2019), the SRB has announced its intention to set consolidated MREL targets for 93 banking groups and 249 individual MREL targets for subsidiaries of those banking groups. Finally, in the 2019 resolution planning cycle (to be completed within 2020), the SRB will set 105 consolidated MREL targets that will cover all banking groups and 537 individual MREL targets for subsidiaries of those banking groups.[546]

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[544] **BRRD**, Article 45(9).

[545] *Ibid.*, Article 45(10).

[546] See **Single Resolution Board (2018c)**, p. 13.

2.2.2 The SRB's MREL determination approach

The SRB's approach to determining the MREL builds upon the determination formula, as set out in the Commission Delegated Regulation 2016/1450. Thus, pursuant to the SRB's policy, the MREL has the following components:[547]

- the **Loss Absorption Amount** (LAA), which reflects the losses that the banking group is expected to incur in resolution,
- the **Recapitalization Amount** (RCA), which reflects the capital required for the post-resolution banking group, and
- the **Market Confidence Charge** (MCC), which is defined as the capital necessary for the banking group to maintain market confidence after resolution.

The SRB's approach for the determination of the MREL is depicted illustratively in ***Figure 19***.

In line with the Commission Delegated Regulation 2016/1450, the **Loss Absorption Amount** is the sum of the following:

- the **minimum capital requirements** set out in **Article 92(1) of the CRR** (i.e. 8% of RWAs),
- the **Pillar 2 Requirement (P2R)** imposed by the ECB in the context of the SREP, and
- the **combined buffer requirement** set out in **Article 128 of the CRD IV.**

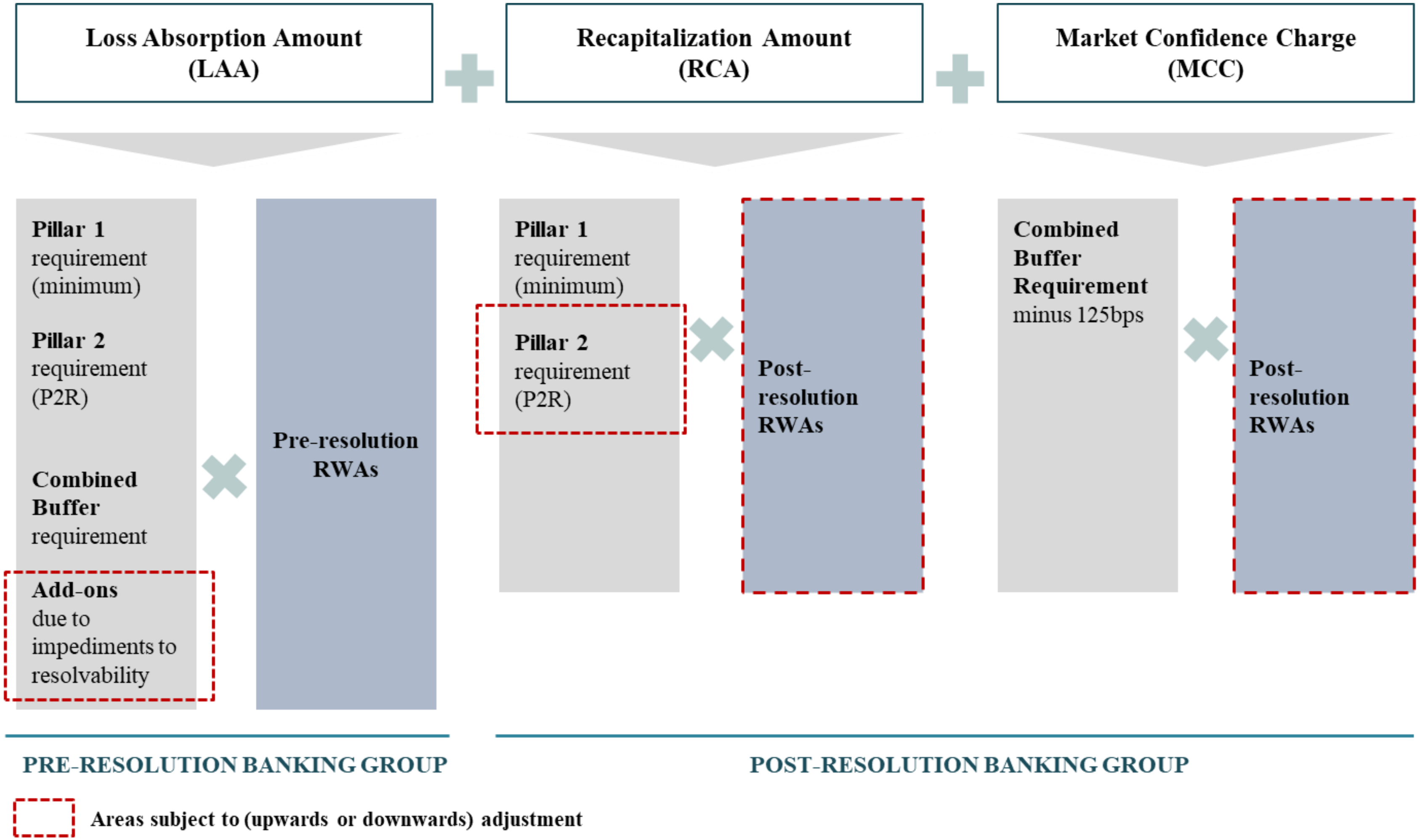
Although the regulatory framework provides the SRB with the discretion to adjust upwards the default Loss Absorption Amount to deal with any impediments to resolvability, the SRB has decided to not opt for this option yet. The SRB is expected to incorporate this element into its policy, once it has completed the first cycle of resolvability assessment of banking groups and has determined substantive impediments to resolvability (expected in the 2018 resolution planning cycle).

In relation to the **Recapitalization Amount**, this consists of:

- the **minimum capital requirements** set out in **Article 92(1) of the CRR** (i.e. 8% of RWAs), and
- the **Pillar 2 Requirement (P2R)** that should be applied to the banking group after its resolution.

[547] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy for 2017 and Next Steps"*, p. 10.

Figure 19: SRB's MREL determination approach



Taking into account that the SRB has set the bail-in tool as the preferred resolution tool for the banking groups under its remit, the Recapitalization Amount has been determined solely based on this assumption. Starting from the 2017 resolution planning cycle, the SRB has decided to make banking group-specific adjustments to the RWAs basis of the recapitalization amount. These adjustments refer to:[548]

(A) Balance sheet depletion: the failure of the banking group due to credit risk losses is expected to result in a smaller balance sheet. Therefore, the SRB adjusts downwards the RWAs of the post-resolution banking group by multiplying the post-resolution balance sheet (decreased by maximum 10%) with the Risk Weight density of the group.[549]

(B) Recovery options: the SRB reduces the RWAs of the Recapitalization Amount by the amount of RWAs that can be released within a short timeframe in resolution due to disposals of subsidiaries and assets, which the group was unable to apply during the early intervention and/or recovery phases.

(C) Restructuring plan divestments: the SRB recognizes for the determination of the Recapitalization Amount any release of RWAs which is expected due to legally binding and time-bound disposal of subsidiaries to which a banking group is committed under a restructuring plan.

The adjustments referred above constitute an interim step towards a more tailored approach for the determination of the MREL. Moving towards the determination of the MREL target based on case-by-case analysis, the SRB has incorporated in its 2018 MREL policy the option for calculation of the MREL target based on the application of transfer tools (i.e. sale of business, bridge institution, asset separation). Thus, when the resolution strategy relies on a transfer tool, the SRB will assume larger balance sheet depletion (minus 20% of total assets instead of minus 10% in the case of the bail-in tool). This adjustment will affect the RWA basis and can be added to other banking group-specific adjustments applied to the Recapitalization Amount.[550]

The SRB's policy introduced the **Market Confidence Charge** as a separate (from the Recapitalization Amount) component of the MREL. The Market Confidence Charge is the amount of own funds and eligible liabilities, which if written down or converted into equity will yield capital sufficient to ensure market confidence to the post-resolution banking group. In accordance with the SRB's policy, this amount should be equal to the combined buffer requirement applied to each banking group minus 125 basis points (bps).

Based on the SRB's approach for setting the MREL target, ***Table 14*** shows an indicative example of the calculation of the MREL target.

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[548] See **Single Resolution Board (2018a)**, p. 19.

[549] The Risk Weight (RW) density is defined as "*the ratio of RWAs over total assets of banking groups*".

[550] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) - 2018 SRB Policy for the first wave of resolution plans"*, p. 10.

Table 14: Indicative example of the calculation of the MREL target

Loss Absorption Amount (LAA)	
Loss Absorption Amount rate	**15%**
Pillar I requirement	8%
Pillar II requirement	3%
Combined Buffer Requirement	4%
RWAs	**€40,000m**
Loss Absorption Amount (LAA)	**€6,000m**
Recapitalization Amount (RCA)	
Recapitalization Amount rate	**11%**
Pillar I requirement	8%
Pillar II requirement	3%
RWAs	
(1) RWAs	€40,000m
(2) Assets	€50.000m
(3) RW density [(1) / (2)]	80%
(4) RWA relief due to resolution= LAA × RW density	€4,800m
RWAs after balance sheet depletion = [(1) – (4)]	**€35,200m**
Recapitalization Amount (RCA)	**€3,872m**
Market Confidence Charge (MCC)	
Market Confidence Charge rate	**2.75%**
Combined Buffer Requirement (CBR)	4%
CBR reduction applied by SRB	(1.25%)
RWAs (calculated as per Recapitalization Amount)	**€35,200m**
Market Confidence Charge (MCC)	**€968m**
MREL TARGET	**€10,840m**

In addition, building upon the Commission Delegated Regulation 2016/1450, the SRB has decided that banking groups for which liquidation is the preferred resolution strategy will have no Recapitalization Amount and Market Confidence Charge. Hence, the MREL is set at the level of the Loss Absorption Amount.[551] In addition, the SRB has employed the "8% of total liabilities and own funds" constraint for all banking groups, as it considers that the MREL should be set at a sufficiently prudent level to allow access to the SRF, where necessary.

The SRB's policy for the MREL does not include any adjustment related to a possible contribution to resolution financing from the DGSs, because the SRB considers that this

[551] *Ibid*., p. 7.

adjustment is not consistent with the preferred resolution strategy selected for the banking groups under its remit.[552]

Aiming to address potential issues relating to the breach of the "no-creditor-worse-off" principle, the SRB has set an additional requirement for the MREL, namely the **subordination requirement**. Subordination is a tool to enhance banking groups' resolvability and limit the risk of breaching the "no-creditor-worse-off" principle. Subordination addresses potential risks stemming from having bail-inable instruments ranking *pari passu* with operational liabilities and other liabilities either explicitly excluded from bail-in or likely to be excluded under the discretionary powers of the SRB.

Under the subordination requirement, banking groups are expected to meet a minimum level of their MREL target with capital and eligible liabilities issued by the parent entity, which rank junior to senior unsecured liabilities (e.g. operating liabilities, derivatives, uncovered deposits) that are included in the scope of the mandatory or discretionary exclusions from bail-in. The subordination requirement is as follows:

- for **G-SIIs**, **13.5%** of RWAs plus combined buffer requirement, and
- for **O-SIIs**, **12%** of RWAs plus combined buffer requirement.

The SRB has not implemented any additional MREL-adjustment to address the risk of the breach of the "no-creditor-worse-off" principle. This refers to an analysis to assess, if liabilities mandatorily excluded from bail-in under **Article 44(2) of the BRRD** or likely to be excluded on the SRB's discretion under **Article 44(3) of the BRRD** exceed the threshold of 10% of the total value of the class.

2.2.3 Determination of MREL targets for banking groups under an MPE approach

Under an MPE approach, separability should not be destructed, which is likely to happen if the failure and subsequent resolution of an entity affects other entities within the banking group. A credible and feasible MPE strategy must be executed without undermining the viability of other resolution groups. Contagion risk is minimized if one regional resolution group within a banking group can be resolved without causing intermediate MREL shortfalls in other regional resolution groups of the same banking group.[553] Aiming to limit contagion risk among the regional resolution groups, the MREL should be set in a way that is consistent with the distribution of risks across banking groups and should be located in entities where such risks are most likely to arise.

Therefore, in the case of banking groups under an MPE approach the SRB sets consolidated MREL targets at the level of the parent entity of each regional resolution group. The MREL targets are based on the total SREP capital requirement and the applicable RWAs of the regional resolution group concerned (i.e. excluding the exposures to other resolution groups within the same banking group).

[552] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy for 2017 and Next Steps*", p. 13.

[553] *Ibid*., p. 13.

2.2.4 MREL-eligible instruments

Under the current SRB's policy, binding targets at consolidated level can be covered with capital instruments and eligible liabilities issued at consolidated level. However, the SRB is expected to amend this approach as of the 2018 resolution planning cycle and require banking groups to cover the MREL only with capital instruments and eligible liabilities issued by the parent entity.

The SRB has set the following restrictions for the eligibility of MREL instruments:[554]

- **liabilities held by retail investors** are considered MREL-eligible, but an overly large proportion of retail holders of eligible instruments may be considered as an impediment to resolvability,
- **liabilities issued by third-country law** are not considered MREL-eligible, unless the banking group is able to demonstrate that the write-down or conversion will be recognized by the courts of the third country,
- **liabilities issued by entities located outside the EU** are not recognized as MREL-eligible,
- **structured notes** are excluded from MREL by default, but the SRB assesses on a case-by-case basis the eligibility of those liabilities:[555]
    - when a given amount of the liability arising from the instrument is known in advance at the time of issuance, is fixed (i.e. the amount cannot go below a minimum floor) and is not affected by a derivative feature,
    - if the instrument, including its derivative feature, is not subject to any netting agreement,
    - the liability is recognized only up to its fixed amount,
- **non-covered non-preferred deposits** are excluded from MREL, unless there is evidence that they cannot be withdrawn within a one-year period.[556]

Although there is no legal basis for exclusion of eligible liabilities held by natural persons or small- and medium-sized enterprises (SMEs) from MREL, holdings of subordinated instruments or senior instruments by such customers could prove to be an impediment to resolution. In the SRB's view, large holdings of liabilities sold to retail investors impede resolution due to the potential loss of the customer base and the risk of withdrawals and the potential litigation brought by retail investors upon or after resolution, which could threaten the group's future viability.[557]

Thus, in the context of the resolvability assessment, the SRB assesses the exposure of banking groups to retail bondholders to determine whether the bail-in of those counterparties might be an impediment to resolvability.[558] The SRB assesses whether the exemption of debt instruments held by retail investors from bail-in is acceptable under **Article 44(3) of the BRRD**. Exemption from bail-in could be justified whether this

[554] See **Single Resolution Board (2018a)**, p. 120.

[555] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy for 2017 and Next Steps*", p. 15.

[556] Deposits that have a redemption clause below one (1) year or for which there is no sufficient evidence that they cannot be withdrawn are excluded from the MREL.

[557] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy for 2017 and Next Steps*", p. 16.

[558] *Ibid*., p. 16.

action would hurt the confidence to the banking sector due to the number of natural persons affected and the press coverage that would cause. If the SRB concludes that such an exemption from bail-in is justified, then, it assesses the impact on the group's loss absorbing capacity. If the amount is so large that the SRB would have to bail-in liabilities that are more senior or *pari passu* with retail holdings, then it is likely a breach of the "no-creditor-worse-off" principle to occur. Hence, this could be determined as an impediment to resolvability which could be removed if the SRB requires the banking group concerned to issue additional MREL instruments.[559]

In addition, the SRB has adopted a stringent and conservative approach for liabilities governed by third-country law. This stance is attributed to the risk that the courts of third countries would not recognize the bail-in or transfer order of the SRB. Therefore, the SRB has decided to not count towards MREL liabilities governed by third-country law, unless banking groups can demonstrate that the write-down or conversion of those liabilities would be recognized by the courts in that third country.[560] This impediment to resolvability can be addressed through the introduction into these liabilities of contractual clauses that ensure that the SRB may exercise its write-down and conversion powers over those liabilities.

Furthermore, the SRB has expanded its approach regarding third-country jurisdictions by not recognizing liabilities issued by entities (e.g. Special Purpose Entities (SPEs)) outside the EU. Given that the SRB's resolution powers are not applicable to non-EU jurisdictions, the SRB requires eligible liabilities to be issued by EU-based entities. This approach does not pertain to minority interests in subsidiaries (i.e. capital issued to external investors), which are recognized as MREL eligible to the extent that they are recognized in the capital of the parent entity.

2.2.5 Transitional period to cover the MREL target

The SRB has granted a transitional period of up to four (4) years to banking groups with binding MREL targets. This transitional period is determined on a case-by-case basis, taking into account bank- and market-specific characteristics. In addition, the SRB has set non-binding interim targets, when the transition period exceeds two (2) years seeking to ensure that banking groups make progress towards meeting the fully-loaded MREL targets. Aiming to ensure timely compliance with MREL, the SRB may require banking groups to submit funding plans to reach the applicable binding MREL target by the end of the transition period.

2.3 Amendment of the MREL framework under the CRR II / BRRD II

2.3.1 Key amendments to the Union crisis management framework

In November 2016, the Commission submitted legislative proposals to amend the Union framework relating to prudential regulation, supervision and resolution of banking groups. In December 2018, the ECOFIN and the European Parliament reached an agreement on these legislative proposals, collectively known as "**Banking Package for Risk Reduction Measures**". In particular, the agreement referred to:[561]

- **Presidency Compromise text on proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013** "*as*

[559] **Statement of the EBA and ESMA** *"on the treatment of retail holdings of debt financial instruments subject to the BRRD"*, p. 18.

[560] **SRB Policy** "*on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy for 2017 and Next Steps"*, p. 17.

[561] On a comprehensive presentation of the core provisions of the Banking Package, see **Gortsos (2018a).**

regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012", (**CRR II**),

- **Presidency Compromise text on proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 806/2014** "*as regards loss-absorbing and Recapitalisation Capacity for credit institutions and investment firms",* (**SRMR II**),
- **Presidency Compromise text on proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU** "*as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures*", 6289/19, February 2019 (**CRD V**), and
- **Presidency Compromise text on proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU** "*on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC*", (**BRRD II**).

The revised framework brought about changes, among others, in the arrangements relating to the determination and application of the MREL. In that context, the key changes pertain to:

- the introduction of a Pillar 1 MREL for G-SIIs and other Top Tier 1 banking groups in accordance with the FSB's requirement for **Total Loss Absorbing Capacity** (**TLAC**),[562]
- the establishment of uniform criteria for MREL-eligible liabilities,
- the introduction of the obligation for banking groups to issue MREL-eligible instruments only by the parent entity and not through SPEs,
- the enhancement of the resolvability of banking groups through the introduction of the subordination requirement and the establishment of limitations to the sale of MREL instruments to retail investors,
- the restriction of the ability of banking groups to call, redeem, repurchase or repay eligible liabilities prior to their maturity,
- the introduction of the internal MREL to alleviate the concerns of host resolution authorities on the loss-absorbing capacity of subsidiaries located in their jurisdictions,
- the introduction of specific supervisory measures and sanctions in case of breach of the MREL, and
- the establishment of specific criteria for the determination of the transitional period during which banking groups must meet the MREL.

2.3.2 Approach for the determination of the MREL

On 9 November 2015, the FSB adopted the TLAC standard, which was subsequently endorsed by the G-20. The TLAC aims at ensuring that G-SIIs have the necessary loss-

[562] For more information on the TLAC, see **Financial Stability Board (2015b).**

absorbing and recapitalization capacity for an orderly resolution. In this way, critical functions can continue performing without taxpayers' contribution or any threat to financial stability.[563] The TLAC introduced for the first time a Pillar 1 requirement of 18% of RWAs applicable to all G-SIIs, which must be met with capital instruments and eligible liabilities that satisfy certain criteria.

In line with the TLAC standard, the revised Union crisis management framework established a Pillar 1 MREL for banking groups determined as G-SIIs. A transitional period has been introduced to accommodate G-SIIs to meet Pillar 1 MREL in a smooth way. Therefore, since 1 January 2019, G-SIIs must meet a Pillar 1 MREL of 16% of RWAs and a leverage ratio of 6%. The fully-loaded Pillar 1 MREL of 18% of RWAs (excluding the combined buffer requirement) and a leverage ratio of 6.75% will apply as of 2022.[564]

In addition, the BRRD II extended the Pillar 1 MREL also to other (non G-SIIs) banking groups with total assets exceeding €100bn, which must meet as of 2022 a Pillar 1 MREL target of 13.5% of RWAs, excluding the combined buffer requirement.[565] This requirement can be extended also to other banking groups with total assets below €100bn, which are assessed by resolution authorities as reasonably likely to pose a systemic risk in case of failure.[566]

The imposition of Pillar 1 MREL does not imply that resolution authorities will not set banking group-specific MREL targets for these banking groups over and above the Pillar 1 MREL. As the BRRD II did not brought about any material amendment to the approach for the determination of the MREL, these MREL targets will be determined in accordance with the approach established under the existing regulatory framework.[567]

The exercise of the write-down and conversion powers to MREL instruments issued by G-SIIs could give rise to contagion and threat financial stability, where these liabilities had been bought by other G-SIIs. Aiming to address this risk, G-SIIs must deduct from their MREL-eligible liabilities the following items:[568]

- holdings of own MREL-eligible liabilities, including own liabilities that the G-SIIs could be obliged to purchase as a result of contractual obligations,
- holdings of MREL-eligible liabilities of other G-SIIs with which the G-SII has reciprocal cross-holdings that artificially inflate the loss absorption and recapitalization capacity of the banking group, and
- a specific amount of MREL-eligible liabilities of G-SIIs in which the G-SII does have a (significant or not significant) investment.

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[563] **BRRD II**, recital (1).

[564] G-SIIs are subject to this requirement within three (3) years following the date on which the banking group has been identified as G-SII or within two years from the data of application of bail-in tool or of the write-down and conversion of capital instruments.

[565] **BRRD II**, Article 45c(3a).

[566] This determination should be based on the following criteria:

- the prevalence of deposits and the absence of debt instruments in the funding model,
- the limited access to the capital markets for eligible liabilities,
- the reliance on CET1 to meet the MREL.

[567] The BRRD II amended the denominator of the MREL target, which is RWAs instead of total liabilities and own funds.

[568] **CRR II**, Article 72e(1).

2.3.3 Key changes in the MREL framework

2.3.3.1 Eligibility criteria for MREL instruments

The revised crisis management framework sets out the types of instruments and the eligibility criteria that those instruments must meet in order to qualify for MREL. European co-legislators decided to establish these rules under a directly applicable legislative act (CRR II) in order to ensure that MREL instruments issued across Member States will be governed by the same terms and conditions.

Thus, pursuant to **Article 72a of the CRR II**, the following items are eligible for MREL purposes:

- **capital instruments**, namely CET1, AT1 and Tier 2 instruments,
- **Tier 2 instruments with a residual maturity of at least one (1) yea**r to the extent that they do not qualify as Tier 2 capital, and
- **liabilities that meet specific MREL-eligibility criteria** and do not fall into any of the categories referred below.

In particular, the following liabilities are excluded from the MREL:[569]

a. covered deposits,

b. uncovered deposits with an original maturity of less than one (1) year,

c. the part of eligible deposits from natural persons and micro, small and medium-sized enterprises (SMEs) exceeding the €100,000 threshold of depositors' coverage,[570]

d. secured liabilities, including covered bonds and financial instruments used for hedging purposes,

e. any liability that arises by virtue of the holding of clients' assets or client money,

f. any liability that arises by virtue of a fiduciary relationship between the banking group (as fiduciary) and another person (as beneficiary),

g. liabilities to credit institutions and investment firms, excluding liabilities to other group's entities, with an original maturity of less than seven (7) days,

h. liabilities with a remaining maturity of less than seven (7) days owed to payment and settlements systems, operators of and participants in those systems, as well as CCPs,

i. liabilities to employees, suppliers of critical services to the banking group, tax and social security authorities and DGSs, and

j. liabilities arising from derivatives and debt instruments with embedded derivatives.[571]

[569] *Ibid.*, Article 72a(2).

[570] These arrangements cover also deposits that would be eligible deposits from natural persons and micro, small and medium-sized enterprises (SMEs), if they were not made through branches located outside the Union of institutions located within the Union

[571] Debt instruments containing early redemption options exercisable at the discretion of the issuer or of the holder and debt instruments with variable interests derived from a broadly used reference rate (e.g. Euribor, Libor) must not be considered as debt instruments with embedded derivatives solely because of such features.

The remaining liabilities can be considered for MREL purposes provided that they have a residual maturity of at least one (1) year[572] and they meet all of the following conditions:

a. the liabilities are directly issued or raised by the parent entity and are fully paid-up,

b. the liabilities are not owned by another group's entity or by an entity in which the issuing entity has a direct or indirect participation of 20% or more of the voting rights or capital,

c. the acquisition of ownership of the liabilities is not funded directly or indirectly by the banking group,

d. the claim on the principal amount of the liabilities under the provisions governing the liabilities is wholly subordinated to claims arising from the excluded liabilities referred above (**subordination criterion**),

e. the liabilities are neither secured, nor subject to a guarantee or any of the other arrangement that enhances the seniority of the claim by the parent entity or any other group's entity,

f. the liabilities are not subject to set off or netting arrangements that would undermine their capacity to absorb losses,

g. the provisions governing the liabilities do not include an incentive for the principal amount to be called, redeemed, repurchased prior to the maturity or repaid early by the banking group, except for the case that the liabilities define a specific date on which the issuer can exercise that option and request redemption and repayment of the instrument,

h. the liabilities are not redeemable by the holders of the liabilities prior to their maturity, except where a holder redemption option determines a possible date on which the option can exercise the redemption option,

i. the liabilities may include one or more early repayment options, including call options, exercisable at the sole discretion of the issuer, except for the previous case,

j. the liabilities may only be called, redeemed, repurchased or repaid early only upon receipt of the SRB's approval,

k. the provisions governing the liabilities do not indicate explicitly or implicitly that the liabilities would be called, redeemed, repurchased or repaid early,

l. the provisions governing the liabilities do not give the holder the right to accelerate the future payment of interest or principal, and

m. the level of distributions payments due on the liabilities is not amended on the basis of the credit standing of the entity.

Liabilities issued prior to the date of entry into force of the CRR II are eligible for MREL purposes if they meet the aforementioned conditions, except for the conditions referred to in points (f) to (m).[573]

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[572] Where eligible liabilities include a holder redemption option exercisable prior to the original maturity, the maturity of the liabilities is defined as the earliest possible date on which the holder can exercise the redemption option and request redemption or repayment of the liabilities. The same applies to liabilities which include an incentive for the issuer to call, redeem, repay or repurchase the liabilities prior to their maturity.

[573] **CRR II**, Article 494b(3).

The subordination criterion (d) can be met under three (3) ways. Under the **contractual subordination,** the contractual provisions governing the liabilities provide that in the case of liquidation under normal insolvency proceedings, the claim on the principal amount of the liabilities ranks below claims arising from any of the excluded liabilities referred above. Based on the **statutory subordination**, the applicable law specifies that in the event of normal insolvency proceedings, the claim on the principal amount of the liabilities ranks below claims arising from any of the excluded liabilities referred above. Under the **structural subordination**, the liabilities are issued by a financial holding company (i.e. an entity that does not have on its balance sheet any of the excluded liabilities referred above).

Upon request by a banking group, the SRB may permit liabilities to qualify for MREL purposes up to an aggregate amount that does not exceed 3.5% of RWAs[574] provided that:[575]

- all the aforementioned conditions, excluding the subordination requirement, are met,
- the liabilities rank *pari passu* with the lowest ranking excluded liabilities, and
- the inclusion of those liabilities would not give rise to material risk of successful legal challenge or of valid compensation claims as assessed by the SRB in the context of the resolvability assessment.

Hence, resolution authorities retain the power to reject the inclusion of liabilities ranking *pari passu* with other senior unsecured liabilities which are excluded from the MREL if their assessment determines that the "no-creditor-worse-off" principle could be breached.

The criteria introduced with the CRR II seek to ensure that MREL-eligible instruments are issued by the parent entity (resolution entity) to which the write-down and conversion powers will be exercised. Thus, under the revised regulatory framework, banking groups are no longer allowed to issue AT1 and Tier 2 instruments and MREL-eligible liabilities through special purpose entities (SPEs). In this way, resolution authorities can promote effective resolution action without any legal and operational impediments, which would be the case particularly if these SPEs were located in third countries, which could create problems with respect to the enforcement of resolution action. Any instruments issued prior to the entry into force of the CRR II will remain eligible for the purposes of capital requirements and MREL until the end of 2021.

Furthermore, the MREL-eligibility criteria ensure that banking groups can call, redeem, repurchase or repay MREL-eligible instruments only upon receipt of the consent of the resolution authority concerned, while the amount of MREL instruments cannot be set off or netted with any claims of the creditors (e.g. loans). These arrangements foster clarity and in relation to the amount and availability of MREL instruments upon resolution.

2.3.3.2 Subordination requirement

Aiming to enhance the resolvability of banking groups and ensure that the application of the write-down and conversion powers would not trigger legal claims from affected creditors, the BRRD II provides resolution authorities with the power to require banking groups to meet the MREL with subordinated liabilities. Resolution authorities must ensure that G-SIIs, banking groups with assets exceeding €100bn and any other banking

[574] Alternatively, the SRB may allow a banking group to include liabilities not meeting the subordination criterion, where these liabilities, which must fulfil the criteria referred above, do not exceed 5% of the total amount of own funds and eligible liabilities.

[575] **CRR II**, Article 72b(3).

group whose failure would pose systemic risk must meet a part of the MREL equal to the higher of:

- 8% of their total liabilities including own funds, or
- an amount equal to the formula (1-X1/X2) x8% of total liabilities including own funds,[576]

with capital instruments and MREL-eligible liabilities that meet the subordination criterion, namely they rank below liabilities excluded or likely to be excluded from the bail-in under the national insolvency ranking.[577]

For the other banking groups, resolution authorities may set a minimum subordination threshold equal to the higher of **8% of total liabilities including own funds** or **an amount that is equal to (1) twice the Pillar 1 capital requirements, (2) twice the P2R and (3) the combined buffer requirement**, where specific conditions are met. Firstly, non-subordinated liabilities have the same priority ranking in the national insolvency hierarchy as certain liabilities that are excluded from the write-down and conversion powers. Secondly, there is a risk that as a result of an application of write-down and conversion powers to non-subordinated liabilities, creditors of claims arising from those liabilities incur greater losses than they would have incurred in the case of liquidation under normal insolvency proceedings. Thirdly, the amount of subordinated liabilities does not exceed the amount necessary to ensure that holders of non-subordinated liabilities do not incur greater losses than they would have incurred in the case of liquidation under normal insolvency proceedings.

The risk referred to in second point above must be assessed by resolution authorities if they determine that within a class of liabilities which includes eligible liabilities, the amount of liabilities that are reasonably likely to be excluded from the application of the write-down and conversion powers totals more than 10% of that class.

2.3.3.3 Sale of MREL liabilities to retail investors

In some past cases, it has been observed that the disclosure practices applied by banking groups in the sale of subordinated debt and senior unsecured bonds to retail investors were not in line with the consumer protection requirements. The cases of Veneto Banca and Banca Popolare di Vincenza are the most remarkable mis-selling cases and obliged the Italian government to compensate subordinated creditors for their holdings of debt issued by the two banking groups which was written down.[578]

Even when there are no incidents of mis-selling, the application of the bail-in tool to debt liabilities held by retail investors may trigger contagion effects and financial instability. Usually, retail bondholders are also customers (e.g. depositors, borrowers) of the banking groups concerned, which is likely to hamper the franchise value and business viability of these groups after their entry into resolution.[579] For these reasons, holdings of MREL instruments by retail investors can be considered as an impediment to resolvability. Resolution authorities may consider this as an impediment to resolvability if they

[576] The formula (1-X1/X2) x8% of total liabilities including own funds is as follows: X1=3.5% of RWAs and X2 is equal to the amount resulting from the sum of (i) 18% of RWAs and (ii) the combined buffer requirement applicable to the banking group concerned.

[577] **BRRD II**, Article 45b(3).

[578] **Commission Decision** "*on State Aid SA. 45664 (2017/N) – Italy – Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid*", point (50).

[579] **Statement of the EBA and ESMA** *"on the treatment of retail holdings of debt financial instruments subject to the BRRD"*, p. 16.

consider that bail-in cannot be applied credibly and feasibly in resolution because of the presence of such a large stock of retail holders whose exemption would reduce the amount of loss-absorbing liabilities to a significant extent. The EBA and the ESMA highlighted the significance of this issue in a joint statement "*on the treatment of retail holdings of debt financial instruments subject to the BRRD* issued in May 2018. Based on this Statement, resolution authorities are asked to assess if there "*is a material presence of retail investors as holders of debt liabilities of an institution subject to resolution and they are encouraged to give attention to this element in their resolution planning*."[580] Resolution authorities should assess whether bail-in cannot be applied because of the presence of a large stock of retail held liabilities, and if this is the case, they should consider if the exclusion of those liabilities from bail-in based on **Article 44(3) of the BRRD** is warranted and what would be the impact of the exemption on the loss absorption capacity of banking groups.

The significance of this problem is reflected in the amount of MREL liabilities held by retail investors. As of Q3 2017, at euro area retail investors held debt securities issued by EU-based banking groups of €262.4bn (17.2% of debt securities issued to euro area investors), of which senior unsecured bonds represented 81% of the amount. This problem mainly concerns Italy, where over €130bn of debt securities were held by retail investors (36.9% of total debt issued by banking groups).[581] In Germany and France, the relevant amount was €49.4bn and €31.7bn respectively.

To address the issue of debt instruments held by retail investors, the BRRD provides two (2) alternative options to Member States to lay down in their national law.[582] Member States may either **introduce limitations on the amount of eligible liabilities held by retail customers** or **establish minimum denomination requirements for the participation of investors to the issuance of MREL-eligible liabilities**.

In particular, under the first option, banking groups may sell subordinated MREL-eligible liabilities only to retail clients who meet specific criteria[583] and whose financial portfolio does not exceed €500,000. Banking groups must ensure that the retail client does not invest in subordinated MREL-eligible liabilities an amount exceeding 10% and that the initial investment amount invested in one or more MREL-eligible liabilities is at least €10,000. Alternatively, under the second option, banking groups must set a minimum denomination amount of at least €50,000 for subordinated MREL liabilities. The first solution has many operational problems, as following the issuance of MREL-eligible instruments it is impossible for banking groups to monitor, let alone to control, the identity of holders of such instruments that are negotiable in the secondary market. Instead, the optimal solution is to set a minimum issuance denomination, which would

[580] *Ibid.*, p. 3.

[581] *Ibid.*, p. 4.

[582] **CRR II**, Article 44a.

[583] Retail clients may buy subordinated MREL liabilities, provided that they meet the following conditions:

- the seller of the eligible liability has performed a suitability test in accordance with Article 25(2) of the Directive 2014/65/EU,
- the seller of the eligible liability is satisfied, on the basis of the test suitability test, that the eligible liability is suitable for that retail client, and
- the seller of the eligible liability immediately communicates in a report to the retail client the outcome of the suitability test.

increase the investment threshold and limit the investments of retail investors in MREL-eligible instruments.

2.3.3.4 Conditions for the reduction of own funds and eligible liabilities

Banking groups must obtain the prior permission of the ECB to reduce, redeem or repurchase CET1 instruments, AT1 or Tier 2 instruments. The ECB may grant such a permission,[584] if either of the following conditions is met: [585]

- earlier than or at the same time, the banking group replaces those instruments with capital instruments of equal or higher quality with terms that are deemed sustainable for the profitability of the group, or
- the banking group has demonstrated that it will meet the capital requirements and the MREL following the reduction or repurchase of the capital instruments.

The ECB may allow banking groups to call, repay or repurchase AT1 or Tier 2 instruments during the five (5) years following their issuance if the aforementioned conditions are met, as well as any of the following:

- there is a change in the regulatory classification of those instruments that would be likely to result in their exclusion from capital or reclassification as a lower quality form of capital, [586]
- there is a change in the applicable tax treatment of those instruments, which is considered by the banking group as material and not foreseeable at the time of their issuance,
- the instruments are grandfathered,
- the banking group replaces (earlier or at the same time) the instruments with capital instruments of equal or higher quality at terms that are sustainable for its profitability and the ECB has permitted this action on the basis that it would be beneficial from a prudential point of view, or
- the AT1 and Tier 2 instruments are repurchased for market making purposes.

In relation to MREL-eligible liabilities, the SRB is responsible to grant permission to a banking group to reduce, repurchase, call or redeem those liabilities, even if the liabilities have a remaining maturity lower than one (1) year, which means that they have ceased

[584] Alternatively, where a banking group provides sufficient safeguards in relation to its ability to operate above capital requirements, the ECB may grant that banking group a general prior permission to reduce, redeem or repurchase capital instruments. This general prior permission must be granted for a period not longer than one (1) year, after which it may be renewed. This permission must be granted for a predetermined amount, which, for CET1 instruments, must not exceed 3% of the relevant issuance and 10% of the amount by which CET1 instruments exceed the CET1 capital requirements. With respect to AT1 and Tier 2 instruments, that predetermined amount must not exceed 10% of the relevant issue and 3% of the total amount of outstanding AT1 and Tier 2 instruments.

[585] **CRR II**, Article 78.

