European Business Organization Law Review (2025) 26:221–240
https://doi.org/10.1007/s40804-025-00344-x

ARTICLE

CMDI Resolution Funding and State Aid Control

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Accepted: 22 January 2025 / Published online: 10 February 2025

Abstract
The State aid regime has dominated crisis management in the EU financial sector ever since the Global Financial Crisis. Even with the BRRD/SRM resolution framework taking effect, most European banks in distress continue to receive public financial support subject only to the State aid regime. However, it is one of the declared aims of the CMDI reform proposals to (further) reduce the bank-sovereign nexus by making it easier for banks of all sizes to access industry-financed resolution and deposit insurance funds instead of obtaining financial support directly from State budgets. This paper explores how the CMDI framework and the State aid regime currently interact and how this would change pursuant to the CMDI reform proposals. It argues that these reform efforts will be unlikely to make much of a difference and that, following their implementation, failing institutions will continue to be channeled away from the BRRD/SRM resolution framework towards a State aid-based assessment and treatment.

Keywords BRRD · SRM · State aid · Resolution · Deposit guarantee schemes

1 Introduction

'State aid rules are intrinsically linked with and complementary to the CMDI framework.' Repeatedly emphasized throughout the CMDI reform proposal documents,[1] historically this is somewhat of an understatement: in many ways, the State aid regime has dominated crisis management in the EU financial sector. During the Global Financial Crisis—before the CMDI framework was even on the horizon—the Commission took on the responsibility of 'de facto crisis-management and resolution authority at EU level' based on the State aid regime.[2] Adopting a very flexible

[1] European Commission (2023a), p 14, note 9; European Commission (2023b), p 4, note 16; European Commission (2023d), p 4, note 16.

[2] Almunia (2013).

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and pragmatic approach, the Commission played a critical role in facilitating the cross-border coordination of government interventions in the banking system and in designing individual rescue measures envisaged by the Member States.[3]

Even with the resolution framework taking effect, most European banks in crisis continue to receive public financial support outside the BRRD/SRM constraints and subject only to the State aid regime.[4] With their 'opt-outs' for precautionary measures and a flexible public interest assessment, it has been said that BRRD and SRM have been 'designed for circumvention.'[5] Accordingly, it is one of the declared aims of the CMDI reform proposals to (further) reduce the bank-sovereign nexus by making it easier for banks of all sizes to access industry-financed standing resolution and deposit insurance funds instead of obtaining financial support directly from state budgets.[6]

This paper argues that these reform efforts will be unlikely to make much of a difference and that, following their implementation, failing institutions will continue to be channeled away from the BRRD/SRM resolution framework towards a State aid-based assessment and treatment. The State aid framework for banks is currently under review with a view to ensuring consistency with, and entry into force at the same time as, the updated CMDI framework.[7] However, due to structural idiosyncrasies, burden sharing and private sector contributions under BRRD/SRM and State aid cannot be fully aligned; the State aid route will remain the more flexible and therefore more attractive option for failing institutions and their regulators. This issue could be addressed by removing all 'opt-outs' from the CMDI framework and making resolution under BRRD/SRM the only show in town,[8] whilst simultaneously removing or at least modifying the 8% minimum loss absorption threshold and utilizing the State aid regime to control moral hazard and ensure market discipline. However, politically, this seems to be unpalatable, at least for now.[9]

We begin with a brief overview of EU State aid control, which is followed by an exploration of how the CMDI framework and the State aid regime currently interact and how this would change pursuant to the CMDI reform proposals. We discuss why the reform proposals will be unlikely to significantly improve the current tendency of relying on national budgets by opting out of the CMDI framework. We conclude by pointing out the need for a radical conceptual rethink.

[3] Gerard (2013), p 234.

[4] European Commission (2023a), pp 30–31: between 2015 and 2022, European banks benefited from EUR 58.2 bn of public financial support in the form of precautionary measures, liquidation aid and public aid in resolution (prior to the 8% bail-in requirement taking effect), as compared to only EUR 6.9 bn of contributions from resolution funds and deposit guarantee schemes.

[5] Gelpern and Véron (2019), p 53.

[6] European Commission (2023b), pp 4–5.

[7] European Commission (2023a), pp 42–43.

[8] Schillig (2021).

[9] European Commission (2023a), p 46, with Annex 14.

2 The EU State Aid Regime: An Overview

The EU State aid regime is sparsely regulated in Arts. 107–109 TFEU, with a general prohibition of state aid,[10] mandatory[11] and discretionary exemptions,[12] procedural rules,[13] and a basis for secondary legislation.[14] The latter has been used to codify Commission practice and case law on procedural matters.[15]

2.1 State Aid Process

A national measure amounts to 'State aid' if it cumulatively meets four conditions: 'First, there must be an intervention by the State or through State resources. Second, the intervention must be liable to affect trade between Member States. Third, it must confer an advantage on the recipient. Fourth, it must distort or threaten to distort competition.'[16] The advantage conferred must be 'such as to favour certain undertakings or the production of certain goods over others which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question.'[17] All of these elements are contested.[18]

The Commission predominantly relies on soft law instruments in which it specifies its intended approach to the compatibility assessment of aid measures under the various exemptions. The compatibility of State aid in the financial sector is assessed pursuant to Art. 107(3)(b): the exemption with a view 'to remedy[ing] a serious disturbance in the economy of a Member State.' Following the first Banking Communication of October 2008,[19] the Commission has issued three further soft law measures: the Recapitalization Communication[20] focusing on the pricing

[10] Art. 107(1) TFEU.

[11] Art. 107(2) TFEU.

[12] Art. 107(3) TFEU.

[13] Art. 108 TFEU.

[14] Art. 109 TFEU.

[15] E.g., Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EC 27.3.1999 L83/1; amended by Council Regulation (EU) No 734/2013 of 22 July 2013 amending Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EU 31.7.2013 L204/16.

