How Single is the Single Resolution Mechanism?

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**Key words**

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**Abstract**

Since the first of January 2016, the Single Resolution Mechanism (SRM) has become fully operational. For the Member States of the European Banking Union the new regime entails a transferral of the decision-making on failing banks to the European level, specifically the Single Resolution Board (SRB). The political sensitivity hereof is illustrated by the European and Italian reaction to the mounting troubles in some parts of the Italian banking sector. The new European regime raises the question if, and if so to what degree, Member States participating in the European Banking Union (EBU Member States) retain discretion in determining the course of action for, and future of, a troubled bank. This question is explored along three lines of inquiry. First, we analyse the degree of harmonisation provided for by the BBRD and SRM. The second line of inquiry analyses EBU Member States’ influence in the SRB’s decision-making process. The third line of inquiry considers the possibilities (if any) for a public recapitalisation of troubled banks without applying the new general bail-in standard.

Our first line of inquiry leads us to conclude that the EBU Member States have surrendered the decision-making on bank resolution to the EBU level, specifically to the SRB. The SRM regulation, consequently, provides for maximum harmonisation, leaving no room for national resolution tools. National resolution powers which operate and compete in the same area as the SRM, such as the Dutch nationalisation law, must thus be held as inapplicable.

In the second line of inquiry we found that the SRM has both a supranational and an intergovernmental dimension. While the SRB in its executive session has a strong supranational character Member State influence in bank resolution decision remains present through the involvement of the Council and the SRB in plenary session in key decisions.

In the third line we conclude that the rules imposed by the BRRD and SRM Regulation in combination with the State aid regime have rendered public recapitalisation without a bail-in virtually impossible. Outside of resolution, NCBs may assist solvent banks through ELA. In addition, EBU Member States could turn to the possibility of precautionary recapitalisation to prevent that the control over a bank’s fate is shifted to the SRB. Such precautionary recapitalisation is however subject to strict conditions.
How Single is the Single Resolution Mechanism?

Danny Busch, Mirik B. J. van Rijn & Marije Louisse*

I. INTRODUCTION

When Odysseus passed the island of the Sirens he had himself bound to the mast of his ship. This allowed him to listen to the Sirens song without falling in their trap. He instructed his men that even as he begged and prayed to be released, they must not obey. Member States participating in the European Banking Union (EBU Member States) agreed to transfer decisions on bank recovery and resolution measures to the European level. However, when those governments hear the cries of struggling national banks, will they indeed adhere to the new European regime? In other words: how strong are the (legal) ties binding the national governments to the mast?

Since the first of January 2016, the Single Resolution Mechanism (SRM) has become fully operational. Constituting the second pillar of the European Banking Union (EBU) – besides the Single Supervisory Mechanism (SSM) and a proposed (future) European Deposit Insurance Scheme (EDIS) – it provides for a resolution regime for banks. The SRM regime subsequently charges the newly created Single Resolution Board (SRB) in Brussels with central decision-making powers on bank resolution. Importantly, the new regime aims to provide a shift from public funded bail-outs of troubled banks, which during the Global Financial Crisis had become common practice, to bail-in. This supposes that shareholders and creditors have to finance their

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1 Currently, the EBU Member States are the Eurozone Member States. All countries that adopt the Euro in the future will automatically become EBU Member States. The non-Eurozone countries can join by establishing a close cooperation agreement, although they will not be represented in the ECB’s Governing Council. See also: Darvas and Wolff (2013); Hüttl and Schoenmaker (2016).

2 The development of the EDIS was most recently discussed by the European Commission in its Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union, COM(2017) 592 final, p. 9-13.

3 The shift from bailout to bail-in is also apparent in the State aid regime. During the crisis the Commission adopted a lenient attitude towards bailouts but has, in its 2013 Banking Communications, adopted a restrictive stance on government assistance to troubled banks, requiring burden sharing by certain stakeholders. This is discussed in § V under ‘Post-crisis State aid regime’.

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bank’s losses, providing an alternative to unpopular public aid and (re)submitting banks to market discipline.

However, the shift of competence from the EBU Member States to the institutions at EBU level is not free of controversy. Uncertainty over the approach of the SRB, and the application of its new bail-in instrument, sparked resolution decisions in Portugal and Italy just days before the SRB came into effect.\(^4\) In the Netherlands a regime of competing national resolution powers remains in effect.\(^5\) Indeed, the SRB operates in a highly politically sensitive setting, as it is ultimately in charge of the liquidation or resolution of Eurozone banks. The functionality and effectiveness of the new European resolution regime is as yet fairly untested\(^6\) and, especially under politically stressed circumstances, uncertain. Mounting troubles in the Italian banking sector especially have provided a first stress test to the new resolution regime. This raises the question if, and if so to what degree, EBU Member States retain discretion in determining the course of action for, and future of, a troubled bank, especially in regard to the possibilities for public recapitalisation.

This question will be explored along three lines of inquiry. First, we analyse the degree of harmonisation provided for by the BBRD and SRM (§ III). We discuss the remaining resolution powers in Dutch national law as an example. The second line of inquiry analyses EBU Member States’ influence in the SRB’s decision-making. In this context we discuss the governance structure of the SRB (§ IV). The third line of inquiry considers the possibilities (if any) for a public recapitalisation of troubled banks without applying the new general bail-in standard. (§ V). The importance of this possibility was most recently illustrated in Italy, where the harsh practical consequences of bail-in rendered a less rigorous application of the bail-in rules the more attractive option. The final section contains our concluding remarks.

### II. PRELUDE: THE CRISIS

The financial crisis painfully exposed the lack of a (harmonized) resolution regime for credit institutions and investment firms\(^7\) (jointly referred to below as ‘banks’). National authorities, instead, had to rely on their domestic corporate insolvency procedures, nationally developed specific resolution instruments and/or publicly funded bailouts. None of these instruments provided a satisfactory response to failing banks.\(^8\)

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\(^4\) Brunsden and Jenkins (2016)

\(^5\) This regime can be found in Part 6 of the Dutch Act on Financial Supervision (\textit{Wet op het financieel toezicht}).

\(^6\) A list of notifications on resolution cases under the EBU resolution regime can be found on the website of the European Banking Authority (EBA). Up till now, the SRB took three resolution decisions, in relation to Banco Popular, Banca Popolare di Vicenza and Veneto Banca. In relation to Banca Popolare di Vicenza and Veneto Banca, the SRB has decided that resolution action by it was not warranted.

\(^7\) Most notably the systemic investment firms or investment firms which are exposed to the same types of risks as credit institutions.

\(^8\) The drawbacks of submitting banks to insolvency procedures have been extensively discussed elsewhere. See, amongst others: Sommer (2014); Rajan (2011), Chapter 8; Cihák and Nier (2012); Ringe (2016); Avgouleas and Goodhart (2015). Suffice to say that the interconnectedness, high leverage and the special nature of both a bank’s assets and liabilities, leads to excessive destruction of value and contagion risks when submitted to insolvency.
The interconnectedness of the financial sector, not in the last part due to highly leveraged balance sheets, renders it prone to contagion effects. Failing financial institutions damaged and dragged their counterparties, mostly other financial institutions, with them and caused run-like behaviour from financial institutions and capital markets.\(^9\)

In this regard, the decision of the department of Treasury and the Fed not to bailout Lehman on September 15, 2008 was the catalytic event which caused widespread panic and contagion. The decision not to bailout Lehman was in part motivated by legal restraints.\(^10\) However, probably of greater importance was the political reluctance to yet again use taxpayers’ money to bailout Wall Street, as well as, the fear that it would set a precedent leading to further removal of market discipline on those firms considered ‘too big to fail’.\(^11\) In the end, however, the bankruptcy of Lehman led the whole financial system to start falling apart.\(^12\)

Ironically, Lehman’s bankruptcy reinforced exactly what it had set out to disprove: that some financial firms are indeed too big (or interconnected) to fail. Governments concluded that they had no alternative but to rescue their big financial institutions.\(^13\) While the bailouts and nationalizations of banks were deeply unpopular, they were also necessary. Ideological concerns – be it the general aversion on the right side of the political spectrum to public interference in the markets and ensuing moral hazard problems\(^14\) or, on the left, the bailout of irresponsible and overpaid bankers – had to take a backseat to pragmatism. A choice between government bailouts or financial, economic and social meltdown, is not really a choice at all. Consequently, US Congress approved a Troubled Assets Relief Program (TARP) of $700  

Illustrative is the report of the Federal Deposit Insurance Cooperation, which estimates that through resolution the general unsecured creditors of Lehman Brothers could have recovered 97 cents on every $1 of claims compared to the 21 cents they actually received in the ‘normal’ bankruptcy procedure of Lehman Brothers. See: FDIC press release, *FDIC Report Examines How an Orderly Resolution of Lehman Brothers Could Have Been Structured under the Dodd-Frank Act*, 18 April 2011.


\(^10\) Mainly the fact that Lehman was thought not to have sufficient collateral to warrant a loan under Section 13(3) of the Federal Reserve Act. At the same time the determination as to what constitutes satisfactory collateral was left at the discretion of the Fed. This renders it an, arguably, quite arbitrary determination. Especially considering that the Fed found, earlier, the assets of Bear Stearns of sufficient quality to back a Federal Reserve loan and after the fall of Lehman – likely shaken by the dire consequences – judged the assets of AIG adequate to secure a $85 billion loan. The discretionary power of the Fed has since been tempered by the Dodd-Frank Act which prohibits the Fed from providing emergency liquidity to financial institutions deemed insolvent (which is the case when the borrower is in bankruptcy, resolution under title II of the Dodd-Frank, or any other Federal or State insolvency proceeding.). Furthermore, emergency lending requires prior approval of the Secretary of Treasury. See: 12 U.S. Code § 343 (B) (ii) and (iv). I

\(^11\) After bailing out Bear Stearns, Fannie Mac and Freddy Mac a line was drawn not to spend any more taxpayers money. See: Blinder (2013), p 123.

\(^12\) According to Fed chairman Bernanke: ‘(..) It [a Lehman bankruptcy] was going to have huge impacts on funding markets. It would create a huge loss of confidence in other financial firms. (..)So there was never any doubt in our minds that it would be a calamity, catastrophe, and that, you know, we should do everything we could to save it.’ See: Financial Crisis Inquiry Commission (2011), p 339.

\(^13\) The G-7 statement of 10 October laid down in no uncertain terms that from then on banks could count on government backing stating, inter alia to “take decisive action and use all available tools to support systemically important financial institutions and prevent their failure”. This intention and the connection to Lehman brothers failure, was also indicated by Secretary of Treasure Henry Paulson, noting that “only after Lehman Brother failed did we get the authorities from Congress to inject capital into financial institutions.” See: Paulson (2010).

\(^14\) Moral hazard sees to the tendency that some form of insurance encourages the depreciation of risks. The classic illustration is car insurance alleging that persons driving in insured cars are less concerned with scratching it than those driving without insurance.
billion and the Fed became increasingly prepared to provide loans to troubled financial undertakings.

In Europe, national authorities spent between 2008 and 2015 circa €759 billion in capital, impaired asset measures and repayable loans and circa €1,188 billion in guarantees on liabilities to support the financial system. Lacking a supranational resolution framework and a European fiscal backstop to share the burden of costly financial rescue operations, national governments remained individually responsible for bailing-out their banks. Such fragmentation along state lines was, however, not paralleled by the banks which, benefiting from the unification of the European markets, had stretched their operations over many nations. Indeed, some Member States were confronted with banks that held more debt on their balance sheets than their GDP. Large scale government bailouts posed a colossal financial burden which propelled their debt-to-GDP ratios.

