The EU Resolution Framework (BRRD and BRRD II proposals) and its interaction with the EU Banking Union (Single Resolution Mechanism and the need for a third Pillar of a Single Deposit Protection Scheme)

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I hereby declare that the work submitted is mine and that where I have made use of another’s work, I have attributed the source(s) according to the Regulations set in the Student’s Handbook.

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Abstract

This dissertation was written as part of the LLM in Transnational and European Commercial Law, Banking Law, Arbitration/Mediation at the International Hellenic University.

Deposit insurance and bank resolution interact with each other as alternative or complementary mechanisms. Given that a direct pay-off under a deposit guarantee scheme will take place only where a failing bank is closed and liquidated and depositors have no longer access to their deposits, bank resolution – under the BRRD framework – ensures the continuity of banking services through the organisation of an orderly failure, reducing thus the likelihood of a deposit pay-off.

Keywords: Bank resolution, Banking Union, Deposit Insurance

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I. Introduction

The banking crisis of 2007-09, the most severe and complex the world has faced since 1929, has undoubtedly left a clear imprint on the global economy. The first major banking – and further, capital – crisis of the 21st century has been attributed to a catalogue of manifold reasons, thoroughly analysed and discussed in various reports, books and papers.

Developments in the market for subprime mortgages, for instance, were just among the triggers – the proximate causes – of the crisis, whereas vulnerabilities in the public and private sector contributed to the amplification of the initial shocks. Lastra and Wood argue that these vulnerabilities are a result of the financial system’s reliance on debt and the inability of the regulatory framework to prevent systemic risk.

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5 “Securitization and other innovations in mortgage markets led to new loan products with the potential to make home ownership easier and more accessible to buyers who could not access credit previously through conventional means. These so-called subprime and near-prime mortgage products allowed buyers with lower credit scores, smaller downpayments, and/or little documentation of income to purchase houses. These new products not only allowed new buyers to access credit, but also made it easier for home owners to refinance loans and withdraw cash from houses that had appreciated in value.” See C. Mayer and K. Pence, ‘Subprime Mortgages: What, Where, and to Whom?’, Finance and Economics Discussion Series Division of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington D.C. (2008), online at https://www.federalreserve.gov/pubs/feeds/2008/200829/200829pap.pdf, accessed 6 January 2019.

6 B. S. Bernanke, ‘Some Reflections on the Crisis and the Policy Response’ Remarks by Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System at the Conference on
Wood note that macroeconomic imbalances along with loose monetary policies, characterised by easy money and cheap credit, gaps and inadequate rules in the regulatory structure combined with failures of supervision were mainly attributed to authorities (governments, regulators, central bankers).\(^7\)

Part of the blame was further put on the market participants.\(^8\) Financial innovation, including extremely complex products and techniques (asset-backed securities) gradually led banks to a more profitable model compared to the traditional deposit-taking and lending business, namely, the securitisation\(^9\) (‘originate-to-distribute’ model\(^10\)) and trading in securities and derivatives markets. As a result, the unregulated market for over-the-counter (OTC) derivatives grew and the so-called shadow banking system expanded.\(^11\)

Comprised of a set of institutions and markets, which, on the one hand, perform traditional banking functions but, on the other, do so outside the traditional system of regulated depository institutions\(^12\), the shadow banking system and its components\(^13\) (securitization vehicles, asset-backed commercial paper (ABCP) conduits, money

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\(^8\) ibid. P. 538.

\(^9\) “Securitisation is part of structured finance. It is a financing technique by which homogeneous income-generating assets – which on their own may be difficult to trade – are pooled and sold to a specially created third party, which uses them as collateral to issue securities and sell them in financial markets. Transactions within this process involve several parties and range from relatively simple and clear to more complex and opaque. Although securitisation was not directly responsible for the 2008 financial crisis, it contributed to it and played a role in its amplification.”


\(^10\) See The Turner Review, p. 16.


market mutual funds, markets for repurchase agreements (repos), hedge funds, private equity groups, broker dealers, mortgage companies) played a crucial role on the world stage of finance before the crisis. Furthermore, corporate governance failures combined with inadequate risk management structures and excessive leverage amplified through human greed and short-term interests and profits should also be mentioned as contributing factors that fuelled the boom.

From this crisis evolved for some euro-area peripheral countries a sovereign debt crisis, mainly due to the sovereign – bank diabolic loop, since the significant amount of state aid required to support banks resulted in the rapid increase of the public debt, rendering banks and sovereigns highly interconnected.

As the aforementioned brief summary of the generally accepted causes together with the touch-paper of the crisis, the subsequent collapse of Lehman Brothers, reveal, the need for a regulatory and supervisory reform agenda, including bank resolution frameworks, to be set both at international and European level was more than urgent. In the aftermath of the crisis, international institutions and organizations (structures formed through political processes, like G20, standard-setters, like the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BSBC) and monitoring authorities, like the International Monetary Fund (IMF) and the World Bank Financial Sector Assessment Program (FSAP)) have committed to reform and

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14 The crisis was caused due to a ‘run on repo’. See G.B. Gorton and A. Metrick, ‘Regulating the Shadow Banking System’, [October 2010], p. 15.
17 M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 2.04;
18 It is argued that the poor planning of the bankruptcy process resulted in losses that could have been avoided in the event that an orderly liquidation process was in place. See M. J. Fleming and A. Sarkar, The Failure Resolution of Lehman Brothers, FRBNY, Economic Policy Review (Dec. 2014), online at https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf, accessed 10 January 2019, p. 175ff.
19 The Financial Stability Forum (FSF), established in 1999, was the predecessor of the FSB. http://www.fsb.org/history/
enhance the national supervisory frameworks as well as to strengthen individual institutions with reference to their capital base and resolvability, and to improve the financial market infrastructure.\textsuperscript{21}

Tackling the issue of ailing banks without endangering the stability of the global financial system was undoubtedly among the priorities of the above-mentioned institutions.\textsuperscript{22} Their efforts towards a stable and sound regime for coping with failed banks was marked with the adoption by the Financial Stability Board’s (FSB) of the \textit{Key Attributes of Effective Resolution Regimes for Financial Institutions}\textsuperscript{23}, which was subsequently endorsed by the G20 Leaders at the Cannes Summit\textsuperscript{24}. Resolving failing financial institutions in an orderly manner avoiding taxpayers’ exposure to the losses and severe systemic disruption while maintaining their vital economic functions was the rationale of the KA.\textsuperscript{25}

At the European level, taking into consideration both the global and Eurozone crisis, the package of reforms in respect of the financial and banking sector dealt with the shortcomings of the macro- and microprudential supervision\textsuperscript{26} in line with the recommendations of the \textit{De Larosière}\textsuperscript{27} Report.\textsuperscript{28}

\begin{itemize}
\item[21] M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 2.06;
\item[27] De Larosière Report, Chapters III-IV.
\end{itemize}
Moreover, implementing the Basel III capital requirements has been of utmost importance in the context of EU banking reform.

With regard to bank resolution, the EU Commission laid out an extensive plan for a legal framework in order for authorities to be able to manage effectively crises in the financial sector. It is the Directive 2014/59/EU, which establishes a framework for the recovery and resolution of credit institutions and investment firms (BRRD). Its proposals to amend the aforementioned Directive (BRRD II) presented the European Commission in November 2016 (reform package), aiming to deal with remaining weaknesses of the financial system and to implement the outstanding and by that time finalized new global standards.

Among the regulatory and supervisory reforms that have taken place since the outbreak of the banking crisis should also be numbered the Deposit Guarantee Schemes Directive (recast). The original Directive of Deposit Guarantee Schemes

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28 M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), paras. 2.07-2.27.
34 European Commission, Frequently asked questions: Capital requirements (CRR/CRD IV) and resolution framework (BRRD/SMR) amendments, Brussels 23 November 2016.
(DGSD)\textsuperscript{36} was rendered obsolete and its provisions on minimum harmonization provided for significant differences among the (national) Deposit Guarantee Schemes (DGS) as regards the level of coverage, the scope of covered depositors and products and the payout delay.

Thus, the review of the DGSD was essential for the harmonisation and simplification of the Directive in order to improve protection of deposits, maintain depositor confidence and strengthen the safety net.\textsuperscript{37} The coverage of national Deposit Guarantee Schemes has now been raised to a harmonised level of €100,000 per depositor.\textsuperscript{38}

Notwithstanding the reform of the EU regulatory framework and the existing coordination between supervisors, the European Commission called “for a Banking Union to place the banking sector on a more sound footing and restore confidence in the Euro as part of a longer term vision for economic and fiscal integration. Shifting the supervision of banks to the European level is a key part of this process, which must subsequently be combined with other steps, such as a common system for deposit protection and integrated bank crisis management.”\textsuperscript{39} The Banking Union currently consists of the Single Supervisory Mechanism (SSM)\textsuperscript{40} and the Single Resolution Mechanism (SRM)\textsuperscript{41}. Its third Pillar, the European Deposit Insurance Scheme (EDIS)\textsuperscript{42}, is yet to be completed.


\textsuperscript{37} European Commission, Frequently asked questions: Deposit Guarantee Schemes, Brussels 15 April 2014.

\textsuperscript{38} Recast DGSD, Art. 6.


\textsuperscript{40} 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, OJ EU L29.10.2013 L287/63.


Therefore, the dissertation will examine the latest reforms in the EU on the creation of a harmonised framework for a recovery and resolution of credit institutions. Moreover, it will look at the European Banking Union with a view to analysing the Single Resolution Mechanism and its interaction with the third and yet to be completed Pillar, a European Deposit Insurance Scheme. The role of a Deposit Protection Scheme in resolution will be explored and the current developments at EU level will be compared with those in the US, where an established Resolution and Deposit Protection Regime has been in place.
II. The EU Resolution Framework

When a bank fails, the money has gone. Obvious is only the fact that someone has to bear the losses, be it the taxpayers, the bank’s shareholders, its depositors or other creditors. Less obvious, though, is the answer to the question of “who pays?”, taking into consideration that large and interconnected banks operate in a global and internationally integrated financial system, both within and beyond national borders. In fact, in the years that preceded the crisis some banks were deemed too big, too interconnected or too complex to be closed or go bankrupt.

