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RESEARCH ARTICLE

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Controlling European money for failing banks: designing the European Stability Mechanism as banking union's financial backstop

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ABSTRACT
The Single Resolution Mechanism (SRM) was designed to create a common framework for the recovery and resolution of ailing banks headquartered in the euro area. The Single Resolution Fund (SRF) was created to be this mechanism's financial backbone and to effectively break the doom loop between banks and governments. However, SRF funds were widely seen as insufficient in the event of the need to resolve one or more large banks. In early 2021, euro area member states agreed to changes to the European Stability Mechanism (ESM) so that it could become the financial backstop for the SRF. This paper analyses the existing and proposed arrangements on the SRF backstops, using elements of the principal–agent model. We argue that the proposed use of the ESM as the SRF's backstop would allow euro area national governments significant control and veto possibilities through the addition of the 'permanence of the legal framework' clause.

KEYWORDS
Single Resolution Fund (SRF); European Stability Mechanism (ESM); banking union; economic and monetary union (EMU); euro area; principal–agent analysis

1. Introduction

The European Union (EU) regime for bank recovery and resolution is an example of the 'tangled governance' – regime complexity – that is characteristic of a number of elements of European and specifically euro area economic governance adopted since the outbreak of the euro area sovereign debt crisis in late 2009 (Henning 2017). This complexity is due in part to the overlap in the EU legal text and the intergovernmental side agreement (IGA) that determine the functioning of the use of common funds for the purpose of recovering and resolving ailing banks in those EU member states participating in banking union. One core element of this legal structure established since 2014 is the Single Resolution Fund (SRF), a common euro area fund to be used in the implementation of EU resolution rules. This fund was created to shield governments and thus taxpayers in those EU member states participating in banking union from bearing the costs of bank resolution.

Due to the massive fiscal impact of the global financial crisis (2007–9) on public finances, EU member state governments moved to reinforce financial sector

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regulation and supervision and, more specifically, to establish common rules, procedures and funds for bank resolution. Tougher resolution rules were widely presented as necessary in order to promote the bail-in of banks by their bond holders rather than bail-out by governments – and thus taxpayers – and their resolution using funds provided by the banking sector (Howarth and Quaglia 2014). Common rules were also seen as vital to preserve the 'level playing field' of the European single market (ibid.). Given the widespread perception that a range of EU-headquartered banks were 'too-big-to-fail', the amount of resolution funds collected from banks was essential to establish confidence in financial markets that even the largest among them could be resolved without recourse to government bail-out (ibid.).

The SRF is an important addition to the EU financial support structure, which was previously only directed at supporting governments. The SRF however is solely intended for banks. Moreover, it does not use public funds but, rather, is capitalised through contributions from euro area-headquartered banks to reach a size equal to 1 per cent of all euro area covered deposits. This amount, currently at around €78bn, is a small percentage of total euro area member state government support for banks over the past two decades (ECA 2019). Thus, in 2019, euro area governments agreed on using the euro area emergency fund, the European Stability Mechanism (ESM), to provide a financial backstop to the SRF, which required modifications to both the intergovernmental agreement creating SRF and the ESM Treaty, both outside the EU legislative framework. The use and the access to the SRF, as well as the use of ESM funds, were fiercely negotiated among governments, resulting in the gradual availability of SRF funding and the adoption of an intergovernmental agreement outside of the EU legal framework, which determined how these funds and emergency credit lines were to be used.

While the SRF is not directly capitalised through public funds, it could create costs for banking sectors or institutions which are, through their type of banking activities, less likely to require recourse to a common resolution fund. At the same time, the use of the ESM as a common backstop to the SRF would make use of public funds to provide emergency lending, which in turn could bear costs for taxpayers in the event of a large-scale intervention in the financial sector which cannot be reimbursed in the medium-term. Thus, these emergency tools bear the risk of transfers by providing incentives for governments to rescue their banks with European funds, burdening more robust banking sectors and fiscally sound governments (Donnelly and Pometto 2024; Howarth and Quaglia 2016). It is therefore to be expected that fiscally stronger countries with low borrowing costs (and potential net contributors), as well as those with a lower risk profile banking sector, sought to minimise their exposure to the risks linked to using SRF and ESM funds for interventions in the banking sector of fiscally weaker countries. These potential costs and benefits divided euro area national governments into coalitions that largely determined their positions on the rules and procedures governing the operation of the SRF and ESM.

The aim of this paper is to examine the SRF intergovernmental agreement (IGA) and ESM Treaty provisions focused upon the role of the ESM as the common backstop, using elements of the principal–agent analytical framework. Fiscally stronger countries, predominantly Germany, built several safeguard mechanisms such as vetoes into the IGA and treaty revisions, which undermined community decision-making through a stability bias reflecting the preferences of German and northern euro area member state governments.

The national credit lines and the ESM can both be described as 'conditional backstops'. The addition of a 'permanence of the legal framework' clause to the reformed ESM Treaty provides individual euro area national governments a de facto veto on the use of ESM funds to support bank resolution.

Following a summary of the control mechanisms of the principal–agent approach – delegation, monitoring and sanctioning – that are relevant to this analysis, the third section of this paper provides an overview of the national preferences on European bank resolution financing and the intergovernmental agreement on the SRF and ESM Treaty reform agreed in 2021. The fourth, fifth and sixth sections apply elements of the principal–agent approach, explaining the decision-making, monitoring, and control mechanisms built into the revised SRF intergovernmental agreement and ESM Treaty. The final section concludes.

