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Looking into Pandora's box of banking crises: supervision and resolution in the EU regulation

SOMMARIO: 1. Introduction – 2. Between supervision and resolution from national and international perspectives – outline of current problems. – 2.1. Crisis management framework for banks and its institutional set-up. – 2.2. Drifting between supervision and resolution powers. – 2.3. Crisis management and home-host issues. – 2.4. Non-banking activities of banks and groups and crisis management. – 2.5. Summary of identified problems – 3. The proposed changes to the EU regulatory framework on crisis management and their assessment. – 4. Unresolved gaps and proposals for a more comprehensive regulatory framework – 5. Conclusion.

1. *Introduction*

The European crisis experiences of 2008-2013 led to the creation of a legal framework[1] that aims to establish an orderly approach to managing and preventing[2] the failures of financial institutions, starting with banks[3]. After a few years of theoretical analyses and individual cases of bank failures, the most appealing questions about the crisis management framework looked to be answered. However, the system could not have been considered flawless[4], and many practical

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[1] The establishment of the framework was based on the works and analyses conducted by the leading international standard-setting bodies, like Basel Committee on Banking Supervision, International Monetary Fund and World Bank. More about the background for the creation of crisis management framework in: J.H. BINDER, *Resolution: Concepts, Requirements, and Tools*, in J.-H. BINDER and D. SINGH (eds), *Bank Resolution: The European Regime* (Oxford University Press 2016).

[2] V. TROIANO, *Cross-border cooperation between resolution authorities in the BRRD*, in M. HAENTJENS and B. WESSELS (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar Publishing, 2015), 103-116.

[3] The provisions also concern investment firms, holding companies and central counterparties. When preparing the article, the work is underway to prepare the legal framework for crisis management and insurance and reinsurance undertakings.

[4] T. HUERTAS, *Reset Required: The Euro-area Crisis Management and Deposit Insurance Framework*, (2022) JFR 187-202, https://doi.org/10.1093/jfr/fjac007; J. BERG AND H. BJERRE-NIELSEN, *Bank resolution, the need to recognize reality in order to prepare for the next crisis*, (SUERF Policy Note No 126) 6; M. HELLWIG, *Twelve Years after the Financial Crisis—Too-big-to-fail is still with us*, (2021) JFR 7(1), 175-187.

uncertainties still intrigued the experts[5]. The examples of tensions in the banking and insurance market in 2022-2023[6] show that the financial crises are like Pandora's box – subsequent crises and following in-depth analysis from the practical angle uncover the challenges that both the supervisors and resolution authorities must face, catalyzing further changes.

The published preliminary lessons learned from the recent crises of Signature Bank, Silicon Valley Bank, First Republic Bank, and Credit Suisse have yet to fully explore prudential regulation or supervision issues from the crisis management perspective[7]. Regarding supervisory issues, the literature on bank resolutions has yet to delve into the problems that may arise from the relationship between resolution and supervision[8]. This lack of consideration was probably due to the

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[5] Most of uncertainties considered bail-in, liquidity provision and funding (internal and external) in resolution. Look e.g. here: JEFFRET N. GORDON, W.-G. RINGE, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, (2015) *Columbia Law Review*, 1297-1369; WOLF-GEORG RINGE, *Bail-in between Liquidity and Solvency*, (University of Oxford Legal Research Paper Series No 33/2016 2017), 15-17.

[6] More about the crisis of Credit Suisse and American banks that failed in 2023 here: S. ROSSI, *The banking crisis of Credit Suisse: origins, consequences, and reform proposals*, (2023) *Investigación Económica* 82 (325), 21-36; Report on the 2023 banking turmoil (BCBS 2023); S. ELLINGSAETER, *Could it happen in the EU? An analysis of loss distribution between shareholders and AT1 bondholders under EU law*, (2024) JRF forthcoming.