Since failure was not an option, public support was required and the taxpayers had to step in (bail-out), rescuing most failed large banks. As Cunliffe notes, the exception of Lehman Brothers, in the case of which the US Government chose not to proceed to a bail-out, and its subsequent disorderly insolvency proved that handling effectively the failure of very large financial institutions could not be taken for granted, even for the oldest and most advanced bank resolution regime.

The game-changing regulation reducing the probability as well as the impact of failure came within the context of the international regulatory reforms. The Financial Stability Board’s Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) constitute the new harmonised international standard for resolution regimes. Despite focusing on global systemically important banks (G-SIBs), they still provide guidance to jurisdictions that are amending national resolution regimes. Their translation into EU law has been achieved through two pieces of legislation, namely the BRRD and the

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SRM Regulation. Although they are complementary, they will be discussed separately, since the Single Resolution Mechanism forms part of the EU Banking Union.

A. The Rationale behind the Resolution Regimes – the Route towards the BRRD

Prior to the crisis, in most European countries bank insolvency would be treated under the general rules of insolvency law (lex generalis), whereas special rules (lex specialis) would apply only where this was explicitly provided for by the respective banking law. By contrast to the majority of the European legislations, the US approach exempts commercial banks from the corporate bankruptcy code so that the declaration and resolution of bank insolvencies are governed by a special Regime, the Federal Insurance Deposit Act.

When the crisis hit in Europe, normal insolvency proceedings proved to be inadequate to deal with bank failures, taking into account the specificity of these financial institutions and their role within the financial sector and society. Hüpkes explains that the functions that banks perform (for instance, collection of deposits from private persons and businesses, provision of loans to households and businesses) on the basis of public trust are crucial for the health of a country’s economy. Loss of confidence in them would lead to massive withdrawals of funds by depositors and creditors, resulting in their failure with possible spillover effects on other banks across

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49 See Chapter IV.
53 Ibid. 43-44.
the globe – due to their high interconnectedness – destabilising the whole financial system.⁵⁶

Contrary to normal insolvency proceedings, the objective of which is to maximize the value of the assets of the failed firm in the interest of its creditors, the resolution aims at a rapid and decisive response to a failing or likely to fail bank in order to restore it back to viability, while maintaining financial stability through the protection of its critical functions and minimizing losses for society. In terms of allocation of losses to shareholders and creditors, it ensures similar results to those of normal insolvency proceedings. Parts of the institution that are considered to be less critical will be allowed to fail in an orderly way, according to the general insolvency rules.⁵⁷

Furthermore, in the absence of robust resolution regimes the fiscal cost of supporting financial institutions in distress was raised at extremely high levels.⁵⁸ Gordon and Ringe stress that uncoordinated and costly bailouts⁵⁹ characterized the European responses to failing banks during the banking crisis, until the U.K. first introduced a special resolution scheme⁶⁰. Gradually, Member States started adopting similar measures, which varied, however, significantly as regards speed and priorities.⁶¹ Consequently, each Member State was concerned with itself, national regulators showed forbearance towards their own banks, while the high interconnectedness between States and their banks resulted in the expansion of their sovereign debt.⁶²

As Mario Draghi underlined, a common resolution scheme “would ensure timely and impartial decision making focused on the European dimension, would credibly pursue

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⁶² Ibid., 1336-1337.
the least cost resolution strategy, assessing possible cross-border spillover effects and systemic concerns, and would help break the vicious bank-sovereign nexus. (...) The adoption of the proposed Bank Recovery and Resolution Directive is an urgently needed step towards a strong European resolution framework.”

B. The BRRD

The BRRD constitutes a harmonised regime, providing national authorities with a minimum set of resolution tools and powers. At the same time, it leaves Member States discretion as regards the design of the respective resolution regime, so that it better fits their own economic circumstances and domestic legal frameworks, provided that the discretionary measures conform to the principles and objectives set out in the Directive.

This set of resolution tools and powers is deemed as an alternative to the national insolvency law arsenal, allowing resolution authorities to intervene rapidly and decisively in order to maintain vital services and to avoid contagion. Once the resolution authority has decided to resolve a failing institution, normal insolvency proceedings are excluded, save for the event that they need to be combined with resolution tools.

1. Overview

Adopted by the European Parliament on 15 May and entered into force on 2 July 2014, the Bank Recovery and Resolution Directive required transposition into Member States’ national law by the end of the same year, except for the bail-in tool provisions, which became effective as of 1 January 2016.

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63 Mario Draghi, President of the ECB, Introductory Statement at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament (18 February 2013); BRRD, Preamble, Recital 9: “The absence of common conditions, powers and processes for the resolution of institutions is likely to constitute a barrier to the smooth operation of the internal market.”
64 BRRD, Preamble, Recital 44.
67 BRRD, Preamble, Recital (44).
68 BRRD Arts. 130(1), 131.
Consistent with the objective of implicit coordination via regulatory harmonisation within the EU, the BRRD applies to those institutions that are subject to the prudential supervision and regulatory capital requirements provisions in the EU Capital Requirements Directive (CRD IV), namely, credit institutions and investment firms with an initial capital of €730,000, as well as financial holding companies established in the Union. Financial institutions that are subsidiaries of the above-mentioned categories and covered by the supervision of the parent undertaking on a consolidated basis, according to the provisions of the CRR, are also included in the scope of the Directive. The Directive further stipulates that Member States are required to designate one or, exceptionally, more resolution authorities that are empowered to apply the resolution tools and powers. National central banks, competent ministries or other public administrative authorities may be designated as resolution authorities. Exceptionally, this role may also be played by the supervisory authorities for the purposes of CRR and CRD IV, on condition that adequate structural arrangements are in place to ensure operational independence and avoid conflicts of interest between these two functions.

2. The BRRD Pillars

The BRRD resolution regime is based on three pillars. In particular, these are Recovery and Resolution Planning, Early Intervention and Resolution.

a) Recovery and Resolution Planning

Serving both as a preparative and as a preventive tool, it is expected that Recovery and Resolution Planning will significantly improve supervision, especially of systemically important institutions and groups, which should anticipate some of the spillover costs in the event of their failure and thus make an effort to reduce their risk exposure.

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70 BRRD Art. 1(1).
71 BRRD, Art. 3.
72 BRRD, Art. 3(3).
The Directive provides that each institution that is not part of a group subject to consolidated supervision is required to draw up and maintain a recovery plan, setting out the measures the institution needs to take in order to restore its financial position in the event of a significant deterioration of its financial situation.\textsuperscript{74} Furthermore, competent authorities must ensure that institutions update their recovery plans at least annually or after a change to the legal or organisational structure of the institution, its business or its financial situation, which could have a material effect on or necessitates a change to the recovery plan.\textsuperscript{75} With regard to the assessment of the plan, the competent authorities are required to review and assess its content within six months of their submission.\textsuperscript{76}

Resolution Planning is drawn by resolution authorities and not the institutions themselves, as was the previous case of Recovery Planning. This process better prepares for future crisis situations, since it assesses the significance of a bank focusing on its critical functions and the likelihood of implications in the event of a failure.\textsuperscript{77} It starts with an assessment\textsuperscript{78} of whether liquidation under normal insolvency proceedings is credible and feasible. If resolution does not seem to be necessary or justified in the public interest and the failure of the institution would not have significant adverse consequences for the financial system, resolution tools are not available. Thus, the institution is deemed to be resolvable through liquidation and simplified obligations for drawing up a resolution plan would apply instead. If a wind down not feasible, a resolution strategy will be identified and a “full” resolution plan will be required.\textsuperscript{79}

After consulting the supervisor, the resolution authority must draw up a resolution plan for each institution that is not covered by consolidated supervision, providing for the actions that the resolution authority may take where the institution meets the conditions for resolution.\textsuperscript{80}

\textsuperscript{74} BRRD, Art. 5(1).
\textsuperscript{75} BRRD, Art. 5(2).
\textsuperscript{76} BRRD, Art. 6(1), (2).
\textsuperscript{77} G. Merc ‘Resolution Planning’ in World Bank Group, \textit{Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD} (April 2017), Chapter 10a, p. 73.
\textsuperscript{78} BRRD, Art. 15.
\textsuperscript{79} Ibid., p. 75.
\textsuperscript{80} BRRD, Art. 10(1).
Resolution planning is not a one-off but a dynamic process aligned with changing business and fluctuating financial markets.\textsuperscript{81} That means, resolution plans must be reviewed and, where appropriate, updated at least annually, should material changes take place.\textsuperscript{82} This may further require the assistance of the institutions.\textsuperscript{83} Moreover, it is required that the resolution authority identifies any material impediments to resolvability and, where necessary and proportionate, presents relevant actions for their removal.\textsuperscript{84} In order to achieve this goal, the Directive provides the resolution authority with broad powers. More precisely, among others, it has the power to require the institution to revise any intragroup financing agreements or review the absence thereof, or draw up service agreement to cover the provision of critical functions, to require the institution to limit its maximum individual and aggregate exposures, to restrict the development of new or existing business lines or sale of new or existing products, to require changes to legal or operational structures of the institution or any group entity etc.\textsuperscript{85}

b) Early Intervention

In an attempt to enhance the supervisory framework in particular with reference to systemically important financial institutions, the FSB recommended that all national supervisors should have the powers to identify risks early and intervene in order to prevent unsound practices and take appropriate countermeasures to safeguard against systemic risks.\textsuperscript{86} Accordingly, the BRRD gives significant powers to the supervisors, not the resolution authority, to \textit{intervene at an early stage} before any financial problems that the institution may face escalate.\textsuperscript{87} A “rapidly deteriorating financial condition”, including a deteriorating liquidity situation, an increasing level of coverage, an increase

\textsuperscript{81} G. Merc ‘Resolution Planning’ in World Bank Group, \textit{Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD} (April 2017), Chapter 10a, p. 76.
\textsuperscript{82} BRRD, Art. 10(6).
\textsuperscript{83} BRRD, Art. 10(5).
\textsuperscript{84} BRRD, Art. 10(2).
\textsuperscript{85} BRRD, Art. 17(5).
\textsuperscript{87} BRRD, Art. 27.
of non-performing loan (NPL) portfolios or a concentration of exposures, constitutes the trigger for early intervention measures.\(^{88}\)

The Directive enables the supervisors to require the management body of an institution to implement the arrangements and measures set out in the recovery plan. Furthermore, they may require the management body to address any identified problems and, in case it does not comply with this requirement, to convene a meeting of shareholders. What is more, some stronger measures are also available to the supervisors, such as the power to require changes to the legal or operational structures of the institution as well as the removal or replacement of one or some of the members of the management body, if these are considered to be unfit to perform their duties.\(^{89}\)

Where replacement of the management body is deemed to be insufficient to remedy the situation, supervisors may appoint one or more temporary administrators to the institution either to replace or work temporarily with the management body. The appointment must be made public and not last more than a year. The role and the powers of the temporary administrator must be specified by the supervisor at the time of the appointment.\(^{90}\)

c) Resolution

Notwithstanding the aforementioned preparative and preventive tools, some institutions will inevitably fail.\(^{91}\) Provided that the conditions for resolution have been met, the resolution authority will then apply the resolution tools and powers accorded to it by the Directive, taking into consideration the objectives of the BRRD, explicitly defined in law.