2. Delegation and control in the principal–agent model

A principal–agent relationship exists between two or multiple partners bound through an act of delegation, in which the principal confers powers upon the agent in order to achieve a set objective (Delreux and Johan 2017; Tallberg 2002), formalised by a contractual agreement. In the EU context, member state governments have delegated a range of tasks to the EU and other European bodies in order to reduce transaction costs and to make a credible commitment to their cooperation (Keohane 1984; see also Braun and Guston 2003; Pollack 1997; Tallberg 2002). Member state governments delegate to tackle more effectively a range of problems that are difficult to resolve unilaterally at the national level (Tallberg 2002). The design of EU/European institutions (and policies) therefore reflects the preferences of the member state principal(s) (Pollack 1997). Tallberg (2002) concludes that delegation occurs only if the expected outcomes outweigh the costs of creating the institutions. Schimmelfennig (2015) and Rehm (2021) argue that crisis resolution in the EU and euro area has followed a two-step process: first, member states all sought to safeguard the Single Market and the euro which necessitated closer integration; while second, member states maintained distinct preferences on the design of this integration. Similarly, a number of scholars have understood member state government support for banking union in terms of the threat of financial instability and contagion risks, even though a number of euro area national governments worked to dilute Commission proposals on the elements of banking union (see, e.g. Howarth and Quaglia 2014).

The principal–agent approach also focuses upon the mechanisms used by the principal to ensure their ongoing control of the agent following delegation, as well as the provisions of mutual control of the members of a collective principal by delegating monitoring powers to the agent. Ex-ante control is exercised through the design of delegation including the rules, procedures and competences conferred to the agent. In general, the more explicit and restrictive the contract, the less an agent is able to capitalise on the margin of manoeuvre arising from incomplete contracting or to deviate from assigned tasks. Ex-post control is exercised through monitoring the behaviour of the agent and through the application of sanctions (Delreux and Johan 2017; Pollack 2003). Monitoring the compliance of the collective principal can be exercised via the agent, which can take on the role of honest broker, or by specific members of the collective principal (Delreux and Johan 2017). Sanctioning and monitoring together form the control mechanism of the principal.

Monitoring can be organised through so-called 'police patrol' oversight, which includes public hearings, studies, field observations and examinations of regular agent reports (Kiewiet and Matthew 1991; Pollack 1997). The purpose of the 'police patrol' monitoring is to discourage the agent from pursuing different tasks or preferences than the delegated ones (Pollack 1997). The 'police patrol' is conducted by the principal to ensure compliance by the agent, but also to verify appropriate behaviour by the members of the collective principal. Monitoring can also be conducted by other actors – third parties – which have an interest in the correct implementation of the delegation at hand. These actors can sound the 'alarm' to inform the principal(s) of any misconduct by the agent or of members of the collective principal – a mechanism referred to as 'fire alarm' oversight (McCubbins and Schwartz 1984). 'Fire alarms' are less costly but at the same time, they are also less centralised and tend to be more superficial than 'police patrols.' Classic principal–agent analysis expresses a clear preference for 'fire alarm' monitoring over police patrols (McCubbins and Schwartz 1984). Sanctioning of the agent by the principal could involve a change of personnel, a change of the agent's mandate, revoking the delegation or simply through defiance against common rules – the last being directed towards the common rule structure.

To understand how national governments delegated competences on the use of the SRF and its ESM backstop, we apply an intergovernmentalist principal–agent analysis. Euro area member state governments form the collective – but fundamentally divided – principal. The Single Resolution Board (SRB), European Commission and the ESM are the agents. We operationalise our analysis in the following way. First, we map which competences were delegated to the SRB and what are the decision-making rules for using the SRF and its backstops. Second, we look at the conditions attached by national governments for the use of the SRF and its backstops in the transition and post-transition period. Lastly, we analyse the mechanisms in place for national governments to control the agents – notably the SRB – but also to ensure compliance by other governments with the rules and procedures.

3. Government preferences in the design of common financial instruments and banking union

In the case of banking union, the collective principal is composed of the governments of euro area member states. Due to their respective banking sector specificities and national fiscal position, their preferences diverged strongly on European bank resolution rules, the design and use of resolution funding and the design of banking union in general. The different member state preferences were shaped by the structure of their domestic banking systems, the potential financial contribution of national governments and/or banks to resolution funds, the financial stability of domestic banks, and the national government's fiscal position. A number of scholars have divided the collective principal into two main coalitions: the governments of France and southern euro area countries and those of Germany and northern euro area countries. The former sought European financial support mechanisms to aid bank resolution, with looser rules to make access less stringent (Howarth and Quaglia 2014, 2016; Rehm 2021; Schimmelfennig

2015). The governments of Germany and northern euro area countries were less likely to face resolution and/or to need recourse to European resolution funds. Their preferences were focused upon reducing a perceived moral hazard and the risk of overusing these funds. They therefore favoured a solution with national decision-making, systems of national resolution funds in the medium-term and strict conditionality, including bail-ins for the use of European backstop facilities. German government preferences were shaped by the country's domestic banking sector and the relative importance of small cooperative and savings banks therein, which were less likely to require recourse to a common fund.[1] The northern coalition national governments were keen to reduce the exposure of their banking sectors to 'legacy issues' in southern euro area-headquartered banks, which had a large share of the euro area's non-performing loans dozing on their balance sheets. As had been the case for financial assistance mechanisms in the euro area since 2010, the German-led coalition was keen on including disincentives in the design of common policies to avoid moral hazard and reducing the risks of having to foot the bill for the legacy issues in the banking systems of other, notably southern euro area, countries.