[16] C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht* ECLI:EU:C:2003:415, para. 75.

[17] C-409/00 *Spain v Commission* ECLI:EU:C:2003:92, para. 47.

[18] Biondi (2013).

[19] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ EU 25.10.2008 C270/8.

[20] Communication from the Commission—The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition, OJ EU 15.1.2009 C10/2.

of recapitalizations; the Impaired Assets Communication[21] addressing in particular the valuation of impaired assets; and the Restructuring Communication[22] setting out restructuring demands as *quid pro quo* for having received government assistance. Going through several phases, the Commission's standard of assessment gradually moved from very lenient and permissive towards a more rigorous approach, making aid compatibility dependent on increasingly stricter conditions.[23] This approach was codified in the 2013 Banking Communication,[24] the legal nature of which was clarified by the Court of Justice in *Kotnik*:[25] by issuing this soft law measure the Commission imposed a limit on the exercise of its discretion. Any departure puts the Commission at risk of being in breach of the principle of equal treatment and the protection of legitimate expectations. However, the adoption of guidelines does not relieve the Commission of its obligation to examine the specific exceptional circumstances relied on by a Member State. In other words, the Commission must, in principle, authorize a proposed aid measure that complies with the guidelines; on the other hand, the Commission may still authorize aid that does not comply with the guidelines in exceptional circumstances.

The State aid procedure is governed primarily by Article 108 TFEU and the Procedural Regulation.[26] Responsibility for the enforcement of the State aid regime rests exclusively with the Commission, in cooperation with the aid-granting Member State. Under the SRM, the procedure had to be modified to bring the SRB, as an EU agency, to the table.[27] The procedural regime for new aid consists of a preliminary examination[28] and, depending on its outcome, a formal investigation procedure.[29]

The Banking Communication has modified this general framework in important respects. For restructuring aid in the form of a recapitalization or impaired asset

[21] Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ EU 26.3.2009 C72/1.

[22] Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ EU 19.8.2009 C195/9.

[23] Doleys (2012).

[24] Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), OJ EU 30.7.2013 C216/1; replacing the earlier 2008 Banking Communication, and adapting and complementing the Recapitalization and Impaired Assets Communications, and supplementing the Restructuring Communication.

[25] C-526/14 *Kotnik and others* ECLI:EU:C:2016:570, paras. 38-44.

[26] Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EC 27.3.1999 L83/1; amended by Council Regulation (EU) No 734/2013 of 22 July 2013 amending Regulation (EC) No 659/1999 laying down detailed rules for the application of Article 93 of the EC Treaty, OJ EU 31.7.2013 L204/16.

[27] SRMR, Art. 19; and European Commission (2023d), new SRMR Art. 19(3).

[28] Art. 108(3) TFEU; conceptualized as a dialogue between the Commission and the respective Member State. It begins with the notification by the Member State of a proposed aid measure to the Commission (Art. 108(3) TFEU, Procedural Regulation, Art. 2) and imposes on the Member State a 'standstill' obligation prohibiting the granting of aid for the duration of the preliminary examination and, where initiated, also for the duration of the formal investigation procedure, until a final decision is reached (Art. 108(3) TFEU, Procedural Regulation, Art. 3).

[29] Art. 108(2) TFEU.

measure, Member States are invited to establish voluntary pre-notification contacts with the Commission, during which the Commission and the Member State may discuss a restructuring plan. Once agreement has been reached, the Member State formally notifies the Commission of the aid measure. Agreement on the restructuring plan is a necessary precondition for the authorization of this measure.[30] Exceptionally, the Commission may authorize a measure on a temporary basis as rescue aid before a restructuring plan has been approved, provided that this is necessary for preserving financial stability.[31] Throughout the process, the Commission has to liaise closely with supervisory authorities to ensure a smooth interplay between the different roles and responsibilities of all authorities involved.[32] Thus, for the financial sector, State aid control is essentially a four-(or more-)way negotiation between the Commission, the relevant Member State's government, the relevant supervisory authorities, and the beneficiary institution.

2.2 State Aid in the Financial Sector

Under the Banking Communication, 'financial stability has been the overarching objective' for the Commission. At the same time, the Commission aims at 'ensuring that State aid and distortions of competition between banks and across Member States are kept to a minimum.'[33] In an acute crisis, financial stability concerns will usually dominate: at the beginning of the Global Financial Crisis, the Commission tended to approve aid measures very generously. However, with the initial panic subsiding, the Commission increasingly insisted on the implementation of compensatory measures that would offset distortions of competition resulting from State aid.[34] Depending on the type of aid measures, nuanced compatibility criteria apply. State aid must be limited to the minimum amount necessary, and the Member State must demonstrate that all measures to limit State aid have been exhausted. To that end, the Member State will be invited to submit to the Commission a capital-raising plan, listing potential capital-raising and burden-sharing measures.[35] 'Adequate' burden sharing, in principle, requires a contribution to loss absorption of equity, capital instruments, and subordinated debt; not, however, senior unsecured debt and any higher-ranking debt, including depositors.[36] There is no strict numerical minimum amount of loss contribution by investors and no hard cap on the amount of public money that may be advanced.[37] In line with *Kotnik*, the Commission may relax

[30] Banking Communication, *supra* n. 24, para. 34.

[31] Ibid., para. 50. The same applies to state guarantees and liquidity support (other than through central banks), although here a threat to financial stability is not a precondition for temporary approval; ibid., para. 56.

[32] Ibid., para. 14.

[33] Ibid., para. 7.

[34] Doleys (2012), p 560.

[35] Banking Communication, *supra* n. 24, para. 32; Hadjiemmanuil (2016), p 98.

[36] Banking Communication, *supra* n. 24, paras. 41–46.

