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Exploring governance issues between the SRB and the ESM in the use of the Common Backstop

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Abstract

To date, the resolution of the Banco Popular Español, being the first and only resolution case in the euro area, has had the “benefit” of bringing to light several shortfalls of this crisis management system. Back then, thanks to the sale of business, the need of the use of the Single Resolution Fund (SRF) has been avoided, prompting criticism on whether the fund had sufficient means to overcome a major widespread crisis.

During the period elapsed from the last financial crisis, the euro area banking sector has built capital and liquidity buffers, which were aimed at protecting them for future shocks. Although it is now widely accepted that crises are of a cyclical nature, new risks and the high interconnectivity of today’s economic activities brought an unexpected crisis due to the current pandemic. The consequences of this unprecedented event in modern history had severe effects to the worldwide economy, mostly for the boundless block of labour activities, which caused severe losses for households, enterprises and governments that consequently affected the financial intermediation function of the banks.

Concerning the European Stability Mechanism (ESM), the current pandemic has had the effect to put temporary on hold the discussion on the revision of the ESM Treaty, including its role as a Backstop to the SRF, so that the Mechanism could experience a new role through the ESM Pandemic Crisis Support.

In such a framework, this paper aims to bring back the attention to the unfinished path in the establishment of the Common Backstop by addressing an important element of risk, namely its decision-making process. The main aim is to explore possible governance issues, which could hamper a timely and effective use of the Common Backstop, in the case that the SRF would be depleted and no alternative funding sources would be available.

1. Introduction

Governance is an element in today's functioning of the euro area authorities which is getting an increasing attention. This field is explained as the "act or process of governing or overseeing the control and direction of [...] a country or an organization",¹ but expressly referred to the highest level of decision-making and management of such organisation.² One of the core reasons for the central relevance of governance in this paper is the possibility that it gives to identify the responsible bodies which take decisions to provide funding of a shared nature during resolution. Considering that the management of a crisis of one (or several) credit institution(s) is a complex procedure which relies on timely and well-structured decision-making bodies and processes to be successful, this paper seeks to explore and determine if there are impediments to the smooth provision of additional funding to support the Single Resolution Fund (SRF).

Concerning the European Stability Mechanism (ESM), the current pandemic has had the effect to temporarily shift discussions on the revision of the ESM Treaty,³ including its role as a Backstop to the SRF, so that the Mechanism, being a safety net for financially troubled Member States (MS), will provide funding via the ESM Pandemic Crisis Support.⁴

Even if, in the last decade, international organisations, institutions and governments intervened in order to mitigate the effects of the last financial crisis in the real economy, the pandemic is going to have severe effects which cannot yet be predicted, or largely avoided.⁵ That is why, in the euro area, institutions and governments are working towards sustaining the economy. Although governments are expanding their fiscal space and increasing their indebtedness to support households and businesses, it was well-expected that national solutions were going to be inadequate to address such a severe impact on public and private finances. Hence, the European Union (EU) MS recently agreed to support their economies with a package of loans and grants that for the first time in the history of the Union, will be jointly supported by its MS.

Apart from the availability of ESM funds, a broader recovery package has been agreed at the political level⁶ after several days of intense discussions among the Heads of State or Government of the 27 EU MS and, as of September 2020, it will be in the negotiation phase at the European Parliament (EP).⁷ These interventions are related to the next Multiannual Financial Framework (MFF) until the year 2027, including a specific temporary funding effort under a new programme called Next Generation EU⁸ which, for the first time will see the European Commission contracting debt (on behalf of the Union) in order to borrow funds from the capital markets and finance such programmes.⁹

¹ Merriam-Webster (2016).

² Combley (2011), p. 380.

³ This will be treated in the related section about the ESM.

⁴ See **Term sheet on the ESM Pandemic Crisis Support, Eurogroup (2020a)**.

⁵ See **Enria (2020)**.

⁶ The ESM Pandemic Crisis Support has been agreed by the Eurogroup, while the recovery package which concerns all the European Union, has been agreed by the European Council. See **European Council (2020)** and **Eurogroup (2020c)**.

⁷ The Parliament stated that it will need to give a consent to the MFF, particularly stressing on the need to revise the system of the EU's own resources. On the matter, see **European Parliament (2020)**. See also P9_A(2020)0206 for the resolution of the EP about the conclusions of the European Council.

⁸ Funding will be raised between 2021 and 2024. See **European Commission (2020)**.

⁹ See EUCO 10/20, pp. 3-4.

Turning back to the banking sector, the current resolution framework has shifted the cost of loss-absorption and restructuring of distressed financial institutions from the taxpayer to the creditors. That is why, in case that a further deterioration of the pandemic will severely hit the euro area banking sector, the funding which would have come from State Aid (as it happened in the period between 2007 and 2014) would have to be covered with the use of bail-in and other resolution tools¹⁰ and, if not sufficient, with the use of the SRF.¹¹

Moving now to briefly describe the structure of this paper, firstly it will be undertaken the setting of the background concerning establishment, scope of action and governance structures of the Single Resolution Board (SRB)/SRF and the ESM. As this paper aims to address governance issues in the context of the intervention of such authorities during resolution, the description of those authorities is aimed to understanding the need of their establishment at a specific point in time. Subsequently, taking as an example the State Aid interventions from the start of the Global Financial Crisis to the sovereign debt crisis¹² and beyond (i.e. 2007-2014), this study will explore the potential needs of the Fund in a similar scenario. Subjected to this, it will be possible to analyse how narrow the area of intervention during a crisis is, which it helps in parallel to explain the reason behind lawmakers' willingness to change the current framework, in order to allow the ESM to intervene by providing a Backstop to the SRF.¹³ In the second part of this work, the decision-making process of the provision of the Backstop will be explored in the light of the governance structures of each authority. This will lead to the discovery of several shortfalls of a system which is still behind the approval phase. As a result, the study will end up with concrete solutions that are based on one side on possible changes to the current framework and, on the other, on arrangements that can simplify and shorten the procedures without the intervention of the legislator.

