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STRENGTHENING THE RESOLUTION FRAMEWORK IN THE EU: THE CMDI PROPOSAL AND NEXT STEPS

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1. INTRODUCTION

In the aftermath of the financial turmoil caused by tensions in the banking sector in US and Switzerland in the Spring of 2023, and with July 2024 marking the ten-year anniversary of the landmark legislation that changed crisis management in the EU, this article looks back on the development of the European resolution framework since the approval of the Bank Recovery and Resolution Directive 2014/59/EU (BRRD) a decade ago. It highlights the achievements and decisive progress made in building a robust and flexible system that has successfully contributed to protect both financial stability and taxpayers these past years. At the same time, it also reflects on the key lessons learned from recent global experiences and puts forward aspects that have yet to be addressed to strengthen the crisis management framework in the Banking Union.

In covering these aspects, this article analyzes the European Commission proposal for reform of the crisis management and deposit insurance framework (CMDI) presented in April 2023 and currently under negotiation. This proposal, born with the main objective of finetuning and levelling the playing field in the resolution of smaller and medium-sized entities, is an important step forward in enhancing several areas of the current design. However, it still falls short of resolving certain weaknesses traditionally identified in the Banking Union and once again brought to light by recent events. The timeliness of the proposal serves as the perfect opportunity to undertake a profound debate on these pending issues and drive continued work on enhancing the framework.

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2. 10 YEARS OF A CHANGE IN PARADIGM

Over a decade has passed since the *Key Attributes of Effective Resolution Regimes for Financial Institutions* were adopted by the Financial Stability Board in response to the global financial crisis. This agreement reflected the profound change demanded in the traditional way of managing banking crises around the world, which up to that moment had mainly fallen on taxpayers' shoulders. It led to a profound institutional and regulatory revolution worldwide that has made it possible, in recent months and years, for authorities to successfully face the crises of even systematically large entities, managing to protect financial stability and the economy while at the same time shielding public funds from bearing losses, an option unavailable only a few years ago.

THE NEW CRISIS MANAGEMENT FRAMEWORK IN EUROPE

In Europe, the new crisis management paradigm was implemented with the Bank Recovery and Resolution Directive (BRRD) and, for Banking Union countries, with the SRMR (Single Resolution Mechanism Regulation 806/2014/EU). As a key step in breaking the sovereign-bank doom loop and reducing the risk of contagion of problems in the banking sector to the public sector, the new regulation enshrined the principle of bail-in, according to which the shareholders and creditors of the entity are the first to bear losses in case of bank failure. For cases in which this absorption of losses by shareholders and creditors is not sufficient, the Directive also established a second line of defense in the form of national financing arrangements—which in the context of the Banking Union became a joint, gradually mutualized, Single Resolution Fund (SRF)—made up of contributions from the industry, reinforcing the principle that the cost of financial crises is borne by the private sector.

Further, to provide the framework with the necessary credibility and ensure preparedness for any crisis situation, the new regulation placed a significant focus on resolution planning and preparation in times of peace by entities and authorities, as well as on the establishment of a minimum requirement for own funds and eligible liabilities (MREL). This requirement, which was further refined with the implementation of the so-called BRRD II (Bank Recovery and Resolution Directive 2019/879/EU), is meant to ensure that entities have a sufficient level of resources on their balance sheets with the capacity to absorb losses and recapitalize the entity in a crisis.

Over the past ten years, the European resolution authorities, led by the Single Resolution Board (SRB) in the Banking Union, have worked hand in hand with banks in drafting and approving resolution plans and operationalizing resolution tools, reducing obstacles to resolvability on a wide range of dimensions (governance, liquidity, operational continuity, etc.), preparing and planning for an eventual crisis and ensuring adequate financing in resolution, both through the build-up of the necessary loss-absorption capacity as well as through the constitution of the Single Resolution Fund.

This January 2024 marks a turning point in the resolution framework in the Bank-

ing Union, with the end of an 8-year transition period. By this date the SRF should be fully built-up and mutualized, reaching its target of 1% of covered deposits (an amount close to 80 billion euros). Entities, on their side, should have met their final MREL targets and must comply with the SRB's Expectations for Banks (EfB) which set out the capabilities a bank should develop to demonstrate they are resolvable. As of end-2022, the cut-off date for the SRB's latest Resolvability Assessment Report, the vast majority of banks were well on track to complying with the EfB as well as with their final MREL target for 2024, including the Combined Buffer Requirement (CBR)[2].