[37] Although aid should be limited to the minimum necessary, Banking Communication, *supra* n. 24, para. 15.

the burden-sharing requirement in exceptional circumstances and has wide discretion for differential treatment of creditors within the same class and across classes, subject only to the 'no-worse-off' principle.[38] For example, in the cases of Banca Popolare di Vicenza and Veneto Banca,[39] the Commission approved the State aid on the basis that the shareholders and junior creditors fully contributed to loss absorption by staying behind with the residual entities in liquidation. An exception could be carved out, however, for junior retail investors who, allegedly, were the victims of mis-selling and could be fully compensated. Given that State aid control in this area will continue to be based on soft-law measures, extending burden sharing to senior unsecured creditors and imposing a minimum contribution threshold like the BRRD's 8% of total liabilities and own funds[40] would still allow the Commission to derogate from these requirements in exceptional circumstances. And most, if not all, bank failures are exceptional, due to their impact on depositors, retail investors, powerful international actors, or certain sectors within a particular economy, as recent cases, discussed further below, have demonstrated.

If, following the implementation of capital-raising measures and burden sharing, a capital shortfall remains, it may be covered through State aid based on a restructuring plan in accordance with the Restructuring Communication.[41] A comprehensive and detailed restructuring plan should demonstrate how the bank will restore long-term viability without State aid as soon as possible. It should identify the reasons for the bank's difficulties and outline how the proposed restructuring measures remedy the underlying problems. Long-term viability requires that State aid is either redeemed over time or remunerated according to normal market conditions, thereby ensuring the timely termination of State aid.[42]

The necessary measures to limit distortions of competition vary depending on the degree of burden sharing: the greater the burden sharing and the bank's own contribution, the less need for offsetting measures.[43] Distortions of competition may be addressed, in addition to the adequate remuneration of any State intervention,[44] through structural measures, which may include the divestiture of subsidiaries, branches, portfolios of customers, or business units, and/or a reduction of business activity through restrictions on the beneficiary bank's expansion in certain business sectors or geographical areas.[45] Additionally or alternatively, behavioral measures may impose restrictions on the use of State aid for acquisitions, pricing restrictions, and/or certain requirements to lend to the real economy.[46] In the course of the 'precautionary recapitalization' of Banca Monte dei Paschi di Siena (MPS),

[38] Gortsos (2016), p 18.

[39] European Commission, State Aid SA. 45664 (2017/N)—Italy—Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca—Liquidation aid, Brussels, 25.6.2017, C(2017)4501 final.

[40] BRRD, Arts. 44(5) and 101(2).

[41] Banking Communication, *supra n.* 24, para. 31.

[42] Restructuring Communication, *supra* n. 22, paras. 9–14.

[43] Ibid., para. 31.

[44] Ibid., para. 34.

[45] Ibid., paras. 35–36.

[46] Ibid., paras. 39–45.

a restructuring plan was agreed after lengthy negotiations between the Commission, the ECB and the Italian authorities. It envisaged a 5-year restructuring period, with a reorientation of the business model towards retail and SME customers and a strengthening of efficiency through branch closures, layoffs, and an executive pay cap, as well as the disposal of MPS' non-performing loan portfolio.[47]

3 CMDI Framework and State Aid Control: Present and Future

The determination of whether a measure amounts to State aid, and if so, its approval or rejection by the Commission, permeates the entire BRRD/SRM crisis management process: the need for 'extraordinary public financial support'—i.e., State aid—renders an institution 'failing or likely to fail'; preventive measures by national deposit guarantee schemes may or may not constitute State aid and therefore potentially lead to resolution; fund aid through the resolution financing arrangements is, in addition to the BRRD/SRM funding restrictions, subject to State aid control, as are precautionary measures and liquidation aid where resolution is not in the public interest.

3.1 State Aid and 'Failing or Likely to Fail'

An institution will be deemed to be failing or likely to fail in case of a breach of capital requirements, illiquidity or insolvency,[48] or if it requires 'extraordinary public financial support'.[49] 'Extraordinary public financial support' is defined as State aid under Art. 107(1) TFEU and similar public financial support at supra-national level.[50] According to the Banking Communication, a public intervention does not constitute State aid if it takes the form of central bank emergency liquidity assistance (ELA), collateralized and with a penal interest rate, granted to temporarily illiquid but solvent institutions.[51] The Commission justifies this analysis with a lack of selectivity 'where a central bank reacts to a banking crisis with general measures open to all comparable market players … rather than with selective measures in favour of individual banks'.[52] This seems to be in conflict with established case law

[47] European Commission—Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS) (1 June 2017), http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm; European Commission—Press Release, State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena (4 July 2017), http://europa.eu/rapid/press-release_IP-17-1905_en.htm.

[48] BRRD, Art. 32(4)(a)-(c); SRMR, Art. 18(4)(a)-(c).

[49] BRRD, Art. 32(4)(d); SRMR, Art. 18(4)(d).

[50] BRRD, Art. 2(1)(28); SRMR, Art. 3(1)(29).

[51] Banking Communication, *supra* n. 22, para. 62.

[52] Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, OJ EU 19.17.2016 C262/1, fn. 71.

according to which measures benefiting an entire sector can be selective.[53] However, it may be argued that only banks maintain reserve accounts with central banks and are therefore factually in a special situation.[54] Consequently, central bank liquidity assistance is subject neither to the BRRD/SRM nor the State aid framework. From a moral hazard/market discipline perspective, this is problematic: central bank facilities clearly shield the failing bank's counterparties from losses that they would otherwise have to bear. For example, the Spanish banking group Banco Popular could be kept afloat for a while with EUR 3.6 bn of ELA, allowing sophisticated counterparties to exit unscathed.