In Europe a related problem manifested, since European banks were inclined to hold large amounts of national government debt. The increasing debt-to-GDP ratios led to stress on the sovereign-bond markets which, in turn, reflected in a deterioration of the European banks’ balance sheets. At the same time, indebted governments relied even more on financing from domestic banks. Thus creating an interdependence between the two, where deterioration of the one impaired the other. This effect is ominously referred to as the European sovereign doom loop.

Consequently, a credible resolution framework for banks was desired in order to break the loop by providing a viable alternative to bailouts and, importantly, a fair cross-border distribution of...
related costs. Indeed, shifting the burden of failing banks away from national budgets to the European level, is often cited as the true *raison d’etre* of the EBU.\textsuperscript{23} Such a regime would, together with European supervision on the largest banks, not only help to break the loop between sovereigns and banks, but, ideally, also provide a credible alternative to dreaded public funded bailouts.

In other words: the resolution regime has to (re)submit banks to market discipline, fairly balance the costs associated with failing banks and align, to the extent possible, the decision-making on resolution measures with the activities of banks, i.e. at the level of the EBU. All the while, taxpayer’s money has to be spared by favouring bail-in to bailout. In the hopeful words of Jonathan Hill, the former European Commissioner for financial stability, ‘no longer will the mistakes of banks have to be borne on the shoulders of the many’.\textsuperscript{24}

### III. FIRST LINE OF INQUIRY: HARMONISATION

In our first line of inquiry we analyse the degree of harmonisation provided by the European resolution regime. This question is explored against the backdrop of the Dutch Intervention Act, which grants the Dutch Minister of Finance the power to expropriate assets of financial institutions. To this end, both the Bank Resolution and Recovery Directive (BRRD) and the SRM Regulation are discussed.

*Degree of harmonisation provided by the BRRD*

Within the European Union a resolution regime for failing banks was first provided by the BRRD.\textsuperscript{25} The BRRD imposes on Member States (both in and outside the EBU) the obligation to implement a set of common resolution tools, to be used on failing banks. These tools are the sale of business tool,\textsuperscript{26} bridge institution tool,\textsuperscript{27} asset separation tool\textsuperscript{28} and the bail-in tool.\textsuperscript{29} Furthermore, the Member States have to appoint national resolution authorities (NRAs),\textsuperscript{30} equipped with the resolution tools granted by the BRRD.

Given the need for a robust resolution regime, which harmonises the fragmentised European practices, one might expect an exhaustive harmonisation measure. However, and perhaps due

\textsuperscript{23} Moloney (2014), p 1624. The European Parliament stated that ‘breaking up the negative feedback loops between sovereigns, banks and the real economy is crucial for a smooth functioning of the EMU’ and ‘requires the realisation of a fully operational European Banking Union’. See: European Parliament resolution of 20 November 2012 with recommendations to the Commission on the report of the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup ‘Towards a genuine Economic and Monetary Union’ (2012/2151(INI)).

\textsuperscript{24} European Commission (2015).


\textsuperscript{26} BRRD, Art. 38.

\textsuperscript{27} BRRD, Art. 40.

\textsuperscript{28} BRRD, Art. 42.

\textsuperscript{29} BRRD, Art. 43.

\textsuperscript{30} BRRD, Art. 3.
to the politically sensitive nature of bank resolution, the BRRD suffices with minimum harmonisation. Member States are, for instance, allowed to assign additional tools and powers to their NRAs.\textsuperscript{31} It leaves the application of these tools to national authorities.\textsuperscript{32} In addition, it provides only limited centralisation by means of Member State cooperation and a limited possibility for mediation by the European Banking Authority.\textsuperscript{33}

Additionally, besides the resolution tools provided to the NRAs, the BRRD leaves Member States with the discretion to apply Government Financial Stabilisation Tools (GFST), when a bank meets all the conditions for resolution.\textsuperscript{34} These amount to public equity support\textsuperscript{35} and temporary public ownership.\textsuperscript{36} The GFST are to be used as a last resort in the very extraordinary situation of a systemic crisis after other resolution tools have been assessed and exploited to the maximum extent practicable whilst maintaining financial stability.\textsuperscript{37} The use of GFST is limited to a prior bail-in of at least 8% of bank liabilities and approval under the State aid framework.\textsuperscript{38} The GFST are, therefore, always applied in succession to a prior bail-in.\textsuperscript{39}

Member States may resort to GFST after they have determined that the application of resolution tools would not suffice to avoid a significant adverse effect on the financial system.\textsuperscript{40} Alternatively, after extraordinary liquidity assistance has been granted by a national central bank, GFST may be applied where resolution tools would not suffice to protect the public

\textsuperscript{31} BRRD, Art. 37(9). Such additional tools and powers are conditional to the requirement that ‘(a) when applied to a cross-border group, those additional powers do not pose obstacles to effective group resolution; and (b) they are consistent with the resolution objectives and the general principles governing resolution referred to in Articles 31 and 34’. To our knowledge, no Member State has assigned additional tools or powers to its resolution authority.

\textsuperscript{32} See also recital 10 of the SRM Regulation, stating that the ‘BRRD is a significant step (…) However, the Directive only establishes minimum harmonisation rules and does not lead to centralisation of decision making’.

\textsuperscript{33} Resolution colleges are established by the group-level resolution authorities pursuant to Art. 88 BRRD. These function, in short, to strengthen cooperation between resolution Member State and third-country resolution authorities. Group resolution schemes are adopted in principal by the group-level resolution authority. However, if the resolution action is likely to result in the failure of group entities in other Member States, the group-level resolution authority proposes the resolution scheme to the resolution college. Resolution authorities which disagree with the scheme may take independent resolution action in the interest of financial stability. EBA may, at the request of a resolution authority assist in reaching a joint decision. See: Arts 91 and 92 of the BRRD for the exact procedures. Additionally, pursuant to Art. 87 of the BRRD, Member States have to ensure that their authorities have regard to a number of general principles when their decisions or actions may have an impact on other Member States. See also: Schillig (2016), pp 502, 503.

\textsuperscript{34} BRRD, Art. 56(4).

\textsuperscript{35} BRRD, Art. 57.

\textsuperscript{36} BRRD, Art. 58.

\textsuperscript{37} BRRD, Art. 56(3).

\textsuperscript{38} BRRD, Art. 37(10) sub (a) & (b). The DG for Financial Stability clarified in its Q&A on the transposition of the BRRD that: “GFST for ailing banks can happen only under the conditions of Article 37 (10) and 56-58, therefore, in the context of systemic crisis and preceded by an 8% contribution to loss absorption and recapitalization. The conditionality in the Directive is very clear already in Article 37 (10). It may be worth clarifying that GFST will need to be combined with the use of a resolution tool that allows imposing those losses on shareholders and creditors (i.e. bail-in) up to 8%; Finally, as it derives from the text in Article 56 (1), GFST can be provided for the purpose of participating in the resolution of an institution. Therefore, GFST will happen, if the conditions are met, within the context of resolution.” See: DG for Financial Stability, Financial Services and Capital Markets Union, ‘BRRD Master Table Member State Q&As’, (last accessed on 1 January 2017 at: http://ec.europa.eu/finance/bank/docs/crisis-management/150101-brrd-questions-and-answers.xlsx).

\textsuperscript{39} See also: Gardella (2015), p 384.

\textsuperscript{40} BRRD, Art. 56(4) sub (a).
interest.\textsuperscript{41} The temporary public ownership tool may only be invoked when the Member State determines that the application of the resolution tools after public equity support would not suffice to protect the public interest.\textsuperscript{42}

The national governments of the Member States are in charge with making the decision whether or not to resort to GFST and whether the conditions for application of the GFST are met. The BRRD therefore still opens the door to national bailout practices which undermines a harmonized approach to bank resolution.\textsuperscript{43} At the same time a bail-in of 8\% must be carried out and the Commission has to give approval under the State aid framework as a result of which the discretion of the Member States is not unlimited.

In conclusion the BRRD offers a harmonized toolbox for bank resolution in the EU. However, it does not provide for centralised decision-making and allows Member States the option to grant State aid through the GFST. As a consequence, the BRRD does not render Member State bailouts of banks a thing of the past.

\textit{Standing Dutch nationalization law under the BRRD}

As indicated in the introduction (§ I), the Dutch government opted not to revoke national resolution provisions when bringing its national legislation in line with the SRM and implementing the BRRD. On the basis of the Dutch Intervention Act (as laid down in Part 6 of the Dutch Financial Supervision Act), the Dutch Minister of Finance has the capacity to nationalize financial institutions, including banks.\textsuperscript{44} This provision was invoked to nationalize SNS REAAL on 1 February 2013.

The Explanatory Memorandum to the Dutch legislation implementing the BRRD and the SRM Regulation acknowledges that while the powers of the Minister of Finance will have hardly any practical meaning in the case of banks or banking groups, because of the BRRD and SRM Regulation, the national resolution powers may, however, still be applied as state emergency law.\textsuperscript{45}

First of all, on a more political note, the continuous application of the powers of the Minister of Finance can hardly be construed as a vote of confidence in the new European resolution regime. Secondly, it raises the question to what degree resolution powers regarding banks have been transferred. As stated, the BRRD provides only minimum harmonisation and allows GFST, thereby leaving substantial resolution powers in the hands of the national authorities. The question is therefore whether the nationalization powers of the Dutch Minister of Finance can be qualified as GFST, even though the Dutch legislator stated that the GFST are not

\textsuperscript{41} BRRD, Art. 56(4) sub (b).
\textsuperscript{42} BRRD, Art. 56(4)(c).
\textsuperscript{43} See also: Schillig (2016), pp 341, 342.
\textsuperscript{44} Unawareness on the part of the Dutch government of a tension between the national nationalization provision and the SRM seems highly unlikely given the fact that then Dutch Minister of Finance, Jeroen Dijsselbloem, was charged with heading the Eurogroup in the trilogue negotiations on the SRM Regulation. Furthermore the explanatory memorandum explicitly addresses the relation of the Dutch resolution provisions with the SRM.
\textsuperscript{45} Kamerstukken II, 2014–2015, 34 208, no.3 (Explanatory Memorandum), p 52.
implemented in the Netherlands. The GFST are subject to the conditions mentioned above. These conditions are fulfilled in part by the Dutch law which requires ‘a serious and immediate risk to the stability of the financial system as a whole’, before allowing nationalization measures. While the Dutch legislation does not explicitly require a mandatory bail-in of 8% of the bank’s liabilities, an expropriation of a bank’s assets and liabilities could in effect entail a bail-in of at least 8%.

In effect, the Dutch law seems generally in line with the GFST allowed under the BRRD. Still, a more precise following of the BRRD requires adding a mandatory bail-in of 8% of the bank’s liabilities and a prior consideration by the Minister of other resolution tools, in combination with public equity support, to the Dutch legislation.

The Single Resolution Mechanism

Since the Netherlands is part of the EBU, the more relevant question is whether the SRM allows for national resolution or bail-out measures in relation to banks and banking groups. The SRM complements the BRRD by providing a European institutional framework by which resolution tools and powers are applied. Does the SRM, in imitation of the BRRD, leave resolution discretion to the Member States? In this respect difficulties arise from the fact that the SRM Regulation is silent in this regard; it does not refer to the GFST provided by the BRRD. The critical question therefore is to what degree the SRM harmonises the laws of the EBU Members States.