[586] The ECB must consider such a change to be sufficiently certain and the banking group must demonstrate that the regulatory reclassification of those instruments was not reasonably foreseeable at the time of their issuance.

to be considered MREL-eligible. The SRB may grant such a permission,[587] if any of the following conditions is met:[588]

- the banking group replaces (earlier or at the same time) the eligible liabilities with capital instruments or eligible liabilities of equal or higher quality at terms that are sustainable for its profitability,
- the banking group has demonstrated to the SRB that the capital and MREL-eligible liabilities would remain above the required level (after the reduction, repurchase or call of the eligible liabilities) by a margin that the SRB considers necessary, or
- the banking group has demonstrated to the SRB that the replacement of the eligible liabilities with capital instruments is necessary to ensure compliance with the capital requirements.

2.3.3.5 Introduction of the internal MREL

Host resolution authorities may have concerns about the extent of information shared by the home resolution authority and the level of coordination and cooperation in crisis situations. This is particularly relevant under an SPE approach, where host resolution authorities are concerned about the willingness of the parent entity to support local subsidiaries in a crisis situation and whether there will be sufficient loss-absorbing and recapitalization capacity at local level if the parent entity is put into resolution. On the contrary, the group-level resolution authority wants to ensure that host authorities will cooperate and support the implementation of an agreed strategy and will not expedite uncoordinated measures that could threaten orderly resolution of the banking group.[589] There is a high risk that host resolution authorities will act independently in case of resolution to preserve national financial stability and their national interests irrespective of the cross-border spillovers that might arise from such a stance.

Since it may be difficult for the parent entity during a crisis to inject new capital to the subsidiary to restore its financial situation,[590] the main tool to address these concerns is the requirement from each material subsidiary to hold a sufficient amount of MREL instruments either externally issued or down-streamed from the parent entity. In this way, host resolution authorities may be confident that they can apply resolution tools to the subsidiaries located in their jurisdictions.

The internal MREL ensures that the parent entity has prepositioned a share of its MREL-eligible instruments to its material subsidiaries abroad. The internal MREL fosters loss-absorbing capacity of material subsidiaries by the application of the bail-in tool to the liabilities held by the parent entity without imposing losses on third parties and without the need to place the subsidiary in resolution. The claims of the parent vis-à-vis the subsidiary are written down or converted into equity, before other creditors (e.g. depositors) bear losses.

Both the Federal Reserve and the Bank of England have expressed their preference for internal MREL rather on externally issued liabilities in order to ensure loss-absorbing

[587] As applies also to own funds instruments, the SRB may grant a general prior permission to a banking group to effect calls, redemptions, repayments or repurchases of eligible liabilities, but only for a certain period and for a predetermined amount.

[588] **CRR II**, Article 78a(1).

[589] See **Hüpkes (2015)**, p. 203.

[590] See **Huertas (2015)**, p. 144.

capacity of subsidiaries.[591] The Bank of England has already set out requirements for the internal MREL both under an SPE and an MPE approach. Under an SPE approach, MREL instruments must be issued by subsidiaries that are not themselves resolution entities to the parent (resolution) entity of the group. In resolution, the write-down and conversion to equity of internal MREL instruments will result in upstream of losses and recapitalization of the subsidiaries. Based on this approach, the whole banking group will remain together.

The SRB has not set any internal MREL targets for material subsidiaries of the banking groups under its remit, but it is expected to do so in the following years in accordance with the provisions of the BRRD II. The revised Directive obliges resolution authorities to set internal MREL for material subsidiaries of parent (resolution) entities.[592] This requirement must be met with liabilities and capital instruments that meet certain criteria. In relation to the liabilities, these must:

- be issued to and bought by the resolution entity or by an existing shareholder that does not belong to the same resolution group as long as the exercise of the write-down and conversion powers would not result in change of the control of the subsidiary be the resolution entity,
- fulfil most of the eligibility criteria referred to in **Article 72a of the CRR II** (except for the criteria of points (b), (c), (k), (l) and (m)), and
- have the same ranking as capital instruments and senior unsecured liabilities under national insolvency ranking,

Capital instruments must be issued to and bought by entities of the same resolution group or by entities that are not included in the same resolution group provided that the exercise of the write-down and conversion powers will not result in change of the control of the subsidiary by the resolution entity.

The BRRD II provides also resolution authorities with the discretion to allow the internal MREL to be met fully or partially with a guarantee provided that the subsidiary and the resolution entity are established in the same Member State and the resolution entity complies with the MREL. The guarantee provided by the parent entity to the subsidiary must satisfy the following conditions:

- the guarantee covers the amount of the MREL that the subsidiary must comply with,
- the guarantee is triggered when the subsidiary is unable to pay its debts or other liabilities as they fall due or a determination has been made to write down and convert into equity its liabilities,
- the guarantee is collateralized for at least 50% of the required amount and incorporates conservative haircuts,
- the collateral backing the guarantee is unencumbered and is not used as collateral to back any other guarantee,
- the collateral has an effective maturity, and
- there are no legal, regulatory and operational barriers to the transfer of the collateral from the resolution entity to the relevant subsidiary, including in the event of resolution action.

[591] See **Huertas (2016)**, p. 7.

[592] **BRRD II**, Article 45g(1).

2.3.3.6 Supervisory and resolution powers in case of breach of the MREL

The ECB and the SRB, where relevant, may apply the following powers to banking groups that fail to meet the Pillar 1 MREL or the MREL target set by the SRB. In specific, they may:[593]

- exercise the powers to address or remove the impediments to resolvability,
- prohibit distributions,
- exercise the supervisory powers set out in **Article 104 of the CRD IV**,
- take early intervention measures,
- impose the administrative penalties and other administrative measures provided for in **Articles 110 and 111 of the CRD IV**, and
- make a determination that the group is "failing or is likely to fail".

Where a banking group does not meet the combined buffer requirement and at the same time the Pillar 1 MREL and/or the MREL target, the SRB may prohibit the group from distributing more than the Maximum Distributable Amount related to the MREL (M-MDA) through specific actions, such as distribution in connection with CET1 capital, creation of obligation to pay variable remuneration or discretionary pension benefits or payments on AT1 instruments.[594]

Depending on the level of the CET1 capital not used to meet the Pillar 1 MREL and/or the MREL target, the SRB may set a limitation on the amount of interim and year-end profits that can be distributed in the aforementioned ways. For instance, where the CET1 capital not used by the banking group to meet the Pillar 1 MREL and/or the MREL target is within the first (i.e. the lowest) quartile of the combined buffer requirement, the distributable amount must be zero. Respectively, if the CET1 capital not used by the group to meet the Pillar 1 MREL and/or the MREL target is within the second quartile of the combined buffer requirement, the distributable amount must be at 20% of interim and year-end profits.[595]

Within two (2) weeks from the receipt of the notification that there are substantive impediments to resolvability due to non-compliance with Pillar 1 MREL and/or the MREL target, the banking group must submit a restoration plan and a timeline within which it will comply with the combined buffer requirement and the Pillar 1 MREL and/or the MREL target. The SRB must decide whether to exercise its power to prohibit distribution after taking into consideration the following elements:

- the reason, duration and magnitude of the breach and its impact on resolvability,
- the financial situation of the banking group and the likelihood to be determined as "failing or likely to fail" in the foreseeable future,
- the prospect that the banking group will meet the combined buffer requirement and the MREL within a reasonable timeframe,
- whether the inability of the banking group to replace the liabilities is of idiosyncratic or system-wide nature, and

[593] *Ibid.,* Article 45k.

[594] *Ibid.*, Article 16a.

[595] Respectively, if the CET1 capital not used by the banking group to meet the Pillar 1 MREL and/or Pillar 2 MREL is within the third and fourth quartile of the combined buffer requirement, the distributable amount must be 40% and 60% of the interim and year-end profits respectively.

- if the exercise of the power to prohibit distributions is the most adequate and proportionate means to address the situation of the banking group based on its potential impact on both the financing conditions and the resolvability of the group.

If the SRB assesses that the banking group is still non-compliant with the combined buffer requirement and MREL six (6) months after this situation has been notified, it must prohibit distributions, unless it assesses that this situation is owed to severe market-wide disturbance that impedes the issuance of MREL-eligible liabilities.[596]

2.3.3.7 Transitional period to cover the MREL

Whereas the Commission Delegated Regulation 2016/1450 does not determine a specific deadline for banking groups to meet the MREL, the BRRD II sets a clear timeline. In particular, **G-SIIs and banking groups with total assets exceeding €100bn** must meet the fully-loaded Pillar 1 MREL by **1 January 2022**. Nonetheless, **all banking groups**, including G-SIIs, must meet the MREL target set by the SRB by **1 January 2024**.[597]

The SRB must determine an intermediate target level with which banking groups must comply by 1 January 2022. This intermediate target must ensure a linear build-up of the MREL. The SRB must communicate to banking groups a planned MREL for each 12 months period during the transitional period aiming to facilitate a gradual build-up of the MREL level.

However, the BRRD II provides the SRB with the discretion to set an even longer transitional period, extending beyond 2024, where this is warranted by the development of the banking group's financial situation, its prospect to meet the MREL within a reasonable timeframe and the ability of the banking group to replace liabilities that no longer meet the MREL-eligibility or maturity criteria.

For the purpose of the determination of the transitional period, the SRB must take into account the prevalence of deposits and the absence of debt instruments in the funding model, the access to the capital markets for eligible liabilities, as well as the reliance on CET1 capital to meet the MREL.

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[596] In particular, the SRB cannot exercise the power to prohibit distributions, if it assesses that at least two of the following conditions are met:

- the breach is due to a serious disturbance to the functioning of financial markets, which leads to broad-based financial market stress across several segments of financial markets,
- this disturbance results not only in increased price volatility of the own funds and eligible liabilities of the banking group or increased costs for the group, but leads to a full or partial closure of markets which prevents the group from issuing own funds and eligible liabilities,
- the market closure is observed not only for the concerned banking group, but also for several other groups,
- the disturbance prevents the concerned banking group from issuing own funds and eligible liabilities instruments in a volume sufficient to remedy the breach, or
- an exercise of the power to prohibit distributions leads to negative spill-over effects for part of the banking sector which may undermine financial stability.

[597] **BRRD II**, Article 45m.

Section 3: Resolution action in relation to significant banking groups

1. Implementation of preparatory measures related to resolution

1.1 Resolution-related valuations

1.1.1 The "failing or likely to fail" valuation (Valuation 1)

In accordance with **Article 20(5)(a) of the SRMR**, the SRB must conduct itself a valuation to inform the determination whether a banking group meets the conditions for resolution or the conditions for write-down or conversion of capital instruments, particularly with regard to the determination of whether the group is in a "failing or likely to fail" situation. This report examines whether the conditions for resolution referred to in **Article 18(4) of the SRMR**, except for the extraordinary public financial support criterion, are met. [598]

Given the urgent circumstances under which this report is drafted, it should rather be understood as a best effort of the SRB to assess the financial situation of the banking group on the basis of all available information and the time constraints at the valuation date. The reference date for the data used in the valuation report should be "*as close as possible to the expected date of the decision by the resolution authority to put the group in resolution*."[599]

This valuation should place emphasis on areas subject to significant uncertainty, which may have significant impact on the overall valuation outcome, such as **loan portfolios**, the expected cash flows of which depend on the counterparties' ability and willingness to meet their obligations and **repossessed assets** whose cash flows are affected by both the assets' fair value at the time the group forecloses on the related security or lien, and the expected evolution of such value after foreclosure.[600]

1.1.2 The ex-ante valuation (Valuation 2)

1.1.2.1 Objectives and key principles governing the ex-ante valuation

Upon determination that the conditions for resolution or for the exercise of the write-down or conversion powers are met, the SRB in its function as group-level resolution

[598] For more information on the content of a Valuation 1 report, see **SRB Valuation Report** *"for the purpose of Article 20(5)(a) of Regulation (EU) No 806/2017 informing the determination of whether the conditions for resolution or the conditions for the write down or conversion of capital instruments are met ('Valuation 1)"*.

[599] **EBA Final draft Regulatory Technical Standards** "*on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms*", Article 4.

[600] The valuation should also cover:

- instruments measured at fair value, which is defined is defined as price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the valuation date, as defined in the relevant accounting framework (Commission Delegated Regulation 2018/345, Article 1(d)).
- goodwill and intangibles,
- legal disputes and regulatory actions whose expected cash flows may be subject to varying degrees of uncertainty relating to their amount and/or timing, and
- other items, including pension assets and liabilities and deferred tax items.

authority is responsible for the appointment of an independent valuer[601] to conduct a valuation of the banking group's assets and liabilities prior to the adoption of a resolution scheme. In the case of an MPE approach, the SRB may appoint different valuers for each regional resolution group.[602]

This valuation, which is called "ex-ante valuation", assesses the economic value of the group and aims to inform the choice and design of resolution action or the extent of write-down and conversion of capital instruments at the point of non-viability.[603] The ex-ante valuation is based on economic values (present value of future cash flows) rather on accounting and prudential rules, particularly where the resolution strategy provides for the application of the sale of assets within a specific disposal period.

The ex-ante valuation has the following objectives:[604]

- if the conditions for resolution are met, to inform the decision on the appropriate resolution action,
- if the power to write down or convert capital instruments is applied, to inform the extent of the cancellation or dilution of shares and the extent of the write-down or conversion of capital instruments,[605]
- if the bail-in tool is applied, to inform the decision on the extent of the write-down or conversion of eligible liabilities,
- if the bridge institution tool or the asset separation tool is applied, to inform the decision on the assets, rights and liabilities to be transferred and the decision on the value of any consideration to be paid to the banking group under resolution or to its shareholders,
- if the sale of business tool is applied, to inform the decision on the assets, rights, liabilities and shares to be transferred and to inform the SRB's understanding of what constitutes commercial terms under which the transfer should be effected, as well as the value which may be offered for the banking group by a potential buyer under an open, fair and competitive auction process, and
- in all cases, to ensure that any losses on the group's assets are fully recognized at the moment the resolution tools are applied or the power to write down or convert relevant capital instruments is exercised.

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[601] Pursuant to **Article 38 of the Commission Delegated Regulation 2016/1075**, "*a natural or legal person may be appointed as a valuer who must be independent from any relevant public authority and the relevant entity, where all the following conditions must be met:*

- *the valuer possesses the qualifications, experience, ability, knowledge and resources required and can carry out the valuation effectively without undue reliance on any relevant public authority or the relevant entity,*
- *the valuer is legally separated from the relevant public authorities and the relevant entity, and*
- *the valuer has no material common or conflicting interest*."

[602] See **Financial Stability Board (2018b**, p. 12.

[603] **Commission Delegated Regulation 2018/345**, recital (7).

[604] **SRMR**, Article 20(5).

[605] If the Valuation 2 report determines that the going-concern value is zero or negative, the SRB will decide the cancellation or full transfer of shares and write-down of liabilities according to the creditor's hierarchy. On the contrary, if the banking group has positive net asset value the shareholders will be diluted based on the conversion rate of debt to equity.

Another element that differentiates resolution from insolvency is related to the fact that loss absorption in resolution is based on valuation rather than on actual liquidation. Resolution authorities decide based on hypothetical assumptions.[606] The subjective nature of the valuations is amplified by their dependency on macroeconomic and market-related conditions and assumptions that is likely not to occur at final. The ex-ante valuation should apply conservative assumptions on the banking group's future losses to avoid successive rounds of recapitalization that would hurt creditors' confidence in the group concerned.[607] Therefore, the ex-ante valuation should be based on prudent assumptions to exclude the possibility the eventual losses to be determined under the Valuation 3 to exceed the initial bailed-in amount, which is a risk inherent in the resolution process.[608]

The ex-ante valuation should be carried out based on certain principles. Thus, the ex-ante valuation should ensure that it does not assume any potential future provision of any extraordinary public financial support, any emergency liquidity assistance or any central bank liquidity assistance provided under non-standard collateralization, tenor and interest rate terms after the implementation of the resolution action. Furthermore, the ex-ante valuation should take into account that, if any resolution tool is applied, the SRB may recover any reasonable expenses properly incurred from the group under resolution or the SRF may charge interest or fees in respect of any loans or guarantees provided to the group.

An ex-ante valuation should be based on information[609] included, among others, in consolidated financial statements, audit reports, regulatory reporting (e.g. COREP, FINREP) as of a period ending as close as possible to the valuation date, as well as updated draft financial statements and regulatory reporting prepared by the banking group as close as possible to the valuation date.[610]

1.1.2.2 Valuation report

In addition to the principles that must govern the ex-ante valuation, the valuation report must meet also specific requirements, including:

- an analysis and estimate of the market value of the assets and liabilities to facilitate the application of the resolution tools. Thus, an explanation of best point estimate, value ranges and sources of valuation uncertainty are necessary to be included in the valuation report,[611]
- an estimation of the liabilities arising from derivatives carried out in accordance with **Commission Delegated Regulation 2016/1401**, as well as an analysis of the key methodologies and assumptions used by the valuer when performing the valuation, and

[606] See **Grünewald (2017),** p. 291.

[607] See **Avgouleas** and **Goodhart (2015)**, p. 14.

[608] See **Franke, Krahnen** and **Von Lüpke (2014)**, p. 11.

[609] **Commission Delegated Regulation 2018/345**, Article 4.

[610] The ex-ante valuation should be based also on information contained in the records of the group, relevant market data, conclusions drawn by the valuer from discussions with management and auditors, any supervisory assessments of the group's financial condition, industry-wide assessments of asset quality and stress test results.

[611] The assets traded in a liquid and deep market the observable market price should be used, while for the non-tradable assets, the valuer should use either the prices of similar assets or a mark-to-model valuation technique.

- an allocation of the creditors of the parent entity into classes in accordance with the national insolvency ranking and an estimate of the treatment that each class of shareholders and creditors would have received if the group's entities had been wound up under normal insolvency proceedings.

Ideally, this valuation should be completed before the resolution decision is taken by the SRB, but in urgent cases (as is the case for most of the resolution events) this valuation can be completed later, but in any case no later than the determination of the final conversion rates (i.e. definitive valuation).[612] In case that the valuation cannot be performed in accordance with the requirements referred above, mainly as a result of the limited timeframe, a provisional valuation must be carried out.[613]

The provisional valuation should aim to assess the value of assets and liabilities of the banking group[614] and form the basis for the SRB to decide on resolution action or on the exercise of the write-down or conversion power of capital instruments. Given its nature, the provisional valuation should be carried out under conservative assumptions and therefore should include a buffer for additional losses. This buffer should reflect facts and circumstances warranting the existence of additional losses of uncertain amount or timing. To that end, the independent valuer must identify factors that may affect expected cash flows as a result of resolution actions which are likely to be adopted. The valuer may extrapolate losses estimated for a part of the group's assets to the remaining part of the balance sheet.

Such a valuation should be considered provisional until an independent valuer conducts a definitive valuation that is fully compliant with all the requirements referred above. The definitive valuation report must contain an updated balance sheet and a report on the financial position of the banking group concerned, as well as an estimate of the accounting value of the assets. Furthermore, the definitive valuation must include the list of outstanding on-balance-sheet and off-balance-sheet liabilities shown in the books and records of the banking group with an indication of the respective credits and priority of claims.

In the Banco Popular resolution case, the aforementioned information was contained in three (3) documents: the valuation report itself, its annex and an addendum which provided a preliminary assessment of the treatment that shareholders and creditors would have received, if the banking group had been put into liquidation under normal insolvency proceedings.[615]

1.1.2.3 The approach for conducting ex-ante valuations

The valuation conducted by an independent valuer aims to assess the impact on the valuation of each resolution action that the SRB may adopt (e.g. hold vs dispose value, the planned restructuring and any anticipated franchise value).[616] Given the urgency of the circumstances, the SRB may consult with the valuer in order to identify the range of resolution actions being considered, including actions provided for in the resolution plan or in the resolution scheme.[617] This approach was applied in the resolution case of Banco

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[612] See **De Nederlandsche Bank (2017)**, p. 5.

[613] **SRMR**, Article 20(3).

[614] *Ibid.*, Article 20(10).

[615] For more information, see **Deloitte and Single Resolution Board (2017a), Deloitte and Single Resolution (2017b)** and **Deloitte and Single Resolution Board (2017c).**

[616] See **Financial Stability Board (2018b)**, p. 13.

[617] **Commission Delegated Regulation 2018/345**, Article 10(1).

Popular, where the SRB consulted with the independent valuer (Deloitte) on the resolution action it was considering to adopt. Thus, the valuation report prepared by Deloitte assumed the sale of business tool as the preferred resolution tool.

This valuation should estimate the cash flows that may arise from continuing to hold the assets (**hold value**)[618] or when the banking group lacks the ability to hold the assets or their disposal is necessary to meet the resolution objectives, the valuation should reflect the cash flows that may arise from the disposal of assets and liabilities over a defined disposal period (**disposal value**).[619] In the first case, the valuation should give due account to the potential impact of the resolution on future cash flows based on fair, prudent and realistic assumptions as to the rates of default and severity of losses. In addition, the valuer should take into account reasonable expectations for the franchise value[620] in order to determine the post-conversion equity value of shares.[621] The ex-ante valuation should provide an estimate of the post-conversion equity value of new shares transferred or issued as consideration to holders of capital instruments or creditors that have been subject to write-down and conversion powers of the resolution authority. That estimate must form the basis for the determination of the conversion rates in accordance with **Article 50 of the BRRD**.

Depending on the resolution tool to be applied, the valuer may select the most appropriate measurement basis. Where the resolution action provides for the application of the bail-in tool, which means that assets and liabilities will be retained by the banking group concerned, the valuer must use the hold value as the appropriate basis. On the contrary, in case of application of other resolution tools, the expected cash flows must correspond to the disposal values envisaged for the expected disposal horizon. The disposal value will be determined based on the cash flows, net of disposal costs and of the expected value of any guarantees, that the banking group can reasonably expect in the currently prevailing conditions through an orderly sale or transfer of assets and liabilities.[622] Under conservative assumptions, the valuer may determine the disposal value by applying a reduction for a potential accelerated sale discount to the observable market price of that sale or transfer.

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[618] Hold value is defined as "*the present value, discounted at an appropriate rate, of cash flows that the banking group can reasonably expect under fair, prudent and realistic assumptions from retaining particular assets and liabilities, considering factors affecting customer or counterparty behavior or other valuation parameters in the context of resolution*" (Commission Delegated Regulation 2018/345, Article 1(e)).

[619] The disposal value should be understood as equivalent to the observable market price that could be obtained on the market for a particular asset or group of assets and may reflect a discount that is appropriate in view of the amount of assets being transferred. Based on the actions to be taken under the resolution scheme, the valuer should determine the disposal value by applying a reduction to such observable market price for a potential accelerated sale discount. Where the assets do not have a liquid market, the disposal value should be determined by reference to the observable prices on markets where similar assets are traded or to model calculations using observable parameters with discounts for illiquidity reflected as appropriate.

[620] Franchise value is defined as "*the net present value of cash flows that can reasonably be expected to result from the maintenance and renewal of assets and liabilities or businesses and includes the impact of any business opportunities, as relevant, including those stemming from the different resolution actions that are assessed by the valuer. Franchise value may be higher or lower than the value arising from the contractual terms and conditions of assets and liabilities existing at the valuation date*" (Commission Delegated Regulation 2018/345, Article 1(g)).

[621] **Commission Delegated Regulation 2018/345**, recitals (8)-(9).

[622] *Ibid.*, Article 12(5).

The aforementioned approach entails that the selection and application of the bail-in tool implies that the valuer will estimate higher value for the banking group, as the valuation will be conducted on the basis of the hold value approach. Another element that influences the outcome of the ex-ante valuation is related to the availability of data. Since the data which is necessary to conduct a full and credible valuation may not be readily available, the valuer may resort to extrapolation which is likely to increase the magnitude of losses and the level of write-down and conversion of capital instruments and liabilities.

1.1.3 The ex-post valuation (Valuation 3)

Aiming to ensure that the resolution action and the relevant decision will not breach the "no-creditor-worse-off" safeguard, the SRB is obliged to conduct (by appointing an independent valuer) an ex-post valuation to assess whether shareholders and creditors of the parent entity would have received better treatment if the group's entities had entered into normal insolvency proceedings. Resolution allows for preservation of the franchise value of a banking group which is expected to result in smaller losses compared to liquidation under normal insolvency proceedings.[623] Hence, it is not very likely for the ex-post valuation to demonstrate any breach of the "no-creditor-worse-off" principle.

This valuation has as an objective to determine whether there is any difference between the treatment that shareholders or creditors of the parent entity would have received if the banking group had been liquidated under normal insolvency proceedings and the actual treatment that they received as a result of the resolution of the banking group. [624]

With respect to the first objective, the valuer must determine the consideration that shareholders and creditors would have received under normal insolvency proceedings based on the discounted amount of expected cash flows.[625] To that end, the valuer must take into account the applicable insolvency law in the Member State where the parent entity is located which may influence factors, such as the expected disposal period or recovery rates. The valuer must also take into consideration the reasonably expected administration, transaction and financing costs, as well as the information on recent past insolvency cases of similar groups. [626]

As far as the treatment of shareholders and creditors is concerned, the valuer must implement the following steps:[627]

- identify all claims outstanding after the write-down or conversion of capital instruments and the application of any resolution action,

[623] The past resolution cases confirm this claim, as in the Austrian HETA case, valuation estimated a 34% recovery rate under a hypothetical insolvency scenario compared to a 46% recovery rate under resolution. The same holds for the Danish Andelskassen, where hypothetical losses of DKK 142.2m were assumed to be 50% higher than the losses under resolution. For more information, see **Grünewald (2017).**

[624] **SRMR**, Article 20(17).

[625] Expected cash flows shall be discounted at the rate or rates reflecting, as appropriate, the timing associated with expected cash flows, prevailing circumstances as of the resolution decision date, risk-free interest rates, risk premia for similar financial instruments issued by similar entities, market conditions or discount rates applied by potential acquirers and other relevant characteristics of the element or elements being valued ('relevant discount rate'). The relevant discount rate shall not apply where particular rates, if relevant for the purposes of the valuation, are specified in applicable insolvency law or practice (Commission Delegated Regulation 2018/344, Article 4(2).

[626] **Commission Delegated Regulation 2018/344**, Article 4(3).

[627] *Ibid.*, Article 5(2)-(3).

- assign those claims to the legal and natural persons who were the shareholders and creditors of the parent entity at the resolution decision date,
- determine the actual treatment of the shareholders and creditors who received equity compensation as a result of the resolution by providing an estimate of the overall value of shares transferred or issued, and
- determine the actual treatment of shareholders and creditors who received debt compensation as a result of the resolution by taking into account factors such as the changes in contractual cash flows.

This ex-post valuation must ensure that any losses on the assets of the banking group are fully recognized in its books of accounts and inform the decision to write back creditors' claims or to increase the value of the consideration paid. If the ex-post valuation concludes that the net asset value of the banking group under resolution is higher than the estimation of the provisional valuation, the SRB may require the NRA concerned to exercise its power to increase the value of the claims of creditors or owners of relevant capital instruments which have been written down under the bail-in tool or instruct the bridge institution or asset management vehicle to make a further payment of consideration in respect of the assets, rights or liabilities taken from the group's entities under liquidation or their shareholders. [628]

2. Adoption of resolution schemes

2.1 The procedural arrangements for resolution of significant banking groups

2.1.1 Resolution scheme in relation to the parent entity

Resolution of cross-border groups should strike the balance between the need for procedures and arrangements that take into account the urgency of the situation and the need to protect financial stability in all the Member States where the group operates.[629] The existing regulatory framework is still far from meeting these objectives, as it allows the involved resolution authorities to take uncoordinated action in order to preserve their national interests.

Under the BRRD framework, the SRB in its function as group-level resolution authority may decide that the parent entity of a cross-border banking group, which has subsidiaries also in non-participating Member States, meets the conditions for resolution. In this case, the SRB must notify to the ECB (consolidating supervisor) and to the other members of the resolution college its decision for the determination of the group as "failing or likely to fail", as well as the resolution action or insolvency measures that it considers appropriate. Such measures may include the implementation of a group resolution scheme in any of the following circumstances:

- resolution action or other measures taken at parent entity level make it likely that the conditions for resolution would be fulfilled in relation to an entity located in a non-participating Member State,
- resolution action or other measures taken at the parent entity level are not sufficient to stabilize the situation,
- one or more subsidiaries of the parent entity meet the conditions for resolution according to a determination by the NRAs responsible for them, or

[628] **SRMR**, Article 20(12).

[629] **BRRD**, recital (97).

- resolution action or other measures taken at parent entity level will benefit the subsidiaries of the group in a way which makes a group resolution scheme appropriate.

The SRB and the NRAs that are responsible for the subsidiaries located in non-participating Member States may reach a joint decision on the group resolution scheme. To that end, the EBA may provide assistance to reach a joint decision in the form of **non-binding mediation** under **Article 31(c) of the EBA Regulation**.[630]

The group resolution scheme has the following objectives:

- to outline the resolution measures that will be taken in relation to the parent entity and other group's entities,
- to specify how these measures will be coordinated, and
- to set out a financing plan for covering resolution costs in a mutualized way pursuant to **Article 107 of the BRRD**.

In case that an NRA disagrees with or departs from the group resolution scheme proposed by the SRB or considers appropriate to take independent resolution action in relation to an entity under its remit, it must provide explanations to the other members of the resolution college for its decision and inform them of the actions that is going to take. The members of the resolution college which do not disagree with the group resolution scheme may reach an agreement for the scheme covering the entities located in their jurisdictions. [631]

Where the SRB and NRAs participating in the resolution college fail to reach a joint decision on the group resolution scheme, the SRB takes its decision in relation to the parent entity, after consulting the resolution college members. If a group resolution scheme is not adopted, resolution authorities concerned must cooperate closely within the resolution college to ensure a coordinated resolution strategy for all affected group's entities.

Consequently, the framework governing cross-border resolution of banking groups does not exclude the possibility for resolution authorities to take unilateral action to deal with a failing group. This option is further enhanced from the fact that the EBA may mediate in case of disagreement only in a non-binding way.

2.1.2 Resolution scheme in relation to subsidiaries

If an NRA of non-participating Member State decides that an entity belonging to a banking group meets the conditions for resolution, it may take resolution action with respect to that entity. In that case, the NRA concerned must notify this determination to the SRB (group-level resolution authority), the ECB (consolidating supervisor) and the other members of the resolution college. Furthermore, the NRA must notify the resolution actions which it considers appropriate to take.[632]

Upon receipt of the notification referred above, the SRB must assess the likely impact of the resolution measures that the NRA intends to take on the other group's entities and whether it would make it likely to trigger the resolution conditions for entities located in

[630] *Ibid.*, Article 92(3).

[631] *Ibid.*, Article 92(5).

[632] *Ibid.*, Article 91(1).

participating Member States.[633] With respect to the latter, in case of positive assessment, the SRB must submit -within 24 hours- a resolution scheme to the resolution college.

The resolution scheme must be adopted via a joint decision taken by the SRB and the NRAs which are responsible for the subsidiaries covered by the group resolution scheme.[634] Any of the involved resolution authorities may request the EBA to assist in reaching a joint decision in a **non-binding way** under **Article 33(c) of the EBA Regulation**.[635]

However, where a resolution authority disagrees with the group resolution scheme proposed by the SRB or considers that it is necessary to take independent resolution action for reasons of financial stability, it must notify the other resolution authorities in relation to the reasons for the disagreement and the measures it intends to take. The other resolution authorities participating in the resolution college may take a joint decision on a group resolution scheme that covers the group's entities under their remit.[636]

Thus, NRAs remain competent for taking resolution action in relation to entities belonging to banking groups, where a group resolution scheme is not adopted. Hence, the BRRD does not preclude the possibility for resolution authorities to adopt unilateral resolution action with respect to a subsidiary located in their jurisdiction, setting aside the objective of ensuring financial stability and promoting internal market.

2.2 The conditions for resolution

2.2.1 The "failing or likely to fail" criterion

2.2.1.1 Criteria for the determination of banking groups as "failing or likely to fail"

A determination that a banking group is "failing or is likely to fail" is one of the (three) conditions for resolution, which if cumulatively met, trigger the resolution procedure. Under that procedure, the SRB decides whether the group will be put into resolution or will be liquidated under normal insolvency proceedings. In addition, the "failing or likely to fail" criterion is one of the two cumulative conditions determining that a banking group is unviable which necessitates the exercise of the write-down and conversion powers in relation to capital instruments under **Article 60 of the BRRD** (see below, under **2.3**).

The decision whether a banking group is "failing or is likely to fail" is taken based on an assessment of qualitative and quantitative information concerning the viability of the group, including the outcome of the SREP. The ECB should make that determination also based on the outcome of the application of supervisory (Pillar II) and early intervention measures, the implementation of recovery options, as well as the results of the ex-ante valuation of the banking group's assets and liabilities.

Taking into consideration the aforementioned elements, the ECB may conclude that a group is "failing or is likely to fail", when one of the following criteria is met:

a. the banking group infringes, or in the near future is likely to infringe, the applicable prudential requirements making unavoidable the withdrawal of its banking license,

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[633] *Ibid.*, Article 91(2),

[634] The organizational and procedural arrangements related to the joint decision process to adopt group resolution schemes are specified in **Articles 97-109 of the Commission Delegated Regulation 2016/1075**.

[635] **BRRD**, Article 91(7).

[636] *Ibid.*, Article 91(8).

including the case that the group has incurred or is likely to incur losses that will deplete all or significant amount of its capital,

b. the assets of the banking group are less than its liabilities or in the near future is likely to be less,

c. the banking group is unable to pay its debts or other liabilities as they fall due or in the near future this is likely to happen,

d. extraordinary public financial support is required except where that support takes any of the following forms aiming to preserve financial stability:

   i. a State guarantee to back liquidity facilities provided by the ECB's standard monetary policy operations,

   ii. a State guarantee of newly issued liabilities, or

   iii. a capital injection or purchase of capital instruments at prices and on terms that do not confer an advantage upon the banking group. That capital injection must be confined to injections necessary to address capital shortfall identified in the context of an adverse scenario of a stress-test conducted by the EBA (Union-wide stress-test) or the ECB (SSM-wide stress-test).

With regard to the cases referred to in points (i), (ii), (iii) of point d), these measures must be taken only in respect of solvent banking groups and must be conditional on final approval under the Union State aid framework. Furthermore, those measures must be of a precautionary and temporary nature.

Since the entry into force of the SRMR, the ECB has determined four (4) banking groups as "failing or likely to fail". In the cases of Banco Popular (Spain) and ABLV (Latvia), the ECB made that determination on the basis of the criterion that "*there are objective elements indicating that the banking group is likely in the near future to be unable to pay its debts or other liabilities as they fall due*".[637] With respect to Banca Popolare di Vicenza (Italy) and Veneto Banca (Italy), the ECB's determination was based on the fact that the two (2) banking groups "*infringe the requirements for continuing authorization in a way that would justify the withdrawal of the authorization*", since both banking groups had breached the respective SREP capital requirements.[638]

In the case of ABLV, the ECB decided to determine as "failing or likely to fail" both the parent entity (ABLV Bank) and its subsidiary in Luxemburg (ABLV Bank Luxembourg), though the latter had very good capital and liquidity performance (capital adequacy ratio exceeding 29% versus the legal requirement of 10.5% and an LCR ratio of 383% versus the minimum requirement of 100%) and a healthy balance sheet.[639] However, on 9 March 2018, the Luxemburg Commercial Court rejected the request from the Commission de Surveillance du Secteur Financier (NSA of Luxemburg) to place the domestic subsidiary in liquidation under normal insolvency proceedings due to the fact that the (good)

[637] On the ECB's assessment on the "failing or likely to fail" situation of Banco Popular, see **ECB** '*Failing or Likely to Fail' Assessment of Banco Popular Espanol.*

[638] On the ECB's assessment on the "failing or likely to fail" situation of Veneto Banca and Banca Popolare di Vicenza, see **ECB** *'Failing or Likely to Fail' Assessment of Veneto Banca Societa per Azioni* and **ECB** *'Failing or Likely to Fail' Assessment of Banca Popolare di Vicenza Societa per Azioni*.

[639] For more information on the financial situation of the ABLV Bank Luxemburg and the decision of the Luxemburg Commercial Court, see: https://www.ablv.com/en/press/2018-03-09-the-court-recognises-the-soundness-of-ablv-bank-luxembourg-s-a-which-can-now-be-sold-to-new-investors

financial situation of the entity did not warrant its determination as "failing or likely to fail" and, hence, its liquidation under normal insolvency proceedings. Based on the court decision, the Commission de Surveillance du Secteur Financier ought to terminate its activity as the temporary administrator of ABLV Bank Luxembourg. The court appointed two (2) external administrators to find new investors for the entity.[640]

The ABLV case made clear that the determination of a banking group as "failing or likely to fail" should not mean that all the group's entities have to be liquidated under normal insolvency proceedings, where the "public interest criterion" is not met. This applies to entities that have met the supervisory requirements and have the financial capacity to continue operating on a stand-alone basis.

2.2.1.2 The SREP assessment as a basis for the "failing or likely to fail" criterion

In the SREP assessment, the ECB is focused on the assessment of banking groups' viability and places emphasis on the risks to capital and liquidity to which groups are exposed, as well as on their business model and governance arrangements. The ECB (or the SRB as the case may be) assess these elements relating to the viability of banking groups also in the context of the "failing or likely or fail" determination. In particular, the ECB assesses the capital and liquidity position of banking groups and any other prudential requirements with which banking groups must comply.

In addition to the aforementioned elements, the ECB gives due account to the fact that the banking group has activated its recovery plan and the implementation of the recovery options failed to produce the expected results and restore the breached recovery indicator to the appropriate level. The ECB may also make the "failing or likely to fail" determination if a notification has been sent by the management body of the parent entity, which states that the group is "failing or is likely to fail", as occurred in the case of Banco Popular in June 2017.