[7] The published reports and articles concentrate mainly on the shortages and inappropriateness in the ongoing supervision of the American banks and materialization of uncertainties in bank resolution than have already been cited by the analysts (e.g. problems with bail-in implementation, funding in resolution). See, e.g., FINANCIAL STABILITY BOARD, *2023 Bank Failures. Preliminary lessons learnt for resolution*, (2023) https://www.fsb.org/wp-content/uploads/P101023.pdf accessed 2 November 2023; UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, *Report to the Committee on Financial Services, House of Representatives. Bank Regulation. Preliminary Review of Agency Actions Related to March 2023 Bank Failures*, (2023) April; FDIC, *FDIC's Supervision of Signature Bank*, (2023) April; FEDERAL RESERVE, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (2023) April; F. HEIDER, J. P. KRAHNEN, L. PELIZZON, J. SCHLEGEL, T. TRÖGER, *European lessons from Silicon Valley Bank resolution: A plea for a comprehensive demand deposit protection scheme (CDDPS)*, (2023) (SAFE Policy Letter No. 98).

[8] However, see T. BECK, C. SILVA-BUSTON and W. WAGNER, *Incomplete supervisory cooperation*, (August 2023) https://acpr.banque-

absence, at least apparent, of disagreements between these authorities, which might suggest their good cooperation. Even with this, however, the relationship between the authorities might only sometimes be performed consistently and promptly. These inefficiencies are likely to occur, especially when authorities from different nations are involved or when the crisis concerns capital groups subject to various national supervisory authorities[9]. It may also be the case with financial conglomerates that include insurance undertakings.

Therefore, this article explores the challenges or inconsistencies in the crisis management framework that may not yet have materialized but may materialize in the future. The above relationship will be analyzed from the point of view of failures of credit institutions to identify the unobvious dependencies, overlaps, and loopholes in the regulatory framework, which regulation should address instead. For this purpose, we usually go beyond the issues that the commentators of the collapses of American banks and Credit Suisse in 2023 have already cited. Since this article aims not to comment on the previous banking crises and their lessons learnt, we concentrate on the critical analysis of the regulations to identify risks or obstacles that have yet to be considered. We also take a specific approach by looking at the crisis management issues from supervisory and resolution perspectives.

In line with this approach, it is necessary to contextualize the functioning of banks and analyze their business as a whole, i.e., the banking business and the businesses related to banks' activity as part of multi-product capital groups (also financial conglomerates), including financial and insurance businesses. The crisis management issues will be examined from a supervisory and resolution perspective and a national and cross-border focus, considering the various financial activities carried out by the banks acting as part of capital groups or financial conglomerates. We will limit the cross-borders perspective to cooperation within the European Union (EU) and EU Member States' authorities, so relations with third-country authorities are out of the scope.

france.fr/sites/default/files/medias/documents/20230516_incomplete_coverage_of_supervisory_cooperation.pdf accessed 6 August 2024.

[9] More about the effectiveness of international supervisors' cooperation is analyzed in e.g. T. BECK, C. SILVA-BUSTON and W. WAGNER, *The Economics of Supranational Bank Supervision*, (2023) JFQA 58(1), 324-351.

Consequently, the research question can be summarized as follows: do current and potential EU crisis management rules adequately consider the link between bank supervision and resolution, considering different national and cross-border (UE) perspectives and dependencies with other financial institutions in the same capital group?

The expected outcomes should be the following:

1) to outline the relevance of the link between supervision and regulation in banking crisis management,

2) to point out if the current rules and those proposed (as part of the so-called CMDI review[10], or the proposed IRRD) have correctly approached such a link,

3) if our answer to the question in point 2 is negative, totally, or partially, present optimal solutions and discuss their pros and cons.

Therefore, the structure of the article is as follows. The first chapter presents the current state of play in bank crisis management. It is, however, not a plain vanilla description of the applicable provisions but a critical review of the supervisory and resolution framework where the background is the financial safety net and cross-border scope of functioning of banking groups. The second chapter refers to the review of the bank crisis management framework endorsed by the European Commission in April 2023 (CMDI review) and the creation of further legislation in the field of crisis management in the financial system (e.g. Insurance Resolution and Recovery Directive proposal, IRRD proposal[11]). The chapter aims to identify if the upcoming changes in the EU regulatory framework deal with the issues arising from the previous analysis. The last chapter presents the authors' proposals to remedy identified problems if the above legislation does not address them. The article ends with conclusions.

