IN-DEPTH ANALYSIS
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A reform of the CMDI framework that supports completion of the Banking Union

Transfers, funding, ranking and groups

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Abstract

This in-depth analysis covers the pending challenges of Europe's bank crisis management framework, with special emphasis on small and medium-sized banks. It focuses on "transfer strategies" for selling failed banks, the framework of funding by deposit guarantee schemes (DGS) and resolution funds, the ranking of deposits to facilitate such transfers, and the need to address banking groups' challenges.

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LIST OF ABBREVIATIONS

AGRI	Agriculture and Rural Development Committee
ALDE	Alliance of Liberals and Democrats for Europe
BAS	Brake-assist systems
CAP	Common Agricultural Policy
CFP	Common Fisheries Policy
CMO	Common market organisation
CoR	Committee of the Regions
CULT	Culture and Education Committee
ECOSOC	Economic and Social Committee
ECR	European Conservatives and Reformists
ECTS	European Credit Transfer System
EFDD	Europe of Freedom and Direct Democracy Group
ENF	Europe of Nations and Freedom
EPP	Group of the European People's Party (Christian Democrats)
FAO	Food and Agriculture Organisation of the United Nations
FPS	Frontal protection systems
GDP	Gross Domestic Product
GM	Genetically-modified
Greens/EFA	The Greens/European Free Alliance
GUE/NGL	European United Left - Nordic Green Left
IFI	International Fund for Ireland
S&D	Group of the Progressive Alliance of Socialists and Democrats in the European Parliament

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1. GENERAL INFORMATION.

KEY FINDINGS

The Crisis Management and Deposit Insurance (CMDI) framework is undergoing a process of reform. The discussion tends to pivot around the expansion of resolution, and the accompanying reforms. This briefing paper does not disagree that expanding resolution could help the Banking Union gain a firmer footing, but this should not be done at the expense of ignoring some pressing issues that can impact resolution, and that depend on national laws (including, but not limited to, insolvency laws).

Completion of the Banking Union requires encompassing small and medium-sized banks, which have to navigate between two waters: a harmonized European resolution framework that was conceived with Global Systemically Important Banks (G-SIBs) in mind, and a patchwork of (unharmonized) national insolvency laws that are often inadequate to deal with bank failures. Such national laws also loom in the background of resolution, and can hinder its effectiveness. Reforms should tackle both fronts in at least three important respects: first, transfer strategies; second, funding; third, banking groups.

First, on transfer strategies, while the current resolution framework shows the concerns about G-SIBs and minimizing taxpayer losses in the rules on bail-in, successful bank crisis management requires transfer strategies more often than bail-in, and transfer strategies are particularly relevant for small and medium-sized banks, which so far have not been resolved in a harmonized manner within the EU. This calls for a harmonization that acknowledges transfer strategies as part of the broader bank crisis management framework beyond resolution. This also requires paying attention to aspects such as the preparation and the marketing process, and a reconsideration of the role of valuation.

Second, the rules on funding and creditor hierarchy should be conducive to ensure the success of transfer strategies. Currently, Deposit Guarantee Schemes (DGS) cannot fund transfer strategies because the legal framework does not enable them to do so, or because the combination between the current tiered deposit preference rules and the least cost test prevents them from doing so. This needs to change. Also, resolution funds (RFs) may sometimes be unavailable if tapping them requires bail-in of an 8% of Total Liabilities including Own Funds (TLOF) and this requires a bail-in of deposits. Moreover, a better coordination between DGSs and RFs is needed.

Finally, the legal framework should deal with the specific problems pertaining to banking groups. Time has come to set to work on a comprehensive and bespoke legal regime on asset and liability management for banking groups, disentangling the “hidden traps” of national company and insolvency laws which stand in the way of a smooth and convergent application of prudential, resolution and liquidation rules for banks. These provisions shall include the need for coordination, not only in the resolution context, but also in the insolvency context, and clarity and legal certainty on intra-group support that ensure the upstreaming of funds and asset and liability management, and the need for rules on the treatment of intra-group claims that are consistent with this intra-group support.

2. REFORMING CRISIS MANAGEMENT AND DEPOSIT INSURANCE (CMDI): TRANSFERS, FUNDING (AND RANKING), GROUPS

The process for revising the Crisis Management and Deposit Insurance (CMDI) framework launched in 2021[1] is underway. Even though the adoption of the BRRD (Directive 2014/59/EU), the SRMR (Regulation 806/2014), and a new harmonised deposit insurance framework through the Deposit Guarantee Schemes Directive (DGSD), and its first update in 2019, had been an impressive institutional feat, the Commission believed that some adjustments were warranted.[2] The majority of respondents to its consultation seemed to agree,[3] an opinion shared by prominent figures in European institutions and agencies such as the European Central Bank (ECB[4]) or Single resolution Board (SRB[5]) or international institutions, such as the Financial Stability Institute (FSI[6]).

The majority of those opinions also agree that a large part of the problem lies in the relationship between the frameworks for bank resolution and for bank liquidation. Bank resolution is harmonised at a European level; bank liquidation relies on national insolvency law (NIL). Banks that do not pass the Public Interest Assessment (PIA) are placed in liquidation under NILs. The number of banks subject to it depends on how the PIA is conceived. Even if the PIA is currently applied by the SRB in a more expansive way than it has been in the first stage of application of the SRM, to also include an assessment of the potential threats to the financial stability of a Member State in the context of a system-wide crisis, a majority of the European banks are placed in liquidation under NILs. This creates at least three general problems: (i) the inefficiency of the system, due to NILs' varying levels of effectiveness, and divergences, (ii) the potential misalignment between resolution and NIL, and (iii) the difficulty of determining how to deal with 'middle class' banks.[7]

The concrete consequences of these general problems include (i) the different availability of transfer tools across EU jurisdictions, which, given that transfer tools tend to facilitate value maximisation, means that the value resulting from the process (and thus the treatment of creditors in practice) will be widely divergent; or (ii) the different access to public funds, given that, once a bank fails the PIA, the possibility of using public funds depends on national law (and availability of funds), and the EU State aid framework, which is less deterministic than the bank resolution framework.

To allow transfer strategies to be applied also to small and medium-sized banks, two options may be conceivable: (i) expanding the scope of resolution by further reviewing the PIA; and (ii) ensuring the availability of transfer powers under national insolvency laws. In both cases, measures would need to be taken to improve the feasibility of transfer strategies to manage bank failures.

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1 https://finance.ec.europa.eu/regulation-and-supervision/consultations/2021-crisis-management-deposit-insurance-review_en.

2 Targeted Consultation (2021).

3 Commission Summary report (2021). In Annex 4, Figure 3, respondents were particularly positive in considering that the current CMDI has limited bank failure's risk for financial stability, and improved deposit protection, but they were less sanguine with objectives such as breaking the bank-sovereign loop, or levelling the playing field between Member States.

4 Enria (2021); Fernández Bollo (2022).

5 König (2021)

6 Restoy; Vrbaski; Walters (2020).

7 See the eloquent summary in Restoy; Vrbaski; Walters (2020). For the problem of 'middle class' banks, see also Enria (2021) and König (2021).

In its consultation, the Commission framed the discussion by presenting a **dichotomy** between both solutions, i.e., it was an **"either resolution or orderly (insolvency) liquidation choice"**.[8] In its subsequent, recently released proposal, the Commission indicated that early on it had discarded the second option, i.e., harmonising national insolvency laws.[9] **This paper** is neutral about these possibilities, but in any event **does not see them as mutually exclusive**. It is possible to modify the Public Interest Assessment (PIA) as the SRB did.[10] It is also possible to expand the PIA even more, through, e.g., a rebuttable presumption that resolution is in the public interest,[11] and still try to ensure greater consistency between national insolvency laws and resolution, for reasons such as the importance to level the playing field, the need to improve effectiveness and certainty of crisis management for small and mid-size banks, and to reduce the uncertainty over the No-Creditor Worse-Off (NCWO) principle, which takes national insolvency law as a yardstick for comparison. Some **tools and mechanisms** typically **associated with resolution** (transfer of the whole banking business, or of deposit liabilities, as discussed in sections 3 and 4) should not be seen as an anomaly, applicable only when justified by reasons of systemic risk or the need to protect critical functions, and **should** instead **be perceived as a way to deal more efficiently** with the crisis of entities that, like banks, present peculiarities over other types of entities.