The ECB may make a "failing or likely to fail" determination based on the outcome of the overall SREP assessment. Based on the SREP assessment, the ECB may determine a banking group as "failing or likely to fail" if:[641]

- an overall SREP score of 'F' is assigned to the group, or
- an overall SREP score of '4' is assigned to the group and the latter fails to comply with the supervisory (Pillar II) measures or early intervention measures taken by the ECB.

The SRB is also entrusted with the task to make such a determination. As applies to the ECB, the SRB may take such a decision based on objective elements concerning banking groups' capital and liquidity position and compliance with other prudential requirements. Making that determination is barely feasible for the SRB, given the limited information that the SRB has at its disposal, which mainly comes from the ECB. In any case, the ECB should provide the SRB with the outcomes of the SREP, at least every time that the ECB assigns to the group a SREP score of 'F' or '4', along with the appropriate documentation.[642]

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[640] *Ibid*.

[641] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par. 31.

[642] This documentation includes:

- a summary of the overall SREP assessment together with all SREP scores,
- the full set of indicators used in the regular monitoring in the course of SREP,

However, since most of these elements fall within the supervisory scrutiny it is reasonable to expect that the ECB will identify first any deterioration of the financial position of the banking group and will make that determination before the SRB.

The standard process applied to cross-border banking groups, which provides for discussion and coordination of the SREP outcomes within the framework of the resolution college, does not apply to that case. Thus, if the ECB considers necessary to assign a SREP score of 'F' to a banking group, it should engage with the SRB towards taking a decision for resolution action without prior discussion or coordination within the resolution college. This arrangement is reasonable given the exceptionally short timeframe that the ECB has to react and address the crisis situation.

Assessment of the capital position of the banking group

However, this "ordinary" SREP process does not prevent the ECB from determining a banking group as "failing or likely to fail" upon occurrence of an event amidst the SREP cycle, which deteriorates drastically its financial situation. Usually, several factors, rather than one, contribute to the determination of a banking group as "failing or is likely to fail". However, there may be cases where just one factor may be so severe to trigger resolution action. This applies mainly to capital- or liquidity driven events.

From a capital perspective, the ECB may determine that a banking group is "failing or is likely to fail", if:

- there are objective elements demonstrating that the group in the near future will infringe its minimum capital requirements (i.e. Total SREP Capital Requirement) because it has incurred or is likely to incur losses that will deplete all or a significant amount of its capital, or
- the assets are less than the liabilities.

To that end, the ECB puts emphasis on the following elements to formulate its determination on whether the banking group is "failing or is likely to fail":[643]

- the level and composition of capital held by the group and whether it meets the minimum capital requirements,
- the results of an asset quality review carried out at Union/SSM/national level, which may reveal significant decrease in asset value leading to infringement of capital requirements,
- the results of any valuation to inform whether the conditions for resolution are met (Valuation 1),
- the results of any other group-specific assessment of the value of its assets and liabilities, which has been prepared either by an independent valuer or the SRB, in accordance with the valuation methodology established under **Article 36 of the BRRD**, and which supports that the assets of the group are less than its liabilities (or this is likely to occur in the near future).

- all details on the applied supervisory (Pillar II) measures and early intervention measures, as well as a description of the group's compliance with them, and
- details on the implementation of recovery options, where applicable, and the results.

[643] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par. 20.

In addition to these key elements, the ECB should consider supplementary elements to conclude whether the capital position of a banking group has severely deteriorated.[644] Nonetheless, these elements cannot lead the ECB to conclude that a banking group is "failing or is likely to fail" but should rather be taken into account as supplementary evidence of the deteriorating financial situation of the group.

Assessment of the liquidity position of the banking group

A banking group may be determined as "failing or likely to fail" not only due to insolvency, but also as a result of illiquidity reflected in a determination that in the near future it will **infringe regulatory liquidity requirements** (Pillar I and Pillar II liquidity requirements) or be **unable to pay debts and liabilities as they fall due**. [645]

Such a determination can be made based on objective elements, including:

- significant adverse developments affecting the evolution of the group's liquidity position and sustainability of its funding profile,
- significant permanent adverse evolution of the group's liquidity buffer and counterbalancing capacity,[646]

[644] Such supplementary elements pertain to:

- threats to group's capital position and viability stemming from a significant non-temporary increase in the cost of funding to an unsustainable level, which is likely to corrode its capital base,
- the likely materialization of the group's significant off-balance sheet items (e.g. guarantees, undrawn credit commitments) in the near future, which may cause significant loss of capital and threaten group's viability,
- significant adverse developments in the macro-economic environment that could threaten the group's capital position, including sharp change of nominal interest rates, drop of real estate values and economic recession. Such developments should significantly impact in an adverse manner the profitability, capital position and viability of the group,
- significant deterioration of the market perception for the banking group reflected in indicators supporting that the solvency of the group is severely impaired and its capital position threatened, as shown in a drop of the price-to-book level or a rapidly increasing level of leverage (i.e. the economic leverage measured as the ratio of total assets to market value of equity), and
- a significant permanent deterioration in the absolute and relative evolution of market indicators, such as equity-based indicators (e.g. share price and book-to-market equity ratio) and market-based indicators (e.g. credit default swaps and subordinated debt spreads), which reflect the increased possibility for the group to incur losses that could threaten its capital position.

[645] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par. 23.

[646] The assessment of the counterbalancing capacity dynamics should consider:

- highly probable liquidity inflows, including received committed credit and liquidity lines,
- any forecasted contractual inflows,
- the capacity to renew funding (including tenors and type of instruments of the new financing),
- the access to long term funding, and
- extraordinary and large reduction or termination of liquidity lines from counterparties.

- permanent increase in the cost of funding to an unsustainable level, reflected in the increase of the spread of secured and unsecured financing compared to peers,
- significant adverse evolution of the group's current and future obligations,[647] and
- developments that could severely impair the group's reputation, in particular significant rating downgrades if they trigger substantial deposit outflows or loss of access to interbank market.

The ECB may consider additional elements as supporting evidence to conclude whether the liquidity position of the group has severely deteriorated.[648]

Assessment of the group's compliance with other prudential requirements

The breach of the prudential requirements set out in the CRR and the CRD IV is definitely a reason for the ECB to determine a banking group as "failing or likely to fail". For this purpose, the ECB should consider whether there are material weaknesses in the governance arrangements, as well as in the group's operational capacity, and whether these weaknesses have significant impact on its capacity to provide banking services.

Deficiencies related to governance arrangements along with other objective elements pertaining to capital and liquidity may lead to the determination that the banking group is "failing or is likely to fail". Such deficiencies include:[649]

- significant misstatements in regulatory reporting or financial statements, especially resulting in a refusal of opinion or provision of a qualified opinion by the external auditor,
- a prolonged deadlock in the parent entity's management body which leads to inability to take critical decisions, or
- an accumulation of material deficiencies in key areas in the governance arrangements, which together have material negative prudential impact on the banking group.[650]

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[647] The evolution of current and future obligations may be affected by:

- expected and exceptional outflows of liquidity, including requests for margin calls and/or early redemption of liabilities,
- expected and exceptional collateral requirements, as well as the evolution of haircuts on collateral by central counterparties, and
- any contingent obligation, including those arising from granted credit and liquidity lines.

[648] Such additional elements include:

- significant adverse developments in the macro-economic environment that could threaten the group's liquidity position, including sharp change of nominal interest rates, drop of real estate values and economic recession, and
- significant deterioration in the market perception of the group reflected in permanent deterioration of the absolute and relative evolution of market indicators, such as equity-based indicators (e.g. share price and book-to-market equity ratio) and market-based indicators (e.g. credit default swaps and subordinated debt spreads), which reflects the increased possibility for the entity to face liquidity problems.

[649] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par. 28.

[650] Such material deficiencies, which in combination can have a material negative prudential impact on the banking group, include:

A banking group may face significant challenges to provide banking/investment services, even if there is no breach of capital and liquidity requirements. Such challenges may arise in the event of negative circumstances including:[651]

- the group's ability, due to persistent operational constraints, to meet its obligations towards its creditors,
- the group's inability to make or receive payments and to carry out banking activities due to operational constraints, and
- the loss of confidence from the market and depositors due to operational risks resulting in group's inability to conduct its business activities.

2.2.1.3 Information exchange between the ECB and the SRB in a "failing or likely to fail" situation

Timely flow of information between the ECB and the SRB is prerequisite for ensuring timely and reliable determination that a banking group is "failing or is likely to fail". As far as the ECB is concerned, it is required to inform the SRB about its determination that the conditions for application of the early intervention measures have been met or any decision to take supervisory (Pillar II) measures.[652] The ECB must inform also the SRB on its decision to take crisis prevention measures, such as the appointment of temporary administrator to the banking group or on its determination that the banking group concerned is in a "failing or likely to fail" situation.[653]

On the other side, the SRB should inform the ECB on its decision to exercise its power to require a banking group to contact potential purchasers in order to prepare for the resolution of the group in accordance with **Article 27(2) of the BRRD** and its decision

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- inadequate strategic planning and formalization of risk tolerance/appetite and risk management framework, leading to the inability to identify, manage and report the risks to which the banking group is or might be exposed,
- material weaknesses, deficiencies or issues that were not properly and/or in a timely manner reported to the management body,
- inadequate internal control mechanisms,
- major reputational depreciation resulting from the non-compliance with 'fit and proper' criteria of individuals with key functions in the banking group,
- major reputational depreciation arising from a lack of transparency in the conduct of business and operations or incomplete/inaccurate disclosure of information,
- major litigation or disputes in the nomination and succession of individuals performing key functions in the banking group, and
- major non-compliance with remuneration requirements.

[651] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par. 30.

[652] **BRRD**, Article 81(2).

[653] When the management body of the parent entity of a banking group assesses that the group's financial difficulties are so severe that the group should be determined as "failing or likely to fail", it must notify the ECB accordingly. Then, the ECB must inform the SRB with respect to that notification. This procedure was applied in the case of the Banco Popular, where the management body of the banking group notified the ECB on its assessment triggering, thus, the resolution procedure that led to the resolution of the banking group.

to request for an ex-ante valuation to be carried out by an independent valuer or to conduct the provisional valuation on its own under **Article 36 of the BRRD**. [654]

Following the determination by the ECB and the SRB that a banking group is "failing or is likely to fail" and that no alternative measures can prevent the group from failure, the supervisory authority and the resolution authority of any subsidiary or branch of the banking group in non-participating Member States must be notified. Furthermore, the relevant information must be communicated to the national central banks, the DGSs, the competent ministries (i.e. typically the ministry of Finance) and the national macroprudential authorities (where different from the central bank) of the participating and non-participating Member States in which the banking group has presence. [655]

Articles 45-49 of the Commission Delegated Regulation 2016/1075 set out detailed and specific arrangements concerning notifications prior and during the resolution procedure.

2.2.2 The "alternative private sector measures" criterion

Following the determination that a banking group is "failing is likely to fail", typically the SRB (or in exceptional circumstances the ECB) should determine whether there are alternative measures which could prevent the failure of the group within a reasonable timeframe. Such alternative measures pertain to **private sector measures** and **supervisory measures.**

The **private sector measures** may include:

- private sale of the whole group to address financial deterioration of its financial situation,
- capital increase or sale of subsidiaries to deal with a capital shortfall,
- raising liquidity through regular market transactions, the ECB's monetary policy operations under standard or extraordinary policy operations, or Emergency Liquidity Assistance (ELA), or
- any other measure provided for in the group recovery plan.

The **supervisory measures** may include:

- Pillar II measures in accordance with **Article 104 of the CRD IV**,
- early intervention measures pursuant to **Articles 27-29 of the BRRD**, or
- write-down and conversion into equity of capital instruments under **Article 59 of the BRRD**.

If the SRB assesses that none of the measures referred above is sufficient to prevent the failure of the banking group within a reasonably (short) timeframe, then the second resolution condition is met.

2.2.3 The "public interest" criterion

For the purpose of determining whether resolution action serves the public interest, the SRB decides whether resolution action or liquidation under normal insolvency proceedings meets to a larger extent the resolution objectives (see below, under **2.4**). To that end, the SRB assesses the credibility of the liquidation of the entities constituting the

[654] **EBA Guidelines** "*on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU*", par.42.

[655] **BRRD**, Article 81(3).

group under normal insolvency proceedings, which is the default option for dealing with banking failures. The SRB followed this approach in its resolution decisions for Banco Popular, Vento Banca and Banca Popolare di Vicenza.[656] In the case of Banco Popular, the SRB determined that:

i. *"resolution action is necessary for the achievement of, and is proportionate to the following resolution objectives: i) to ensure the continuity of critical functions; and ii) to avoid significant adverse effects on financial stability, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline, and*

ii. *winding up of the Institution under normal insolvency proceedings would not achieve the above resolution objectives to the same extent as resolution action*".

The regime of insolvency proceedings applicable in each Member State plays a major role in that determination, as shown in the case of Banca Popolare di Vicenza and Veneto Banca, where the relevant national law allowed the transfer of assets, rights and liabilities of the failed banking groups to a private sector purchaser (Intesa SanPaolo) limiting thus the adverse impact on national economy and financial system.[657] Only if the national regime governing insolvency proceedings is less favourable in relation to the achievement of resolution objectives, the SRB can decide that resolution action is in the public interest.[658]

The cases of Banca Popolare di Vicenza and Veneto Banca showed that the lack of harmonization of the national regimes for liquidation of groups' entities under normal insolvency proceedings may provide a leeway to circumvent the resolution framework. The significance of this loophole of the regulatory framework is analyzed in detail in **Chapter C, Section 2**, under **3.1**.

[656] For more information on the determination of the "public interest criterion", see **SRB Decision** of the Single Resolution Board in its Executive Session of 7 June 2017 "*concerning the adoption of a resolution scheme in respect of Banco Popular, S.A., (the "Institution") with a Legal Entity Identifier: 80H66LPTVDLM0P28XF25, Addressed to FROB*", pp. 11-19, **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution"), with the Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority*", (SRB/EES/2017/11), pp. 11-21 and **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Banca Popolare do Vicenza S.p.A. (the "Institution"), with the Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority*", pp. 11-21.

[657] For a more detailed analysis of the Compulsory Administrative Liquidation applicable to Italian institutions, see **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Banca Popolare do Vicenza S.p.A. (the "Institution"), with the Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority*", pp. 3-5.

[658] For more information on the public interest criterion and potential infringements of rights of shareholders and creditors, see **Binder (2017)**.

2.3 Write-down and conversion of capital instruments

2.3.1 Conditions and procedure related to write-down or conversion of capital instruments of the parent entity

The SRB may decide to write down or convert capital instruments of the parent entity of a banking group, where it assesses, either on its own initiative or upon receiving an assessment made by the ECB, that one or more of the following conditions are met:[659]

a. the conditions for resolution have been met, before any resolution action is taken,

b. the parent entity will no longer be viable, unless its capital instruments are written down or converted into equity, where these instruments are recognized for the purposes of meeting capital requirements on an individual and consolidated basis,

c. the banking group will no longer be viable, unless the capital instruments issued by a subsidiary are written down or converted into equity, where these are recognized for the purposes of meeting capital requirements on an individual and on a consolidated basis,

d. extraordinary public financial support is required by the group, apart from the case that the capital shortfall arises from an adverse scenario of a stress-test exercise.

The SRB in its executive session may make an assessment that a banking group is no longer viable, only after informing the ECB of its intention and only if the ECB does not make such an assessment within three (3) days. In that context, a banking group is considered as non-viable, only if the following two (2) conditions are met. Firstly, the **group is "failing or likely to fail"**, namely the group infringes or is likely to infringe in the near future the consolidated prudential requirements in a way that would justify action by the ECB, including the case that the group has incurred or is likely to incur losses that will deplete all or a significant amount of its capital. Secondly, there is **no reasonable prospect that any action**, including alternative private sector measures or supervisory action (including early intervention measures), **would prevent the failure of the group**, except for the case of the exercise of the write-down or conversion powers in respect of capital instruments, independently or in combination with resolution action.[660]

Thus, a banking group reaches the point of non-viability when it meets the first two (2) conditions for resolution (i.e. the "failing or likely to fail" criterion and the "no alternative private sector measures" criterion) and the SRB determines that it will cease to be unviable with the application of the write-down and conversion of capital instruments. Under the procedure described in **Article 18 of the SRMR** (see above in **Chapter A, Section 2**, under **4.2.1**), the SRB takes a decision to instruct the NRA concerned to exercise the write-down or conversion powers, or alternatively called "mild bail-in",[661] in accordance with **Articles 59 and 60 of the BRRD**.

Before exercising the write-down or conversion powers, the NRA must conduct an ex-ante valuation pursuant to **Article 20 of the SRMR** to calculate the level of write-down or conversion to be applied to capital instruments. The SRB must ensure that the NRA exercises the write-down or conversion powers in a way that produces the following results. In particular, CET1 instruments are reduced first in proportion to the losses and to the extent of their capacity. Then, the principal amount of Additional Tier 1 instruments is written down or converted into CET1 instruments or both, to the extent

[659] **SRMR**, Article 21(1).

[660] *Ibid.*, Article 21(3).

[661] See **Freudenthaler (2017)**, p. 101.

required to achieve the resolution objectives or to the extent of the capacity of the relevant capital instruments, whichever is lower.[662] Lastly, the principal amount of Tier 2 instruments is written down or converted into CET1 instruments or both, to the extent required to achieve the resolution objectives or to the extent of the capacity of the relevant capital instruments, whichever is lower.

The reduction of the principal amount of capital instruments must be permanent, with only exception the write-up mechanism provided for in case that the ex-post valuation shows that holders of those capital instruments incurred greater losses than would have incurred in insolvency.

2.3.2 Write-down and conversion of capital instruments issued by subsidiaries located in non-participating Member States

Specific arrangements apply to the write-down and conversion of capital instruments issued by entities being under the remit of the appropriate authority (i.e. Member States may assign this power either to the supervisory authority or resolution authority) of non-participating Member States.[663] According to **Article 62(1) of the BRRD**, before the appropriate authority determines that it is necessary to write down or convert capital instruments issued by a subsidiary and which are used to meet capital requirements on an individual and consolidated basis, it must notify without undue delay the ECB (consolidating supervisor) and the SRB. Following that notification, the appropriate authority, after consulting the authorities notified, must assess the following matters:[664]

- whether alternative measures (e.g. Pillar II measures, early intervention measures or transfer of funds or capital from the parent entity to the subsidiary) are available,
- if such measures can feasibly be applied, and
- if such measures could offer a realistic prospect to prevent the failure of the entity in an adequate timeframe.

Should the appropriate authority conclude that such measures can feasibly be applied and prevent the failure of the entity, it has to notify the SRB and the appropriate authorities of other non-participating Member States and make every effort to reach a joint decision.[665] If no joint decision is reached, the write-down or conversion of capital instruments cannot be applied. On the contrary, if the appropriate authority assesses that

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[662] Capital instruments can be converted into CET1 instruments where the following conditions are met:

- the CET1 instruments are issued by the parent entity with the agreement of the relevant resolution authority,
- the CET1 instruments are issued prior to any issuance of shares by that entity for the purpose of provision of capital by the government,
- the CET1 instruments are awarded and transferred without delay following the exercise of the conversion power, and
- the conversion rate that determines the number of CET1 instruments is in line with the provisions set out in **Article 50 of the BRRD**.

[663] In accordance with **Article 61(2) of the BRRD**, each Member State must designate the national supervisory authority or the national resolution authority as the appropriate authority to determine whether it is necessary to write down or convert capital instruments.

[664] **BRRD**, Article 62(4).

[665] *Ibid.*, Article 61(8).

there are no measures that can prevent the failure of the entity, it can decide whether it is appropriate to proceed to write-down or conversion of capital instruments.

2.4 Resolution objectives

2.4.1 Resolution objective No. 1: Ensuring continuity of critical functions

The SRB assesses whether the banking group concerned performs activities and provides services whose discontinuance is likely to lead to the **disruption of services that are necessary for the national economy or the Union economy** or the **disruption of the financial stability at national or EU level**.[666] Typically, this resolution objective is the most critical for the determination of whether resolution action meets the "public interest criterion". In particular, this criterion is met if the SRB determines that the critical functions of the banking group (e.g. deposit-taking, lending, payment services) are provided to a large or limited number of third parties and cannot be replaced within a reasonable timeframe by other market participants. For that assessment, the SRB is based on the outcome of the annual resolution planning cycle, as referred above in **Section 2**, under **1.1.2.2**, except if the relevant figures have changed significantly in the meantime.

The SRB may consider that resolution action is in the public interest, where the disruption of the deposit-taking function of the banking group could undermine the general confidence of market participants or give rise to contagion (i.e. bank runs in the whole banking system). Moreover, in case that liquidation under normal insolvency proceedings implies activation of the national DGS, the SRB must assess whether the available funding means of the DGS are sufficient to cover the compensations due to covered depositors. Should the DGS have not such capacity, the SRB has no option than to conclude that resolution action is necessary for the public interest.

2.4.2 Resolution objective No. 2: Avoiding significant adverse impact on financial stability

Resolution action is necessary upon determination that the liquidation of a banking group's entities would result in significant adverse impact on the financial stability of the Member States. Protection of financial stability is the core objective of resolution action.[667] The SRB may come to that conclusion, after taking into account:[668]

- the size of the banking group in terms of assets and market share,
- whether the banking group has been classified as systemically important at domestic level (O-SII), and
- the level of financial and operational interconnectedness with other financial institutions, as a high degree of interconnectedness is likely to result in spill-over effects.[669]

[666] **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Banca Popolare do Vicenza S.p.A. (the "Institution"), with the Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority*", p. 12.

[667] See **Psaroudakis (2018)**, p. 5.

[668] **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution"), with the Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority*", (SRB/EES/2017/11), p. 16.

[669] The SRB assesses, among others, whether the banking group's entry into normal insolvency proceedings will threaten its access to FMIs, mainly payment and clearing systems. For that

With respect to the latter point, the SRB examines if the liquidation under normal insolvency proceedings would give rise to direct or indirect contagion to the domestic banking system. Direct contagion may arise if other banking groups bear losses due to holdings of bonds issued by the banking groups concerned or provision of funding to that group. Indirect contagion may happen as a result of the rise of subordinated and senior bond yields, which may create problems to the access of other banking groups to capital markets.[670]

2.4.3 Resolution objective No. 3: Protecting public funds by minimizing reliance on extraordinary public financial support

When the SRB decides on the public interest criterion, it assesses also whether resolution action requires the use of extraordinary public financial support either in the form of government financial stabilization tools or through the use of the SRF. Should this happen, resolution action does not meet this resolution objective, which entails that liquidation outweighs over resolution action.

In addition, the SRB examines if the liquidation of a group's entities requires the use of the available funding means of the DGS concerned. In accordance with **Article 11(3) of the DGSD**, it is at Member States' discretion to introduce in national law a provision that allows the DGS to finance the transfer of assets and liabilities of the parent entity of a banking group to a purchaser, where no resolution action has been taken. This case falls within the scope of State aid rules (subject to Commission's approval) and, therefore, the SRB must assess whether not taking resolution action may result in the use of extraordinary public financial support in the form referred above.

2.4.4 Resolution objective No. 4: Protecting covered depositors and investors covered by the Directive 97/9/EC

In accordance with the BRRD, depositors and investors falling within the protection of the DGSD and the Directive 97/9/EC[671] respectively are not affected by resolution action. Typically, the same applies to the case of liquidation under normal insolvency proceedings, provided that the DGS concerned has sufficient available financial means to pay the compensations required. Furthermore, under extraordinary circumstances a Member State (as is the case for Italy) may allow for the possibility to transfer assets and liabilities (including covered deposits) to a private sector purchaser ensuring that this resolution objective will be met, even under a liquidation process.[672]

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purpose, the SRB assesses if the group participates in FMIs which provide only liquidity or credit against collateral or in FMIs which run credit or liquidity risks due to the participation of the entity.

[670] **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution"), with the Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority*", (SRB/EES/2017/11), p. 16.

[671] Directive 97/9/EC lays down the obligation for Member States to establish investor-compensation schemes which must compensate investors who entrusted money or financial instruments to an institution that has been unable to return credits or financial instruments belonging to investors due to being subject to insolvency proceedings. The fund compensates each investor with an amount not less than €20.000, as it is at Member State's discretion to set a higher level of coverage.

[672] **SRB Decision** of the Single Resolution Board in its Executive Session of 23 June 2017 "*concerning the assessment of the conditions for resolution in respect of Banca Popolare do*

With respect to protection of investors, the BRRD does not require the resolution authority to transfer the money and financial instruments held by the parent entity of a banking group to another purchaser under the sale of business tool or bridge institution tool. It is at the resolution authority's discretion to decide on this issue. However, given that the potential purchaser would most likely have no interest to obtain such liabilities, the relevant investors are likely to be left to the residual entity. In that case, investors will be indemnified in the same manner as applies to normal insolvency proceedings, which means that both options provide the same level of protection for investors.[673]

2.4.5 Resolution objective No. 5: Protecting client funds and client assets

Financial instruments and money belonging to clients must be kept separate from the parent entity's assets as well as from other clients' assets. The creditors of the parent entity cannot claim these customers' assets, neither the group can use these assets for rehypothecation.[674] In case of resolution action (i.e. sale of business tool or bridge institution tool), client funds and client assets could be protected by being transferred to the purchaser. However, even in the case that client funds and assets are not transferred to the purchaser or to the bridge institution and are left behind in the residual entity, they would enjoy the same level of protection as in case of normal insolvency proceedings.

2.5 Appointment of special manager to banking groups under resolution

The resolution scheme adopted by the SRB may require the NRA of the Member State where the parent entity is located to appoint a special manager to replace the management body of that entity. The special manager will have all the powers of the shareholders and the management body of the entity concerned.[675] The NRA should appoint for this position a person with the necessary qualifications, skills and expertise required to carry out its tasks. The main task assigned upon the special manager pertains to taking all the necessary measures to achieve the resolution objectives and implement the resolution scheme. In that context, the special manager may take various measures, including capital increase, reorganization of the ownership structure of the group or completion of takeover of the group's business lines by other entities.[676]

The special manager must act in line with the guidance provided by and under the control of the NRA. For that purpose, at regular intervals the special manager must submit to the NRA reports on the financial situation of the banking group and on the actions performed. The NRA may limit the actions of the special manager or require the special manager to obtain its prior consent before taking specific action.[677] In extreme cases, the NRA may decide to remove the special manager from the administration of the banking group, before the expiry of its term, which is one (1) year (renewable under exceptional circumstances).

In case of banking groups with entities both in participating and non-participating Member States, where the SRB and any of the NRAs from non-participating Member States intend to appoint special manager to the entities under their remit, they may

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Vicenza S.p.A. (the "Institution"), with the Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority", p. 19.

[673] *Ibid.*, p. 20.

[674] *Ibid.*, p. 20.

[675] **BRRD**, Article 35(1).

[676] *Ibid.*, Article 35(3).

[677] *Ibid.*, Article 35(4).

consider whether it is appropriate to appoint the same special manager to all the group's entities.[678]

3. Implementation of resolution action

3.1 Resolution tools

3.1.1 The sale of business tool

3.1.1.1 Key principles for the implementation of the sale of business tool

Under the sale of business tool, the SRB may decide that the NRA of the Member State where the parent entity concerned is located must transfer to a private sector purchaser that is not a bridge institution shares issued by the entity concerned and all or any of its assets, rights or liabilities.[679] Under the sale of business tool, the SRB is expected to transfer to the private sector purchaser the subsidiaries of the parent entity, as is case for Banco Popular whose subsidiaries-credit institutions (i.e. Banco Pastor, Popular Banca Privada, Banco Popular Portugal), were also transferred to Banco Santander. Where the subsidiaries have incurred significant losses that triggered the group's failure, the SRB may decide to not transfer the parent entity's stakes in those subsidiaries to the private sector purchaser but to put them into liquidation under normal insolvency proceedings.

The NRA must ensure that the transfer is made under commercial terms, having regard to the circumstances and in accordance with the Union state aid law. Any consideration paid by the purchaser must benefit the **shareholders of the parent entity**, where the sale of business has been effected by transferring shares from the group under resolution to the purchaser, or the **parent entity under resolution**, where the sale of business has been effected by transferring assets, rights or liabilities from that entity to the purchaser.[680] The NRA may make supplemental transfers of shares, assets, rights or liabilities to the purchaser without being obliged to get the consent of the shareholders or any third party other than the purchaser and without complying with any procedural requirements under company or securities law.

Article 38(8) of the BRRD laid down arrangements that facilitate the transfer of shares issued by the parent entity under resolution to a purchaser circumventing, thus, the requirements set out in **Articles 22-25 of the CRD IV**. These requirements pertain to the assessment by the supervisory authority (i.e. ECB) of the intention of the purchaser to obtain or increase its qualifying holding in an entity. In that case, the ECB must carry out the assessment in a timely manner in order to not delay the application of the sale of business tool and prevent the satisfaction of the resolution objectives. Nonetheless, even if the ECB has not completed this assessment on time, the transfer of shares to the acquirer will have immediate legal effect. As long as the ECB carries out its assessment, the acquirer's voting rights attached to the shares must be suspended and vested solely in the NRA, which has no obligation to exercise those voting rights.[681] Upon completion of the assessment, the ECB notifies the NRA and the acquirer on whether it approves or opposes to the acquisition of the shares. In case that the ECB grants its consent for the

[678] *Ibid.*, Article 35(7).

[679] *Ibid.*, Article 38(1).

[680] *Ibid.*, Article 38(4).

[681] *Ibid.*, Article 38(9).

transfer of shares to the acquirer, then the voting rights attached to those shares will be fully vested in the acquirer.[682]

The NRA must ensure that the purchaser may continue to exercise the rights of membership and access to payment, clearing and settlement systems, stock exchanges, investor compensation schemes and DGSs of the group's entities under resolution on condition that it meets the relevant membership and participation criteria, as required by those systems.[683] Member States must ensure that the payment, settlement and clearing systems incorporated in their jurisdictions may not deny access to the purchaser because it has no rating from a credit rating agency or that rating is below the necessary threshold to have access to such systems. If the purchaser does not meet the criteria for membership and participation in the aforementioned systems, the NRA will exercise the rights of membership and access to those systems for a period of time not exceeding 24 months, renewable on application by the purchaser to the NRA.

3.1.1.2 Procedural arrangements for the application of the sale of business tool

When the SRB adopts a resolution scheme that provides for the use of the sale of business tool, the NRA concerned must implement specific procedural arrangements to ensure the successful completion of the project. To that end, the NRA is obliged to make the relative arrangements for the marketing of the shares, assets, rights or liabilities that intends to transfer.[684] The marketing process must be carried out in accordance with the following criteria:

- it must be as transparent as possible and must not materially misrepresent the shares, assets, rights or liabilities which the NRA seeks to transfer,
- it must not unduly favor or discriminate between potential purchasers,
- it must be free from any conflict of interest,
- it must not confer any unfair advantage on a potential purchaser,
- it must take account of the need to effect a rapid resolution action, and
- it must aim at maximizing, as far as possible, the sale price for the shares, assets, rights or liabilities involved.

Nonetheless, for reasons of urgency it may be impossible for the NRA to carry out a marketing process complying with all the aforementioned requirements within a very short timeframe. Thus, the NRA may diverge from the application of a marketing process, when it determines that compliance with those requirements would be likely to undermine one or more of the resolution objectives and in particular if the NRA considers that there is a material threat to financial stability arising from a likely failure of the banking group under resolution. The same approach may be applied also when

[682] If the supervisory authority opposes to the transfer of shares to the acquirer, then:

- the voting rights attached to those shares will remain vested in the NRA,
- the NRA may require the acquirer to divest those shares within a divestment period determined by the NRA having taken into account prevailing market conditions, and
- if the acquirer does not complete such a divestment within the divestment period established by the NRA, then the supervisory authority, with the consent of the NRA, may impose on the acquirer penalties and other measures for infringing the requirements for acquisitions or disposals of qualifying holdings.

[683] **BRRD**, Article 38(12).

[684] *Ibid*, Article 39(1).

compliance with those requirements is likely to undermine the effectiveness of the sale of business tool in addressing that threat or achieving the resolution objective of avoiding a significant adverse impact on the financial system.

The NRA should consider factual circumstances under which a marketing process could pose risks to the banking group under resolution and result in aggravating uncertainty and loss of market confidence. Such circumstances include any of the following:[685]

- the risk of a systemic crisis based on the number, size and significance of banking groups that are at risk of meeting the conditions for early intervention or the resolution conditions or at risk to be put into liquidation under normal insolvency proceedings,
- the risk of discontinuance of critical functions,
- the withdrawal of short-term funding or deposit outflows,
- decrease in share prices of peer-entities,
- reduction in short or medium-term funding available to banking groups,
- impairment to the functioning of the interbank funding market reflected in the increase of margin requirements and the decrease of collateral available to banking groups, and
- increase in prices for credit default swaps or decrease in ratings of banking groups.

The NRA must assess whether the compliance with the aforementioned requirements specified in **Article 39(1) of the BRRD** is likely to undermine the effectiveness of the sale of business tool or the aim of achieving the resolution objective of avoiding significant adverse impact on financial stability. To that end, with regard to the **requirement of transparency**, the NRA should consider the risk that marketing to a wider circle of potential purchasers and disclosure of risks and valuations may generate additional uncertainty and result in loss of confidence.[686]

With respect to the **principle of non-discrimination**, the NRA should give due account to the fact that certain potential private sector purchasers are more likely to ensure financial stability due to their financial position, structure and business model, which may facilitate the integration of the transferred business lines into the receiver and may promote timely implementation of the resolution action.[687]

With regard to the **principle that the marketing process must be free from conflicts of interests**, the NRA should ensure that such a requirement does not impede the feasibility and timely implementation of the resolution action. Given the limited number

[685] See **EBA Guidelines** "*on factual circumstances amounting to a material threat to financial stability and on the elements related to the effectiveness of the sale of business tool under Article 39(4) of Directive 2014/59/EU*", par. 3.

[686] The marketing process is executed under strict confidentiality rules to minimize the risk of liquidity outflows and any contagion risks to the domestic or Union banking system. Thus, public disclosure of the marketing that would be mandatory under **Article 17(1) of the Regulation 596/2014** of the European Parliament and the Council of 16 April 2014 on "*market abuse*" (Market Abuse Regulation) may be delayed on the basis of **Article 17(4) or (5) of the same Regulation**.

[687] **EBA Guidelines** "*on factual circumstances amounting to a material threat to financial stability and on the elements related to the effectiveness of the sale of business tool under Article 39(4) of Directive 2014/59/EU*", par. 5(b).

of service providers, advisers and potential purchasers in the market, a certain risk of conflicts of interest may be inherent to the sales process.

In addition, when the NRA assesses **whether advantages to potential purchasers are unfair** in accordance with **Article 39(2)(d) of the BRRD**, it is necessary to take into account that the resolution objectives and the need for swift action may justify incentivizing purchasers or limiting their risk, in particular by making use of the SRF.

Lastly, while aiming to **maximize the sale price**, the NRA should take into consideration the need for rapid action, which may be in conflict with prolonged negotiations on the price consideration or bidding processes, and the resolution objectives (e.g. continuity of critical functions), which may be in conflict with maximizing the sale price.[688]

3.1.2 The bridge institution tool

3.1.2.1 Key principles for the bridge institution tool

Where no private sector purchaser has shown interest for the assets, rights, liabilities or shares of the parent entity of the group under resolution, the SRB may resort to the bridge institution tool. The bridge institution is a legal person that meets the following requirements:[689]

- it is wholly or partially owned by one or more public authorities, including the SRF, the NRA or the national resolution fund,
- it is controlled by the NRA, and
- it is created for the purpose of receiving and holding some or all of the shares issued by the parent entity under resolution and some or all of the assets, rights or liabilities.

The SRB must ensure that the total value of the liabilities to be transferred to the bridge institution will not exceed the total value of the assets and rights transferred. This obligation was introduced in order to avoid the need to cover any funding gap that would arise if the liabilities exceeded the value of assets. In that case, the SRF would have to contribute more funds in the bridge institution.

When the transfer takes place, the bridge institution may pay consideration in exchange for the shares, assets, rights or liabilities it receives. This consideration may benefit the shareholders of the parent entity under resolution, where transfer of shares to the bridge institution has been implemented, or the (parent) entity under resolution, where transfer of assets, rights or liabilities to the bridge institution has been implemented. [690]

For the purpose of transferring shares, assets, rights and liabilities, the NRA is not obliged to get the consent of the shareholders or any third party other than the bridge institution. In addition, there is no obligation to comply with procedural requirements under company or securities law.[691] For the purposes of exercising the rights to provide services or to establish itself in another Member State in accordance with the CRD IV, the bridge institution is considered to be continuation of the group under resolution and may continue to exercise any such right that was exercised by that group with respect to assets, rights or liabilities transferred.[692]

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[688] *Ibid.*, par. 5(e).

[689] **BRRD**, Article 40(2).

[690] *Ibid.*, Article 40(4).

[691] *Ibid.*, Article 40(1).

[692] *Ibid.*, Article 40(9).

The SRB may decide that the NRA must transfer rights, assets or liabilities back from the bridge institution to the parent entity under resolution or the shares back to their original owners provided that either the instrument by which the transfer was made states explicitly that the shares, assets, rights or liabilities might be transferred back or the shares, assets, rights or liabilities do not fall within the classes specified in the instrument by which the transfer was made.

In case that the SRB decides to apply the bail-in tool together with the bridge institution tool, the bridge institution must be controlled by the NRA even if the shares of that institution are owned by the private sector as a result of the application of the bail-in tool to shares and liabilities of the group under resolution.

