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TOWARDS ESTABLISHING A GENUINE RESOLUTION REGIME FOR BANKS IN THE EUROPEAN UNION

The article traces the evolution of the European Commission's ideas and proposals for the establishment of a genuine resolution regime for credit institutions in Member States and the Banking Union. It examines the common resolution regime, to be introduced by the Bank Recovery and Resolution Directive, which will serve as a basis for the operation of the Single Resolution Mechanism within the Banking Union. The analysis focuses on the characteristic features of the bail-in tool as an alternative to bailout. Special emphasis is placed on the on-going debate at the EU institutions on selected key issues of bank resolution and bail in, as reflected by comparing the initial Commission proposal for the Bank recovery and resolution Directive with the follow up Council's general approach agreement on it.

JEL: G21; G28; G32; G33

During the recent financial crisis many financial institutions, especially those considered too big to fail, were bailed out by large amounts of public funds, which contributed to the sovereign debt crisis. Between October 2008 and October 2011, the European Commission approved different state aid measures for financial institutions amounting to €4.5 trillion (about 37% of EU GDP). They helped avoid massive bank failures but contributed to increasing public debt burden and affected negatively the performance of the real economy. In addition, bailouts caused distortions to competition. State aid support for systemic institutions encouraged excessive risk taking and enhanced moral hazard. Due to all these negative effects bailouts are no longer considered acceptable. At present an understanding prevails that a new approach to failing banks should be introduced, which should put an end to rescuing banks with public funds. In 2009 G20-leaders called for a review of resolution regimes that would make the orderly winding down of large complex cross-border institutions possible (G20, 2009). In 2011 the Financial Stability Board (FSB) published key attributes of an effective resolution regime for financial institutions, which allow bank resolution in an orderly way (FSB, 2011). In the US the introduction of the Dodd-Frank Act further improved the existing resolution arrangements. Since 2008 many Member States (the UK, Spain, Germany, Sweden, etc.) have introduced special resolution regimes for banks but their harmonisation and reinforcement is still to take place through the introduction of common EU rules.

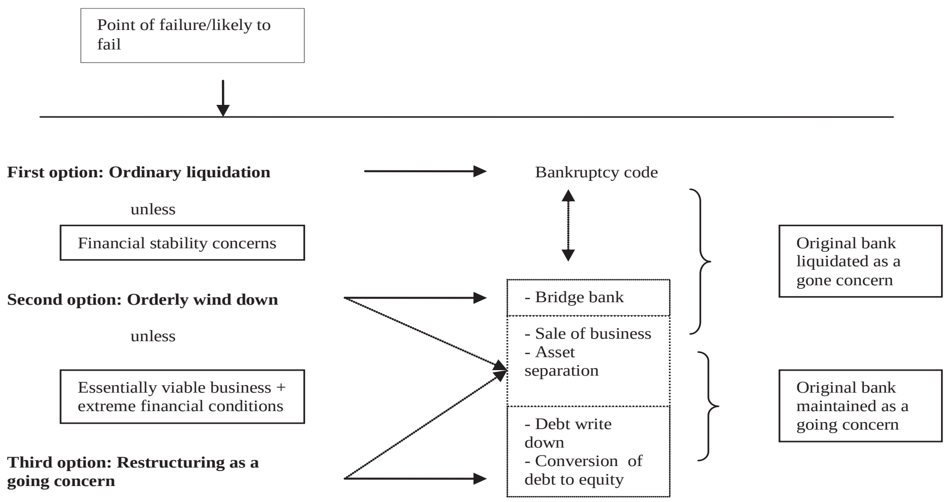
The resolution framework

In June 2012 the Commission published its Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and financial firms, (EC, 2012c) known also as Bank recovery and resolution directive (BRRD). Only a couple of months later, in September 2012, it launched a roadmap towards establishing a Banking Union (BU) (EC, 2012a), which would strengthen the financial stability in the euro area and contribute to breaking the vicious circle between banks and sovereigns. The Single Resolution Mechanism (SRM), which is one of the key building blocks of the BU, is expected to create an effective resolution regime for banks and in particular for cross-border banking groups. It will operate on the basis of the common resolution regime to be introduced by the BRRD. The negotiations on the proposed Directive are still going on. In June 2013 the Council published its general approach agreement as the latest version of the BRRD, which is the basis on which the operation of the SRM has been designed.