The legal basis for the SRM Regulation was found in Article 114 TFEU. This Article provides a general basis for the adoption of legislative acts, for the harmonisation of the laws of the Member States, with the object of improving the conditions for the establishment and functioning of the internal market. Harmonisation of the internal market falls within the area of shared competences between the EU and the Member States, entail that both the Union

46 Explanatory Memorandum, p 51.
47 Explanatory Memorandum, p 52; Financial Supervision Act, Art. 6:2(1). The relevant provision reads: “The Minister may, if he considers that the stability of the financial system is in serious and immediately danger due to the position of a financial institution established in the Netherlands, in view of the stability of the system decide to expropriate assets of the concerned institution, securities issued by or in cooperation with the institution or claims to the institution, if necessary, in derogation of regulations or statutory provisions, except for those set by this section.” (translation provided by the authors).
48 Article 4(2) sub (a) TFEU provides the basic premise that the internal market is a shared competence. Article 114(4) TFEU juncto Art. 36 TFEU provides Member States with the possibility to maintain national provisions on grounds of major needs relating to public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing Artistic, historic or archaeological value; or the protection of industrial and commercial property. Additionally Article 114(5) TFEU states that Member States may introduce national provisions based on new scientific evidence relating to the protection of the environment or the working environment on grounds of a problem specific to that Member State. As the Dutch law allowing for the nationalisation of financial institutions was introduced before the SSM Regulation, it satisfies the requirement under Art. 114 (4) that national measures may be maintained. Additionally, according to Art. 114(6) TFEU, the Commission has to approve or reject the national provisions after verifying whether they are a means of arbitrary discrimination or a disguised restriction on trade between Member States and whether they constitute an obstacle to the functioning of the internal market. See: Craig and De Búrca (2011), pp 591-594. It is questionable whether the Dutch legislation serves any of the objectives mentioned. Furthermore, they do constitute an obstacle for the functioning of the internal market. This is underlined by inter alia consideration (1), (2) and (3) of the SRM Regulation; as the regulation aims precisely to create an internal market for banking services.
and the Member States may legislate and adopt legally binding acts in that area. The Member States may, however, only exercise their competence to the extent that the Union has not exercised its competence.⁴⁹

The SRM was created by the EBU Member States, based on the need to vest centralised resolution powers in a neutral European body – echoing the centralised supervision of banks by the European Central Bank (ECB) in accordance with the SSM.⁵⁰ They agreed to transfer the decision-making on the resolution of banks which are failing or are likely to fail to the SRB.

The SRB centralizes resolution decision-making at the level of the EBU. It is vested with the power to place Eurozone banks and banking groups in resolution. This is achieved by the adoption of a resolution scheme, by the SRB, in which it determines the application of resolution tools, including the application of bail-in.⁵¹ The scheme also determines claims on the Single Resolution Fund (SRF) in support of the resolution measures.⁵² The SRM is characterised by a composite administration where the decisions taken by the SRB have to be implemented at national level by the NRAs by exercising their resolution powers under national law transposing the BRRD and in accordance with the conditions laid down in national law.⁵³ The responsibility for the effective and consistent functioning of the SRM lies, however, with the SRB.⁵⁴

The SRB is directly responsible for resolution planning and decision-making for Eurozone banks and banking groups directly supervised by the ECB pursuant to the SSM⁵⁵ and for cross-border banking groups.⁵⁶ Resolution planning and decision-making for banks and banking groups for which the SRB has no competence lies with the NRAs, which have to inform and closely coordinate their measures with the SRB.⁵⁷ The SRB may also replace, on its own initiative, a NRA by exercising directly all of the relevant powers under the SRM Regulation.

**Degree of harmonisation provided by the SRM**

The SRM aims to harmonise the resolution regime in the EBU Member States by providing uniform provisions and ensuring a uniform application by entrusting decision-making to a central authority.⁵⁸ The SRM reiterates and mirrors the resolution rules provided by the BRRD.

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⁴⁹ Art. 2(2) TFEU. Protocol (No 25) on the exercise of shared competence further clarifies this as ‘those elements governed by the Union act in question and therefore does not cover the whole area’.

⁵⁰ SRM Regulation, Art. 27(5) and (14).


⁵² SRM Regulation, Art. 18(9) and 29(1), second paragraph.

⁵³ SRM Regulation, Art. 7(1).

⁵⁴ These are banks considered by the ECB to be ‘significant’ pursuant to Art. 6(4) of the SSM Regulation or banks in relation to which the ECB has decided to exercise direct supervision in accordance with Art. 6(5)(b) of the SSM Regulation.

⁵⁵ SRM Regulation, Art. 7(2).

⁵⁶ SRM Regulation, Art. 7(3).

⁵⁷ SRM Regulation, Art. (4) sub (b).

⁵⁸ Recital (11) & (12) of the SRM Regulation.
The formal scope of the SRM extents to all credit institutions established in EBU Member States, regardless of size. Additionally, parent undertakings subjected to consolidated supervision by the ECB in accordance with the SSM Regulation and investment firms and financial institutions that are covered by the consolidated supervision of the parent undertaking by the ECB in accordance with the SSM Regulation are also in scope of the SRM, in so far they are established in an EBU Member State.

Within the SRM the tasks are divided between the SRB and the NRAs. The SRB is responsible for the resolution of significant banks and banking groups, other banks and banking groups that are directly supervised by the ECB and cross-border banking groups. The NRAs are directly responsible for the resolution of all other banks and banking groups. Furthermore if the resolution action requires the use of the SRF, the SRB shall adopt the resolution scheme, also in relation to banks and banking groups for which the NRAs are in charge.

The NRAs are, when putting a bank in resolution within the SRM, bound to the resolution tools referred to in the SRM Regulation. Consequently, they do not dispose of additional resolution tools granted under national legislation, if any. In order for the NRAs to apply the relevant provisions of the SRM they must exercise the corresponding resolution powers conferred on them under national law transposing the BRRD in accordance with the conditions laid down in national law. In addition, the SRM Regulation does not provide for a basis for the exercise of resolution powers by the SRB. As a result thereof, the resolution powers are always exercised by the NRAs on the basis of the implementation by their respective Member State of Chapter VI of the BRRD, also in relation to the implementation of a resolution scheme that has been adopted by the SRB.

It should be pointed out that, in so far as this may lead to differences in the application of the resolution tools, for example due to divergent national implementations of the BRRD, the SRB remains responsible for the uniform and consistent application and may, to this effect, intervene. As pointed out earlier, the SRB may issue a warning to an NCA or even decide to take over its tasks.

As a result, one could conclude that the SRM Regulation has fully harmonized the use of the resolution tools, but this harmonisation has not been extended to the exercise of the resolution powers. This is still a national matter. The question is whether this also applies in respect of the GFST.

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59 SRM Regulation, Art. 2(a).
60 According to Art. 4(1) sub (i) of the SSM Regulation.
61 Covered investment firms are those subjected to the initial capital requirement of EUR 730 000. See: SRM Regulation, Art. 3(2) juncto BRRD, Art. 2(3) juncto CRR, Art. 4(1) point (2) juncto CRD IV, Art 28.
62 According to Art. 4(1) sub (g) of the SSM Regulation.
63 SRM Regulation, Art. 2(b) and (c).
64 SRM Regulation, Art. 7.
65 Following the determination of the ECB in accordance with SSM Regulation, Art. 6(4).
66 SRM Regulation, Art. 7(3), 2nd para.
67 SRM Regulation, Art. 7(3) sub (e).
68 SRM Regulation, Art. 7(3), 4th para.
69 SRM Regulation, Art. 7(4) sub (a) & (b).
As mentioned before, the BRRD provides governments not only with NRAs but also allows them, subject to conditions, to apply the GFST. The SRM Regulation does not explicitly revoke the possibility to apply the GFST, but remains silent in that respect. The question therefore is whether the national discretion to apply the GFST would be incompatible with the SRM. On the one hand, the possibility to apply the GFST would undermine the aim of creating a uniform resolution regime. This view is supported by the Q&A on the transposition of the BRRD, prepared by the DG for Financial Stability, Financial Services and Capital Markets Union. On the other hand, one could question whether the SRM Regulation forms the correct legal basis for restricting the possibilities for EBU Member States to provide State aid, taking into account the methodology of the State aid provisions in the TFEU. In addition, there is some unclarity as to the scope of Article 27(9) SRM Regulation. This Article allows that further funding may be sought from “alternative financing sources” in extraordinary circumstances, after the 5% contribution limit for the SRF has been reached and all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full. It is not specified what is meant by “alternative financing sources”. It may be that bailouts (such as on the basis of the Dutch Intervention Act) are captured by this provision.

There is however no doubt that the SRM Regulation places the Dutch nationalization law between a rock and a hard place. As is well known, the European Court of Justice (‘CJEU’) already in 1964 articulated that the Treaties and the law adopted by the Union on the basis of the Treaties have primacy over the laws of the Member States. As a result of the supremacy principle any national law which conflicts with EU law is rendered inapplicable and the adoption of new national law which would conflict with EU law is prevented.

IV. SECOND LINE OF INQUIRY: GOVERNANCE

As we have seen, the SRM provides for maximum harmonisation, leaving no discretion to the EBU Member States. This does not mean that the EBU Member States have no influence on the decision-making process within the SRM. After all, EBU Member States interests and votes carry great weight within the EU decision-making process, especially in regard to politically sensitive issues. The demand of some EBU Member States to keep a say in the resolution proceedings is driven by concerns of the capability and willingness of the SRM to account for


71 See in that respect Art. 37(1) BRRD that specifies that the resolution authority may seek funding “from alternative financing sources through the use of government stabilisation tools”.

72 The landmark case in this regard is Costa v E.N.E.L. where the CJEU stated that a ‘unilateral act incompatible with the concept of the Community cannot prevail’. Reiterated in reiterated declaration 17 by the Lisbon Treaty. This also known as the principle of supremacy.

73 This does not mean that national court, when confronted with such a situation, have to annul the national law provision, instead they have to refuse to apply it. See: Cases C-10-22/97 Ministero delle Finanze v IN.CO.GE. ‘90 Srl [1998] ECR I-6307, [21].
national interest in resolution proceedings. Given the sums involved, EBU Member States, notably Germany, demand influence and control in compensations to any fiscal contributions.\textsuperscript{74}

Indeed, Member States responses to the crisis are for a substantial part characterised by an intergovernmental nature.\textsuperscript{75} An intergovernmental dimension is also present in the SRM. This is obviously the case in regard to the SRF, as it was established through an intergovernmental treaty outside the EU Treaties.\textsuperscript{76}

Moreover, the SRM’s decision-making structure, intergovernmental versus supranational, was avidly discussed during the negotiations.\textsuperscript{77} On one side were the Commission, European Parliament, ECB, southern EBU Member States and France, which favoured a supranational approach to resolution decisions. They argued such a regime to be better equipped for effective and fast decision-making.\textsuperscript{78} On the other side, Germany and other Northern EBU Member States wished the involvement of national authorities in the decision-making process.\textsuperscript{79} Germany initially even demanded that the European Council, acting on unanimity, would be in charge of resolution decisions.\textsuperscript{80}

Another important factor in the discussion on the design of the SRM stemmed from limitations resulting from the Meroni doctrine.\textsuperscript{81} The Meroni doctrine prohibits an EU institution from delegating discretionary power implying a wide margin of discretion. While these legal concerns where real, they were also used to push a supranational or intergovernmental agenda.\textsuperscript{82} Accordingly, the Commission advanced legal limitations to convince Member States that it should be in charge of resolution decisions.\textsuperscript{83} Germany, however, raised legal and institutional objections on the initial SRM proposal and the key role it attributed to the Commission, contending that the legal basis, Art. 114 TFEU, does not provide a suitable basis for such

\textsuperscript{74} Access of the SRF to fiscal resources is not guaranteed and is left to the participating Member States. See § V for a more extensive discussion on the financing arrangement of resolution actions. See also: Busch (2015), pp 310-312.