(1) Objectives – General Principles – Conditions

The foremost objective of the BRRD resolution is to ensure that a failing bank can be resolved rapidly and with minimal risk to financial stability. In other words, a bank

\(^{88}\) BRRD, Art. 27(1).
\(^{89}\) BRRD, Arts. 27(1)(d), (g), Art. 28.
\(^{90}\) BRRD, Art. 29(1)-(3), (7).
\(^{91}\) M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 9.01.
resolution should not entail any negative impacts on the real economy nor recourse to taxpayers’ money (bail-in instead of bail-out).\textsuperscript{92}

The BRRD objectives are of equal importance\textsuperscript{93} and they must be balanced by the resolution authority, according to the nature and circumstances of each case. More precisely, resolution authorities must aim to ensure the continuity of critical functions; to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; and to protect public funds, insured depositors and insured investors, as well as client funds and client assets.\textsuperscript{94} The Directive further stipulates that, when pursuing the above objectives, the resolution authority must seek to minimise the cost of resolution and avoid destruction of value, unless necessary to achieve the resolution objectives.\textsuperscript{95}

Moreover, resolution action must take place in tune with a host of \textit{general principles of resolution}. Indicatively, the shareholders of the institution under resolution are the first to bear losses, creditors of the institution under resolution bear losses after the shareholders, in accordance with the creditor hierarchy, as specified under the BRRD and national insolvency law, management body and senior management of the institution under resolution are replaced, natural and legal persons are made liable for their responsibility for the failure of the institution etc.\textsuperscript{96}

The Directive stipulates that resolution action must be initiated, only in those cases in which three specific \textit{conditions} are cumulatively met. First, it must be determined that the institution is failing or likely to fail. Second, there must no reasonable prospect that alternative private sector measures would prevent the failure. Third, resolution action must be in the public interest.\textsuperscript{97}

An institution is considered to be failing or likely to fail, if it infringes the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority or its liabilities exceed the assets (“balance

\textsuperscript{93} BRRD, Art. 31(3).
\textsuperscript{94} BRRD, Art. 31(1), (2).
\textsuperscript{95} BRRD, Art. 31(2).
\textsuperscript{96} BRRD, Art. 34.
\textsuperscript{97} BRRD, Art. 32 (1).
sheet” insolvency) or it is unable to pay its debts as they fall due or extraordinary public support is required. The European Banking Authority, which has a key role in resolution by issuing guidelines and implementing technical standards, stresses that the analysis of these objective elements should remain an expert judgment and that in most cases, several factors rather than simply one would determine that an institution is failing and, thus, trigger resolution.

Alternative private sector measures include supervisory action, early intervention or the write-down or conversion of capital instruments and measures in the form of an intervention by an Institutional Protection Scheme (IPS) or deposit insurance fund.

With regard to the public interest test, a resolution action should be necessary and proportionate to one or more of the resolution objectives and winding up of the institution under normal insolvency proceedings would not meet those resolution objectives to the same extent. This criterion draws a comparison between these two regimes and reveals that insolvency proceedings are not edged out by resolution. Rather, it makes clear that in the event of a bank failure a case-by-case assessment is required in order to determine whether resolution or insolvency proceedings are to be initiated.

Since the trigger of resolution is likely to affect the fundamental rights of shareholders and creditors, such as the right to property or to a fair trial, a clear objective would be necessary to justify any interference with these rights. Through the principle that no creditor should be worse off than in liquidation (NCWOL), the BRRD ensures that no

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98 BRRD, Art. 32 (4).
102 BRRD, Art. 32 (5).
105 BRRD, Art. 74.
creditor incurs a loss greater than if the institutions had gone into liquidation.\textsuperscript{106} Whether the winding up of an institution under normal insolvency proceedings would meet the BRRD resolution objectives to the same extent, is rather challenging to be assessed ex-ante and under time pressure. Thus, resolution authorities may use the discretion provided by this rather abstract definition of public interest and be inclined to determine that their resolution actions are justified in the public interest.\textsuperscript{107}

(2) Resolution Tools

The insulation of impaired assets before their failure spreads to other parts could render the financial system more resilient, preventing a downward spiral of asset prices and limiting the impact on consumers and businesses by maintaining critical functions. Transfers of viable parts of a failing institution’s business to a private sector purchaser or to a bridge bank along with the separation of performing assets from the non-performing (‘good bank/bad bank’ model) and bail-in constitute the set of tools\textsuperscript{108}, which the resolution authorities can deploy in order to achieve the resolution objectives.\textsuperscript{109}

(a) Sale-of-business-tool

According to the sale-of-business-tool, a business, or parts of it, can easily and quickly be transferred to a private sector purchaser through the sale of its assets, rights, or liabilities.\textsuperscript{110} This may take place in the form of a traditional merger or acquisition, where a healthy bank is willing to recapitalise and manage the failed bank.\textsuperscript{111}

(b) Bridge institution tool

In the absence of such a recipient in the market, the resolution authority has the power under the BRRD to “bridge time” until a private sector solution is found through the use of the bridge institution tool, aiming to maintain the critical functions of the

\textsuperscript{106} D. Freudenthaler and P. Lintner, ‘Conditions for taking resolution action and the adoption of a resolution scheme’ in World Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 14, p. 106.

\textsuperscript{107} Ibid., p. 107.

\textsuperscript{108} BRRD, Art. 37.

\textsuperscript{109} M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 10.01.

\textsuperscript{110} BRRD, Art. 38.

\textsuperscript{111} M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 10.04.
failing bank.\textsuperscript{112} The temporary bridge institution (known as a bridge bank) is a legal
entity, wholly or partially owned by one or more public authorities (resolution
authority is included) and controlled by the resolution authority, to which all or some
of the assets, rights, or liabilities of the failing bank are to be transferred.\textsuperscript{113}

(c) Asset separation tool
By contrast to the aforementioned resolution tools, which can be applied either
individually or in combination, the asset separation tool may only be applied in
combination with another one.\textsuperscript{114} For the cleansing of a failing bank’s balance sheet of
impaired (‘toxic’) assets, resolution authorities can rely on this tool, transferring the
underperforming assets to an asset management vehicle (‘bad bank’), which is a legal
entity, likewise in the case of the bridge institution tool.\textsuperscript{115} It must be noted that the
asset separation tool may only be used with regard to assets, the liquidation of which
under normal insolvency proceedings could have an adverse effect on financial
markets, or where the transfer is necessary to ensure the proper functioning of the
institution under resolution or bridge institution, or to maximize liquidation
proceeds.\textsuperscript{116}

Although not a stricto sensu resolution tool, the write-down or conversion to shares of
capital instruments at the point of non-viability (PONV) is a possibility that the
resolution authorities have under the BRRD and which precedes bail-in.\textsuperscript{117} It applies
upon determination by the resolution authority that the institution is failing or likely to
fail and that there is no reasonable prospect that any action rather than the write
down or conversion of capital instruments would prevent the failure of the institution
within a reasonable timeframe.\textsuperscript{118} The first step is to write down Common Equity Tier 1
(CET 1) capital in proportion to the losses. The second step would be the write-down of
Additional Tier 1 (AT 1) capital instruments or their conversion into CET 1. If neither

\textsuperscript{112} Deutsche Bundesbank, ‘Europe’s new recovery and resolution regime for credit institutions’, Monthly
Report, June 2014, 31, 38; M. Hormaeche Lazcano, ‘The Bridge Institution Tool (Bridge Bank) in World
Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April
2017), Chapter 17, p. 126.

\textsuperscript{113} BRRD, Art. 40(1), (2).

\textsuperscript{114} BRRD, Art. 37(4), (5).

\textsuperscript{115} BRRD, Art. 42(1), (2); M. Schillig, Resolution and Insolvency of Banks and Financial Institutions

\textsuperscript{116} BRRD, Art. 42(5).

\textsuperscript{117} BRRD, Art. 59.