Against the background of the application and scrutiny of the resolution framework in the Banking Union so far,[12] this paper highlights the relevance of transfer strategies in Section [3]. Section [4] focuses on aspects that need to be considered in the legal framework to allow an adequate preparation for the application of transfer powers. Section [5] addresses aspects of funding to facilitate an orderly resolution or liquidation by making use of transfer strategies. Section [6] discusses aspects relating to managing the failure of groups and how this connects with the broader, yet fundamental, policy issue of a bespoke group-wide asset and liability management regime for banks, and cross-border challenges. Section [7] concludes.

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8 Question 3 of the Targeted consultation read as follows: "Should the use of the tools and powers in the BRRD be exclusively made available in resolution or should similar tools and powers be also available for those banks for which it is considered that there is no public interest in resolution? In this respect, would you see merit in <u>extending the use of resolution</u>, to apply it to a larger population of banks than it currently has been applied to? <u>Or, conversely</u>, would you see merit in <u>introducing harmonised tools outside of resolution</u> (i.e. integrated in national insolvency proceedings or in addition to those) and using them when the public interest test is not met? If such a tool is introduced, should it be handled centrally at the European (banking union) level or by national authorities? Please explain and provide arguments for your view" (the emphasis is ours).

9 See Annex 14. Options discarded at an early stage, in the European Commission Impact Assessment (2023).

10 The SRB varied its Public Interest Assessment (PIA) in May 2021 to account for system-wide events. Arguably, a scenario that takes into account the direct *and indirect* contagion effects caused by the failing bank in the context of an extreme but plausible macroeconomic deterioration affecting all banks simultaneously can result in 'casting a wider net', where banks that are less significant may be subject to resolution.

11 Commission Impact Assessment (2023) Chapter 6, no. 6.1.2.1. On Option 3 (preferred) the Commission staff states that *"Importantly and differently from option 2, the legislative amendments to the PIA would also clarify that national insolvency proceedings should be selected as the preferred strategy only when they achieve the framework's objectives better than resolution"*. See also ibid chapter 7 (preferred option).

12 The Commission Proposals for a Directive of the European Parliament and Council amending Directive 2014/59/EU as regards early intervention measures, conditions for resolution and financing of resolution action; Regulation of the European Parliament and Council amending Regulation (EU) 806/2014 as regards early intervention measures, conditions for resolution and financing of resolution action; Directive of the European Parliament and Council amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency were released on April 18 2023. However, the specific Terms of Reference for this Briefing Paper referred to the analysis of possible reforms to complete the Banking Union, without specifically touching on the Commission proposals. The paper may nonetheless include some specific references to it, when useful for purposes of comparison.

3. BANK CRISIS MANAGEMENT AND TRANSFER STRATEGIES

The current bank crisis management, based on bank resolution, was shaped by the Great Financial Crisis (GFC) and its concerns over Global, Systemically Important Banks (G-SIBs) that could be Too-Big-To-Fail (TBTF) and the need to minimise taxpayer losses. For the largest institutions (G-SIBs), it is habitual to select bail-in as the resolution strategy, since a successful transfer of shares, or of all the assets and liabilities, may be difficult to guarantee. Transfer strategies are in principle, at the stage of resolution planning, less common for Top-tier banks (with assets above 100 € bn) or O-SIBs, but more common for banks below 100 € bn. However, even for banks where bail-in has been selected as the resolution strategy, as clearly witnessed by the Banco Popular and more recently by the SVB and Credit Suisse cases, resolution authorities may deviate from the resolution plan, or adopt a variant strategy based on transfer tools. Thus, there may be different combinations between transfers and bail-in, or the write-down and conversion of own funds and liabilities.

Indeed, even with a framework skewed towards bail-in and MREL, bank crisis management *practice* has primarily involved transfers of shares, assets, liabilities and losses. The Annex provided at the end of this paper explains the different examples. By way of summary, the crisis of Banco Popular Español was resolved by transferring the bank to Banco Santander, and the crisis of Sberbank was resolved by transferring the Croatian and Slovenian subsidiaries of the bank to acquirers (both by the SRB). Domestically, in Portugal, Banco Espirito Santo (BES) assets and liabilities were transferred to a bridge bank (Novo Banco), and the authorities organised the sale of Banif to Santander Totta, together with an asset separation tool for non-performing assets to an asset management vehicle (Oitante).[13] Transfers of non-performing assets to Asset Management Companies (AMCs) were used in Ireland (NAMA), Slovenia (DUTB), Spain (SAREB), or Hungary (MARK). AMCs were also used for nationalisation schemes in Austria (HETA) and Germany (FMS-WM, for Hypo Real Estate). Italy presents examples of all kinds of transfer strategies: acquisitions (Banca Carige, Banca Popolare di Vicenza or Veneto Banca), and a variety of NPLs transactions, such as securitisations, using a national vehicle (AMCO), including by means of spin-offs or demergers (Monte dei Paschi di Siena – MPS).

Transfer strategies are particularly relevant for small and medium-sized banks, and, importantly, they present challenges to an understanding of crisis management based on corporate insolvency law. Indeed, the asset disposal process involved in liquidation under insolvency law can be too lengthy for the banking business, where asset value may rapidly deteriorate if those assets (typically, loans) are not adequately serviced. Furthermore, the banking business is characterised by the close link between its lending activity and its liabilities, in the form of deposits, which are essential to ensure the provision of liquidity, payments and account management services. The deposit base may need to be preserved also regardless of its link to the assets, since a flight of depositors can easily spread panic across the banking system. Enabling the transfer of the whole banking business (assets and liabilities), or its deposits, is often the way to preserve franchise value, stabilise the deposit base and prevent contagion.

Yet, in spite of this, **transfer strategies have not been decisively addressed as a key tool** to help managing the crisis of small and medium sized banks **in a harmonised manner** within the EU, something highlighted as 'the 'middle class issue'.[14] The EU framework on bank resolution dedicates scant attention to transfer tools, (e.g., BRRD dedicates a mere 5 articles 38-42). Furthermore, the public interest assessment ("PIA") (resolution action may only be taken if this is necessary in the public

[13] See the Annex for a sample of cases in which a transfer strategy has been applied within the EU.

[14] E.g., FSI 2018.

interest) has resulted in a high threshold for resolution in the Banking Union[15] and divergent approaches for dealing with bank failures under national insolvency laws.[16] Some EU jurisdictions contemplate the possibility of giving effect to transfers of assets and liabilities, such as France (Articles L 641-10, L 642-2 and article R 641-18 of the French Commercial Code), Italy (Legislative Decree 385 of 1 September 1993, Consolidated Law on Banking, in case of Compulsory Administrative Liquidation – CAL), Greece (Article 145b of Law 4261/2014), or the Netherlands (Articles 212hga*, 212hgb Failissementswet or Dutch Insolvency Act). Yet, these may differ widely on the objectives, scope, grounds and execution of such transfer, while other jurisdictions do not expressly contemplate such transfer powers (e.g., Spain). **Bank insolvency frameworks** should **contemplate** the possibility of **transfers**, which should not be seen as a "resolution exception".

4. ADEQUATE PREPARATION FOR TRANSFER STRATEGIES

4.1. General

First, it should be ensured that **resolution authorities are allowed to prepare for resolution** (e.g., by starting a marketing process and conducting a valuation) **at an early stage**. Currently, Article 13 SRMR refers to such preparatory actions, but it does so in the context of early intervention. While the SRB has so far started its preparation for resolution also in the absence of early intervention measures, it would be useful to clarify in the legislative texts that prior early intervention measures are not a precondition for preparatory actions. The conclusion should be analogous if this is contemplated for a harmonisation of liquidation under national laws.

Second, the **'intervention ladder'** could benefit from **clarification**.[17] The legal framework currently contains a number of possible measures – supervisory measures pursuant to the CRD and early intervention measures pursuant to the BRRD – that partially overlap, both in substance and in the conditions for applying them. At the same time, the BRRD contains a specific sequence for early intervention measures (Article 27), the removal of managers (Articles 28) and the appointment of a temporary administrator (Article 29). However, which of these measures may be most effective will depend on the circumstances, and some 'drastic' measures (e.g., appointing a temporary administrator) may be useful in the absence of previous early intervention measures.