Moreover, an investment attributable to a Member State may not amount to State aid if made under conditions that a private owner would have accepted, in the sense that any risks assumed by the State and its emanations will be compensated at market rates. Consequently, when the regional government, as shareholder, funded the recapitalization of the German lender NordLB to the tune of EUR 2.8 bn, the measure did not amount to 'extraordinary public financial support' because the envisaged cost-cutting measures and infrastructure upgrades were deemed sufficient to allow the bank to return to profitability and to ensure that the public shareholders would receive a return on their investment in line with market conditions.[55]

Advances from national industry-financed resolution and deposit guarantee funds may amount to State aid in accordance with general State aid doctrine.[56] However, in Joined Cases T-98/16, T-196/16 and T-198/16 *Italian Republic et al v European Commission*, the General Court held that financial support granted by the privately organized and funded Italian FITD to the ailing Banca Tercas did not amount to State aid because the level of involvement and input of the Bank of Italy as the competent authority in the restructuring measures was limited to checking compliance with the regulatory framework and therefore insufficient to render the Fund's intervention attributable to the State.[57] Thus, where the resources of the privately organized fund are exclusively obtained from the financial services sector on a voluntary basis,[58] the involvement of public authorities in any rescue measures is limited to an assessment of legality (compliance), and the available amount is sufficiently large so that the national budget is unlikely to be needed as a backstop, an intervention

[53] Cases 6/69 and 11/69 *Commission v France* ECLI:EU:C:1969:68; 173/73 *Italy v Commission* ECLI:EU:C:1974:71; C-241/94 *France v Commission* ECLI:EU:C:1996:353; C-75/97 *Belgium v Commission* ECLI:EU:C:1999:311.

[54] Gebski (2009), p 93.

[55] European Commission—Press release, State aid: Commission concludes that recapitalisation of German NordLB is market conform (5 December 2019), https://ec.europa.eu/commission/presscorner/detail/en/IP_19_6684.

[56] Case 290/83 *Commission v France* ECLI:EU:C:1985:37, para. 15.

[57] Joined Cases T-98/16, T-196/16 and T-198/16 *Italian Republic et al v European Commission* ECLI:EU:T:2019:167. The Commission's appeal was dismissed by the Court of Justice: Case C-425/19 P *European Commission v Italian Republic et al* ECLI:EU:C:2021:154.

[58] E.g., Statut des Einlagensicherungsfonds (October 2023), § 2a; Satzung Bundesverband deutscher Banken (April 2024), § 6. This will be different where the statutory DGS is utilized for restructuring purposes in accordance with DGSD, Art. 11(3). The necessary involvement of the resolution authority and competent authority are likely to trigger the applicability of the State aid framework; Brescia Morra (2019), pp 364–365.

by the fund will not amount to EU State aid.[59] Consequently, a rescue with private deposit guarantee fund assistance may constitute a suitable 'alternative private sector measure'.[60]

This is the basis for Germany's complex web of deposit guarantee schemes and institutional protection systems. For example, the Einlagensicherungsfonds des Bundesverbandes deutscher Banken e.V. provides additional protection beyond that mandated by the DGSD.[61] 'In the interest of depositors', the fund is tasked with 'providing assistance to banks that are currently in, or in the near future likely to face, financial difficulties.' It may take any suitable measure, including the payment of creditors, the furnishing of guarantees, and the assumption of other obligations.[62] In the case of Düsseldorfer Hypothekenbank, the fund initially guaranteed the bank's loss exposure and subsequently took it over through a wholly owned investment company, to eventually sell it back to the market.[63] This did not amount to State aid, and the private deposit guarantee fund option has emerged as the preferred private sector alternative in certain Member States.[64]

3.2 Fund Aid as Sate Aid

Where resolution is justified in the public interest, the general resolution principles establish a schedule for the allocation of losses: shareholders bear first losses; creditors bear losses after the shareholders in accordance with the order of priority of their claims under national law; creditors of the same class must be treated in an equitable manner; and covered deposits are fully protected. Moreover, no creditor shall incur greater losses in resolution than they would have incurred if the institution had been wound up under normal insolvency proceedings—the 'no-creditor-worse-off' principle.[65]

In line with the underlying anti-bailout philosophy, the preferred means of resolution financing are private sources: existing shareholders and creditors, willing purchasers, and providers of new finance. Should these turn out to be inadequate, the EU resolution framework has established standing resolution funds, pre-funded by risk-calibrated financial industry contributions: the European System of Financing Arrangements under the BRRD[66] and the Single Resolution Fund (SRF) as part of

59 Gelpern and Véron (2019), p 42.

60 BRRD, Art. 32(1)(b); SRMR, Art. 18(1)(b); now defined in European Parliament (2023) (new Art. 2(1)(29a)) as 'any support not qualifying as extraordinary public financial support.'

61 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L173, 12.6.2014, p 149.

62 Statut des Einlagensicherungsfonds, *supra* n. 58, § 2.

63 See: https://bankenverband.de/newsroom/presse-infos/verkauf-der-dusseldorfer-hypothekenbank/.

64 De Aldisio et al (2019).

65 BRRD, Art. 34(1); SRMR, Art. 15(1).

66 BRRD, Art. 99.

the Banking Union's SRM.[67] Resolution authorities may draw on financing arrangements only to the extent that this is necessary to ensure the effective application of resolution tools and powers.[68] To absorb losses directly, financing arrangements may only be used where eligible liabilities have been excluded from the application of bail-in, and the losses otherwise to be borne by these liabilities cannot be passed on fully to other creditors.[69] Indirectly, losses may be passed on to the financing arrangements where, for example, contributions made to a bridge bank or asset management vehicle cannot be fully recouped through a subsequent sale of the bridge or a liquidation of the assets under management, and moreover, where creditors must be compensated in accordance with the 'no-worse-off' principle.