\textsuperscript{75} The European Stability Mechanism, the Fiscal Compact and the Single Resolution Fund have all been established by intergovernmental treaties outside the EU Treaties. See: Maris and Sklias (2015), p 67; Fabbrini (2014).

\textsuperscript{76} Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund, Brussels, 14 May 2014. This construction was motivated by German demands regarding the elimination of the European Parliament (EP) and minimizing the Commission’s role. See: Howarth and Quaglia (2014), p 135.

\textsuperscript{77} Other stumbling blocks where the legal basis, scope, time-frame and availability of a public backstop for bank recapitalisation. See for a detailed account on the negotiations: Changeur and Bion (2014).

\textsuperscript{78} Finance Minister Pierre Moscovici stated that ‘we need an effective decision-making process, as simple as possible’. See: EUBusiness (18 december 2013). In the same vein Commissioner Michel Barnier called for ‘a system which can deliver decisions quickly and efficiently’, (European Commission (2013a).) The ECB for its part pled for a ‘A strong and independent single resolution authority should be at the centre of the SRM’, (Opinion of the European Central Bank of 6 November 2013).

\textsuperscript{79} Barker and Ehrlich (2013); Howarth and Quaglia (2014), p 134.

\textsuperscript{80} Barker et al. (2013).

\textsuperscript{81} Meroni & Co., Industrie Metallurgiche, Spa v High Authority of the European Coal and Steel Community (1957-8)

\textsuperscript{82} Arguably the legal concerns have since been diminished by the CJEU’s, more recent, judgement in the Short Selling case. The CJEU revisited the Meroni doctrine finding that delegation of discretionary powers to an EU agency is allowed as long as its discreions are circumscribed, precisely delineated and amendable to judicial review in the light of objectives established by the delegating authority. See: Pelkmans and Simoncini (2014)

\textsuperscript{83} Barker et al. (2013)
transfer of power to the EU. Eventually the obstacles arising from the Meroni doctrine were tackled by having the Commission endorse or object to the resolution scheme adopted by the SRB.

This resulted in a governance structure marked by compromise, balancing between the interests of individual Member States and the interests of the Eurozone or the EU as a whole. Consequently, the SRM has both a supranational dimension, represented by the SRB in its executive session and the Commission, and a more intergovernmental dimension through the involvement of the Council and the SRB acting in plenary session in certain key decisions, since in plenary sessions, all members of the SRB participate.

The primary decision maker with regard to bank resolution is, however, the SRB acting in executive session. In this session the SRB is composed of the Chair, four additional full-time members, representatives of the relevant Member States, permanent observers of the Commission, the ECB and other invited observers. Lacking consensus, decisions are made by the Chair and the four fulltime members through simple majority.

The decision-making structure of the SRM is a complex, layered process involving many actors. To illustrate the influence of the different players in the resolution process, we give the example of the decision-making process with regard to the key question whether or not to place a bank in resolution. This decision is dependent on fulfilment of the following conditions: a. the entity is failing or likely to fail; b. there is no reasonable private sector alternative; c. resolution is necessary in the public interest.

"a. the entity is failing or likely to fail"

First, the determination that an entity is failing or likely to fail lies primarily with the ECB, but can also be made by the SRB. The latter, acting in its executive session, may make such a determination after it informed the ECB and only after the ECB, within three days of receiving such information, does not make such an assessment itself. Pursuant to the SSM the decision-making of the ECB takes place within the Supervisory Board. It is composed of a Chair and Vice Chair, four representatives of the ECB and one representative of the NCA of each EBU Member State. Consequently, Member State representatives hold a majority and while the national representatives are obliged to act in the common European interest, this might in practice open the door to considerations of national interest.

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84 Zavvos and Kaltsouni (2015), p 118
85 SRM Regulation, Art. 18(7).
87 Art. 49 SRM Regulation.
88 SRM Regulation, Art. 53(1), 1st para, juncto Art. 43(1) sub (b).
89 SRM Regulation, Art. 53(3) & 53(4).
90 SRM Regulation, Art. 53(1), 3rd para.
91 SRM Regulation, Art. 55.
92 SRM Regulation, Art. 18(1).
93 See for the regulatory resolution triggers § V under ‘public precautionary recapitalisation’.
94 SSM Regulation, Art. 26(1).
95 See also Véron (2015), p 27.
b. there is no reasonable private sector alternative

Secondly, the determination whether there is a reasonable prospect to a private sector alternative – including measures by an Institutional Protection Scheme, or supervisory action, including early intervention measures or the write-down or conversion of relevant capital instruments – is left to the SRB in its executive setting, in close cooperation with the ECB.

c. resolution is necessary in the public interest

Third, a resolution action meets the public interest requirement, if it is necessary for the achievement of, and is proportionate to, one or more of the resolution objectives and winding up of the entity under normal insolvency proceedings would not meet those resolution objectives to the same extent. This assessment lies primarily with the SRB’s executive session but as we shall see below, the Commission and Council are also involved.

When the SRB assesses in executive session that the three resolution conditions are fulfilled, it will adopt a resolution scheme which places the entity or group under resolution. After adopting a resolution scheme the SRB transmits it to the Commission. The latter then has 24 hours to either adopt the decision or object to it on grounds of objections on discretionary aspects. Besides the Commission, the Council is also involved in the adoption of the resolution scheme. This is the case when the Commission proposes objections to the fulfilment of the ‘public interest’ requirement to the Council or when the Commission proposes a material modification of the amount of the SRF to be used. The Council decides on these issues by simple majority.

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96 An Institutional Protection Scheme is a contractual or statutory liability arrangement of a group of banks which protects the member institutions and in particular ensures their liquidity and solvency. See: Art. 113(7) of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L. 176 of 27 June 2013, (CRR).

97 SRM Regulation, Art. 18(1).

98 The resolution objectives are: (a) to ensure the continuity of critical functions; (b) to avoid significant adverse effects on financial stability, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (e) to protect client funds and client assets’, SRM Regulation, Art. 14(2).

99 SRM Regulation, Art. 18(5). In this regard it is interesting to note the recent decision of the SRB’s not to pursue resolution actions concerning two failing Italian banks in the Veneto region. In this regard the ECB, on 23 June 2017, determined that the Italian banks Banca Popolare di Vicenza and Veneto Banca both were failing or likely to fail. Both banks fell under direct supervision of the ECB due to their status as significant bank pursuant to the SSM Regulation. Interestingly the SRB decided, in deviation of earlier Resolution Plans, that for both banks resolution actions were not necessary in the public interest. The banks are therefore wound up under normal Italian insolvency proceedings. See ECB press release, “ECB deemed Veneto Banca and Banca Popolare di Vicenza failing or likely to fail” of 23 June 2017; Decision of the Single resolution Board concerning the assessment of the conditions for resolution in respect of Veneto Banca of 23 June 2017 and Decision of the Single resolution Board concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza of 23 June 2017.

100 SRM Regulation, Art. 18(6) sub (a).

101 SRM Regulation, Art. 18(7).
Additionally, when specific resolution action requires more than €5 billion of the SRF a decision to this effect has to be taken by the SRB in plenary session.\textsuperscript{102} In this instance, a decision must be reached by simple majority but representing at least 30 per cent of the contributions to the SRF. This places extra Member State scrutiny on the use of large amounts from the SRF.\textsuperscript{103}

Consequently, EBU Member States demands for a more intergovernmental decision-making process are addressed by (i) assigning a substantial role to the Council, in which all Member States are represented and are free to pursue their own interests and (ii) by placing certain high impact decisions under the scrutiny of the plenary session of the SRB.\textsuperscript{104} This, arguably, renders the resolution procedure more democratic, giving Member States a direct say in resolution decisions which have a far reaching impact on their financial stability and their fiscal situation.\textsuperscript{105} On the other hand, it adds an additional, highly political, layer to an already complicated decision-making procedure in which time is of the essence.

As a result, the SRM has both a supranational and an intergovernmental dimension. But, as bank resolution decisions which involve less than €5 billion are made in executive session, an independent Union body with a supranational character, now practically decides over bank resolution. At the same time, Member States influence remains substantial through the involvement of the Council and the SRB in plenary session in key decisions.

All things considered, the suboptimal governance coupled with the need for speedy decision-making seems to warrant some scepticism on the SRM’s functionality. Streamlining the governance of the SRM would, however, probably entail a reduction of Member State influence in the decision-making process. Recalling that the original SRM proposal, which gave the Commission final say on bank closures met with insurmountable political resistance, such a transfer seems unlikely, especially in the current political climate. A further decrease in EBU Member State influence will undoubtedly meet with resistance.

V. THIRD LINE OF INQUIRY: RECAPITALISATION

The creation of the EBU resolution regime aimed to weaken the links between sovereigns and their banking sector. This was to be achieved by mutualising the costs of bank recapitalisation

\textsuperscript{102} In its plenary session is composed of the Chair, four further full-time Board Members and a member appointed by each participating Member State, representing their national resolution authorities. The latter are not present in the executive session and substantially increase Member State influence in the decision-making. See: SRM Regulation, Art. 49 \textit{juncto} 43(1) and Art. 3(1) of the Decision of the Plenary Session of the Board of 29 April 2015, adopting the Rules of Procedure of the Single Resolution Board in its Plenary Session, (SRB/PS/2015/9).

\textsuperscript{103} The SRB, in plenary session, will also evaluate the application of the resolution tools and provide guidance which the executive session shall follow in subsequent resolution decisions once the net accumulated use of the Fund in the last consecutive 12 months reaches the threshold of €5 billion. See: SRM Regulation, Art. 50(1) sub (d).

\textsuperscript{104} This does not only concern the use of the SRF above the threshold of 5 billion euro, but also some other decisions and tasks as set out in Article 50 SRM Regulation.

\textsuperscript{105} As is also stated in recital 24 of the SRM regulation ‘Given the considerable impact of the resolution decisions on the financial stability of Member States and on the Union as such, as well as on the fiscal sovereignty of Member States, it is important that implementing power to take certain decisions relating to resolution be conferred on the Council.’
at EBU level. In relation thereto, the SRF was established by the EBU Member States. The SRF may however not be used to directly recapitalise a bank.\textsuperscript{106} Instead, the European Stability Mechanism (ESM) has been granted the power of direct bank recapitalisation in relation to banks that are established in the Eurozone.\textsuperscript{107} During the negotiations on the EBU, access to a common fiscal backstop at EBU level proved still highly sensitive. This resulted in a regime which aims to avoid public bailouts by imposing strict bail-in requirements and leaves primary fiscal responsibility for resolution at the level of national Member States.\textsuperscript{108} In December 2017, the Commission however believed the time was right to publish a proposal for a Council Regulation on the establishment of the European Monetary Fund (the EMF).\textsuperscript{109} It is the intention that the EMF will replace the ESM and take over its tasks. In addition, it will get a new task consisting of providing credit lines or setting guarantees in support of the SRB for any task assigned to it.\textsuperscript{110}

The mutualisation of the costs of bank recapitalisation is not the only element of the EBU resolution regime that contributes to weakening the links between sovereigns and their banks. An important tool in this regard is the bail-in tool that is now available to resolution authorities in the resolution of banks. The bail-in tool aims to ensure that taxpayers do not suffer losses and banks are kept under market discipline. Although the Banking Communication adopted by the Commission in 2013\textsuperscript{111} (the 2013 Banking Communication) already formed a prelude, the shift from bail-out to bail-in is a crucial element of post-crisis bank resolution regulation. The strict new bail-in requirements under the SRM and, as of 1 January 2016, the control over the application of the bail-in tool by the SRB, however led to EBU Member States’ unease. This triggered a number of EBU Member States to place banks in resolution before the new regime kicked in.\textsuperscript{112} This did not mean that no bail-in was required at all. We emphasize that in any case, in order to get approval for the award of State aid (e.g. in the form of public recapitalisation) from the Commission, the bail-in requirements under the post-crisis State aid regime should be met. Discussions with the Commission however tend to give some space for manoeuvre, while the discussion with the SRB is much more defined in the EBU resolution regime.