Third, there are **limitations to the right to be heard** in the context of bank crisis management. Article 41(2)(a) of the Charter of Fundamental Rights acknowledges every person's right to be heard before the adoption of adverse measures. In the resolution of Banco Popular Español ("BPE"), the General Court concluded that hearing the shareholders and creditors of a bank before it is placed under resolution would undermine financial stability, and compromise resolution's effectiveness, by, e.g., triggering a bank run. The bank affected has the right to be heard,[18] and although shareholders and

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[15] The PIA has been interpreted differently within the EU. For instance, the Danish authorities consider that also smaller banks should in principle pass the PIA (see the Annex). The SRB made efforts to ensure a level playing field in the Banking Union by publishing an approach to PIA for the banks under its direct responsibility (SRB, Public Interest Assessment: SRB Approach 2019, with addendum (2021)).

[16] For instance, following a negative PIA by the SRB in 2017, the Italian banks Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A. were resolved under the Italian bank-specific and administrative-based insolvency regime, which allows transfer strategies. On the other hand, ABLV Bank Luxembourg entered into judicial liquidation following a negative PIA in 2018, in accordance with Luxembourg insolvency law, which does not explicitly provide for asset and liability transfer powers during winding-up procedures.

[17] See also EBA (2020).

[18] Similarly, the Court rejected applicants' claims that they should have been provided access to the SRB's documents in the BPE file before the resolution action, noting that "the person subject of the SBR's decision" is the bank that is placed under resolution (not its

creditors could be adversely affected, and "it cannot be ruled out" that they may rely on a right to be heard, such right may be subject to limitations. Some legislative amendment could clarify that the right to be heard *before* crisis management action is subject to limitations in accordance with Article 52 of the Charter, in contrast with the right to be heard *after* resolution action (particularly, in the context of Valuation 3), which should apply in full.

Fourth, there is the need to **coordinate** the crisis management process with **competent authorities**. Transfer strategies may consist in a *partial* transfer, while some assets and liabilities may be left behind. Impaired assets may need to be wound up, but a partial authorisation may be needed while liquidation begins. For the part being transferred there is a need to coordinate with competent authorities to ensure that the effectiveness of transfer-based strategies are not unduly hindered by the application of licensing requirements, or the **fit-and-proper assessment** of the prospective acquirer.

4.2. Marketing process

Transfer strategies may be the best option to serve resolution goals, but differ from bail-in in one important respect: they **need other parties** (market players) to be interested **to succeed**. In bail-in the authorities adopt a unilateral decision to write-down and convert instruments; in transfer strategies the authorities can have the power to act as the transferor, but there has to be a transferee, like a bank, or a specialist entity who will buy only if the conditions are satisfactory. This requires authorities to **learn from market** (e.g., M&A) **practice**, but neither the BRRD/SRMR nor (generally) national insolvency laws are too M&A-friendly).

Article 39 BRRD in principle requires the marketing process to be as transparent as possible, non-discriminatory, free from conflicts of interest, and aimed at maximising the sale price as much as possible. At the same time, it allows resolution authorities to contact particular potential purchasers and to deviate from these marketing requirements under specific conditions. As confirmed by the practice so far (see the Annex) and given the need to act swiftly**, it is essential that the resolution authority is able to target the marketing process at a restricted group of potential purchasers, considering the circumstances of the specific case** (including a margin of appreciation in assessing the necessary capital and liquidity capacity, the reputation of the potential purchaser to ensure depositors' confidence and its ability to continue critical functions of the failing bank would be key). Such approach was scrutinised and upheld by the General Court in the BPE cases, where the SRB had instructed FROB to contact only the five parties that had been involved in the private sale process.

In the Banco Popular resolution the General Court found that the sale process for the transfer of business was lawful (see next point). However, in our view, resolution authorities and the competent authorities for liquidation can use their experience with the now tested framework to develop their practice, and the legal framework should enable this. The authorities should be able to delineate the **perimeter of assets and liabilities** subject to transfer to achieve the best possible return from the sale and [to] serve resolution or liquidation objectives, including (i) the sale of the whole business; (ii) the sale of the bank's deposits, together with its most liquid assets; or (iii) the sale of deposits, liquid assets, and pools of assets (e.g., groups of loans). They should also be able to **share (confidential) information about the failing bank with potential acquirers,** who should also be allowed (if time permits) to conduct their own **due diligence** to enable them to make their bid. The authorities should have the possibility of deciding what information is disclosed to whom, by balancing considerations of

shareholders or creditors). On a separate note, the Court noted that the right to access the file, when applicable, does not cover confidential information.

value maximisation and the need for confidentiality. Such balancing exercise should not be prevented by bank secrecy rules as long as authorities have adequate procedures to safeguard the confidentiality of the information. Finally, authorities should be able to develop their practice to enable a **fair bidding process** to achieve commercial terms, taking into account market conditions and confidentiality requirements. Depending on such market conditions the authorities should select between 'closed' auctions (when avoiding contagion is key) and more 'open' processes, e.g., when the information is known, and the goal is to reach a high number of bidders to maximise the price, which may happen in case of asset pools, perhaps less so in the case of transfers of whole businesses, or deposits. Finally, the clear **definition of the potential risks and liabilities** assumed by the acquiror is key in acquisition processes, and it is important here as well, where taking over hidden liabilities may act as a deterrent for potential acquirors. Thus, transfer tools should be flexible enough to grant equivalent protections, e.g., making it possible to compensate creditors and shareholders without having them sue the acquiror, a solution that finds some backing in case law and statutory law[19] (see also the section on Funding). **Demergers** (or spin-offs) could in some cases help alleviate this problem since the acquirer's liability is limited to the value of the net asset transferred to it, while granting shares of the acquiror to the shareholders of the failed bank, preserves the chance of a future upside. However, regular corporate laws (requiring a vote by the shareholders) could not be applicable without exceptions.

4.3. Valuation in the EU framework: the cart before the horse?

Before any resolution action is taken, the BRRD (Art. 36) and SRMR (Art. 20) require that a "fair, prudent and realistic valuation" of the entity's assets and liabilities is carried out by an independent person. There is a **'Valuation 1'** to assess whether the conditions for resolution (or for write-down or conversion) are met, which must be closely linked to accounting principles and prudential regulations, a **'Valuation 2'** to inform the decision on the resolution action, including the extent of the write-down or conversion, the object of the transfer, and the value of the consideration to be paid, and a **'Valuation 3'**, to assess the treatment of shareholders and creditors in resolution *versus* under normal insolvency proceedings[20].

Valuation 2 determines the economic value of the entity's assets and liabilities, and, when urgency does not allow a full valuation by an independent expert, a provisional valuation may be carried out, and an *ex-post* definitive valuation may be needed, perhaps simultaneously with Valuation 3.

In the case of Banco Popular Español (BPE), Valuations 1 and 2 were carried out, and were both provisional. Both were subject to legal challenges, decided by the General Court in the BPE 'pilot' Banco Popular cases[21], where the Court stated crucial principles for the EU resolution framework and its

[19] The Court of Justice, in *Banco Santander v JAC* Case C-410/20, ECLI:EU:C:2022:351 held that those liabilities could not be considered transferred to the acquiror. Yet, it also held that those liabilities should be considered in the valuation of the compensation due to affected shareholders or creditors… Easier said than done. In the case of Banca Popolare di Vicenza and Veneto Banca the same solution was achieved by a specific statute. The constitutionality of the law was challenged, and the Constitutional Court held that the challenge was inadmissible in judgment of 7 November 2022, No 225.

[20] In case creditors and shareholders are worse off under resolution than under normal insolvency proceedings, compensation must be paid from the Single Resolution Fund in accordance with Art. 20(16) and Art. 76(1)(e) SRMR.