Direct and indirect loss absorption is subject to strict preconditions: existing shareholders and creditors must have contributed to loss absorption an amount of not less than 8% of total liabilities, including own funds, through write-down, conversion, or otherwise. Moreover, the fund's contribution must not exceed 5% of total liabilities, including own funds, of the institution under resolution, as established through an independent valuation.[70] Not mandated by international standards, the 8% minimum requirement is the result of a review of bank recapitalizations in Europe during the height of the Global Financial Crisis, showing that banks could have been restored to viability if 8% of own funds and eligible liabilities had been used for loss absorption.[71] The 5% fund aid limit further restricts the exposure to losses of national budgets and taxpayers. Fund aid is subject to the State aid regime and requires prior approval by the Commission.[72] Any additional fund aid or state aid beyond the 5% limit is subject to exceedingly strict requirements.[73]

The 8% minimum requirement poses a significant hurdle for failing smaller and medium-sized banks to access the resolution financing arrangements.[74] Where institutions are primarily funded by capital and deposits and do not meet the 8% MREL requirement at the time of failure, losses would have to be imposed on depositors, including eligible depositors (but not covered depositors), with potentially adverse effects on financial stability (runs on other banks). Where the risk of contagion is low, it may well be argued that there is no justification for generally insulating the holders of unsecured senior debt, including eligible deposits, from bearing any losses.[75] After all, adjusting depositors—banks and non-bank financial companies, public authorities, and municipalities—are not eligible for good reason: they are

[67] Built up over 8 years from 2016 to 2023, the SRF has reached its target level of at least 1% of the amount of covered deposits of credit institutions in all 21 Banking Union countries—or EUR 77.6 bn—at the end of 2023.

[68] BRRD, Art. 101.

[69] BRRD, Arts. 44(4) and 101(1)(f).

[70] BRRD, Arts. 44(5) and 101(2). The 8% minimum contribution and 5% cap do not apply to liquidity support measures of the resolution fund, International Monetary Fund (2018), para. 18.

[71] Schelo (2015), p 120; see also Galliani and Zedda (2015).

[72] BRRD, Recital (47); SRMR, Art. 19(1) and (3).

[73] BRRD, Art. 44(7); SRMR, Art. 27(9)-(10).

[74] Lehmann (2019), p 16.

[75] Hellwig (2017), para. 2.5.

capable of risk-monitoring and can act as an early warning system for resolution authorities. And, perhaps less justifiably so, the maximum coverage level of EUR 100,000 for eligible deposits is being maintained, making clear that less than 100% protection of even retail deposits can be on the cards. Politically, the 8% requirement can become a problem well before the burden-sharing cascade even reaches (eligible) depositors. Where, as with Banca Monte dei Paschi di Siena (MPS), significant numbers of retail investors hold junior debt and equity instruments, possibly as part of their retirement savings, any resolution that would impose losses on these constituencies is likely to cause a massive political headache.

Given that the 8% minimum requirement seems to be the problem, surely the most elegant solution would be its removal or modification (e.g., exempting smaller and medium-sized institutions).[76] Moral hazard concerns could be addressed through the imposition of stringent structural and/or behavioral measures in combination with adequate compensation as part of the applicable State aid control. However, for now, touching the 8% requirement was deemed politically unfeasible.[77] Consequently, to allow for the absorption of losses by financing arrangements without having to encroach on depositors' entitlements, a sensible way around the 8% minimum loss contribution requirement had to be found for smaller institutions.

The CMDI reform proposals seek to achieve this by introducing a DGS bridge mechanism so that the losses that would otherwise have to be absorbed by eligible deposits that exceed the coverage level (Natural Person/SME eligible deposits) and by excluded depositors can be imposed on the DGS in a way that makes it count towards the 8%. This requires three substantial changes to the current framework: first, and obviously, it must be stipulated that the DGS contributions in resolution count towards the 8% threshold. Consequently, where the loss absorption of shareholders and creditors together with the DGS contribution reach the 8% threshold, the resolution financing arrangement can be accessed to fund the resolution action, which must, however, result in the failing institution's exit from the market.[78] Secondly, to increase the DGS's capacity to absorb losses, the scope of the contribution that a DGS can make in resolution must be extended beyond covered deposits. Consequently, (only) where the sale of business tool or the bridge institution tool is applied, possibly in combination with other resolution tools, the relevant DGS may contribute an amount up to the difference between the value of the transferred assets and the nominal value of covered deposits and any liabilities with the same or a higher priority ranking than deposits. Where the buyer is required to make a payment as part of the transaction, the DGS may also contribute to ensure capital neutrality for the buyer following the transfer. Importantly, eligible deposits exceeding the coverage limit and deposits excluded from coverage may be transferred and protected from losses where this is justified on systemic risk grounds.[79] Limiting the amount of contribution by the DGS in this way (deposits and equally or higher-ranking liabilities minus transferred assets) ensures that the DGS can only be used

76 Schillig (2021).

77 European Commission (2023a), Annex 14.

78 European Commission (2023b), new BRRD Art. 109(2b).

79 Ibid., new BRRD Art. 109(1)(b).

for the protection of depositors (and similarly or higher-ranked creditors). Moreover, the losses to be incurred by the DGS will be limited to the costs that the DGS would have had to bear as a result of a covered depositor pay-out in insolvency following subrogation to their claims based on a least-cost analysis.[80] This necessitates a third substantive change: under the current super-priority of covered depositors,[81] the DGS would, in most cases, expect a full recovery so that its capacity to bear additional losses would be very limited. Accordingly, the Commission Proposal introduces a general depositor preference with a single-tier ranking: all deposits, including eligible deposits above the coverage level and excluded deposits, rank above ordinary unsecured claims, and all deposits rank *pari passu*.[82] By contrast, the Parliament favors a two-tier depositor preference: covered deposits and eligible deposits of natural persons and SMEs above the coverage level have a ranking ahead of other deposits (including other eligible deposits and excluded deposits) which take priority over ordinary unsecured creditors.[83] Since here the DGS would still rank ahead of non-covered deposits (except NP/SME eligible deposits), the funds unlocked under the least-cost test would be significantly lower than under the Commission Proposal's single-tier depositor preference.[84]