But progress has not only been made in the planning and preparation dimension. The new framework was successfully put to the test for the first time in 2017 in Spain, with the resolution of Banco Popular. On that occasion, the shareholders and creditors of the institution assumed the cost of the failure of the 6th largest bank in the country. After implementing the sale of business tool, branches opened the following day in business as usual, without any impact to the markets or depositors, with the buyer providing the necessary liquidity to keep the bank operating.

Subsequently, the failure of several entities in other European countries such as Italy or Latvia took place. In these cases, the SRB concluded that resolution action was not warranted in the public interest, and as a result, the banks were wound up under national insolvency proceedings, in some cases with State aid to support the liquidation process. In February 2022, a new resolution took place, and the SRB again implemented a sale of business tool for the subsidiaries of the Sberbank group in Croatia and Slovenia, while the Austrian parent company of the group was wound up under normal insolvency proceedings. In this instance, the moratorium tool was also successfully used for the first time.

These first experiences already offered a number of key lessons, most notably the need to finetune the resolution legislation to more specifically address the failure of small and medium-sized entities and ensure a level playing field across the Banking Union. This prompted the European Commission legislation proposal covered more in-depth later in this article. All in all, however, in early 2023 there was widespread confidence not only on the progress achieved in reinforcing the resilience of the banking sector since the past crisis, with entities having survived largely unscathed the tensions derived from extremely grave and unprecedented circumstances such as a global pandemic and a war in Ukraine, but also on the capacity and ability gained to quickly and effectively confront any crisis, even very sudden ones.

2023: THE MOMENT OF TRUTH

It has to be said that the true test to the new global framework came in the first quarter of 2023, when the US and Swiss authorities once again faced a crisis of a dimension that dangerously evoked the events of fifteen years ago.

[2] 2023-09-10_SRB-Resolvability-Assessment-2022.pdf (europa.eu).

There are many important lessons to be learned for authorities from these recent cases. Certainly, traditional ones for supervisors, with regard to the sustainability of business models, governance and risk management. New ones as well, related to the impact technology now has on the liquidity position and evolution of an entity in the run-up to a crisis. Depositors' ability to withdraw deposits at extraordinary speed from any electronic device 24/7 and the amplification of bank runs that social media provides, with communications exponentially increasing in speed and scope of distribution, represent key challenges and materially influence the timing of a crisis.

In this article, however, I will focus on one of the most relevant aspects to be learned from a traditional crisis management perspective: all the spring crises were addressed by selling the entity in crisis, as had already been the case before with Banco Popular and Sberbank. In addition, given the abruptness and systemic dimension of the crisis, it was also necessary for authorities to provide:

(1) ample guarantees to address the uncertainties that the balance sheets presented to buyers.

(2) substantial liquidity support from Central Banks, also backed by national guarantees.

The fact that these guarantees ultimately came from the Treasury and, thus, the taxpayer and that, in the case of Credit Suisse, the situation was managed outside of resolution (without authorities formally declaring the entity as failing or putting it into resolution) initially generated a certain degree of mistrust in the framework, which was further aggravated by some controversial measures such as the write-down of AT1 instruments without a prior write-down of shares. Voices were heard putting the whole new crisis management paradigm into question and criticizing its lack of effectiveness. Indeed, more than a decade after the FSB Key Attributes, many interpreted that we were back to square one in managing crisis, once again resorting to massive government intervention to save the day.

However, time has shown that the decisions taken at the time were effective for preserving resolution objectives and that in the end, US and Swiss authorities successfully managed to stabilize the markets and the banking sector, protecting financial stability and the economy, at no ultimate cost to the taxpayer.

Indeed, it is important to highlight two key developments of the last months:

- In the US, the estimated cost of the resolution cases to the FDIC (around 16.3 bn USD), attributable to the protection of uninsured depositors, is expected to be recouped from a special assessment on the industry which

will start to be collected in 2024. The FDIC Board of Directors approved the final rule on its implementation in November 2023[3].

- In Switzerland, UBS voluntarily terminated in August the CHF 9 billion Loss Protection Agreement and the CHF 100 billion Public Liquidity Backstop that had been granted by Swiss authorities in March[4]. These guarantees that kicked in following the absorption of losses by shareholders and creditors were necessary to restore confidence but ultimately the taxpayer did not have to bear any cost.