¹⁰ Concerning the resolution case of the Banco Popular Español, to date the only one managed by the SRB, it was made use of the sale of business tool. See **Single Resolution Board (2017)**.

¹¹ In case of severe conditions, State Aid could still be granted by the European Commission. However, in **European Central Bank (2020c)** it was stated that (until April) there was no evidence of systemic solvency problems in the banking sector of the euro area.

¹² **Hadjjemmanuil (2015)**, pp. 4-10, divided this timeframe into three different periods: a first phase concerning the Global Financial Crisis and other two phases around the sovereign debt crisis, with a focus on the Spanish case in 2012.

¹³ As it will be illustrated in the following section, the ESM in its original setting was already able to provide funding to distressed banks via the indirect supply of funding to the specific national authority.

2. The ESM

The European Stability Mechanism (ESM) is “an intergovernmental organisation under international public law”¹⁴ that has been established in February 2012 by the euro area MS in the middle of the sovereign debt crisis,¹⁵ designed with the aim “to endow the [European Monetary Union – EMU] with a permanent stability mechanism to assist those countries facing fiscal difficulties.”¹⁶ The ESM was initially planned along the lines of the International Monetary Fund (IMF), both as regards the structure, the methods of intervention and the financing. Indeed, during the first Greek rescue programme in 2010, the IMF played a prominent role. The former President of the Eurogroup, Jeroen Dijsselbloem, commenting on the intervention on Greece stated that “not only was the technical support from the IMF important but also its financial involvement.”¹⁷ However, according to the scope of this study, in the course of the years the ESM experienced an increasing role in supporting euro area financial institutions in difficulty. Therefore, it can be said that, at the moment it represents a key actor of the economic governance of the euro area.

In its Article 1(1), the Treaty Establishing the ESM¹⁸ points out that the same is “an international financial institution”¹⁹ which provides financial assistance to economically fragile MS under strict conditions.²⁰ The conditionality policies of the ESM, required to have access to its funding, have been object of violent criticism from politicians of MS with greater need of financial assistance. On the contrary, these have been supported by countries considered more favourable to “austere” policies. These criticisms began at the time of the negotiations for the reform of the ESM Treaty, which includes its new role as a backstop for the SRF²¹ and escalated during the pandemic, until a compromise was reached regarding the ESM Pandemic Crisis Support.²² It should be stressed that the ESM has always been associated with extreme circumstances, which foresee an equal degree of intensity and rigor in the consequential macroeconomic adjustment programmes (i.e. reduction of the public debt).

Concerning its funding structure, the initial capital stock was fixed at around EUR 700 billion, which was divided into shares, each characterised by a nominal value of EUR 100 000.²³ The structure of the ESM capital impacts the decision-making among “richer” MS, comparing to others. The reason is simple, the quota of each MS is represented by the “subscription by their national central banks to the capital of the ECB”,²⁴ meaning that those countries which transferred more money, have a bigger quota and thus more power. For example, Germany, France and Italy, which hold a quota above the 15% each, have veto powers and they can oppose any emergency decision. This is particularly

¹⁴ See **Olivares-Caminal (2013)**, p. 213.

¹⁵ For an exhaustive analysis on the sovereign debt crisis in Europe, see **Lane (2012)**.

¹⁶ See **Fabbrini (2016)**, Part I(3)(3).

¹⁷ **European Stability Mechanism (2019)**: p. 77.

¹⁸ See T/ESM 2012-LT/en pp. 1-60. This study will refer to the Treaty also as the “ESM Treaty”.

¹⁹ T/ESM 2012-LT/en p. 9.

²⁰ As stated in Article 3 of the ESM Treaty.

²¹ See **Euro Summit (2018a)** and the **Draft revised text of the Treaty Establishing the European Stability Mechanism**.

²² **Term sheet on the ESM Pandemic Crisis Support**.

²³ See Article 8(1) of the ESM Treaty.

²⁴ See **Fabbrini (2016)**, Part I(3)(3). This is based on Article 29 of **Protocol (No 4)**.

interesting for the current analysis, as an opposition of one of those countries could negatively impact the functioning of the Common Backstop. It must be highlighted that, despite of the quota of shares detained by each ESM MS, the respective Member of the Board of Governors has only one vote.²⁵ Apart for the initial capital stock, according to Article 3 of the ESM Treaty, there are three ways for the ESM to raise funding in order to support its Members,²⁶ namely “by issuing financial instruments or by entering into financial or other agreements or arrangements with ESM Members, financial institutions or other third parties.”²⁷

The instruments of the so-called ESM “lending toolkit” which accomplish to the objective of granting financial assistance are: the “precautionary financial assistance”²⁸ which, according to Article 14(1) of the ESM Treaty can be of two types, either “in the form of a precautionary conditioned credit line or in the form of an enhanced conditions credit line”.²⁹ The two credit lines are subject to the strict conditionality referred to in Article 12(1) of the ESM Treaty; the “financial assistance for the recapitalisation of financial institutions of an ESM Member”,³⁰ known also as loans for indirect bank recapitalisation,³¹ “loans” to ESM Members with an *ad-hoc* adjustment programme in a MoU which contains the agreed conditionality; and, lastly, a support facility in the form of purchases in primary³² and secondary³³ markets. To date, it has provided financial assistance to Greece, Cyprus, Ireland, Portugal and Spain through different credit lines, depending on their specific needs. However, several instruments share the fact that they have never been used. Undeniably, Greece has been the major beneficiary of the ESM while Spain, more in line with the scope of this study, has benefited of assistance from the ESM to rescue its fragile banking sector.³⁴

The “complicated”³⁵ governance of the ESM, is characterised by two main governing bodies, i.e. the Board of Governors and the Board of Directors.³⁶ The Board of Governors represents the leading decision-making body of the ESM. It is composed of a representative of the government of each of the (currently 19) ESM MS and, in principle, this representative is identified in the minister holding the finance portfolio.³⁷ The Board of Governors is currently chaired by the President of the Eurogroup,³⁸ as from mid-July 2020 this position is held by the Irish finance minister Pascal

²⁵ Olivares-Caminal (2013), p. 219.