In combination, these changes enhance the DGS's capacity to bear losses where this is justified on systemic risk grounds, to a greater (the Commission Proposal) or lesser (the Parliament Proposal) extent.[85] The DGS bridge mechanism is available only to institutions whose resolution plans do not provide for their orderly winding-up in case of failure. This is to ensure a level playing field in terms of MREL, since only these institutions' MREL will include both loss absorption and recapitalization amounts.[86]

The DGS bridge mechanism can address the problem of access to the resolution funding arrangement where capital, junior and senior unsecured debt combined are insufficient for reaching the 8% threshold without having to impose losses on depositors. However, it won't help where, for reasons of political necessity, equity positions and unsecured claims within the creditor hierarchy below general depositor preference cannot be relied on to contribute to loss absorption. As mentioned before, MPS had significant numbers of retail investors holding junior debt instruments as part of their retirement savings. A write-down of these instruments was deemed to be politically untenable. Another instructive example is the recent bailout of Credit Suisse in the form of a state-assisted merger by absorption by UBS. The package included liquidity assistance loans from the Swiss National Bank to the tune of CHF 250 bn and guarantees from the federal government of overall CHF 109 bn. Importantly, Credit Suisse's shareholders received USD 3.25 billion in UBS shares, whereas the

80 Ibid., new BRRD Art. 109(1), with European Commission (2023c), new DGSD, Art. 11e.

81 BRRD, Art. 108(1).

82 European Commission (2023b), new BRRD Art. 108(1).

83 European Parliament (2023), new BRRD Art. 108(1).

84 European Commission (2023a), p 327 (Annex 8).

85 Ibid.

86 European Commission (2023b), p 16.

AT1 bondholders were completely wiped out.[87] Whether overriding the generally accepted order of priority in this way was legal, either based on the AT1 bonds' terms and conditions or the Swiss government's Emergency Ordinance, is currently subject to litigation. It is clear, however, that the Swiss authorities deemed it necessary to keep the shareholders sweet, including the Saudi National Bank as the largest among them. After all, they may be needed for future financing and investment needs. In these and similar cases—generally, whenever the holders of capital instruments and junior debt, for whatever reason, seem untouchable—the DGS bridge makes no difference. The incentives for opt-outs therefore remain strong.

3.3 'Opt-out' 1: Precautionary Measures

An institution's need for extraordinary public financial support will normally invoke the application of the resolution framework, including its mandatory loss allocation cascade, provided there is no private sector option available and resolution is necessary in the public interest.[88] However, exceptionally, the measure may be assessed exclusively on the basis of the State aid regime, where extraordinary public financial support takes the form of a so-called 'precautionary recapitalization' (or constitutes a state guarantee to back central bank liquidity facilities or newly issued liabilities). A precautionary recapitalization entails an injection of own funds or the purchase of capital instruments to remedy a serious disturbance in the economy of a Member State and to preserve financial stability.[89] It was conceptualized as a safety valve to deal with legacy cases, reserved for unique situations of viable institutions that suffer temporarily from an external shock. In practice, however, it seems to have been applied rather generously.[90]

The CMDI reform proposals seek to clarify the circumstances under which precautionary measures, and in what form, are still permissible. Aimed at addressing the adverse consequences of external shocks, the measures must be temporary in nature and should not be used to compensate for intrinsic weaknesses, such as an outdated business model.[91] Consequently, the use of CET 1 instruments will be permissible only in exceptional circumstances where other capital instruments would be inadequate. This is to be combined with stricter and explicit requirements for determining in advance the duration and exit strategy for the precautionary measure. Failure to exit in accordance with the predetermined strategy renders the institution failing or likely to fail. The solvency requirement at the time of the measure is to be assessed by the competent authority and requires that the institution is not in breach of, and is not likely to breach, the applicable capital requirements in the next 12 months. By requiring that a measure does not confer an 'undue' advantage on the

87 FINMA (2023), pp 39–40.

88 BRRD, Art. 32(4)(d); SRMR, Art. 18(4)(d).

89 BRRD, Art. 32(4)(d)(III); SRMR, Art. 18(4)(d)(III).

90 Binder (2017), p 70; Hellwig (2017), para. 4; but see Véron (2017), para. 4.

91 European Commission (2023b), p 19.

recipient institution, the provision aligns better with the State aid framework (which, by definition, necessitates an 'advantage').[92]

The requirement that the injected amounts may not be used to offset losses incurred or likely to be incurred soon,[93] seeks to ensure that these losses are absorbed by the existing holders of capital instruments. Precautionary measures may only be used to shore up an institution's finances to prepare for possible capital needs that would materialize if economic conditions were to worsen significantly. In other words, they may only be used to cover a capital shortfall arising under the adverse scenario of a stress test, whereas capital shortfalls under the baseline scenario should be covered by private means or trigger resolution or insolvency. This has now been clarified in the CMDI proposals.[94]

The Parliament seeks to further emphasize the exceptional nature of precautionary measures by requiring a serious disturbance in the economy of a Member State 'of an exceptional or systematic nature'.[95]