The BRRD offers an alternative to bailout by equipping national authorities with common powers and instruments to preempt and manage bank failures in an orderly manner, while preserving essential bank operations and minimizing taxpayers' exposure to losses. It introduces 3 stages of recovery and resolution of banks: (i) preparatory and preventive stage, (ii) early intervention stage, and (iii) a resolution stage. The need for resolution should be reduced to the minimum thanks to strict common prudential rules and enhanced supervision. The general rule applicable at the resolution stage is that failing credit institutions should be liquidated under ordinary insolvency proceedings. However, in some cases an orderly winding down through resolution will be more appropriate and necessary in the public interest because it would minimise contagion, ensure continuity of vital economic functions and preserve the value of remaining assets (see Figure 1.). Any additional resources needed to help finance bank resolution should be provided by the banking sector and not by taxpayers. The resolution principles and rules introduced by the BRRD are in line with the key attributes of effective resolution regimes for financial institutions, developed by the Financial Stability Board (FSB) (FSB, 2011).

Figure 1

Resolution and liquidation



Source: European Commission.

The resolution regime relies on resolution tools, which are of particular importance because they are applied at the stage when banks are close to insolvency. These tools are: (i) a sale of business (or part of business) tool; (ii) a bridge bank tool, which transfers good assets to a publicly controlled entity; (iii) an asset separation tool, which transfers impaired assets to an asset management vehicle, and (iv) a bail-in tool, which allows absorption of losses by shareholders and creditors. The bail-in tool is a new resolution tool, which has been proposed as an alternative to bailout. It has not been sufficiently tested yet, deserves special attention and will be treated in more detail in the next sections.

Resolution authorities

The resolution regime introduces a new approach to failing banks, which cannot be executed by any of the existing authorities. It requires the setting up of new resolution bodies, which will be fully in charge of the resolution function. In order to implement the resolution regime successfully and in a timely manner, Member States (MSs) will have to establish national Resolution Authorities (RAs). They should make an assessment whether a bank meets the conditions for resolution, while the request for assessment should come from the supervisory authority or the concerned bank. The RA is also responsible for choosing the most appropriate resolution tool for the institution under resolution. Each MS will have the flexibility to identify its own RA, which should be an administrative rather than a legal one. RAs may be the competent authorities for supervision, competent ministries, national Central Banks or other public administrative authorities (C, 2013b, p. 61).

One key issue to be addressed when one institution combines the functions of supervision and resolution is the issue of guaranteeing the operational independence of the two functions. First of all the two functions have to be clearly defined and separated. Then, MSs should make sure that there is operational independence between them. Finally, MSs should put in place adequate arrangements to manage any possible conflicts of interest (C, 2013b, p. 61). The debate on the Directive at different EU institutions concluded that the operational independence and clear division of functions between RAs and supervisors would provide the basis for the effective implementation of resolution. It also focused on the need to simplify the assessment and notification procedures regarding resolution triggers in order to speed up the decision and execution of resolution (Roussenova, 2013).

Resolution triggers

Any successful resolution depends on the timely initiation of the action by appropriate triggers. The resolution action should be initiated neither too early nor too late but at the right moment. The difficulty here is how to choose the appropriate timing and select the correct resolution triggers. The discussions with MSs and banking industry representatives concluded that there should be one trigger point for all resolution tools. The debate focused on the choice between soft and hard triggers. Most MSs were in favour of a soft trigger, which would leave the decision to the assessment authorities, while banks expressed concerns regarding the discretion involved in it. Soft triggers usually capture a broader range of factors that might cause bank failures. Quantitative hard triggers (for example the institution no longer possesses sufficient Tier 1 capital instruments) might be too restrictive and might delay intervention but would make it ex-ante known and transparent to stakeholders.