In fact, far from proving the failure of the framework, it can be said that events in spring actually demonstrated its relevance and effectiveness in helping manage a banking crisis, even if crises never unfold the way they were originally foreseen to. In the case of Credit Suisse, it is true that a resolution was not executed, but the fact that the framework was in place and that many years had been dedicated to resolution planning and building TLAC decisively contributed to finding a solution. To name only a few differential factors of the Credit Suisse case with regard to crises a decade earlier:

- The group held sufficient bail-inable instruments to absorb losses and recapitalize the entity in case of need. A clear alternative course of action was therefore prepared and readily available in case a sale to a third party, a solution which is always the preferred one for authorities but which can unfortunately never be guaranteed ex-ante, failed.

- This alternative to the sale left shareholders in a much worse situation, a factor which presumably was quite persuasive in helping pave the way to an agreement with a rival who appeared to only be willing to buy outside a resolution context.

- The crucial close cooperation and coordination between the many authorities monitoring the situation of a systemically global entity was made possible through the open lines of communication and collaboration built through the set-up of Crisis Management Groups and regular exchanges in other international fora established under the auspices of the FSB.

In short, it is fair to defend that the management of these latest crisis cases contributed to consolidating the paradigm shift illustrated in the FSB Key Attributes. Although no amount of preparation can provide full visibility on how a crisis will evolve and which solution will be implemented in the last instance, the work of recent years has endowed

[3] FDIC: Final Rule on Special Assessment Pursuant to Systemic Risk Determination.

[4] UBS Group AG voluntarily terminates Loss Protection Agreement and Public Liquidity Backstop guaranteed by Swiss government and Credit Suisse AG fully repaid ELA+ loan | UBS Global.

authorities and banks with the capabilities and tools to handle a crisis, being able to react flexibly to evolving circumstances.

LESSONS FOR THE BANKING UNION

In the case of the Banking Union, however, although key pillars of the framework are well established, recent experiences in the US and Switzerland also provide an opportunity for further reflection on certain aspects that have yet to be incorporated into the framework in order to allow us to manage bank failures with the same degree of effectiveness as our international counterparts.

I would highlight three key missing pieces:

- We have long been calling for a fully European and sufficiently powerful mechanism to address the liquidity needs of newly resolved entities. Despite their restored solvency, these entities may need time to regain the confidence of the market and will likely face liquidity tensions in the immediate aftermath of a resolution. The current framework relies on a Single Resolution Fund (SRF) and, if the new ESM Treaty is ever ratified, on a backstop provided by the European Stability Mechanism (ESM), but the unprecedented level of deposit outflows from an entity seen this spring (with 40 billion dollars being transferred out of Silicon Valley Bank in a matter of hours) stresses the need for an immediate and extensive access to funds, of a different magnitude than that available in the Banking Union (the SRF's approximate 80 bn EUR can increase potentially up to around 150bn EUR with a common backstop). The recent crisis cases clearly show that only Central Banks have the firepower to provide access to potentially unlimited resources to support liquidity and confidence in the aftermath of a resolution. Taking into account the expected depletion of collateral in the run-up to a crisis, some sort of public guarantee would be needed to support access to central bank facilities until confidence is restored and the entity regains access to private sources of funding. In the Banking Union it is paramount that this guarantee is provided at a European level, in order to avoid the damage of fragmentation, and to be consistent with the fact that the entity has been resolved according to harmonized European rules.

- Until such a solution is put on the table, given the lack of readily available liquidity sources post-resolution, both the sale-of-business tool and the guarantees required to facilitate this sale become increasingly important. Indeed, finding a buyer can ensure continued access to deposits, thus restoring confidence. But experience shows that, at the moment of crisis,

the time pressure and uncertainty over certain items of the balance sheet can discourage potential buyers. As we have learned in Spain through the success of APSs (Asset Protection Schemes) and guarantee programs granted in the past crisis, the capacity to cover certain liabilities can be instrumental not only in facilitating a sale but also in maximizing the price offered precisely in this context of high uncertainty. Developing the role that the Deposit Guarantee Schemes (DGSs) and the SRF can play in offering these guarantees, which is very limited in the current framework, is fundamental, so that these guarantees are preferably granted by industry funds rather than the taxpayer.

- Finally, and also very much related to liquidity, the recent cases have also illustrated one unintended consequence of the shift to the new paradigm, which is a potential increase in financial instability and contagion derived from the flight of uncovered deposits expected to contribute as creditors to the cost of a resolution. This has led to much analysis and debate at an international level, with several options being put forward, including the possibility of extending depositor protection to certain deposits depending on their nature and their importance to the real economy (for example, to protect all transactional deposits, as is currently the case in certain jurisdictions such as Japan). Finally, this aspect is closely linked to another long-called for reform in the Banking Union which is a European Deposit Insurance Scheme (EDIS) that would enhance the level playing-field in the Banking Union by ensuring exactly the same protection to depositors independently of their location in the Banking Union.