\textsuperscript{118} BRRD, Art. 59(4).
this is enough to achieve the resolution objectives, a third step would be to write down Tier 2 capital or convert it into CET 1 instruments.\textsuperscript{119} Despite the structural similarities to the bail-in tool, the above-mentioned options do not constitute resolution tools in the narrow sense, since the underlying liabilities were issued as subordinate, loss-absorbing instruments from the outset.\textsuperscript{120}

(d) Bail-in tool

\textit{Bail-in}\textsuperscript{121} is the most innovative of the tools that the resolution authorities have at their disposal in the context of BRRD.\textsuperscript{122} Instead of being imposed on taxpayers (‘public bail-out’), losses are allocated to shareholders and to unsecured and uninsured creditors, a key element introduced by the FSB reform agenda.\textsuperscript{123} It is, by definition, a process that applies to some but not all of its senior creditors (some of them must be protected) and the essence of which is the idea that some senior creditors should, in certain circumstances, have part of their claim against the bank, wholly or in part, written down after the write-down of lower ranking subordinated claims and equity. As Gleeson explains, such senior creditors may be granted new shares in the bank, but the claims of subordinated creditors may simply be annihilated.\textsuperscript{124} With regard to its uses, the bail-in tool enables the resolution authorities to recapitalise an ailing institution to the extent sufficient to restore its ability to comply with the conditions for authorisation. They may further apply it in order to reduce the principal amount of, or convert into equity, claims or debt instruments that are transferred either to a bridge institution or under the sale of business tool or the asset separation tool.\textsuperscript{125} Its scope is very broad and covers all liabilities that do not fall under any of the exceptions provided for by the BRRD. Specifically, liabilities excluded are the following: covered deposits; secured liabilities including covered bonds; liabilities arising from the

\begin{itemize}
  \item \textsuperscript{119} BRRD, Art. 60(1).
  \item \textsuperscript{120} Deutsche Bundesbank, ‘Europe’s new recovery and resolution regime for credit institutions’, Monthly Report, June 2014, 31, 38.
  \item \textsuperscript{121} BRRD, Art. 43.
  \item \textsuperscript{123} Financial Stability Board, Key Attributes (KA) of Effective Resolution Regimes for Financial Institutions (October 2014), 3.
  \item \textsuperscript{124} S. Gleeson, ‘Legal Aspects of Bank Bail-Ins’, Special Paper 205, LSE FINANCIAL MARKETS GROUP PAPER SERIES, January 2012, p. 5.
  \item \textsuperscript{125} BRRD, Art. 43(2).
\end{itemize}
holding of client assets or client money or from a fiduciary relationship between the institution and another person; liabilities owned to other institutions with an original maturity of less than seven days; liabilities owed to a clearing or settlement system with a remaining maturity of less than seven days; liabilities owed to employees, commercial or trade creditors as well as tax and social security claims, provided that those liabilities are preferred under the applicable law; and contributions owed to deposit guarantee schemes.\textsuperscript{126}

In exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude certain liabilities from the application of the write-down or conversion powers where: it is not possible to bail-in that liability within a reasonable time; the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines and to avoid giving rise to widespread contagion; or where the application of the bail-in tool would cause a destruction in value.\textsuperscript{127}

Taking into consideration the fact that a bank under resolution will have a large variety of instruments that could be used to absorb losses, the BRRD provides that the loss absorption order is aligned with the priority prescribed in normal insolvency proceedings.\textsuperscript{128} Shareholders are the first to bear losses and creditors follow thereafter in the priority applicable under general insolvency law.\textsuperscript{129} It is noteworthy that equity must have already been written down (loss absorption in full) before any debt instrument is subject to bail-in.\textsuperscript{130}

The need to ensure that failing institutions dispose of sufficient bail-inable instruments at all times, so as to enable an effective bail-in and an orderly resolution, led to the establishment of the minimum requirement for own funds and eligible liabilities (MREL).\textsuperscript{131} This new regulatory ratio, similar to the total loss-absorbing capacity (TLAC) concept, which was introduced by the FSB,\textsuperscript{132} is expressed as a percentage of the total

\textsuperscript{126} BRRD, Art. 44(2).
\textsuperscript{127} BRRD, Art. 44(3).
\textsuperscript{129} BRRD, Arts. 47, 48.
\textsuperscript{130} N. Kleftouri, Deposit Protection and Bank Resolution, (Oxford: Oxford University Press, 2015), para. 8.34.
\textsuperscript{131} BRRD, Art. 45.
liabilities and own funds of the institution, the numerator of which is comprised of own funds and MREL-eligible liabilities. The assessment criteria for the determination of the MREL will be further specified by the EBA. It should be noted that the setting of the MREL and the verification that the institutions maintain the required minimum aggregate amount form part of the resolution planning.

Not all bail-inable liabilities, though, are MREL-eligible. MREL should be composed of liabilities, which fulfil the following criteria: are issued and fully paid up; are not owed to, secured by or guaranteed by the institution itself; the purchase of the instrument was not funded directly or indirectly by the institution; have a remaining maturity of at least one year; do not arise from a derivative; do not arise from a deposit which benefits from preference in the insolvency hierarchy. Nonetheless, it should be noted that according to Avgouleas and Goodhart the bail-in process may also have some significant disadvantages over bailouts. They stress that bail-ins may be more contagious and procyclical, more litigious, slower and more expensive as a process, requiring greater subsequent liquidity injections.

(e) Government financial stabilisation tools

In the event of a systemic crisis, the government financial stabilisation tools may be applied by the government or the ministry of finance in consultation with the resolution authority. The public equity support tool and the temporary public ownership tool are, in effect, government bail-aways sanctioned by the BBRD. Taking

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133 BRRD, Art. 45(1); G. Merc ‘Resolution Planning’ in World Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 11, p. 83.
134 BRRD, Art. 45(6).
135 BRRD, Art. 45(2).
136 BRRD, Art. 45(15).
137 BRRD, Art. 45(4).
139 BRRD, Art. 56(3) and 37(10).
140 BRRD, Art. 57.
141 BRRD, Art. 58.
into account that they contradict the objectives set under the Directive (avoidance of
the use of public funds), they should only be used as a last resort after all other
resolution tools have been exploited to the maximum extent practicable.\footnote{142}

Finally, it is noteworthy that the interference in the property rights of shareholders
and creditors which derives from the application of the above-mentioned resolution
tools is justified by the overriding need to intervene in the “public interest”, while
legal safeguards provided for by the BRRD ensure that their use has not been
improper.\footnote{143}

(3) Cross-Border Group Resolution

The BRRD takes into consideration the cross-border nature of some banks and
addresses the issue of cross-border group resolutions as regards co-ordination and co-
operation, when more than one Member States\footnote{144} or third countries\footnote{145} are involved.
National resolution authorities under the guidance of the group resolution authority
ensure that resolution tools are coherently applied across different
jurisdictions.\footnote{146}

Established around the core of existing supervisory colleges,\footnote{147} resolution colleges are
required to provide a framework for the group-level resolution authority and the
participating authorities that includes the relevant tasks, which are to be performed.
Exchanging information in respect of or developing group resolution plans, assessing
the resolvability of groups, setting the minimum requirements of eligible liabilities or
coordinating the use of financing arrangements are only some of the tasks of the
resolution colleges, which may also be used as fora to discuss any relevant
issues.\footnote{148}

European resolution colleges must be established, where a third country institution or
third country parent undertaking has Union subsidiaries or maintains significant

\footnote{142} Deutsche Bundesbank, ‘Europe’s new recovery and resolution regime for credit institutions’, Monthly
\footnote{143} BRRD, Arts. 73-80; G. Merc ‘Resolution Planning’ in World Bank Group, Understanding Bank Recovery
and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 20.
\footnote{144} BRRD, Arts. 87-92.
\footnote{145} BRRD, Arts. 93-98.
\footnote{146} European Commission, EU Bank Recovery and Resolution Directive (BRRD), Frequently Asked
\footnote{147} BRRD, Preamble, Recital (96).
\footnote{148} BRRD, Art. 88.
branches, established in two or more Member States.\textsuperscript{149} Their tasks are similar to those performed by the resolution colleges and, provided that there are other groups or colleges carrying out the same functions, the requirement to establish a European resolution college may be waived by mutual agreement of all the relevant parties.\textsuperscript{150}

(4) Resolution financing arrangements

Bank resolution financing refers to the allocation of losses, incurred or future, and is necessary for the purpose of achieving the resolution objectives, mainly in order to maintain critical bank functions and to preserve financial stability.\textsuperscript{151} In the case of the bridge institution tool, for instance, the resolution authorities will need capital or short-term loans to be able to operate. The funds needed should not come from national budgets. Instead, it should be the financial industry as a whole that finances the stabilisation of the financial system.\textsuperscript{152} In order to be fair, the contributions will be calculated on the basis of the degree of credit, liquidity and market risk incurred by the institutions, incentivising thus the latter to operate under a less risky model.\textsuperscript{153} To this end, the BRRD creates a European System of Financing Arrangements, comprised of national financing arrangements, borrowing between national financing arrangements and the mutualisation of national financing arrangements in the case of a group resolution.\textsuperscript{154} Within this system, Member States are required to establish their national financing arrangements through a fund, the use of which may be triggered by their resolution authorities.\textsuperscript{155} The minimum target level of these financing arrangements must, by 31 December 2024, reach at least 1% of the amount of covered deposits of all the institutions authorised in their territory.\textsuperscript{156} Either through \textit{ex ante} (raised at least annually) or through extraordinary \textit{ex post} contributions and, where necessary, borrowings or other forms of support from financial institutions and other third parties\textsuperscript{157} (hierarchy of funding resources)\textsuperscript{158} the

\textsuperscript{149} BRRD, Art. 89.
\textsuperscript{150} BRRD, Art. 89, paras. (2) and (4).
\textsuperscript{152} BRRD, Preamble, Recital (103).
\textsuperscript{153} BRRD, Preamble, Recital (107).
\textsuperscript{154} BRRD, Art. 99.
\textsuperscript{155} BRRD, Art. 100(5).
\textsuperscript{156} BRRD, Art. 102(1).
\textsuperscript{157} BRRD, Arts. 103-105.
national resolution funds must be financed and further used only to the extent necessary to ensure the effective application of the resolution tools, but not to directly absorb losses or recapitalise a failing institution.\footnote{M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para 12.29.} Indirectly, losses may be passed on to the resolution fund, where, for instance, contributions made to a bridge bank cannot be fully recouped through the sale of the bridge.\footnote{BRRD, Art. 101(2).} In this respect, the Directive provides that at least 8\% of the total liabilities (including own funds) of a firm in resolution must be exposed to loss first.\footnote{M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.30.}

As of 2016 national resolution funds within the euro area have been replaced by the Single Resolution Fund (SRF) owned by the Single Resolution Board (SRB).\footnote{See Chapter II.} During an eight-year transitional period national contributions will still be held in national compartments. The SRF will take over as a fully centralised fund thereafter.\footnote{D. Huber, ‘Ex-ante Financed Resolution Funds’, in: World Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 21b, p. 150.}