²⁶ It should be reminded that “the initial maximum lending volume of the ESM is set at EUR 500 000 million, including the outstanding EFSF stability support.” See T/ESM 2012-LT/en p. 5.

²⁷ T/ESM 2012-LT/en p. 10.

²⁸ See Olivares-Caminal (2013), p. 220.

²⁹ T/ESM 2012-LT/en p. 30.

³⁰ Olivares-Caminal (2013), p. 220.

³¹ Likewise, the ESM can provide a direct recapitalisation instrument, which will be analysed in section 4.1.

³² Article 17 of the ESM Treaty.

³³ Article 18, T/ESM 2012-LT/en p. 35.

³⁴ See European Stability Mechanism (2019), pp. 213-228.

³⁵ It has been labelled in this term in Olivares-Caminal (2013), p. 218.

³⁶ The ESM comprises also an independent Board of Auditors.

³⁷ Article 5(1) of the ESM Treaty.

³⁸ Article 137 TFEU represents the legal base for the meetings of the ministers of those EU MS having in common the euro as currency, called Eurogroup. See OJ C 202, 7.6.2016, p. 107 and Protocol (No 14).

Donohoe³⁹ for the duration of a two-year mandate, renewable.⁴⁰ During its meetings, the Board of Governors has the faculty to allow the participation of representatives of the Commission and the European Central Bank in the capacity of observers.⁴¹

In line with the composition of the Board of Governors, the ESM Board of Directors has a strong link with each Member State. In point of fact, it is formed by senior officials from each of the ESM MS. As stated in Article 6(1) of the ESM Treaty, they should have strong skills and experience in economic and financial matters.⁴² The main task of the Board is to ensure that the ESM is managed according to the ESM Treaty⁴³ and related statutes. In addition, the Board of Directors has the possibility to decide on affairs delegated upon by the Board of Governors. The Board of Directors is responsible for indicating the direction of the ESM's operations and is chaired by a Managing Director for a mandate of five years.⁴⁴ The latter position, currently held by the CEO of the EFSF⁴⁵ Klaus Regling, who is also allowed to participate to the meetings of the Board of Governors and is assisted by the Management Board for conducting the daily business.⁴⁶

Moving to the core of the topic, the idea which was going to give the ESM the possibility to come into play to finance the SRF started in conjunction with the need to overhaul its Treaty. So forth, the path for revision started with the Euro Summit of 29 June 2018⁴⁷ and seems to reach completion with the foreseen signature of the revised ESM Treaty, as agreed on the 30 November 2020 by the Eurogroup.⁴⁸ The revision of the ESM Treaty is driven by a long-term vision that sees the ESM as an integral part of the European corpus, thus making it a full part of the European framework, being entirely compliant with EU law. Therefore, according to a Europeanist thinking aiming at an increased integration of euro area in financial matters, the ESM should become a European Monetary Fund.⁴⁹

³⁹ See **Eurogroup (2020b)**.

⁴⁰ Nevertheless, in line with Article 5 (2) and (7)(b) of the ESM Treaty and referring to **Protocol (No 14)**, the Board of Governors can decide “either to be chaired by the President of the Euro Group [...] or to elect a Chairperson and a Vice-Chairperson from among its members”.

⁴¹ Including the President of the Eurogroup, whether the latter is not the Chairperson of the ESM. See Article 5(3) of the ESM Treaty.

⁴² T/ESM 2012-LT/en p. 18.

⁴³ Article 6(6) of the ESM Treaty.

⁴⁴ Re-appointment for one additional mandate is permitted. See Article 7, T/ESM 2012-LT/en p. 20.

⁴⁵ Regling is CEO of the EFSF since its establishment in 2010. The EFSF is not able any longer to provide financial assistance, which is solely done by the ESM. However, it is still active for receiving loan repayments and similar activities.

⁴⁶ Article 7(3) of the ESM Treaty.

⁴⁷ See **Euro Summit (2018a)**, p. 2.

⁴⁸ The signature will be followed by the launch of the ratification process. See **Eurogroup (2020d)**.

⁴⁹ The idea of a European Monetary Fund is explored by **Wyplosz (2017)** and **Andritzky (2018)**.

3. The SRF

The Single Resolution Fund (SRF) has been established by the Single Resolution Mechanism Regulation (SRMR).⁵⁰ The rationale for a common fund is strictly associated with the pursue of Banking Union's highest objectives, namely the interruption of the vicious circle between banks and sovereigns⁵¹ and "the equalization across countries of banks' bailout prospects".⁵² In line with the scope of the SRMR, one of the key elements at the base of the creation of the SRF, which is present as well in the Common Backstop, is that the use of such instruments shall be made when private funds are insufficient to restore the viability of banks of systemic importance.

According to Article 69(1) SRMR,⁵³ the SRF should reach a target level which represents at the least the 1% of all the covered deposits⁵⁴ of the credit institutions established in the Banking Union.⁵⁵ This amount has to be reached by 31 December 2023, meaning that the SRB has eight years⁵⁶ to collect *ex-ante* contributions from around 3 000 institutions⁵⁷ and that there will be a completion of the progressive mutualisation of the national compartments.⁵⁸ It should be considered that, over the years, the exact amount matching target size might change substantially due to various reasons: consolidation of the banking sector; impact of the current pandemic on deposits;⁵⁹ and the entry of Bulgaria and Croatia into the Banking Union.⁶⁰

It can be said that, the fact that the size of the SRF was going to be insufficient to face the funding needs in resolution is not remote. Indeed, the SRMR and the Intergovernmental Agreement (IGA)⁶¹ acknowledged in Recital 102 and Recital 10 respectively that funding could be insufficient to cover a comprehensive intervention of the Fund. In this sense, Recital 102 SRMR allows the Fund "to contract borrowings or other forms of support from institutions, financial institutions or other third parties in the event that the *ex-ante* and *ex-post* contributions are not immediately accessible or do not cover the expenses incurred by the use of the Fund in relation to resolution actions."⁶² This recital is important because it shows that already in the drafting phase EU lawmakers knew that the size of the Fund was going to be insufficient. Moreover, it underlines the funding might not be available immediately, exactly what could happen in the period preceding the end of 2023.