Given these clarifications and tightened prerequisites, one might wonder whether a scenario such as the failure of Silicon Valley Bank (SVB), were it to occur within the geographical scope of the CMDI framework, could be addressed through precautionary measures. SVB's failure resulted from a risky business model combined with inadequate risk management and a lack of timely regulatory action. 70–80% of SVB's total assets were funded by uninsured deposits of corporate clients, highly concentrated in the tech and venture capital sectors. This was SVB's unique business model and accounted for its rapid expansion in the lead-up to its failure. In addition, SVB failed to properly manage the interest rate risk on its portfolio of long-term securities, on which it sustained significant (unrealized) losses when interest rates started to rise. Regulators were aware of these issues for some time but failed to escalate any regulatory action. When losses were realized during a sale of securities and a private recapitalization attempt failed, deposits started to be withdrawn on a massive scale and the bank was put under FDIC receivership. Invoking the systemic risk exception to the least-cost rule, all deposits (insured and uninsured) were guaranteed by the FDIC. This was justified based on the risk of financial contagion—a least-cost resolution would have intensified deposit runs and liquidity pressures on other US banks—and the adverse effects on the wider economy. Many uninsured depositors were corporate entities that needed to pay employees and suppliers, so any inability to swiftly access their funds could have resulted in disruptions to US markets and industrial operations.[96] All in all, the SVB resolution can be seen as a massive bailout of America's tech and venture capital sector.

If taken seriously, the notion that precautionary measures may not be used to offset losses that have materialized as a result of a failed business model would seem to prevent this opt-out from being available in a scenario such as that in the case of SVB. Having said that, the possible effects on the wider economy would presumably

92 Ibid., new BRRD Art. 32c.

93 Ibid., new BRRD Art. 32c(2)(d).

94 Ibid., new BRRD Art. 32c(2).

95 European Parliament (2023), new BRRD Art. 32c(1)(a).

96 United States Government Accountability Office (2023).

amount to a serious disturbance in the economy (of an exceptional nature). On that basis, it seems likely that if a sector deemed to be of strategic importance within a national economy were potentially adversely affected by a bank's failure, regulators would seek to mobilize this opt-out. Under the State aid framework, the Commission's wide discretion could more easily accommodate national idiosyncrasies, whilst moral hazard and market discipline concerns could be addressed through adequate compensation measures.

3.4 'Opt-out' 2: Public Interest Assessment

Where the resolution authority determines that resolution pursuant to BRRD/SRM is not in the public interest, the failing institution is to be dealt with under the applicable national insolvency law as the default option.[97] Resolution will be in the public interest if it achieves, and is proportionate to, one or more of the resolution objectives,[98] and winding up the institution pursuant to normal insolvency proceedings would not meet those objectives to the same extent. The SRB has attempted to clarify its approach to the 'public interest assessment,'[99] providing some procedural clarity, although the substantive elements remain vague and malleable.[100] For example, the presence in the market of institutions with a business model that is similar to that of the failing institution may suggest an enhanced risk of contagion favoring resolution,[101] or may suggest easy substitutability of the functions provided by the institution so that corporate insolvency could be sufficient.[102]

This flexible public interest test allows smaller institutions to be resolved through national bank insolvency law, supported by generous State aid packages granted by the home Member State. Normally, any losses sustained by an institution would have to be fully absorbed by equity and debt investors in accordance with the

[97] BRRD, Arts. 32(5) and 32b; SRMR, Art. 18(5).

[98] When applying resolution tools and powers, resolution authorities must aim (i) to ensure the continuity of critical functions; (ii) to avoid significant adverse effects on financial stability, including by preventing contagion and maintaining market discipline; (iii) to protect public funds by minimizing reliance on extraordinary public financial support; (iv) to protect depositors as well as client funds and assets; and (v) to minimize the cost of resolution and avoid the unnecessary destruction of value; BRRD, Art. 31(2); SRMR, Art. 14(2).

[99] Single Resolution Board (2019).

[100] Lastra et al (2019), pp 13–15.

[101] Decision of the Single Resolution Board in its Executive Session of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Español, S.A, (the "Institution") with a Legal Entity Identifier: 80H66LPTVDLM0P28XF25, Addressed to FROB (SRB/EES/2017/08), para. 4.4.2.

[102] Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution") with a Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority (SRB/EES/2017/11), para. 4.2.1.1; Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A. (the "Institution") with a Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority (SRB/EES/2017/12), para. 4.2.1.1.

applicable order of priority.[103] However, this baseline loss-sharing arrangement may be superseded by the EU State aid regime. Conceptually, this route is reserved for non-systemic institutions for which standard insolvency law was deemed to be sufficient. However, it is not inconceivable that for a bank of any size, the government of a Member State may strike a deal with the Commission on the granting of State aid, and then argue that resolution under BRRD/SRM would not meet the resolution objectives to the same extent.

The CMDI reform proposals seek to narrow down this opt-out by modifying the public interest assessment (PIA). First, the proposals clarify three of the five resolution objectives. The 'critical functions' to be continued now include services the discontinuation of which may disrupt financial stability at 'national or regional level',[104] making clear that a mere regional impact of firm failure can justify resolution. The objective to protect public funds by minimizing reliance on extraordinary public financial support now puts special emphasis on the protection of national budgets of Member States,[105] in the sense that if extraordinary public financial support is necessary, it should, where possible, come from industry-funded resolution financing arrangements and deposit insurance schemes as the preferred option.[106] Lastly, depositors should be protected while minimizing losses for the deposit guarantee scheme.[107] In other words, resolution should be preferred where insolvency would be more costly to the DGS.[108]

Secondly, the comparison in terms of achieving resolution objectives between resolution and insolvency is tilted in favor of resolution: currently, resolution is in the public interest only if resolution objectives cannot be achieved to the same extent in insolvency; under the proposals, resolution will be in the public interest unless the objectives can be better achieved in insolvency.[109] Thus, while keeping insolvency as the default option, the burden of proof that resolution is not in the public interest increases with a view to broadening the application of resolution.[110] As part of the public interest assessment, the resolution authority is now explicitly called upon to consider and compare all extraordinary public financial support that can be reasonably expected in the event of both resolution and insolvency under national law, thereby re-emphasizing the preference for the protection of national budgets with a view to channeling more institutions into resolution and resolution funding:

[103] Only covered depositors would remain unscathed (although the DGS subrogated to the claims of covered depositors may sustain losses if the assets in liquidation are insufficient to fully compensate for any payouts made).