Admittedly, the complexity and highly political nature of these topics makes any progress on them slow and challenging. As chance would have it, however, when the events this spring unfolded, the Commission was getting ready to present its proposal on a review of the framework focusing on addressing the failure of small and medium sized entities and setting the scene for a profound debate.

3. THE CMDI PROPOSAL

Although its presentation coincided with the international spotlight shining on crisis management, the CMDI proposal presented on April 18 2023[5] had already been several years in the making. In June 2022, the Eurogroup issued a statement on the future of the Banking Union, acknowledging, among other aspects, the need to reinforce this area and tasking the European Commission with a review and a proposal to adjust and

[5] Reform of bank crisis management and deposit insurance framework - European Commission (europa.eu).

further strengthen the EU's existing bank crisis management and deposit insurance (CMDI) framework.

The proposal tackles all three of the main rules dealing with banking crisis management since 2014: the BRRD and SRMR that have already been mentioned before, as well as the DGSD (Deposit Guarantee Schemes Directive 2014/49/EU). The most significant changes are aimed at improving the crisis tools used to manage the failure of small and medium-sized banks, where practices appear to have not always been as harmonized as would have been desirable within a common framework, potentially generating an unlevel-playing field where bank creditors could be treated differently depending on their location in the Banking Union.

MAIN ELEMENTS OF THE PROPOSAL

Among the most notable elements of the proposal, concentrating much of the attention in Council and Parliament discussions in recent months, are the following:

Extension of the scope of resolution

The resolution framework is meant to be applied to any entity in difficulties, regardless of its size and business model, if national legislation does not have the appropriate instruments to adequately manage its failure through traditional bankruptcy procedures.

With the reform, the public interest assessment (PIA), which determines when a failing entity should go into resolution (instead of being wound up under normal insolvency proceedings) is intended to be expanded and harmonized.

To this end, the proposal revises the PIA introducing several relevant clarifications in the draft text (such as the consideration of the interruption of critical functions at the regional level, and not only at national level), while preserving the case-by-case assessment by the resolution authority at the time of resolution.

But the main factor in extending the scope of resolution is the proposed reversal in the "burden of proof" in the public interest assessment so that it is only negative when liquidation under the ordinary bankruptcy procedure achieves resolution objectives more effectively than in resolution (and not only to the same extent as in the current legislative text).

The main rationale behind this broader scope of resolution is twofold. On the one hand, achieving higher harmonization and level playing field given the wide diversity in insolvency regimes across Europe. On the other, recognizing that many national insolvency proceedings are ill-suited to manage the failure of even small banks, given their key deposit-taking role and potential risk to financial stability and the need to facilitate transfer strategies (sale of business and bridge bank) which are not always available in the different national systems.

For countries like Spain, without a bank-specific insolvency regime, where the liquidation of an entity may lead to very lengthy and complex processes, this change is par-

ticularly relevant, although one is left to wonder whether the reformulation of the PIA is sufficient to ensure a level playing field, given that it is still determined case by case relative to each national insolvency regime, which remains to be harmonized.

It is also important to note that being an entity earmarked for resolution also implies certain obligations in terms of resolution planning and MREL requirements that smaller entities may struggle to meet. Many have limited resources to devote to resolution planning and less access to capital markets than larger institutions. This raises the need to accompany this extension in scope with proportionate requirements and further reforms to ensure the necessary financing in resolution for smaller entities, while still fully respecting the key principles enshrined in the FSB Key Attributes.

These concerns on proportionality for the smallest institutions have led to an increasing consensus under the Spanish presidency of the Council whereby the extension of the scope of resolution would not affect the smallest institutions.

Increasing financing capacity in resolution through the use of DGS resources

As a crucial complement to the proposed increased scope of resolution, the proposal dwells on the critical question of funding and reinforces the role played by national DGSs in resolution and offers a bridge to access the SRF funds.

With regards to the role of DGSs to support resolution, it is extended in two ways:

- The DGS resources may be used to facilitate the transfer of all types of deposits (including non-covered deposits, although only under specific circumstances), and not only covered deposits;

- DGS support may take the form not only of cash (covering the difference in value of the assets and deposits being transferred), but also of guarantees. As illustrated by recent crisis cases, this possibility is particularly relevant to facilitate a sale and can achieve a more efficient use of DGS resources, since they do not have to be disbursed upfront.