⁵⁰ Article 67 SRMR.

⁵¹ See **Hadjiemmanuil (2015)**, pp. 19, 27 and **Euro Summit (2012)**.

⁵² **Hadjiemmanuil (2015)**, p. 27, Recitals 19 and 100 SRMR.

⁵³ It refers to Recital 105 SRMR as well.

⁵⁴ See **Single Resolution Board (2019)**.

⁵⁵ It should reach an estimated amount of EUR 55 billion. See **De Groen, W.P. and D. Gros (2015)**, p. 1.

⁵⁶ Starting from 2016.

⁵⁷ See **Single Resolution Board (2019)**, p. 1, Articles 70-71 SRMR and Articles 4-10 of the **Intergovernmental Agreement (No 8457/14)** for the modalities for the collection of the contributions. The study will refer to the IGA (EU/SRF/en pp. 1-45) as the "SRF Agreement".

⁵⁸ Article 4 of the SRF Agreement.

⁵⁹ As shown in **Deposit Solutions (2020)**, with data publicly available from the ECB, the volume of deposits of the euro area increased during the pandemic, especially in the month of March 2020. See also **Arnold (2020)**.

⁶⁰ However, it is worth mentioning that, in line with Recital 106 and Article 69(1) and (3) SRMR, if the SRF will have made disbursements of more than half percent of covered deposits, the time-limit for reaching the target level can be extended to other four years.

⁶¹ EU/SRF/en p. 10.

⁶² OJ L 225, 30.7.2014, p. 18.

In order to get the full picture about the role of the SRB in the use of the SRF, it is necessary to spend a few words about the governance structure of the SRB. The decision-making bodies of the Board are divided into a Plenary session, an Executive session⁶³ and a Chair.⁶⁴ While the Plenary Session is entrusted with the most sensitive tasks,⁶⁵ the use of the Fund is split between the two sessions, depending on the amount required in each particular circumstance. The use of the Fund impacted the powers of the Board from the very beginning. In this sense, according to Article 7(3) SRMR, in regular circumstances the national resolution authorities of the participating MS are able to adopt and apply resolution decisions with the exclusion of those cases that foresee the use of the Fund. Moving further down in the text of the Article it is specified that given the need of “the use of the Fund, the Board shall adopt the resolution scheme.”⁶⁶ Even during the resolution planning phase,⁶⁷ while the Board should consider different scenarios and assigning a relevant solution through the use of one (or more) resolution tool(s), as mandated by Article 8(6) SRMR, it cannot consider “any extraordinary public financial support besides the use of the Fund”,⁶⁸ which includes the ESM Backstop in its sphere⁶⁹ as it does not specify any other sources apart from central bank liquidity assistance.

⁶³ For the tasks of the Executive session, see Article 54 SRMR.

⁶⁴ The Board counts also a Secretariat, which is in charge of administrative and technical support.

⁶⁵ See Article 50 SRMR.

⁶⁶ OJ L 225, 30.7.2014, pp. 26-27.

⁶⁷ According to Article 10 SRMR, this applies also to the assessment of resolvability.

⁶⁸ OJ L 225, 30.7.2014, p. 28.

⁶⁹ Even if at the time of the drafting of this regulation, the Backstop was not yet envisaged.

4. The Common Backstop

In the context of the Banking Union, in the case that the SRF is used under the conditions mentioned in the previous section, the ESM can come into rescue. This sort of safeguard works in the form of a “backstop”, supplying additional funds in the circumstance that the SRF will have exhausted its own funds. The lack of funds is important for the role of the Backstop, as it is undisputed that the ESM must be used as a last resort,⁷⁰ it will be not only related to the SRF being “out of stock”, but also to the impracticability for the SRB to raise funding from other sources. Actually, those funds from alternative sources could not still be sufficient.

During the current transition phase, the alternative sources that could be used to boost the SRF are: the temporary transfer of funds which are not mutualised;⁷¹ the possibility to borrow from third parties;⁷² and the sale of shares that it obtains from its previous interventions.⁷³ Moreover, the ESM can provide financing to banks facing difficulties through the Direct Recapitalisation Instrument (DRI).⁷⁴ To date, this tool having a capacity of EUR 60 billion was never used⁷⁵ and, because of the changes in the legislation brought by the Bank Recovery and Resolution Directive (BRRD)⁷⁶ and the SRMR, the need for providing funding has enlarged its scope. This exactly where the SRF may require more funding to intervene through “extend short-term funding to a failed bank or a bridge entity, provide guarantees to potential purchasers of a failed bank or inject capital in a bridge entity; [however, it cannot] absorb losses or recapitalize”⁷⁷ a bank. Consequently, the establishment of the Common Backstop will coincide with the withdraw of the DRI among the available instruments of financial support of the ESM toolkit, thanks to Article 19 of the ESM Treaty, which allows the Board of Governors to “review the list of financial assistance instruments”.⁷⁸ There are similarities between the DRI and the Backstop. Both instruments have been created with a forward-looking approach, by building necessary tools and capacity to be used when extremely difficult times come. Accordingly, Klaus Regling said that “instruments like the direct recapitalisation instrument, which have never been used, are good to have *just in case* something goes terribly wrong”.⁷⁹ Another aspect which should be considered is that those instruments serve the supplementary purpose to disseminate security that the authorities have sufficient tools to deal with complex crises. During the last financial crisis, it was widely experienced that statements made by the governing bodies of euro area authorities and their reputation have been essential to avoid even greater losses.⁸⁰

⁷⁰ In principle, the same approach works also for the use of the SRF.