The bridge institution may continue to exercise the rights of membership and access to payment, clearing and settlement systems, stock exchanges, investor compensation schemes and DGSs of the group's entities under resolution on condition that it meets the relevant membership and participation criteria, as required by those systems. As applies also to the sale of business tool, Member States must ensure that the payment, settlement and clearing systems incorporated in their jurisdictions may not deny access to the bridge institution because it has no rating from a credit rating agency or that rating is below the necessary rating in order to grant access to such systems. If the bridge institution does not meet the criteria for membership and participation in the aforementioned systems, the NRA will exercise the rights of membership and access to those systems for a period of time not exceeding 24 months, renewable on application by the bridge institution to the NRA.

3.1.2.2 Procedural arrangements for the application of the bridge institution tool

The bridge institution is authorized as a credit institution in accordance with the CRD IV and is subject to supervision pursuant to the rules established under the CRD IV and the CRR. Moreover, the bridge institution must operate in accordance with the Union state aid rules and in that respect the NRA must specify restrictions on its operations accordingly.[693]

Since the bridge institution is controlled by the NRA, the latter has a wide set of powers concerning its operation. Thus, the NRA is responsible for the approval of the contents of the bridge institution's constitutional documents, the appointment of or the approval of the bridge institution's management body, the approval of the remuneration of the members of the management body, as well as the approval of the strategy and risk profile of the institution.[694] The business strategy of the bridge institution must be focused on maintaining access to critical functions and facilitating the sale of the institution or its assets, rights or liabilities to one or more private sector purchasers where conditions are appropriate, preferably within a 2-year period.[695]

The bridge institution must cease to exist when it is merged with another entity or it stops meeting the requirements for which it was established. In addition, it will cease to exist

[693] Where necessary to meet the resolution objectives, the bridge institution may be established and authorized without complying with BRRD for a short period of time at the beginning of its operation. For that purpose, the resolution authority must submit a relevant request to the supervisory authority and if the latter decides to provide such a waiver it has also to indicate the relevant period during which the bridge institution will be exempted from these requirements.

[694] **BRRD**, Article 41(1).

[695] *Ibid.*, Article 41(2).

when all or most of its assets, rights or liabilities are sold to a third party[696] or are completely wound down and its liabilities are completely discharged. The initial duration of the bridge institution is two (2) years after the date on which the last transfer from the entity under resolution was made. However, the BRRD provides NRAs with the option to extend the operation of the bridge institution for a longer period under reasonable conditions (e.g. essential for the continuity of essential banking or financial services).[697]

3.1.3 The asset separation tool

3.1.3.1 Key principles for the asset separation tool

Should the SRB decide that the optimal solution is the application of the asset separation tool, along with the bail-in tool or the sale of business tool, it has to set up an asset management vehicle. The asset management vehicle is defined as a legal person that complies with all of the following requirements:

- it is wholly or partially owned by one or more public authorities, including the SRF, the NRA or the national resolution fund,
- it is controlled by the NRA, and
- it is created for the purpose of receiving and holding some or all of the shares issued by the parent entity under resolution and some or all of the assets, rights or liabilities.

As applicable also to bridge institutions, since the asset management vehicle is controlled by the NRA, the latter has a wide set of powers concerning its operation. Thus, the NRA is responsible for the approval of the contents of the asset management vehicle's documents, the appointment of or the approval of the asset management vehicle's management body, the approval of the remuneration of the members of the management body, as well as the determination of their appropriate responsibilities and the approval of the strategy and risk profile of the asset management vehicle. [698]

The use of this tool is subject to certain conditions which refer to the fact that the situation of the particular market for those assets is of such a nature that their liquidation could have an adverse impact on one or more financial markets or the transfer of those assets is necessary for the proper functioning of the group under resolution or bridge institution or such a transfer is necessary to maximize liquidation proceeds. [699]

Assets, rights or liabilities can be transferred to an asset management vehicle under a consideration paid to the group under resolution or to the bridge institution. This consideration may have a nominal or negative value and may also be paid in the form of debt issued by the asset management vehicle. The NRA may transfer assets, rights or liabilities from the parent entity under resolution to one or more asset management vehicles more than once. In addition, the NRA may transfer assets, rights or liabilities back to the parent entity under resolution, where the instrument by which the transfer was made states explicitly that the shares, assets, rights or liabilities might be transferred back or the shares, assets, rights or liabilities do not fall within the classes specified in the instrument by which the transfer was made.

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[696] Sale of assets or liabilities must be made in an open and transparent fashion and the sale must not materially misrepresent or unduly favour or discriminate between potential purchasers.in addition, any asset sale must be made on commercial terms. (BRRD, Article 41(4))

[697] See **Vardi (2017)**, p.10.

[698] **BRRD**, Article 41(1).

[699] *Ibid.*, Article 42(5).

3.1.3.2 Determination of when the liquidation could have an adverse impact on financial markets

The SRB may take a decision to apply the asset separation tool (together with another resolution tool), where specific conditions (as referred above) are met cumulatively, including when the liquidation of assets and liabilities under normal insolvency proceedings could have an adverse impact on one or more financial markets. To that end, the SRB should consider the following elements when assessing the market situation for the assets concerned and the potential direct and indirect effects on financial markets:

- whether the market for these assets is impaired,
- the impact of the disposal of these assets on the markets where they are traded, and
- the situation of the financial markets and the direct and indirect effects of an impairment on the markets for these assets.

As far as the first point is concerned, the assessment of **whether the market for these assets is impaired** (e.g. mortgage loans, SME loans) should be based on the following indicators:[700]

- the evolution of the liquidity of the markets for these assets,
- whether these assets have been classified as impaired for accounting purposes and whether other entities have made provisions for these assets,
- incurred losses and high-volatile cash flows under these assets,
- downward value adjustments of the assets or corresponding price developments of associated hedges, and
- reduction of share prices and deterioration of ratings and refinancing conditions of entities holding high amounts of these assets compared to the rest of the market.

With regard to the assessment of the **impact of assets' disposal on the markets where they are traded**, the SRB should take into account:[701]

- the size of the markets concerned and the range of potential purchasers,
- the impact that the liquidation of these assets is expected to have on prices for comparable asset prices, and
- the expected timeline for the liquidation of the assets under normal insolvency proceedings, including a potential accelerated distressed sale.

Lastly, the **assessment of the (direct and indirect) effects of an impairment on the markets** should be based on the following elements:[702]

- the risk of a systemic crisis, as evident from the number, size and significance of the entities that are at risk of meeting the conditions for early intervention or the conditions for resolution or at risk of liquidation under normal insolvency proceedings,
- whether the sale of the assets or an impairment of markets can result in contagion,
- an increase in the cost of short- or medium-term funding available to entities, and

[700] **EBA Guidelines** "*on 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*", par. 4(a).

[701] *Ibid.*, par. 4(b).

[702] *Ibid.*, par.4(c).

- an impairment to the functioning of the interbank funding market, which may be reflected in an increase in margin requirements or a decrease in ratings of entities.

In case of transfer of a portfolio of derivatives or trading assets and liabilities that are legally or economically interlinked, the SRB should assess the impact that unwinding the portfolio could have on the financial markets, taking into account the effect on counterparties to these assets and liabilities, such as the discontinuance of hedging relations and the need to find a replacement for them.

3.1.4 The bail-in tool

3.1.4.1 Liabilities mandatorily excluded from bail-in

The SRB may apply the bail-in tool to the liabilities of the parent entity of a banking group under resolution, except for the following liabilities, whether they are governed by the law of a Member State or a third-country law:[703]

- **covered deposits**,
- **secured liabilities**, including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form and integral part of the cover pool and which according to the national law are secured in a way similar to covered bonds,[704]
- **any liability that arises by virtue of the holding of client assets or client money** including client assets or client money held on behalf of UCITS[705] or of Alternative Investment Funds (AIFs),[706] provided that such a client is protected under the applicable insolvency or civil law,
- **any liability that arises by virtue of a fiduciary relationship** between the parent entity (as fiduciary) and another person (as beneficiary) provided that the latter is protected under the applicable insolvency or civil law,
- **liabilities to credit institutions and investment firms**, excluding other group's entities, **with an original maturity of less than seven (7) days** (i.e. sight deposits, overnight deposits, unsecured money market placements),

[703] **BRRD**, Article 44(2).

[704] All secured assets relating to a covered bond remain unaffected, segregated and with enough funding. However, the SRB may apply the bail-in tool to any part of a secured liability or a liability for which collateral has been pledged that exceeds the value of the assets, pledge, lien or collateral against which it is secured.

[705] In accordance with **Article 1(2) of the Directive 2009/65/EC**, 'UCITS' is defined as an undertaking:

- with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading, and
- with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption.

[706] In accordance with **Article 4(1) of the Directive 2011/61/EU**, 'AIFs' are defined as collective investment undertakings, including investment compartments thereof, which:

- raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and
- do not require authorization pursuant to **Article 5 of Directive 2009/65/EC**.

- **liabilities with a remaining maturity of less than seven (7) days**, owed to payment or security settlement systems or operators of such systems or their participants and arising from their participation in such a system,
- **liabilities to any of the following**:
    - ➢ **employees**, in relation to accrued salary, pension benefits or other fixed remuneration, except for the variable remuneration which is not regulated by a collective bargaining agreement,
    - ➢ **commercial or trade creditors** arising from the provision of services and goods which are critical for the functioning of the banking group, including IT services, utilities and rental, servicing and upkeep of premises,
    - ➢ **tax and social security authorities** provided that such liabilities are preferred under the applicable law,
    - ➢ **deposit guarantee schemes** arising from contributions due in accordance with the Directive 2014/49/EU (DGSD),
- **liabilities to other entities of the same resolution group**, irrespective of their maturities except where these liabilities rank below ordinary unsecured liabilities under the relevant national insolvency ranking.

3.1.4.2 Liabilities potentially excluded from bail-in on the SRB's discretion

In addition to the aforementioned mandatory exclusions from the scope of bail-in, the BRRD has assigned on resolution authorities the power to decide on a case-by-case basis on the need to exclude additional liabilities, where certain conditions are met (discretionary exclusions).[707] Thus, in exceptional circumstances, the SRB may exclude (fully or partially) certain liabilities from the application of the write-down or conversion powers where:[708]

a. it is not possible to bail-in that class of liabilities within a reasonable timeframe,
b. the exclusion of those liabilities is necessary and proportionate to achieve the continuity of critical functions and core business lines in order to maintain the ability of the group under resolution to continue key operations, services and transactions,
c. the exclusion of those liabilities is necessary and proportionate to avoid giving rise to widespread contagion, particularly with regard to eligible uncovered deposits of natural persons and micro, small and medium-sized enterprises, which would severely disrupt the financial system and the real economy,
d. the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

In relation to the first case (i.e. **bail-in is not possible within a reasonable timeframe**), the SRB may exclude liabilities because there is no sufficient timeframe within which all the tasks related to the application of the bail-in tool can be performed.

Secondly. the SRB may also exclude liabilities from bail-in, where it assesses that such action would **undermine the orderly functioning of critical services and critical**

[707] The power of resolution authorities to exclude on a discretionary basis some liabilities from the scope of the bail-in tool has been subject to criticism due to the uncertainty it creates to creditors. Indicatively, see **Tröger (2017a)** and **Hadjiemmanuil (2015b)**.

[708] **SRMR**, Article 27(4).

functions. Such implications could arise where the bail-in of the relevant liabilities could result in unavailability of funding or termination of critical services provided by third parties (e.g. infrastructure). In addition, this decision is warranted in case that the critical function in question pertains to a service provided by the parent entity to third parties which depend on the uninterrupted performance of the liability.[709]

Thirdly, a banking group that is highly interconnected with financial institutions and financial market infrastructure providers may trigger **widespread direct or indirect contagion** upon failure. With respect to direct contagion,[710] the SRB may exclude certain liabilities, if it assesses that the group's exposure to specific counterparties could cause knock-on failures and there is high systemic importance of counterparties which are at risk of failing. Indirect contagion may be determined in cases that the bail-in of specific liabilities (e.g. uncovered deposits of natural persons and SMEs) could:[711]

- give rise to widespread lack of confidence in the banking sector, especially in banking groups with similar characteristics with the group concerned because there is a large number of natural persons directly or indirectly affected by the bail-in,
- result in a significant number of counterparties to withdraw funding or cease making transactions with other entities,
- trigger widespread withdrawal of short-term funding or deposits in significant amounts, or
- cause significant impairment to the functioning of the interbank funding market.

Lastly, the SRB may exclude certain liabilities from the scope of bail-in in order to **avoid destruction of value** that would result in holders of non-excluded liabilities to be in worse position compared to what they would be if these liabilities had been bailed-in. To that end, the SRB must compare and determine the outcome for all creditors of a potential bail-in and non-bail-in. This case applies mainly to derivative liabilities, which are analyzed in detail below (under **3.1.4.7**).

The circumstances allowing the SRB to exclude partially or fully certain liabilities from the scope of the bail-in tool under **Article 44(3) of the BRRD** should be narrowly clarified and any deviation from the *pari-passu* principle must be proportionate, justified by the public interest and not discriminatory.[712] Therefore, any exclusion should be limited to the minimum necessary to achieve the objectives and, hence, partial exclusion is preferable to full exclusion.[713]

The SRB must ensure that the exclusion of a liability or class of eligible liabilities from the write-down and conversion powers will not result in an increased level of write-down and conversion applied to other liabilities. This condition reassures that the "no-creditor-worse-off" principle will not be breached. In any case, the SRB may not exclude a

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[709] **Commission Delegated Regulation 2016/860**, Article 7(1).

[710] Pursuant to Commission Delegated Regulation 2016/860 "*direct contagion is defined as a situation where the direct losses of counterparties of the entity under resolution, resulting from the write-down of the liabilities of the entity, lead to the default or likely default for those counterparties in the imminent*".

[711] **Commission Delegated Regulation 2016/860**, Article 8(2).

[712] *Ibid*., recital (2).

[713] *Ibid.*, recital (5).

liability or class of liabilities from the scope of bail-in due to its maturity, or the expectation of an increase in funding costs or the expectation of future profit.[714]

The decision of the SRB to apply these powers to exclude certain liabilities from the scope of the bail-in tool should give due account to:

- the principle that losses are borne first by the shareholders and next by the creditors of the parent entity of the group under resolution by order of preference,
- the level of the loss absorbing capacity that would remain in the banking group under resolution if these liabilities were excluded, and
- the need to maintain adequate resources for resolution financing.

The decision of the SRB to make use of its discretion must be based on at least one of the resolution objectives. When the SRB takes such decision, it must justify the exceptional circumstances that warrant such a decision and which differ from those prevailing when the resolution plan was drafted and if the need for exclusion was provided for in the resolution plan, how the SRB addressed this need under the resolvability assessment.[715]

3.1.4.3 Implementation of the bail-in tool

When applying the bail-in tool, the SRB must assess the aggregate of:

- the amount by which eligible liabilities must be written down in order to ensure that the net asset value of the parent entity under resolution is equal to zero, and
- the amount by which eligible liabilities must be converted into common shares or other types of capital instruments in order to restore the CET1 ratio of either the parent entity under resolution or the bridge institution.

Eligible liabilities must be written down or converted into equity to such an extent that the CET1 ratio will be restored above the minimum regulatory thresholds, while market confidence will be retained in the group under resolution or the bridge institution ensuring thus that it will continue its operations for at least one (1) year.

Under the bail-in tool, the write-down and conversion powers are applied based on the following order:

1. CET1 instruments are reduced first in proportion to the losses and to extent of their capacity,
2. if and only if, the total reduction pursuant to point (1) does not suffice to ensure a positive net asset value of the parent entity or restore the CET1 ratio to the targeted level, Additional Tier 1 instruments are reduced to the extent required and to extent of their capacity,
3. if and only if, the total reduction pursuant to point (2) is not sufficient, Tier 2 instruments are reduced to the extent required and to extent of their capacity,
4. if and only if, the total reduction of shares and capital instruments (points (1)-(3)) is not sufficient, the principal amount of subordinated debt that is not Additional Tier 1 or Tier 2 instruments is reduced to the extent required and to extent of their capacity,

[714] *Ibid*., Article 7(4).

[715] *Ibid*., Article 4(7).

5. if and only if, the total reduction of shares, capital instruments and other subordinated debt is not sufficient, the principal amount of other eligible liabilities is reduced to the extent required and to extent of their capacity.

The SRB must ensure that the application of the write-down and conversion powers entails that the losses are allocated equally between shares and eligible liabilities of the same rank by reducing their principal amount to the same extent pro rata to their value, except where a different treatment is warranted under the circumstances specified in **Article 44(3) of the BRRD** (i.e. discretionary exclusions from bail-in).[716]

The exercise of the write-down and conversion powers to capital instruments is governed by two (2) guiding principles. Firstly, the SRB should treat capital instruments, which belong to the same category of the aforementioned sequence and which rank equally in insolvency, in the same way irrespective of their other characteristics.[717] Secondly, the SRB should apply the same treatment to all instruments eligible as capital independently of whether they are fully or partially excluded from counting towards group's capital.[718]

With respect to the first guiding rule, the issued Additional Tier 1 (AT1) instruments which meet fully the conditions of **Article 52 of the CRR** and instruments grandfathered according to the same Regulation with the same ranking in the creditor hierarchy are subject to the same treatment for the purposes of the sequence of the write-down and conversion. In particular, both categories of instruments must be written down to the same extent or subject to the same terms of conversion.[719]

In accordance with the second principle, the Tier 2 instruments that are governed by the amortization regime provided for in the CRR should be subject to the same treatment as the Tier 2 instruments which are fully included in the group's capital. **Article 63 of the CRR** provides for specific criteria with which Tier 2 instruments must comply in order to be eligible for capital. Based on one of those criteria, Tier 2 instruments must have an original maturity of at least five (5) years.[720] Where the remaining maturity falls below five (5) years, the respective instruments are subject to an amortization regime (**Article**

[716] **BRRD**, Article 48(2).

[717] **EBA Guidelines** "*concerning the interrelationship between the BRRD sequence of write-down and conversion and CRR/CRD*", par. 10.

[718] *Ibid*, par. 11.

[719] As referred to in par. 13 of the EBA Guidelines "*concerning the interrelationship between the BRRD sequence of write-down and conversion and CRR/CRD*", "*in order to be included as own funds, AT1 instruments should meet the conditions of Article 52 of the CRR*". Article 52 provides that AT1 instruments should contain contractual provisions according to which, upon the occurrence of a trigger event, the principal amount of the instruments is written down on a permanent or temporary basis or the instruments is converted to CET1. For the purposes of this provision, **Article 54(1)(a) of the CRR** further requires that AT1 instruments be converted when the CET1 ratio decreases to 5.125%, or higher if specified in the provisions governing the instrument. The provisions of the instrument may include more than one trigger and must specify either the rate of conversion and limit on permitted amount of conversion, or a range within which the instruments will convert to CET1 (**Article 54(1), (b) and (c) of the CRR)**. However, the Directive 2006/48/EC, which was superseded by the CRR did not provide for the same condition for the purposes of the eligibility of instruments as capital. Thus, according to the provisions of **Part 10, Title 1, Chapter 2 of the CRR** (grandfathering of capital instruments), items eligible as capital under national transposition measures for Directive 2006/48/EC are eligible to be calculated in capital for the purposes of the CRR even though they do not meet all the conditions provided for in Articles 52 and following of the CRR. Thus, grandfathered instruments which do not provide for the contractual trigger of **Article 54 of the CRR** are included in capital in accordance with the limits laid down in the regulation.

[720] **CRR**, Article 63(g).

64 of the CRR),[721] which provides that the value of Tier 2 instruments that can be included in capital is amortized on a straight-line basis in the final five (5) years before maturity. The amount subject to amortization is not included in capital, even if the Tier 2 instruments meet the eligibility criteria set out in **Article 63 of the CRR**.

Nonetheless, for the purposes of determination of the order and amount of write-down and conversion with respect to Tier 2 instruments, the SRB should treat in the same way the Tier 2 instruments which are included in the same class irrespective of whether they are included in capital. Hence, the amortized amount of the Tier 2 instruments (grandfathered instruments) should enjoy the same treatment with the amount of Tier 2 instruments which are included in the group's capital.

3.1.4.4 Stylized example of the bail-in mechanism

Taking into account the scope of the bail-in tool and the order of liabilities subject to write-down and conversion powers, ***Figure 20*** indicates how the bail-in mechanism works. Assuming that the parent entity of a banking group with assets of €100 incurs losses of €15 due to impairments in its loan portfolio, its CET1 capital (€15) is fully depleted. As a result, there is a breach of the minimum capital requirements and the banking groups is determined by the ECB as "failing or likely to fail".

Following that determination, the SRB assesses that the conditions for resolution are met and decides to apply the bail-in tool to the parent entity to recapitalize the banking group. The write-down and conversion powers are applied to Tier 2 instruments and senior unsecured bonds, which rank junior to other senior liabilities (e.g. deposits). Given that the bail-in tool should be applied to the extent necessary to ensure restoration of the CET1 ratio above the minimum regulatory threshold, only half of the senior unsecured bonds are subject to the write-down and conversion powers. Thus, Tier 2 instruments (€5) and senior unsecured bonds (€5) are converted into equity (CET1 capital of €10).

This example of the application of the bail-in tool shows in a simplistic way how the SRB can recapitalize a banking group through the conversion into equity of capital instruments (Tier 2 instruments) and eligible liabilities (senior unsecured bonds) issued by the parent entity.

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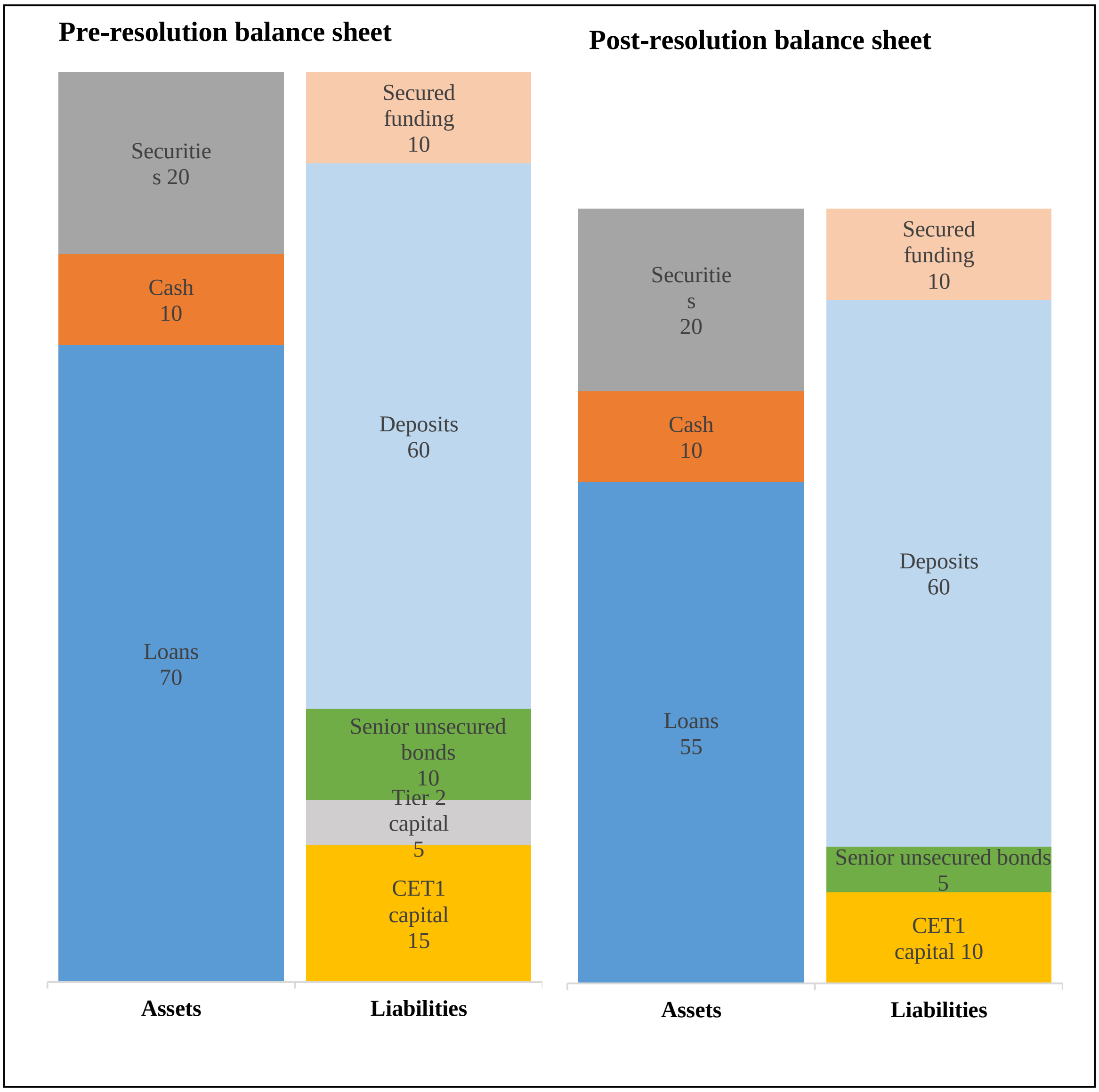
[721] Pursuant to **Article 64 of the CRR**, "*the extent to which Tier 2 instruments qualify as Tier 2 items during the final five years of maturity of the instruments is calculated by multiplying the result derived from the calculation in point (a) by the amount referred to in point (b) as follows:*

a. the nominal amount of the instruments or subordinated loans on the first day of the final five-year period of their contractual maturity divided by the number of calendar days in that period;

b. *the number of remaining calendar days of contractual maturity of the instruments or subordinated loans*."

Figure 20: Indicative example of the bail-in mechanism



3.1.4.5 Treatment of shareholders under the bail-in tool and the write-down or conversion of capital instruments

Shareholders sit at the bottom of the insolvency creditor hierarchy and are the first to take losses on both a going-concern and a gone-concern basis. Under some circumstances, it is appropriate for existing shares not to be cancelled or transferred in their entirety, but instead to be diluted through the conversion of other eligible liabilities into shares. This is the case only if shareholders would have retained some value in insolvency, meaning that full cancellation of shares would result in breach of the "no-creditor-worse-off" principle.

The application of the bail-in tool or the exercise of the write-down or conversion powers with respect to capital instruments entails that[722] existing shares are canceled[723] and transferred[724] to bailed-in creditors, if the parent entity under resolution has a negative or zero asset value. Furthermore, existing shareholders and holders of capital instruments of the parent entity are diluted[725] if it has a positive net value, as a result of the conversion into shares of relevant capital instruments and/or eligible liabilities. Conversion of existing shares must take place under a rate of conversion that will severely dilute existing shareholders.

The aforementioned actions may be taken also with respect to shares issued or conferred in the following circumstances:

- where debt instruments with embedded contractual terms that were converted into shares on the occurrence of an event that preceded or occurred at the same time when the SRB determined that the conditions for resolution are met,
- where conversion of capital instruments to shares took place in accordance with the write-down or conversion powers of the SRB (**Article 59 of the BRRD**).

Where the net asset value according to the ex-ante valuation is positive, the extent of cancellation or transfer of shares should be partial and ensure that shareholders retain at least the net asset value estimated under the Valuation 2, in particular based on the estimation of the treatment which they would have received under normal insolvency proceedings in accordance with **Article 36(8) of the BRRD**.[726] On the contrary, if the net asset value according to the ex-ante valuation is zero or negative, the SRB must write down, at least partially, creditors more senior in insolvency to shares ensuring, though, that shareholders retain no value.

Shares not cancelled or transferred in full, are severely diluted by the conversion of liabilities into equity. Severe dilution means that both shareholders' percentage of ownership and the value of shares are reduced, unless this would breach the "no-creditor-worse-off" principle. In this respect, conversion rates are determined at such level that they ensure that shareholders bear first losses and based on the creditor hierarchy. If a specific creditor class is expected to be worse off after resolution than before resolution in accordance with the ex-ante valuation, the SRB should set a conversion rate equal to or close to zero for all classes of liabilities and instruments which have a more junior rank in insolvency.[727]

Dilution of existing shareholders may be combined with a partial cancellation or partial transfer of shares. Where the ex-ante valuation shows a positive net asset value of the group under resolution, the SRB may apply partial cancellation and/or transfer of shares

[722] **BRRD**, Article 47(1).

[723] 'Cancellation of shares' means that shares are cancelled and the shareholders' economic claims are completely erased on those shares.

[724] 'Transfer of shares' means that shares are transferred to creditors and the original shareholders' future economic claims on those shares are erased.

[725] 'Dilution of shares' means that new shares are issued and, as such, the existing shareholders' future economic claims and other rights are proportionately reduced but are not necessarily erased. They may retain some economic and administrative (voting) ownership rights.

[726] **EBA Guidelines** "*on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments*", point 1.6.

[727] *Ibid*, point 1.12.

and dilution, while in case of zero or negative net asset value the SRB may apply full cancellation and/or full transfer of shares.

Lastly, when considering whether to cancel and/or to transfer shares, individually or together with dilution, the SRB should give due account to the particular features of the shares. For instance, where certain shares confer particular special voting rights, the SRB may consider that it would be more appropriate to cancel those shares than to transfer them in order to simplify the structure of the reorganized banking group.[728] Furthermore, if there are shares which do not qualify as CET1 capital (e.g. preference shares which qualify as Additional Tier 1 instruments), the SRB may choose to cancel them and not to transfer.

3.1.4.6 Rate of conversion of debt to equity

The BRRD allows resolution authorities to apply differential conversion rates to different classes of liabilities or capital instruments. However, resolution authorities are not obliged to do so, provided that they achieve the resolution objectives and respect the sequence of write-down and conversion under **Article 48 of the BBRD**.[729] In accordance with **Article 50 of the BRRD**, the conversion of debt (i.e. Additional Tier 1 instruments, Tier 2 instruments, subordinated debt and other eligible liabilities) to equity must be implemented under certain principles.[730] The conversion rate must represent an appropriate compensation to the affected creditors for any loss incurred as a result of the exercise of the write down and conversion powers. In addition, a higher conversion rate should be applied to liabilities that are ranked senior under the applicable insolvency law compared to subordinated liabilities.

Principle 1 - no creditor worse off: The SRB should decide on the conversion rate seeking to ensure that no shareholder or creditor is expected to receive worse treatment than in insolvency. This determination should be made in accordance with the ex-ante valuation, which includes an assessment of the expected treatment in insolvency based on an estimate of the treatment that each class of shareholders and creditors would have received if the group's entities had been wound up under normal insolvency proceedings.

Upon application of the bail-in tool, the conversion rates should be set at such a level to ensure that for each shareholder or creditor the expected value of the combined equity and debt claims after application of the write-down and conversion powers is equal to or greater than the expected value that they would have realized had the group's entities been put into liquidation.[731] Where the total estimated value of equity received by the affected creditors following write-down and conversion is expected to be greater than the aggregate amount of debt claims written down or converted into equity, compliance with the "no-creditor-worse-off" principle can be ensured without applying differential conversion rates. On the contrary, if the total expected value of the equity received by the affected creditors is lower than the aggregate amount of debt claims written-down or converted into equity, differential conversion rates may be necessary.

For creditors whose claim has been wholly converted into equity, the expected value of equity should be at least as large as their expected recovery in insolvency. In case of partial conversion into equity, the expected value of equity that creditors will receive

[728] *Ibid*, point 1.22.

[729] **EBA Guidelines** "*on the rate of conversion of debt to equity in bail-in*", par. 1.4.

[730] **BRRD**, Article 50.

[731] **EBA Guidelines** "*on the rate of conversion of debt to equity in bail-in*", par. 1.16.

should be at least as large as their expected recovery in insolvency, less the expected value of their remaining debt claim.

The use of differential conversion rates in the same class of liabilities might be necessary, when equally ranking creditors have been excluded from bail-in, resulting in a greater level of write-down or conversion for the liabilities that have not been excluded.

Principle 2 - creditor hierarchy: the SRB should set conversion rates ensuring that:[732]

- shareholders of the parent entity under resolution bear first losses,
- creditors of the parent entity under resolution bear losses after shareholders and in accordance with the order of priority of claims under normal insolvency proceedings, and
- creditors of the same class are treated in an equitable manner.

In accordance with the abovementioned, any value preserved by resolution will be allocated first to senior and subordinated creditors' claims. In addition, differential conversion rates must be applied to ensure that creditors bear losses after the shareholders in accordance with the priority of claims under normal insolvency proceedings. Differential conversion rates may be set to allow shareholders to retain some claims with positive value or for equity to be shared in some proportion by two or more classes of creditors.

Shareholders could retain some positive value when there is no need to write down any creditors, namely when the bail-in tool requires only conversion. Equity could be shared in some proportion by two or more classes of creditors where a creditor class had been fully converted into equity but more conversion was still required and the partial or full conversion of the more senior creditor class did not result in a loss (i.e. the more senior creditors receive a total equity and debt claim of value at least equal to the value of the original debt claims).[733] If a given class of creditors is expected to take loss, which means that the total value of remaining debt and equity claims after the application of resolution powers is less than the value of the claims of that class before resolution, the SRB should set a conversion rate equal to or close to zero for all more junior classes of liabilities and capital instruments.

3.1.4.7 Treatment of derivatives under the bail-in tool

Derivatives may represent a substantial share of the liability structure of a banking group, in particular if it has employed a universal banking model and is heavily involved in trading. The determination of the value of derivative contracts is complex, as it is linked to the value of underlying instruments, which evolves over time and crystallizes at maturity or upon close-out.[734]

Derivative liabilities are subject to resolution authorities' write-down and conversion powers, unless the resolution scheme provides for the exclusion of derivative liabilities from the scope of the bail-in in accordance with **Article 44(3) of the BRRD**. These powers can be exercised only upon or after closing-out the derivatives contracts.

The value of liabilities arising from derivatives is determined as an early termination amount calculated as the sum of the following:[735]

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[732] *Ibid.*, par. 1.10.

[733] *Ibid.*, par. 1.26.

[734] **Commission Delegated Regulation 2016/1401**, recital (2).

[735] *Ibid.*, Article 5(1).

- unpaid amounts, collateral or other amounts due from the group under resolution to the counterparty, less unpaid amounts, collateral and other amounts due from the counterparty to the group under resolution, and
- a close-out amount covering the amount of losses or costs incurred by derivative counterparties, or gains realized by them.

In practice, the SRB should estimate close-out amounts that may be due from the failing banking group to its counterparties, taking into account the replacement cost that the counterparty might incur. The SRB should deduct any collateral that the failing group had pledged to its counterparties in order to determine the derivative liability subject to bail-in.[736]

Liabilities arising from derivative transactions subject to netting agreements are determined on net basis in accordance with the terms of the agreement. This means that the valuation covers netting sets defined in the netting arrangements without choosing certain contracts and exempting others. In addition, the valuation is carried out prior to the SRB's decision to exclude derivative liabilities from the scope of the bail-in. Therefore, the valuation should enable the SRB to assess the potential amount by which derivative liabilities might be bailed-in following the close-out, as well as the potential destruction in value that might arise as a result of the close-out.[737] This may happen if the losses incurred or expected to be incurred from the close-out of derivatives exceed the amount of liabilities that can be bailed-in resulting, thus, in additional losses for other creditors of the group under resolution.[738]

Given that the impact of netting and collateral yield in immaterial increase of CET1 capital upon bail-in, the SRB may decide to exclude derivatives from close-out and bail-in in accordance with **Article 44(3) of the BRRD**, as "*the application of the bail-in tool to those liabilities would cause destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in*".[739]

3.1.4.8 Ancillary provisions for the implementation of the bail-in tool

NRAs are competent for implementing the bail-in tool and, therefore, they have the power to complete all the administrative and procedural tasks necessary to give effect to the write-down or conversion of capital instruments and eligible liabilities. Such tasks include the amendment of all relevant registers, the delisting or removal from trading of shares or debt instruments, the listing or admission to trading of new shares and the relisting or readmission of debt instruments which have been written down without the requirement for the issuance of a prospectus in accordance with the Directive 2003/71/EC "*on the prospectus to be published when securities are offered to the public or admitted to trading*".[740]

Furthermore, Member States must take all the necessary measures to ensure that the conversion of liabilities into shares under the bail-in tool cannot be impeded due to

[736] See **Huertas (2016)**, p. 18.

[737] **Commission Delegated Regulation 2016/1401**, recital (8).

[738] The close-out of derivatives may create additional losses that are not reflected in the going-concern valuation that may stem from actual replacement costs incurred by the counterparty that would increase the close-out costs owed by the banking group under resolution or from costs incurred by the group concerned in re-establishing trades on exposures subject to open market risk resulting from the exposure.

[739] See **Huertas (2016)**, p. 19.

[740] **BRRD**, Article 53(2).

existing instruments of incorporation or statutes, including pre-emption rights for shareholders or requirements for the consent of shareholders to an increase in capital.[741]

3.1.5 Contribution of deposit guarantee schemes in resolution

The primary function of DGSs is to payout covered depositors of entities that have been put into liquidation under normal insolvency proceedings. However, under the BRRD recourse to DGSs is possible also upon resolution. Thus, when resolution authorities take resolution action, and provided that depositors retain access to their deposits, the DGS to which the parent entity is affiliated is liable for:[742]

- upon **application of the bail-in tool**, the amount by which covered deposits would have been written down in order to absorb losses in the entity concerned, had covered deposits been included within the scope of bail-in, or
- in case of **application of other resolution tools**, the amount of losses that covered depositors would have incurred, had they suffered losses in proportion to the losses that creditors with the same level of priority under the national law governing normal insolvency proceedings would have suffered.

The participation of DGSs in resolution is delineated by certain principles. Firstly, the application of the write-down powers to the eligible liabilities, which are subordinated to covered deposits under national law, does not suffice to eliminate the negative asset value of the banking group. Secondly, the contribution of the DGS may not exceed the amount required to restore the net asset value to zero.