The Commission's preferred option is with the soft trigger – the decision is left to the assessment of authorities (resolution or supervisory authorities), which can apply resolution tools when the institution is *close to failure or fails to fulfil the authorisation conditions*. The proposal for BRRD determines that resolution tools should be applied when the institution *is (i) failing or likely to fail*, (ii) *no alternative private sector or supervisory solutions would be able to prevent the failure* of the institution and restore it within an appropriate timeframe and (iii) the resolution action is necessary in the *public interest*. An institution is *failing or likely to fail* when (C, 2013b, p. 120):

- it is in breach or will be in breach in the near future of the requirements for continuing authorisation due to incurred losses that will deplete all or a significant amount of its own funds;
- the assets of the institution are or will be in the near future less than its liabilities;
- the institution is or will be in the near future unable to pay its debts when they fall due;
- extraordinary public support is required (except in cases when it is needed to preserve the financial stability in the economy of the MS).

The trigger conditions proposed by the BRRD depend on the judgment of authorities, which implies that their application may vary by MS. The issue of potential divergent application of judgment-based triggers by national authorities is addressed by a proposal that the European Banking Authority (EBA) should issue guidelines concerning the interpretation of the circumstances when an institution can be considered as failing or likely to fail.

While giving the assessment authorities the flexibility to judge whether an institution is failing or likely to fail on the basis of compliance or non-compliance with capital requirements is fully acceptable, at the same time the early signals provided by failures to comply with other regulatory requirements should not be ignored. For example, regular breaches of liquidity requirements could be detrimental to the viability of the institution and should also be taken into consideration when assessing whether it is likely to fail (IMF, 2013a, p.15). Unfortunately, both the original and the latest version of the Directive underestimate the advantages of liquidity triggers.

General principles of resolution and the right to a judicial review

Resolution is a highly intrusive action and should be governed by strict principles and rules. The BRRD defines the following general principles governing the application of resolution tools and powers (C, 2013b, p. 124):

- Losses should be allocated at first in full to shareholders and then to creditors following the hierarchy of claims established by the normal insolvency proceedings or alternatively by the BRRD;

●Creditors of the same class should be treated in an equitable manner;

●No creditor should incur losses greater than what he would have incurred if the institution had been wound up under the normal insolvency proceedings.

The RAs should have all the legal powers needed to apply properly the resolution tools, designed and introduced by the Directive. Those powers might include: powers to transfer shares, assets, rights or liabilities of a failing institution to another institution or a bridge institution, powers to write off or cancel shares, powers to write down or convert debt of a failing institution, powers to impose a temporary moratorium on the payment of claims, etc. Such broadly defined powers imply that the decisions made by a RA may seriously interfere with the rights and interests of the affected parties.

According to the Charter of Fundamental Rights, the affected parties have the right to due process and remedy against any measures affecting them. Therefore persons affected by the decisions taken by the RAs should have the right to apply for a judicial review of those decisions. Since the BRRD treats situations of extreme urgency, and as the suspension of any decision of the RAs might impede the continuity of essential functions, and/or even create risks for the stability of financial markets, it is necessary to make sure that the automatic suspension of the resolution decision should not be allowed as it would be considered against the *public interest*. The consideration of public interest prevails over the protection of private rights, as a result of which challenging the decision of the RA in court is possible, but limited. Any remedies for wrongful decisions should be limited to the award of compensation for the damages suffered by the affected person (C, 2013b, p.27).

The Bail-in tool

The IMF defines the bail-in tool as the “statutory power of a resolution authority …. to restructure the liabilities of a distressed financial institution by writing down its unsecured debt and/or converting it to equity” (Jianping et al., 2012). The BRRD follows the same principle and defines the bail-in tool as a tool by means of which a RA could write off all equity, and either write down subordinated liabilities or convert them into an equity claim, when an institution meets the trigger conditions for entry into resolution. MSs may apply the bail-in tool to recapitalize an institution that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for its authorisation (C, 2013b, p.155). The bail-in tool is applicable when there is a realistic prospect to restore the institution to financial soundness and long-term viability.