In the following part we will examine what, if any, possibilities are left for Member States under the EBU resolution regime to recapitalise their banks (with the help of the SRF and/or the ESM) and whether a bail-in under the EBU resolution regime can be avoided. We will pay specific

\begin{itemize}
  \item \textsuperscript{106} SRM, Art. 76(3).
  \item \textsuperscript{107} The ESM only gained the competence to provide direct capitalisation to failing banks in December 2014 – see the section on ‘direct recapitalisation by the ESM’ below. The direct recapitalisation tool has not been used yet by the ESM. The ESM did use the ‘indirect recapitalisation tool’ in December 2012 and February 2013, as a result of which the Spanish government could restructure its banking sector, centring on the saving banks or cajas. See: \url{https://www.esm.europa.eu/assistance/spain} (last accessed on June 2017).
  \item \textsuperscript{108} See: Hadjiemmanuil (2015).
  \item \textsuperscript{109} European Commission (2013c). The Annex to the Proposal contains the proposed Statute of the European Monetary Fund (the Proposed EMF Statute).
  \item \textsuperscript{110} Proposed EMF Statute, Art. 3(2) sub b.
  \item \textsuperscript{111} European Commission (2013b)
  \item \textsuperscript{112} Italy for example placed a number of banks under resolution shortly before 1 January 2016, in order to avoid the full application of bail-in under the SRM. See: Stanghellini (2016), p 159. See for an overview of recent resolution and State aid cases: Mesnard (2016).
\end{itemize}
attention to the examples from the Italian banking sector. Before we turn to the possibilities for recapitalisation during resolution and outside of resolution under the current EBU resolution regime, we pay some attention to the burden-sharing principle under the post-crisis State aid regime, as this principle is still relevant today.\textsuperscript{113}

\textit{Burden sharing under the post-crisis State aid regime}

The provision of State aid to financial institutions falls within the scope of the EU State aid regime. The general principle, laid down in Article 107 TFEU, prohibits Member States from granting aid to undertakings which distorts or threatens to distort competition. In specific circumstances exceptions are allowed. Indeed, during the Global Financial Crisis Article 107(3) sub (b) TFEU, which allows State aid in order to “\textit{remedy a serious disturbance in the economy of a Member State}”, was used as a legal basis to ease the reigns on the State aid prohibition. The Commission has detailed the conditions for its assessment of applicability of this exception through the adoption of a framework for temporary State aid in a series of Communications.\textsuperscript{114}

However, the adoption of regulatory and institutional changes in the wake of the crisis, including the EBU resolution regime, necessitated a reflection on the State aid regime. Consequently, in July 2013, the Commission adopted the 2013 Banking Communication, replacing the Banking Communication of 2008. The 2013 Banking Communication reiterates the principle that before any aid is granted all burden-sharing measures of a bank’s shareholders and junior debt holders should be exhausted. In other words: public recapitalisation of a capital shortfall is only allowed, if accompanied by a bail-in on a bank’s equity and junior and hybrid debt holders.\textsuperscript{115} When the identified capital shortfall of a bank does not extend to a breach of the regulatory minimum the bank must first try, and will normally be able, to restore its capital position on its own primarily by raising capital. If this proves inadequate and no other supervisory action, such as early intervention measures, is possible then subordinated debt must be converted into equity, in principle before State aid is granted.\textsuperscript{116} When there is a capital shortfall to such a degree that the bank no longer meets the minimum regulatory capital requirements equity, hybrid capital and subordinated debt must fully contribute to offset losses.\textsuperscript{117} Infringement of the minimum capital requirements thus requires a write-down or conversion of the bank’s junior debt before State aid is allowed. The 2013 Banking Communication does not require write-down or conversion of senior debt. In addition, the Commission grants that no bail-in is required where implementing such measures would endanger financial stability or lead to disproportionate results. This could cover cases where the amount of aid is small in comparison to the bank’s risk weighted assets and the capital shortfall has already been reduced, particularly by raising capital.\textsuperscript{118}

\begin{itemize}
\item[113] The Commission still applies this principle in its assessment of State aid awards in the banking sector.
\item[114] Quigley (2012).
\item[115] The Commission does not require contributions from senior debt holders as a prerequisite to State aid.
\item[116] European Commission (2013b), para 43.
\item[117] European Commission (2013b), para. 44.
\item[118] European Commission (2013b), para 45.
\end{itemize}
Recapitalisation during resolution

We now continue discussing the possibilities that are left for public recapitalisation of a bank in resolution and whether a bail-in can be avoided. For completeness sake, we note that with “public recapitalisation” we mean a recapitalisation by a Member State or through Member State resources. With “bail-in” we mean the power to write down or convert relevant capital instruments and the application of the bail-in tool on eligible liabilities under the EBU resolution regime. The sequence of bail-in provides that shareholders bear first losses followed by the bank’s creditors in accordance with the creditor’s hierarchy laid down in national law.\(^{119}\) The application of bail-in is limited by an exclusion of, *inter alia*, covered deposits. Additionally, the ‘no creditor worse off’ principle applies. This means that no creditor shall incur greater losses than would be incurred, if the bank had been wound up under normal insolvency proceedings.\(^{120}\)

a. Application of GFST

The BRRD allows for public support, to a bank in resolution, by applying GFST. Before public funds may be administered to a bank in resolution through GFST, however, a bail-in, through write-down or conversion, of stakeholders amounting to at least 8% of the bank’s total liabilities has to be applied.\(^{121}\) As discussed, it is questionable whether the GFST are also available under the SRM Regulation. Recapitalisation of a bank in resolution under the SRM can therefore in principle only take place through the application of the bail-in tool.\(^{122}\) This means that under the SRM Member States cannot recapitalise a bank that is in resolution – unless they happen to be a shareholder or creditor of a bank in which case they may be forced to contribute to the recapitalisation of the bank by means of the application of the bail-in tool.

b. Contribution by the national resolution funds or the SRF

The national resolution funds may not be used to recapitalise a bank.\(^{123}\) The national resolution authorities may however decide to use the national resolution funds for a contribution to the bank under resolution in lieu of the write down or conversion of liabilities of certain creditors, when the bail-in tool is applied and the resolution authority decides to exclude certain creditors from the scope of bail-in in accordance with Article 44(3) to (8) BRRD.\(^{124}\) This requires, in principle, that a contribution to loss absorption and recapitalisation of not less than 8% of the bank’s total liabilities has been made by the shareholders and creditors, and that the contribution of the national resolution fund does not exceed 5% of the bank’s total liabilities.\(^{125}\) Contributions by national resolution funds to the resolution of banks outside the EBU under the BRRD involve the award of State aid, even if financed through private contributions.\(^{126}\)

\(^{119}\) SRM, Regulation, Art. 15(1) sub (a) and (b) *juncto* Art. 17(1).

\(^{120}\) SRM Regulation, Art. 15(1) sub (g) and (h).

\(^{121}\) BRRD, Art.. 37(10)(a); SRM Regulation, Art.. 27(7)(a).

\(^{122}\) BRRD, Art. 43(2).

\(^{123}\) BRRD, Art. 101(2).

\(^{124}\) BRRD, Art. 101(1)(f).

\(^{125}\) BRRD, Art. 44(5).

\(^{126}\) 2013 Banking Communication, point 64.
result contributions can only be made to a bank that is put in resolution and after this has been approved by the Commission upon request of a Member State.

The foregoing is a bit different for contributions from the SRF. Supranational resources that are centrally managed by EU institutions and are not directly or indirectly under the control of the Member States are not considered as State resources for the purposes of Article 107(1) TFEU. The use of the SRF is directed by the SRB. The Member States therefore have no direct control over the use of the SRF, although when specific resolution action requires more than €5 billion of the SRF a decision to this effect has to be taken by the SRB in plenary session. Although contributions from the SRF may not qualify as State aid, the Commission however applies to the use of the SRF the criteria established for the application of State aid rules as enshrined in Article 107 TFEU. Any contributions by the SRF therefore require the prior approval from the Commission. In addition, contributions can also only be made to a bank that is put in resolution, taking into account the restrictions that the SRM Regulation sets for the use of the SRF. The SRF may also not be used to directly recapitalise a bank in resolution. Same, as for the national resolution funds, the SRF can however contribute to a recapitalisation where an eligible liability or class of eligible liabilities is excluded or partially excluded from the bail-in tool. Such contribution is capped to a maximum of 5% of a bank’s total liabilities. In extraordinary circumstances, after all unsecured non-preferred liabilities other than eligible deposits have been written down or converted in full, further funding, in excess of the 5% limit, may be sought.

c. Direct recapitalisation by the ESM

As of December 2014, direct recapitalisation of banks by the ESM has become possible through the adoption of the Direct Recapitalisation Instrument (DRI). Failing banks which are systemically important or whose failure would likely threaten financial stability in the Eurozone

127 As soon as such resources come under the control of a Member State, they are however regarded as State resources. Bacon (2017), p 66; Quigley (2015), p 45.
128 The SRF has a target level of 1% of the guaranteed deposits of all banks authorised in the EBU. The SRF is funded by ex-ante and extraordinary ex-post contributions raised, at national level, from the covered banks. The estimated size of the SRF will be €55bn. This amount is insufficient to fund resolution in a systemic crisis. In certain cases the SRF may also seek additional ex-ante or ex-post contributions or alternative funding. Such alternative funding can also come from the EMF, after the Commission’s proposal has been adopted. SRM regulation, Arts 69, 70, 71, 73 and 74. See: Schillig (2016), p 331; Gordon and Ringe (2015), p 1348; Gros and Groen (2015).
129 SRM Regulation, Art. 19(1).
130 SRM Regulation, Art. 67(2).
131 SRM Regulation, Art. 76(3).
132 Such contribution may be used to (a) cover any losses which have not been absorbed by eligible liabilities and restore the net asset value of the institution under resolution to zero, or (b) purchase instruments of ownership or capital instruments in the institution under resolution, in order to recapitalise the institution. SRM Regulation, Art 27(6).
133 BRRD, Arts. 44(5)(b) and 44(7); SRM Regulation, Art. 27(7)(b).
134 SRM Regulation, Art. 27(9) and (10).
135 Before the creation of the direct recapitalisation instrument the ESM could only recapitalise financial institutions indirectly by providing a loan to an ESM Member State government. See also: Press Release, ‘ESM direct bank recapitalisation instrument adopted’, 8 December 2014.
136 The scope of financial assistance by the ESM is equated to credit institutions, financial holding companies and mixed financial holding companies as referred to in Articles 2(3) - (5) of the SSM Regulation.
or the affected Member State, can now receive direct recapitalisation from the ESM.\textsuperscript{137} The ESM may decide upon using the DRI upon request of an ESM Member State. The requesting ESM Member State must be unable to provide the necessary financial assistance to the bank in full without very adverse effects on its own fiscal sustainability, even when the Member State has received a loan from the ESM for the recapitalisation of the bank.\textsuperscript{138} Additionally, the DRI can also be considered when other alternatives would have the effect of endangering the continuous market access of the requesting ESM Member and consequently require the financing of its sovereign needs via the ESM.\textsuperscript{139}