[21] Judgments of the General Court of 1 June 2022 in cases T-481/17 *Fundación Tatiana Pérez de Guzmán el Bueno and SFL v SRB* (under appeal, cases C-551/22 P and C-448/22P); T-510/17 *Del Valle Ruiz and Others v Commission and SRB* (under appeal, case C-539/22P); T-523/17 *Eleveté Invest Group and Others v Commission and SRB* (under appeal, case C-541/22P); T-570/17 *Algebris (UK) and Anchorage Capital Group v Commission*; T-628/17 *Aeris Invest v Commission and SRB* (under appeal, case C-535/22P).

future.[22] Valuation 1 was carried out by the SRB on a provisional basis on 5 June 2017, the day before the ECB made its FOLTF assessment. The General Court found that in spite of the fact that the SRB had conducted a **Valuation 1**, it could rely on the **ECB's FOLTF assessment** on 6 June 2017, which focused more on the bank's liquidity position. After SRB's Valuation 1 reference date (31 March 2017) the situation had rapidly deteriorated, and the ECB relied on the significant deposit withdrawals in April and May 2017. Actually, apart from when the SRB initiates the FOLTF trigger, one wonders **whether it makes sense to assign to the SRB the task to carry out a Valuation 1, rather than relying on the ECB's assessment**, which can assess the bank's solvency, but also its liquidity (which, in and of itself, can give rise to a FOLTF assessment) with more up-to-date information.[23]

A provisional Valuation 2 was conducted by an independent expert and submitted to the SRB on 6 June 2017, which estimated the economic value of BPE at € 1.3 billion in the best-case scenario, at - € 8.2 billion in the worst-case scenario and at - € 2 billion for the best estimate, taking into account the use of the sale of business tool. The applicants argued that the valuation should have guided the SRB. Yet, the General Court held that **the valuation must provide the SRB with the technical and economic information necessary to implement the resolution tool chosen by the SRB,** not to dictate which resolution tool is to be applied. The Court also accepted that the conditions under which the valuation took place meant that some uncertainties and approximations are inherent in any provisional valuation, and that the breadth of the valuation range **was justified by the method used, i.e., a category-by-category approach for each class of assets and liabilities**, and that **the difference between the two extremes represented only 7% of BPE's total balance sheet**.

Finally, a separate question was **whether a definitive Valuation 2 should have been conducted**. The General Court held that this was not necessary in this context, since, according to Article 20(11) SRMR, the rationale for the ex-post definitive valuation is: (i) to ensure that any losses on the assets of the entity are fully recognised in its books of accounts; and (ii) to inform the decision to write back creditors' claims or to increase the value of the consideration paid, under Article 20(12) SRMR, which refers **only to the bail-in tool, bridge institution tool and the asset management tool, not the sale of business tool**. Thus, an *ex-post* definitive valuation would serve no practical purpose, nor could it lead to a compensatory decision since the sale of BPE to Banco Santander had already been completed and the price for that sale had been determined in an open, fair and transparent marketing process.[24] Thus, according to the Court, *"**the right price [therefore] corresponds quite simply to the actual market price**, as determined"*.[25]

The case law of the General Court illustrates that **the emphasis of the resolution framework on 'valuation' may be misleading**. A valuation informs, but does not dictate which crisis management action to adopt, and it may be trumped, for purposes of deciding which crisis management action to adopt, as soon as it becomes outdated, and for other purposes if there is a market price. Thus, it would appear that the EU framework puts the c[h]art before the horse: instead of placing so much emphasis on the valuation, it should focus on (i) getting right the assessment of the FOLTF situation, and (ii) the

[22] Given the highly complex scientific and technical facts and the complex economic assessment, in accordance with the established case-law of the CJEU, the review of the General Court was confined to verifying that there was no manifest error of assessment.

[23] Indeed, it may be expected that the ECB as the competent banking supervisor may have access to more detailed and up-to-date information than the SRB (which would generally need to rely on information provided by the ECB). Valuation 1 by the SRB may thus be of more relevance when the resolution action is based on a FOLTF assessment initiated by the SRB.

[24] Case T-599/18 *Aeris Invest v SRB* (confirmed in appeal, case C-874/19P); T-2/19 (confirmed in appeal, case C-934/19 P).

[25] Case C-934/19P, paragraph 93.

preparation and marketing process to ensure that the price is, truly, a 'market price', and *then* insert the possibility of an ex-ante valuation in that context, as a supporting element.

5. FUNDING (AND CREDITOR HIERARCHY)

The success of a transfer strategy depends on the possibility of resolution and liquidation authorities to cover any **funding gaps**, which could otherwise deter potential acquirors from completing the transfer. The current system is deficient. DGS funding and resolution funds are generally unavailable for transfers, while public funds outside resolution can be tapped under more generous conditions. Thus, the interplay between the resolution framework and national laws (and idiosyncratic solutions) disincentivises "official" solutions (transfers funded by DGS and/or resolution funds) and incentivizes other solutions. Clearly, the system needs to be improved to make the current funding mechanisms more easily available, while limiting alternative avenues. This raises several considerations: first, on the use of deposit guarantee schemes (DGS); second, on creditor hierarchy, more specifically the ranking of bank deposits and the DGS; third, on the use of resolution funds and the Single Resolution Fund (SRF), and its coordination with the DGS; fourth, on the use of public funds outside resolution; fifth, other practical considerations.

First, **DGSs** are critical players in some jurisdictions, by funding transfer strategies and ensuring their success, notably in the US[26] and Japan[27], and Italy in the EU context (both under the compulsory and the voluntary schemes, following the *Tercas* judgment of the European courts[28]). A transfer funded by the DGS can ensure that the value obtained for the business or assets is higher than under piecemeal liquidation, minimize the risk for financial stability, and reduce the risk for depositors, since depositors would not need to be paid out by the DGS, but would be integrated in the acquiring institution. Yet, **the DGS funding of transfers is severely limited.** For starters, under the Directive 2014/59/EU on Deposit Guarantee Schemes (DGSD) the DGS can intervene to fund "preventive measures" to avoid the failure of a credit institution (Article 11(3) DGSD), or, crucially, to fund "alternative measures", such as asset transfers (Article 11 (6) DGSD). Yet, there is a **wide divergence** among Member States in the **transposition** of Article 11 (6) DGSD, which means that the funding of transfers is not possible in many jurisdictions.[29] Thus, one possibility to be considered would be a more uniform transposition of Article 11 (6) DGSD, to facilitate the use of DGS for transfer strategies.

Second, even if Article 11 (6) DGSD were effectively transposed in all Member States, the effectiveness of such funding is decisively influenced by **creditor ranking**, and, in particular, **deposit preference.** Article 11 (6) DGSD requires that the DGS costs of funding alternative measures, like a transfer, do not exceed the amount that would result in a liquidation.[30] This "least cost principle" or "**least cost test**" seeks to ensure that the DGS does not incur higher costs than needed, normally by referencing the

[26] Federal Deposit Insurance Corporation (FDIC) Crisis and Response: an FDIC History, 2008-2013, (2017). https://www.fdic.gov/bank/historical/crisis/

[27] Deposit Insurance Corporation of Japan (DICJ) *A Guide to the Deposit Insurance System*, 2005. https://www.dic.go.jp/content/000010138.pdf

[28] Case T-98/16 Italian Republic and Others v European Commission ECLI:EU:T:2019:167 and, on appeal, Case C-425/19 P ECLI:EU:C:2021:154

[29] CEPS & Milieu Consulting (2019) section 5.4., p. 139. 11 Member States transposed the option, of which, only a few established detailed provisions (with different frameworks for the transfer) and even fewer have used it in practice. States like Italy or Poland transposed the provision (see, e.g., See De Aldisio et al. (2019)), but others, like Spain or the Netherlands, did not.

[30] *"Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned".*

maximum amount that the DGS can contribute to the so-called "pay out counterfactual", i.e., the amount that the DGS would have to disburse if it had to pay out depositors.[31] Such counterfactual is not easy to define with precision,[32] but by referring to the "net" amount that the DGS would have to disburse, the DGS has to discount the amounts recovered in a piecemeal liquidation under insolvency law. Pursuant to **Article 108 BRRD**, there is a **two-tier preference**, where "covered" (typically insured) depositors *and* the DGS subrogated in their position enjoy a preference over other preferred, but not covered, depositors (e.g., by retail clients and SMEs), which, in turn, enjoy a preference over other senior non-preferred creditors. This also-called **"super-priority"** means that the net pay outs would be minimal, which hinders the possibility of the DGS funding a transfer. Yet, appearances can be deceiving, since paying out covered deposits in insolvency will require a significant upfront cash disbursement, and the DGS will face the uncertainty of recovery rates under a piecemeal liquidation, while an intervention to support a transfer will normally require a lower cash disbursement, will preserve franchise value and access to deposits, and more quickly restore depositor confidence.[33]

An approach to mitigate this problem would be to move to a system of **general deposit preference**, where *all deposits* would rank above ordinary unsecured claims.[34] Since in liquidation insured deposits would share in the losses *pari passu* with other deposits, this would increase the "pay out counterfactual", meaning that the DGS could also contribute more for the transfer. It appears that the Commission shares this view, as it is proposing to move from the tiered deposit preference to a general deposit preference in its recent proposals.[35] It is important to note that the relative ranking of other claims under national insolvency law would also be important in order to make the assessment.