Even more importantly, a key bridge function is introduced, with the contribution from the DGS counting towards the calculation of the minimum bail-in of 8% TLOF (including own funds) which is necessary to access SRF financing in resolution. This bridge function, however, is not automatic as it is subject to adequate safeguards:

i) Only for banks earmarked for resolution (and therefore having to meet stricter MREL requirements as first line of defense);
ii) Only where the resolution authority determines that non-covered deposits should be protected from losses. This would be the case where the exclusion is strictly necessary and proportionate in order to preserve the continuity of critical functions or where necessary to avoid widespread contagion and financial instability;
iii) Only for the protection of depositors, which caps the DGS contribution

to any shortfall in the value of the transferred assets in comparison to the value of the transferred deposits and liabilities with the same or a higher priority ranking in insolvency than those deposits;

iv) Only up to the amount necessary to meet the 8% TLOF requirement to access the SRF only for transfer strategies with market exit of the resolved entity;

v) Finally, the contribution is capped by the amount of losses that the DGS would bear in insolvency if it paid out covered depositors and subrogated to their claims (least cost test).

The relevance of this bridge function lies in the fact that it limits the use of national resources to the amount necessary to unlock funds that are mutualized in the Banking Union, thus avoiding fragmentation in the management of banking crises along national lines.

Change of the depositor preference in the hierarchy of claims.

The proposal reinforces the role to be played by the DGS in resolution, but it maintains the conditions that must be met for its funds to be used, notably the so-called least cost test (LCT). In accordance with this test, the DGS can only intervene outside of its payout function if the estimated cost of its intervention is less than the cost it would incur in a hypothetical payout to depositors in the event of liquidation (net of recoveries).

To increase the probability of this least cost test being met in resolution, the proposal aims to remove the “super-preference” of the DGS enshrined in the current regime and create a single tier ranking for all deposits (covered deposits and deposit guarantee schemes' claims, non-covered but preferred deposits of households and small and medium enterprises, other non-covered, non-preferred deposits). If DGS claims rank *pari passu* with other depositors’ claims, instead of preferred to them, their losses in liquidation would increase. This increases the amount available under the LCT.

Further, the proposal also establishes the preference of all deposits relative to ordinary unsecured claims, a situation that already exists in certain European countries but that changes the scenario of others like Spain where senior debt continues to rank pari passu to deposits. This enhances and harmonises the protection of depositors by clearly distinguishing deposits from senior liabilities that can bear losses in case of failure with a less material impact on financial stability.

The change in the creditor hierarchy of covered deposits has been one of the most controversial aspects of the proposal, together with the increased role of DGSs in supporting resolution. It is important to highlight that the creation of a single tier of deposits does not undermine the protection of covered deposits, since they remain protected by the DGS in any case: in case of insolvency, the payout by the DGS is triggered immediately, and the DGS surrogates in the position of covered deposits in insolvency. It is therefore the protection of the DGS in insolvency that the proposal changes, not that of covered depositors. In this respect, it is useful to recall that DGSs are funded by the industry and one may wonder why funds from the industry should benefit from a

super-preference against other types of deposits (from households, SMEs, corporations or other financial institutions, for instance).

Under the Spanish presidency of the Council, discussions on the hierarchy of deposits and the use of DGS funds in resolution have not led to any clear consensus. However, some progress has been made in identifying potential elements for a common ground, sketched out in the Presidency Progress Report. Among the most interesting proposals laid out, it is worth mentioning the possibility to define two tiers of deposits (with all deposits ranking senior to other senior debt), combined with a more flexible least cost test that could even include a systemic exemption. At the end of the article, I take the opportunity to further elaborate on this latter aspect.

OTHER CHANGES INTRODUCED BY THE PROPOSAL

The above changes have undoubtedly been the ones to attract the most attention and can perhaps be considered the most relevant (and controversial!) from among the many modifications introduced by the European Commission in its CMDI review.

But the proposal also introduces a number of other novelties in a wide range of areas, more technical in nature, building on experience acquired and lessons learned which are also of key importance for resolution authorities. Among these changes, I would highlight:

- Strengthened cooperation between authorities:
  - — The proposal reinforces close cooperation and collaboration between supervisory and resolution authorities, strengthening information sharing mechanisms in the run-up to resolution, with the introduction of an early Failing or Likely to Fail (FOLTF) warning, among other measures.
  - — Very importantly for resolution authorities from a legal point of view, the proposal also explicitly clarifies that the work to prepare the resolution may begin (sales process and request for information to the entity to prepare the valuation) without the need to activate early intervention.