⁷¹ To be repaid before the end of 2023. See Article 7 of the SRF Agreement.

⁷² Article 73 SRMR.

⁷³ Article 24 SRMR.

⁷⁴ See **Eurogroup (2013)**.

⁷⁵ On the matter, see also **Merler (2014)**.

⁷⁶ OJ L 173, 12.6.2014, pp. 190–348.

⁷⁷ Those are the ways in which the Fund can provide funding during resolution. See **Hadjjemmanuil (2015)**, p. 28, on the base of Recital 100 and Article 76 SRMR.

⁷⁸ See the **Draft Resolution of the ESM Board of Governors**, the **Terms of reference of the common backstop to the Single Resolution Fund** and **Eurogroup (2020d)**.

⁷⁹ **European Stability Mechanism (2019)**: p. 291.

⁸⁰ The reference is made to the well-known speech by the former ECB President Mario Draghi in the peak of the sovereign debt crisis. See **European Central Bank (2012)**.

The Common Backstop will be able to operate in the form of revolving credit lines. This is a flexible option to provide funds when needed, up to a predetermined limit. Concerning its size, it is necessary to divide it into two periods. First, during the transitional period, which is related to the achievement of the target size by the SRF, the Backstop will be levelled to the amount of the former. Second, during the steady state, such amount should reach the cap of the SRF after a decision of the ESM Board of Governors by the date of the ESM Treaty change.⁸¹

Moreover, there will be the possibility to provide parallel credit lines. The difference between these two types lies in the membership within the Banking Union: while revolving credit lines are granted to entities established in the euro area when the SRF is depleted; parallel credit lines see the participation of a State not belonging to the euro-area (although having formally decided to join the Banking Union)⁸² that will contribute to the financing to the SRF together with the ESM.⁸³ This is not a remote option, because Bulgaria⁸⁴ and Croatia,⁸⁵ which have been recently included in the Exchange Rate Mechanism (ERM II),⁸⁶ may require such an intervention before the formal adoption of the euro in both countries.

In the current state of the art, the Common Backstop was supposed to be operational by 1 January 2024.⁸⁷ However, it existed the possibility to allow the establishment of the Backstop before this date, provided that the banks established within the Banking Union made significant progress, especially with respect to the reduction of several risk-factors. Among them, the level of Non-Performing Loans (NPLs)⁸⁸ that each bank has within its balance sheet, is one of the most relevant.⁸⁹ It could be argued that, perhaps, the current pandemic could jeopardise this objective because, despite swift interventions of EU institutions and MS, the level of NPLs is most likely to increase due to the long stop of economic activities experienced in Europe between the months of March and May 2020.⁹⁰ Instead, contrary to such expectations, thanks to the “progress made in risk reduction [the Eurogroup has] agreed to advance the entry into force of the common backstop to the Single Resolution Fund by the beginning of 2022.”⁹¹ Accordingly, the SRF Agreement will be amended with the aim to foster “the mutualisation of ex-post contributions.”⁹² The progress made refers mainly to the significant

⁸¹ **Terms of reference of the common backstop to the Single Resolution Fund**, p. 1.

⁸² A simple decision from the non-euro area Member State is not sufficient, the Member State should receive an approval to join the ERM II programme, which coincides with joining the Banking Union.

⁸³ See **Terms of reference of the common backstop to the Single Resolution Fund**.

⁸⁴ See **European Central Bank (2020a)**.

⁸⁵ See **European Central Bank (2020b)**.

⁸⁶ The participation to the ERM II is subject to the approval of the ECB President, the euro area finance ministers, the finance ministers and central bank governors of Denmark and the candidate country (Bulgaria or Croatia) with the involvement of the Commission. The candidate country agrees to join at the same time the Banking Union and the ERM II.

⁸⁷ As reported in Recital 5A of the **Draft revised text of the Treaty Establishing the European Stability Mechanism** and in the “Early introduction” section of the **Term sheet on the European Stability Mechanism reform**, p. 4.

⁸⁸ *Ibid*

⁸⁹ See the **Term sheet on the European Stability Mechanism reform**, p. 2, ft. 1.

⁹⁰ On the matter, see **Arner, Avgouleas and Gibson (2020)**. Furthermore, the stop of economic activities is taking place in scattered order Europe, mostly depending on the worsening of the pandemic in each specific MS.

⁹¹ **Eurogroup (2020d)**.

⁹² See the **Draft Resolution of the ESM Board of Governors and Eurogroup (2020d)**.

decrease in the level of NPLs and the continuous build-up of MREL capacity.⁹³ While this represents an important achievement, the current environment shows that maintaining those commitments in the near future will prove difficult.

Resuming the discussion about the decision making, even if the resources of the Fund are taken from the private sector, the fact that a disbursement needs the green light from the Commission places this action at the same level of a State Aid.⁹⁴ For this reason and because of similarities of the effects and severity of the current pandemic with those of the last financial crisis, this section will analyse possible needs of the Fund (and the Backstop) using State Aid interventions as a quantitative support. Therefore, the analysis made by De Groen and Gros⁹⁵ has been used as framework to identify the possible needs of the intervention of the SRF and the amount which will fall beyond the capacity of the Fund. Thus, to be covered by the Common Backstop. While it is acknowledged that the reference framework is not recent,⁹⁶ there are important similarities which justify this choice: the financial crisis and the one driven by the pandemic can be considered as systemic; both are characterised by liquidity and capitals needs as a consequence of a heavily distressed banking sector; and they have (or will have) effects for several years.