Tallberg (2002) describes a principal–agent relationship as a dynamic process that includes repeated revision of the terms of delegation by the principals. The principals undergo a learning phase in which the delegation produces positive and negative feedback loops on which the principals base their assessment and goals for revision. The principal–agent relationship assumes a renegotiation of the terms of delegation in a constant fashion based on the principal's learning and preferences. Lessons learnt by the principal could result in a reduced role for the agent in the future due to the agent's unwelcomed action. However, in their study on the European Commission's response to the crisis, Savage and Verdun (2016) observe that the feedback loop created a strengthened role of the Commission agent in its monitoring capabilities in relation to its member state principals. Divergent preferences within the collective principal could cause significant inefficiencies in the implementation of a common policy, if the terms of delegation do not include barriers to constant renegotiation of the contract. The agent therefore requires a degree of stability in order to function, which also results in the problem that principals might be stuck with a specific agent and contract, due to the inability to agree on reform of the rules or the agent's role (Scharpf 1988).

Howarth and Quaglia (2014, 2016) argue that the German government's preferences were decisive on the design of the initial banking union legislation, in general, and the resolution rules and funds, in particular, due to Germany's relatively important economic and financial position in the euro area. The assertiveness and relative influence of Germany and the northern coalition can be seen in the design of the first instruments of joint European intervention in the banking sector, which were the indirect and direct recapitalisation instruments of the ESM. First, these governments stressed the need to establish a European supervisory mechanism – the Single Supervisory Mechanism (SSM) – before any bank could be recapitalised by the ESM (Howarth and Quaglia 2016). Second, the loan format of the indirect instrument and the eligibility criteria and bail-in conditions attached to the direct recapitalisation of banks included disincentives to avoid moral hazard (Merler 2014; Rehm 2021).

The ESM's indirect recapitalisation instrument, which was first used by Spain in July 2012, was a loan to a national government for the purpose of being used for bank recapitalisation. The difference between this instrument and a normal assistance programme to the government was the conditionality targeted at recipient banks. The direct recapitalisation instrument created officially in December 2014 was seen by some observers as unusable due to its threshold and the significant level of expected contributions by the national government of the recipient banking sector (Merler 2014, see also IMF 2014; Hadjiemmanuil 2022). Thus, both instruments were based on the fiscal involvement of the national government in the intervention in the banking sector – following the preference of the northern coalition – and offered an insufficient solution to the problems facing the bank-sovereign doom-loop.

4. Resolution funds in EU law and the intergovernmental side agreement

EU member state governments agreed on the need for a common bank resolution framework and a European mechanism to help resolve failing European banks, which had contributed to national fiscal problems in a range of member states in the context of the euro area's sovereign debt crisis. The governments of the French and southern euro area member states argued that a common European fund for recovery and resolution was necessary to cut the doom-loop between banks and sovereigns. Prior to the creation of national resolution funds, EU member state governments had little choice but to intervene to save or close national banks with public funds. In parallel to the creation of tougher bank regulation and ECB bank supervision, member states agreed upon the need to have national and European resolution funds available to make it more politically and financially manageable to resolve failing banks.

The Bank Recovery and Resolution Directive (BRRD) adopted in 2014 established a resolution framework in all member states, with national resolution funds collected from banks and national resolution authorities in charge of the implementation of bank resolution.[2] Unlike the BRRD that applies at the national level and in all member states, the Single Resolution Mechanism Regulation (SRMR) introduces an additional European-level mechanism for resolution. The first chapter of the regulation provides the rules and procedures for resolution and specific tools to be used (Art. 24–27 SRMR). It designates a European resolution authority, the Single Resolution Board (SRB), in charge of all systemically important banks headquartered in banking union countries and supervised by the European Central Bank (ECB) under the Single Supervisory Mechanism (SSM).[3] The SRB is in charge of the orderly resolution of banks that have been deemed by the ECB to be 'failing or likely to fail' and to minimise the impact of this action on other banks and the wider economy (Asimakopoulos and Howarth 2022; European Commission 2022).

The second part of the SRM Regulation is the Single Resolution Fund (SRF). The SRF is the financial backbone of the SRM financed ex-ante by contributions from the banking sector and which holds a total of about 1 per cent of covered deposits in the euro area – around €78 billion since 2024. This fund is to be used for resolution interventions concerning all banks. Combined, the BRRD and the SRM Regulation created: first, authorities, rules, and tools for resolution action at the national level; and second, a European (banking union) authority and fund. Most importantly, these legal frameworks specify which instruments, including bail-in provisions, are to be used by the national resolution authorities and the SRB for resolution.