- Adjustments to the MREL calibration of transfer strategies, essentially reflecting in Level 1 legislation the practices already in place at the SRB for calculating the recapitalization amount when setting MREL targets for entities with a transfer strategy.

- Within the scope of the SRB, the proposal introduces some changes in its governance:
  - — Possibility for the Chair, Vice-Chair and permanent Board members

of the SRB to serve a second term in office (at present, mandates are non-renewable).

— Voting rights are granted to the Vice-Chair, together with the full-time Members of the SRB Board having the right to vote.

4. WHERE DO WE GO FROM HERE?

Although it set out to simply finetune the crisis management framework, it must be said that, without any need for radical upheavals, the CMDI proposal takes bold steps in deepening and strengthening it. And even though it was not a direct answer to events earlier this year, it appears to already address many of the lessons learned.

In my personal view, there a number of positive elements to highlight:

- One of the main foundations of the proposal is recognizing the potential systemic implications of even smaller banks, given their vital role as deposit-takers, and the need to offer those countries without a bank-specific or agile bankruptcy regime with the necessary tools to effectively manage the failure of all types of banks, no matter their size or business model. Resolution appears no longer to be for the few, but for a more pragmatic as many as needed, in order to ensure bank insolvencies are managed through effective administrative regimes allowing for the quick transfer of deposits.

- This raises, however, the question of financing in resolution for the smaller entities, where issuing sufficient eligible liabilities to reach an 8% of TLOF to access the SRF may be unrealistic at the point of resolution. To fulfil their MREL requirements these entities usually rely on CET 1, which may have been largely depleted at the point of insolvency. Deposits usually stand almost next in line to absorb losses. Therefore, reaching an 8% TLOF at the time of resolution may require imposing losses on deposits with potential implications on financial stability. The CMDI proposal also addresses this issue head on proposing a greater use of DGS financing to support the transfer of all deposits in resolution. Importantly, however, at the same time, the proposal builds on and strengthens the key FSB principles, notably that shareholders and creditors must be the first to assume losses in a crisis. It stresses that MREL should continue to be the first line of defence, with all entities maintaining sufficient “skin in the game” to ensure the effective implementation of resolution tools. In my view, further reflections on instruments that would enable smaller entities to fulfil their MREL requirements without radically upsetting their business model would be warranted.

- Given the importance of ensuring liquidity post-resolution and the lack of

European sources of funding at present, it is worth noting that the proposal facilitates the implementation of transfer strategies as the preferred resolution tool for smaller and medium-sized entities. It takes decisive steps towards enabling mechanisms that can facilitate the sale, notably guarantees provided by DGSs, which have proven very effective in protecting taxpayers in past cases, even before BRRD; or in providing a sound legal basis for resolution authorities to start preparations for a sale process at an early stage.

However, the proposal could have been more ambitious on other elements to address long-standing issues in the Banking Union:

- Undoubtedly one of the elements that may raise most questions, in the context of a Banking Union, is the recourse to national funds (with impact on national accounts) in the resolution of an entity under the authority of the SSM and the SRB, which could be perceived to go in the opposite direction to the spirit of the Banking Union in terms of European financial integration. This means that the resolution of entities will be backed by their respective national financial sectors, a situation dangerously evoking spirits of doom loops past. The use of these national funds can only be understood as a second best, with DGSs assuming a first loss tranche ahead of the use of the fully mutualized resources of the SRF. This only highlights the importance of unlocking access to the SRF once the necessary amounts have been obtained from national resources. In the long term, however, EDIS should remain a goal to preserve the level-playing field in the Banking Union.

- Further, although one of the objectives of the reform was harmonization and levelling the playing field in the PIA, to ensure an equal treatment of entities and creditors across jurisdictions, this objective seems complicated to achieve with the proposed reform being still based on a comparison of the resolution framework against each of the national ordinary bankruptcy proceedings of the countries in the Banking Union.

Finally, it is important to stress that the CMDI proposal makes sense as a package, since it contains a number of inter-related elements that need to be put in place simultaneously for the reform to be successful. Discussions in the Council have shown a risk that some elements of the reform could be preserved without others, and we would strongly urge caution in altering a delicate balance. For instance, extending the scope of resolution to smaller entities requires mechanisms to support transfer strategies. Otherwise, resolution authorities could be left in an impossible situation, if they have to declare resolution for entities without the means to finance the necessary solutions.

The overall reform should be coherent and feasible for resolution authorities to implement.

The CMDI negotiations are currently underway and the final outcome of the review is still uncertain. What does seem to be clear is that reaching a common position will require not only maintaining a very technical perspective but also taking new and creative approaches and questioning long-established dogmas.