The bail-in tool is a new resolution tool, which has not been sufficiently tested yet, especially in systemic crises. During the debate on the Commission’s proposal at different EU institutions some concerns were expressed regarding possible spill over effects when the main investors in a bank's eligible liabilities subject to bail-in are other banks with interconnected businesses. Concerns regarding the consequences of the simultaneous activation of the bail-in tool for many financial institutions in periods of systemic crises were also raised (Roussenova, 2011). Similar situations should be considered carefully and addressed appropriately to avoid any risks of contagion. One possible solution, offered by the Council's general approach agreement on the BRRD and discussed below, is the power given to RAs to exclude, or partially exclude from bail in, liabilities on a discretionary basis in order to avoid contagion. However, in a situation of systemic crises such exclusions would hardly be sufficient and perhaps additional preventive measures should be put in place.

Eligible liabilities and the required minimum

In order to achieve its objectives the bail-in tool should be applied as widely as possible to a range of unsecured liabilities of failing institutions. However, it should not be applied to liabilities that are secured, collateralised or otherwise guaranteed. This implies that some liabilities have to be excluded from bail in. The original Commission's proposal excludes ex-ante from bail in the following liabilities: secured liabilities, covered deposits, liabilities with residual maturities less than 1 month, exceptionally some liabilities to physical persons or legal entities when there is a necessity to ensure the critical operations of the institution, tax and social security authorities, provided that those liabilities are preferred under the applicable insolvency law (EC, 2012c, article 38).

The subsequent debate on the Directive modified some of the original exclusions and added new ones. One example is the ex-ante exclusion of liabilities arising from a participation in payment systems, which have a remaining maturity of less than seven days instead of liabilities with remaining maturity less than 1 month. MSs expressed concerns that if liabilities with residual maturities less than 1 month were to be excluded ex-ante from bail-in, that might encourage banks and their customers to deliberately increase such liabilities. Thus the Council's general approach agreement of June 26/27 accepts that the following types of liabilities should be permanently excluded from bail-in: covered deposits, secured liabilities including covered bonds, liabilities to employees of failing institutions (for example fixed salary and pension benefits), commercial claims relating to goods and services critical for the daily functioning of the institution, liabilities arising from a participation in payment systems which have a remaining maturity of less than seven days, inter-bank liabilities with an original maturity of less than seven days, etc. (C, 2013a).

During the debate at the Council many MSs insisted on having certain degree of *flexibility* to exclude liabilities from bail-in in addition to the ex-ante exclusions. Keeping flexibility at a minimum level helps promote the level-playing field across institutions and countries, while maximising it would cause inequality and would jeopardise the harmonisation efforts. The negotiations at the Council on flexibility resulted in a compromise, which introduced a limited discretion (IMF, 2013b),1 allowing national RAs to have the power to exclude, or partially exclude, liabilities on a discretionary basis only for the following reasons (C, 2013a):

[1] This approach was supported also by the IMF.

●if they cannot be bailed in within a reasonable time,
●to ensure continuity of critical functions,
●to avoid contagion,
●to avoid value destruction that would raise losses borne by other creditors.

In case of discretionary exclusions of some liabilities from bail in the RA should make up for the unabsorbed losses by passing them on to other creditors. This should be possible only as long as no creditor is worse off than under normal insolvency proceedings. If the losses cannot be passed on to other creditors, the Resolution Fund/resolution financing arrangement may make a contribution to the institution under resolution, subject to certain conditions. Such a flexibility would be possible only if: (i) losses totaling not less than 8% of total liabilities including own funds have already been bailed in, and (ii) the contribution of the Resolution Fund (RF) would be limited to 5% of the institution's total liabilities including own funds. In extraordinary circumstances of discretionary exclusions when the RF's resources are insufficient, the RA may seek funding from alternative financing arrangements but only after the 5-percent limit has been reached (C, 2013b, p. 23).

The bail-in tool can be applied successfully only if credit institutions have in their balance sheets a sufficient amount of liabilities that can absorb losses. However, banks may deliberately structure their liabilities in a way to diminish eligible liabilities and impede the effective application of the bail-in tool. The introduction of both ex-ante and discretionary exclusions of certain liabilities from bail-in creates additional risks that credit institutions might not have sufficient amount of liabilities allowing the successful application of bail-in. To avoid similar risks a requirement is introduced for a *minimum amount of eligible liabilities* subject to bail in, which institutions will have to meet at all times.