Consequently, a DGS is not liable to contribute to the recapitalization of the parent entity of a banking group so as to have capital ratios above the minimum capital requirements.[743] The liability of a DGS in case of application of the bail-in tool is limited to the amount needed to restore the net asset value of the banking group under resolution to zero. This contribution cannot be greater than the amount of losses that the DGS would have incurred had the parent entity been liquidated under normal insolvency proceedings. If the ex-post valuation determines that the DGS has incurred greater losses than it would have incurred had the parent entity been put into liquidation, the DGS is entitled to compensation by the SRF.

Where the resolution action provides for the application of the sale of business tool or the bridge institution tool, depositors have no claim against the DGS in relation to any part of their deposits at the banking group under resolution that has not been transferred, provided that the covered part of their deposits (up to €100,000) is transferred to the purchaser or to bridge institution.[744]

In all cases, the DGS must not contribute to resolution costs an amount greater than 50% of its target level (i.e. 0.4% of covered deposits of banking groups located in the Member State concerned), unless the Member State has determined a percentage higher than 50% in the transposition of the DGSD in its national law.[745] The lack of harmonization in relation to the target level of DGSs hinders the consistent implementation of the resolution framework and the creation of a level playing field, as will be further analyzed in **Chapter C, Section 2**, under **2.2**.

[741] *Ibid.*, Article 54(3).

[742] *Ibid.*, Article 109(1).

[743] *Ibid.*, Article 109(1).

[744] *Ibid.*, Article 109(4).

[745] *Ibid.*, Article 109(5)(second subparagraph).

3.1.6 Business reorganization plan

3.1.6.1 Objectives of the business reorganization plan

Given that the application of the bail-in tool restores the solvency of the banking group concerned, the next step is to ensure that the group has a viable and sustainable business model, which will generate adequate profits to safeguard its capital position. Market confidence to the banking group is necessary to be restored quickly after resolution action. Otherwise, the banking group would face lack of trust from depositors, creditors and counterparties, which is likely to hamper its franchise value and raise concerns over its ability to repay the liquidity support it has received.[746] It is necessary for the SRB to take all the necessary measures to address the reasons behind the failure of the banking group.

Therefore, within one (1) month after the implementation of the bail-in tool, the parent entity of the group under resolution must draw up a business reorganization plan and start its implementation.[747] This responsibility may be conferred either on the management of the parent entity or to a person appointed by the SRB for that purpose in accordance with **Article 72(1) of the BRRD**.[748]

The business reorganization plan aims to restore the long-term viability of the banking group within a reasonable timeframe. The plan should be based on realistic assumptions in relation to the economic and financial conditions under which the group will operate. In addition, the business reorganization plan is necessary to be aligned and compatible with the restructuring plan submitted to and approved by the Commission, where state aid has been granted.

3.1.6.2 Content of the business reorganization plan

The business reorganization plan should include all the relevant information to describe the reasons for the failure of the banking group and prescribe the strategy that must be implemented during the reorganization phase. Information contained in the recovery plan and the resolution plan can be included in the business reorganization plan to the extent that such information remains valid to achieve the objective of ensuring the long-term viability of the group.[749]

The assumptions and projections of the business reorganization plan should be formed based on a base-case scenario.[750] However, the plan should consider also best-case and worst-case scenarios, which would aim to restore long-term viability, though the reorganizational period, the measures and the financial performance may differ from the base-case scenario.[751] The worst-case scenario should reflect a significant, but plausible, deterioration of the underlying assumptions compared to the base-case scenario.

[746] See **Avgouleas** and **Goodhart (2015)**, p. 15.

[747] In exceptional circumstances the deadline to draw up and submit the reorganization plan up may be maximum two (2) months after the application of the bail-in tool.

[748] **BRRD**, Article 51(2).

[749] **Commission Delegated Regulation (EU) 2016/1400**, recital (3).

[750] Pursuant to **Article 1(point 2) of the Commission Delegated Regulation (EU) 2016/1400**, the ‘base case’ is defined as the business scenario which the management body or the person(s) appointed to operate the banking group consider as most likely to materialize in the process of restoring the long-term viability of the group.

[751] **Commission Delegated Regulation (EU) 2016/1400**, Article 4(3).

In that context, the plan should include at a minimum the following elements:[752]

- an analysis of the banking group, its strengths and weaknesses, as well as the markets and jurisdictions where the group operates and the risks and opportunities that they present,
- a detailed description of the factors and problems that led the group to failure,
- a description of the measures to be adopted which aim to restore the long-term viability of the group, and
- a timetable for the implementation of those measures.

The plan should include a description of the business reorganization strategy and the measures aiming to restore the long-term viability of the group, including a description of each of the following:[753]

- the new business model,
- the measures implementing the business reorganization strategy at group, entity and business line level,
- the target duration of the reorganization period[754] and significant milestones,
- the interaction with the ECB and the SRB, as well as with the external stakeholders (e.g. labor unions), and
- the internal and external communication strategy for the business reorganization strategy.

The business reorganization plan should include drastic measures aiming to address the causes that triggered the failure and to ensure its long-term viability. Indicatively, such measures pertain to:[755]

- the reorganization of the activities carried out by the banking group,
- changes to the operational systems and infrastructures within the group,
- the withdrawal from loss-making activities,
- the restructuring of existing activities so as to increase competitiveness and profit generation, and
- disposal of assets or business lines.

With respect to the parts of the banking group that are to be wound down or sold, the reorganization strategy must identify:

- the business line that is to be wound down or sold and the method for achieving that purpose,
- an estimation of any expected losses,

[752] **BRRD**, Article 52(5).

[753] **Commission Delegated Regulation (EU) 2016/1400**, Article 2(1)(c).

[754] Pursuant to **Article 1(point 1) of the Commission Delegated Regulation (EU) 2016/1400**, the ‘reorganization period’ is defined as “*the period of reasonable timescale between the application of the bail-in tool and the time that the banking group under resolution is expected to have restored its long-term viability, during which measures included in the business reorganization plan are implemented*”.

[755] **BRRD**, Article 52(6).

- the expected timeline, and
- any financing or services provided by or to the remaining entity.

For the parts of the group which will not be wound down, the business reorganization plan should set out actions to remedy any shortcomings in their operation or performance that may have an impact on their long-term viability.

3.1.6.3 Assessment of the business reorganization plan

As referred above, the business reorganization plan must include sufficient information to allow the ECB and the SRB to assess the feasibility of the proposed measures and to conduct a detailed analysis of the plan's impact on the critical functions of the banking group. To that end, the SRB and the ECB should assess the business reorganization plan based on the following principles:[756]

- the management body should be aware and committed to implement effectively the plan,
- the plan should demonstrate that its application will restore the long-term viability based on credible assumptions, a scenario-based analysis and appropriate performance indicators,
- the plan should be feasible and realistic, which means that the reorganization strategy, measures, milestones and performance indicators should take into account the situation in the relevant markets and the interdependencies between the legal entities and business lines in the group,
- the reorganization period should be as short as possible to achieve long-term viability of the banking group,
- the business reorganization plan should be consistent with the restructuring plan, where applicable, and
- any milestones and performance indicators should be sufficiently concrete to enable their monitoring.

The SRB must assess the business reorganization plan within one (1) month from its submission in order to determine whether it meets its objective (i.e. to restore the long-term viability). The SRB needs the ECB's consent to approve the plan.[757] Where the SRB and the ECB are not satisfied with the plan, in particular with regard to the measures envisaged therein, they may require from the banking group to amend and resubmit the plan within two (2) weeks after having addressed the issues raising concerns. If a disagreement between the two authorities cannot be resolved within that timeframe, either of the two authorities can refer the issue to the EBA requesting for non-binding mediation under **Article 31 of the EBA Regulation**.[758]

With respect to banking groups with entities both in participating and non-participating Member States, as well as in third countries, the SRB has the leading role in the approval, monitoring and assessment of the business reorganization plan. Therefore, prior to the approval of the plan, the SRB should:[759]

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[756] **EBA Guidelines** "*on the minimum criteria to be fulfilled by a business reorganization plan*", pp. 18-22.

[757] **BRRD**, Article 52(7).

[758] **EBA Guidelines** "*on the minimum criteria to be fulfilled by a business reorganization plan*", par. 1.5.

[759] *Ibid.*, par. 2.1.

- communicate the plan to the NRAs of non-participating Member States and resolution authorities of third countries,
- consider communicating the reorganization plan to the banking group's resolution college, and
- provide these resolution authorities with the opportunity to comment on the business reorganization plan.

The same procedure described above applies also with respect to the ECB and its interaction with supervisory authorities of the non-participating Member States and third countries.

3.1.6.4 Monitoring the implementation of the business reorganization plan

The management body or the person appointed by the SRB under **Article 72(1) of the BRRD** must implement the business reorganization plan as agreed with the SRB and submit a progress report at least every six (6) months. Following each submission of the progress report, the SRB and the ECB should coordinate and share their assessment on the progress report.

The implementation of the business reorganization plan should include quarterly implementation milestones and performance indicators, which must be monitored in order to allow early identification of any deviations or other difficulties. In such cases, adjustments to the milestones or measures originally envisaged in the business reorganization plan should be made. These adjustments should be communicated to the SRB and the ECB in the progress report regarding the implementation of the plan.[760]

The progress report must indicate the progress of the implementation of the business plan covering at least the following:[761]

- the milestones that are met, the measures that are implemented and how their impact compares to the envisaged by the reorganization plan,
- the performance of the banking group in relation to the forecasts of the business reorganization plan,
- the reasons why any milestones or performance indicators have not been met, and
- a proposal for adjustments to measures, milestones or performance indicators.

3.2 Resolution powers

3.2.1 General powers

Within the institutional framework of the SRM, the responsibility for the application of resolution tools has been conferred upon NRAs. To that end, NRAs are authorized to exercise extensive resolution powers in accordance with **Article 63 of the BRRD**, including general and ancillary resolution powers.

Having regard to the resolution objectives and the general principles governing resolution, the specific circumstances of the banking group under resolution and the need to facilitate the effective resolution of cross-border groups, NRAs decide whether it is appropriate to exercise resolution powers in any of the following two (2) ways:

- by exercising control over the parent entity of a banking group under resolution in order to:

[760] **Commission Delegated Regulation 2016/1400**, Article 4(2).

[761] *Ibid.*, Article 6(1).

- operate and conduct its activities and services with all the powers of its shareholders and management body, and
- manage and dispose the assets and property of the group under resolution, or

- by taking executive order in accordance with the national administrative competences and procedures. [762]

In the first case, the control may be exercised directly by the NRA concerned or indirectly by a person or persons appointed by the NRA. Voting rights conferred by shares of the parent entity under resolution cannot be exercised during the period of resolution.

As far as **general resolution powers** are concerned, these powers that can be exercised individually or in combination include:

- the power to require any person to provide any information necessary for the SRB to decide upon and prepare resolution action, including updates and supplements of information provided in the resolution plans,
- the power to take control of a banking group under resolution and exercise all the rights and powers conferred upon the shareholders and the management body of the parent entity,
- the power to transfer shares issued by a group's entity,
- the power to transfer to another entity, with the consent of that entity, rights, assets and liabilities of a banking group under resolution,
- the power to reduce, including to reduce to zero, the principal (or outstanding amount) of eligible liabilities of the parent entity under resolution,
- the power to convert eligible liabilities of the parent entity under resolution into ordinary shares of that entity or of a bridge institution to which assets, rights or liabilities of the entity are transferred,
- the power to cancel debt instruments issued by the parent entity under resolution except for secured liabilities,
- the power to reduce, including to reduce to zero, the nominal amount of shares of the parent entity under resolution and to cancel such shares,
- the power to require the parent entity under resolution to issue new shares or other capital instruments (including preference shares and other contingent convertible instruments),
- the power to amend or alter the maturity of debt instruments and other eligible liabilities issued by the parent entity under resolution or amend the amount of interest payable under such instruments or the date on which the interest becomes payable, including by suspending payment for a temporary period, except for secured liabilities,
- the power to close out and terminate financial contracts or derivatives contracts for the purposes of applying **Article 49 of the BRRD**,
- the power to remove or replace the management body and senior management of the parent entity under resolution, and

[762] **BRRD**, Article 72(3).

- the power to require the supervisory authority to assess the buyer of a qualifying holding in a timely manner by way of derogation from the time-limits laid down in **Article 22 of the CRD IV**.

When applying the resolution tools and exercise the resolution powers, NRAs are not subject to any of the following requirements that would otherwise apply by virtue of law or contract. Specifically, this applies to requirements to obtain approval or consent from any person either public or private, including the shareholders or creditors of the parent entity under resolution.

When the NRAs exercise the aforementioned powers, the safeguards provided for in the BRRD or safeguards that deliver the same effect must be applied to the persons affected, including shareholders, creditors and counterparties.

3.2.2 Ancillary powers

In addition, NRAs have been assigned with ancillary powers, which supplement the general resolution powers and facilitate the implementation of resolution action. In that context, NRAs have the power to:[763]

- provide for a transfer of financial instruments, rights, assets or liabilities to take effect free from any liability or encumbrance. For that purpose, any right of compensation under the BRRD must not be considered to be a liability or an encumbrance,
- remove rights to acquire further shares of the entity under resolution,
- require the relevant authority to discontinue or suspend the admission to trading on a regulated market or the official listing of financial instruments,
- provide for the recipient to be treated as if it were the group under resolution for the purposes of any rights or obligations of, or actions taken by, the group under resolution, including any rights or obligations relating to participation in a financial market infrastructure (FMI). This power cannot affect any right of a party to a contract to exercise rights under that contract, including the right to terminate, where entitled to do so in accordance with the terms of the contract by virtue of an act or omission by the group under resolution prior to the relevant transfer, or by the recipient after the relevant transfer,
- require the parent entity under resolution or the recipient to provide the other with information and assistance, and
- cancel or modify the terms of a contract to which the parent entity under resolution is a party or substitute a recipient as a party.

When exercising a resolution power, NRAs have the power to provide for continuity arrangements necessary to ensure that resolution action is effective and the transferred business may be operated by the recipient. Such continuity arrangements include the continuity of contracts entered into by the parent entity under resolution so that the recipient assumes the rights and liabilities of the group under resolution relating to any financial instrument, right, asset or liability that has been transferred and is substituted for the parent entity under resolution, explicitly or implicitly in all relevant contractual documents.[764] Continuity arrangements refer also to the substitution of the recipient for the group under resolution in any legal proceedings relating to any financial instrument, right, asset or liability that has been transferred. This power cannot affect the right of an employee to terminate a contract of employment or any right of a party to a contract to

[763] *Ibid.*, Article 64(1).

[764] *Ibid.*, Article 64(3).

exercise rights under the contract, including the right to terminate, where entitled to do so in accordance with the terms of the contract by virtue of an act or omission by the parent entity under resolution prior to the relevant transfer, or by the recipient after the relevant transfer.[765]

3.2.3 Other resolution powers

3.2.3.1 Power to require the provision of services or liabilities

The BRRD conferred upon NRAs a number of ancillary powers to ensure the effective implementation of the partial transfer of the business of a banking group through the application of the sale of business tool, bridge institution tool or asset management tool. Under **Article 65 of the BRRD**, NRAs are entitled to require the uninterrupted provision of critical services from other parts of the group, where relevant, or from the residual part of the group which is liquidated following the partial transfer of the business. This refers to the requirement for the group's entities under liquidation to continue providing services or facilities that are necessary to enable a recipient to operate effectively the business transferred to that. This arrangement applies to operational services and facilities (not to any form of financial support) and is applicable even in the case that the banking group has entered into normal insolvency proceedings.

The power conferred upon NRAs under **Article 65 of the BRRD** facilitates the implementation of the MPE strategy, as it ensures that a group's entity will continue providing critical services and facilities to another entity that is separated and transferred to a recipient (i.e. other institution, bridge institution, asset management vehicle).

Such services and facilities must be provided either **on the same terms**, where services and facilities were provided under an agreement to a group under resolution immediately before the resolution action was taken and for the duration of that agreement, or **on reasonable terms**, where there is no agreement or where the agreement has expired.

In accordance with the EBA Guidelines "*on the minimum list of services and facilities*", NRAs should consider require continuity of provision of services and facilities falling within the following categories:

- human resources support,[766]
- information technology,[767]

[765] *Ibid.*, Article 64(4)(b).

[766] 'Human resources support' covers:

- staff administration, including administration of contracts and remuneration, and
- internal communication,

[767] 'Information technology' covers:

- IT and communication hardware,
- data storage and processing,
- other IT infrastructure, workstations, telecommunications, servers, data centres and related services,
- administration of software licenses and application software,
- access to external providers, in particular data and infrastructure providers,
- application maintenance, including software application maintenance and related data flows,

- transaction processing, including legal transaction issues, in particular anti-money laundering and anti-terrorism financing,
- real estate and facility provision or management,[768]
- legal services and compliance functions,[769]
- treasury-related management,[770]
- trading/asset management,[771]
- risk management and valuation,[772]

- report generation, internal information flows and data bases,
- user support, and
- emergency and disaster recovery.

[768] 'Real estate and facility provision or management' covers:

- office premises and storage,
- internal facilities management,
- security and access control, and
- real estate portfolio management.

[769] The category 'legal services and compliance functions' pertains to:

- corporate legal support,
- business and transactional legal services, and
- compliance support.

[770] The category 'treasury-related management' includes the following services:

- coordination, administration and management of the treasury activity,
- coordination, administration and management of entity refinancing, including collateral management,
- reporting function, in particular with respect to regulatory liquidity ratios,
- coordination, administration and management of medium and long-term funding programs, and refinancing of group entities, and
- coordination, administration and management of refinancing, in particular short-term issues.

[771] The category 'trading/asset management' includes the following services:

- operations processing: trade capture, design, realization, servicing of trading products,
- confirmation, settlement, payment,
- position and counterparty management, with respect to data reporting and counterparty relationships, and
- position management (risk and reconciliation),

[772] The category 'risk management and valuation' includes the following services:

- central or business line or risk type-related risk management, and
- risk report generation.

- accounting,[773] and
- cash handling.

The aforementioned list of services should be regarded as a minimum list allowing NRAs to require the provision of additional services. Nonetheless, it is likely that in most of the resolution cases, particularly where the recipient is a banking group that obtained the transferred business under the sale of business tool, the recipient will not need the provision of all these services, as it will be able to carry out some of them on its own (e.g. risk management, treasury- related services).[774]

However, in the context of resolution planning, NRAs must take the necessary measures to ensure that the aforementioned services and facilities can be transferred to a recipient under a partial transfer. For that purpose, NRAs must require from a group's entities to assess the enforceability upon resolution of contracts with third-party service providers and take the necessary measures (e.g. introduction of relevant clauses in contracts) to ensure that they will remain in force in resolution, including in case of partial transfer.

3.2.3.2 Power to suspend certain obligations and restrict the enforcement of security interests

NRAs are empowered to suspend any payment or delivery obligation in accordance with any contract to which the parent entity under resolution is party from the publication of a notice of the suspension under **Article 83(4) of the BRRD** until midnight at the end of the business day following that publication (i.e. up to two business days).[775] The same suspension period is granted also to the counterparties of the parent entity under resolution with respect to their own payment or delivery obligations.

This two-way stay on payment and delivery obligations is not applicable to **eligible deposits**, **payment and delivery obligations** owed to payment or settlement systems or operators of thereof,[776] central counterparties and central banks, as well as to **eligible claims for the purposes of Directive 97/9/EC**.[777] When a payment or delivery obligation would have been due during the suspension period, this obligation must be due immediately upon expiry of the suspension period.

Furthermore, NRAs have the power to restrict secured creditors of the parent entity under resolution from enforcing security interests in relation to any assets from the publication of a notice of restriction under **Article 83(4) of the BRRD** until midnight at the end of the business day following that publication.[778] This power cannot be applied by NRAs to

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[773] The category 'accounting' includes the following services:

- statutory and regulatory reporting,
- valuation, in particular of market positions, and
- management reporting.

[774] **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*", p. 5.

[775] **BRRD**, Article 69(2).

[776] **Directive 98/26/EC** of the European Parliament and of the Council of 19 May 1998 "*on settlement finality in payment and securities settlement systems*".

[777] **Directive 97/9/EC** of the European Parliament and of the Council of 3 March 1997 "*on investor-compensation schemes*".

[778] **BRRD**, Article 70(1).

any security interest of systems or operators of systems designated for the purposes of Directive 98/26/EC, central counterparties and central banks over assets pledged or provided by way of margin or collateral by the entity under resolution.

3.2.3.3 Exclusion of certain contractual terms in early intervention and resolution

Any crisis prevention measures or crisis management measures taken in respect of the parent entity of a banking group, including the occurrence of any event linked to the application of such measures, must not be deemed as an enforcement event[779] within the meaning of Directive 2002/47/EC[780] or as insolvency proceedings within the meaning of Directive 98/26/EC. This condition applies provided that the substantive obligations under the contract, including payment and delivery obligations and the provision of collateral, continue to be performed.[781]

The **general resolution stay** established under **Article 68(3) of the BRRD** holds also for contracts entered into by:

- a subsidiary, the obligations under which are guaranteed by the parent entity or by any other group entity, or
- any group entity which includes cross-default provisions.

On condition that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral continue to be performed, a crisis prevention measure or a crisis management measure must not make it possible for anyone to exercise any termination, suspension, modification, netting or set-off rights, including in relation to a contract entered into by:[782]

- a subsidiary, the obligations under which are guaranteed by the parent entity or by any other group entity, or
- any group entity which includes cross-default provisions

Moreover, a crisis prevention or crisis management measure does not imply that anyone may obtain possession, exercise control or enforce any security over any property of the parent entity concerned in relation to a contract which includes cross-default provisions. The general resolution stay applies automatically upon occurrence of resolution without requiring any specific decision from the resolution authority.[783]

3.2.3.4 Power to temporarily suspend termination rights

NRAs may suspend the termination rights of any party to a contract with the parent entity of a banking group under resolution for two (2) business days, provided that the payment and delivery obligations and the provision of collateral continue to be performed.[784]

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[779] Under Directive 2002/47/EC, an enforcement event is defined as an event of default or any similar event as agreed between the parties on the occurrence of which, under the terms of a financial collateral arrangement or by operation of law, the collateral taker is entitled to realize or appropriate financial collateral or a close-out netting provision comes into effect.

[780] **Directive 2002/47/EC** of the European Parliament and of the Council of 6 June 2002 "*on financial collateral arrangements*".

[781] **BRRD**, Article 68(1).

[782] *Ibid.*, Article 68(3).

[783] See **International Swaps and Derivatives Association (2017)**, p. 6.

[784] **BRRD**, Article 71(1).

The power referred above can be exercised also in respect of a contract with a subsidiary of the parent entity under resolution, where:[785]

- the obligations under that contract are guaranteed by the parent entity,
- the termination rights under that contract are based on the insolvency or financial condition of the group under resolution, and
- in the case of a transfer power that has been or may be exercised in relation to the group under resolution, either:
  - all the assets and liabilities of the subsidiary relating to that contract have been or may be transferred to and assumed by the recipient, or
  - the NRA provides in any other way adequate protection for such obligations.

Any suspension must not apply to payment or settlement systems or operator thereof, central counterparties or central banks.

However, a person may exercise a termination right under a contract before the end of the suspension period if that person receives notice from the NRA concerned that the rights and liabilities covered by the contract will not be transferred to another entity or will be subject to write down or conversion powers (under the bail-in tool) in accordance with **Article 43(2)(a) of the BRRD**. [786] Where an NRA exercises the power to suspend termination rights, those rights may be exercised on the expiry of the period of suspension in the following ways. If the rights and liabilities covered by the contract have been transferred to another entity, the counterparty may exercise termination rights in accordance with the terms of that contract only on the occurrence of any continuing or subsequent enforcement event by the recipient entity. On the contrary, if the rights and liabilities covered by the contract remain with the parent entity under resolution and the NRA has not applied the bail-in tool to that contract, the counterparty may exercise termination rights in accordance with the terms of that contract on the expiry of the suspension period.

NRAs may request the parent entity to maintain detailed records of financial contracts[787] in accordance with the Commission Delegated Regulation 2016/1712. This Regulation determines that the parent entity must maintain on an on-going basis a minimum set of information on such contracts, where the group resolution plan provides for resolution actions in relation to that entity in the event the conditions for resolution are met.[788]

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[785] *Ibid.*, Article 71(2).

[786] *Ibid.*, Article 71(4).

[787] In accordance with **Article 2(1)(100) of the BRRD**, "*financial contracts" include the following contracts and agreements:*

a. *securities contracts*
b. *commodities contracts,*
c. *futures and forward contracts,*
d. *swap agreements,*
e. *inter-bank borrowing agreements where the term of the borrowing is up to three (3) months,*
f. *master agreements for any of the contracts or agreements referred to in points (a) to (e).*"

[788] **Commission Delegated Regulation 2016/1712**, Article 1(1).

3.2.3.5 Power to enforce crisis management measures or crisis prevention measures in other Member States

The BRRD ensures that when a transfer of shares or assets, rights or liabilities includes assets that are located in a Member State other than the Member State of the resolution authority or rights or liabilities governed by the law of a Member State other than the Member State of the resolution authority, the transfer has effect in or under the law of that other Member State. Additional safeguards for the orderly exercise of the resolution powers provide that shareholders, creditors and third parties being affected by the transfer of shares, assets, rights or liabilities are not entitled to prevent, challenge or set aside the transfer under any provision of law of the Member State where the assets are located or of the law governing the shares, rights or liabilities.[789]

In addition, the BRRD provides that in case that the NRA of a Member State exercises the write-down or conversion powers to capital instruments and eligible liabilities of the parent entity under resolution, this power covers also the:

- instruments or liabilities that are governed by the law of a Member State other than the State of the resolution authority that exercised the write down or conversion powers (Member State B), and
- liabilities owed to creditors located in Member State B.

In accordance with the BRRD, EU Member States are obliged to ensure that the principal amount of those liabilities or instruments is reduced or converted into equity in line with the exercise of the write-down or conversion powers by the resolution authority of Member State A. Creditors that are affected by the exercise of write-down or conversion powers are not entitled to challenge the reduction of the principal amount of the instrument or liability or its conversion, as the case may be under any provision of law of Member State B.

Moreover, the BRRD stipulates that the following are determined in accordance with the law of the Member State of the NRA concerned:[790]

- the right for shareholders, creditors and third parties to challenge, by way of appeal in accordance with **Article 85 of the BRRD**, a transfer of shares, assets, rights or liabilities,
- the right for creditors to challenge, by way of appeal in accordance with **Article 85 of the BRRD**, the reduction of the principal amount, or the conversion, of a capital instrument or liability, and
- the safeguards for partial transfers in relation to assets, rights or liabilities.

3.2.3.6 Powers with respect to assets, rights, liabilities and shares located in third countries

Pursuant to **Article 67 of the BRRD**, where resolution involves action taken in respect of assets located in third countries or shares, rights or liabilities governed by the law of third countries, NRAs may require that:[791]

- the administrator, receiver or other person exercising control of the parent entity of the group under resolution and the recipient take all necessary steps to ensure that the transfer, write down, conversion or actions becomes effective, and

[789] **BRRD**, Article 66(3).

[790] *Ibid.*, Article 66(6).

[791] *Ibid.*, Article 67(1).

- the administrator, receiver or other person exercising control of the parent entity under resolution hold the shares, assets or rights or discharge the liabilities on behalf of the recipient until the transfer, write down, conversion or actions becomes effective.

Where the NRA assesses that, in spite of all the necessary steps taken by the administrator, receiver or other person, it is highly unlikely that the transfer, conversion or action will become effective in relation to certain assets located in a third country or certain shares, rights or liabilities governed by third-country law, the NRA must not proceed with the transfer, write down, conversion or action. If it has already ordered the transfer, write down, conversion or action, that order must be void in relation to the assets, shares, rights or liabilities concerned.[792]

3.3 Resolution action and third-country law implications

3.3.1 Cross-border effect of resolution actions

Recognition and enforcement in non-EU jurisdictions of resolution action taken by the SRB remains a significant challenge, given that the BRRD is enforceable only within the EU boundaries. Banking groups with subsidiaries and branches in third countries face the risk of a territorial approach applied by host resolution authorities. In that case, the host resolution authority may take separate resolution action for the foreign entity of the banking group and act in an uncoordinated way in order to protect its national interests and domestic customers.[793]

Regulatory authorities have developed international standards to promote recognition and enforcement of resolution proceedings enacted in foreign jurisdictions through statutory and contractual approaches. In accordance with the "*Key Attributes for Effective Resolution Regimes*", jurisdictions must ensure that resolution measures taken by a foreign resolution authority have cross-border effect provided that domestic creditors are treated equitably in the foreign resolution proceedings. This applies also to resolution action taken in respect of an EU-based banking group that **operates a branch or controls a subsidiary in a third country** or **holds assets, liabilities and rights located or governed by the law of a third country**.

In reaction to the commitment of the G-20 political leaders, as affirmed in St. Petersburg G20 Summit in 2013 to "*undertake the necessary actions to remove obstacles to cross-border resolution*",[794] in November 2015 the FSB issued the "*Principles for Cross-border Effectiveness of Resolution Actions*". These Principles established statutory and contractual arrangements that countries should consider including in their national law to give cross-border effect to resolution actions.

The **statutory approach** for giving effect to foreign resolution actions covers:[795]

(A) Recognition: upon request from the SRB, a third country accepts the commencement of a foreign resolution proceeding and empowers the domestic resolution authority to enforce the SRB's measures or grant other forms of domestic relief (e.g. stay on domestic creditor proceedings). Once the recognition is granted, the measures taken by the SRB are given effect in accordance with the law of the third-country resolution proceedings.

[792] *Ibid.*, Article 67(2).

[793] See **Huertas (2015)**, p. 139.

[794] See **G20 (2013)**, p. 16.

[795] See **Financial Stability Board (2015a)**, pp. 5-6.

(B) Resolution action taken by the domestic (third-country) authority: upon request from the SRB, the domestic resolution authority may take resolution action that is consistent with the SRB's resolution action.

Potential inconsistencies between resolution powers of the involved authorities may threaten the achievement of the desired outcome. Therefore, it is necessary for the SRB and the Commission to convene banking group-specific cooperation agreements and MoUs with third-country resolution authorities to identify differences in the legal frameworks of the relevant jurisdictions.[796]

Alternatively, **contractual recognition** may support the cross-border enforceability of resolution action and offer a workable solution until the adoption of comprehensive statutory regimes. In addition, contractual arrangements supplement statutory regimes once they are in place. Such contractual arrangements may be considered to support the cross-border enforceability of:[797]

- temporary restrictions or stays on the exercise of early termination rights in financial contracts governed by third-country law, and
- write-down or conversion into equity of debt instruments governed by third-country law.

Temporary stays on early termination rights are necessary to prevent the close-out of financial contracts, which could disrupt the provision of critical functions upon entry into resolution of the banking group concerned. In line with the Key Attributes, the BRRD conferred upon resolution authorities the power to impose such temporary stays for contracts governed by law of an EU Member State. However, this arrangement does not apply to contracts governed by third-country law. Therefore, the International Swaps and Derivatives Association (ISDA) has developed a Resolution Stay Protocol for Over-The-Counter (OTC) bilateral derivatives documented under the ISDA Master Agreement (1992 and 2002 versions). The Protocol limits the exercise of termination rights for parties opted to adhere to it. The FSB Members have made a commitment to promote the broad adoption of the contractual approach to cross-border effectiveness. Thus, many banking groups, mainly G-SIIs, have selected the contractual approach to deal with this risk, namely the adoption of the ISDA protocol. This contractual solution is binding only to the parties that agree to it.

As far as the application of the bail-in tool to third-country debt instruments is concerned, the instruments should include legally enforceable contractual provisions recognizing the application of resolution tools by the SRB. This approach supports the enforceability of bail-in actions taken by the SRB (or other EU resolution authority) in relation to the issuing entity. Although there cannot be complete legal certainty, courts will generally enforce contractual provisions properly entered into, unless they are considered to be contrary to the public policy.[798]

The adoption of effective statutory frameworks is the optimal solution to give effect to cross-border resolution actions. Until the development of such frameworks, recourse to the contractual approach is useful to promote the enforceability of resolution measures. However, the contractual approach cannot achieve the same degree of legal certainty with the statutory approach, while it is necessary for banking groups to ensure widely

[796] *Ibid.*, p. 6.

[797] *Ibid.*, p. 7.

[798] *Ibid.*, p. 8.

adoption of the contractual approach by all their counterparties in relation to all relevant contracts.[799]

3.3.2 Contractual recognition of bail-in

Resolution authorities may exercise the write-down and conversion powers in relation to instruments or liabilities governed by third-country law. For the purposes of enhancing legal certainty, banking groups are obliged to introduce clauses to such liabilities and instruments to facilitate the exercise of the write-down and conversion powers. Thus, contractual terms must be inserted by which the creditor or party to the agreement creating the liability recognizes that the liability may be written down or converted and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation provided that such liability:[800]

- is governed by the law of a third country,
- does not fall within the scope of liabilities excluded from bail-in under **Article 44(2) of the BRRD** (mandatory exclusions from bail-in),[801]
- is not uncovered deposit of natural persons or SMEs, and
- was issued or entered into force after the date when the BRRD provisions had been transposed into national law and entered into force.

However, there is no need for contractual recognition of bail-in, where liabilities or instruments governed by third-country law can be subject to write-down and conversion powers by the resolution authority of a Member State in accordance with the laws of the third country or a binding agreement concluded with the third country. Resolution authorities may require banking groups to provide them with a legal opinion relating to the legal enforceability and effectiveness of such a term.

The contractual term that should be introduced in a relevant agreement includes the following:[802]

- the acknowledgment and acceptance by the counterparty that the liability may be subject to the exercise of the write-down and conversion powers by a resolution authority,
- the description of the write-down and conversion powers of the resolution authority in accordance with the national law transposing the BRRD,
- the acknowledgment and acceptance by the counterparty that it is bound by the reduction in the principal amount or outstanding amount due or the conversion of that liability into common shares, and
- the acknowledgment and acceptance by the counterparty that the contractual term is exhaustive on the matters described therein to the exclusion of any other agreements and arrangements between the counterparties.

[799] *Ibid.*, p. 8.

[800] **BRRD**, Article 55(1).

[801] Under **Article 43(1) of the Commission Delegated Regulation 2016/1075**, this exclusion does not cover not fully secured liabilities or liabilities that are fully secured but are governed by contractual terms that do not oblige the debtor to retain the liability fully secured on a continuous basis.

[802] **Commission Delegated Regulation 2016/1075**, Article 44.

3.3.3 ISDA 2015 Universal Resolution Stay Protocol

The BRRD imposes stays and overrides of direct-default and cross-default rights in the event of resolution where both counterparties are located in the EU. As described above, resolution authorities have the power to suspend temporarily:

- the termination rights of any party to a contract provided that the banking group under resolution continues to perform its payment and substantive obligations under the contract, and
- the rights of a secured creditor of the banking group under resolution to enforce any security interest that the creditor has in relation to any assets of the group concerned.

Statutory stays apply to all contracts with all counterparties governed by the law of an EU Member State, but there is uncertainty over whether a stay would be enforceable on a cross-border basis and recognized in a foreign jurisdiction by a foreign court, if derivative transactions are governed by third-country law. For example, in case of a banking group located in the UK whose subsidiary in the USA has derivative transactions with a US counterparty under New York law, the stay and overrides under BRRD might not be recognized under the New York law by a New York court. This entails that the US counterparty could exercise cross-default clauses and terminate the outstanding transactions with the subsidiary.

In response to the G-20 leaders' request to make progress towards ending the "too-big-to-fail" issue, in 2014, the ISDA developed the ISDA 2014 Resolution Stay Protocol to provide a contractual solution to resolution stays for derivative contracts governed by third-country law until statutory recovery and resolution regimes were adopted.[803] The ISDA 2014 Resolution Stay Protocol was substituted by the ISDA 2015 Universal Protocol, which was developed by ISDA member institutions in coordination with the FSB.

The ISDA 2015 Universal Protocol, which applies to OTC derivatives contracts and securities financing transactions,[804] has separate Jurisdictional Modules designed to reflect the requirements set out in the national law of relevant jurisdictions (i.e. France, Germany, Japan, the UK, the USA). Any banking group can adhere to the ISDA 2015 Universal Protocol (and the ISDA Jurisdictional Modular Protocol) on a voluntary basis to agree to opt-in to and be bound by stays applicable to all other adhering parties to the Protocol.[805] When a banking group adheres to the Protocol, it decides whether its provisions would apply to all banking groups having adhered to that, only to G-SIIs or to a specific group.

An adhering party to the ISDA Jurisdictional Modular Protocol acknowledges that the provisions concerning the temporary suspension of termination rights and other contractual rights may be applied to the liabilities of a counterparty (adhering party to the Protocol).[806] Adhering parties amend the terms of their ISDA Master Agreements by opting in to resolution regimes that stay and override certain cross-default and direct-default rights included in contracts that arise upon the entry of a banking group into resolution. The Resolution Stay Jurisdictional Modular Protocols enable market

[803] The ISDA 2014 Resolution Stay Protocol focused on the 18 largest dealers in OTC derivatives, which amended their ISDA Master Agreement documentation.

[804] See **Financial Stability Board (2016c)**, p. 13.

[805] See **Jennings-Mares (2017)**, p. 118.

[806] Indicatively, see the ISDA Resolution Stay German Jurisdictional Module (**International Swaps and Derivatives Association (2016b)**).

participants to comply with national laws that ensure the cross-border enforceability of stays on contractual termination rights.[807] In the example referred above, adherence to the Protocol would imply that the US counterparty had opted in to the law transposing the BRRD into the UK law and would be subject to the requirements set thereunder.