The abovementioned study, aimed at providing “estimates of potential financing needs of the SRF”,⁹⁷ is based on data concerning State Aid provided to Banking Union entities⁹⁸ in the period between 2007 and 2014.⁹⁹ In the study, were taken into account 72 banks representing the 45% of the euro area banking assets, which faced EUR 313 billion in losses.¹⁰⁰ According to the data provided by the European Commission’s DG Competition,¹⁰¹ out of 72 banks analysed, 62 banks had complete data. Out of those, 31 banks are outside of the scope of this study, because 17 of them were not short on capital and the remaining 14 could experience the application of the bail-in tool, in order to reach minimum capital levels. Therefore, 31 banks, representing about the 6% of the total assets of the Banking Union, would be requiring the intervention of the SRF, as the 8% minimum bail-in would not be sufficient.

Those 31 banks would have needed support from the SRF of around EUR 72 billion. This contribution would be divided into: 13 banks requiring EUR 10 billion for the Fund after that the bail-in already covered a portion of losses from the initial EUR 32 billion; the second group of 18 banks with aggregate losses of EUR 182 billion, would have recovered EUR 33 billion via bail-in. Despite such

⁹³ See the latest **Monitoring Report on Risk Reduction Indicators**.

⁹⁴ **Hadjiemmanuil (2015)**, p. 28.

⁹⁵ **De Groen and Gros (2015)**.

⁹⁶ For example, concerning the estimates of capital requirements in 2013.

⁹⁷ **De Groen and Gros (2015)**. However, the data set in **European Commission (2018)**, used to make these assumptions, gave information only on the amount received through State Aid. For resolution purposes, it did not cover for example an estimation of the losses or the total liabilities.

⁹⁸ It considers entities falling under the scope of the Banking Union, even if those interventions were made in a period preceding its establishment.

⁹⁹ **De Groen and Gros (2015)**, p. 3.

¹⁰⁰ *Ibid*

¹⁰¹ **European Commission (2018)**.

intervention, in order to cover the remaining EUR 149 billion, the Fund would have provided a maximum of EUR 62 billion, leaving still EUR 87 billion to be absorbed.¹⁰²

De Groen and Gros argue that a backstop financing would be needed in the start of the transition phase.¹⁰³ On the contrary, it is argued here that the Common Backstop should be implemented as a stable support mechanism, because of the uncertainty about the impact of the pandemic and subsequent real financing needs.¹⁰⁴ That study is correct in recognising that the actual amount needed for the SRF, due to different factors, cannot be predicted with precision. However, the authors flagged that four conditions need to apply, considering a worse-case scenario, which could be equivalent to a severe impact of the pandemic with a return of the contagion.¹⁰⁵ Those conditions are important to show that the Fund will not have to cover all the actual losses, because: “it is unlikely that all banks in the system will fail at the same time [and] the bail-in tool [will] act as a shock absorber”.¹⁰⁶ This last aspect is very important because the SRF can cover up to five percent of total liabilities, if at least the eight percent of them have been already bailed-in. Moreover “the losses do not necessarily exceed the maximum contribution of the fund”,¹⁰⁷ and the SRF is “unlike to contribute to the restructuring of all banks”¹⁰⁸ because its intervention is not mandatory and its subject to a strict decision-making. It should be considered that the SRB could use other “capital relief measures to improve the capital position”¹⁰⁹ of the banks through instruments like sale of business or asset separation. However, the application of these measures could put a burden on the SRF.

¹⁰² De Groen and Gros (2015), p. 7.

¹⁰³ In 2015, well before the discussions of the Backstop, the authors labelled the DRI as appropriate.

¹⁰⁴ De Groen and Gros (2015), p. ii, refer as well to “extreme circumstances” that could be applied to the current pandemic.

¹⁰⁵ This would mean another stop to economic activities. This represents one of the scenarios described in Enria (2020).

¹⁰⁶ De Groen and Gros (2015), p. 2.

¹⁰⁷ *Ibid*

¹⁰⁸ *Ibid*

¹⁰⁹ De Groen and Gros (2015), p. 11.

4.1 Decision-making process

At this stage, it is clear that, in order to secure the success of the resolution procedure, the circumstance which will motivate the SRB to ask for the use of the ESM as a Backstop is the depletion of the SRF and the subsequent need of additional funds. The procedure for the obtainment of the resources is rather complex and, as this analysis attempts to demonstrate, it could jeopardise the entire operation, due to the proven need to act within a limited time horizon and given the considerable number of actors involved.

4.1.1 SRB

First of all, this paper focuses on the resolution of heavily distressed credit institutions established in the Banking Union, which are therefore under the direct remit of the SRB, in line with Article 7(2) SRMR,¹¹⁰ including the so-called “less significant institutions”¹¹¹ if a request of the use of the Fund is made.¹¹² The resolution procedure develops in the following way. According to Article 18 SRMR, the ECB (after consulting the SRB)¹¹³ issues a Failing or Likely to Fail (FOLTF) declaration¹¹⁴ stating that, for example, the bank is not complying any longer with the conditions for holding the banking license.¹¹⁵ At this point, the SRB determines if the viability of the bank could not be restored using “alternative private sector measures”¹¹⁶ and that the bank will be resolved in the public interest.¹¹⁷ Thus, avoiding a so-called “national insolvency procedure”,¹¹⁸ which represents a winding-up procedure depending on the EU Member State’s specific insolvency regime. While “normal insolvency law remains directed at liquidation of the insolvent business and the maximization of creditor value, [...] resolution rules are both directed at the preservation of certain assets and functions, such as insured deposits and critical services, and at the (controlled) liquidation of all other assets of the bank.”¹¹⁹

Next, the SRB will approve the resolution plan “specifying the appropriate resolution tools and financing arrangements, including the extent to which the SRF may be used.”¹²⁰ From then on, the SRB will make use of one of the four resolution tools (or a combination of them) if approved by the

¹¹⁰ This category includes all the entities which enjoy the supervision of the ECB and other cross-border groups. For the 2020 list of cross-border groups, check **Single Resolution Board (2020)**.

¹¹¹ Less significant institutions are those not falling under the criteria of significance listed in Article 6(4) of the Single Supervisory Mechanism Regulation.

¹¹² See Article 7(3) SRMR.

¹¹³ The SRB is allowed to issue its own FOLTF declaration, given that it has informed the ECB accordingly and the latter has not responded in three days.