The minimum requirement of *eligible liabilities* should be calculated as the amount of own funds and *eligible liabilities* expressed as a percentage of *total liabilities* and own funds (excluding liabilities arising from derivatives) of the institution[2] (C, 2013b, article 39(1)). The RA should be able to require on a case-by-case basis that this percentage is totally or partially composed of own funds or of a specific type of liabilities. The Council's general approach agreement specifies that each national RA should set the minimum requirements for own funds and eligible liabilities for each institution, based on its size, risk and business model. In 2016 a review would enable the Commission to introduce a harmonised minimum requirement for own funds and eligible liabilities applicable to all banks (C, 2013a).

Hierarchy of claims

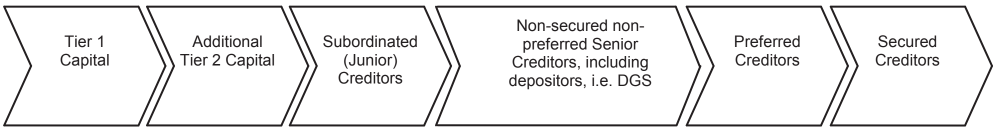
The resolution regime is possible only if it follows a clearly defined hierarchy of claims. The resolution framework establishes a detailed hierarchy of claims, which supersedes and/or complements the hierarchy of claims established by the

[2] More precisely article 39 (1) states that "The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds (excluding liabilities arising from derivatives) of the institution".

normal insolvency regimes. Losses should be absorbed at first by regulatory capital instruments and should be allocated to shareholders either through the cancellation of shares or through dilution. Where those instruments are not sufficient the RAs can convert or write down subordinated debt, followed by senior liabilities if the subordinate classes have been converted or written down completely (C, 2013b, p. 24) (see Figure 2.).

Figure 2

Hierarchy of claims under the original resolution proposal of the European Commission



Treatment of deposits and Deposit Guarantee Scheme (DGS) is one of the issues, which caused a vigorous debate among MSs and at EU institutions. From the very beginning there was a principle agreement that covered/guaranteed deposits should not be subject to the bail-in tool and depositors should continue having access to them, while the DGS should contribute to resolution funding by absorbing losses to the extent of the net losses that it would have had to suffer after compensating depositors in normal insolvency proceedings. The debate focused on the ranking of the DGS. According to the Commission's initial proposal the DGS ranks pari passu with unsecured non-preferred senior creditors (Figure 2). The Council's general approach agreement decided that the DGS would always step in for covered deposits but would have *a higher ranking* than initially proposed by the Commission. The next section addresses this issue in detail.

Resolution financing arrangements/ Resolution Funds

The BRRD defines the relationship between the internal loss-absorbing capacity of an institution to be exhausted by bail-in and the additional resolution financing to be provided by the financial sector. A similar arrangement excludes the use of public funds under normal circumstances. The internal loss-absorbing capacity of an institution is equal to its own funds + eligible liabilities subject to bail-in. If it turns out to be insufficient, a resolution financing arrangement/Resolution Fund (RF) could provide additional funding for resolution. RFs would be able to contribute to resolution by providing (i) contributions to institutions under resolution in addition to what has been absorbed by the bail-in tool, (ii) compensation to shareholders and creditors who suffered losses greater than what they would have suffered under liquidation, (iii) loans to the institution under resolution, to a bridge bank institution or to an asset management vehicle, (iv) guarantees to potential purchasers of assets of the institution under resolution, (v) capital to a bridge bank, etc. Resolution financing is not supposed to change the role of central banks in providing liquidity to the financial system in times of stress.

The BRRD requires MS to set up ex-ante resolution financing arrangements/ RFs, which will be financed by banks and not with funds from national budgets. Within the course of 10 years RFs will have to reach the target level of 0.8% of covered deposits of all credit institutions licensed in a MS. To reach that target level each credit institution should make annually ex-ante risk-adjusted contributions based on its liabilities, excluding own funds and covered deposits. When the funding from ex-ante contributions is insufficient to cover the losses, additional ex-post contributions could also be collected. In its original proposal the Commission introduced a rule according to which national financing arrangements should be able borrow from each other. However, this provision is hardly applicable in an environment of serious differences among national financing arrangements, some of which are underfunded or ex-post funded. The follow-up debate on the Directive at the Council and other EU institutions resulted in an agreement that lending between national RFs would not be obligatory but should take place *only on a voluntary basis*.