To shift the resolution action onto the European level and to weaken the sovereign-bank doom loop, the SRM Regulation required the merger of national resolution funds established under the BRRD into the SRF by the end of 2023. In the transition period from 2016, the gradual merger of national funds into the SRF was legislated via the intergovernmental side agreement – rather than EU law – which set the time frame of seven and a half years starting in mid-June 2016 and ending on 1 January 2024.[4] In this transition period, the funds in the SRF were only gradually made available for EU-wide action, which meant that each euro area member state banking sector was first and foremost using funds from its own national 'compartment' in the SRF. As the transition period progressed, the amount available from the shared/common fund increased, while the amount from the national compartment declined. From the start of 2024, all national compartments were merged into a single European compartment in the SRF.

Due to the potential scenario that the SRF was insufficiently filled during the transition period, banking union national governments and the SRB signed bridge financing arrangements. These Loan Facility Agreements were linked to the size of their respective banking sectors' share in the SRF and could be used to cover funding shortfalls in the SRF (SRB 2017). These Loan Facility Agreements were based on national law adopted by each country unilaterally. Apart from this option, the SRB could also contract loans from private or public entities to cover resolution action above the SRF's capital.[5] In 2020, euro area member state governments agreed to use the ESM as a common backstop to replace the national Loan Facility Agreements from the start of 2024. This new task for the ESM was part of a reform of the ESM Treaty agreed in 2021. Thus, the use of the SRF and its backstops have been legislated in two separate EU laws, one intergovernmental agreement on the transfer of funds in the transition period (which expired at the start of 2024), several national pieces of legislation establishing the Loan Facility Agreements, and in the revised intergovernmental ESM Treaty – yet to be ratified by Italy as of late 2024.

5. Delegation of borrowing competences to the SRB

The management of the SRF was delegated to the SRB and the European Commission. This delegation pooled new powers at the European level, giving the SRB and the Commission competences to prepare and to some extent decide over resolution cases. In the SRM Regulation, the SRB is in charge of managing the SRF as well as being the decision-maker on the application of resolution tools that require funds from the SRF. The SRB has an executive session and a plenary session. The former is composed of the SRB Chair, four full-time Board members and a representative of the respective country in which a resolution case occurs. In this format, the SRB proposes resolution action involving not more than €5bn to the Commission. The Commission must first approve the bank resolution action in terms of EU state aid rules. When the Commission objects – either to the use of the SRF or to the public interest of resolution – and the changes are not discretionary, the SRB's plenary decides by simple majority to either approve or reject the Commission's objection. The plenary session is composed of the SRB Chair, the four full-time board members and the representatives of all the banking union national resolution authorities – 21 as of 2025.[6]

The plenary may be convened by any national resolution authority after the SRB's executive has proposed a resolution action using funds in excess of €5bn. The majorities for plenary decision-making vary according to the amount needed for the resolution. The use of the SRF above €5bn is taken by simple majority representing at least 30 per cent of contributions. Decisions relating to the raising of ex-post contributions, as well as borrowing from other national resolution funds or the market are taken by a two-thirds majority representing at least 50 per cent of contributions.[7] After the transition period – from the start of 2024 – this contribution threshold lowered to 30 per cent. The use of funds from a public backstop facility can be formally requested by the SRB if the plenary approves by the same majority as in the former cases (Art. 52(3), SRMR).

The northern coalition centred around Germany, Finland, Austria, and the Netherlands only accounts for approximately 40 per cent of national contributions to the SRF; whereas France, Italy, Spain and Portugal are at almost 50 per cent. Furthermore, the number of votes in plenary to block a decision is at least nine, given that the SRB's full-time members vote as well. This plenary voting allows the collective principal to be involved and to oppose any action that the agents in the form of the SRB and Commission might propose that is seen to contradict the collective principal's preferences. It should be noted that there is no European legislative requirement that national resolution authorities must be politically and operationally independent of governments, and we assume that an authority will normally respect the position of its national government. Actions above the €5bn threshold and the raising of additional funds from alternative sources require a larger share of the collective principal's composing parts to agree. However, these voting rules do not favour a clear group within the collective principal.

The barrier for the SRB to issue debt to raise additional resolution funds and to collect ex-post contributions could thus be overcome with no significant veto possibilities for national authorities, with the exception of a possible Franco-German coalition during the transition period. At the same time, none of these possible actions bear any direct risk for national government budgets as the funds would be collected from banks, not governments, and SRB debt – if issued – would be sold to market actors and reimbursed in the medium-term through ex-post contributions to the SRF. Banking union national governments – and in particular Germany with its large number of low-risk cooperative and savings banks – sought to avoid any undue financial burden for domestic banks. Thus, the implementing and delegated acts on bank contributions to national resolution funds and the SRF specify risk profiles as a major factor determining these contributions (Art. 70(6) SRMR).

With regard to using the national and common (European) backstops, the SRB plenary could decide by two-thirds majority representing at least 30 per cent of contributions (see Table 1). However, throughout the transition period, the credit lines from member states were under national control and could technically be refused. Thus, even though the SRB

Table 1. Use of the SRF and member state decision-making.

Use of SRF	Up to €5bn (capital already in the SRF)	More than €5bn (capital already in the SRF)	Borrowing from the market or public instruments, collection of ex-post contributions (capital not in the SRF)
Member states intervention possibility	Only when Commission objects to SRB proposal	In the SRB plenary by simple majority (30% of contributions) if requested	In the SRB plenary by 2/3 majority (30/50% of contributions)
Assessment of control	Weak	Collectively if majority agrees	Collectively with 1/3 +1 to block or 2/3 to agree; individual veto on national and ESM backstops

had and has the competence to ask for a credit, it had and has no direct control over receipt of the funds. The same holds true for a potential common European backstop via the ESM. The SRB can ask for the credit from the ESM, but the ESM Board of Directors – i.e. government representatives – which decides by unanimity, could refuse the provision of a credit to the SRB (ESM 2019).