A third consideration is the use of **Resolution Funds (RFs) and the SRF, and its coordination with Deposit Guarantee Schemes (DGS).**[36] Although "resolution" and "liquidation" under national insolvency law are treated separately, in practice the decision to put a bank in resolution because it is in the public interest (see PIA above) depends on whether "liquidation" under national insolvency law can fulfil resolution objectives or not, which, in turn, depends on whether a DGS-funded transfer can be accomplished swiftly. In other cases, there may be a need to combine resolution and liquidation under national insolvency law. Yet, under current rules, there is not a good coordination between DGS funding and resolution funds.

The use of **resolution funds** is possible only if there has been the bail-in of an **8%** of Total Liabilities including Own Funds (**TLOF**). For small and medium-sized banks that are primarily financed with deposits, a prior bail-in of 8% of the bank's TLOF may be challenging (if not impossible) without bailing-in deposits (e.g., uninsured deposits).[37] In its case 8/18 the Appeal Panel decided that the SRB could set

[31] Mecatti, I. (2020)

[32] Costa et al. (2022).

[33] See, e.g., Eule, Kastelein, Sala – ECB (2022); European Commission Impact Assessment (2023), Annex 5 (evaluation), sections 7.1.4.4 and 7.2.2.6.

[34] See IMF (2020) for the different types of deposit preference.

[35] Commission Impact Assessment (2023) chapter 6, no. 6.1.2.4. states that "Option 3 explores a harmonisation of the ranking of deposits in the hierarchy of claims through a single-tier depositor preference and by removing the super-preference of covered depositors and the DGS in the hierarchy of claims." See also chapter 7 (preferred option).

[36] See, e.g., Eule, Kastelein, Sala – ECB (2022).

[37] The results of the exercise in the EBA Call for Advice (2021) and the Commission Impact Assessment (2023) show that, under the conditions of the exercise, of a total sample of 368 banks, 91 could only meet the 8% threshold through the bail-in of deposits. Of those, given the current tiered preference, the DGS could only provide funding in 3 cases.

Minimum Requirements of own funds and Eligible Liabilities (MREL) consisting in a loss absorption amount (LAA) and a recapitalisation amount (RCA) where MREL instruments fell below 8% of TLOF because the bail-in of an 8% of TLOF was still possible if the liabilities that were not eligible for MREL, but were bail-inable nonetheless, like uninsured deposits, were actually bailed-in.[38] Yet, even if such scenario is possible, it does not mean that it should be desirable, given that the bail-in of deposits, even uninsured deposits, could lead to contagion, financial instability, and undesirable impacts on the real economy. This prompted the 2019 reform which made it possible for the SRB on own initiative or upon request of national resolution authorities, through a so called "fishing request", the imposition of at least 8% of TLOF for G-SIIs and other entities the total assets of which exceed EUR 100 billion pursuant to Article 12c SRMR.[39] The reform of creditor hierarchy suggested above to replace the current tiered deposit protection with a general deposit preference would allow the DGS to contribute funds enough to reach the 8% threshold when resolution funds can be tapped. This seems to be the path suggested in the recent Commission proposal.[40]

A fourth consideration is the **use of public funds outside resolution**. If the above points try to enable the use of DGS and RF funding, it is also important to ensure that other sources of funds are not more easily available. Currently, public funds may be provided, e.g., in "precautionary recapitalisations" (Article 32 (4) BRRD), subject to the State aid framework. This, in practice, can mean access to funding on **terms less onerous than those under resolution funding**, which means that some creditors may be better treated under insolvency than under resolution. This can also create distorted incentives for resolution authorities when deciding the PIA, particularly if there are reasons why they wish to avoid the loss allocation under resolution. The **state aid regime should therefore be revised** to ensure alignment between the conditions for access to funds under the State aid framework, and under the resolution framework.

The fifth group of **practical considerations** tries to envisage how to use DGS funds and resolution funds to ensure the effectiveness of transfer strategies. Potential transferees are always concerned about hidden losses or liability. Regular M&A tools used for this purpose, such as representations and warranties (R&W), indemnities, etc. which distribute the liability between transferor and transferee may not be easy to implement. Yet, the logic underpinning them is that of limiting the exposure of the transferee to hidden liabilities, and a more flexible use of resolution funds, or DGS funds, may achieve that purpose. One possibility would be for the DGS and/or the RFs to be able to subscribe "**loss-sharing agreements**", typical in US practice.[41] In this regard, the SRF may need to be used not for direct payments, but to **offer guarantees** to prospective purchasers, in order to adjust some of the uncertainties about the potential liabilities. This logic can be extended to other transfer scenarios. For example, if a prospective acquirer for the business is not found, and a transfer of assets is implemented, guarantees may still be needed for the acquirer. If an asset separation tool is implemented, and an SPV is used, the SRF may need to issue guarantees to the debt of the SPV. Given the importance to develop the practice of the marketing process (*supra* 4.2.) the role of the DGS and RFs should be aligned with it. Another practical consideration is the need to devise a more **credible liquidity strategy** for post

[38] SRB Appeal Panel decision 8/2018, of 16 October 2018. https://www.srb.europa.eu/system/files/media/document/case_8_18_decision_anonymised.pdf

[39] For a recent dispute partly concerning such "fishing" request, see SRB Appeal Panel Decision 3/2022, of 13 February 2023. https://www.srb.europa.eu/system/files/media/document/case/2023-03-21_SRB-Appeal-Panel-Case-3-2022_0.pdf.

[40] See EBA Call for Advice (2021) also included in the Commission Impact Assessment (2023) p. 57. In case of a general deposit preference, of the total sample of 368 banks, only 48 banks would need to bail-in deposits to reach the 8% TLOF. Of those, the DGSs would be able to provide funding in 41 cases, which would be enough to reach the 8% TLOF in 31 cases.

[41] See FDIC Shared Loss FAQ.

resolution or liquidation to the benefit of the entity or the acquiror. This may include the expectation that the acquirer will have an adequate liquidity position (with the necessary flexibility to not hinder the transfer process) and the possibility to coordinate with the procedure for accessing to central bank facilities, to speed such access up, if needed.

6. (CROSS-BORDER) GROUPS.

Banking groups are perhaps the most frequent banking structure, yet corporate and insolvency laws deal with them ineffectively. Banking regulation and resolution rules do not fully palliate the problem and, instead, are often prevented from achieving their intended goals by hidden traps of such national corporate and insolvency laws. Parent company guarantees, in turn, depend on the often uneven specificities of national contract law and of national case-law (see below), thereby contributing to further fragmentation and legal uncertainty, which are both costly and unsafe for credit institutions and supervisory/resolution authorities alike. Yet, the effective management of crises affecting banking groups is essential for the success of any crisis management framework. This entails three type of considerations: one, on coordination; two, on the effectiveness of intra-group support, three, on intra-group claims. This lays the ground for a bespoke asset and liability management regime for banking groups.

First, on **coordination**, EU cross-border corporate insolvency rules (the European Insolvency Regulation – EIR) provide, in the context of groups, clear principles of cooperation and communication between insolvency practitioners and courts,[42] complemented by a framework for group coordination proceedings,[43] but they would need some adaptation to acknowledge the special role that administrative authorities including supervisors, play in the field of bank crisis management. Conversely, bank resolution rules provide a solid framework for cooperation in the form of 'colleges', as well as mutual recognition,[44] both of which cover the phenomenon of groups, but only for bank resolution, while Directive 2001/24/EC on the Winding Up of Credit Institutions (Winding Up Directive) remains entity-centric. It would be desirable to acknowledge the reality of groups, and the need for procedural coordination in the insolvency context (Winding Up Directive) and the potential coordination within resolution, and between resolution and insolvency. In the context of **insolvency** the rules should ensure the possibility of a **centralisation** of proceedings, and, if multiple proceedings are necessary or inevitable, the need for coordination. The rules should provide an adequate framework for the appointment of representatives, cooperation and information exchange between representatives and competent authorities, coordination of hearings, and recognition and giving effect of crisis management measures. These provisions should be applied with the aim to (i) facilitate the maintenance of group synergies and operational continuity or (ii) to facilitate the application of group-wide strategies consisting in the application of transfer tools, when this helps maximise the value of the overall insolvency estate and to better protect depositors and other creditors. Enhanced procedural cooperation should also seek to deter from ring-fencing strategies, and give effect to the "hotchpot rule", which prevents any creditor from obtaining more that he would otherwise obtain in one liquidation proceeding, by claiming in more than one liquidation proceedings.