One of the innovative for some MSs initiatives of the Commission was the proposal, which allowed MSs to choose whether to keep separate or combine their Resolution Funds (RFs) and Deposit Guarantee Schemes (DGSs). It was introduced by different Commission communications prior to the proposal for BRRD and was extensively debated at the EU institutions. During the debate many MSs opposed the proposal while others, among which Bulgaria, welcomed the potential benefits from the synergy of establishing a single institution for the DGS and RF. Those who opposed the proposal, expressed concerns that a joint institution would interfere with the key function of the DGS to protect covered depositors. The European Economic and Social Committee recommended that the Directive should put in place realistic provisions guaranteeing that the DGS can perform its main function to protect covered depositors at all times (Roussenova, 2013). As a result of the debate the BRRD introduced a provision according to which MSs would be free to choose whether to keep separate or combine their RFs and DGS. However, neither the original Directive proposal nor the Council's general approach agreement explain how this should be done. The specific details are obviously left to the discretion of each MS but some general rules would be helpful and are desirable.

Regardless of whether the DGS would remain separate or would be combined with the RF, it should contribute to resolution for an amount equivalent to the losses that it would have to bear in normal insolvency proceedings. Initially the Commission proposed the '*no-depositor-preference'* approach, according to which, in order to provide sufficient funding in resolution, the DGS *should rank pari passu* with senior unsecured non-preferred creditors (Figure 2). However, if after resolution the institution fails at a later stage and the DGS does not have sufficient funds to repay covered depositors, the DGS should have arrangements to raise the necessary funds *immediately* from its member-banks.

The follow-up debate at the Council and other EU institutions on the Directive focused on the choice between the '*no-depositor- preference*' approach vs. 'depositor-preference' approach. Many MSs, especially those that were underfunded, expressed their preference for the 'depositor-preference' approach. The experience with bank resolution in Cyprus, as well as an IMF recommendation in favour of the "depositor-preference" approach influenced the final decision of the Council (IMF, 2013a). The 'depositor preference' approach implies that covered depositors and DGS rank after senior unsecured non-preferred creditors. This approach would diminish the disbursements made by the DGS and therefore would diminish the risk of its depletion as the burden would be shifted to other creditors. Taking into consideration the fact that in many MSs the DGSs are still underfunded and/or ex-post funded, the debate resulted in the following decisions:

- covered depositors and DGS *should have preference* (i.e. the last category in the hierarchy of claims for bail in*)*
- deposits over Euro 100 000 should also benefit from deposit preference (with some reservations towards large corporate deposits)

Finally, the Council's general approach agreement (C, 2013b, p. 34) accepted that under the national insolvency law eligible deposits above the level of covered deposits from natural persons and micro, small and medium-sized enterprises, as well as liabilities to the European Investment Bank, should have preference over the claims of ordinary unsecured, non-preferred creditors and depositors from large corporations. The DGS should always step in for covered deposits (i.e. deposits below €100,000) and should have an even higher ranking than the categories of eligible deposits mentioned above.

Towards a Single Resolution Mechanism

In July 2013 the European Commission proposed a Regulation establishing a Single Resolution Mechanism within the Banking Union (to be referred to in the text as the Regulation), which rejects the two-step approach suggested earlier by Germany. The Single Resolution Mechanism (SRM) will complement the Single Supervisory Mechanism (SSM) and will be the next step in the construction of the Banking Union (BU). It is designed to "*to put the sector on a sounder footing, restore confidence and overcome fragmentation in financial markets*."(EC, 2013a; EC 2012b). The BRRD aims at establishing a harmonised network of national RAs and RFs in order to protect the integrity of the Single Market and minimise the differences in the national approaches to resolution. However, a network of national RAs and RFs for banks, which are subject to the SSM within a common currency area, will be insufficient. Nowadays banks are too interconnected and national resolution regimes would hardly be successful and efficient even under harmonised arrangements, especially when dealing with the bigger EU banks. Speed and coordination are crucial to restore confidence in such institutions in crisis periods, but in the absence of common backstops coordination might be difficult to achieve. Only resolution actions at an European level would ensure that spill over effects would be avoided when resolving EU big cross-border banks. The combination of European single supervision of banks with national resolution would hardly be stable and effective in situations when the new SSM would propose to put a bank under resolution while the national RA might refuse to act accordingly. To avoid tensions in the BU between the Single Supervisor (ECB) and national RAs when dealing with failing banks, bank supervision and resolution should be at the same level. This understanding implies that the scope of the SRM should be compatible with the scope of the SSM and that the SRM should be in charge of resolution of banks, which participate in the SSM and the BU (EC, 2013b).