EU member state governments have delegated substantial competences to the SRB. The Board can decide on resolution action in the plenary and borrow from public and private entities, based on future contributions from the banking sector. While the SRM Regulation states that the funds borrowed had to be reimbursed by the banking sector in time of the maturity of the loan (Art. 73), the regulation does not limit the amount which could be borrowed. Considering that the SRF's funding base is the entire banking system in the EU, its borrowing costs and access to private market funds could be easier to obtain. For money already available in the SRF and for borrowings on the private market and from public entities, the SRB decides in its plenary, composed principally of representatives from national resolution funds. This composition prevents resolution action and borrowing if a majority of member states is opposed. Thus, for actions involving more substantial funds and borrowing, the decision-making reflects better an intergovernmental design similar to the Council, rather than a supranational entity.

6. Monitoring the implementation of the SRM

Under the SRM Regulation, the SRB is accountable to the EU Council of Ministers, the European Parliament and the Commission. Monitoring of its activity is undertaken through an annual report presented to these institutions, as well as to national parliaments and to the EU Court of Auditors (Art. 92 SRMR). The European and national parliaments have the right to request hearings and exchange views with members of the SRB (Art. 46 SRMR). The member states also required the Commission to undertake a triennial review of the operation of the SRM. This review is to consider the impact of the SRM on the functioning of the Single Market and assesses institutional and policy effectiveness including: the necessity to allocate competences to an independent EU body; progress in terms of breaking the sovereign-bank doom loop; the appropriateness of the governance/voting arrangements in the SRB; and the amount and collection of contributions to the SRF.

Through the explicitness of the reporting requirements, the collective principal assigned the agent a clear task. Regarding the transition period, the member states imposed reporting every 18 months on the SRB regarding the implementation of a compliance clause of the IGA. Through reporting and reviews, the member states have put in place a police patrol: regular required reporting by the SRB and the Commission to the European Parliament and Council, specifically examining the main elements of delegation which include decision-making, competences and the achievement of regulatory objectives. This police patrol is coupled with fire alarm mechanisms. The SRM Regulation assigns the various actors to which the SRB reports the possibility to monitor the Board's behaviour and to signal if this behaviour is not in line with the regulation. Through these reports, national governments are also aware of the behaviour of the compliance of other governments – for example, with regard to the transfer of funds to the SRF. Member states can thus rely on several institutions – which focus on a number of issues in the implementation of the SRM Regulation – to sound the alarm when needed.

Based on the monitoring of the implementation and functioning of the SRM, member state governments can decide to modify resolution rules and procedures. The barrier for changing the European banking union legislation – both the BRRD and the SRM Regulation which are based on EU secondary law – is the Ordinary Legislative Procedure. Thus, the European Parliament is co-legislator and the Council decides according to qualified majority vote (QMV). The monitoring competences are only conferred regarding these pieces of legislation. However, no monitoring is foreseen for the Treaty Establishing the ESM and the intergovernmental side agreement on the gradual transfer of national funds to the SRF, which ceased to apply at the start of 2024. For this treaty and the IGA, the barrier for adjustment was/is unanimity, without the European Parliament's involvement.

7. Ex-ante conditionality and control in the transition period

The design of the SRF and its backstops reflects a balancing act between northern euro area member state governments, which sought to avoid imposing an excessive burden on their banking sectors and public finances, while increasing the credibility of the SRM vis-à-vis the financial sector and financial markets more generally. The result was a mix of burden sharing via the increasing transfer of funds to the SRF and risk reduction to avoid overburdening relatively stable banking sectors and fiscally sound member state governments. The above-mentioned monitoring mechanisms were thus coupled with the possibility of member states revoking – by simple majority – access to the SRF if a banking union member state failed to transfer national resolution funds to the SRF in the transition period (IGA Art. 20(2)).

The transition period is a clear example of this balancing act: it combined the construction of a common European safety net with rules and procedures designed to avoid shifting to the European level the cost of 'legacy issues' affecting specific national banking sectors. Non-performing loans (NPLs) were a particular problem in Italy and Portugal. The northern member state governments were keen to impose the ex-ante reduction of bank balance sheet risks. They also sought to create disincentives for turning to European resolution funds by including – as with the ESM's Direct Recapitalisation Instrument – a bail-in provision that imposed initial losses upon the bondholders of financial institutions prior to accessing the SRF (Art. 15, SRMR). This provision required bondholders to bail-in at least 8 per cent of the total liabilities of a bank subject to resolution procedures, allowing the SRF to contribute a maximum of 5 per cent of total liabilities to individual resolution efforts.

The SRM Regulation bail-in provision created particularly sensitive political issues for the Italian government. Many depositors of Italian banks had a significant percentage of their savings in the form of bank bonds, thus making them bondholders and not just depositors – which were secured to an amount of €100,000 by EU and national legislation. The SRM bail-in provision disincentivised Italian banks – and the Italian government – from using the SRF, as it inevitably came with a large social cost for citizens (Messori 2016). At the same time, this bail-in provision was the key condition for northern member state governments to accept the transfer of national resolution funds to the SRF. While the rules and provisions – at least to some extent – disincentivised the use of the SRF, the gradual transfer of national funds during the transition period increased the safety structure for bank resolution and recovery at the EU level – a dynamic that Arnal (2023, 1) describes as a combination of risk sharing and risk reduction.