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[10] As proposed by the European Commission. The evaluation of needed CMDI review's elements from the point of view of setting the genuine banking union was presented here: C. V. GORTSOS, *A reform of the CMDI framework that supports completion of the Banking Union* (2023) (EBI Working Paper Series No. 142) 23-44.

[11] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of insurance and reinsurance undertakings and amending Directives 2002/47/EC, 2004/25/EC, 2009/138/EC, (EU) 2017/1132 and Regulations (EU) No 1094/2010 and (EU) No 648/2012, COM/2021/582 final.

2. *Between supervision and resolution from national and international perspectives – outline of current problems*

The analysis and identification of the problems will follow chronological order—the potential problems will be analyzed in the context of the next phases of possible crisis development (subsequent phases of the crisis management framework), as presented in point a) below.

2.1 *Crisis management framework for banks and its institutional set-up*

The EU set forth the crisis management framework for banks through legal acts. The fundamentals are BRRD[12], DGSD[13], and Banking Communication[14].

Since the crisis management framework includes a broad scope of actions[15], the preparation for the crisis starts when the bank is in a sound financial position. At that point, the bank must prepare a recovery plan to be activated when its financial situation deteriorates[16]. Although connected with crisis management, recovery planning fits into the ordinary, current supervision over the entity.

In parallel, the resolution planning takes place, and the resolution authority analyzes each bank and possible intervention options to be implemented when the bank meets resolution triggers. The result of its analysis is the preparation of the resolution plan[17].

That means two different, but in-substance-related activities are conducted in parallel, and separate authorities run them. Even if the same institution embeds the supervisor and resolution authority, the

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[12] Consolidated version of Directive 2014/59/EU of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173.

[13] Consolidated version of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L 173.

[14] 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, C 216/1.

[15] M. BODELLINI, *International Bank Crisis Management. A Transatlantic Perspective* (Hart Publishing 2022) 3.

[16] BRRD, art. 5.

[17] BRRD, art. 10.

BRRD requires these functions to be separated and independent[18]. The recovery and resolution planning should create a continuous path for crisis management. However, the planned recovery options may hinder the possibility of implementing resolution actions (e.g., the assets that could be transferred in resolution may already be sold in the recovery phase). This risk creates a potential conflict of interest between supervisory and resolution authority. However, separating resolution/recovery and supervision reduces the risk of regulatory forbearance (e.g., resulting in the lack of identification of resolution impediments) that could materialize when all functions are not operationally isolated.

The turning point is when the bank is failing or likely to fail (FOLTF)[19], and, at the same time, no supervisory and self-recovery actions will improve the bank's standing[20]. Here, a few types of authorities are engaged.

Firstly, the supervisor. Its task is to verify if the bank is threatened with collapse, and it may support a determination that no other action (on the side of the supervisor or private sector) might be taken to safeguard the bank against failure[21]. Secondly, the resolution authority. It may verify if the bank is FOLTF (even if the supervisor informs the resolution authority about the FOLTF state, the resolution authority should confirm that within the independent valuation). Moreover, it must assess whether the potential resolution is in the public interest – if that evaluation is positive, then the resolution should be started[22]. If not, the bank should exit the market according to national procedures[23].

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[18] BRRD, art. 4. More about institutional arrangements in: P. BAUDINO, C. SÁNCHEZ and R. WALTERS, *Institutional arrangements for bank resolution*, (FSI Insights No 32), 4-29.

[19] C. A. PETIT, *Failing or likely to fail: banking union cooperation tested since 2017*, (2023) JEI 45(1) 157-180.

[20] BRRD, art. 32(1).

[21] BRRD, art. 32(1)-(2).

[22] BRRD, art. 32(1) and 32(5).

[23] BRRD, art. 32(1) and 32(5). The legal framework needs to address what should be done if the public interest assessment suggests that the bank should be put into resolution. However, the resolvability assessment suggests that the bank is unresolvable (*i.e.* there are impediments to effectively implementing resolution action).