Use of the DRI is conditional to (1) a bail-in, through write-down or conversion, amounting to at least 8\% of the total liabilities; (2) a contribution of the resolution financing arrangement of 5\% of total liabilities has been made, either by the SRF or national resolution funds\textsuperscript{140}; (3) all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full;\textsuperscript{141} and (4) the requesting Member State makes a capital contribution alongside the ESM.\textsuperscript{142} Consequently, the DRI cannot be used outside resolution, as a precautionary recapitalisation instrument, as discussed below.\textsuperscript{143} The DRI will also be available after the EMF has been established in accordance with the Commission’s proposal.\textsuperscript{144}

It can be derived from the foregoing that recapitalisation of a bank in resolution always involves the application of the bail-in tool. A Member State (by means of the GFST), the SRF and national resolution funds, and the ESM can contribute to the recapitalisation, but only, if a bail-in takes place. In addition, in case the resolution takes place under the SRM, the possibilities for Member States to contribute to the recapitalisation are rather restricted, if one pursues that the GFST are not available under the SRM, takes into account that the national resolution funds are not available under the SRM and the use of the SRF is controlled by the SRB. Member States can then actually only request the ESM to apply the DRI. Application of the DRI does require that the Member State itself also contributes to the recapitalisation. We understand that Article 27(9) of the SRM Regulation caters for that situation.

d. Exclusion of liabilities from bail-in

A bail-in might not always be desirable.\textsuperscript{145} The drawbacks of a bail-in have recently come to the fore in Italy. There, some banks, most notably the world’s oldest bank Monte dei Paschi di

\textsuperscript{137} ESM Guideline on Financial Assistance for the Direct Recapitalisation of Institutions, 8 December 2014, (ESM Guideline), Art. 3(1)(b).
\textsuperscript{138} ESM Guideline, Art. 3(2)(a).
\textsuperscript{139} Ibid.
\textsuperscript{140} It is our understanding that the reference made to the national resolution funds should be seen against the backdrop of the set-up of the SRF, taking into account that the national resolution funds play no role within the SRM.
\textsuperscript{141} ESM Guideline, Art. 8(3).
\textsuperscript{142} The ESM board can partially or fully suspend the contribution in exceptional cases. ESM Guideline Art. 8 and 9.
\textsuperscript{143} ESM Guideline, Art. 8(1). Precautionary recapitalisation is provided by Art. 32(4)(d)(iii) BRRD and Article18(4)(d)(iii) SRM.
\textsuperscript{144} Proposed EMF Statute, Art. 19.
\textsuperscript{145} Scott finds that: “The major shortcoming common to all forms of creditor bail-in, aside from the very wide ranging financial and legal uncertainty associated with implementing it, is the significant destabilizing effect it
Siena (MPS), stuck with large non-performing loans portfolios, have come under stress. Further complicating the implications of a bail-in is the fact that much of the bail-in-able debt is held by private investors, which invested their pensions in bank bonds. This rendered a bail-in on these classes of investors deeply unpopular.

The difficulties surrounding the bail-in on MPS may be illustrative to a broader issue, namely to what extent a uniform resolution regime is equipped to account for heterogeneous markets. Indeed, the conditions under which a bank failure occurs are relevant for the (broader) effects of resolution measures. Applying bail-in to a bank which is failing due to a systemic crisis, has a higher risk of contagion, as creditors withdraw their claims, than a bail-in of a bank which is failing as a result of idiosyncratic shocks, for example fraud. This provokes the question whether different circumstances necessitate a differentiated approach to resolution, specifically bail-in, and whether the SRB or the national resolution authorities are legally capable and willing to do so.

Besides the statutory exclusion of certain liabilities from bail-in, the SRB and the national resolution authorities do have some discretion to exclude certain classes from bail-in. In exceptional circumstances liabilities may be excluded where:

(a) it is not possible to bail-in a liability within a reasonable time;
(b) the exclusion is necessary for the continuity of critical functions;
(c) the exclusion is necessary to avoid widespread contagion, especially regarding eligible deposits of natural persons and SME enterprises, which would disrupt the functioning of the financial markets, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union; or
(d) the application a bail-in to those liabilities would cause losses on other creditors to be higher than if those liabilities were excluded.

Especially option (c), seems relevant in relation to the difficulties sketched earlier. As, arguably, the bail-in of bonds held by retail investors could trigger widespread panic and lead to bank runs.

could exert on short-term creditors of financial institutions that are targeted by regulators for recapitalization, as well as of any other institutions that are not explicitly targeted by regulators but that creditors fear could become targets in the future.” See: Scott (2016), p 177.
146 Merler (17 March 2017); Gandrud and Hallerberg (2017).
148 SRM Regulation, Art. 27(3) sub (a)-(g). Excluded classes are amongst others covered deposits, secured liabilities and liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days.
149 SRM Regulation, Art. 27(5) mirroring BRRD, Art. 44(3).
150 This seems to be the case in Italy where ‘infuriated and scared customers started to withdraw deposits from the new banks, putting them under pressure notwithstanding their high capital and liquidity ratios, reducing their value (and, therefore, increasing the losses for the resolution fund) and potentially igniting a wider crisis’. See: Stanghellini (2016), p160. Avgouleas and Goodhart point out that the possibility to exclude liabilities from bail-in is an important instrument to diminish contagion concerns arising from the bailing in of liabilities held by individuals and SMEs are also acknowledged by. See: Avgouleas and Goodhart (2015), p 17.
An exclusion should be justified in the public interest and may not discriminate, directly nor indirectly, on the grounds of nationality.\textsuperscript{151} As mentioned earlier such discretionary powers are – when exercised by the SRB – subject to limitations under the Meroni doctrine and consequently need to be approved by the Commission through its endorsement of or objection to the resolution scheme. The SRB, however, does not seem keen to exclude liabilities held by retail investors. Ms König, Chair of the SRB, stated in relation to the Italian unrest, ‘that a bank used cheap retail money to fund itself is not a reason to say that something went wrong and... that you get bailed out’.\textsuperscript{152} The SRB criticizes Italy for non-compliance with the European provisions ensuring investor protection, as the placement of subordinated debt with retail investors may expose them to, unforeseen, excessive risks.\textsuperscript{153} Whether this persistence by the SRB on the full application of bail-in will endure during a systemic crisis remains to be seen.

\textit{Recapitalisation outside resolution}

As we have seen in the preceding paragraphs, the possibilities for a Member State to assist a bank in resolution are fairly limited under the SRM. The GFST are - presumably - not available for Member States, the SRF is under the control of the SRB and the SRB decides upon the exclusion of liabilities from the scope of the bail-in tool (unless Art. 7 SRM Regulation determines that an NRA is the relevant resolution authority). Member States only have the possibility to request the ESM (the future EMF) to apply the DRI, albeit that this instrument may only be applied following a bail-in.

In the following, we aim to review what possibilities remain for a public recapitalisation outside resolution. As discussed, the EBU resolution regime restricts the possibility for a bailout of a bank in resolution without a preceding bail-in of, at least, the capital instruments. Therefore, if a bailout of a bank is desired without an accompanied bail-in, the bank should be recapitalised while avoiding that it is placed in resolution. This can be achieved through the provision of capital by the central bank by means of normal monetary policy operations or, when the bank is no longer eligible for the former, by Emergency Liquidity Assistance (ELA). Alternatively, resolution can be avoided through a private sector capitalization or in specific circumstances through a public precautionary recapitalisation.

a. Lender of Last Resort: Emergency Liquidity Assistance

Ever since Bagehot’s rule, of the year 1873, the conventional wisdom of central bankers holds that during times of financial distress, central banks, in order to maintain financial stability,

\textsuperscript{151} SRM Regulation, Art. 6 and recital 60. BRRD, Art. 44(3).
\textsuperscript{152} See: Brunsden and Jenkins (2016)
should lend liberally to illiquid but not insolvent financial institutions. Such an arrangement is commonly referred to as a Lender of Last Resort (‘LoLR’) function.

During normal times, a Eurozone bank can receive credit from the ECB through its normal monetary policy operations. Banks may, at an interest rate set by the Governing Council and against approved collateral, take out loans from the ECB. However, when a solvent bank cannot produce acceptable collateral for normal monetary policy operations, it may turn to its Eurosystem national central bank (NCB) to draw upon Emergency Liquidity Assistance (ELA).

While the exact rules and procedures on the provision of ELA are (intentionally) shrouded in mystery, the ECB has stated that ELA can be granted to illiquid but not insolvent credit institutions. Central bank loans to insolvent institutions may be incompatible with the prohibition on monetary financing (when bringing relief to EBU Member States). From an economic point of view this is also undesirable due to associated market distortions and moral hazard problems. Furthermore, ELA can only be provided against adequate collateral. Furthermore ELA is limited to the temporary provision of liquidity in very exceptional circumstances.

Through the provision of ELA the NCB provides (a) central bank money and/or (b) any other assistance that may lead to an increase in central bank money. The NCB bears the costs and risks for the ELA granted by it. The decision to – and the responsibility for – the provision of ELA lies primarily with the NCBs.

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154 The distinction between illiquid and insolvent has, in practice, proven to be difficult. As the crisis has shown that illiquidity may very well lead to insolvency. Illiquidity most often has the effect of deteriorating confidence. This, in turn, might impede access to the financial markets rendering its assets less valuable, while the firm liabilities become more expensive. See: Blinder (2013), pp 103-104. However J. B. DeLong points out that this nuance was already present in Bagehot’s work. Indeed, the famous maxim “Illiquid but not insolvent” should be interpreted as meaning that central banks should only lend against collateral that would be good in ordinary times. At the same time, it will be very difficult to determine what, during time of crisis, worthless collateral will in normal times be good. See: DeLong (2012).

155 4th Protocol, Art. 18.

156 The ratio to keep the requirements to ELA vague are related to moral hazard concerns. Such ‘constructive ambiguity’ on the terms and conditions to ELA support prevents banks from counting on such supports, thus keeping them subject to market discipline. See: Domanski et al. (2014), p 61; Xirou (2017).

157 Further guidance as to when a bank is considered to be solvent by the ECB can be found in the Agreement on emergency liquidity assistance, 17 May 2017.

158 Art. 123, TFEU. Sinn (2014), p 169-175. See also the opinion of the ECB of 3 February 2017 on liquidity support measures, a precautionary recapitalisation and other urgent provisions for the banking sector (CON/2017/01), footnote 40. According to the ECB the financing by a national central bank of an insolvent credit institution would be incompatible with the monetary financing prohibition since the national central bank would be assuming a government task.

159 European Central Bank, The EU arrangements for financial crisis management, ECB Monthly Bulletin 1, 81 (Feb. 2007).

160 European Central Bank, ‘The procedures underlying the Governing Council’s role pursuant to Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank with regard to the provision of ELA to individual credit institutions’, (2015), (ELA Procedures). See also: Scott (2016), pp 116-120.