The 2014 intergovernmental side agreement on the transition period thus stated that the use of the mutualised funds of the SRF as well as the transfer of funds to the SRF were contingent on the adherence to bail-in provision in the BRRD and the SRM Regulation. This aspect was referred to as 'permanence of a legal framework', stating:

> The use of the Fund on a mutual basis and the transfer of contributions to the Fund shall be *contingent upon the permanence of a legal framework on resolution whose rules are equivalent to, and lead at least to the same result of those under the SRM Regulation* as laid down in the following rules, and without changing them: [. . .] notably the principles that the *shareholders of the institution under resolution bear first losses* and that the creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims [. . .]. (IGA, Article 9. (1a-c); italics added)

This 'permanence of a legal framework' clause included in the IGA thus made it de facto impossible to make substantial changes to the bail-in provisions or decision-making rules of the SRM Regulation and BRRD. The intergovernmental character of the agreement allowed each national government signatory to invoke a 'fundamental change of circumstances' ending the agreement and with it the use of SRF funds and further transfer of funds to the SRF. The IGA referred to the Vienna Convention on Law of Treaties as well as to international customary law. These references were a novum, indicating that a change to the bail-in provisions constitutes a change to the essential basis of consent to the IGA and thus to the funding of the SRF.

The national credit lines as backstops to the SRF during the transition period were not part of an intergovernmental agreement. Rather, these were instruments which were entirely in the hands of the individual banking union national governments. The harmonised Loan Facility Agreements signed between governments and the SRB required each government to set up a credit line of the size of their national compartment in the SRF, which could be drawn upon by the SRB in plenary. However, the disbursement of this credit was to be decided solely by the country that lent to the SRB (eISB, 2016), which preserved each country's fiscal sovereignty and the possibility to veto the use of additional funds. Thus, in addition to the safeguard included in the deviation from the rules and procedures laid down in the SRM Regulation, BRRD, and IGA, governments could also withhold their national backstop to the SRF.[8] Hence, the principal(s) had sanctioning mechanisms at both the European and national levels to ensure compliance with the common rules.

8. Ex-post control from the start of 2024

Before the Loan Facility Agreements could be replaced by the ESM as a common backstop for the SRF, the northern coalition of member states demanded the ex-ante reduction of risks on bank balance sheets, notably in euro periphery countries – and specifically the reduction of non-performing loans (NPLs). This requirement forced risk reduction in the euro area. Between 2016 and 2022, the NPL ratio dropped below the respective 5 (gross) and 2.5 (net) per cent reference points. For example, in Italy, this development was driven by government schemes enabling banks to off-load their NPLs into special purpose vehicles and thus strengthening their capital ratios (Dimarco 2018). In response to this risk reduction, the euro area member states agreed to transform the ESM into the SRF's common backstop in the ESM Treaty reform of 2021.[9] Originally, the ESM was to take up the role of the common backstop from the start of 2024. As of October 2024, these amendments have yet to be ratified by Italy, leaving the SRF without national credit lines and without a common backstop.

From the start of 2024 and with the fully funded SRF, banking union national government exposure to direct risks was to be limited to the use of the ESM funds in its role as a common backstop. The amended ESM treaty foresees a maximum amount of €68bn for its new role as the SRF's common backstop. Funds up to this amount would be lent to the SRF, which would reimburse the ESM in the medium-term, making this lending fiscally neutral for ESM national governments. Furthermore, the lending to the SRF is seen as less risky than to a single bank (FitchRatings 2018). The possible use of ESM credit to the SRF will have an impact upon the ESM's overall lending capacity with a 1:1 ratio, whereas the use of the Direct Recapitalisation Instrument of €60bn, which is to be replaced by the backstop, would affect it with a 1:3 ratio (ESM, n.d.). Yet the €68bn are considered to be part of the mechanism's overall lending capacity of €500bn.[10] Thus, its use potentially reduces the availability of funds to support euro area national governments in need.

If the revised ESM Treaty is ratified, the ESM would decide on the release of each backstop credit by unanimity within its Board of Directors (i.e. government representatives). The ESM would receive all relevant information on the resolution cases to be covered by its backstop including a confirmation that no other means are available to cover the SRF's expenses (ESM draft guidelines on backstop, Art. 4). These provisions make the backstop, even if ratified, not automatic, and gives significant oversight to governments on the use of the SRF. While decision-making on resolution cases is not foreseen within the ESM, a case could easily be used by a government as leverage to demand further conditions for the use of the ESM in a specific case. Thus, even though the ESM is only to monitor the proper use of its funds in case of the use of its backstop, its intergovernmental character and use of unanimous voting gives governments a significant control and veto possibility on its use – an important sanctioning mechanism coupled with police patrol monitoring of SRB action by the ESM.

Euro area national governments also included a 'permanence of the legal framework' clause in the revised ESM Treaty. This permanence refers to the maintenance of the equivalence of the rules regarding resolution – resolution procedures, decision-making rules, general principles of resolution, and rules on resolution tools – and emphasises in particular the threshold of bail-in rules and minimum requirement for own funds and eligible liabilities.