(5) Use of Deposit Guarantee Funds in the context of resolution

Apart from the resolution funds, international standard-setters include deposit guarantee schemes (DGS) in the pre-established funding mechanisms that will provide the necessary resolution financing.\footnote{FSB, Key Attributes (KA) of Effective Resolution Regimes for Financial Institutions (October 2014) para 6.3; M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.01.} As it will be examined in the subsequent Chapter, DGS are designed to compensate depositors in the case of a bank’s liquidation. They may also be used to preserve depositors’ access to covered deposits with respect to national insolvency proceedings other than a direct pay-out.\footnote{G. Merc, ‘Use of Deposit Guarantee Schemes under Resolution’, in: World Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 22, p. 153.} In the case of a bank resolution, the BRRD stipulates that the DGS may further be used to finance the resolution of credit institutions, provided that the resolution action ensures depositors’ continued access to their deposits.\footnote{BRRD, Art. 109.} The synergy between

\footnotesize{\begin{itemize}
\item \footnote{M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para 12.29.}
\item \footnote{BRRD, Art. 101(1).}
\item \footnote{BRRD, Art. 101(2).}
\item \footnote{M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.30.}
\item \footnote{BRRD, Arts. 101(2) and 44(5); N. Kleftouri, Deposit Protection and Bank Resolution, (Oxford: Oxford University Press, 2015), para 8.44.}
\item \footnote{D. Huber, ‘Ex-ante Financed Resolution Funds’, in: World Bank Group, Understanding Bank Recovery and Resolution in the EU: a Guidebook to the BRRD (April 2017), Chapter 21b, p. 150.}
\item \footnote{FSB, Key Attributes (KA) of Effective Resolution Regimes for Financial Institutions (October 2014) para 6.3; M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.01.}
\item \footnote{BRRD, Art. 109.}
\end{itemize}}
resolution and DGS becomes clear from the fact that when a resolution framework that limits contagion is in place, the number of bank failures is reduced and consequently the likeliness of DGS-payouts.  

The Directive distinguishes between the cases, whether the bail-in tool or other (than the bail-in) resolution tools are applied. In the first case, the DGS is liable for the amount by which covered deposits would have been written down in order to absorb the losses in the institution, had covered deposits been included within the scope of bail-in. In the latter, the respective amount of liability encompasses the losses that covered depositors would have suffered under a hypothetical liquidation scenario.  

In all cases, the BRRD provides that the liability of the DGS must not be greater than the amount of losses that it would have had to bear, had the institution been wound up under normal insolvency proceedings (net pay-out amount). Additionally, in order to limit the likelihood that the DGS may be depleted through the resolution financing, the BRRD sets a cap in respect of the DGS target level. In particular, the DGS must be liable for an amount equal up to 50% of the Deposit Insurance Fund (DIF) target level, which is equivalent to 0.8% of the amount of the covered deposits of its members. A percentage higher than 50% may be set by the Member States, taking into consideration the specificities of their banking sector.  

With regard to their ranking in the creditor hierarchy, the BRRD provides for a super preference of the DGS. More precisely, being subrogated to the rights and obligations of covered depositors together with covered deposits, the DGS have a rank ahead of eligible deposits from natural persons and micro, small and medium-sized enterprises that exceed the coverage level of €100,000, as well as of ordinary unsecured, non

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169 BRRD, Art. 109(1)(a).

170 BRRD, Art. 109(1)(b)

171 BRRD, Art. 109.


173 BRRD, Art. 109(5).
preferred creditors. As Merc notes, this special treatment safeguards the funds of deposit guarantee schemes and enables them to compensate the depositors in the event that deposits become unavailable. At the same time, this high ranking reduces the likelihood of resolution financing through DGS and limits it only to the case, in which losses are high and the bank strongly deposit-financed.

Finally, the resolution and deposit insurance funds may either constitute a single financing arrangement, having the same administrative structure, or be created as separate financing arrangements. A question arises with regard to the first option and in the hypothetical scenario of the insufficiency of the available financial means. Rather than satisfying all the requests, priority will be given to the protection of covered depositors.

**C. The BRRD II**

On 23 November 2016 the European Commission presented its proposals to amend the Bank Recovery and Resolution Directive as regards loss-absorbing and recapitalization capacity of credit institutions and investment firms and the ranking of unsecured debt instrument in insolvency hierarchy.

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174 BRRD, Art. 108.
176 BRRD, Art. 100(2).
1. Loss-absorbing and recapitalisation capacity of credit institutions and investment firms

Taking into account the assessment of the EBA, which is required under the BRRD to report to the Commission on the modalities of the MREL requirement, the Commission committed to revise the MREL by putting forward a legislative proposal in order to ensure its consistency with the standards developed by international fora. With the general BRRD framework remaining valid and intact, this proposal aims at implementing the TLAC standard into EU law through its integration into MREL requirement. Avoiding duplication by applying two parallel requirements would help prevent unwarranted legal complexities and compliance costs.

Despite their similar regulatory objective, which is the enhancement of the effectiveness of resolution through the availability of sufficient bail-inable liabilities, conceptually they differ. In terms of their scope, the TLAC is addressed only to global systemically important banks (G-SIBs), whereas MREL applies to all banks in the EU (as covered under the BRRD). Moreover, the latter is expressed as a percentage of an institution’s total liabilities, including regulatory capital, and is not based only on the risk weighted assets (RWA) of an institution. By contrast to the MREL, which is set by the resolution authority on a case-by-case basis, there is a mandatory fixed minimum TLAC requirement.

In particular, the amended BRRD recognises the Single Point of Entry (SPE) and the Multiple Point of Entry (MPE) resolution strategies. By contrast to the latter strategy, under which more than one entity may be resolved, the SPE strategy provides for the resolution of only one group entity (usually the parent). The other group entities

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181 BRRD, Art. 45(19).
182 In its Communication “Towards the completion of the Banking Union” (24.11.2015) COM (2015) 587 final, the Commission committed to put forward a legislative proposal, implementing the TLAC standard.
(operating subsidiaries) are not put in resolution, but upstream their losses to the entity to be resolved. In line with the TLAC standard, the proposal deals with an external MREL requirement, applicable to resolution entities, and with an internal MREL requirement that applies to subsidiaries which are not resolution entities. Furthermore, the measurement metrics of the MREL are aligned with those of the minimum requirement for G-SIs as provided in the TLAC standard and, hence, the MREL should be expressed as a percentage of the total risk exposure amount and of the leverage ratio exposure measure of the relevant institution. Moreover, the modified BRRD introduces the concept of 'guidance', allowing resolution authorities to require institutions to meet higher levels of MREL, while addressing in a more flexible manner any breaches of those levels. With the view to ease compliance costs of banks where their liabilities are governed by the laws of third countries, it was necessary to introduce more flexibility in the contractual relationships of Union banks with third countries. This need for proportionality is addressed in respect of the contractual recognition of bail-in. The introduction of a waiver allows the resolution authority to exclude the obligation of institutions to include bail-in recognition clauses in agreements or instruments governed by third country laws, if it determines that this would not impede the resolvability of the bank.

2. The ranking of unsecured debt instruments in insolvency hierarchy

In order to comply with the TLAC standard and the ‘subordination requirement’ deriving therefrom as implemented in the CRR and the BRRD, certain Member States

191 G-SIs are required to meet the minimum TLAC requirement, with certain exceptions, with subordinated liabilities resulting from debt instruments that rank in insolvency below other senior liabilities.
have amended their insolvency ranking of unsecured senior debt under their national insolvency law. In the absence of harmonised rules, though, such efforts entail significant divergences and, to a great extent, this inhomogeneity can further result in the unequal treatment of unsecured debt holders and creditors across the different jurisdictions.192

The proposal aims at partially harmonising193 bank insolvency creditor hierarchy as regards the priority ranking of holders of bank senior unsecured debt, eligible to meet the BRRD rules and the TLAC standard on loss absorbency and recapitalisation capacity for banks. The existing class of senior debt is maintained, while a new asset class of ‘non-preferred’ senior debt is created. The latter should only be bailed-in in resolution after other capital instruments but before other senior liabilities. Institutions may opt for the issuance of debt in both classes. However, it should be noted that only the 'non-preferred' senior class is eligible for the minimum TLAC requirement or any subordination requirement that could be imposed by resolution authorities on a case-by-case basis.194

By contrast to the aforementioned one, this proposal has already been adopted.195

**D. Conclusive remarks**

Following the global financial crisis, the European Union has kept pace with the developments taking place at international level, embarking on an extensive reform of its regulatory agenda as regards financial services. Normal insolvency proceedings proved to be inadequate to deal with failing banks taking into account the likeliness of cross-border contagion within the highly interconnected financial sector. Costly bailouts resulted in the creation of the so-called sovereign debt crisis, particularly with

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194 Ibid., p. 7.

reference to certain Member States of the Euro-area periphery, and thus, perpetuating the sovereign-bank diabolic loop.

The adoption of the BRRD has definitely satisfied the need for harmonisation and coordinated action, representing a significant step towards a strong European resolution framework. Since prevention is considered to be the best kind of therapy, recovery and resolution planning along with the early intervention measures introduced by the BRRD can better deal at an early stage with any deficiencies and problems that may arise. Contrary to normal insolvency proceedings, which relate to already failed and not failing/likely to fail financial institutions, financial institutions under resolution (provided that the conditions are met) will be restructured and their viability restored, while their critical functions will be maintained and the financial stability preserved. This can undoubtedly contribute to the avoidance of spillover effects. Hence, it is deducted that preemptive measures, like those provided for by the BRRD, will help to prevent future systemic crises.