If resolution action in relation to a banking group is successful (typically by the end of the next business day), its derivatives counterparties would no longer have the right to terminate outstanding derivatives transactions. On the contrary, if resolution action is unsuccessful, counterparties can exercise cross-default and termination clauses.

As of December 2018, 380 banking groups, including 23 G-SIIs, have adhered to the ISDA Universal Resolution Stay Protocol.[808]

3.3.4 Contractual resolution stays for financial contracts governed by third-country law

The BRRD II introduces the obligation for banking groups to insert contractual clauses in financial contracts governed by third-country law by which the parties to such contracts recognize that these contracts may be subject to resolution authorities' power to suspend or terminate rights and obligations (Articles 33a, 68, 69, 70 and 71 of the BRRD II).[809] This obligation applies to financial contracts:

- under which a new obligation is created, or an existing obligation is materially amended, after the date of entry into force of the national law transposing the BRRD II,
- which provide for the exercise of one or more termination rights or rights to enforce security interests, the exercise or enforcement of which could be suspended or prevented or the application of which would be disregarded, if the financial contract was governed by EU law, and
- are governed by third-country law.

The obligation referred above does not include financial contracts entered into or concluded with payment and securities settlement systems, central counterparties, central banks and central governments.

[807] See **International Swaps and Derivatives Association (2016a)**.

[808] The following banking groups have adhered to the ISDA Universal Resolution Stay Protocol: Bank of America, Bank of New York Mellon, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, ING Bank, JP Morgan Chase, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Société Générale, Standard Chartered, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group and Wells Fargo. The seven G-SIIs that have not yet adhered to the 2015 Universal Protocol are Agricultural Bank of China, Bank of China, China Construction Bank, Groupe BPCE, Groupe Crédit Agricole, Industrial and Commercial Bank of China Limited and Santander.

[809] **BRRD II**, Article 72a.

Section 4: Provision of external capital and liquidity in resolution

1. State aid under the EU resolution regime

1.1 The Government Financial Stabilization Tools (GFSTs)

The resolution framework has as objective to minimize, rather to eliminate, the burden that taxpayers may incur upon failure of banking groups. For that purpose, appropriate safeguards have been established to ensure that shareholders and creditors would bear losses mostly and prior to the use of public funds.

The resolution framework has not excluded the option for Member States to contribute to loss absorption and recapitalization of banking groups under strict conditions, where a systemic crisis has sparked.[810] Thus, resolution authorities may request for use of alternative funding sources via the means of the government financial stabilization tools (GFSTs), namely the **public equity support tool** and the **temporary public ownership tool**, if the following conditions are met:[811]

- shareholders, holders of capital instruments and other creditors have contributed to loss absorption and recapitalization of the parent entity under resolution with an amount not less than 8% of total liabilities and own funds, measured at the time of resolution action, and
- the Commission has granted prior and final approval to the use of state aid.

Hence, the GFSTs cannot be used for bail-out purposes, but only as a last resort option after having exploited the resolution tools to the maximum extent practicable. This solution can be activated only on the initiative of competent ministries or governments. The SRB has no authority to require Member States to grant access to public funds, as this would impinge on Member States' fiscal sovereignty that cannot be encroached upon under **Article 114 of the TFEU**. Therefore, the SRMR does not make any reference to the GFSTs.

Prior to use of the GFSTs, the competent ministry (typically the Ministry of Finance) and the SRB must ensure that both the conditions for resolution and one of the following conditions are met:[812]

- the application of the resolution tool(s) is not adequate to prevent a significant impact on the financial system,
- the application of the resolution tool(s) cannot protect the public interest, where ELA has been provided to the banking group concerned. In that case, it is preferable to use public funds to contribute to loss absorption and recapitalization than to let the parent entity fail, which would result in losses for the national central bank that had provided ELA to that entity, or
- resort to the temporary public ownership tool is necessary given that the application of the resolution tool(s) is not sufficient to protect the public interest, where the public equity support tool has been used.

Where the conditions referred above are met, governments may participate in the loss absorption and recapitalization of the parent entity under resolution through the public equity support tool and/or the temporary public ownership tool.

[810] For a thorough presentation of the options for government support under the BRRD framework, see **Gortsos (2016).**

[811] **BRRD**, Article 37(10).

[812] *Ibid.*, Article 56(4).

The public equity support tool allows governments to provide capital in exchange for CET1 instruments, Additional Tier 1 instruments or Tier 2 instruments. Thus, the government concerned acquires a stake (and not full control) in the parent entity under resolution. The control of the parent entity remains in the hands of the shareholders having resulted from the write-down and conversion of prior shareholders and creditors. If the public equity support tool is used, the parent entity concerned must be managed on a commercial and professional basis, while it is necessary to ensure that it will be transferred to private sector purchasers as soon as commercial and financial circumstances allow.[813]

The temporary public ownership tool allows governments to take the temporary public ownership and control of the parent entity under resolution. The recipient of the shares is either a nominee of the government or a company wholly owned by the public sector.[814] Whereas the parent entity is under the control of the government, the latter has to ensure that it is managed on a commercial and professional basis, without any political interference in the management decisions and take all the necessary measures to return the parent entity to the private sector as soon as possible.[815]

Consequently, the key differences between the two (2) government financial stabilization tools pertain to the share of the government in the parent entity concerned and the control of it, namely under the temporary public ownership tool the government has the majority stake and the control of the parent entity, whereas under the public ownership tool the government' share is limited to a minority stake.

1.2 Direct recapitalization of banking groups by the ESM

1.2.1 Eligibility criteria for the provision of financial assistance

On 8 December 2014, the Board of Governors of the ESM adopted a Resolution on the establishment of the Direct Recapitalization Instrument (DRI) in accordance with the Treaty on the establishment of the ESM. In addition, the ESM adopted a Guideline "*on Financial Assistance for the Direct Recapitalisation of Institutions*", which sets out the terms and conditions under which the ESM may provide aid to banking groups under resolution.[816] Thus, at the request of an ESM member (i.e. euro area Member States), which is within or outside the confines of a Macroeconomic Adjustment Program, the ESM may grant financial assistance to recapitalize the parent entity of a banking group already put into resolution. This instrument cannot be used for winding up group's entities under normal insolvency proceedings.[817]

The ESM's financial assistance aims to preserve the financial stability of the euro area as a whole and of its Member States by addressing the cases where a euro area Member State cannot cope with difficulties related to its financial sector without endangering its fiscal position due to a severe risk of contagion from the financial sector to the sovereign. Thus, the ESM's direct recapitalization instrument applies to cases where the use of the government financial stabilization tools cannot be financed by a Member State itself due to fiscal difficulties.

[813] *Ibid.*, Article 57(2)-(3).

[814] *Ibid.*, Article 58(2).

[815] *Ibid.*, Article 58(3).

[816] For an analysis of the ESM's Direct Recapitalization Instrument, see **Hadjiemmanuil (2015a)** and **Vovolinis (2015)**.

[817] **ESM Guideline** *"on Financial Assistance for the Direct Recapitalisation of Institutions"*, Article 2(3).

The ESM may grant financial assistance to recapitalize the parent entity under resolution, where specific conditions related to both the group and the Member State concerned are met. With respect to the group-related conditions, a euro area Member State may request for financial assistance with respect to a banking group which meets the following conditions:[818]

- the banking group is, or is likely to be in the near future, in breach of the minimum capital requirements set by the ECB,
- the banking group is unable to raise capital from private sector sources to address its problems,[819]
- the application of the bail-in tool is not expected to address fully the capital shortfall, and
- the banking group has a systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of the requesting Member State.[820]

With regard to the requesting Member State, the ESM Guideline provides that certain conditions must be met. Firstly, the requesting Member State cannot provide financial assistance to the failing parent entity in full without putting in danger the viability of its fiscal position, including the case of indirect recapitalization through a loan granted by the ESM to the Member State for that purpose. Secondly, the financial assistance is necessary to safeguard the financial stability of the euro area as a whole or of the Member State concerned.

1.2.2 Procedure for the provision of financial assistance

Prior to providing financial assistance, the ESM conducts a thorough due diligence, stress test or economic valuation of the parent entity's assets to determine the amount of incurred, expected and unexpected losses, as well as its loss absorption capacity, after taking into account the level of bail-in that can be conducted.[821] However, given the extremely tight timeframe which the ESM is expected to have at its disposal to take such a decision, it may make use of the results of a stress-test and/or economic valuation already conducted within a three-month period prior to the request.[822]

The contribution of the ESM to the recapitalization of the parent entity is subject to the following conditions:[823]

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[818] *Ibid.,* Article 3(1).

[819] Private sector sources mean both new market investors and existing shareholders.

[820] The systemic relevance is assessed based on the size, interconnectedness, complexity and substitutability of the banking group. Systemic relevance refers to global and domestically important entities located in the euro area and other banking groups, not necessarily cross-border whose insolvency could have a significant negative impact on the financial system because of adverse market circumstances of financial stress.

[821] **ESM Guideline** *"on Financial Assistance for the Direct Recapitalisation of Institutions"*, Article 7(1).

[822] *Ibid.,* Article 7(1).

[823] For the period from December 2014 to 31 December 2015, the use of the direct recapitalization instrument by the ESM was subject to less stringent conditions, since it was required only a contribution of 8% of total liabilities including own funds of the banking group under resolution from the shareholders and holders of capital instruments and other eligible liabilities, as well as a contribution of the national resolution fund up to the amount of contributions raised up to 2015

- shareholders and holders of capital instruments and other eligible liabilities have contributed through write-down and conversion to loss absorption and recapitalization with an amount not less than 8% of the total liabilities including own funds of the parent entity under resolution, [824]
- the SRF has contributed with an amount of 5% of the total liabilities including own funds of the parent entity under resolution, and
- all unsecured, non-preferred liabilities, other than eligible liabilities, of the parent entity have been written down or converted in full.

The contribution of the ESM to the recapitalization of the parent entity is subject to the obligation of the requesting Member State to contribute also to the recapitalization. Where the group's CET1 ratio falls below 4.5%, the requesting Member State must inject capital to the parent entity to ensure that the CET1 ratio reaches 4.5%. If the CET1 ratio is above 4.5%, the Member State concerned is required to contribute with a 10% of the capital shortfall that must be covered.[825] If the contribution under the first case is below the level that the Member State would have been required to contribute under the second case, that Member State must contribute an additional amount alongside the ESM to cover the difference.[826] Hence, the Member State has to contribute with an amount equal to 10% of the capital shortfall, except for the case that the capital shortfall up to 4.5% exceeds that benchmark.

The financial assistance corresponding to the Member State may be partially or fully suspended, where the Member State faces fiscal problems, which may create severe implications for its access to capital markets and it is unable to fully provide its contribution to the recapitalization. In that case, the ESM will cover the share of the Member State provided that:[827]

- the Member State agrees to indemnify the ESM for any loss incurred on the share of capital that was acquired by the ESM in lieu of the Member State, and
- the Memorandum of Understanding signed by the two parties contains requirements of macroeconomic nature.

Any loss incurred by the ESM as a result of holding the share of capital that had to be acquired by the Member State will be treated as a long-term loan to the Member State.

In principle, the financial assistance provided by the ESM to the parent entity under resolution must be in means of CET1 instruments (i.e. common shares). Provided that it also holds an appropriate level of common shares of the parent entity, the Board of Governors of the ESM may decide to contribute to the recapitalization with **other capital instruments**, such as special shares, hybrid capital or contingent capital or **guarantees**, if strictly warranted for reducing the total cost of the recapitalization. [828] In exceptional circumstances, the ESM may provide financial assistance in the form mentioned above

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target level, which was the 0.1% of total covered deposits of the banking groups located in the Member State concerned.

[824] **ESM Guideline** *"on Financial Assistance for the Direct Recapitalisation of Institutions"*, Article 8(3).

[825] *Ibid.*, Article 9(1)-(2).

[826] During the first two years following the entry into force of the direct recapitalization instrument, the Member States had to contribute with an amount of 20% of the capital shortfall.

[827] **ESM Guideline** *"on Financial Assistance for the Direct Recapitalisation of Institutions"*, Article 9(3).

[828] *Ibid.*, Article 10(2)(a)-(b).

to a bridge institution or asset management vehicle, where it has also provided assistance to the parent entity under resolution that has transferred the assets.[829]

1.2.3 Conditionality arrangements

The use of the direct recapitalization instrument is subject to strict conditions both for the beneficiary, as well as for the Member State concerned in order to address the sources of difficulties in the financial sector and other possible weaknesses related to its macroeconomic situation. Provision of financial assistance is accompanied with group-specific and sector-specific measures, as well as measures of macroeconomic nature.[830]

The financial support from the ESM falls within the scrutiny of the European Commission to assess its compatibility with the Union State aid law**.** Recourse to the ESM direct recapitalization instrument meets the conditions for state aid, as it is the last resort option to prevent the liquidation of the entities constituting a banking group and therefore recourse to state resources is needed. Based on **Article 1(1) of the Treaty on the establishment of the ESM**, the ESM is an international financial institution whose members are the euro area Member States, which have fully covered the ESM's capital of €705bn. These Member States decide unanimously on the use of the DRI and each Member State is liable for the obligations of the ESM up to its portion of the authorized capital stock at its issue price. Hence, resort to the direct recapitalization instrument is considered as state aid, as referred also in par. 59 of the **Commission Notice (2016/C262/01)** "*on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union*", which provides that "*a transfer of State resources is also present if the resources are at the joint disposal of several Member States who decide jointly on the use of those resources. This would be the case for funds from the ESM*".

In accordance with **Article 4(4) of the ESM Guideline**, the Member State where the parent entity is located must notify, pursuant to **Article 108(3) of the TFEU**, the Commission, for itself and on behalf of all ESM members, of the intention to grant State aid within the meaning of **Article 107(1) of the TFEU**.[831] The Member State must also submit a restructuring plan, which is drawn up by the ESM, jointly with the parent entity of the banking group and the Member State concerned, and in consultation with the ECB and the SRB. The objective of this restructuring plan is to ensure the viability of the group after recapitalization. The ESM may provide direct recapitalization to a banking group only if the restructuring plan has been approved by the Commission.[832] Hence, the Commission may object to the provision of financial support from the ESM if the restructuring plan does not meet the criteria set out in the Restructuring Communication, mainly with respect to measures to limit distortions to competition (e.g. divestments, constraints on acquisitions, aggressive pricing and marketing strategy).[833]

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829 *Ibid.,* Article 10(2)(c).

830 *Ibid.,* Article 1(4).

831 *Ibid.,* Article 4(4).

832 *Ibid.,* Article 4(11).

833 Given that recourse to the DRI is permitted only under very strict conditions (i.e. prior write-down and conversion of at least 8% of total liabilities and own funds, including all the unsecured, non-preferred liabilities), the key requirement of the Banking Communication to find a state aid compatible with internal market, namely the application of burden-sharing measures to shareholders and junior bondholder of the beneficiary banking group, should be considered met.

Monitoring of compliance with group-specific conditions related to **Articles 107 and 108 of the TFEU** is conducted by the European Commission, as holds also for banking groups having received state aid by national governments.

1.3 The role of resolution funds in resolution of significant banking groups

1.3.1 Resort to the SRF to cover resolution costs

The decision of the SRB to exclude, in full or partially, certain liabilities from the scope of the bail-in (see above in **Chapter B, Section 3,** under **3.1.4.2**) may trigger the use of the SRF, if the losses that would have been borne by those liabilities have not been passed on fully to other creditors. In this case, the SRF may make a contribution to the parent entity under resolution aiming either to cover any losses which have not been absorbed by eligible liabilities and restore its net asset value to zero or purchase shares or capital instruments of the parent entity under resolution to restore its CET1 ratio above the regulatory minimum threshold.[834]

However, recourse to the SRF is permitted under strict conditions, namely:[835]

- shareholders, holders of capital instruments and other eligible liabilities are required to have contributed to loss absorption and recapitalization through write down and conversion of at least 8% of total liabilities and own funds of the parent entity under resolution, and
- the contribution of the SRF must not exceed 5% of total liabilities including own funds of the parent entity under resolution.

The contribution of the SRF may be financed by:[836]

- the ex-ante contributions raised,
- any ex-post contribution which the SRF may raise. where necessary, and
- where the amounts referred above are insufficient, any other amounts that the SRF may raise from alternative financing sources, such as borrowings or other forms of support from institutions, financial institutions or other third parties in accordance with **Article 105 of the BRRD**.

As referred above, in extraordinary circumstances, further funding may be sought from other sources (i.e. through the GFSTs or ESM’s direct recapitalization instrument), after a contribution by the SRF of 5% of the total liabilities including own funds has been made and all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted into equity.[837] As an alternative or in addition to these

[834] **SRMR,** Article 27(6).

[835] *Ibid.*, Article 27(7).

[836] *Ibid.*, Article 27(8).

[837] Under **Article 44(8) of the BRRD**, recourse to alternative financing arrangement is possible if the following conditions are met:

- the contribution of shareholders and holders of capital instruments and other eligible liabilities to the loss absorption and recapitalization is equal to an amount not less than 20% of the RWAs of the banking group under resolution,
- the national resolution fund of the Member State concerned has ex-ante contributions of at least 3% of covered deposits of all the banking groups authorized in the territory of that Member State.

financing sources, the SRB may make use of any ex-ante contributions raised by the SRF which have not yet been used, even if this amount exceeds the cap of 5% of total liabilities including own funds of the parent entity concerned.[838] Recourse to the SRF's funds may exceed this threshold, where the total amount of unsecured non-preferred liabilities (including uncovered deposits belonging to public sector and corporates) has been written down or converted into equity.

1.3.2 Mutualization of resolution funds in resolution of cross-border groups

In accordance with **Article 107 of the BRRD**, the SRF and the national resolution funds of non-participating Member States must contribute to resolution financing of a cross-border banking group based on specific arrangements. To that end, the SRB (in its function as group-level resolution authority), after consultation with the resolution authorities of non-participating Member States, must propose a financing plan as part of the group resolution scheme.[839] The financing plan must be proposed before the resolution action takes place and the decision must be taken under the joint decision process described above for group resolution scheme.

The financing plan must include at least the following elements:[840]

- an ex-ante valuation for the affected group's entities, which must determine the losses to be recognized by each entity upon application of the resolution tools,
- for each affected entity, the losses that would be suffered by each class of shareholders and creditors,
- any contribution that DGSs would be required to make, if necessary,
- the total contribution of the SRF and the national resolution funds concerned, as well as the purpose and the aim of the contribution, and
- a timeframe for the use of the SRF and the national resolution funds concerned.

Unless otherwise agreed between the SRF and the NRAs of non-participating Member States, the contribution of each party must be calculated based on the following principles:[841]

- the proportion of RWAs and assets of the group's entities,
- the proportion of the losses, which have given rise to the need for group resolution, which originated in the group's entities, and
- the proportion of the resources of the SRF and the national resolution funds concerned, which are expected to be used for the resolution of the group's entities.

For the purpose of implementing consistently the group resolution scheme and the resolution financing plan, the SRF and the national resolution funds concerned may contract borrowings or other forms of support from institutions and other third parties.

This provision was introduced in BRRD upon request of certain Member States and is not applicable to the Banking Union, as per **Article 27(11) of the SRMR**.

[838] **SRMR**, Article 27(10).

[839] **BRRD**, Article 107(2).

[840] *Ibid.*, Article 107(3).

[841] *Ibid.*, Article 107(5).

1.4 Procedural arrangements for the approval of state aid and SRF aid

The Commission has a twofold role in the decision-making process for the adoption of a resolution scheme. Firstly, it may object to the proposed by the SRB resolution scheme in relation to discretionary aspects of it, or to the use of the SRF or to whether resolution action meets the public interest criterion. Secondly, the Commission must assess and approve (or object to) the provision of state aid or SRF aid, where provided for in the resolution scheme. Thus, the Commission assesses resolution schemes both from a financial stability perspective and from an internal market perspective.

In the latter case, if the resolution scheme provides for the use of the SRF, the SRB must notify to the Commission the proposed use of the SRF providing also the Commission with the necessary information.[842] Although the SRF is funded by the banking industry, the use of its funds is considered as state aid, given:[843]

- the compulsory character of contributions, which can be assimilated to taxes,
- that the SRF's resources are under public control and the decision for their use is taken by a public authority (i.e. by the SRB), and
- an economic advantage is brought to the beneficiary.

Thus, the Commission will start a preliminary investigation to assess whether the use of the SRF would distort or threaten to distort competition by favoring the beneficiary or any other undertaking so as it would affect trade between Member States and would be incompatible with the internal market.[844] The Commission must assess the application of the use of the SRF based on the criteria set out in **Article 107 of the TFEU** on state aid. The same process is applied in the case of use of state aid (through the GFSTs or ESM's direct recapitalization instrument), where the Member State in which the parent entity is located must notify to the Commission the proposed use of the state aid measures. In any of the two (2) cases (use of state aid or SRF aid), the resolution scheme cannot be adopted until the Commission has adopted a positive or conditional decision on the compatibility of the use of the aid with the internal market.

If the Commission has serious doubts in relation to the compatibility of the proposed use of the SRF with the internal market, it may open an in-depth investigation and notify the SRB accordingly. The SRB, any Member State or any person, undertaking or association whose interests maybe affected by the use of the SRF may comment within the timeframe provided by the Commission.

At the end of the period of investigation, the Commission must make an assessment on the compatibility of the use of the SRF with the internal market. This assessment must be made based on the Regulation adopted pursuant to **Article 109 of the TFEU** and the **2013 Banking Communication**. The decision of the Commission on the use of the SRF may be contingent on conditions, commitments or undertakings in respect of the beneficiary. In addition, the decision may establish obligations for the SRB, NRAs or Member States concerned, including the requirement to appoint a monitoring trustee to assist in monitoring the compliance of the beneficiary with its obligations.

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[842] **SRMR,** Article 19(2-3).

[843] See **Commission Notice (2016/C262/01)** "*on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union*", par. 50 and **Gardella (2015)**, p. 213.

[844] For an overview of the procedure for the approval of State aid and the competition-related implications from resolution action, see **Smolenska (2017)** and **Barata** and **Smolenska (2017).**

If the Commission concludes that the beneficiary does not comply with its decision in relation to the obligations undertaken, it may issue a decision addressed to the NRA concerned requiring the authority to recover the misused amounts. Upon receipt of a negative decision by the Commission on the compatibility of the use of the SRF with the internal market, the SRB must prepare a revised resolution scheme.[845]

By way of derogation from the procedure described above, upon application by a Member State, the Council acting unanimously may decide -within seven (7) days from the filing of this application- that the use of the SRF is compatible with the internal market, where such decision is justified by exceptional circumstances.[846]

2. Liquidity in resolution

2.1 An overview of the sources of liquidity in resolution

The Union resolution framework was designed to address failures due to solvency reasons. The existing resolution tools are focused on loss absorption and recapitalization. The implicit assumption is that the recapitalization of a banking group would allow it to raise funding from money markets and capital markets. However, the recapitalization of a failing banking group cannot per se ensure the continuity of critical functions if the group cannot preserve access to liquidity to refinance its liabilities as they fall due. Even a well-capitalized banking group is likely to experience heightened liquidity needs due to market volatility and an asymmetry of information concerning the group's viability.[847] Market participants may abstain from entering into financial transactions to provide liquidity to the recapitalized banking group, if there is widespread uncertainty over the group's ability to meet its increased liquidity needs. These concerns are mitigated in the case of the adoption of the sale of business tool, as the receiver is likely to have the ability to fund the transferred assets through either internal resources or access to capital markets.

In resolution, a banking group should first use its **internal liquidity sources** (e.g. cash and other liquid assets available for sale or use as collateral) either held by the parent entity or transferred from other group's entities to meet its funding needs. If internal sources are insufficient, the parent entity should recourse to **private markets** to raise liquidity and, as a last resort, the parent entity should resort to credible **public sector backstop mechanisms** to cover liquidity needs and ensure continuity of critical functions.[848]

Pursuant to the FSB's Guiding principles *"on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB")*", the ability of a banking group to use **private sources of funding** in resolution depends, among others, on:[849]

- the timing of resolution action, i.e. when the resolution authority places the group into resolution,
- the state of the banking group upon entering into resolution, particularly with respect to the amount and quality of available collateral to the extent of asset encumbrance prior to resolution,

[845] **SRMR**, Article 19(3).

[846] *Ibid*., Article 19(10).

[847] See **Financial Stability Board (2016b)**, p. 6.

[848] *Ibid.*, pp. 6-7.

[849] *Ibid.*, p. 9.

- the prevailing macroeconomic environment, including market liquidity,
- the market confidence towards the recapitalized banking group and the trust for the reorganization plan, and
- the existence of an effective public sector liquidity backstop.

It is more likely for a banking group to have easier access to private funding channels, if the SRB takes resolution action at an early stage, when the group's liquidity position has not been deteriorated significantly and the group maintains sufficient amount of unencumbered high-quality collateral.

In relation to the public sector backstop funding mechanisms, they must have certain characteristics. In particular, they must be sufficiently large to cover the liquidity needs of many banking groups in case of a systemic crisis and be operationally capable to grant liquidity in time to address liquidity gaps of the banking groups concerned. Furthermore, the terms of funding should generally extend no longer than needed to preserve continuity of critical functions, but sufficiently long to allow the banking group concerned to regain access to private sources of funding.[850] The public sector backstop mechanisms must provide temporary funding under the following strict conditions:[851]

- the banking group meets the applicable capital requirements,
- the banking group has no or insufficient access to private market sources,
- funding is necessary to ensure financial stability and enable successful completion of resolution action,
- liquidity is provided under terms that minimize moral hazard risk,[852]
- liquidity is provided in exchange for collateral discounted with prudent haircuts of nominal value,
- liquidity is granted at such rates that create incentive for receiver to return to private markets, and
- provision of liquidity should be accompanied with conditions that create incentives for the banking group concerned to exit such mechanism promptly.

2.2 The limitations of the current framework for liquidity in resolution

Where the recapitalized banking group cannot cover its funding needs through internal liquidity sources or external private sources, the only available option is to resort to any of the following sources:[853]

- the ECB's standard monetary policy operations,
- the Emergency Liquidity Assistance (ELA), or
- the available financial means of the SRF.

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[850] *Ibid.*, p. 12.

[851] *Ibid.*, pp. 12-14.

[852] The existence of a public sector backstop mechanism may give rise to moral hazard risks including reduced incentives for banking groups to transact with other financial institutions on market terms and to hold sufficient high-quality liquid assets to use as collateral in resolution.

[853] See more detailed analysis of the aspects relating to funding in resolution in **Croitoru, Dobler** and **Molin (2018)**.

A recapitalized banking group can raise liquidity through the standard monetary facilities of the Eurosystem, namely the **open market operations**[854] and the **marginal lending facility,**[855] provided that it meets the relevant eligibility criteria and can pledge eligible collateral. The collateral accepted in those facilities must be of such a quality and quantity that in the event of a counterparty's default and a subsequent collateralization of the collateral, the Eurosystem would recover the full amount of its claim.[856] Thus, the Eurosystem accepts high credit quality marketable and non-marketable financial assets, pertaining mainly to central/regional government securities, unsecured bank bonds, corporate bonds, covered bank bonds and asset-backed securities.

However, it is highly unlikely that a banking group after its resolution would have sufficient amount of unencumbered collateral eligible for Eurosystem funding. Consequently, the banking group concerned must resort to the ELA through the National Central Bank of the Member State where the parent entity is located.[857] Pursuant to the **ECB Agreement** *"on Emergency Liquidity Assistance*", the provision of ELA is allowed both at the pre-resolution and during the resolution phase. In the second case, National Central Banks can provide ELA under the following conditions:[858]

- there is a credible prospect of recapitalization within the next six (6) months, where the minimum thresholds for CET1, Tier 1 and Total Capital ratios are not met (4.5%, 6% and 8% respectively)
- the banking group concerned has sufficient collateral, and
- insolvency proceedings have not been initiated.

A banking group has a credible prospect of recapitalization if the capital shortfall can be covered by private means or through the application of the bail-in tool within the resolution context. Nonetheless, the prospect of recapitalization depends on whether the SRB determines that the resolution of the banking group is in the public interest. Once the SRB determines that the public interest criterion is met, the resolution procedure is activated and the National Central Bank concerned may continue or start providing ELA, if the banking group has sufficient collateral to pledge. Against this backdrop, the ELA cannot be considered available in all cases, since it is contingent on the following conditions:

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[854] The ECB provides the bulk of liquidity to the banking system through the Main Refinancing Operations (MROs), which along with longer-term refinancing operations are the most common liquidity-providing reverse transactions conducted by the Eurosystem. MROs have a maturity of one week, while longer-term refinancing operations have longer maturity (from three months to 48 months).

[855] Under the marginal lending facility, the ECB provides to banking groups overnight liquidity against sufficient eligible assets.

[856] Collateral should comply with strict eligibility criteria under which the probability of default over a one-year horizon does not exceed 0.4%. Such assessment is mostly based on ratings issued by credit ratings agencies (eligible collateral must be rated above BBB-). Debt instruments issued or guaranteed by Member States, which are subject to Economic Adjustment Programme, are considered eligible irrespective of the credit rating (waiver of minimum credit ratings requirements).

[857] For a thorough presentation of the framework for the provision of ELA, see **Gortsos (2015d)**, **Lastra (20015)** and **Hallerberg** and **Lastra (2017)**.

[858] See **European Parliament (2018a)**, p. 2.

- the recapitalized banking group has eligible collateral to pledge, which is uncertain, particularly in the case of a banking group that has been determined as "failing to likely to fail" due to liquidity reasons (e.g. Banco Popular case), and
- the National Central Bank concerned approves the provision of ELA, which should not be taken for granted, if it has concerns for the losses that is may incur in case of non-repayment of the ELA.

Furthermore, National Central Banks are not allowed to provide ELA, if there is no reasonable prospect for the recapitalization of the banking group.[859] This holds for the timespan between the determination that a banking group is "failing or likely to fail" and the SRB's decision on whether the public interest criterion is met, as there is a possibility for the SRB to decide that the banking group must be put into liquidation under normal insolvency proceedings.[860] This case is particularly relevant, if the decisions of the ECB and the SRB are not taken within the same day but the SRB needs more time to determine whether the public interest criterion is met.

Hence, provision of ELA in resolution encounters significant challenges and uncertainties. Therefore, the SRF may step in and provide liquidity directly to a banking group after its resolution or guarantee its borrowings from other banking groups. The SRF's available financial means (c. €60bn) may suffice for the provision of liquidity to small or medium-sized banking groups. However, the limited firepower of the SRF may be proved insufficient to cover liquidity needs of a G-SII, let alone in a systemic crisis. In the absence of a common fiscal backstop to enhance the capacity of the SRF, the cost of resolution may fall upon the Member State where the parent entity is located, which would go against the objective of the Banking Union, namely to break the vicious circle between governments and banking sectors.[861]

Proposals to remedy the weaknesses referred above include the functioning of the ESM as a **common fiscal backstop to the SRF** and the **provision of liquidity in resolution by the ECB**. Both proposals are analyzed below in **Chapter C, Section 2**, under **2.1**.

[859] The only exception to this rule is if the banking group, though has been determined as "failing or likely to fail" (e.g. due to liquidity reasons), has a Total Capital ratio above 8%. Given that the banking group remains solvent, the National Central Bank concerned may provide ELA.

[860] On the options and limitations on central bank financing in resolution, see **Mersch (2018)**.

[861] The need for a fiscal backstop at euro area level is analyzed in **Schoenmaker (2017)**.

Chapter C:

Assessment of the Union crisis management framework

1. Good start but further improvements needed[862]

Since 2014, the ECB and the SRB have managed to remedy many of the problems of the euro area banking system, to deal successfully with the few banking failures and to prevent the outburst of a new financial crisis. The ECB has managed to improve the overall financial situation of the euro area banking sector by carrying out a rigorous SREP assessment and confine the contagion risk from the banking failures. The SRB confronted with four (4) "failing or likely to fail" situations, all of which were quite simple to deal with. There was no failure of G-SII or banking group with significant cross-border activities, let alone a systemic crisis at national or Union level.

The limited experience from banking failures and the only one (1) resolution case during this period does not allow to draw safe conclusions on the suitability of the regulatory framework to address potential crises. Material aspects of the BRRD have applied to a limited extent (e.g. early intervention measures, intragroup financial support agreements) or have not applied at all (e.g. bail-in tool, GFSTs, ESM direct recapitalization instrument). Other critical elements of the resolution framework remain unclear; the transfer tools (sale of business tool, bridge institution tool) have to date been applied to small- and medium-sized banking groups with simple corporate structures and limited cross-border activities.[863] It is highly doubtful, if these tools could be applied to large and complex banking groups with thousands of entities worldwide (e.g. G-SIIs).

In relation to the bail-in tool, which is considered as the cornerstone of the new framework to address banking failures, **Tröger (2017a)** has argued that the relevant rules set out in the BRRD and the SRMR are complicated and provide resolution authorities with discretions which pose risks to the consistent implementation of the bail-in tool. Indeed, the regulatory framework provides for some (mandatory and discretionary) exceptions of liabilities from the scope of the bail-in tool, which are likely to create uncertainty to banking groups and creditors on the liabilities that will be bailed-in upon resolution.[864] However, this situation is expected to change, once banking groups are compliant with the MREL. Capital instruments and senior unsecured bonds are the first to absorb losses minimizing the risk for other liabilities to incur losses. Since banking groups are still not compliant with the MREL, a decision to place a banking group in resolution is highly likely to trigger serious social costs and negative implications for financial stability. Compliance with the MREL limits the risk of exercising the write-down and conversion powers to:

- deposits from the public sector (e.g. pension funds, hospitals, universities), which could cause social and political side effects, and

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[862] This title is used to assess the performance so far both of the SSM and the SRM. It comes from the report of the **European Court of Auditors (2016)** for the functioning of the SSM.

[863] See **Binder (2018a)**, p. 23.

[864] For a more information on this argument, **s**ee **Tröger (2017a).** Another argument is **t**hat the goals of statutory bail-in tool could be achieved in a similar way if banking groups were obliged to issue a sufficient amount of contingent capital instruments (CoCos). However, there are significant drawbacks in this proposal, mainly related to the level of the trigger-events whose breach would convert bonds to common equity, as well as to the higher cost for banking groups to issue CoCos instead of senior unsecured bonds, which constitute the bulk of MREL-eligible instruments.

- uncovered deposits from viable and healthy corporates, which could result in deterioration of their financial situation and potential inability to repay their loans both towards the resolved banking group and other domestic (solvent) banking groups, creating, thus, serious concerns for the financial stability.

Compliance with the MREL (expected not earlier than 2022 for most of the banking groups) means that banking groups would have a sufficient amount of capital and eligible liabilities (mainly senior unsecured bonds) that can be bailed-in without significant implications for the financial stability and the economy.[865] Nonetheless, until all banking groups comply with the MREL, the new resolution framework will be incomplete and less effective to deal with idiosyncratic and system-wide banking crises.

The experience from the functioning of the first two pillars of the Banking Union (SSM and SRM) has shown that there are still weaknesses at **institutional**, **regulatory** and **operational** level that must be remedied. Further improvements are needed to ensure that the Union crisis management will be fit for purpose in addressing potential threats to financial stability, let alone a new financial crisis. These weaknesses are necessary to be addressed also for financial integration purposes. Up till now, there is limited, if any, progress on the enhancement of financial integration in the euro area, as reflected in the large dispersion of interest rates on loans and deposits across the euro area.[866] In addition, as shown in ***Figure 4***, cross-border M&As have remained stagnant since the onset of the Banking Union.[867]

With respect to **institutional level**, the euro area political leaders decided to establish the Banking Union and assign upon two (2) supranational authorities the responsibility for supervision and resolution of the largest banking groups. However, the institutional framework continues involving many actors, including national authorities, which creates complexity in the decision-making process and the implementation of resolution schemes. In particular, the crisis prevention and crisis management framework involve:

- the ECB and the NSAs of participating Member States,
- the SRB and the NRAs of participating Member States,

[865] However, the MREL is expected to increase the funding cost of banking groups, as some classes of creditors may ask for a risk premium. The new resolution framework and the obligation for banking groups to comply with the MREL are likely to lead the banking system to be organized into two (2) well-defined categories as argued by **Restoy (2018)**. The first one will consist of Tier 1 banking groups that are subject to resolution proceedings in case of failure, while the second category will include smaller banking groups that will be liquidated under normal insolvency proceedings. Hence, there is no room for a "middle class" of banking groups. The Tier 1 banking groups would be obliged to meet the MREL, while Tier 2 groups would not be subject to the MREL. This distinction is likely to affect the business models of banking groups. Deposit-funded groups would have to issue senior unsecured bonds with high cost (only) for MREL purposes, while Tier 2 banking groups would find it difficult to attract uncovered deposits. Depositors would prefer to deposit their money in Tier 1 banking groups which, in case of failure, would be recapitalized through write-down and conversion of MREL instruments, rather than on Tier 2 groups that would be liquidated, which means that they would lose their money.

[866] **European Central Bank (2018e)**, p. 155.

[867] Limited cross-border consolidation can be at attributed also to two (2) reasons. Firstly, the sheer number of regulatory initiatives undertaken after the financial crisis generated significant uncertainty and deterred banking groups from exploring options for business expansion. Secondly, the uncertainty about the quality of banking groups' assets made mergers less attractive and reduced banking groups' capacity to take them on. Ensuring regulatory certainty across euro area and alleviating investors' concerns for the asset quality of (target) banking groups could give a decisive boost to cross-border M&As in the following years.