¹¹⁴ Article 18(1) SRMR.

¹¹⁵ The ECB makes a prior assessment whether the entity can be restored through measures of the recovery plan. See Article 18(4)(a) SRMR.

¹¹⁶ Article 18(1)(b) SRMR. This includes actions of the supervisory authority and early-intervention measures.

¹¹⁷ According to Article 18(1)(c) and (5) SRMR, which refer to the objectives listed in Article 14 SRMR.

¹¹⁸ For a complete view on national insolvency proceedings in relation with the bank resolution rules, see **Haentjens (2014)**.

¹¹⁹ **Haentjens (2014)**, p. 4.

¹²⁰ **Hadjiemmanuil (2015)**, p. 18, which refers to Article 18(1) and (6) SRMR.

Commission, or in case that the latter will raise objections, referring the issue to the Council.¹²¹ In such a case, the SRB will have to adjust the plan.¹²² Progressing, the SRB will make use of the SRF only if the strict conditions outlined in Article 76 SRMR are met.¹²³ However, even if it is only up to the SRB to decide whether to make use of the Fund, due to the fact that the Commission has the duty to endorse the resolution scheme, if it foresees the use of the SRF, the Commission needs to approve it according to the State Aid rules.¹²⁴ Likewise, the Council can intervene in the decision-making process only, when “strictly limited to the existence of a public interest and to material modifications by the Commission of the amount of the use of the Fund”.¹²⁵ This intervention during such an extremely delicate scenario is not an isolated case. Indeed, Recital 33 and Article 50(1)(c) SRMR¹²⁶ envisage a situation in which, any Plenary Member can request that the decision of the use of the Fund shall be made by the Plenary session rather than the Executive,¹²⁷ if the required funding “in that specific resolution action”¹²⁸ is above five billion euro.

Although resolution is considered as an “exceptionally expeditious”¹²⁹ procedure, there is a high political sensitivity in the use of the Fund, especially when talking about considerable amounts of it. Due to the fact that decisions whether to provide funding are taken by the Plenary session where all the national authorities of the participating MS are present, it would be more difficult to reach a consensus as national interest could overcome common solutions. Moreover, in the letter (d) of the abovementioned Article the Plenary session has the duty to intervene more in dept. The Plenary can assess and instruct the Executive session when applying the resolution tools and using the Fund, this time if the threshold of five billion euro has been reached in a period of twelve months.¹³⁰ Such a scenario is not that far away from reality, as similar funding needs and interventions have been experienced during the last financial crisis. The current pandemic, if not well managed, might lead to analogous crises.

All those interventions from other EU institutions and larger decision-making bodies, as it is the case of the Executive session compared to the Plenary, are valid elements which this study highlights as impediments for a timely action during resolution. It is visible how the responsibility of the SRB thins out when considerable amounts need to be withdrawn from the Fund. From a logical point of view, the more authorities involved, the longer the time in which these authorities will formulate a decision and the greater the obstacles which will arise. Even if the establishment of the SRB has been attacked for being outside the scope of the Treaties,¹³¹ in this case there is no perceived problem of legitimacy

¹²¹ Article 18(7) SRMR.

¹²² *Ibid*

¹²³ From a purely legal point of view, it must be underlined that, when referring to the use of the Fund, the legal base shall be identified in the BRRD and the SRMR, as stated in Recital 20 of the latter.

¹²⁴ In line with Article 19 SRMR.

¹²⁵ As stated in Recital 26 of the SRMR.

¹²⁶ See also **SRB/PS/2015/9**.

¹²⁷ About the rules of procedure of the Executive session, see **SRB/PS/2015/8**.

¹²⁸ OJ L 225, 30.7.2014, p. 68.

¹²⁹ See **Hadjimmanuil (2015)**, p. 18, who commented the procedure based on Article 18 SRMR.

¹³⁰ See also Article 54(1)(b) SRMR.

¹³¹ See the opinion (14547/13), of the Legal Service of the Council about the problem of allowing an agency “to adopt legal binding measures [...] as long as its powers are not discretionary”, which refers to the so-called Meroni doctrine. **Alexander (2013)**, while comparing the euro area resolution framework with the one from the United Kingdom, heavily

or accountability. Given that the actions of the SRB are subject to scrutiny by the EU Court of Justice, on the contrary, it warns a disproportionate need for preventive control over the actions of the Board itself by most of the authorities surrounding it.

4.1.2 ESM

It was previously described that the ESM enters the resolution procedure once the SRF has exhausted its funds and no alternative sources of funding are available. This is the point when the SRB should make a request to the ESM Board of Governors. Such request should be accompanied by a proposal of the ESM Managing Director, which could be cause of delays. That is why a suitable solution in this sense could be inspired by the FOLTF declaration. At the time of drafting the FOLTF statement, the ECB is required to consult the SRB.¹³² Therefore, following a similar reasoning, the SRB could formulate the request to be addressed to the ESM, including a mandatory consultation of its Managing Director. This solution could be envisaged in internal arrangements between the authorities or acknowledged in the ESM Treaty reform. As a result, in addition to speed up the decision-making process, this would ensure the outcome of a proposal that already contains sufficient formal elements for its approval by the Board of Governors.

The decision whether to grant a loan to the SRB, probably due to the sensitivity of the matter and the amount that should be disbursed, is made by the ESM Board of Governors with a decision based on unanimity.¹³³ Despite being out of the strict decision-making process authorising the Backstop, the Board of Directors is responsible for the specific decisions on the approval of the disbursements.¹³⁴ These last decisions have to be taken within 12 hours from the receipt of the SRB's request. The fact that the Managing Director is further allowed to move the deadline up to 24 hours, might give an idea that lawmakers were more focused on protecting particularly difficult situations. Notwithstanding the possibility of the occurrence of such complex scenarios, especially in the case when the SRF is depleted due to multiple rescue efforts, the need to act fast in such circumstances seems to have had less weight. It must be stressed that this analysis considers the time factor as crucial during resolution, timely action is key to the success of the whole procedure, particularly when several credit institutions are involved. However, the Board of Governors can delegate certain decisions to the Board of Directors. It is still under discussion whether such procedure should be granted as well for the Backstop.¹³⁵

criticised it for not being adequate to the challenge it was going to face. He argued that more power and centralisation is needed for the resolution authority to properly manage resolution and to ensure coherence with the supervisory framework.