> The backstop facility and its use under this Article *shall be contingent upon compliance with the condition of permanence of the legal framework* for bank resolution. Where the condition of the permanence of the legal framework for bank resolution is not complied with, a comprehensive review will be initiated and a decision by the Board of Governors shall be required to continue the backstop facility [. . .] (Art. 18a(8), revised ESM Treaty; italics added)

The use of the ESM as a backstop is, under this clause, dependent on the continuous adherence to the rules and procedures of the SRM Regulation adopted in 2014. As Germany and the Netherlands had strong preferences for bail-ins (Howarth and Quaglia 2016), they favoured the inclusion of an additional safeguard in the ESM Treaty reform of 2021 – similar to that in the 2014 IGA – which solidified this element of banking union by making it a permanent condition. The aim was to prevent any gradual erosion of this principle by member states favouring less stringent rules on bail-in from the start of 2024.

Under the reformed ESM Treaty of 2021, participating national governments obtained the right to notify the ESM and SRB of a breach of the permanence clause – an important sanctioning mechanism regarding the future operation of the ESM backstop. This notification is to trigger a comprehensive review procedure as long as no other ESM national government has made a request to the Court of Justice of the EU and the latter has ruled that no such breach occurred. Following the comprehensive review, the ESM Board of Governors – consisting of national ministers of finance – is to decide by unanimity on continuing the backstop or to amend it.[11] After receiving the notification and initiating the comprehensive review procedure, the ESM's role as a backstop is to be suspended if no decision is made after 90 days (see ESM 2019). Thus, instead of being stuck with a common backstop in case of disagreement, the ESM's role as common backstop would be suspended.

If in theory a banking union member state notifies a fundamental change, and the Court of Justice has ruled against it, any member state will still have the possibility to block any use of the backstop in individual cases through voting in the Board of Governors. The decision to set up a credit line to the SRF is to be taken by unanimous vote, giving each euro area national government the possibility of a veto.[12] This required unanimity is an inherent feature of the ESM's intergovernmental structure, established to safeguard creditors as much as possible from involuntary expenses. This will give member states strong sanction mechanisms enabling them to suspend the ESM's delegated role, and significantly raises the barrier on legal change.

Scholars have observed that the inclusion of the 'permanence of the legal framework' clause assigns more power to a single member state and is a potent threat to EU law (Keppenne, Maxian Rusche, and Estrella Blaya 2019). The SRF IGA mentions a 'fundamental change of circumstances', which under public international law allows for a unilateral withdrawal from an agreement. In this case, a single member state could prevent any substantial amendment to the SRM Regulation with the threat of suspending contributions or revoking the national credit line (in the transition period) or the ESM's role as common backstop (after the transition period). This 'permanence of the legal framework' clause is a novel safeguard for member states against the 'Europeanisation' of the backstop facility under the SRF IGA and reformed ESM Treaty, by which is meant that neither the European Parliament nor the Council can amend by QMV the SRM Regulation without severe repercussions exercised through the veto of a single member state.

A breach of the permanence clause would result in member states playing a central role – through sanctioning – in the form of a veto on the use of the backstop. This in turn potentially undermines the role of the European Parliament in future decision-making on the operation of the SRM.[13] A veto possessed by each member state government allows it to block the procedure to amend the SRM Regulation. The governments of the northern coalition of member states have thus in effect introduced the 'permanence of the legal framework' clause into the reformed ESM Treaty to prevent the collective principal from potentially hijacking the SRM by slowly eroding its rules and procedures. This conditionality on the backstop is thus, potentially, an important sanction mechanism to ensure that all members of the collective principle adhere to the existing SRM rules. At the national level, opposition political parties and other individuals could – through national courts – also trigger a 'fire alarm' in the event they fear a breach of the permanence clause of the SRF IGA of 2014 and the reformed ESM Treaty of 2021. They could force the hand of individual euro area national governments – legally and politically – to block proposed reforms to the SRM Regulation. Thus, the combination of monitoring and sanctioning mechanisms would provide a strong control of the use of the common backstop through national governments.

9. Conclusion

Member state governments have partially addressed the issue of public financing for bank resolution through the creation of national and European resolution funds, financed through ex-ante contributions by banks. The use of these and other funds was to undermine the sovereign-bank doom loop by sparing governments and taxpayers the financial burden of bank bail-outs. However, there was significant disagreement among member state governments on several issues concerning the SRF, including the control over and the conditions for accessing the fund's backstop facilities. The member states agreed compromises on the main legislative texts to establish, on the one hand, a European system of bank resolution funding with supranational authority and decision-making but, on the other hand, a very strong national role in the oversight of the use of the SRF and its backstops.

The terms of delegation on the use of the SRF and its backstops were strongly influenced by the German and northern coalition preference of minimising a potential financial burden and avoiding moral hazard by imposing ex-ante conditions. The rules and procedures for resolution and recovery are very explicit, including bail-in provisions, limiting the margin of manoeuvre of the agents as to how to apply the SRF and backstop funds. The delegation of decision-making varies. While decision-making within the SRB is dependent on the amount of funds used from the SRF, and mainly follows a qualified majority structure similar to the Council, any use of the backstops – the national Loan Facility Agreements and eventually the ESM – were and would be dependent on national government approval. Thus, decision-making is 'tangled' between supranational, intergovernmental and national actors (Henning 2017).