With regard to the bail-in tool, the most innovative and thus heatedly debated element of the Directive, the BRRD intended to put an end to the taxpayers’ exposure to public debt. Allocating the losses to shareholders and creditors will limit the state aid required in the past and break eventually the vicious bank-sovereign circle. In order to answer the question whether bail-ins can be more contagious, slower and expensive over bailouts, one should take into account the proposal of the European Commission to amend the BRRD. The implementation of the FSB TLAC standard into EU law through its integration into the MREL requirement is expected to reduce unwarranted legal complexity and compliance costs created due to the application of two parallel requirements. Among the changes anticipated through the amendment of the creditor hierarchy is the reduction to a minimum of credit institutions costs of compliance with the subordination requirement, as well as any negative impact on their funding costs. Hence, in addition to new asset class of ‘non-preferred’ senior debt, the existing class of senior debt (which has the highest insolvency ranking among debt instruments and is less costly for credit institutions to issue than any other subordinated liabilities), is also maintained.196

Nonetheless, it must be underlined that the credibility of a resolution framework depends on its applicability. As Mark Branson notes, only through practical examples\textsuperscript{197} can be determined whether the new arrangements, particularly bail-in, actually work\textsuperscript{198} and since the bail-in tool is yet rather untested, resolutions that took place before the entry into force of the BRRD cannot be used to draw conclusions about the effectiveness of resolution under a fully operational BRRD framework.\textsuperscript{199}

\textsuperscript{197} The Case of the Danish Andelskassen in 2016 (Resolution via Bridge Bank and Bail-In including of Uninsured Depositors) is one of the first BRRD resolutions, giving an example of the NCWOL principle. Resolutions, for example, in Cyprus, Italy, the Netherlands, Portugal, Austria and Slovenia took place either prior to the adoption of the BRRD or via the application of other, rather than the bail-in, resolution tools. The Case Study of the Greek Resolutions (2009-2015) is interesting, since it reveals that if the BRRD had been in place, the uncovered deposits would have been subject to bail-in, hence, undermining public confidence in the financial system. See World Bank Group, ‘Bank Resolution and “Bail-In” in the EU: Selected Case Studies Pre and Post BRRD’ (December 2016), online at https://openknowledge.worldbank.org/bitstream/handle/10986/25975/112265-WP-P143745-PUBLIC-December-12-2016-FinSAC-BRRD-CaseStudies.pdf, accessed 30 January 2019.


\textsuperscript{199} P. Lintner and J. Lincoln, World Bank Group, "Bank Resolution and “Bail-In” in the EU: Selected Case Studies Pre and Post BRRD’ (December 2016), p. 3.
III. The European Banking Union

The ‘Banking Union’ stricto sensu has already been achieved via European regulation, namely the Directives and Regulations that constitute the set of common rules under which banks operate in the EU. In the absence of effective rules on cross-border crisis management and insolvency, this “narrow” Banking Union was not complete, as evidenced by the financial crisis. A ‘broader’ Banking Union should go beyond regulation and comprise macro-and micro supervision, crisis management – including deposit insurance, resolution and insolvency – and the lender of last resort function.200 Basically, the Banking Union can be defined as a set of institutions, establishing supranational competencies in respect of supervision and resolution of banks, along with a financing mechanism within the context of resolution and restructuring.201

A. The Route towards the European Banking Union

The idea to create a centralised European supervisory authority has not been newly conceived.202 However, it was only in 2012 that views supporting the centralisation of banking supervision, backed up by a single bank resolution authority and a single deposit insurance fund were clearly expressed. Christine Lagarde, the IMF’s Managing Director, pointed out that in order “to break the feedback loop between sovereigns and banks, we need more risk sharing across borders in the banking system. In the near term, a pan-euro area facility that has the capacity to take direct stakes in banks would help. Looking further ahead, monetary union needs to be supported by stronger financial integration, which our analysis suggests be in the form of unified supervision,

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a single bank resolution authority with a common backstop, and a single deposit insurance fund.” In his introductory statement, Mario Draghi, President of the European Central Bank, acknowledged the negative feedback loop between banks and sovereigns and the 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.”

Jose Manuel Barroso, President of the European Commission, stressed the necessity of moving towards a Banking – and a fiscal – Union, which ‘appears as a natural priority’, in order to reap the full benefits from deepening the Economic and Monetary Union. Herman Van Rompuy, President of the European Council, promoted the idea of creating “an integrated financial framework, having two central elements, namely, a single European banking supervision and a common deposit insurance and resolution framework”.

Three weeks after the BRRD proposal, the European political leadership affirmed the imperative character the coordinated action should have in order for the vicious circle between banks and sovereigns to be broken. Thus, the Commission was asked to present its proposals for a Single Supervisory Mechanism and the Council to “consider them as a matter of urgency by the end of 2012.” The first step was taken.

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B. Objectives

The primary and overarching objective was two-fold; namely, to break the doom loop between banks and sovereigns and to enhance the single monetary policy by stopping financial fragmentation and restoring the credit flows within the Eurozone. Furthermore, at the most basic level, the objective was to create a “level playing field for the European banking industry and to remove any national biases or supervisory forbearance, preventing the hiding of bad assets – or even leniency – towards so-called ‘national champions’”. Tackling the specific risks within the Euro area, where pooled monetary responsibilities have increased the possibility of cross-border spillover effects in the event of bank crises as well as ensuring that taxpayers’ money will not be used in order to bail out banks were also acknowledged by European Regulators as goals of the proposed Banking Union. As Wagner argues, a fully-fledged banking union has also the potential to reduce systemic risk in the Eurozone.

However, the sceptical and critical voices among the scholars are not missing. Buch, Körner and Weigert note that a successfully implemented and fully operational Banking Union can contribute towards deeper financial integration. Yet, they identify several shortcomings of the legal framework of the Banking Union, which are rooted in...

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the boundaries of European primary law, making the changes of the EU treaties necessary. Hence, the Banking Union is no panacea.\textsuperscript{215} Munchau goes even further and argues that, instead of having this ill-designed banking union, it should be better to have no banking union at all.\textsuperscript{216} Otero-Iglesias and Steinberg state that the future of the banking union – and of the Euro – depends on the capacity of European leaders to strengthen EMU with the necessary political institutions.\textsuperscript{217} Allen, Carletti and Gimber point out the likelihood that the ECB in its role as supervisor within the context of the SSM will treat failing banks more leniently than national supervisors, due to concerns about the risk contagion across the Eurozone and to the availability of its resources.\textsuperscript{218} So, what is in real terms the Banking Union? A closer look at its components should at this point be taken.

\textbf{C. The Three Pillars}

Based on a novel institutional set-up, the Banking Union constitutes a highly centralised regime as regards the supervision and resolution of banks in the Euro area and beyond.\textsuperscript{219} Its regulatory framework comprises the Capital Requirements Regulation (CRR), the Capital Requirements Directive IV (CRD IV), the Bank Recovery and Resolution Directive (BRRD) and the recast Deposit Guarantee Schemes Directive; namely, the Single Rulebook in banking, which is consistently applied across the Member States.\textsuperscript{220}

\textsuperscript{216} W. Munchau, ‘Europe Should Say No to a Flawed Banking Union’, Financial Times (16 March 2014) online at https://www.ft.com/content/0e6b4800-ab67-11e3-8cae-00144feab7de, accessed 11 December 2018.
As set out by the European Commission, the establishment of the Single Supervisory Mechanism was the first major step.²²¹ Yet, a partial banking union is no better than no banking union at all.²²² It cannot be considered as complete without a more centralised management of banking crises. To this end, "common mechanisms to resolve banks and guarantee customer deposits" were also referred to in the report by the Presidents of the European Council, the Commission, the Eurogroup and the European Central Bank of 26 June 2012 as further steps towards the completion of the Banking Union.²²³ The Single Resolution Mechanism has already been in place. On the contrary, a European Deposit Guarantee Scheme is yet to be completed.

1. Single Supervisory Mechanism (SSM)

Due to the restricted scope of this paper as set under its topic, the Single Supervisory Mechanism will be discussed less extensively compared to the other two pillars. Yet, its importance cannot be overlooked and, therefore, it warrants a particular mention. As Yves Mersch, Member of the Executive Board of the ECB, aptly observes, “SSM and SRM are like Siamese twins; they cannot survive without the other. A supervisor can only credibly do his job, if liquidation is possible without undue risks to financial stability. Conversely, the resolution mechanism must be able to rely on the well-founded and impartial judgement of the supervisor before putting any funds at his disposal”.²²⁴

The SSM Regulation²²⁵ confers upon the ECB a number of tasks relating to the prudential supervision of credit institutions in the euro area and in other participating

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The overarching aim is to contribute to the safety and soundness of the credit institutions within the Union and each Member State, safeguarding the stability of the financial system and the integrity of the internal market.\textsuperscript{226} The Member States of the Euro area are automatically members, while non-Euro area Member States can decide to participate in the SSM, entering into ‘close-cooperation’ arrangements with the ECB.\textsuperscript{227} The direct supervision of ‘significant banks’, representing almost 85 per cent of banking assets in the Euro area, is conferred upon the European Central Bank, which is also indirectly responsible for the supervision of less systemically important banks.\textsuperscript{228} In accordance with the Regulation, the ECB must carry out supervisory tasks in relation to recovery plans and early intervention, where a credit institution or group in relation to which the ECB is the consolidating supervisor, does not meet or is likely to breach the applicable prudential requirements.\textsuperscript{229} The planning and execution of the tasks conferred on the ECB will be fully undertaken by an internal body, the SSB, composed of its Chair and Vice Chair.\textsuperscript{230} Further, they must be carried out independently from other EU institutions and separately from the tasks related to the monetary policy.\textsuperscript{231} As Nieto notes, the economic rationale in the Banking Union is that full coordination via centralised prudential supervision in the SSM and resolution in the SRM would ensure the highest level of safety and soundness, since only this approach would minimise any potential negative externalities of cross-border banking.\textsuperscript{232}

\textsuperscript{226} SSM Regulation, Art. 1.
\textsuperscript{227} SSM Regulation, Art. 7(1) and (2)(a)-(c); M. R. Lastra, ‘Banking Union and Single Market: Conflict or Companionship?’\textsuperscript{, FORDHAM INT’L J.} 1190 (2013), 1190, 1204.
\textsuperscript{229} SSM Regulation, Art. 4(1)(i).
\textsuperscript{230} SSM Regulation, Art. 26.
\textsuperscript{231} SSM Regulation, Arts. 19(1), 25(2).
2. Single Resolution Mechanism (SRM)