In **resolution**, save for the more "vertical" cases, where the SRB is the resolution authority, and instructs National Resolution Authorities (NRAs), horizontal coordination is based on **resolution colleges**. One

[42] Articles 56-60 EIR.

[43] Articles 61-77 EIR.

[44] Articles 87 and ff. BRRD.

relevant question is whether the extremely detailed procedure envisaged in articles 97-107 of Delegated regulation 1075/2016 for the joint decision on a cross-border resolution scheme is compatible with the swiftness and flexibility required in case of a transfer, where there is a parallel process for organising a sale process, drafting the documentation, etc. A further reflection may be needed on the coordination between the resolution and the insolvency framework in the context of cross-border groups.

A related aspect is **how to deal with the different entities of a banking group**, **if these do not all meet the conditions for resolution**. It follows from Article 16 SRMR, *inter alia*, that resolution action may be taken in relation to a parent undertaking if: (i) it meets the conditions for resolution; or (ii) one or more of its subsidiaries meets the resolution conditions, provided that these are 'institutions' (banks or investment firms) and that their failure threatens an institution or the group as a whole, and resolution action with regard to that parent is necessary either for the resolution of those subsidiaries or for the resolution of the group as a whole. Similarly, Articles 91 and 92 of the BRRD govern situations in which the failure or likely failure of one or more subsidiaries, or the parent company, may lead to the adoption of a group resolution scheme involving several group entities.

Finally, it is important to note that, even in the presence of ironclad rules, such as those of the BRRD and the Winding Up Directive, there may be issues with the recognition of transfer decisions, as in the resolution of Banco Espirito Santo (BES) (Box 1[45]).

Box 1: Cross-border recognition risk for transfer strategies - the case of Banco Espirito Santo.

The resolution of Banco Espirito Santo (BES) involved the transfer of assets and liabilities to a bridge bank (Novo Banco). However, doubts arose with regard to assets and liabilities governed by foreign law, or subject to a foreign jurisdiction, leading to subsequent confirmations by Banco de Portugal over the transfer of specific assets or liabilities. In the *Goldman Sachs v Novo Banco* litigation in the UK the plaintiff sought to have the UK courts declare themselves competent to decide over a loan facility, because, the plaintiff alleged, a confirmatory act of 'not transfer' was not a 'transfer' subject to automatic recognition. The High Court sided with the plaintiff, but the Court of Appeal and the Supreme Court saw beyond the clever strategy, and enforced the system of recognition of the Winding Up Directive.

Yet, in in *Banco de Portugal, Novo Banco and Fondo de Resolucion v VR*, the Court of Justice ruled that the unconditional recognition of the *retroactive effect* of the measures over BES (asset transfer) would be contrary to EU law if it meant that a client could no longer sue the 'bridge bank', because it was an issue of fundamental rights such as judicial protection.

Second, on **intra-group support**, and more in general **group-wide asset and liability management**, when a bank subsidiary sustains heavy losses, it is normal for its parent entity to financially assist that subsidiary to pay its liabilities and/or to absorb its losses by writing off own funds or converting liabilities. Yet, the prospect of assisting a financially troubled subsidiary raises several concerns: one, the parent company's board will be afraid to face liability under an entity-centric national company and insolvency law; two, the board or management will seek to secure the authorities' blessing, but

[45] See *Goldman Sachs v Novo Banco,* [2015] EWHC 2371 (Comm), [2016] EWCA Civ 1092, [2018] UKSC 34; Judgment of 29 April 2021, Case C-504/19 Banco de Portugal, Fundo de Resolução, Novo Banco SA, Sucursal en España v VR, ECLI:EU:C:2021:335.

without incurring disproportionate costs; three, the authorities must ensure the enforceability of intra-group support under national law; fourth, uncertainties about such enforceability may amplify tensions between home and host authorities. Intra-group waivers for capital and liquidity requirements under Article 7 and 8 CRR, and for iMREL under Article 12g and 12h SRMR are granted only if the parent and the subsidiary are both domestic (and, in Article 12h, if there are no foreseen legal or practical impediments to the prompt transfer of funds or repayment of liabilities). If a parent guarantee is granted, it is subject to national contract and company law, and this ends up by further bringing about fragmented solutions, with their undesirable burden of legal uncertainty and uneven playing field.

Articles 19-26 BRRD contemplate intra-group financial support agreements, which can be activated in case of early intervention. Yet, the link between group support and recovery options is not perfect,[46] and supervisory authorities lack the power to require the parent company (or another group company) to financially assist a subsidiary in financial difficulties as part of early intervention powers, even if this is envisaged in the recovery plan, if the parent (or the other company) is not in a situation of early intervention.[47] These difficulties can be amplified in the context of resolution, where the gone-concern situation may make the assisting company more reluctant, which explains the limitation of iMREL waivers only to domestic groups, and the open-textured wording of "foreseen practical or legal impediments", which can be a source of uncertainty (see Box 2, on Appeal Panel cases 2/2021, 3/2021, or 2/2022). As mentioned above, even a commitment by a parent company (parent company guarantee or comfort letter) to financially assist its subsidiary can be formulated in different ways, and its enforceability can depend on national contract law, which may rely on relatively subtle factors, such as whether the execution of the guarantee is subject to preconditions, or whether it is formulated as an obligation of means, or of result. Entity-centric company law may make it difficult, if not impossible, to state with certainty whether a parent will face no legal or de facto constraints to financially assist its

Box 2: Cases 2/2021, 3/2021 and 2/2022 decided by the Appeal Panel for the Single Resolution Board.

In each of these cases the Appellant challenged the Single Resolution Board (SRB) refusal to waive internal MREL (iMREL) in the case of a banking group.

The Appeal Panel found in all cases that the concept of an "impediment" to transfer was formulated in a sufficiently broad manner as to allow the SRB to require the issuance of a guarantee, depending on the circumstances of the case. In case 2/2021 it found that the SRB had not satisfied the duty to state reasons when explaining why it rejected the guarantee offered by the parent, while in case 3/2021 it found that the refusal was sufficiently justified. In case 2/2022 the Appellant had failed to make a formal request for a waiver, and the Appeal Panel found that, in the specific circumstances (where the appellant did not make a request for a waiver, the Board could not be expected to grant a waiver of its own motion.

Case 3/2021 was appealed before the General Court in case T-71/22, and thus the above findings are not final. Yet, the main issue is that national contract, corporate and insolvency law determine the effectiveness of the transfer mechanisms, and the matter can be sufficiently uncertain to give rise to strong disagreements about the existence of "impediments".

[46] Enria; Fernández Bollo, 2020.

[47] Ibid.

subsidiary should the need arise. The current *status quo* means that there may be greater reluctance to grant waivers, which, in turn, enhances the tendency towards ring-fencing.

One solution would be to **make the regime of intra group support more comprehensive, bespoke and enforceable**. This would require three steps. One, extending the BRRD provisions on intra-group financial support to the domain of crisis management and insolvency. Two, extending through a reform of CRR and BRRD/SRMR the framework of capital and iMREL waivers to cross-border groups. Three, removing for banks the relevant obstacles under national company and insolvency law to ensure the enforceability of such intra-group support, and promote a smooth and safe group-wide asset and liability management. Such regime should ensure the upstreaming of losses (e.g., through harmonized rules on the validity requirements for parent guarantees) or down-streaming of funds to cover losses in an insolvent or troubled subsidiary when this is beneficial to the interest of creditors of both the subsidiary bank(s) and of the parent company or in the interest of financial stability. To be justified, it should be subject to disclosure and *ex ante* approval by supervisory and resolution authorities, based on harmonized conditions, and/or its use (i) when there is a reasonable prospect to redress the viability of the subsidiary; (ii) with the objective of preserving the viability of the group as a whole, to maximise the value of a transfer, or to implement a Single Point of Entry (SPE) strategy; and (iii) the financial support is provided on fair economic terms and in compliance with the group-level resolution or liquidation plan. The details of the assistance could be contemplated in intra-group financial arrangements.

A third area where clarity and legal certainty is necessary is on the **treatment of intra-group (and related party) claims**. Such treatment varies widely among jurisdictions,[48] which increases uncertainty, especially if, apart from subordination, there is the risk of transaction avoidance. Furthermore, subordination of intra-group claims may have different effects. Intra-group transactions may be necessary to both (i) ensure the upstreaming of losses and/or the down-streaming of funds from the parent company, in which case subordination may be an element to ensure that goal, but also (ii) to facilitate liquidity to the subsidiary, in which case subordination may not be desirable. Thus, the rules applicable to intra-group (and related party) claims should acknowledge this reality, and provide exceptions for intra-group support agreements that ensure that the funding arrangements approved by competent authorities (and resolution authorities, in the case of resolution entities) operate as anticipated in the agreements themselves.