However, such procedures are enormously varied among the EU Member States[24] and may translate into:

- Liquidation of the bank by the liquidator/administrator within the standard insolvency procedure and the payout of the guaranteed deposits by the deposit insurance scheme[25].

- Taking the bank out of the market within the special liquidation procedures (e.g., through the P&A transactions), which supervisors, DGSs or other national authorities might run.

When the bank is FOLTF due to the liquidity problem, the central bank might need to be added to the group of intervening authorities as the next party[26].

When the resolution is initiated, multiple resolution tools might be applied, i.e. bail-in[27] or transfer tools (sale of the business, transfer to the bridge bank, or transfer to the bad bank)[28]. It should be added that – although the resolution authority itself selects the applied tool – some kinds of actions may also require the supervisor's participation (e.g., approval of the new owner of the bank, acceptance of the merger with another entity, granting the license for the bridge bank[29]).

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[24] S. BUCKINGHAM, S. ATANASOVA, S. FRAZZANI and N. VERON, *Study on the differences between bank insolvency laws and on their potential harmonization* (DG FISMA 2019) 56, https://finance.ec.europa.eu/system/files/2020-06/191106-study-bank-insolvency_en.pdf accessed 6 August 2024.

[25] Alternative application of DIS in bank crisis management is presented here: C. HOFMANN, *The Role of Deposit Insurance in Bank Resolution*, (2020) JFR 6(1), 148-158.

[26] More about the potential sources of liquidity in bank resolution in: M. KOZIŃSKA, J. MICHALEWICZ and B. ZDANOWICZ, *In Search of Ways for Financing the Bank's Liquidity in Resolution*, (2021) Safe Bank 1 (82), 8-47.

[27] Bail-in is said to be the core resolution tool, which enables to make shareholders and creditors financially liable for the bank failure. There are multiple works analyzing the effectiveness and potential effects of the application of tools, e.g. T. TRÖGER, *Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime*, (2018) JFR 4(1), 35-72; E. AVGOULEAS and C. GOODHART, *Critical Reflections on Bank Bail-ins*, (2015) JFR 1(1), 3-29.

[28] BRRD, art. 37(3).

[29] While the provisions assume that the transfer tools should be implemented without the necessity to apply procedural requirements applicable under company and securities law (e.g. BRRD, art. 38(1), 40(1)), supervisory approvals have not been waived (e.g. BRRD art. 38(7), 41(1)).

Considering that the universal banking model dominates in Europe[30], not only the banking sector supervisor might be engaged, but others might be involved if the bank is involved in various activities, including insurance or capital market services. Moreover, all resolution authority's decisions are backed by the valuations prepared by the independent valuer[31].

The resolution is only feasible if it is supported by viable funding, primarily from the resolution or deposit guarantee funds (both funded by private sector institutions)[32], which might be managed by separate authorities/entities. Considering that the resolution funds are public funds, all actions entailing its usage must be reviewed and accepted by the European Commission from the point of view of state aid[33].

As evidenced, the engagement of multiple financial safety net institutions during the crisis management of a single bank at the national level might be extensive. For the cross-border banks, however, the additional entity in the crisis management institutional set-up is the resolution college[34], which is the platform for preparing and coordinating bank resolution in the international context[35]. For banks acting in the banking union, additional players like the Single Resolution Board (as resolution authority of significant and cross-border banks) and European Central Bank (as supervisor of significant banks) come into play. They overtake the primary responsibilities of national resolution and supervisory authorities but do not replace them since part of the tasks still rests with national entities[36].

The presented crisis management rules from the point of view of the institutional set-up show that the range of engaged entities is broad, and the resolution procedure – even at the national level – employs multiple

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[30] M. CHAVAZ and D. ELLIOTT, *Separating Retail and Investment Banking: Evidence from the UK* (Banco de Espana 2021), 62.

[31] BRRD, art. 36 and 74.

[32] BRRD, art. 101, 105-106, 109.

[33] Banking Communication, point 64.

[34] The analysis of different cooperation models for cross-border is presented here: AGNIESZKA SMOLIŃSKA, *Multilevel cooperation in the EU resolution of cross-border bank groups: lessons from the non-euro area Member States joining the Single Resolution Mechanism (SRM)*, (2021) JBR 23, 42-53.