As already mentioned in the previous chapter, the implementation of the FSB Key Attributes into EU law has been achieved through the BRRD and – as it will be now discussed – the Single Resolution Mechanism Regulation233. These two pieces of legislation are complementary; the BRRD provides uniform rules for the whole EU single market, while the SRM Regulation sets out the institutional and funding architecture for the application of those rules in Member States participating in the Banking Union.234 Being an essential complement to the SSM for more integrated bank oversight and crisis management in the Banking Union, the SRM aims at putting in place a framework that allows for more efficient recovery and resolution of ailing banks with minimal costs to the taxpayer and the real economy.235 Concerning the interaction of the BRRD and the SRM, it should be further noted that the Directive comprises minimum harmonisation rules and, hence, it does not lead to centralisation of decision making, given that it leaves discretion to national authorities as regards the application of resolution tools and powers. Thus, inconsistent decisions by Member States are not to be excluded and may be particularly costly in the case, for instance, of resolution of cross-border groups.236 The SRM provides instead for an integrated decision-making structure aligning resolution under the SRM with supervision under the SSM.237

With regard to its scope, the Regulation establishes uniform rules and procedures for the resolution of the entities238, established in the participating Member States, which

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238 SRM Regulation Art. 2.
must be applied by the Single Resolution Board (SRB), together with the Council and the Commission and the national resolution authorities within the framework of the SRM. The SRM will be further supported by a Single Resolution Fund (SRF). Participating Member States are considered to be those falling within the scope of SSM.\(^{239}\)

The \textit{Single Resolution Board}, which is the core of the SRM, constitutes a new EU agency.\(^{240}\) Like the ECB for the SSM,\(^{241}\) it is responsible for the effective and consistent functioning of the SRM.\(^{242}\) The Board is required to draw up the resolution plans and adopt all decisions in relation to resolution of the entities that are not part of a ‘group’, and of groups that are considered to be significant in accordance with the SSM Regulation.\(^{243}\) Among its responsibilities for resolution planning the development of so-called “living wills” is also included.\(^{244}\) With reference to its relation to the BBRD, the Regulation stipulates that, if the Board performs tasks and exercises powers, which, pursuant to the BRRD, are to be performed or exercised by the national resolution authority, the Board is considered to be the relevant national resolution authority for the application of both the SRM Regulation and the BRRD.\(^{245}\)

The Regulation provides that the national resolution authorities are mainly responsible for the less significant banks, while being required to assist the SRB in its task to draw the resolution plans as regards the banks directly supervised by the ECB.\(^{246}\) It is noteworthy that during the negotiations of the Regulation arose the question of whether the SRB should be the ultimate decision-making authority within the SRM. This complexity derived from the fact that the SRB constitutes an EU agency and not an EU institution. Hence, the Board alone cannot be entrusted with ‘discretionary powers’ or make ‘policy choices, given that its scope is limited by the


\(^{240}\) SRM Regulation Art. 42.

\(^{241}\) SSM Regulation, Art. 6(1) second sentence: The ECB shall be responsible for the effective and consistent functioning of the SSM.

\(^{242}\) SRM Regulation Art. 7(1).

\(^{243}\) SRM Regulation Art. 7(2).


\(^{245}\) SRM Regulation Art. 5(1).

\(^{246}\) SRM Regulation Art. 7(3).
well-established Meroni\textsuperscript{247} case law.\textsuperscript{248} In its ruling, the ECJ held that delegation of powers to EU agencies can only relate to clearly defined executive powers, the use of which must be entirely subject to the supervision of the Commission (Meroni doctrine). Thus, ultimate decision-making authority as regards the initiation of resolution proceedings rests with the Commission and the Council.\textsuperscript{249}

A similar issue arose in respect of the legal basis of the \textit{Single Resolution Fund}, as argued by the Commission under its proposal for a SRMR,\textsuperscript{250} generating a heated debate. Although Article 114 TFEU was the legal basis for the creation of the SRB, this article was eventually considered to be inadequate, pursuant to Article 125(1) TFEU,\textsuperscript{251} for the establishment of an EU resolution fund that would mutualise the risks related to bank resolution across participating Member States.\textsuperscript{252} The solution was given through the enactment of the Intergovernmental Agreement “on the transfer and mutualisation of contributions to the Single Resolution Fund.”\textsuperscript{253} This Agreement establishes the modalities regarding the transfer of the national contributions to the SRF, as well as the conditions for their progressive merger in a single pool.\textsuperscript{254} The SRB, the owner of the SRF, may only use it in order to ensure the effective application of the resolution tools and exercise of the resolution powers.\textsuperscript{255} The contributions must be raised \textit{ex ante}, reaching a target level of at least 1\% of the amount of covered deposits of all banks authorised in all of the participating Member States by the end of a transitional period of eight years starting from 1 January 2016.\textsuperscript{256} Until the Fund reaches its specified target level, the contributions will be raised at national level and

\begin{itemize}
\item \textsuperscript{247} Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community, (9/56) [1958] E.C.R.133.
\item \textsuperscript{250} European Commission, Proposal for a SRM Regulation, p. 6.
\item \textsuperscript{251} ‘The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State’.
\item \textsuperscript{255} SRM Regulation Art. 67(2), (3).
\item \textsuperscript{256} SRM Regulation Art. 69(1).
\end{itemize}
further transferred to national compartments, into which the SRF remains divided. The merger of the raised funds will take place progressively in due time.\textsuperscript{257} The pool of resources available under any circumstances aims at avoiding any procyclical, destabilising effects of ex-post levies on other banks, particularly, in situations of systemic crises.\textsuperscript{258}

Finally, it should be mentioned that the proposed amendment to the SRM Regulation, namely the SRMR II, which forms part of the legislative package, including amendments to the CRR, the CRD IV and BRRD, has not yet been adopted.\textsuperscript{259}

3. European Deposit Insurance Scheme (EDIS)

The public policy rationales behind deposit insurance have usually been consumer protection and the enhancement of financial stability.\textsuperscript{260} Neither sound nor ailing banks dispose of enough liquid funds to redeem all of their deposits on the spot. This explains why they are particularly vulnerable to the risk of bank runs, if depositors lose confidence in their banks. A massive withdrawal of deposits at the same time could cause cracks in the edifice of the banking sector, jeopardising the financial stability. If, despite the high level of prudential supervision, the closing of a bank cannot be prevented, the respective Deposit Guarantee Scheme (DGS) reimburses depositors up to a certain ceiling (the ‘coverage level’).\textsuperscript{261}

Therefore, deposit insurance and bank resolution interact with each other as alternative or complementary mechanisms. Given that a direct pay-off under a deposit guarantee scheme will take place only where a failing bank is closed and liquidated and depositors have no longer access to their deposits, bank resolution – under the BRRD

\textsuperscript{257} SRM Regulation Art. 77; M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.32.
framework – ensures the continuity of banking services through the organisation of an orderly failure, reducing thus the likelihood of a deposit pay-off.\footnote{D. Howarth and L. Quaglia, 'Banking Union as Holy Grail: Rebuilding the Single Market in Financial Services, Stabilizing Europe’s Banks and ‘Completing’ Economic and Monetary Union’, JCMS (2013), Vol. 51, 103, 109; M. Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford: Oxford University Press, 2016), para. 12.05.}

\paragraph{a) The current European Deposit Insurance Framework}


In particular, the recast (hereinafter DGSD) provides that each Member State is required to establish one or more DGSs within its territory and that credit institutions must not take deposits, unless they are members of a scheme.\footnote{DGSD, Art. 4.} Eligible for protection is almost every type of deposits. Few have been explicitly exempted, among which deposits made by other credit institutions on their own behalf and for their own account, deposits by investment firm and insurance undertakings etc.\footnote{DGSD, Art. 5.} With regard to the coverage level, Member States must ensure a coverage of EUR 100 000 per depositor in the event that the deposits become unavailable. A higher (than 100,000€) protection is also introduced, but it relates to specific types of deposits and only within a limited time range.\footnote{DGSD, Art. 6.}
Furthermore, DGSs should have sufficient financial means in order to cover their potential liabilities. Contributions must be raised annually and reach by 2024 a target level of 0.8% of the amount of the covered deposits of its members. Contributions raised in respect of resolution financing arrangements must not count towards the target level. The respective reduced target level must not be lower than 0.5% of covered deposits.\textsuperscript{271} The repayable amount must be made available within seven working days. However, Member States may, for a transitional period until 31 December 2023, set the repayment period to 20 or 15 working days.\textsuperscript{272}

With reference to the use of DGS funds, the Directive has retained the primary ‘pay-box-function’.\textsuperscript{273} In the aftermath of the financial crisis and following the global trend,\textsuperscript{274} the DGSD expanded the possible uses of the DGS funds, which now further encompass the use for alternative measures in to prevent a failure and the use to finance measures to preserve the access of depositors to covered deposits (financing of bank resolution).\textsuperscript{275}

With regard to the latter and within the context of bail-in resolution, it should be underlined that the DGS absorbs the losses that covered depositors would have absorbed, had covered deposits been included within the scope of bail-in and been written down to the same extent as creditors with the same level of priority under the national law governing normal insolvency proceedings. A practical difficulty derives from the application of this rule. Given the super priority of covered depositors in the creditors’ hierarchy in case of insolvency, the extent of write-down cannot be easily determined, since no other creditor of the same priority would be subject to bail-in. Hence, the RA must define a hypothetical amount of bail-in for covered depositors in order to determine the amount of liability of the DGS.\textsuperscript{276} According to the subrogation principle, in the event that a DGS makes payments in the context of resolution

\textsuperscript{271} DGSD, Art. 10.
\textsuperscript{272} DGSD, Art. 8.
\textsuperscript{273} DGSD, Recital(14) and Art. 11(1).
\textsuperscript{274} ‘Mandates can range from narrow “pay box” systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a variety of combinations in between”. See International Association of Deposit Insurers,’ IADI Core Principles for Effective Deposit Insurance Systems’\textsuperscript{\textcopyright} (November 2014), online at https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf, accessed 7 January 2019, p. 10.
\textsuperscript{275} DGSD, Art. 11.
\textsuperscript{276} O. Aloupi, ‘The interaction of deposit insurance and bank resolution, in particular under the legal framework of the European Banking Union’, J.I.B.L.R. (2018), 259, 263.
proceedings, the Scheme has a claim against the relevant credit institution for an amount equal to its payments. That claim must rank at the same level as covered deposits under normal insolvency proceedings.\textsuperscript{277}