In terms of compliance, the backstop facilities only exist as long as the procedures and rules of the SRM Regulation are not amended in a way that makes the bail-in rules less stringent or the procedures different from the agreed formats. The use of the SRF and implementation of the SRM are monitored by a range of police patrol and fire alarm mechanisms managed by European and national bodies. These monitoring activities are coupled with strong sanctioning mechanisms for governments in case of non-compliance with the delegated rules and procedures. During the transition period, any banking union national government had the possibility to revoke its national backstop, and – thanks to the provisions of the revised ESM Treaty, if ratified –

any banking union national government will be able to suspend the ESM as a backstop to the SRF. These vetoes provide the most effective control mechanism available to member state government principals to ensure the terms of delegation. Governments could also use their veto as leverage to coerce other governments into political concessions for cases which require the use of the SRF in combination with the ESM backstop.

In mid 2025, the reform to the ESM has yet to be ratified. The European resolution regime in place has limited firepower which has yet to be put to the test. It remains to be seen how cases involving large amounts from the SRF will be handled, especially where these cases have a significant political cost regarding potential bail-ins. The SRM includes rules according to which larger banks are not supposed to rely on their home governments for bail-outs and their resolution is directly handled by the SRB. However, the resolution of small and mid-sized banks is still managed through national rules – the BRRD as transposed into national law – and by national resolution authorities. In effect, this increases the likelihood of bail-outs (European Commission 2023). Thus, in 2023, the Commission proposed to apply the SRM rules to the resolution of smaller banks using the SRF. However, this proposal was opposed by several member state governments as it again included some form of a common deposit guarantee scheme – which did not yet exist – and additional rules for smaller banks. Thus, an effective test of the operation of the SRF and its backstop will only take place when a larger bank is allowed by its home government to fail.

Member state governments are unlikely to make substantial changes to the European resolution regime – which would require unanimity in the Council. The ‘permanence of the legal framework’ clause included in both the 2014 SRF IGA and revised ESM Treaty of 2021 in effect annuls the Ordinary Legislative Procedure (OLP) applied to the BRRD and the SRM. Thus, the ‘permanence of the legal framework’ makes the ESM a ‘conditional backstop’. The provisions on resolution are deliberately difficult to amend, while providing individual member state governments a relatively easy procedure to unilaterally block the ESM backstop.

Those member states, the banks of which are less likely to need to use the SRF, could find in the ‘permanence of the legal framework’ clause a useful tool to veto possible amendments to the SRM Regulation. The current and proposed European resolution regime should thus be seen as a limited form of delegation, supranational in parts but intergovernmental in the use and maintenance of the backstop, making its use highly conditional on the compliance with the rules of the SRM Regulation, and giving member states a strong control over the entire structure. The use of non-EU, intergovernmental legal agreements to constrain the operation and potential modification of EU legislation is problematic. If ratified, the revised ESM Treaty will contribute to further ‘tangling’ the governance of the European banking union.

Notes

1. The German government was also mindful of the ongoing threat of domestic legal challenges to European-level financial support mechanisms.
2. The bail-in provision became mandatory as of 1.1.2016, which triggered several resolution cases before this deadline.

3. As of early 2025, the ECB was in charge of 114 larger banks and four cross-border banking groups (together representing about 82 per cent of euro area banking assets), while thousands of smaller banks (Less Significant Institutions) headquartered in banking union countries remained under the supervision of national authorities.
4. Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund.
5. SRM regulation Art. 71–74.
6. These 21 national representatives include those from the authorities of 20 euro area countries and one from the resolution authority of Bulgaria, which has a closer cooperation agreement with the SRB/F.
7. Note: Art. 73 of the SRM Regulation allows the SRB to contract borrowings on the market as part of step 5. The legal provisions do not specify the amount the SRB can borrow.
8. In the transition period, the SRF could also make internal transfers between compartments to address shortcomings in one national compartment. However, governments could also limit the use of these non-mutualised funds in the SRF. The order of funds to be used was explicit in the SRF IGA, and the transfer between compartments was only possible if ex-post contributions were not immediately accessible. Governments could object to the transfer under a number of conditions. Given limited space we do not explore these possible internal transfers – which never took place.
9. Part of the agreement was a change to the IGA regarding extraordinary ex-post contributions. This 'agreement amending the agreement of transfer and mutualization of contributions to the Single Resolution Fund' was however, not ratified by Italy.
10. As credits from the ESM to the SRF are to be repaid within three years (fiscal neutrality in the medium-term) via ex-post contributions, the question remains whether banks would be able to shoulder such an effort, considering that the use of the ESM is last resort, meaning that the SRF is already depleted. Banks would then have to replenish the SRF and repay the ESM within 3 years, which indicates that their annual contribution could not only double compared to standard ex-ante payments, but could reach approximately five times the amount. At the same time, many banks might lack funds given the needed resolution capital used from the SRF and ESM.
11. According to Art. 4 of the ESM Treaty: 'The adoption of a decision by mutual agreement requires the unanimity of the members participating in the vote. Abstentions do not prevent the adoption of a decision by mutual agreement'.
12. Even the emergency procedure which requires support by 85 per cent of the capital subscribers of the ESM gives a veto possibility to each of Germany, France and Italy alone.
13. However, the European Parliament can still perform a potentially important 'fire alarm' role to alert national governments to problems in the SRM and SRB and thus discourage the use of the ESM backstop.

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