With this "disruptive" approach in mind, I would like to take this opportunity to make some suggestions to jumpstart discussions:

- Revisiting the need for a Least Cost Test (LCT) when using the DGS in resolution.

  The LCT's main objective is to safeguard the resources of national deposit guarantee funds, that is, industry funds. This test is useful in guaranteeing an efficient use of resources when faced with different alternatives to deal with the failure of an entity in insolvency proceedings. However, in the event of a larger crisis, the US and other jurisdictions do away with this test by invoking the systemic risk exception. This is safeguarded by a sound governance. The result is that authorities have the option to exceed the limits of the LCT to prevent a systemic risk. This systemic risk exception was precisely used by US authorities during the events in March to prevent wider contagion.

  The European framework lacks a comparable tool. However, it already has in place a sound governance framework to assess whether a resolution would be in the public interest. It could be argued that the resolution decision itself in Europe is already a de facto systemic risk clause: when declaring an entity in resolution, authorities have already appreciated a risk to the financial system and that liquidation does not protect resolution objectives to the same extent, with higher potential cost for the economy, for financial stability, for bank clients... In this situation, if the LCT limits the use of the DGS and makes it impossible to access the SRF, we could end up in a potentially destabilizing situation with a very high cost to the economy, financial markets and ultimately with a high potential risk to the taxpayer, which seems counterintuitive when there are still unused industry funds available. Therefore, there is a strong case for considering whether in resolution DGSs should contribute above the limits of the LCT in order to safeguard financial stability, taking into account that there are strong conditions and a sound governance already in place for declaring an entity in resolution. It goes without saying that the amounts provided by national DGSs should be limited to the amounts necessary to unlock European funds provided by the SRF, to avoid fragmentation in the Banking Union.

  This proposal would allow: (i) to have the necessary financing in resolution, avoiding higher costs for the economy, in line with the practice in other jurisdictions, (ii) to dispense with the debate on the hierarchy of deposits, where discussions are stagnant.

- The point made above does not mean that industry funds should be unlocked indiscriminately to support resolution. On the contrary, MREL should remain the first line of defence for financing banking crises. This is clear from the Commission proposal and there is consensus in this respect. At the same time, we should acknowledge that our framework places great emphasis on the capacity of an entity to issue debt or rely on own funds, which for the smallest banks may entail some challenges. The smallest banks may lack the capacities to access capital markets regularly (for instance, this requires a rating) and for volumes sufficient to ensure that their issuances have attractive liquidity. At best, they would be forced to issue at a premium. At worst, the resolution framework may impose disproportionate obligations on the smallest entities, with an impact on their profitability and therefore on their business model, pushing them towards riskier assets seeking higher returns. A framework designed to reduce risks in the banking system would be achieving the opposite.
  The immediate option available for these entities to fulfil their MREL requirements is CET1, which is eligible under the current framework (while the TLAC standard requires that part of TLAC is made up of debt liabilities). In a solvency crisis CET1 is expected to have been depleted at the point of resolution, and thus not available to absorb losses. This illustrates that, rather than focusing on the quantity of MREL required, resolution authorities should focus on its quality and whether this MREL will still be available at the point of resolution.
  While larger entities would have the capacity to issue subordinated debt that can easily be converted into capital without creating NCWO risks, for smaller entities alternatives need to be explored. I would like to suggest a reflection on possibilities to make funds available to authorities without necessarily forcing smaller banks to issue in the market. For instance, entities could constitute voluntary, pooled funds available to be used at the discretion of resolution authorities in case of resolution. These funds could replace part of the entities' MREL requirements. In defining the amounts that need to be available, authorities should take into account that these entities are expected to be resolved by using a transfer tool, preferably a sale of business, entailing their exit from the market, and that therefore no recapitalisation will be needed, only sufficient amounts to absorb losses and incentivise buyers. In addition, by pooling resources among various entities, some diversification benefits could be achieved, given that if the crisis is idiosyncratic not all entities would need to draw from the fund simultaneously.

- Finally, although as resolution authorities we must continue to prepare for any possible scenario, the practical experience in crisis management of the past decade clearly shows that the sale of business is ultimately the best solution in any situation, not only for small entities but even in the failure of a globally systemic one. At a later moment, there will certainly be time to address market and competition concerns and implement business reorganization and restructuring plans as required, but in the face of financial turmoil and contagion in this

highly technological world, the certainty a solvent buyer provides always appears to be the best alternative to protect financial stability. In addition, the sale of business addresses the crucial issue of liquidity after resolution, an aspect that is not satisfactorily addressed with the bail-in tool which only restores solvency. The recent crisis cases highlight the relevance of liquidity in accelerating a crisis and restoring confidence, so the capability of a buyer to provide liquidity is also a relevant aspect to take into account.