Whether the objectives set under the DGSD can be effectively reached remains questionable. As Gerhardt and Lannoo note, the Commission intended through the proposed amendments to address the problems raised by the crisis, as well as the recommendations of the experts in the ‘De Larosière Report’ for further harmonisation. According to the report, “depositors should enjoy the same level of deposit protection in all member states, as the existing variety of DGS is considered unsustainable and unreliable in times of crisis”. Yet, Gerhardt and Lannoo argue that the recast Directive cannot be considered as a sufficient response to the problems that arose during the crisis. Since many issues concerning the governance of DGS, the role of the Schemes as regards financial stability and their cross-border dimension have only been partially addressed, there is much scope for regulatory arbitrage, competitive distortions and moral hazard\textsuperscript{278} left. Thus, further harmonisation is required in order for an integrated financial market to be sustained.\textsuperscript{279}

b) The EU Commission Proposal for an EDIS

In November 2015 the European Commission brought forward a legislative proposal, envisaging the establishment of a single European Deposit Insurance Scheme\textsuperscript{280}. It had already called in 2012 for a Banking Union that “would place the banking sector on a more sound footing and restore confidence in the Euro as part of a longer term vision for economic and fiscal integration”.\textsuperscript{281} So far, only the first two pillars have been

\textsuperscript{277} DGSD, Art. 9.  
\textsuperscript{278} “Moral hazard refers to the adverse effects, from the point of view of the insurer, which insurance may have on the insuree’s behaviour. Moral hazard incentives may relate to bank managers, shareholders, depositors, other creditors, or other stakeholders. Banks insured against are the most likely to take advantage of the insurance policy by taking additional risk, based on the assumption that should the risk taking prove to be successful, then management and shareholders will benefit, directly, but should the bank fail, it will be the deposit protection scheme that will have to pay compensation to depositors.” N. Kleftouri, Protection and Bank Resolution, (Oxford: Oxford University Press, 2015), para. 2.09. See also, N. Kleftouri, ‘Deposit insurance system and moral hazard, J.I.B.L.R. (2013), 271-278.  

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established, whereas the third one is still to be completed. Yet, it was the Five Presidents' Report\textsuperscript{282}, which brought the creation of the European Deposit Insurance Scheme (EDIS) back onto the political agenda.

In the Banking Union, deposit insurance remains purely national. Consequently, DGSs are susceptible to large local shocks. Given that the underlying proposed Regulation builds on the existing framework of the DGS Directive,\textsuperscript{283} it is of importance, any significant differences across Member States in respect of the implementation of the Deposit Guarantee Scheme Directive rules (for instance, regarding the conditions to declare deposits unavailable, the eligibility of deposits, the financing of Deposit Guarantee Schemes or the use of Deposit Guarantee Scheme funds) to be set aside. Through greater harmonisation, the EDIS would enhance stability in the banking sector by providing strong and uniform insurance coverage for all its depositors, irrespective of their geographical location within the Banking Union.\textsuperscript{284}

The scope of the EDIS, which corresponds to the scope of the DGSD, will include every deposit-taking bank established in the Banking Union.\textsuperscript{285} Currently, each Member State has a deposit guarantee scheme in place, as required by the DGSD.\textsuperscript{286} National DGSs would continue to co-exist alongside EDIS, which will be established in three subsequent stages. In particular, under the re-insurance scheme, which is proposed to apply for three years until 2020, EDIS may provide limited funding, and cover a limited share of the loss of a participating DGS that encounters a payout event or has been requested to contribute to resolution.\textsuperscript{287} The second phase would be a co-insurance scheme, applying for four years until 2024. In the event of a pay-out or resolution procedure, participating DGSs may request both funding and loss cover as from the “first euro” and the share borne by EDIS would gradually increase over the co-


\textsuperscript{285} EDIS Regulation, Proposal, Art. 2(2)(b).

\textsuperscript{286} DGSD, Art. 4.

\textsuperscript{287} EDIS Regulation, Proposal, Art. 41a.
insurance period.\textsuperscript{288} In the final stage, \textit{the full insurance}, deposits would be fully insured and EDIS would cover all liquidity needs and losses in the event of a pay-out or resolution procedure.\textsuperscript{289} The proposed Regulation, building on the existing framework of the DGSD, provides the Single Resolution Board with decision-making, monitoring and enforcement powers relating to EDIS.\textsuperscript{290} Participating DGSs have the duty to notify the Board without delay once they become aware of circumstances that are likely to result in a payout event or a request from the resolution authority to contribute to resolution.\textsuperscript{291} The Board would decide within 24 hours whether the conditions for EDIS support have been met and determine the amount of funding that would be provided.\textsuperscript{292} Following the provision of funding in case of a payout event, the Board would closely monitor the payout and the insolvency procedure of the credit institution concerned.\textsuperscript{293}

c) The US Paradigm

A look across the Atlantic would answer the question whether it is feasible for deposit insurance and resolution to be combined under a single institution. The Federal Deposit Insurance Corporation (FDIC), formed in 1933 following the bank failures of the Great Depression, has primarily the mandate to provide deposit insurance to depository institutions that qualify for insurance coverage under the Federal Deposit Act.\textsuperscript{294} The FDIC pays off depositors of failed banks out of the Deposit Insurance Fund and may serve as receiver or conservator for failed depository institutions.

According to the Orderly Liquidation Authority (OLA) introduced by the Dodd-Frank Act, the FDIC may further act as receiver for financial companies that are proved to

\begin{footnotesize}
\begin{enumerate}
\item EDIS Regulation, Proposal, Art. 41h.
\item EDIS Regulation, Proposal, Art. 41l.
\item EDIS Regulation, Proposal, Art. 41m.
\item EDIS Regulation, Proposal, Arts. 41p and 41q.
\end{enumerate}
\end{footnotesize}
be risky for the US financial stability. In its role as receiver or conservator, the FDIC may be categorised as the resolution authority, acting in accordance with the ‘least-cost’ principle. \footnote{Ibid., para. 6.39; This principle requires the FDIC to choose the less costly resolution method. See N. Kleftouri, Deposit Protection and Bank Resolution, (Oxford: Oxford University Press, 2015), paras. 10.26-10.27.} It is the manager of the Orderly Liquidation Fund, which constitutes a separate fund in the US Treasury, remaining inactive and unfunded until the appointment of the FDIC as receiver for a covered financial company. \footnote{N. Kleftouri, Deposit Protection and Bank Resolution, (Oxford: Oxford University Press, 2015), paras. 10.39-10.41.} Apart from the ‘two separate-funds model’, a single fund may also be established, comprising both the deposit insurance and the resolution fund. In the latter case, it must be ensured that the available financial means are sufficient to cover all liabilities deriving therefrom. \footnote{Ibid., para. 10.02.}

In a nutshell, the mission of the FDIC has been the insurance of deposits, the examination and supervision of financial institutions for safety and soundness and consumer protection, the resolution of large and complex financial institutions, and the management of receiverships. \footnote{Federal Deposit Insurance Corporation, 2016 Annual Report (February 2017), online at \url{https://www.fdic.gov/about/strategic/report/2016annualreport/2016ar_final.pdf}, accessed 10 January 2019, p. 1.}

**D. Conclusive remarks**

To conclude, a question is reasonably raised: is there a need for a third pillar? The opinions expressed have been many and various and the academic discussion lively. Gerhard and Lannoo stress that only a single pan-Europan fund, which would replace existing DGS, would deliver the solution to many challenges that the networks structure or ‘28 regime’ (co-existence of DGSs and of the EDIS) cannot deal with adequately. \footnote{M. Gerhardt and K. Lannoo, ‘Options for reforming deposit protection schemes in the EU’, ECRI Policy Brief 4 (March 2011),} Gordon and Ringe advocate that a banking resolution pillar strengthened through the ‘self-insurance’ approach would render the third pillar unnecessary, yet the Banking Union operational and less dependent on ‘state’ insurance. In view of the political deadlock, a self-insurance resolution mechanism
would constitute a viable solution.\textsuperscript{300} Deposit insurance and resolution are in principle separate functions.\textsuperscript{301} Yet, recognising the interrelation between them, Gros and Schoenmaker have proposed the creation of a European Deposit Insurance and Resolution Authority (EDIRA), by analogy to the role of the FDIC in the US.\textsuperscript{302} In the same direction, Colaert stresses that the concept of a separate pan-European DGS should be considered outdated before it has ever been implemented. A combination of a resolution and deposit guarantee fund for the Eurozone would be the way forward.\textsuperscript{303}

Despite the divergence of the aforementioned opinions, it is deducted that the common denominator remains the trend towards a centralised Deposit Insurance Fund, given that the national DGSs cannot ensure a homogenous deposit protection throughout the EU. Full harmonisation is necessary more than ever. The third pillar needs to be established. Only a fully-fledged Banking Union with all three pillars will deliver its full potential as part of a strong Economic and Monetary Union.

IV. Conclusions

Bank failures – and future financial crises – could decisively be prevented, provided that strong resolution frameworks are in place. The adoption of the BRRD has been, undoubtedly, a significant step towards this direction.

It provides uniform rules for the whole EU single market and constitutes the legal harmonized framework, upon which the Single Resolution Mechanism, the second pillar of the European Banking Union is based. Given that the Directive comprises minimum harmonisation rules, it does not lead to centralisation of decision making. Hence, it leaves discretion to national authorities as regards the application of resolution tools and powers, resulting in inconsistent and costly decisions. The SRM provides, instead, for an integrated decision-making structure aligning resolution under the SRM with supervision under the Single Supervisory Mechanism.

What is more, deposit insurance and bank resolution interact with each other as alternative or complementary mechanisms. Given that a direct pay-off under a deposit guarantee scheme will take place only where a failing bank is closed and liquidated and depositors have no longer access to their deposits, bank resolution – under the BRRD framework – ensures the continuity of banking services through the organisation of an orderly failure, reducing thus the likelihood of a deposit pay-off.

Taking into account the interconnectedness of bank resolution and deposit insurance, it should be noted that a fully centralised and integrated resolution framework (BRRD – SRMR) makes evident the need for a fully harmonised deposit insurance protection system. Therefore, the third missing pillar of the Banking Union should be completed as soon as possible in order for the Banking Union to be able to deliver its full potential.
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