[104] European Commission (2023b), new BRRD, Art. 2(1)(35).

[105] Ibid., new BRRD, Art. 31(2)(c).

[106] Ibid., p 14.

[107] Ibid., new BRRD, Art. 31(2)(d). In accordance with its two-tiered depositor preference, the Parliament reserves this protection to covered deposits and the uncovered part of eligible deposits of natural persons and SMEs; European Parliament (2023), new BRRD Art. 31(2)(d).

[108] European Commission (2023b), p 14.

[109] Ibid., new BRRD, Art. 32(5). The Parliament's proposal contains a rebuttable presumption that for smaller institutions subject to simplified obligations pursuant to Art. 4 resolution is not in the public interest, European Parliament (2023), new BRRD, Art. 32(5).

[110] European Commission (2023b), p 14.

if liquidation aid is expected in the insolvency counterfactual, this should lead to a finding that resolution is in the public interest.[111]

This is, thirdly, complemented by seeking to facilitate an orderly winding-up outside of resolution, thereby rendering this opt-out less attractive. Without trying to harmonize national bank insolvency law, the proposals emphasize that a failing institution that does not meet the PIA test must exit the market within a reasonable timeframe through an orderly winding-up. This is facilitated by stipulating that a finding of failure or likely to fail and a negative PIA justify the withdrawal of the banking license under national law, which, in turn, constitutes a reason for the commencement of bank insolvency proceedings under national law.[112] This seeks to address the issue in the case of Latvian Bank ABLV and its Luxembourg subsidiary: a failing institution with a negative PIA that does not meet the preconditions for liquidation under national law.

At least on paper, the new PIA test seems more robust, arguably making it harder for institutions and regulators to avoid resolution. Whether this will translate into greater use of the BRRD/SRM resolution framework in practice remains to be seen. It seems that the following line of reasoning advanced by the Bank of Italy during the liquidation of the Veneto region banks is still valid:

> If the SRB had decided to launch the [resolution] procedure, the entire value of the equity and the junior bonds would have been lost.
> Moreover, the procedure would have triggered the application of the bail-in tool for senior bonds and unprotected deposits. This would have generated higher costs for all the parties involved: the State, banking customers and the rest of the Italian banking system.[113]

Comparing *ex ante* the potential degree of realization of resolution objectives in hypothetical resolution and insolvency scenarios entails, by necessity, difficult value judgments—not least because there is no strict hierarchy between resolution objectives—as well as preliminary valuations of notoriously difficult-to-value assets and liabilities. Circumstances may be in flux and change very quickly. Retrospectively, it will be impossible to verify whether a judgment call made at the time was right or wrong; basically, any decision can be justified with sufficient argumentative effort. It is also worth keeping in mind that decisions made in the resolution context are often political decisions: there will be winners and losers, and how losses are allocated will have political consequences. We may want to protect junior retail investors and their pension savings, or powerful international players that must be kept sweet for further rounds of investments, or entire sectors of an economy of strategic importance that bank in a certain way. The possibilities are endless. The State aid regime's flexibility will remain attractive for these and other situations.

[111] Ibid.

[112] Ibid., new BRRD, Art. 32b.

[113] See: https://www.bancaditalia.it/media/fact/2017/0712-venete-anticipo/index.html.

4 Conclusion: What Needs to Be Done

Are the current CMDI reform proposals a missed opportunity? Given that the aim is to expand the scope of resolution with a view to relying more on industry-funded safety nets (resolution and deposit insurance funds) rather than taxpayer-funded bailouts, the answer must probably be 'yes.' Resolution decisions are always political, and the flexible State aid regime will remain very attractive; the opt-outs from resolution, although being tightened, will continue as relatively easy exit options. Having said that, the reform proposals are obviously dictated by what is currently politically feasible. Modifying the 8% threshold and removing the opt-outs is simply not on the cards. In the end, the outcome might be tolerable: the State aid regime, whether applied inside or outside of resolution, not only allows for adequately addressing distortions of competition, it can also keep moral hazard in check and reinforce market discipline.

Still, we end up with a framework that is overly complex and opaque: for institutions and investors it may be impossible to predict in what way a failing institution will be resolved; perhaps through an alternative private sector measure of a privately organized rescue fund, perhaps resolution under BRRD/SRM will be deemed to be in the public interest so that the mandatory 8% bail-in applies; or maybe precautionary measures outside of resolution can be used, or, if resolution is not deemed to be in the public interest, national insolvency law applies. This set-up seems very costly: *ex ante* it will be hard for investors to price their investments correctly, resulting in higher costs of capital for European banks. Institutionally, there seems to be an unnecessary duplication of assessments and safeguards. There are also significant compliance costs for institutions. And all this to prop up a framework that is unlikely to be used. Of course, no crisis is the same, and generally it seems advantageous to have various options within a flexible system. However, the State aid regime already provides this flexibility under a single roof and applies either in addition to the resolution framework or on a stand-alone basis, in any case (except for alternative private support measures).

In the aftermath of the Credit Suisse rescue, the Swiss Minister of Finance relayed in an interview that she had come to the conclusion that the (Swiss) resolution framework is unsuitable for resolving a systemically significant institution in distress.[114] In combination with other recent bank failures and the history to date of the EU resolution framework, this seems to suggest that bailouts will remain the preferred and almost inevitable mode of operation when a bank fails. This should give pause for thought and could be the basis for a more radical reconceptualization of the resolution framework in the long run.

[114] See: https://www.nzz.ch/schweiz/keller-sutter-zur-cs-rettung-dass-viele-eine-wut-im-bauch-haben-verstehe-ich-gut-ld.1732017?reduced=true.

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