European case law has already been confronted with related aspects, such as the treatment of instruments issued by a group entity other than the entity under resolution, i.e., whether they may be made subject to write down and conversion powers. This question was at the heart of case T-557/17[49] on the resolution of BPE. The applicant was the owner of a bond issued by BPE Financiaciones, SA, a wholly owned subsidiary of BPE, which according to the SRB qualified as a Tier 2 instrument of BPE. Pursuant to Article 6(1)(d) of the resolution decision, the relevant bonds were converted into shares, which were subsequently transferred to Banco Santander. The case was declared inadmissible by the General Court,[50] but the judgment clarified some aspects. The Court dismissed the applicant's

48 SRB Insolvency Ranking (2021).

49 Case T-557/17 *Liaño Reig v SRB* (decision upheld by the Court of Justice, C-947/19P).

50 The applicant had requested a partial annulment of the SRB's resolution scheme, to the extent it concerned the conversion of specific Tier 2 instruments into new shares of BPE. The Court considered, in short, that such partial annulment was not possible since the provision on the conversion of those Tier 2 instruments was not severable from the resolution scheme as a whole. The Court indicated that the conversion of all Tier 2 instruments was a prerequisite for applying the sale of business tool and for the sale to Banco Santander (that sale could not have taken place under the same conditions if some of the Tier 2 instruments outstanding as at the date of the resolution

arguments that BPE Financiaciones was not the subject of a resolution scheme since it did not fall within the scope of the SRMR, and confirmed that the power to write-down and convert instruments does not depend on the entity which issued the bonds, but on the characteristics of those bonds ('Tier 2 instruments' under the CRR).[51]

decision had not been converted). The provision on the conversion of some Tier 2 instruments was therefore intrinsically linked to the very substance of the resolution decision and could not be annulled separately.

[51] Instruments not directly issued by a bank may qualify as Tier 2 instruments. I was relevant in this respect that the applicant had not disputed that the securities issued by BPE Financiaciones constituted Tier 2 instruments of BPE.

7. CONCLUSIONS

The Crisis Management and Deposit Insurance (CMDI) framework is undergoing a process of reform. The discussion tends to pivot around the expansion of resolution, and the accompanying reforms. This briefing paper does not disagree that expanding resolution could help the Banking Union gain a firmer footing, but this should not be done at the expense of ignoring some pressing issues that can impact resolution, and that depend on national laws (including, but not limited to, insolvency laws).

Completion of the Banking Union requires encompassing small and medium-sized banks, which have to navigate between two waters: a harmonized European resolution framework that was conceived with Global Systemically Important Banks (G-SIBs) in mind, and a patchwork of (unharmonized) national insolvency laws that are often inadequate to deal with bank failure. Such national laws also loom in the background of resolution, and can hinder its effectiveness. Reforms should tackle both fronts in at least three important respects: first, transfer strategies; second, funding; third, banking groups.

First, on transfer strategies, while the current resolution framework shows the concerns about G-SIBs and minimizing taxpayer losses in the rules on bail-in, successful bank crisis management requires transfer strategies more often than bail-in, and transfer strategies are particularly relevant for small and medium-sized banks, which so far have not been resolved in a harmonized manner within the EU. This calls for a harmonization that acknowledges transfer strategies as part of the broader bank crisis management framework beyond resolution. This also requires paying attention to aspects such as the preparation and the marketing process, and a reconsideration of the role of valuation.

Second, the rules on funding and creditor hierarchy should be conducive to ensure the success of transfer strategies. Currently, Deposit Guarantee Schemes (DGS) cannot fund transfer strategies because the legal framework does not enable them to do so, or because the combination between the current tiered deposit preference rules and the least cost test prevents them from doing so. This needs to change. Also, resolution funds (RFs) may sometimes be unavailable if tapping them requires bail-in of an 8% of Total Liabilities including Own Funds (TLOF) and this requires a bail-in of deposits. Finally, a better coordination between DGSs and RFs is needed.

Finally, but not less importantly, the legal framework should deal with the specific problems pertaining to banking groups. These include the need for coordination, not only in the resolution context, but also in the insolvency context, the need for specific rules on intra-group support that ensure the upstreaming of funds and asset and liability management, and the need for rules on the treatment of intra-group claims that are consistent with this intra-group support.

Successfully dealing with these issues will be a sure way to complete the Banking Union in the field where such completion is missing: small and medium banks. Yet a bespoke asset and liability management regime for groups shall also be very beneficial for bigger banks, and shall pave the way for smoother cross-border banks' consolidation, and its desirable effects on better risk dispersion (geographically), of better resilience and of better profitability (if we really want banks to reap the fruits of the European internal market), in line also with the EBA's and ECB's recent initiatives heralding a reconsideration of prudential policies to lift (intended and unintended) prudential barriers to interstate consolidation (the ECB 2020 Guide on the supervisory approach to consolidation in the banking sector being the clearest example).

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ANNEX

Examples of cases in which transfer strategies have been applied and key points for consideration

Banco Espírito Santo, Portugal (2014)

In August 2014, the bridge bank tool was applied in the resolution of Banco Espírito Santo S.A. (BES), at the time the third largest banking group in Portugal. The resolution was conducted based on national Portuguese law, not the BRRD. The Bank of Portugal considered the possibility of a sale of business but soon concluded that it would not be feasible over the weekend as no private purchaser would be willing to step in without proper assessment

BES' business and most of its assets and liabilities were therefore transferred to a bridge institution, Novo Banco, which had been set up by the Bank of Portugal for that purpose. Novo Banco was capitalised with funds from the Portuguese Resolution Fund as single shareholder, which took out loans from the Portuguese State and a group of banks. The remaining assets and liabilities were left behind in the residual entity (BES), which entered into judicial liquidation proceedings. Loss absorption was thus achieved not by means of a write down, but by leaving liabilities behind in BES.

In December 2014, a sale process was launched, which was however suspended by the Bank of Portugal in September 2015 since the terms and conditions of the offers that had been received were deemed unsatisfactory. The duration of the bridge institution was extended, as was the deadline set by the European Commission for the sale of Novo Banco.

In December 2015, Banco de Portugal transferred certain non-subordinated bonds back from the bridge institution to BES given that the assets of BES had been overvalued.

In January 2016, a new sale process was launched which led to the sale of 75% of the shares in Novo Banco to U.S. private equity fund Lone Star. The restructuring process of Novo Banco was considered completed by the European Commission end-2022.

Key points:

- *A bridge bank is intended to be a temporary entity, but it may be challenging to sell the bridge institution or its assets, rights and liabilities in a short timeframe (the BRRD prescribes a period of in principle maximum two years).*
- *A valuation is important in the context of a bridge bank tool, to determine the net asset value of an entity under resolution, decide on the perimeter to be transferred and the consideration to be paid for such transfer (see Section 4.3 on the role of valuations in the context of a sale of business tool).*
- *The transfer led to challenges from a cross-border perspective. BES and Novo Banco signed an agreement confirming the transfer of the assets and liabilities governed by foreign law and/or located abroad (confirmatory agreement), which helped to solve some but not all recognition problems, as in some situations BES had to confirm that a certain asset had indeed been transferred to Novo Banco (see Box 1 on the cross-border recognition of transfers in the case of BES).*

Banco Internacional do Funchal, S.A (Banif), Portugal (2015)

In December 2015, Banif, at the time the seventh largest Portuguese banking group, was placed under resolution by the Bank of Portugal. The Bank of Portugal invited the banks that had participated in a voluntary sale process to submit offers.

This led to the transfer of the vast majority of Banif's assets and liabilities to Banco Santander Totta, for a price of € 150 million. The gap between the price offered by Banco Santander Totta for the assets and liabilities of Banif amounted to € 2,255 million. That funding gap was filled by a contribution of € 489 million by the Resolution Fund and €1,766 million by the Portuguese Government.

The problematic assets held by Banif were transferred to Oitante S.A., an asset management company set up for this purpose and owned by the Portuguese Resolution Fund. Oitante paid Banif by issuing bonds guaranteed by the Resolution Fund and counter-guaranteed by the Portuguese State. The remaining assets and liabilities (equity and liabilities such as hybrid instruments, subordinated debt and claims from related parties) were left behind in Banif, which was put into judicial liquidation.