[35] BRRD, art. 88.

[36] M. BODELLINI, *International Bank Crisis Management. A Transatlantic Perspective* (Hart Publishing 2022) 9-16.

authorities. The complicated institutional setup relates to various risks, e.g. time constraints, the actual scope of the responsibilities (and prepared documents) and, in international terms, differences in the national implementation of the framework and political disagreements[37].

It should be noted that the resolution procedures are designed and harmonized in most countries, mainly for the banking sector. As mentioned, banks sometimes combine various types of activities, e.g., sellers of insurance or investment products, which are designed internally within the bank by dedicated organizational units or on the grounds of additional licenses by connected companies. Within capital groups, companies often have divergent profiles. Also, the capital groups have different structures, whether the holding company might be a regulated entity. However, the resolution procedure is harmonized only for banking and investment firms[38]. An EU resolution regime for (re)insurance undertakings has only recently been agreed upon and has yet to be implemented in the Member States.

2.2. *Drifting between supervision and resolution powers*

As mentioned, resolution issues relate to the going concern and bank activity. Supervisory[39] and resolution intertwine at both stages.

At the going concern stage, the resolution and supervisory mandates overlap when the recovery options, resolution strategy, and resolvability assessment are decided. The selection of resolution strategy (and preferred tool) translates into the level of minimum

[37] E. PAGGI, C. MARTINEZ, *Panel I of the SRB Legal Conference – Legal and Operational Challenges That Arise in Respect of the Cooperation Between Banking Supervision and Resolution Authorities in the EU and in Respect of Their Cooperation with Third-Country Authorities*, (2022) ECFR 6, 924-935.

[38] There is also a resolution regime for CCPs, but it constitutes the financial market infrastructure's crisis management framework, proving its services mainly to other institutions (i.e., professional market participants). The analyses suggest that their potential to spread contagion is high. Source: T. B. KING, T. D. NESMITH, A. PAULSON and T. PRONO, *Central Clearing and the Systemic Liquidity Risk*, (2023) IJCB, 85-142, https://www.ijcb.org/journal/ijcb23q4a3.pdf/.

[39] More about the lessons for the ongoing bank supervision from the recent crises here: T. ADRIAN, M. MORETTI, A. CARVALHO, H. K. CHON, K. SEAL, F. MELO AND J. SURTI, *Good Supervision: Lessons from the Field*, (IMF Working Papers 181, 2023).

requirements for own funds and eligible liabilities (MREL)[40]. As a prudential requirement, it should be considered by the supervisor in the supervisory review and evaluation process (SREP) and when evaluating the bank's recovery plans (as one of the indicators conditioning activation of recovery options[41]).

Looking at the construction of MREL requirement[42], setting MREL (with appropriate buffer) as a recovery indicator may mean that the recovery is initiated when the prudential ratios are relatively high. However, activation of the recovery plan should be treated as the event requiring publication of information, according to MAR[43]. The latter may negatively affect the bank’s reputation when the situation is relatively sound, which is undesirable for such an institution, the supervisor, and the resolution authority. The education of investors is of the utmost importance here[44]. Only prudent and well-educated investors understand how to read and interpret the communications from the banks (not creating panic).

After selecting the preferred resolution strategy and tool, the resolution authority should analyze if it can be applied effectively and efficiently. This stage constitutes the resolvability assessment. If the resolution authority assesses any obstacles to using resolution tools, it obliges the bank to remove identified limitations[45].

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[40] BRRD, art. 45c. The aim of MREL requirement is to secure the sufficient amount of capital and liabilities to apply write-down or conversion tool or bail-in. Some authors indicate the drawbacks and shortcomings of the requirement, *e.g.* T. TRÖGER, *Why MREL won’t help much: minimum requirements for bail-in capital as an insufficient remedy for defunct private sector involvement under the European bank resolution framework*, (2019) JBR 21, 64-81.

[41] EBA, *Final Report. Guidelines on recovery plan indicators under Article 9 of Directive 2014/59/EU*,(2021), 5.