The legal basis for the establishment of the proposed SRM is Article 114 of the Treaty on Functioning of the EU, which represents the basis for the Single Market legislation. Some countries among, which Germany challenge this understanding and insist that changes to the European Treaties should be introduced on the way towards a sound and genuine BU.

The Single Resolution Board

Before the publication of the Commission's Regulation on the Single Resolution Mechanism (SRM) there was a proposal to establish an independent Single Resolution Authority (SRA) at the core of the SRM, which would have all the powers afforded to the national RAs. The preliminary debate focused on whether the SRA should be a new institution or should be hosted by an existing one. The establishment of a new institution would require a Treaty change. Under the current EU Treaty only an EU institution, such as the European Commission, ECB, European Stability Mechanism (ESM), etc. can make the final decision on triggering bank resolution at an European level. One option was to have the European Central Bank (ECB) host the Single Resolution Authority, while another option was to empower the ESM to host it. Both options were rejected:

- The mandate of ECB defined in the Treaty does not include resolution, which makes it inappropriate unless Treaty amendments are introduced;
- The second option also turned out to be unacceptable due to possible conflicts of interest, as granting the ESM direct resolution powers would imply creating conflicting incentives to use public money in banking crisis and would most probably require a change in its Treaty.

Given the time constraints, the European Council recommended to establish the SRM and SRA through secondary legislation. Taking into account this recommendation and the legal considerations, the Commission proposed that the SRM would consist of a Single Resolution Board (SRB) and a Single Resolution Fund (SRF) and the Commission itself would have *the final say* whether and when to place a bank under resolution.

Under these conditions the Regulation introduces quite a complicated resolution procedure. The Single Supervisor (ECB) or a national RA assess the conditions of resolution and communicate them to the Commission and SRB. Upon receiving this communication or on its own initiative, the SRB conducts its own assessments of whether the resolution conditions have been met and makes recommendations to the Commission on (i) placing the entity under resolution, (ii) the framework of the resolution tools, and (iii) the use of the SRF to support the resolution action. However, the Commission can do all that on its own initiative. The Commission's role is to make the final decision on triggering resolution and setting a resolution framework consistent with the Single Market and EU rules on state aid. The SRB can also recommend the Commission to amend the resolution framework and the use of the Fund's resources but this is only a recommendation and the Commission is not obliged to comply with it. There is no specific arrangement in the Regulation treating the resolution of any possible disagreements between the Commission and the SRB, perhaps because the leading assumption is that for legal reasons, the final say cannot be with the Board but with the Commission (EC, MEMO, 2013). This part of the Regulation is somewhat ambiguous and needs further clarifications in order to avoid confusion and unwanted delays in the execution of resolution.

Within the proposed framework, the SRB makes decisions on the detailed resolution scheme, the application of appropriate resolution tools and the possible allocation of funds from the SRF. After that the national RAs will be in charge of the execution of the resolution plan while the SRB will supervise the process. If a national RA fails to implement a resolution decision according to the agreed resolution framework, the SRB will be empowered to intervene directly and to require the implementation of the resolution decision.

The resolution approach under the SRM is designed to allow the selection and application of the resolution tools and procedures in a uniform manner. However, the resolution procedure as proposed by article 16 of the Regulation is complicated and needs further simplification and clarifications. In circumstances of urgency the procedure is clumsy and would hardly contribute to a fast and timely decision on triggering resolution, setting an appropriate resolution framework and executing it effectively.