- the Commission and the Council which are responsible for the adoption of resolution schemes submitted by the SRB,
- the ECB and the National Central Banks, which function as providers of liquidity through either the Eurosystem's standard policy operations or ELA,
- the Ministries of Finance which may decide to inject capital under either the precautionary recapitalization instrument or the GFSTs and provide funding to the SRF under the Loan Facilities Agreements,
- the ESM which may contribute to the recapitalization of a resolved banking group through the Direct Recapitalization Instrument,
- the national DGSs that may contribute to resolution costs or compensate covered depositors upon liquidation of banking groups under normal insolvency proceedings, and
- the DG Comp which is responsible to approve state aid either within or outside the resolution framework.

The involvement of such a large number of (supranational and national) actors is an inherent weakness of the financial architecture that puts at risk the effective and timely reaction to a banking failure, particularly if this evolves into a system-wide crisis. Transfer of additional powers from national to supranational level is necessary. This applies to the establishment of a **fiscal backstop** which should be the ESM, the **provision of liquidity in resolution** which should be carried out by the ECB, the **enhancement of the SRB's role and powers** and the **deposit guarantee**, where national DGSs should be substituted by a European Deposit Insurance Scheme.

At the **regulatory level**, legislators should proceed to **further harmonization of the regulatory framework**, which is relevant to national laws for liquidation under normal insolvency proceedings, national insolvency rankings, moratorium tools, early intervention tools and the 2013 Banking Communication for state aid.

At the **operational level**, the ECB and the SRB should improve their performance in their supervisory and resolution planning-related tasks respectively in order to both minimize the risk of failures and mitigate the cost of such failures, if eventually arise. Cooperation and coordination with the authorities of non-participating Member States and third countries both in going-concern and crisis situation is an additional source of risks.

2. Improvements needed at institutional level

2.1 Funding in resolution

2.1.1 The ESM as a fiscal backstop to the SRF

The provision of temporary funding in resolution is an outstanding issue that the Banking Union needs to address. Funding constitutes a material threat to the orderly completion of resolution action, as there is a risk of insufficient liquidity to maintain critical operations as a result of the banking groups' inability to roll-over short-term liquidity.

In contrast to other large banking jurisdictions, a temporary public backstop funding mechanism does not exist in the Banking Union. In the USA, the FDIC has access to a credit line from the US Treasury to borrow up to $500bn[868] to make loans and guarantee obligations of banking groups that have been recapitalized under the Orderly Liquidation

[868] See **Nieto (2016)**, p. 147.

Authority.[869] The amount paid by the Treasury is repaid by the FDIC through contributions raised from the banking industry. In the UK, the Bank of England has adopted the **Resolution Liquidity Framework**, which is available to banking groups put in resolution by the BoE.[870] Under this liquidity facility, the BoE can provide liquidity in either sterling or foreign currency to allow the resolved banking group to make the transition to market-based funding. This facility is a last resort option and no such presumption can be made in the resolution plans.[871]

A common fiscal backstop to the SRF is necessary to make the resolution framework effective. This is particularly relevant either in a systemic crisis when several banking groups would face serious problems at the same time or if a G-SII needs financing. The SRF does not have the firepower to provide liquidity of triple billion figures, if necessary.[872] Therefore, it is necessary for a fiscal backstop to be established, which should be designed in such a way to ensure that the following conditions are met:[873]

- it is of adequate size to deal with a systemic crisis,
- it is activated swiftly,
- it is fiscally neutral and any losses are incurred by the banking sector,
- it provides liquidity only to solvent and viable banking groups,[874] and
- the use of public resources is limited.

The first option is for the ESM to undertake this role, as it has the lending capacity, the knowledge of how markets function and the necessary creditworthiness. Alternatively, Member States could provide simultaneously loans or guarantees to the SRF. However, this option lacks time-efficiency given the difficulties to mobilize the committed funds in case of crisis. In addition, this option would impact the fiscal budget of Member States because they would have to increase their debt, even in a temporary basis (fiscally neutral in the long-run) to meet their commitments towards the SRF.[875]

On the basis of the Franco-German Declaration of Mesenberg (18 June 2018), the Eurogroup held in June 2018 reached an agreement for the use of the ESM for resolution purposes,[876] which was further specified at the December 2018 Eurogroup meeting. In particular, the ESM will provide the common backstop in the form of a revolving credit line whose size will be at the level of the SRF (i.e. approx. €60bn).[877] Member States which may join the Banking Union under the close cooperation procedure would provide parallel revolving credit lines. The fiscal backstop should be considered only as last resort instrument and be fiscal neutral, as any losses will be incurred by the banking sector and not by the ESM Members.

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[869] See **Baxter** and **Snodgrass (2015)**, p. 82 and **Ringe (2017)**, pp. 33-35.

[870] See **Bank of England's approach to resolution**, p. 22.

[871] See **Lehmann (2018)**, p. 11.

[872] See **König (2018d)**, p. 45.

[873] See **European Commission (2017a)**, p. 20.

[874] See **König (2018d)**, p. 45.

[875] See **European Commission (2017a)**, p. 20.

[876] The assignment upon the ESM of the responsibility to act as fiscal backstop has been discussed extensively from the beginning of the Banking Union. See indicatively, **Schoenmaker (2014)**.

[877] See **Eurogroup (2018a)**, p. 2.

The backstop would enter into force prior to the end of the transitional period (2024) if sufficient progress has been made in risk reduction measures.[878] The political decision on the early introduction of the fiscal backstop will be informed by the assessment of the progress achieved by 2020 with respect to the build-up of MREL buffers and the trend in reduction of NPEs. This assessment will be made against the aim of 5% gross NPEs, and 2.5% net NPLs or adequate provisioning, for all significant banking groups and progress thereto. In addition, banking groups are expected to build up MREL buffers steadily in line with the 2024 fully-loaded targets and 2022 intermediate targets.[879] Once the fiscal backstop is in place, it will replace the direct recapitalization instrument.[880] Moreover, the credit line will be activated based on a swift and efficient decision-making process. The decision for the disbursements must be taken within twelve (12) hours from the receipt of the SRB's request. In exceptional circumstances, the deadline can be lengthened to 24 hours. Furthermore, the ESM's Board of Governors should take a conditional decision on the activation of the ESM's credit line before the adoption of the resolution scheme based on all available information.

It is notable that on 6 December 2017 the European Commission submitted a legislative proposal on the establishment of the European Monetary Fund (EMF) to succeed and replace the ESM. Pursuant to this proposal, the EMF would be mandated, among others, with the task to contribute to safeguarding the financial stability of the participating Member States.[881] For that purpose, the EMF is proposed to be assigned with two (2) tasks, namely, the **provision of direct public financial assistance to banking groups through the Direct Recapitalization Instrument**,[882] and the **provision of credit lines or guarantees in support of the SRB**.[883]

2.1.2 Proposal for the ECB as a provider of liquidity in resolution

The main disadvantage of the agreement on the fiscal backstop is related to its funding capacity. The combined firepower of the SRF and the ESM's credit line is estimated at €120bn. A bulk of €120bn for liquidity provision in resolution is considered inadequate in case of a systemic crisis that involves many large banking groups. Indicatively, the liquidity support granted for the restructuring of the banking group Hypo Real Estate exceeded €145bn, which exceeds the combined firepower of the SRF and ESM.[884] As highlighted by the Chair of the SRB, Elke König, "*it is likely that the SRF, even if secured by a backstop, might not be sizeable enough to provide funding when a major and complex institution is resolved. We must therefore continue to explore alternative options, particularly in cooperation with the national central banks and the ECB*".[885]

The resolution framework cannot deal with a liquidity crisis relating to a large cross-border banking group, let alone a systemic crisis, without the active role of the Eurosystem. Indeed, the ECB is working towards introducing an instrument for provision

[878] For more information on the future role of the ESM, see **Eurogroup (2018b).**

[879] See **Eurogroup (2018d)**, p. 4

[880] On the key elements of the fiscal backstop, see **Eurogroup (2018c).**

[881] For an analytical presentation of the Commission's proposal for the establishment of the EMF, see **Gortsos (2017).**

[882] **Annex to the Proposal for a Council Regulation** *"on the establishment of the European Monetary Fund"*, Article 19(1), second sentence and recital (46).

[883] *Ibid.,* Article 22.

[884] See **European Parliament (2018a)**, p. 4.

[885] See **König (2018b).**

of liquidity to resolved banking groups. This instrument, called "**Eurosystem Resolution Liquidity**" (ERL), could be applied if a banking group meets all the conditions for resolution, which means that the option for liquidation is out of scope. The activation of this instrument should be governed by the following principles:[886]

- the parent entity of the banking group concerned is an eligible counterparty for Eurosystem monetary policy operations (i.e. it is a credit institution and is financially sound),
- the collateral provided may be of lower quality compared to the collateral of ECB's standard monetary policy operations,
- the Eurosystem is covered by a public-sector guarantee at the European level for the amount of liquidity provided by the ERL, and
- a remuneration at least equal to the marginal lending facility rate should be paid.

Furthermore, the instrument should provide that the financing is temporary and is replaced by private funding once the banking group restores its access to capital markets. Possible losses could be minimized if funding from this mechanism has a super priority in the national insolvency rankings.

The establishment of the ERL would facilitate the effective implementation of the common fiscal backstop. The ECB could provide liquidity secured by a guarantee issued from the ESM/SRF with no risk to incur losses, as it would act as a mere provider of funds.[887] However, this instrument would not solve the problem of the limited financial resources to provide liquidity in resolution. This problem could be addressed only if the ECB decides to perform the function of lender of last resort for significant banking groups,[888] particularly those put into resolution. The task of lender of last resort has not been conferred explicitly upon the ECB in the TFEU because at the time of writing of the Maastricht Treaty the objective was to avoid moral hazard.[889] However, assigning upon the ECB the responsibility for provision of ELA requires no Treaty amendment, as argued by Professors Lastra and Gortsos.[890] A solid legal basis can be found in **Article 127 of the TFEU**, **Article 18 of the ESCB Statute** and the principle of the subsidiarity. In a crisis situation, action by the ECB is more effective than any action may be taken by national authorities given that "*they do not have the ability, authority or inclination to deal effectively with externalities with cross-border effects*".

The President of the ECB, Mario Draghi, has argued also for the centralization of the ELA. In particular, at the ECON meeting of 22 February 2018, he stated that "*the ELA policy should be changed and I personally have argued several times for a centralisation of ELA. This is a remnant from a past time, but to change it we ought to have the agreement of all the members of the governing council, namely all countries in fact. They have to decide that they would abandon this remnant of national sovereignty in monetary policy, because that is what it is*."[891]

[886] See **European Parliament (2018a)**, p. 10.

[887] See **BBVA (2018a)**, p. 6.

[888] For more details on this proposal, see **Gortsos (2015d)**, pp. 64-70, and **Lastra** and **Goodhart (2016)**, pp. 37-54, **Gordon** and **Ringe (2014)**, pp. 1359-1361 and **Ringe (2017)**, pp. 38-39.

[889] On this issue, see **Zilioli (2015)** and **Gortsos (2018b)**.

[890] For an analysis of this viewpoint, see **Hallerberg** and **Lastra (2017)**, p. 17, and **Gortsos (2018a)**, p. 169.

[891] See **Committee on Economic and Monetary Affairs (2018)**, p. 10.

The centralization of the ELA would push forward the completion of the Banking Union, as it would:

- ensure that a credible public backstop funding mechanism is in place to provide liquidity in resolution, and
- confer at supranational level another element of the "bank safety net" contributing, thus, to the establishment of a genuinely Banking Union.

2.2 The role of a European Deposit Insurance Scheme (EDIS) in resolution

In the Banking Union, deposit guarantee remains at national level. The establishment of a single deposit guarantee scheme is the missing element of the Banking Union. During last years, there has been a lot of debate on the need to establish such a single scheme.[892] The 2015 Five Presidents' Report on "*completing the Europe's Economic and Monetary Union*" recognized the significance of establishing a European Deposit Insurance Scheme (EDIS),[893] which was followed by a relevant Commission's legislative proposal.[894] However, the discussions at the European Parliament and the Council have revealed that there are divergent positions in relation to the design and the timing of setting up such a system, as well as due to moral hazard issues. The major concerns relating to the EDIS are centered on the need to ensure that banking groups are sufficiently robust and cleaned up from legacy issues before sharing the potential cost from banking failures.[895] Pursuant to the 2016 Council Roadmap, "*the Council will continue constructive work at technical level. Negotiations at political level will start as soon as sufficient further progress has been made on the measures on risk reduction*".[896] Aiming to break the deadlock in the discussions concerning the EDIS, in October 2017, the Commission submitted a mediating proposal on a more gradual introduction of the EDIS in line with the progress achieved with regard to risk reduction and tackling of the NPE problem.[897]

In accordance with the DGSD, Member States have set up their own DGSs that collect contributions from domestic banking groups in order to reach a target level of at least 0.8% of covered deposits of domestic banking groups. The DGSs' financial means are primarily used to repay depositors upon insolvency of banking groups. In addition to the primary function of DGSs as "paybox" for depositors,[898] the introduction of the BRRD assigned upon DGSs the task to contribute to resolution costs in accordance with **Article**

[892] Indicatively, see **Schoenmaker** and **Gros (2012)**.

[893] See **European Commission (2015)**, p. 11.

[894] **Proposal for a Regulation** of the European Parliament and of the Council "*amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme*", COM/2015/0586 final.

[895] **Commission** Communication "*to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions*", p. 10.

[896] See **Council of the European Union (2016)**.

[897] The Commission's proposal provides that the transition from the re-insurance phase to the co-insurance phase would be conditional on the cure of the NPE problem. Transition to the co-insurance phase, which would provide for loss coverage by the EDIS, could be achieved following the implementation of a targeted AQR to identify capital shortfall to high-NPE banking groups. The AQR could be carried out during the re-insurance phase (before 2022 at the latest) to ensure that legacy problems are addressed before the start of the co-insurance phase. Once the problems have been tackled, the co-insurance phase could start.

[898] **DGSD**, Article 11(1).

109 of the BRRD (see above in **Chapter B, Section 3**, under **3.1.5**). Furthermore, it is at each Member State's discretion to allow its DGS:

- to use its available financial means for alternative measures in order to prevent the failure of a banking group,[899] and
- to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors.[900]

The last function is relevant to the application of the sale of business tool in the context of winding-up a group's entities under normal insolvency proceedings.

The DGSD does not achieve full harmonization of the arrangements for deposit guarantee allowing Member States to retain national discretions, such as those referred to the DGS's target level and functions.[901] These discrepancies among Member States does not ensure a level playing field for banking groups and contribute to the fragmentation of the internal market.

The lack of harmonization in relation to the target level and the tasks of DGSs affect also the implementation of the resolution framework, which is linked to some extent with the deposit guarantee framework. As referred to in **recital 45 of the BRRD** "*a failing institution should in principle be liquidated under normal insolvency proceedings*". Hence, upon determination of a banking group as "failing or likely to fail", the default option for the SRB is to place the group's entities into liquidation, which would trigger the activation of the relevant national DGSs. Nevertheless, the decision of the SRB on whether the public interest criterion is met, depends also on the capacity of the national DGS to compensate affected depositors. Where the available financial means of a DGS are not sufficient, ex-post contributions may be required from other domestic banking groups, which could jeopardize domestic financial stability. Consequently, the different target level of DGSs impede the implementation of a consistent policy on whether the public interest criterion is met. The same concerns on the target level apply also to the contribution of a DGS on financing resolution costs in accordance with **Article 109 of the BRRD**, though such use is subject to strict conditions and is highly unlikely in most of the cases.

An additional obstacle to the uniform application of resolution rules refers to the discretions granted to Member States to use DGSs also for crisis prevention measures

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[899] This function of the DGS is subject to the following conditions:

a. the resolution authority has not taken any resolution action under **Article 32 of the BRRD**,

b. the DGS has appropriate systems and procedures in place for selecting and implementing alternative measures and monitoring affiliated risks,

c. the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS,

d. the use of alternative measures by the DGS is linked to conditions imposed on the banking group that is being supported, involving at least more stringent risk monitoring and greater verification rights for the DGS,

e. the use of alternative measures by the DGS is linked to commitments by the banking group being supported with a view to securing access to covered deposits, and

f. the ability of the affiliated banking groups to pay the extraordinary contributions is confirmed in the assessment of the supervisory authority.

[900] See **Baglioni (2016)**, p. 119.

[901] For a general overview and assessment of the DGSD, see **Gortsos (2014)**.

and for the application of a transfer tool outside the resolution process. Member States may circumvent the resolution framework by using the available funds of the DGS to transfer assets and (covered and uncovered) deposits of the parent entity of a banking group under liquidation to another entity. The only precondition is that the costs borne by the DGS must not exceed the amount that the DGS have paid to covered depositors of the parent entity concerned under its “paybox” function.

Taking into consideration the aforementioned remarks, the establishment of the EDIS and its functioning based on harmonized rules would promote the effective implementation of the resolution framework within the Banking Union. Notably, the EDIS would reduce depositors’ vulnerability to large financial shocks, which cannot be addressed effectively by national DGSs due to their limited resources, as well as to break the link between banking systems and sovereigns.

2.3 Enhancement of the SRB’s role and powers

The complex governance structure of the SRM may cause problems when swift action is needed. This is relevant both to the decision-making process and the implementation of the resolution schemes by the NRAs in accordance with their national law transposing the BRRD. The past resolution cases did not reveal any deficiencies in the cooperation of the involved authorities but challenges might arise if complicated and politically sensitive resolution cases occur, particularly if they involve G-SIIs. Such challenges are mostly related to the decision-making process, where critical decisions must be taken within 48 hours by the SRB, the Commission and the ECOFIN, where appropriate. The situation may become even more complex, where resolution action requires the involvement of governments, central banks, DGSs and the ESM.

Furthermore, the execution of resolution schemes may be another challenge for the SRB. The SRM functions in a decentralized manner, as the SRB relies on NRAs to a significant degree for the implementation of resolution schemes.[902] Should an NRA deviate from the instructions issued by the SRB, this would put in risk the orderly implementation of the resolution scheme.

The governance issues analyzed above can be attributed to the limitations set by the Meroni doctrine. The amendment of the TFEU, though difficult to achieve, would be the optimal solution to address these issues. The governance of the SRM should be amended in order to make the decision-making process more efficient and enhance the role and powers of the SRB in the execution phase.[903]

[902] See **Gortsos (2018c)**, p. 210.

[903] See **Baglioni (2016)**, p. 98.

3. Necessary improvements at regulatory level

3.1 Establishment of cross-border capital and liquidity waivers

As referred above (see **Chapter B, Section 1**, under **2.2.1)**, the existing regulatory framework does not promote free transfer of funds within cross-border banking groups, as it does not treat the Banking Union as a single jurisdiction, which would allow the application of waivers for individual capital and liquidity requirements for group's entities. Aiming to address this shortcoming, the Commission's proposal on the amendment of CRR included, among others, provisions on the extension of the waiver to individual capital and liquidity requirements beyond a Member State through the modification of **Articles 7 and 8 of the CRR**. This proposal aimed at removing obstacles in the intragroup flow of capital and liquidity between group's entities located in participating Member States.[904] Under the Commission's proposal, the application of capital and liquidity requirements for subsidiaries located in other Member States than the parent entity could be waived if the parent entity committed to support those subsidiaries through guarantees for the whole amount of the waived requirement and the guarantee was collateralized for at least half of the guaranteed amount.[905] However, the Commission's proposal to have cross-border capital and liquidity waivers in the Banking Union[906] was not adopted in the final text of the CRR II due to Member States' concerns about the financial stability implications at domestic level.

In addition to the obligation for group's entities to comply with capital and liquidity requirements at individual level, the existing regulatory framework sets restrictions to intragroup exposures limiting, thus, free flow of funds and centralized liquidity management within banking groups. Firstly, intragroup exposures may enjoy preferential risk-weighting treatment (i.e. risk weight of 0%) only if they apply to entities located in the same Member State.[907] Secondly, intragroup exposures between entities located in different Member States may not exceed the limit of 25% of Tier 1 capital, unless the relevant supervisory authority permits the (partial or full) exemption of the intragroup exposure from that limit in accordance with **Article 400(2)(c) of the CRR**. However, Member States retain (until 2029) the option to supersede the decision of the supervisory authority to fully or partially exempt intragroup exposures from the limit of 25%.[908] Thus, although in the Banking Union the ECB has decided to exempt intragroup

[904] **Proposal for a Regulation** of the European Parliament and of the Council "*amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012*", p. 11.

[905] The liquidity waiver could be available only if the parent entity provided a guarantee to the subsidiary equal to an amount at least equivalent to the amount of the net liquidity outflows of the subsidiary, which must be collateralized for at least 50% of the guaranteed amount.

[906] **Proposal for a Regulation** of the European Parliament and of the Council "*amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012*", pp. 43-44.

[907] **CRR**, Article 113(6).

[908] *Ibid.*, Article 400(2)(c).

exposures from the large exposure limit,[909] several Member States have decided to override the ECB's decision and continue applying their own national policy.[910]

These restrictions limit the ability of banking groups to transfer funds between their entities, which results in the enhancement of financial fragmentation and the creation of unlevel playing field among EU-based groups. In light of the establishment of the SSM and the SRM, which apply the Union regulatory framework for crisis prevention and crisis management in a harmonized manner, national ring-fencing measures appear to be obsolete and less reasonable than they were in the pre-Banking Union period.

Therefore, the regulatory framework should be revised to remove the current Member State dimension and treat the Banking Union as a single jurisdiction. Banking groups should enjoy cross-border capital and liquidity waivers for their entities located in participating Member States. Such waivers should be available also in relation to subsidiaries located in non-participating Member States providing the NSAs of non-participating Member States with the discretion to take such decisions, where certain conditions are met. Lastly, it is necessary to abolish the options for supervisory authorities and Member States to prohibit the preferential treatment of intragroup exposures both in terms of risk-weighting and large exposures limit.

The introduction of the aforementioned arrangements could promote free flow of funds and foster financial integration ensuring efficient capital and liquidity management throughout banking groups.

3.2 Harmonization of rules on liquidation under insolvency proceedings

The regime for winding-up insolvent entities is governed by the **Directive 2001/24/EC** of the European Parliament and of the Council of 4 April 2001 "*on the reorganization and winding-up of credit institutions*". This act does not provide for minimum harmonization of national reorganization measures and winding-up proceedings, but it introduced the principle of mutual recognition of such measures. In particular, it ensures that all assets and liabilities of an entity, irrespective of the Member State where they are situated, are dealt within a single process in the home Member State and that creditors in the host Member States are treated in the same way as creditors in the home Member State.[911] Thus, the administrative or judicial authorities of the home Member State are solely competent to decide on the initiation of these proceedings for a group's entities, including its branches in other Member States.

The BRRD has partially harmonized insolvency law, only in relation to the ranking of claims for the purposes of the application of the bail-in tool. Nonetheless, the BRRD has not set out rules on the winding-up of group's entities under normal insolvency proceedings, which is still governed by national law and can be effected as an alternative or in parallel with resolution. Whereas resolution rules are harmonized at the European level, liquidation remains regulated at national level. The current non-harmonized framework for liquidation allows Member States to keep intact national arrangements that resemble those provided for in the BRRD but remain out of the scope of it.[912] Thus,

[909] **Regulation 2016/445** of the European Central Bank of 14 March 2016 "*on the exercise of options and discretions available in Union law*", Article 9(3).

[910] See **Nouy (2018)** and **Praet (2018).**

[911] **BRRD**, recital (119).

[912] The Netherlands is another example of Member State which has retained a preferential national regime for liquidation. In the Netherlands, under the Intervention Act the Ministry of Finance may take the control of a banking group and expropriate its assets and shares, if there is a threat to the financial stability. For more information, see **International Monetary Fund (2017)**.

if the SRB determines that the first two (2) conditions for resolution are met, but the third one (public interest criterion) is not met, the parent entity of the banking group concerned should be liquidated under the national rules.

The case of Veneto Banca and Banca Popolare di Vincenza is the most notable one and highlights how Member States may take advantage of this loophole of the regulatory framework to protect senior bondholders and depositors from bail-in. Upon determination that Veneto Banca and Banca Popolare di Vincenza were in a "failing or likely to fail" situation, the SRB assessed whether the other two (2) conditions for resolution are met. The SRB determined that the public interest criterion was not met because the banking groups' failure would have no systemic impact neither at national nor at local level. Thus, the parent entities of both banking groups were put into liquidation under national rules. However, under an Italian Government's Decree the placement of the two (2) parent entities into a forced administrative liquidation would entail a sudden disruption in the provision of credit to businesses and families with negative repercussions of economic and social character.[913]

Therefore, Italy decided to adopt a special liquidation regime to allow the immediate sale of the assets and liabilities of the two (2) banking groups to Intesa Sanpaolo along with the provision of state aid.[914] In addition, Italy financed an Asset Management Company (AMC) to purchase assets that were not included in the sale perimeter and were left in the entities in insolvency.[915] The state aid aimed at allowing an orderly exit of the two banking groups from the markets without causing disruption, particularly in the areas where they were operating. Such disruption could be sparked due to the application of bail-in to senior bondholders and depositors for the part of their deposits exceeding €100,000. The provision of state aid was accompanied with the application of burden-sharing measures to the shareholders and subordinated creditors of the entities concerned.[916]

In the case of Veneto Banca and Banca Popolare di Vincenza, the Commission approved the request of Italy to grant state aid to mitigate disturbance at regional level.[917] In accordance with the European Commission, "*while the winding up of smaller banks may not affect the European financial system, their market exit may still have effects in the regions where such banks are most active. Therefore, outside the European banking resolution framework, it is for Member States to decide whether they consider a bank exit to have a serious impact on the regional economy, e.g. on the financing of small and*

[913] See **Merler (2018)**, p. 7.

[914] The state aid granted to Intesa Sanpaolo referred to:

- a contribution of €3.5bn to cover for a recapitalization of the transferred activities up to 12.5% CET1 ratio,
- a contribution of €1.285bn to cover for future restructuring costs,
- a coverage of the deficit between the value of the assets transferred to Intesa Sanpaolo compared to the transferred liabilities in the form of guarantees of €5.35bn. In return to this contribution, Italy would receive a senior claim on the residual entities, and
- a guarantee to cover for legal risks relating to the liquidation procedure of the two failed banking groups.

[915] **Commission Decision** "*on State Aid SA. 45664 (2017/N) – Italy – Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid*", point (7).

[916] *Ibid.*, point (50).

[917] See **European Parliament (2018b)**, p. 3.

medium enterprises in the regional economy, and whether they wish to use national funds to mitigate these effects."[918]

Hence, the SRB determined that resolution would not serve the public interest due to the limited systemic relevance of the banking groups, whereas the Italian government decided (with the Commission's consent) that the systemic importance of both groups at regional level warranted their liquidation under a preferential national regime and the provision of state aid.[919] This contradiction can be attributed definitely to political reasons that allowed Italy to circumvent the BRRD framework and the application of resolution tools to (mainly domestic) senior bondholders and depositors. In any case, Member States may take advantage of the lack of harmonization in the national laws governing liquidation, as Italy did, only if the SRB and the Commission allow to do so.

Therefore, it is necessary for the Commission to undertake a legislative initiative to promote the harmonization of the national laws governing liquidation of groups' entities.[920] Certainly, there are difficulties to harmonize insolvency law across the EU, as has been also recognized in the 2009 Commission's Communication "***An EU Framework for Cross-Border Crisis Management in the Banking Sector***", which referred that "t*he difficulty and sensitivity of such work should not be underestimated. Insolvency law is closely related to other areas of national law such as the law of property, contract and commercial law.*"[921]

The need to take action in this field is supported also by the SRB's Chair, Elke König, who has emphasized in favour of the harmonization of the liquidation regimes of EU Member States.[922] In accordance with **Article 94(1) of the SRMR**, the Commission ought to publish a report by 31 December 2018 which would include, among others, an assessment of the need to take steps in order to harmonize insolvency proceedings for failing banking groups. Taking advantage of this report, legislative action should be taken

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[918] The Commission has provided some clarifications on the interaction of the Union state aid and the BRRD. For more information, see **European Commission (2017b).**

[919] The Commission assessed the compatibility of the aid measures in light of the following criteria:

- **limitation of costs of winding down**: state aid should enable banking groups to be wound down in an orderly fashion, while limiting the aid amount to the minimum necessary,
- **limitation of distortions of competition**: given that the two banking groups were not very large, the impact on competition was assessed as small,
- **own contribution (burden-sharing)**: both shareholders and junior bondholders remained in the two banking groups contributing to the absorption of losses. Italy could have decided senior creditors to contribute also to losses, limiting, thus, the amount of aid provided,
- **restoration of long-term viability of the acquiring banking group**: the Commission concluded that Intesa Sanpaolo would not face any significant risks to its viability due to the acquisition of part of the assets and liabilities of the two banking groups, given that most of the acquired branches would have been closed by June 2019 and the business acquired was cleaned up (i.e. no NPLs were taken over).

[920] On the need for further harmonization of the national insolvency laws, see **Haentjens (2017)**.

[921] See **Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank** on *"An EU Framework for Cross-Border Crisis Management in the Banking Sector",* p. 16.

[922] For more details on the views of the SRB's Chair on this issue, see **Konig** (2018c).

to address the loopholes of the regulatory framework and ensure that the Italian case will not function as precedent for future banking failures.

3.3 Amendment of national insolvency rankings

3.3.1 The middle layer problem

The BRRD amended partially the national laws governing normal insolvency proceedings to provide preferential treatment to covered deposits in relation to uncovered deposits. Within the latter class, uncovered deposits belonging to natural persons and SMEs must rank senior to other uncovered deposits (e.g. from corporates or public sector).[923]

The BRRD did not touch upon the class of senior unsecured liabilities, which typically stands at the middle of national insolvency rankings. The middle layer includes both bail-inable liabilities and liabilities which are explicitly excluded from bail-in (e.g. liabilities to payments systems) or are likely to be excluded at the discretion of the resolution authority. This class contains a large number of very different liabilities, which rank *pari passu* in the insolvency hierarchy of many Member States.[924] For instance, this class includes liabilities, such as senior unsecured bonds, which are well-suited to bail-in, but also liabilities that, if used to absorb losses, could raise concerns due to their importance for the economy (e.g. uncovered corporate deposits) or their complexity (e.g. derivatives).

Thus, under national insolvency rules, an MREL-eligible liability could rank *pari passu* with other liabilities that are explicitly excluded from the scope of bail-in (e.g. operational liabilities, short-term inter-bank loans) or can be excluded at the discretion of the resolution authority (e.g. derivatives, structured notes).[925] This could lead to situations where bondholders would be bailed-in, while other creditors in the same class would be exempted from bail-in. Given that these bondholders may have been treated worse off than in insolvency, they could claim compensation from the SRF.

A simplified example has been developed in ***Table 15*** below based on which the parent entity of a banking group incurs losses of €150 which are distributed among shareholders and creditors. Under the considerations referred above, the discrepancy between the bail-

[923] In accordance with **Article 108 of the BRRD**, under national laws governing normal insolvency proceedings, the order of priority is as follows:

- the following have the same ranking, which is higher than the ranking provided for the claims of ordinary unsecured creditors:
  - the uncovered part of eligible deposits from natural persons and micro, small and medium-sized enterprises, and
  - deposits that would be eligible deposits from natural persons and micro, small and medium-sized enterprises were they not made through branches outside the EU,
- the following have the same priority which is higher than the ranking provided to the aforementioned claims:
  - covered deposits, and
  - deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency.

[924] Indicatively, in Netherlands, senior unsecured bonds have a position in hierarchy on par with other senior claims that could be excluded from bail-in (e.g. uncovered corporate deposits, derivatives), if the resolution authority makes use of the discretionary powers under **Article 44(3) of the BRRD**.

[925] See **European Commission (2016)**, p. 20.

in waterfall under the BRRD and the priority of claims under national insolvency results in breach of the "no-creditor-worse-off" principle. Hence, the SRF would have to compensate affected creditors (i.e. holders of senior unsecured bonds and other senior liabilities, depositors for the part of deposits exceeding €100,000) with an amount of €6.8.

Table 15: Example of distribution of losses (resolution vs liquidation) before the Directive 2017/2399

in €	Amount	Losses under resolution	Losses under liquidation	Difference (resolution-liquidation)	SRF contribution
First layer					
CET1	50	50	50	-	-
AT1	10	10	10	-	-
Tier 2	20	20	20	-	-
Middle layer					
Senior unsecured bonds	50	10	6.6	3.4	3.4
Other senior liabilities	10	10	6.6	3.4	3.4
Liabilities excluded from bail-in	30	-	6.6	-6.6	-
Lower layer					
Uncovered deposits	60	-	-	-	-
Covered deposits	200	-	-	-	-
Secured liabilities	20	-	-	-	-
TOTAL	**450**	**100**	**100**	**6.8**	**6.8**

3.3.2 The Directive on ranking of unsecured debt instruments

In light of the aforementioned implications, Member States started to amend their national laws on insolvency rankings in order to **operationalize the application of the bail-in tool** and **minimize the risk of legal challenges by creditors** based on the criterion that the losses incurred in resolution are greater than the losses they would have incurred in case of liquidation.

This decision was prescribed also by the obligation to ensure compliance with the TLAC standard, which requires G-SIIs to meet the minimum requirement mostly with liabilities that rank in insolvency below liabilities excluded from bail-in (subordination requirement). In that context, Italy amended its insolvency ranking in such a way that senior debt ranked *pari passu* with derivatives and operational liabilities but junior to all types of deposits (general depositor preference).[926] Spain adopted the contractual subordination approach under which MREL-eligible instruments must include an explicit

[926] See **Huertas (2016)**, p. 18.

subordination clause in relation to liabilities outside the bail-in scope. In Germany, senior unsecured bonds were statutorily subordinated to operational liabilities, deposits and derivatives.[927]

However, the national laws diverged significantly. Therefore, in June 2016, the ECOFIN asked the Commission to "*put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution*". In November 2016, the Commission submitted a relevant legislative proposal and at the end of 2017, co-legislators adopted the **Directive 2017/2399** "*as regards the ranking of unsecured debt instruments in insolvency hierarchy*".[928] This Directive amended **Article 108 of the BBRD** by setting out that ordinary unsecured claims have a higher priority ranking than that of unsecured claims resulting from debt instruments that satisfy the following conditions:[929]

- the original contractual maturity of debt instruments is of at least one (1) year,
- debt instruments do not contain embedded derivatives and are not derivatives themselves, and
- the relevant contractual documentation, related to their issuance, and the prospectus explicitly refer to their lower ranking under normal insolvency proceedings.

Hence, the Directive 2017/2399 created a new class of senior non-preferred debt that should rank in insolvency above capital instruments and other subordinated liabilities, but below other senior preferred liabilities.[930] The adoption of these arrangements seeks both to **minimize the possibility for breach of the "no-creditor-worse-off" principle**" and the need for the SRF to compensate affected creditors (see ***Table 16*** below) and to **ensure compliance with the subordination requirement** set out in the TLAC standard and the BRRD II.

[927] See **Munoz (2017)**, pp. 271-272.

[928] The deadline for transposition of the Directive into national laws was 29 December 2018.

[929] **Directive, 2017/2399**, Article 1.

[930] *Ibid*., recital (10).

Table 16: Example of distribution of losses (resolution vs liquidation) after the Directive 2017/2399

in €	Amount	Losses under resolution	Losses under liquidation	Difference (resolution-liquidation)	SRF contribution
First layer					
CET1	50	50	50	-	-
AT1	10	10	10	-	-
Tier 2	20	20	20	-	-
Middle layer					
Senior unsecured bonds	50	20	20	-	-
Middle-low layer					
Other senior liabilities	10	-	-	-	-
Liabilities excluded from bail-in	30	-	-	-	-
Lower layer					
Uncovered deposits	60	-	-	-	-
Covered deposits	200	-	-	-	-
Secured liabilities	20	-	-	-	-
TOTAL	**450**	**100**	**100**	**-**	**-**

3.3.3 General depositor preference

The Directive 2017/2399 fosters harmonization of national insolvency rankings but only to a certain degree. There are still elements of the insolvency rankings of participating Member States (e.g. Spain, Portugal, Cyprus) that may jeopardize the effectiveness of the resolution framework and put at risk compliance with the "no-creditor-worse-off" principle.[931] Decisions taken by the SRB to apply the write-down and conversion powers could be judicially challenged.

As argued by the ECB, further harmonization of national insolvency rankings would be useful, particularly if the general depositor preference was adopted instead of the tiered approach currently in place.[932] Based on the tiered approach, covered deposits rank senior to uncovered deposits and the latter rank higher than other senior liabilities. Under a

[931] For more information on the insolvency rankings of euro area Member States, **Single Resolution Board (2018d).**

[932] On the Opinion of the ECB on the Proposal for a Directive of the European Parliament and of the Council on amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy, see **ECB Opinion** of 8 March 2017 "*on a proposal for a directive of the European Parliament and of the Council on amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy*"**.**

general depositor preference, all deposits rank higher than ordinary unsecured non-preferred claims. Such a reform would enhance resolvability of banking groups by ensuring that senior unsecured liabilities (e.g derivatives, operational liabilities) bear losses prior to deposits and would alleviate concerns over possible breach of the "no-creditor-worse-off" principle. In addition, the harmonization of national insolvency legal frameworks among Member States should be ensured also in relation to capital instruments. In some Member States, other creditors, such as those with a special relationship with the banking group (e.g. major shareholders or intragroup positions) may absorb losses in insolvency before AT1 and/or T2 instruments. Furthermore, in some Member States national laws differentiate between the rank of Tier 2 instruments and other subordinated liabilities in insolvency, while in other jurisdictions they rank *pari passu*.