Therefore, how can authorities attract buyers in a crisis or how to incentivise them into submitting offers in the midst of high uncertainty? Crucial for the success of a sales transaction is the capacity of authorities to launch a competitive and transparent sales process under the extreme time pressure of a crisis. Sometimes, authorities may be fortunate to be able to rely on a sales process already launched in the recovery phase. Other times, they may have to start from scratch. This is why a stronger legal basis that enables resolution authorities to start preparations in advance is so relevant. The more time authorities can be granted to prepare, the greater the options for launching a competitive process that maximizes the price. At the same time, authorities will have to thread carefully, balancing the need to start preparations on time with the risks of accelerating a crisis if confidentiality is jeopardized. In this respect, the capabilities of the institutions to provide complete, reliable and accurate information on time and to upload it into a virtual data room become fundamental for the success of the transaction. These capabilities on the side of the institutions provide most optionality for authorities, both to switch between resolution tools (for instance, implementing a sale of business instead of a bail-in) and to be able to even change the resolution strategy (entities earmarked for liquidation may need to be resolved depending on the circumstances of the crisis). This would call for ensuring that all entities have a minimum set of capabilities, with the necessary proportionality for the smaller entities, especially those earmarked for liquidation.

With respect to mechanisms that facilitate the execution of the transaction, we have already referred to the necessary mechanisms for not only the DGS but also the SRF to offer guarantees, as already pointed out before. In a context of extremely high uncertainty, these guarantees may prove to be the defining factor that determines the success of a transaction. These guarantees would be provided by industry funds. However, as we have pointed out before, should public guarantees be required for systemic crises or to support access to sufficient liquidity, these should be used only as a last resort, for solvent institutions following a European, harmonised resolution process, and be provided at the European level in order to avoid fragmentation in the Banking Union and ensure consistency with decisions taken at the European level. Recent experience shows that these guarantees can go a long way in restoring confidence in the midst of a crisis, with ultimately no cost to the taxpayer, and in the unlikely event that costs are incurred by public funds, these should be recouped from the banking industry that ultimately benefits from the restored confidence.

Finally, in order to facilitate transfer strategies, it may be necessary to consider potential changes to the framework providing Boards of Directors with the competences to submit binding offers for an entity in resolution (as a general rule, purchases are the competence of the Board of Directors, but they become a shareholder decision if the assets bought exceed a certain value or relative size). It is crucial that before markets open authorities can announce the transaction with sufficient certainty and there may not be sufficient time to call for a shareholders' meeting to approve the transaction during a resolution. The Board should therefore be empowered to assess the purchasing opportunity in a resolution and submit binding offers without risks that at a later stage the buyer can backtrack from the transaction.

5. CONCLUSION

There is a lot to be proud of when looking back at the work done over the past decade in developing a new crisis management framework. Events in recent years have shown that we have built a robust and flexible system with the capacity to quickly and effectively confront banking crises of different magnitudes, successfully managing to protect financial stability and taxpayers.

But the episodes the financial sector experienced this last spring also served as a reminder of how quickly crises can evolve and how important it is to continue learning from experience and applying those lessons to further strengthening and improving the framework. In the case of the Banking Union in particular, there are still some missing pieces that are necessary to complete the reform that began over ten years ago.

The CMDI proposal is not a reaction to the recent banking crises and was originally intended to fine-tune some aspects of the resolution regime. However, its timing provides an excellent opportunity to discuss more far-reaching reforms. As we have noted in this article, the proposal provides a very good basis for progress, but discussions in the Council have shown that any agreement will require an openness to more creative solutions. We have sketched out some proposals that may contribute to strengthen the resolution framework, focusing on the importance of enabling authorities to respond to systemic risks with the necessary tools and adapting the framework to different types of entities, with different sizes and business models.

By enhancing the credibility of the resolution framework, crisis management in the Banking Union would become more predictable, thus preserving the level-playing field with a harmonized framework. Experience shows that banking crises cannot be fully avoided, but it is possible to manage them in order to prevent them from wiping out the prosperity gains achieved in periods of greater stability. This ultimately supports the goals of the EU of increasing levels of sustainable prosperity for its citizens, and it is important that this goal can be achieved consistently across all jurisdictions in the EU.