The operation of the SRM is based on the rules and principles to be introduced by the BRRD. The original Regulation proposal is based on the Council's general approach agreement on the Directive and in line with it, the Regulation proposes that any intervention by the SRM should comply with the following principles:

- The need for resolution should be reduced to the minimum, thanks to strict common prudential rules, and improved coordination of supervision within the SSM;
- Where intervention by the SRM is necessary, shareholders and creditors should bear the costs of resolution before any external funding is granted;
- Any additional resources needed to finance bank restructuring should be provided by mechanisms funded by the banking sector through a single RF.

The proposal for the BRRD is still being negotiated and the SRM will have to be fully in line with the final agreement on it to be reached between the Council and the European Parliament.

The Single Bank Resolution Fund

The Commission proposes the setting up of a SRF, which will operate under the control of the SRB. It will replace the national RFs of MSs participating in the BU, and will be ex-ante funded by risk-adjusted contributions from banks in participating MSs. The establishment of a SRF is a better solution than a framework of national RFs because it will pool funds from banks from all participating MSs. The larger contribution base would provide a stronger reputational base that would allow the Board, if needed, to borrow more and at lower costs in the market. In extreme cases an opportunity like this would reduce the need to rely on public resources and would further contribute to breaking the vicious link between sovereigns and banks.

The primary objective of the SRF will be to ensure financial stability, rather than to cover losses, which are to be absorbed mainly by applying the bail-in tool. Only in exceptional circumstances the Fund could act as a backstop to the private resources and would be allowed to absorb losses after at least up to 8% of the liabilities and own funds of the institution have been exhausted.

The target size of the Fund should be about 1% of covered deposits of the banking system of the participating Member States or about Euro 55 billion estimated on the basis of the 2011 data for banks and covered deposits in the euro-area. A transitional period of 10 years is foreseen before the Fund reaches its full target size. The risk-adjusted contributions will be calculated on the basis of bank's liabilities excluding own funds and covered deposits, in line with the requirements of the BRRD. This implies that banks financed exclusively by deposits, will make lower contributions to the SRF but will pay higher contributions to their national DGS. In line with the Directive when a bank is placed into resolution, the corresponding national DGS will contribute to resolution for the amount of losses that it would have had to bear (up to the amount of covered deposits) if the bank had been wound up under normal insolvency proceedings.

Whenever the ex-ante contributions are insufficient and the ex-post contributions not immediately accessible, especially in the transitional phase, additional backup funding might be needed to ensure the continuity of the restructuring process. In such circumstances the Fund would be allowed to contract borrowings or other forms of support from financial institutions, markets or even from public sources (EC, 2013b). The proposed Regulation allows the Fund to borrow from or lend to other resolution financing arrangements, on a voluntary basis. The Detailed Explanation of the proposal for the Regulation states that "Provisions [of the BRRD] on the interaction between different resolution funds (mutualisation and voluntary mutual borrowing and lending) also fully apply between the SRF and national RF of non-participating MS" (EC, 2013b, p.10). The proposed Regulation intends to allow the SRF to *borrow from or lend to* other resolution financing arrangements and to support the resolution financing arrangements in MS even outside the SRM (EC, 2013b, p.16). However, the Regulation contains no specific provisions allowing the Fund to *lend to RFs outside the SRM,* which contradicts the statements in the Detailed Explanation of the Regulation. The introduction of additional specific provisions treating lending from the SRF to national RFs outside the SRM is desirable because they would introduce consistency and clarity to the Regulation.

Conclusions

According to the initial proposals the BRRD and SRM are expected to enter into force from January 2015, with an exception for the bail-in tool, which will apply from January 2018. The debate on the proposed BRRD has not been finalised yet while the debate on the Regulation proposing the SRM has just begun and is expected to be heated and intense in view of the tight schedule proposed by the Commission and the conflicting views of some members of the BU. Despite the challenges of the on-going debate, the proposals of the Commission for setting up a harmonised resolution regime for MSs and a SRM for those of them, which participate in the BU, are definitely among the most important initiatives in the EU in the last couple of years. They represent a milestone in the construction of the BU and mark significant progress in the efforts to break the vicious circle between banks and sovereigns in the EU. Put in a broader perspective the establishment of a genuine resolution regime for banks would contribute to creating a deep and genuine European economic and monetary union (EC, 2012b).

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