The (still existing) discrepancies in the Member States' insolvency rankings may give rise to legal implications with respect to the "no-creditor-worse-off" principle, particularly in case of resolution of a cross-border banking group. Moreover, they impede the SRB's work both in resolution planning and in resolution action, since it has to deal with 19 different national insolvency rankings in order to conduct the "no-creditor-worse-off" test (i.e. comparison of losses in resolution and liquidation).

Further harmonization of insolvency rankings could address these deficiencies and contribute to a consistent and effective implementation of the resolution framework across the Banking Union.

3.4 Harmonization of the crisis prevention tools

3.4.1 The significance of harmonized moratorium tools

Certain past banking failures have highlighted the need to introduce into the Union crisis management framework a "**moratorium tool**", which is defined as the power of resolution authorities to temporarily suspend payments or performance of obligations and/or temporarily prohibit contracting new obligations.[933] This power would prevent severe liquidity outflows from distressed banking groups, which are likely to accelerate their failure.

In the case of ABLV, a moratorium tool on all payments for five (5) days was imposed enabling the ECB and the SRB to manage effectively the crisis. Whereas the Latvian law provides for a moratorium tool, this is not the case for all euro area (and EU) laws. For instance, Spanish law has no provision for moratorium tool. The significance of this tool became evident in the Banco Popular resolution case, where rumors on its financial difficulties accelerated deposit outflows resulting in the illiquidity of the banking group, the exhaustion of eligible collateral for ELA funding and, finally, its failure.[934]

In particular, Banco Popular was confronting with significant cash outflows between 31 March 2017 and 1 June 2017 which led to severe deterioration of both the deposit base and the counterbalancing capacity. On 10 April 2017, Banco Popular announced that a capital increase or corporate transaction might be needed in response to its tight capital position and in order to deal with potential additional impairment costs of its non-performing portfolio. The announcement triggered serious concerns among investors and depositors over the financial situation of the banking group. The deterioration of the financial situation of the banking group along with a reputation hit as a result of the media coverage on that announcement sparked significant deposit outflows during May 2017. Hence, the liquidity outflows accelerated the failure of the banking group and, on

[933] See **European Commission (2016)**, p. 21.

[934] See **Lehmann (2018)**, p. 13.

(Tuesday) 6 June 2017, the ECB determined the banking group as "failing or likely to fail" not because of its actual problems relating to capital adequacy and asset quality, but because it would be in the near future unable to pay its debts or other liabilities as they fell due.[935] Within the same day, the SRB determined that the other two (2) resolution conditions had been met and adopted a resolution scheme that provided for the write-down and conversion of its capital instruments and the sale of the group to the Banco Santander.

If the moratorium tool was in place, the ECB and the SRB could prevent a further deterioration of Banco Popular's financial situation. In that way, they could stabilize the liquidity position of the group and ensure equal treatment of creditors eliminating, thus, the first mover advantage (i.e. the first creditors that would redeem their claims would be paid in full, while those who would act late would face losses).[936] In addition, the SRB could have more time to complete effectively all the necessary preparatory work for taking resolution action. This work covers the execution of the Valuation 1 and Valuation 2, the determination of the appropriate resolution tool and the conduct of a marketing process to find a private sector purchaser for the assets and liabilities of the banking group concerned, where the sale of business tool was to be applied.

3.4.2 Current state of play and the amendments of the BRRD II

The existing Union regulatory framework does not provide for bank moratoria in the pre-resolution phase, but only upon entry of a banking group into resolution. In this case, resolution authorities may suspend payments by the parent entity of a banking group under resolution and prevent certain enforcement actions against the group for a maximum period of up to two (2) business days. Pre-resolution bank moratoria can only be imposed by some Member States with modalities and limits that differ from country to country.[937] Almost all Member States have moratorium tools in their national law, though differing in relation to timing, scope and duration.[938]

In some Member States, the activation of the moratorium tools is permitted in the early intervention phase, while in other Member States this is considered a resolution-related tool that can be applied once a banking group is determined as "failing or likely to fail".[939] With respect to the scope, twelve (12) Member States have moratorium tools applicable to covered deposits, while in most countries payment obligations to CCPs or payment settlement systems are excluded from the scope of moratorium powers.[940] In relation to the duration of moratorium tools, in most Member States there is a predefined maximum duration, though ranging from one (1) working day to twelve (12) months. [941]

These inconsistencies across Member States impede the implementation of the resolution framework in a harmonized manner across Member States, particularly with respect to

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[935] **SRB Valuation Report** *"for the purpose of Article 20(5)(a) of Regulation (EU) No 806/2017 informing the determination of whether the conditions for resolution or the conditions for the write down or conversion of capital instruments are met ('Valuation 1)"*, p. 8.

[936] See **European Commission (2016)**, p. 22.

[937] On the discrepancies among Member States in relation to moratorium tools, see **Angeloni (2018)**.

[938] Out of 24 Member States which replied to a survey of the Commission, 21 Member States have in place a type of moratorium tool (EE, BG, ES, FI, HR, LU, FR, PT, SK, BE, PL, AT, IE, EL, CZ, RO, LV, HU, LT, DE, UK).

[939] See **European Commission (2016)**, p. 24.

[940] *Ibid.*, p. 23.

[941] The most frequent maximum duration is six (6) months.

cross-border banking groups with entities in many jurisdictions. Furthermore, such regulatory loopholes contribute to the fragmentation of the internal banking market and give rise to regulatory arbitrage as creditors have the incentive to transfer their claims in countries with no or limited moratorium tools.

The BRRD II aims at addressing the said deficiencies by conferring upon resolution authorities the power to suspend, for a limited period of up to two (2) business days, certain contractual obligations of banking groups that have been determined as "failing or likely to fail" and before they are put into resolution. This suspension power applies to payment and delivery obligations to which a banking group is party, except for the obligations owed to payment and settlement systems or operators of those systems, central counterparties and central banks.[942] Furthermore, resolution authorities may exercise the powers to suspend termination rights of any party to a contract with the banking group concerned for the same duration. Resolution authorities are allowed to set the scope of the suspension power, as they consider appropriate. However, the BRRD II sets out that resolution authorities must carefully assess the appropriateness of extending the suspension powers to eligible deposits, particularly with respect to covered deposits held by natural persons and SMEs. If resolution authorities decide to apply suspension powers also to covered deposits, they must ensure that depositors retain access to a sufficient amount to cover daily needs.[943]

The arrangements introduced under the BRRD II are a step towards the right direction, as acknowledged also from the SRB.[944] The moratorium tool facilitates resolution action and provides resolution authorities with more time to carry out the ex-ante valuation and select the suitable resolution tool(s) to deal with the banking groups' failure.

Nonetheless, the BRRD II does not harmonize the national laws providing powers to (supervisory and/or resolution) authorities to suspend payment or delivery obligations before a determination that a banking group is "failing or likely to fail" has been made. Hence, the revised crisis management framework does not ensure that the ECB and the SRB enjoy the same powers across Member States. Furthermore, the application of the moratorium tools during the pre-resolution phase entails that the SRB cannot apply the same powers to the entity concerned in the post-resolution phase, as provided for in Articles 69, 70 and 71 of the BRRD. Lastly, national laws apply to suspension powers applicable to a group's entities which are to be liquidated under normal insolvency proceedings and that exceed the scope and duration (2 business days) foreseen in the BRRD II.[945]

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[942] **BRRD II**, Article 33a(2).

[943] This point was raised by the ECB in its Opinion "*on amendments to the Union crisis management framework*". The ECB had also suggested the pre-resolution moratorium tool to be available also to supervisory authorities in order to have adequate time to determine whether a banking group is "failing or likely to fail". The ECB supported that the maximum duration of the moratorium tool should be five (5) working days. For more information, see **European Central Bank (2017)**.

[944] On the view of the SRB's Chair, see **König (2018a)**.

[945] **BRRD II**, Article 33a(8).

3.4.3 Harmonization of early intervention tools

Since November 2014, when the SSM started operating, there is limited experience in the application of the regulatory framework for crisis prevention by the ECB. One lesson learned from the four (4) "failing or likely to fail" cases of this period pertains to the need to amend the regulatory framework with respect to early intervention measures. In some cases, early intervention measures which are set out in the BRRD overlap with supervisory (Pillar 2) powers established under the CRD IV.[946] This overlap applies to the content and the conditions for the application of the measures. As a result, significant challenges arise due to the lack of clarity concerning the application of early intervention measures. In addition, it could be envisaged to introduce early intervention measures in the SRMR in order to allow the ECB to implement these measures in a consistent manner and avoid divergences currently existing in national law. The ECB also shares the same view, as it recommended the removal from the BRRD of the early intervention measures set out in the CRD IV and the SSMR and requesting for the introduction of the early intervention measures in the SRMR.[947]

3.5 Revision of the 2013 Banking Communication on state aid

The Commission Communication on State aid was issued in 2013, prior to the adoption of the BRRD. Thus, there are aspects of the Communication that need to be revised in order to align with the Union resolution framework.

The Banking Communication sets out that the provision of ELA is not considered as state aid, if "*the credit institution is temporarily illiquid but solvent at the moment of the liquidity provision which occurs in exceptional circumstances and is not part of a larger aid package*."[948] This requirement contradicts to the ECB's "*Agreement on the Emergency Liquidity Assistance*" which has adopted a forward-looking approach that permits provision of ELA "*if there is a credible prospect of recapitalization*." Hence, the ECB has adopted a broader definition for the eligibility of the counterparty to receive ELA in relation to the relevant conditions envisaged in the Banking Communication. This means that if the ECB grants access to ELA to the parent entity of a banking group that does not meet the minimum regulatory requirements, but has a credible prospect of recapitalization, including through the application of resolution tool(s), the Commission would determine such provision of liquidity as state aid. Consequently, the Commission should update the Banking Communication to align its eligibility criteria with those used by the ECB.

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946 See **Psaroudakis (2018)**, p. 14.

947 **ECB Opinion** of 8 November 2017 "*on amendments to the Union crisis management framework*", p. 7.

948 The ELA is not considered state aid, unless one of the following requirements is not met:

- the banking group is considered solvent but illiquid at the time of provision of ELA,
- the liquidity provided is fully collateralized and appropriate haircuts are applied,
- the liquidity is provided under higher interest rate compared to standard monetary facilities, and
- the measure is taken at the ECB's own initiative and is not backed by any counter-guarantee by the national government.

Furthermore, the Banking Communication provides that state aid for the liquidation of groups' entities under ordinary insolvency proceedings may be considered compatible with the internal market, where state aid is granted:[949]

- to encourage the exit of non-viable players ensuring that the process takes place in an orderly manner so as to preserve financial stability,[950] or
- to enable the beneficiary entity to be effectively wound up in an orderly way, while as long as it remains in the market, it must not actively compete on the market.

In light of the Italian case, the Commission Communication should be updated to prohibit or, at least minimize, the possibility for Member States to take advantage of this option in order to circumvent the resolution framework and save senior bondholders and depositors with state aid. This is particularly relevant as long as there is no harmonization of the framework for liquidation under normal insolvency proceedings.

Lastly, the Commission should consider revising the scope of the burden-sharing measures to include also senior unsecured bonds. In this way, the state aid rules will align with the provisions of the BRRD and limit the incentives for governments and banking groups to resort to the precautionary recapitalization instrument or the national rules for liquidation.

4. Need for improvements at operational level

4.1 Improvement needed in the resolution planning process

4.1.1 Need for comprehensive resolution plans for all banking groups

The SRB became fully operational in January 2016 and since then it has made some progress in enhancing banking groups' resolvability and increasing its capability to deal with crisis situations. The SRB follows a gradual approach in the resolution planning process designed to achieve by 2020 the complete coverage of banking groups under its remit. Although there are some advanced resolution plans, most of the resolution plans are still at premature level and need further development.[951]

At the initial stage of its functioning, the SRB drafted 36 Transitional Resolution Plans (TRPs), which were focused on the strategic business analysis section. These plans were used only for internal purposes and were not approved by the SRB's Executive Session. At the second phase, the SRB leveraged on the TRPs and adopted more comprehensive resolution plans (Phase 2 plans), which were submitted for approval to resolution colleges. Nonetheless, these 92 Phase 2 plans did not include MREL targets at consolidated level. Subsequently, in 2017 the SRB adopted 103 Phase 3 plans, which included MREL targets at consolidated level.[952] Nonetheless, the SRB has not yet adopted complete resolution plans (Phase 4 plans), which will determine substantive impediments to resolvability and set MREL targets both at consolidated and solo level.

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[949] **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')*", par. 66.

[950] **Commission Decision** "*on State Aid SA. 45664 (2017/N) – Italy – Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca – Liquidation aid*", point (97).

[951] See **Single Resolution Board (2018c)**, p. 10.

[952] The SRB agreed also host resolution plans with the Bank of England, the Swedish National Debt Office and the Central Bank of Denmark.

In relation to the timeline, the SRB has announced that in 2019 it is going to adopt 113 resolution plans and 93 MREL decisions at consolidated level. Elke König has promised that the SRB will have developed complete and sophisticated resolution plans at the latest by 2020 for all the banking groups under its remit. Until then, resolution plans will be gradually refined until they reach the desired level.[953] Hence, this delay in developing full resolution plans raise concerns over the SRB's ability to handle the failure of a banking group, particularly if it refers to a G-SII.

As far as the quality of the work undertaken by the SRB, the European Court of Auditors' (ECA) assessment demonstrated that the SRB had drawn up fewer resolution plans compared to its obligation (65 phase 2 plans and 32 TRPs instead of 113 resolution plans) and these plans did not meet a substantial number of requirements laid down in the BRRD and the relevant Level 2 and Level 3 acts.[954] With regard to the strategic business analysis, the ECA report identified shortcomings on the description of the structure, business models, governance and financials of the groups concerned.[955] Weaknesses were also noted on the description of alternatives for the preferred resolution strategy, if it could be implemented, as well as on the estimated timeframe for executing all the important aspects of the resolution plan. Furthermore, the ECA report determined that resolution plans did not include an assessment of the feasibility and credibility of the selected resolution strategies, taking into account whether it can be applied effectively and in a timely manner.[956]

Taking into account the aforementioned considerations, the SRB seems to have adopted a "one-size-fits-all" approach for resolution plans, as they are not tailored to the business model, risks, size and complexity of each banking group. This assumption is based on the significant differences between the resolution plans and the SRB's decisions relating to the four (4) banking groups that have been determined as "failing or likely to fail". Whereas all the resolution plans for these banking groups envisaged resolution as the preferred resolution strategy and the bail-in tool as the preferred resolution tool, at the time of crisis the SRB took different decisions. In particular, three (3) of the banking groups (Vento Banca, Banca Popolare di Vincenza, ABLV) were placed into liquidation under normal insolvency proceedings, while Banco Popular was put into resolution but under the sale of business tool.

4.1.2 Improvement needed in the determination of the MREL

The SRB is lagging behind other resolution authorities in major banking jurisdictions in relation to the determination of MREL targets both in terms of timeline and content. Indicatively, the Bank of England (BoE) has adopted a more advanced and comprehensive policy on the determination of the MREL. The BoE's policy has made significant progress in relation to the link of the MREL with the preferred resolution tool, the determination of internal MREL[957] and the transitional period provided to banking groups to reach MREL targets.

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[953] See **Single Resolution Board (2018c)**, p. 8.

[954] See **European Court of Auditors (2017)**, p. 13.

[955] *Ibid.*, p. 22.

[956] *Ibid.*, pp. 44-45.

[957] The BoE sets internal MREL targets for "material subsidiaries" of banking groups. A material subsidiary meets one of the following criteria:

- has more than 5% of the consolidated RWAs of the banking group,
- generates more than 5% of the total operating income of the banking group,

Pursuant to the BoE's approach, the preferred resolution strategy is linked to the approach for setting the MREL target. Firstly, where the BoE determines the modified insolvency as the preferred resolution strategy, the recapitalization amount of the MREL is set at zero. The BoE has set clear criteria to determine that a banking group will enter modified insolvency rather into resolution. Such criteria include:[958]

- whether the failure of the banking group is likely to cause disruption to the UK financial system, either directly through the cessation of services it provides or indirectly by negatively affecting confidence in the financial system, or
- if the banking group provides fewer than 40,000 to 80,000 transactional bank accounts (i.e. accounts from which withdrawals have been nine or more times within a three-month period).

Secondly, if the BoE considers appropriate to transfer the critical functions of a banking group to another entity, then a transfer tool can be applied instead of the bail-in tool. This approach applies mainly to banking groups with a balance sheet of up to £15bn-£25bn. For these banking groups, the recapitalization amount is reduced to reflect the fact that the post-resolution banking group will have less assets that the pre-resolution banking group. In addition, the BoE considers whether the Pillar 2 requirements need to be reduced as a result of the transfer of assets. Thirdly, for banking groups with total assets exceeding £25bn, the BoE is likely to make use of the bail-in tool. Therefore, these banking groups, mainly G-SIIs and O-SIIs. are required to meet fully-loaded MREL targets by 2022.[959]

On the contrary, the SRB applies the same simplistic MREL approach to almost all banking groups irrespective of their riskiness, size, complexity and interconnectedness.[960] In the 2017 resolution planning cycle, the SRB adopted some adjustments on the recapitalization amount, but there is still room for improvement. In particular, the SRB should link its MREL approach to the preferred resolution strategy and set different MREL targets based on the preferred resolution tool (bail-in tool or asset transfer tool). Based on the preferred resolution tool, a different reduction rate of the RWAs basis for the recapitalization amount should apply.

Furthermore, both the existing framework (Delegated Regulation 2016/1450) and the BRRD II allow resolution authorities to adjust downwards the P2R of the recapitalization amount, if this is justified by the riskiness of the post-resolution banking group. This provision is particularly relevant for high-NPE banking groups, which have been

- has a total leverage exposure measure larger than 5% of the group's consolidated leverage exposure, or
- exceptionally, it is material for the delivery of group's critical functions.

The internal MREL for material subsidiaries is to be set in the range of 75%-90% of the full amount of external MREL that otherwise would be required to meet if the material subsidiary was a resolution entity subject to an external MREL target.

[958] See **Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)**, p. 5.

[959] The fully-loaded MREL targets are equal to the higher of:

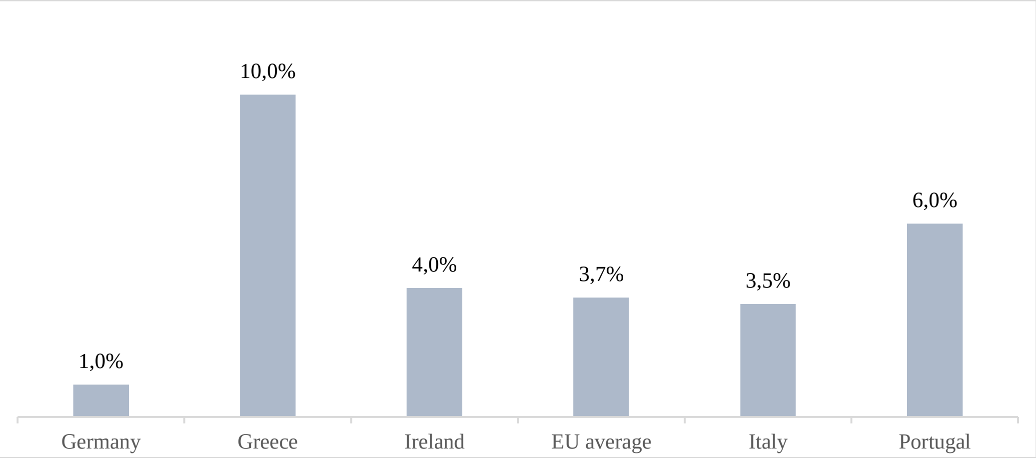
- twice the sum of Pillar 1 and Pillar 2 requirements [2x (Pillar 1 plus P2R)], or
- twice the applicable leverage requirement (6.75% for G-SIIs and 6.5% for O-SIIs).

[960] In contrast to the view expressed by **Tröger (2017b**) that the current framework for the determination of the MREL is complicated and differentiates the MREL targets across banking groups, the SRB has adopted a "one-size-fits-all" approach for the determination of the MREL through the application of a default methodology for all banking groups under its remit.

assigned with high P2R due to their large stock of NPEs (as shown in ***Figure 10***). Upon resolution, the Loss Absorption Amount is likely to be used to increase provision coverage and write-off of NPEs (bail-in tool) or NPEs not be transferred to the new entity (asset transfer tool). Hence, the SRB should consider adjusting downwards the P2R of the recapitalization amount, where the post-resolution banking group is assessed to be less risky than the pre-resolution one.

The adjustments referred above will limit the financial burden for banking groups, which must issue significant amounts of MREL-eligible liabilities in the following years to meet the MREL. Based on an analysis carried out by the EBA (based on data as of end-December 2016) the estimated MREL funding needs for a sample of 112 EU banking groups[961] range from €131.5bn to €284.6bn depending on the MREL determination approach used.[962] However, MREL shortfall presents significant divergence across Member States, as demonstrated by an analysis conducted by the Spanish banking group BBVA.[963] As shown in ***Figure 21*** below, banking systems that were hit by euro area fiscal crisis have significantly higher MREL needs (in terms of RWAs) compared to the banking systems that remained unaffected from the crisis.

Figure 21: MREL shortfall (% RWAs) of euro area banking groups



Source: *BBVA (2018b)*

Consequently, the SRB should determine MREL targets on a case-by-case basis and make additional downwards adjustments. Lower MREL targets will allow banking groups to meet the MREL with the least possible implications for their profitability and financial situation.

[961] The sample covers 112 banking groups (from 17 EU Member States) representing approximately 60% of the assets of the EU banking sector.

[962] The EBA deployed two approached to estimate the MREL needs; first, the LAA buffer [2x (Pillar 1 + P2R) + combined buffer requirement] and second the higher of the LAA buffer and the 8% total liabilities and own funds (TLOTF) floor. In order to assess the impact of the subordination requirement, the EBA has assumed a partial subordination requirement of:

- 14.5% of RWAs (+ combined buffer requirement) for G-SIIs, and
- 13.5% of RWAs (+ combined buffer requirement) for O-SIIs.

[963] On the analysis for the MREL targets and MREL needs per banking sector, see **BBVA (2018b).**

4.2 Enhanced cooperation with the authorities outside the Banking Union

The creation of the Banking Union has limited the role of national authorities in the decision-making process relating to significant banking groups which operate only in participating Member States. Close cooperation and effective exchange information between the ECB and the SRB is necessary to ensure orderly and timely reaction to crisis situations. At the beginning of the Banking Union, there have been some problems in the cooperation and exchange of information between the ECB and the SRB, as the latter had limited access to the information available to the former. The revised MoU (May 2018) between the two authorities is expected to improve their cooperation given that it remedies the deficiencies identified in these areas.

On the contrary, coordination and cooperation with the supervisory and resolution authorities of non-participating Member States and third countries remains a challenge both for the ECB and the SRB. Although resolution colleges have made significant progress and have intensified the level of the engagement of the participants,[964] particularly in the resolution planning process, there is still room for improvement.[965] In accordance with an assessment carried out by the EBA, resolution plans for cross-border banking groups need further improvement in the following areas:[966]

- **operational aspects of the resolution plans**, such as bail-in execution, funding in resolution, access to FMIs and coverage of material subsidiaries outside the home jurisdiction,
- **removal of impediments to resolvability**, as no decisions on this issue have been taken yet, and
- **determination of MREL targets both at solo and consolidated level**, though some joint decisions on MREL targets have been taken. However, the EBA demonstrates that the MREL targets should be determined based on groups' riskiness and characteristics and not based on a default approach.

In contrast to the cooperation arrangements concerning the resolution planning process, cooperation between the Banking Union's authorities and the authorities of non-participating Member States during crisis situations has not been tested yet. The existing framework provides that joint decisions are required to take significant crisis prevention measures and resolution action for banking groups operating both in participating and non-participating Member States. However, it is reasonable to assume that during crisis situations the NSAs of non-participating Member States will prioritize their national

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[964] The EBA carries out an annual assessment of the functioning of resolution colleges to determine whether they apply consistently the provisions of the regulatory framework. The EBA recognized the significant progress achieved towards enhancing groups' resolvability, particularly with respect to:

- **loss absorption capacity**: the determination of MREL policies and the introduction of the class of non-preferred senior bonds allowed banking groups to enhance their MREL capacity,
- **operational continuity**: banking groups have initiated workstreams to map critical services to critical functions, to set up service companies and to include resolution-proof clauses in their contracts for critical services with internal and external counterparties
- **early termination of financial contracts**: banking groups with significant derivatives portfolio have made progress through the adherence to the ISDA protocols on stays the introduction by some authorities of rules on the contractual recognition of stays on financial contracts.

[965] **European Banking Authority (2018b)**, p. 10.

[966] *Ibid.*, pp. 11-13.

interests and the protection of the national stakeholders instead of safeguarding the integrity of the internal market.

In that context, the EBA can play a mediating role (particularly where binding mediation applies) to restrict national bias and ensure that the final decisions serve both the objective of financial stability and the orderly functioning of the internal market. However, as shown in ***Table 17***, there are areas to which binding EBA mediation do not apply. These areas cover both the crisis prevention phase (e.g. early intervention measures) and the crisis management phase (e.g. write down and conversion, resolution action). Hence, national authorities may object to a draft decision proposed by the ECB or the SRB, where relevant, and take unilateral action in relation to their entities under their remit.

Table 17: Areas within the scope of the EBA mediation

Option for both binding and non-binding EBA mediation	Option only for non-binding EBA mediation
SREP decision	Decision on the activation of the intragroup financial agreement
Assessment of group recovery plans	Early intervention measures
Ex-ante approval of the proposed intragroup financial agreement	Financial measures to address impediments to resolvability
Structural measures to address or remove impediments to resolvability	Write-down and conversion of capital instruments (in relation to subsidiaries)
Decision for the MREL	Assessment of the business reorganization plan
	Decision on resolution action (both for the parent entity and subsidiaries)

This problem can be resolved if the regulatory framework is amended so as to extend the option for binding mediation to all critical decisions. The amendment of the regulatory framework would force the involved authorities to make every effort to reach joint decisions prior to the EBA's involvement. Until such an amendment takes place (or more non-participating Member States join the Banking Union, which is the optimal solution to address such issues),[967] the SPE approach for banking groups operating both in participating and non-participating Member States could be a solution. Under this approach, banking groups would have to issue MREL-eligible instruments at parent entity level. Upon resolution, the SRB can achieve the orderly resolution of the whole banking group through the application of the write-down and conversion powers at the liabilities issued by the parent entity.

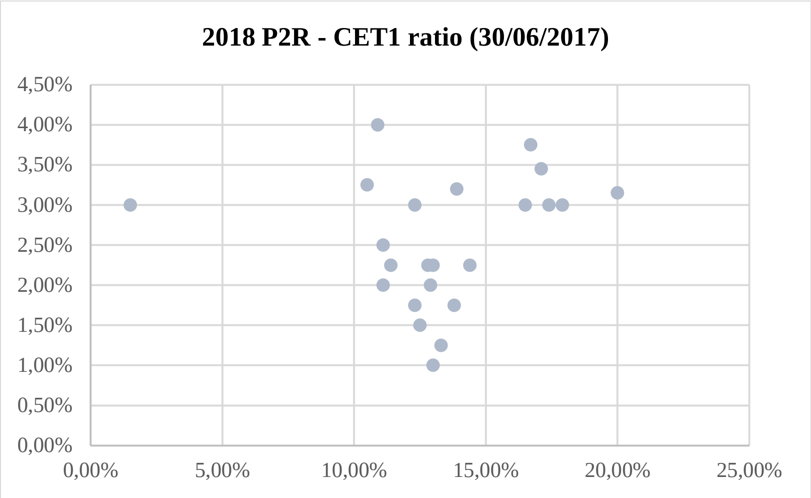
With respect to banking groups with material subsidiaries in third countries, significant problems are likely to arise both in the decision-making process and in the enforcement of the SRB's decisions. The SRB has established Crisis Management Groups (CMGs) for G-SIIs (most of which operate in third countries) and has signed MoUs with some third-country resolution authorities. However, these MoUs facilitate the cooperation and exchange of information between the involved parties but cannot ensure that both parties will take coordinated action either in resolution planning or upon resolution. Taking into consideration this inherent weakness relating to the cooperation with third-country

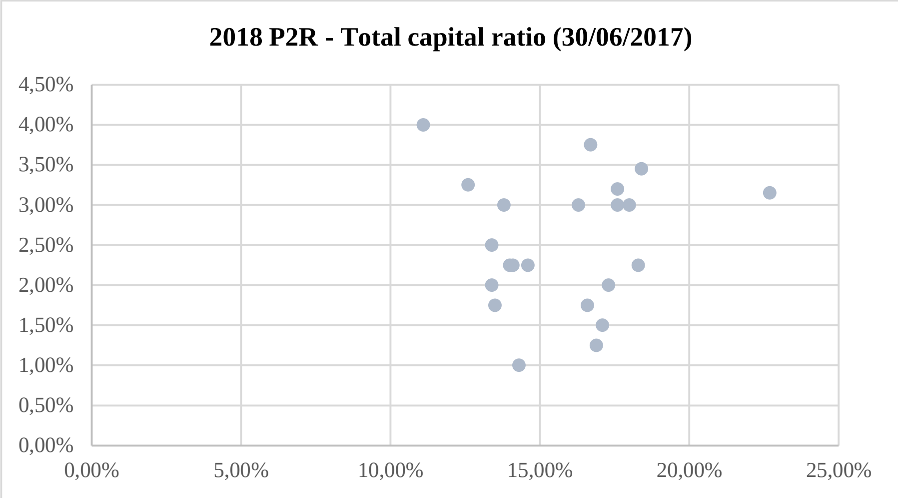
[967] In that context, in 2018 Bulgaria submitted an application for the establishment of close cooperation with the ECB. For more information, see: https://www.bankingsupervision.europa.eu/press/pr/date/2018/html/ssm.pr181112.en.html

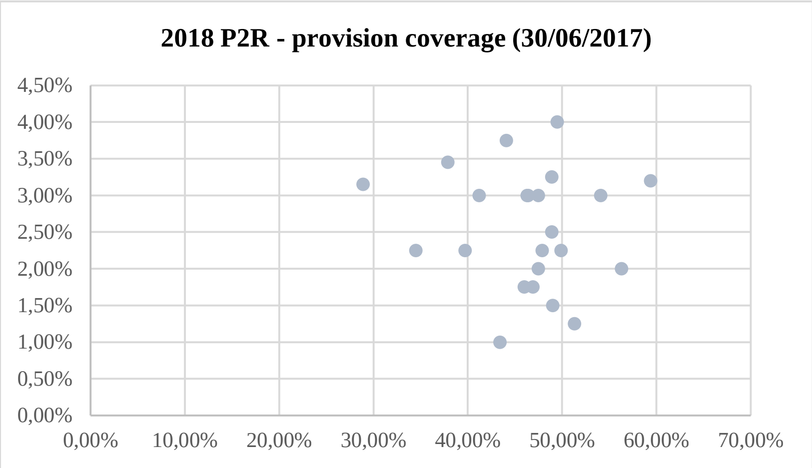
authorities along with the lack of enforceability of the SRB's decisions in third countries, it is critical for resolution authorities to adopt a suitable resolution strategy for each banking group. Under the MPE approach, a banking group which has operations in many third countries will consist of separate regional resolution groups. Upon failure of the relevant regional resolution group, the resolution authority concerned can apply the write-down and conversion powers to the MREL-instruments issued by the parent entity of the regional group. The regional resolution group is resolved and walks away from the other regional groups of the banking group. In this way, the resolution authority can deal with the risks of a (likely) defective cooperation with third-country resolution authorities and mitigate any adverse impact on EU-based resolution groups.

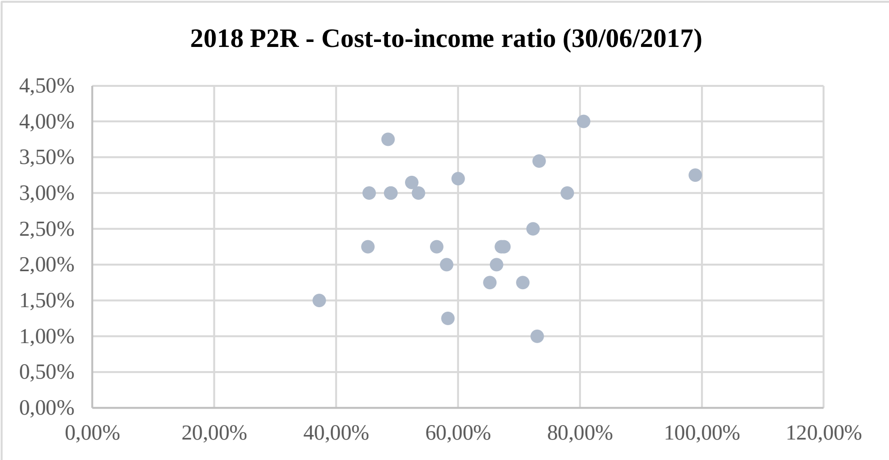
Annex

Name of the banking group	Country	Size class	2018 P2R	CET1 ratio (30/06/2017)	Total Capital ratio (30/06/2017)	NPE ratio (30/06/2017)	NPE provision coverage (30/06/2017)	Cost-to-income ratio (30/6/2017)
AIB Group plc	Ireland	€75-100 bn	3,15%	20,00%	22,70%	17,4%	28,90%	52,40%
Permanent tsb Group Holdings plc	Ireland	€30-50 bn	3,45%	17,10%	18,40%	25,9%	37,90%	73,30%
Bank of Ireland Group plc	Ireland	€100-125 bn	2,25%	14,40%	18,30%	9,2%	34,50%	67,10%
Alpha Bank, S.A.	Greece	€50-75 bn	3,00%	17,90%	18,00%	51,4%	46,30%	45,40%
Eurobank Ergasias, S.A.	Greece	€50-75 bn	3,00%	17,40%	17,60%	46,5%	47,50%	48,90%
National Bank of Greece, S.A.	Greece	€75-100 bn	3,00%	16,50%	16,30%	37,6%	54,10%	53,50%
Piraeus Bank, S.A.	Greece	€75-100 bn	3,75%	16,70%	16,70%	53,4%	44,10%	48,50%
Banca Carige S.p.A. – Cassa di Risparmio di Genova e Imperia	Italy	€30-50 bn	3,25%	10,50%	12,60%	30,2%	48,90%	98,90%
Banca Monte Dei Paschi Di Siena S.p.A.	Italy	€150-300 bn	3,00%	1,50%	-	17,7%	46,40%	77,90%
Banco BPM S.p.A.	Italy	€150-300 bn	2,50%	11,10%	13,40%	21,8%	48,90%	72,30%
BPER Banca S.p.A.	Italy	€50-75 bn	1,75%	13,80%	16,60%	19,8%	46,90%	65,20%
Banca Popolare di Sondrio, Società Cooperativa per Azioni	Italy	€30-50 bn	2,00%	11,10%	13,40%	14,8%	47,50%	58,10%
Credito Emiliano Holding S.p.A	Italy	€30-50 bn	1,00%	13,00%	14,30%	5,4%	43,40%	73,00%
ICCREA Banca S.p.A.	Italy	€30-50 bn	1,75%	12,30%	13,50%	7,2%	46,00%	70,60%
Intesa Sanpaolo S.p.A.	Italy	€500-1,000 bn	1,50%	12,50%	17,10%	11,2%	49,00%	37,20%
Mediobanca – Banca di Credito Finanziario S.p.A.	Italy	€50-75 bn	1,25%	13,30%	16,90%	4,5%	51,30%	58,30%
UniCredit S.p.A.	Italy	€500-1,000 bn	2,00%	12,90%	17,30%	9,0%	56,30%	66,30%
Unione di Banche Italiane Società per Azioni	Italy	€100-125 bn	2,25%	11,40%	14,10%	12,0%	49,90%	56,50%
Bank of Cyprus Holdings Public Limited Company	Cyprus	€10-25 bn	3,00%	12,30%	13,80%	42,0%	41,20%	49,00%
Hellenic Bank Public Company Limited	Cyprus	€5-10 bn	3,20%	13,90%	17,60%	35,4%	59,40%	60,00%
Banco Comercial Português, SA	Portugal	€50-75 bn	2,25%	13,00%	14,00%	16,9%	39,70%	45,20%
Caixa Geral de Depósitos, SA	Portugal	€75-100 bn	2,25%	12,80%	14,60%	13,5%	47,90%	67,50%
Novo Banco	Portugal	€50-75 bn	4,00%	10,90%	11,10%	33,8%	49,50%	80,60%


2018 P2R - CET1 ratio (30/06/2017)
4,50%
4,00%
3,50%
3,00%
2,50%
2,00%
1,50%
1,00%
0,50%
0,00%
0,00%
5,00%
10,00%
15,00%
20,00%
25,00%


2018 P2R - Total capital ratio (30/06/2017)
4,50%
4,00%
3,50%
3,00%
2,50%
2,00%
1,50%
1,00%
0,50%
0,00%
0,00%
5,00%
10,00%
15,00%
20,00%
25,00%


2018 P2R - provision coverage (30/06/2017)
4,50%
4,00%
3,50%
3,00%
2,50%
2,00%
1,50%
1,00%
0,50%
0,00%
0,00%
10,00%
20,00%
30,00%
40,00%
50,00%
60,00%
70,00%


2018 P2R - Cost-to-income ratio (30/06/2017)
4,50%
4,00%
3,50%
3,00%
2,50%
2,00%
1,50%
1,00%
0,50%
0,00%
0,00%
20,00%
40,00%
60,00%
80,00%
100,00%
120,00%

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