In the case of Banif (as well as BES), the Bank of Portugal generally avoided transferring equity holdings of subsidiaries located in third countries for fear that such decision would not be recognised by courts and supervisors.

Key points:

- *The application of the sale of business tool may build on a previously launched private sale process.*
- *Perhaps the most crucial aspect for the application of the sale of business tool is how to fill a 'funding gap' between the price offered by a private purchaser and the assets and liabilities to be transferred (see Section 5).*
- *Resolution planning and advance cross-border cooperation is key to minimise cross-border challenges during resolution.*

Banco Popular Español, Spain (2017)

Banco Popular Español S.A. (BPE) was the parent undertaking of a large banking group (the sixth largest in Spain at the time), whose business was focused mainly on providing banking services to natural persons, small and medium-sized enterprises (SMEs) and large corporations.

At the beginning of 2017, the group had total assets of around € 147 million, over 1.600 branches in Spain and more than 10.000 employees. It had subsidiaries in Spain, Portugal and the United States. In addition, it had a stake in a Mexican financial company and in several Spanish companies.

As of end-2016, the liquidity situation of BPE deteriorated significantly and this continued in the first half of 2017. BPE tried to remedy the situation but the deposit outflows continued, which finally led the European Central Bank (ECB), to conclude on 6 June 2017 that the bank was "failing or likely to fail" (FOLTF).

The Single Resolution Board (SRB) subsequently decided to place the bank under resolution, applying the 'write down or conversion of capital instruments tool' (WDCI tool) and then selling the shares of the bank to a private purchaser. Following a marketing process between 3-6 June 2017, which built on a previously launched private sale process, Banco Santander was the only bank that made a binding offer, for the price of € 1.

The resolution action was informed by an independent valuation carried out by an independent valuer, which estimated the economic value of BPE to be between € -8,2 bln and € 1,3 bln, with a best estimate of € -2 bln.

Step 1: WDCI tool	**Step 2: Sale of business tool**
• Cancellation of 100% of shares (~€ 2 bln) • Conversion of Additional Tier 1 instruments into newly issued New Shares 1 (€ 1,35 bln) • Cancellation of 100% of New Shares 1 • Conversion of Tier 2 instruments into newly issued New Shares 2 (€ 684 mln)	Transfer of 100% of New Shares 2 to Banco Santander for the purchase price of € 1

Key points:

- *The role of valuations in the context of the sale of business tool has been the subject of legal debate. The General Court dismissed all pleas challenging the provisional valuations, including those concerning the large breadth of valuation ranges (see Section 4.3).*
- *The application of the sale of business tool may follow a previously launched private sale process. It is important that the resolution authority has the flexibility to contact potential purchasers that had already shown interest in buying (parts of) the bank, and if necessary, to limit the marketing process to such entities only (see Section 4.2).*
- *For the application of the WDCI tool, regard should be had to the capital instruments and eligible liabilities of the bank under resolution, which may have been issued by other group entities (see Section 6).*

Københavns Andelskasse, Denmark (2018)

On 13 September 2018, the Danish supervisory and resolution authority determined that Københavns Andelskasse (Andelskassen) – a cooperative bank - was likely to fail and that there was no prospect of a private sector solution to its lack of capital. At the time of failure, the cooperative had around 1,940 depositors with deposits in the amount of DKK 311 million (around EUR 46 million). The Finansiel Stabilitet (FS) – the second Danish resolution authority – considered that the conditions for resolution were met and took control over the bank with immediate effect.

On the basis of a provisional valuation by FS, the capital of the members of the cooperative was cancelled, and the claims of subordinated creditors, ordinary unsecured creditors and depositors with deposits above the deposit insurance level (€ 100,000) were written down entirely.

FS set up a bridge bank, Broinstitut II A/S (a subsidiary of FS), which took over the ownership of Andelskassen. New capital was injected from the Danish Resolution Fund.

In 2020, the final valuation was made public. The valuation results confirmed the need to bail-in shares and the claims of subordinated creditors in full. However, on the basis of the final valuation ordinary unsecured creditors should receive a payout of 34%, while eligible deposits should not have been bailed-in. The FS therefore announced that these creditors would be repaid accordingly.[52]

A similar resolution action took place in 2015 (Andelskassen J.A.K. Slagelse). In that case, the FS tried to sell the shares of the entity to another bank, but the transaction could not be completed since the Danish supervisory authority did not approve the sale.

Key points:

- *The Danish authorities consider that small banks should pass the public interest test under the BRRD, because of depositors' need to access their deposits and the payment system (as most daily payments are made through electronic transfers) without any interruptions. The resolution strategy for such banks is generally: (i) write down of relevant capital instruments and if necessary a bail-in; (ii) FS takes control of the entity and replaces its management; (iii) ownership is transferred to a bridge bank holding company, owned by the FS; (iv) assets are sold or the entity is wound-down under the FS' control (controlled liquidation).[53] FS considers itself both a resolution authority and liquidator (it deals with the bad assets in form of NPL work-outs or selling asset portfolios). The resolution scheme is pre-approved under the EU State aid regime for institutions with total assets of less than € 3 billion.*

Sberbank, Slovenia and Croatia (2022)

Sberbank Europe AG is a bank operating in Austria, with a branch in Germany, subsidiaries in Croatia, Slovenia, Czech Republic, Hungary, Bosnia and Herzegovina and Serbia. Sberbank Europe AG is a fully owned subsidiary of Sberbank of Russia, which is majority owned by the Russian Federation.

The SRB determined on 27 February 2022 that Sberbank Europe AG in Austria and its subsidiaries in Croatia and Slovenia were FOLTF due to a rapid deterioration in their liquidity situation, confirming the ECB's assessment. The SRB applied a suspension of payments, enforcement and termination rights ("moratorium"), to the three banks, entailing that, until 1 March 2022 at midnight: (i) contractual payment or delivery obligations were suspended, with some exceptions (e.g., obligations towards CCPs and central banks); (ii) secured creditors were restricted from enforcing security interests in relation to any of the assets of those three institutions; and (iii) the termination rights of parties to a contract with these entities were suspended. Depositors were able to withdraw a daily allowance amount, determined by the respective national resolution authorities.

In the meantime, on 28 February 2022, the Croatian and Slovenian resolution authorities contacted a limited number of potential purchasers with the liquidity capacity to immediately support the banks, the market reputation to stop the liquidity drain and hence the overall capacity to avoid material adverse effects on financial stability.

On 1 March 2022, it was decided that no resolution action was necessary for the Austrian parent, while the SRB adopted resolution schemes for the subsidiaries in Croatia and Slovenia:

[52] See https://www.fs.dk/nyheder/meddelelser/vurderingsrapport-vedroerende-koebenhavns-andelskasse-under-kontrol.

[53] For large banks, the preferred resolution strategy in Denmark is a single point of entry open bank bail-in. See IMF FSAP Denmark (August 2020), par. 23.

- All shares of Sberbank d.d. (Croatia) were transferred to Hrvatska Poštanska Banka d.d. (Croatian Postbank) for HRK 71.000.000,00. The provisional valuation had informed the SRB that the estimated value of the shares was in the range between HRK -2 million and 1 million.

- All shares of Sberbank banka d.d. (Slovenia) were transferred to Nova Ljubljanska banka d.d. (NLB d.d.) for € 5.108.504,32. The provisional valuation had informed the SRB that the estimated value of the shares was in the range between € -2 million and 1 million.

Key points:

- *The imposition of a moratorium, for a strictly limited period of time, may enable resolution authorities to decide how to proceed with a FOLTF bank, and it may facilitate preparatory actions for the application of the sale of business tool (e.g., conducting a sale process and drawing up the necessary documentation).*
- *In view of the need to act swiftly, it is important that resolution authorities are able to target the marketing process at a restricted group of pre-selected potential purchasers, considering the circumstances of the specific case (apart from the necessary capital and liquidity capacity, e.g., the market reputation of the potential purchaser to ensure depositors' confidence and the potential buyer's ability to continue critical functions of the FOLTF bank due to its business model).*

This in-depth analysis covers the pending challenges of Europe's bank crisis management framework, with special emphasis on small and medium-size banks. It focuses on ''transfer strategies'' for selling failed banks, the framework of funding by deposit guarantee schemes (DGS) and resolution funds, and the ranking of deposits to facilitate such transfers, and the need to address banking groups' challenges.

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