161 ELA Procedures.

162 Whether this task should be transferred to the ECB is up for discussion. Especially with the establishment of the Banking Union, and the subsequent pooling of banking supervision at the EU level, the ECB would seem in a better position to complement its supervisory tasks of significant credit institutions with a LoLR functions.
There are however some European checks on the provision of ELA. The NCB has to inform the ECB’s Governing Council of the detail of any ELA operations. If the ELA operations envisaged exceeds an amount of €500 million, the NCB must inform the ECB as early as possible prior to the extension of the intended assistance. In instances where the ELA exceeds a threshold of €2 billion, the Governing Council will consider whether there is a risk that this may interfere with the objectives and tasks of the Eurosystem. When the Governing Council, acting with a two-third majority, finds that this is the case, it may restrict the ELA operations.\footnote{Article 14.4 of the ESCB Statute.}

b. Public precautionary recapitalisation

Both the BRRD and the SRM Regulation allow under specific circumstances for Member States to grant financial support to a struggling bank without triggering the resolution criteria. Indeed, the resolution regime is only set in motion when the bank is failing or is likely to fail, there is no reasonable prospect that a private sector solution, supervisory action or write down or conversion of capital instruments would prevent the failure of the bank within a reasonable timeframe and resolution action is necessary in the public interest.\footnote{BRRD, Art. 32(1). SRM Regulation, Art. 18(1). This concerns the resolution stage, which is the final and most serious stage in the resolution cascade. Preceding phases of bank resolution are first preparatory and preventive measures i.e. resolution planning through the drawing of resolution plans and assessments of resolvability (BRRD, Arts 4-26; SRM Regulation, Arts 8-12). Secondly, early intervention measures may be taken, for example requiring banks to hold own funds in excess of the capital requirements (SRM Regulation, Art. 13). In the third phase the SRB has the possibility to write-down or convert capital instruments of banks which have met the resolution trigger or which are no longer viable unless the relevant capital instruments are written down or converted into equity (SRM Regulation, Art. 21). The SRB assesses whether this is the case in its executive session. Banks are regarded as no longer viable when they are failing or likely to fail and there is no reasonable prospect that any other action, such as private sector measures or supervisory action potentially combined with resolution action, would prevent the bank’s failure within a reasonable timeframe. Write-down and conversion of capital instruments are thus closely related to the resolution stage.}

A bank is considered to be failing or likely to fail, when extraordinary public financial support is required\footnote{BRRD, Art. 32(4)(d). SRM Regulation, Art.18(4)(d). The third option to inject capital in a bank was not present in the Commission’s original legislative proposal for a BRRD but the Council managed to insert it in the course of the legislative procedure. This is illustrative of the desire of Member States to retain at least some form of control over troubled banks.} except where, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, that extraordinary public financial support takes any of the following forms:

1. A State guarantee to back liquidity facilities provided by central banks in accordance with the central banks' conditions;
2. A State guarantee of newly issued liabilities; or
3. An injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the entity.\footnote{BRRD, Art. 32(4)(d). SRM Regulation, Art.18(4)(d).}

The third option provides Member States with a possibility to inject capital in the bank, upon the latter’s request, in order to address a capital shortfall without triggering the resolution
scheme. Although not denominated as such by the BRRD or SRM regulation, the third option is commonly referred to as precautionary recapitalisation. This option provokes the question to what degree EBU Member States could use the administration of extraordinary public financial support to prevent that the control over a bank’s fate is shifted to the SRB.

Precautionary recapitalisation is subject to numerous other conditions besides the requirement that the support is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. These conditions amount to the following: the bank must be solvent; the support must be approved under the Union State aid framework; the support must be of a precautionary and temporary nature; the support must be proportionate to remedy the consequences of the serious disturbance; and the support may not be used to offset losses that the bank has incurred or is likely to incur in the near future. Furthermore, the injection of capital should be limited to what is needed to address a capital shortfall identified under the adverse scenario of a stress test. Additionally, the bank may not, at the time of the precautionary recapitalisation, meet the circumstances under which it is considered failing or to likely to fail. Finally, the injection of capital must be at prices and on terms that do not confer an advantage upon the entity.

In order to establish whether precautionary recapitalisation is truly an instrument for a Member State to recapitalise a bank without interference by the SRB or the application of a bail-in, it is important to establish which entity has the authority to decide whether the conditions for precautionary recapitalisation, as set out above, are met. Most notably, this concerns the conditions that the bank is not failing or likely to fail and that the bank is solvent.

**The bank does not meet the conditions triggering the failing or likely to fail status**

As discussed in paragraph IV, the assessment whether a bank is failing or likely to fail is made by the ECB for those entities it directly supervises pursuant to the SSM, after consulting the

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167 In contrast, the State guarantees to back liquidity facilities and State guarantees on newly issued liabilities (i.e. option (i) and (ii) allow the bank to address temporary liquidity problems. See: Olivares-Caminal and Russo (2017), p 7.

168 The ECB explained, in a rephrasing of the BRRD and SRM Regulation, that precautionary recapitalisation entails an “injection of own funds into a solvent bank by the state when this is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. It is an exceptional measure that is conditional on final approval under the European Union State aid framework. It does not trigger the resolution of the bank.” ECB explainer on precautionary recapitalisation, ‘What is a precautionary recapitalisation and how does it work?’ 27 December 2016’ See: www.bankingsupervision.europa.eu (last accessed on 13 February 2018) (‘ECB explainer on precautionary recapitalisation’).

169 This of course presupposes that the concerned bank falls within the remit of the SRB. This is discussed in paragraph III.


171 In the Commission’s original BRRD proposal the public financial support was limited to a maximum duration of three months.

172 This is the case when entity infringes, or will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the ECB, including the fact that the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; or when the assets of the entity are, or will, in the near future, be less than its liabilities; or the entity is, or will, in the near future, be unable to pay its debts or other liabilities as they fall due. See BRRD, Art 32(4)(a)-(c). SRM Regulation, Art 18(4)(a)-(c). BRRD, Art. 32(4)(d). SRM Regulation, Art.18(4)(d) read in conjunction with the ECB explainer on precautionary recapitalisation.


Electronic copy available at: https://ssrn.com/abstract=3309189
SRB. Alternatively, the SRB, in its executive session, may make such an assessment after informing the ECB of its intention and only if the ECB, within three calendar days of receipt of that information, does not make such an assessment. While Member States have representatives in the decision-making bodies of these supranational institutions, their individual influence in the decision-making of these institutions is limited. The determination whether a bank is failing or likely to fail is therefore predominantly of a supranational character.

The bank must be solvent

A closely related condition is the fact that a recipient of a precautionary recapitalisation must be solvent. After the bank applies to its government authorities for a precautionary recapitalisation, the ECB has to be informed and must confirm that the bank is solvent. According to the ECB a bank is solvent if it fulfils the minimum capital requirements (Pillar 1 requirements) and does not have a shortfall under the baseline scenario of the relevant stress test. Véron notes that the ‘solvency’ requirement seems at odds with the condition that the bank is not failing or likely to fail as the latter are more demanding than a mere solvency test.

Importantly, both the ‘failing or likely to fail test’ and the ‘solvency test’ are characterised, to a certain extent, by a subjective element as the valuation of many banks’ assets is extremely difficult and depends on various assumptions. This is, for instance, illustrated by the diverging valuations of Monte dei Paschi di Siena’s (MPS) assets, where the ECB increased the identified capital shortfall with EUR 3.8 billion in a mere three months. Accordingly, the application of subjective criteria combined with limited transparency on the considerations underpinning the decision, runs the risk of casting suspicions that political deliberations may be inserted in these determinations.

174 These are banks considered by the ECB to be ‘significant’ pursuant to Art. 6(4) of the SSM Regulation or banks in relation to which the ECB has decided to exercise direct supervision in accordance with Art. 6(5)(b) of the SSM Regulation.

175 SRM Regulation, Art.18(1).

176 See: ECB explainer on precautionary recapitalisation.

177 BRRD, Art. 32(4)(d). See: EBA, in its Single Rulebook Q&A provides that ‘solvency’ in the context of BRRD, Art 32(4)(d) should be interpreted as referring to an institution which does not meet the BRRD, Art 32(4)(a)-(c) conditions for failing or likely to fail. Confusingly however the EBA, in its Single Rulebook Q&A provides that ‘solvency’ in the context of BRRD, Art 32(4)(d) should be interpreted as referring to an institution which does not meet the BRRD, Art 32(4)(a)-(c) conditions for failing or likely to fail. Furthermore, EBA states that, “as regards Article 32(4)(a), the concept of solvency does not refer to meeting conditions for authorisation that would relate to non-financial resources (such as systems and controls)”. The EBA’s (non-binding) interpretation of solvency seems to align the concept of solvency to a larger degree with the 32(4)(a)-(c) conditions for failing or likely to fail. See: www.eba.europa.eu/single-rule-book-qa

178 Véron (2017), p 12. The double requirement can perhaps be explained by the fact that the solvency requirement applies to all forms of extraordinary public financial support (i.e. also for State guarantees), whereas the requirement that the entity is not failing or likely to fail is added specifically in relation to the provision of precautionary recapitalisation.

179 The EBA notes, in its Guidelines on the failing or likely to fail considerations that “while the objective elements listed in these Guidelines should be carefully analysed (…) the determination that an institution is failing or likely to fail should remain an expert judgement and should not be automatically derived from any of the objective elements alone.” See: EBA (2015), p 12. See also: Hellwig (2017), p 22 and Groen (2017), pp 11-12.

180 See: Merler (27 December 2016). Also as indicated by Groen the difference of the book value and the economic value under the most negative adverse scenario for Banco Popular was about € 19.2 billion. See: Groen (2017), p 11.

181 Investors in Banco Popular, for instance, have commenced legal procedures before the Court of Justice questioning, among other things, how the bank was valued. The ECB, making an exception on its general
transparency, it should also be borne in mind that disclosure of calculations and assumptions on which a valuation is based may have far reaching and damaging effects on the concerned bank and, even, possibly others or the financial markets at large.\footnote{Similar transparency dilemmas have surfaced in regards to the valuation of Banco Popular for the purpose of resolution. According to Article 20(1) of the SRM Regulation the SRB has to ensure a fair, prudent and realistic valuation of the assets and liabilities of the bank carried out by an independent person. The resulting ‘valuation report’ functions as an integral part of the decision-making in the resolution decision procedure (Art 20(15) SRM Regulation). In a procedure before the SRB Appeal Panel, appellants sought full disclosure of Banco Popular’s valuation report and the resolution decision. The Appeal Panel found that the SRB decision to deny access in full to the Valuation Report is too far-reaching, ordering the SRB to prepare access to a non-confidential redacted version of the Valuation Report. See: Case 38/2017 (Decision dated 28 November 2017).}

Crucial for the determination if, and if so, to what extent a precautionary recapitalisation is allowed is the result of a bank’s stress test. Indeed, the outcome of the stress test imposes limitations on a precautionary recapitalisation in two ways. First, if a stress-test identifies a capital shortfall under its baseline scenario the bank is marked as insolvent and thus ineligible for a precautionary recapitalisation. This obviously limits the cases in which a recapitalisation is permitted.\footnote{It could be argued that the restrains imposed by the solvency requirements are too narrow. Arguably, in cases where precautionary recapitalisation provides advantages over resolution actions, these benefits are not necessarily diminished by the fact that bank is no longer solvent. Hellwig, for instance, contends that a precautionary recapitalisation has clear benefits over resolution when the troubled entity is a globally systemically important financial institution whose systemically important operations can only be maintained if the organization is kept intact. He indicates that Lehman Brothers was probably insolvent and would thus not qualify for a precautionary recapitalisation, yet it is the poster example of an institution for which a precautionary recapitalisation would have been preferable. See: Hellwig (2017), p 21. The same could arguably be said in regard to the concentration of junior and senior debt with retail customers in Italy which provided an incentive for a precautionary recapitalisation in order to avoid a bail-in of retail investors, regardless of the bank’s solvency.}

Second, the precautionary recapitalisation is capped to the shortfall identified under the adverse scenario of the stress test\footnote{This requirement is subject to criticism as it might lead to an insufficient recapitalisation. Indeed, previous experiences have shown that troubled banks often are in need of more than one recapitalisation action.}.