¹³² According to Article 18(1) SRMR.

¹³³ For an exhaustive list of the different decisions, which must be made either by the Board of Governors or the Board of Directors, see the Annex in **Olivares-Caminal (2013)**, pp. 227-229.

¹³⁴ For example, as referred to in Article 16(4) of the ESM Treaty. See also **Terms of reference of the common backstop to the Single Resolution Fund**, p. 3.

¹³⁵ **Terms of reference of the common backstop to the Single Resolution Fund**, p. 1.

Conclusion

In conclusion, lawmakers could shorten the ESM internal decision-making process, with the specific opportunity to delegate the entire decision-making (including the loan or disbursement to be granted) to the ESM Board of Directors; or by excluding the possibility of a further delay permitted by the Managing Director.

Concerning the first solution, while this analysis acknowledges the existence of an emergency voting procedure that, in line with Article 4(4) of the ESM Treaty, allows the Board of Directors to decide also on behalf of the Board of Governors, this same procedure has still some shortfalls. It is important to highlight that the proposal can be validated only if a qualified majority of the 85% of the votes cast is reached. However, in order to proceed with the emergency procedure, both the Commission and the ECB need to conclude that, if the ESM will not approve a decision whether to grant financial support to the SRF, the stability of the euro area could be put at risk. Another possibility envisaged in the Terms of reference of the common backstop to the Single Resolution Fund is that to include in the ESM Treaty a provision allowing the Board of Directors, via a unanimous vote, to decide for a delegation for a limited period of time to the ESM Managing Director.¹³⁶ In this case we would have an important speed up of the process.

Notwithstanding the relevance of the intervention of the Commission and the ECB to speed up the decision-making process, the involvement of both authorities could be itself a source of delay. It is also surprising that the SRB, being the main authority in charge of the resolution procedure and the sole manager of the SRF, is not yet taken into account for asking a faster decision to the ESM. While it is true that both Commission and ECB have their own role in resolution,¹³⁷ the SRB has the data, experience¹³⁸ and capability to quickly ascertain that one or multiple resolution procedures may humper the stability of the euro area and thus flag it to the ESM. The reason why lawmakers chose to assign this task to the two authorities instead of the SRB could be of a political relevance or for accountability issues. For the latter it was already argued here that there should be no such issues. This analysis considers that the actions of the legislator are justified by elements relating to the first option. Seeing this from a purely political point of view, in the event of possible threats to the financial stability of the euro area, such a level of sensitivity of decisions would not be properly fitting in the shoes of an administrative authority.

It must be stated that both solutions already consider the hazard of shortening the time of complex and not clear scenarios. That is why this paper considers the drafting of a specific arrangement to be essential for a smooth functioning of the Backstop. While it is worth mentioning that the SRB and the Commission already signed a MoU in 2019, however, concerning the Fund, it is difficult to spot

¹³⁶ **Terms of reference of the common backstop to the Single Resolution Fund Terms of reference of the common backstop to the Single Resolution Fund**, p. 3.

¹³⁷ For example, on the Commission side, concerning the tools to be implemented and, especially, the use of the Fund; concerning the ECB, for the FOLTF declaration.

¹³⁸ Apart for having managed the resolution of the Banco Popular Español, since 2017 the SRB has built experience in the management of a resolution procedure with the establishment of “dry-runs”, namely live simulation exercises which represent the concrete phases of resolution. See **Single Resolution Board (2016)**, p. 16.

any improvements for its use. Indeed, Section 8.3, letters (a) and (e),¹³⁹ are only repeating certain provisions¹⁴⁰ about the involvement of the Commission in the case in which the Fund will be used.

As a result, this study flags the “Joint position on future cooperation between the European Commission and the ESM”¹⁴¹ as a perfect example to understand what is required to improve the functioning of the Common Backstop. This position was prepared ahead of the Euro Summit of December 2018¹⁴² which foresee the need “to agree on the division of labour [between the Commission and the ESM] with regard to the Single Resolution Fund (SRF) backstop”.¹⁴³ This text argues that such an understanding shall be drafted and agreed likewise by the ESM and the SRB with a stronger sense of urgency compared to the one with the Commission, as the SRB is thoroughly involved in the resolution procedure. Given the criticality of the intervention of the Backstop, the parties should also concentrate their mutual efforts on clarifying transparency and accountability. Because of the important role played by the Commission during resolution,¹⁴⁴ together with the ESM, it is possible to evaluate that they are working to address these same issues. Despite being a recent organisation, the SRB has already signed several MoUs and other arrangements¹⁴⁵ which are highly beneficial for the work of this authority,¹⁴⁶ which proves to be a temporary effective solution to overcome deficiencies of the decision-making process, thanks to the improvement of working arrangements.

¹³⁹ EC-SRB MoU, pp. 5-6.

¹⁴⁰ Already included in the SRMR as well.

¹⁴¹ See **European Stability Mechanism (2018)**.

¹⁴² **Council of the European Union (2018)**.

¹⁴³ **European Stability Mechanism (2018)**. See also the **Term sheet on the European Stability Mechanism reform**, p. 3.

¹⁴⁴ In relation with its assessment of the resolution measures and the possibility to oppose to the scheme proposed by the SRB.

¹⁴⁵ See **Gortsos (2019)**, pp. 84-88.

¹⁴⁶ Those arrangements with participating and non-participating MS, EU and third-country authorities range from cooperation during resolution planning and execution to the exchange of relevant information and mostly reflect duties arising from Articles 30-32 of the SRMR.

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