Given the importance of stress test results for the possibility of a precautionary recapitalisation, it is important to inquire which authority may execute such stress test. The BRRD and SRM Regulation provide that a precautionary recapitalisation shall be “limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities, where applicable, confirmed by the competent authority.”\footnote{Mainly they contend that the principal features of a stress test should be “a timeline, a scope, a time horizon and reference date, a quality review process, a common methodology and, where relevant, a macro-economic scenario and hurdle rates, as well as a timeframe to address the shortfall”}

The EBA has published guidelines on the types of tests, reviews or exercises that may lead to support measures.\footnote{Mainly they contend that the principal features of a stress test should be “a timeline, a scope, a time horizon and reference date, a quality review process, a common methodology and, where relevant, a macro-economic scenario and hurdle rates, as well as a timeframe to address the shortfall”}

These Guidelines are, however, very limited.\footnote{Véron (2017), p 11; Groen (2017), p 17.} Importantly, for significant banks, it is the ECB which has to confirm the existence of a capital shortfall. It has to determine the amount of the shortfall under the adverse scenario on the basis of the most relevant EBA or Supervisory Review and
Evaluation Process stress test exercise. Likewise, the ECB also has to confirm that the bank has no shortfall under the baseline scenario.188

One of the other requirements for precautionary recapitalisation is that the Commission has approved on it under the Union State aid framework.189 This means, inter alia, that the burden sharing principle set out in the 2013 Banking Communication, as described earlier, applies, although the bail-in requirement does not apply. As a result, the Commission, too, is fiercely inserted in the deliberation whether a precautionary recapitalisation is allowed. This is further illustrated by the following description of the Commission’s role in the decision on approving a preliminary recapitalisation of MPS.

Precautionary recapitalisation of Monte dei Paschi di Siena

After it became clear that MPS would not manage to raise enough private capital to address its capital shortfall, it requested State aid from the Italian government. The latter adopted on 23 December 2016 a decree allowing MPS to receive liquidity guarantees and a capital injection.190 The aid would be received from a new €20bn fund, created through public debt issuance, approved by the Italian parliament some days earlier for possible intervention in MPS and, if needed, other troubled institutions.191

On 1 June 2017, Commissioner Margrethe Vestager, in charge with competition policy, reached an agreement in principle with the Italian Minister of Economy and Finance, on the restructuring plan of MPS to enable the precautionary recapitalisation of the bank in line with EU rules.192 Agreed was that, in exchange for public recapitalisation, MPS will go through a far-reaching restructuring with the purpose of ensuring MPS’s viability in the long term. Entailing that MPS will dispose of its entire non-performing loan portfolio on market terms and that it takes a number of measures to substantially increase its efficiency. Additionally, and most interestingly, it was agreed that, in line with EU State aid rules, MPS’s shareholders and junior bondholders will contribute to the costs of restructuring of the bank. This underlines the conclusion that the new resolution regime in combination with the State aid rules have rendered a public funded bailout without a bail-in virtually impossible. As even a precautionary recapitalisation must be accompanied with a partial bail-in of liabilities under the State aid rules.

In the agreement reached between Commissioner Margrethe Vestager and the Italian Minister of Economy and Finance on the restructuring plan of MPS it was however also included that retail junior bondholders, which were mis-sold financial instruments due to inadequate information about potential risks, can be compensated. Indeed, the agreement continues with the determination that “MPS will compensate retail junior bondholders who were mis-sold by

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188 See: ECB explainer on precautionary recapitalisation.
190 Politi and Sanderson (2016).
191 Treanor and Kirchgaessner (2016a); Treanor and Kirchgaessner (2016b).
192 European Commission, ‘Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS)’, Brussels, 1 June 2017.
converting these bonds into equity and buying those shares from the retail investors. MPS will pay retail investors in more secure senior instruments.”

In line with this agreement the Italian government stated that the recapitalisation of MPS is accompanied by a bail-in in the form of a conversion of tier 1 subordinated bonds (mostly held by institutional investors) to equity at 75% of their nominal value. Tier 2 subordinated bonds (approximately €2.2bn) are converted into equity and bought by MPS, at 100% of their nominal value. Additionally, MPS will offer to swap the resulting equity for (senior) bonds, while selling the shares to the State.\footnote{Fonte and Za (2016)}

This solution manages to on the one hand not undermine the bail-in requirements of the State aid regime while on the other hand providing relief for its consequences on retail bondholders.

In view of the above, the European resolution rules, under certain conditions, provide an option for granting public financial support without having to place a bank in resolution. The possibility for a preliminary recapitalisation provides Member States with an opportunity to aid struggling banks and keep them out of the reach of a (supranational) resolution procedure. Importantly, a public precautionary recapitalisation opens a door to recapitalise a bank without having to apply the bail-in requirements under the BRRD or SRM Regulation. However, a precautionary recapitalisation is contingent and subject to numerous conditions the satisfaction and compliance of which are scrutinised by either the ECB or the Commission. Accordingly, the verification whether a bank which falls under direct supervision by the ECB is solvent is executed by the ECB, as is the determination of the maximum amount of capital which may be injected in the bank under the precautionary recapitalisation. At the same time, the State aid rules are applicable and the public recapitalisation has to be approved by the Commission. Furthermore, the State aid rules also require a precautionary recapitalisation to be accompanied by a bail-in of shareholders and junior debt holders. As a result, Member State have little discretion in deciding whether a bank, and under which conditions, qualifies for a preliminary recapitalisation which restrains their possibilities to use the precautionary recapitalisation as an instrument to retain control over a struggling bank.

c. Private sector capitalization

The delineation between on the one hand measures which constitute State aid – and are thus subject to the State aid regime – and on the other hand private investments is a subtle one. This is – again – illustrated by the MPS case.\footnote{Fonte and Za (2016)}

The ECB had identified a capital shortfall during a stress test and required MPS to raise €5bn, later raising this figure to €8.8bn.\footnote{Politi (2016a)} The Italian government, confronted with large amounts of non-performing loans in its banking sector and wider economic stagnation, sponsored the establishment of a bank fund which serves as backstop to the Italian banking sector, aptly named ‘Atlas’. Atlas acts as subscriber of last resort for newly raised capital and buys junior and mezzanine tranches of securitized non-performing loans. These loans are bundled by Special Purpose Vehicles, into Asset Backed Securities. The senior tranches of these ABS are eligible
to State guarantees, which boosts their rating and thus their value. The Commission considered the guarantees on the senior notes in compliance with the State aid rules. It arrived at this conclusion because (1) the guarantees are conditional to the fact that at least half of the junior tranches are sold to private investors; (2) the risks for the State are limited because the State guarantees only apply to the senior tranche; and (3) because the State guarantees are to be priced at market terms. In addition, the Commission considered the Atlas Fund itself not to constitute State aid.

Still, the Atlas Fund did not succeed in restoring the Italian banking sector; it was too small and by requiring contributions from a number of financial institutions even increased their interconnectedness exacerbating contagion risks. Even a second fund (‘Atlas II’) did not provide a solution as the fund manager had strong reservations on the terms of a bridge loan to MPS. Additionally, the uncertain political climate, arisen from the lost referendum on constitutional reform and the subsequent resignation of prime minister Renzi, did not help the attraction of major investors.

This left the Italian government, wanting to avoid submitting MPS to European resolution and hence the SRB, with no other option than to explore other ways of recapitalisation. MPS entered public precautionary recapitalisation as discussed in the preceding paragraph.

VI. CONCLUSION

In the light of national concerns, the desire of Member States to remain involved in resolutions decisions is understandable. At the same time, the functionality of the SRM is questioned due to its cumbersome governance structure. Which in turn causes Member States to preserve national backup resolution powers or take measures to keep banks outside resolution. Divergent national approaches to bank resolution have however proven to be ineffective.

In the preceding we addressed the question whether, and if so, to what extent, EBU Member States retain discretion over bank resolution decisions. This question was explored along three lines of inquiry.

First, we found that the EBU Member States have surrendered the decision-making on bank resolution to the EBU level, specifically to the SRB. The latter has the power to apply the resolution tools provided by the SRM Regulation. The SRM regulation, consequently, provides for maximum harmonisation, leaving no room for national resolution tools. The SRM

195 Merler (22 April 2016); Jenkins and Sanderson (2016).
198 Sanderson et al. (2016).
199 Politi (2016b).
200 Arnold and Sanderson (2016).
Regulation does however not provide for a basis for the exercise of resolution powers by the SRB. As a result, thereof, the resolution powers are always exercised by the NRAs on the basis of the implementation by their respective Member State of Chapter VI of the BRRD, also in relation to the implementation of a resolution scheme that has been adopted by the SRB.

The second line of inquiry analyses Member States’ influence in the SRB’s decision-making. We found that the SRM has both a supranational and an intergovernmental dimension. At the one hand, resolution decisions, involving less than €5 billion, are made in by the SRB in its executive session, leaving little room for Member State influence. At the same time, Member States influence remains substantial through the involvement of the Council and the SRB in plenary session in key decisions.

The third line of inquiry considered (a) the possibilities for an EBU Member State to assist a failing bank through public recapitalisation, and (b) the situations in which such assistance would not trigger the new general bail-in standard under the BRRD and the SRM Regulation. The conclusion is that the rules imposed by the BRRD and SRM Regulation in combination with the State aid regime have rendered public recapitalisation without a bail-in virtually impossible. Recapitalisation of a bank in resolution always involves the application of the bail-in tool. A Member State (by means of the GFST), the SRF and national resolution funds, and the ESM can contribute to the recapitalisation, but only, if a bail-in takes place. In addition, in case the resolution takes place under the SRM, the possibilities for Member States to contribute to the recapitalisation are rather restricted, if one pursues that the GFST are not available under the SRM, taken into account that the national resolution funds are not available under the SRM and the use of the SRF is controlled by the SRB. Member States can then actually only request the ESM to apply the DRI. Application of the DRI does require that the Member State itself also contributes to the recapitalisation. We understand that Article 27(9) of the SRM Regulation caters for that situation. Outside of resolution, NCBs may assist solvent banks through ELA when they cannot produce acceptable collateral for normal monetary policy operations. In addition, EBU Member States could turn to the possibility of precautionary recapitalisation to prevent that the control over a bank’s fate is shifted to the SRB. Such precautionary recapitalisation is however only possible, if strict conditions are met, including that the bank is considered solvent. Such assessment is again made at European level, by the ECB or the SRB.

The choice that is made to restrict the possibilities for public recapitalisation without applying the strict bail-in standard may be noble, but turns out to be difficult to pursue in practice. The recent troubles in the Italian banking sector and the agreement in principle between the Commission and Italy illustrate the possible adverse effect of an inflexible bail-in requirement. It could be questioned how rigorous the legal framework must be in requiring a bail-in of creditors as opposed to (or at least as a prerequisite to) a possible public bailout. This question should also be appreciated against the backdrop that for several years to come, the new resolution tools will have to be applied to balance sheets that are not quite ready for it.201 Banks face challenges both in meeting the minimum requirement for eligible liabilities (MREL) in

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absolute numbers and creating a funding structure that suits resolution. Inflexible legal obstacles to a public recapitalisation might therefore be counterproductive, also recalling that during the GFC massive public bail-outs and insurances were needed to calm the markets. While it is understandable that the new rules should be strict, leaving little room for public bailouts in order to alleviate moral hazard, an emergency option to do ‘whatever it takes’ at the discretion of public authority should still be available in our view. Admittedly this is somewhat of a paradox, but perhaps unavoidable. The dilemma can be illustrated as an acrobat walking on a tightrope: without a safety net present he has more incentive not to take excessive risks, however if he falls a safety net would still be preferable. Especially when he would otherwise drag others down with him, as failing financial institutions tend to do.

Although the European resolution regime provides for the possibility to exclude liabilities from the scope of the bail-in instrument, the introduction of a general financial stability exemption may further contribute to the efficiency (and adequacy) of the resolution regime.

In the end, we have seen that the EBU Member States have transferred a considerable part of their control over failing banks to the SRB. We encourage this from a level playing field view, but we would also like to stress that the particularities of a failing bank could in some situations be a reason to consider some flexibility in applying the strict bail-in requirements under the SRM.

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