[42] In simplification, MREL doubles the sum of basic and additional own funds requirements.

[43] Consolidated version of Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, OJ L 173.

[44] More about the link between investors literacy and financial stability here: C. BUCH, *Financial Literacy and Financial Stability*, (Deutsche Bundesbank 2018), https://www.bis.org/review/r180525b.pdf accessed on 6 August 2024.

[45] BRRD, art. 17.

The analysis of the subject of the resolvability assessment[46] allows evaluation of to what extent the resolvability assessment and identification of obstacles to resolution interweave with supervision over the bank. In this regard, EBA published in 2022 so-called Resolvability Guidelines[47]. The guidelines require banks to have multiple solutions that facilitate resolvability, making it possible to swiftly implement resolution actions thanks to removed operational, technical, and legal barriers. They usually address the internal structure of the bank, its operations, internal systems, and relations with other parties. Such issues are traditionally strictly regulated and sometimes even approved by the supervisor. This step may create tensions between the supervisor and the resolution authority since the solutions that were worked out and accepted by the supervisor might be challenged by the resolution authority since its role is to ensure the smooth operations of the bank, but from another perspective, i.e., crisis management, instead of ongoing activity earmarked for supervisor.

This challenge also creates problems for the bank, which might have to simultaneously address requirements concerning the same area (e.g., internal systems, liquidity, internal structure) but coming from various authorities, whose expectations may vary as the supervisor focuses on risk management. In contrast, the resolution authority focuses on preparing to implement resolution tools and powers[48].

The next phase of the resolution framework is when the bank becomes FOLTF. Current provisions are vague, leaving the supervisor much flexibility in assessing that the bank is on the brink of collapse. Also, the second condition for resolution (depletion of supervisory powers and self-recovery options) is flexibly formulated. The advantage of such a flexible framework is the discretion of the

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[46] Resolvability assessment is more about the individual bank's assessments. Isabel Schnabel provides more general outlook on the resolvability. More here: I. SCHNABEL, *Are Banks Finally Resolvable? A Perspective from Europe*, (2020) JMCB 52(S1), 77-86.

[47] EBA, *Guidelines on improving resolvability for institutions and resolution authorities under articles 15 and 16 BRRD*, (2021).

[48] For example, while the supervisor may require banks acting within the institutional protection scheme to set the limits for mutual support (to limit the potential exposures and contagion), the resolution authority may favour the unlimited arrangements supporting the financing during the resolution without unnecessary constraints. Such examples might be more.

authority, which prevents too early initiation of the resolution (e.g., the bank's problems are only temporary). The disadvantage is that the supervisory authority may delay the resolution, which usually increases the costs of crisis intervention (e.g., due to the piling up of losses in the failing bank).

The open question also concerns supervision over the bank in resolution, which differs from the residual bank. In principle, according to the EU resolution framework, the resolution authority takes control of the bank when the resolution is initiated. That means that the resolution authority, as a public authority from the financial safety net, monitors banks' activities and directly manages the bank. Consequently, after the resolution initiation, the bank under resolution is controlled by two separate authorities. The mandates of these institutions remain the same, e.g., the supervisor is still responsible for monitoring the bank's capital adequacy. Initiating the resolution also does not mean that the license is automatically revoked. From the formal point of view, the functioning entity is not the bank but the bank in resolution. This situation creates the following areas of uncertainty:

a) what is the relation between supervision and resolution authority – from the moment of resolution, the running of the bank is taken over from the commercial party to the public authority (resolution authority); in this regard, the resolution authority monitors and runs the bank and it is evident that aims to solve the problems (very often non-compliance with banking regulations); it is not clear what role should the supervisor have in such a situation – control over other safety net institution may create tensions and seems to be outside the supervisor’s mandate;

b) To what extent the bank in resolution should be subject to supervision – as mentioned above, in the case of only open bank bail-in application, the banking activity is maintained in the entity subject to resolution and is continued as usual; under such a scenario, the continuation of the normal scope of supervision seems to be justified[49];

[49] The legal provisions seem to not address such a situation appropriately – at least in total. The open bank bail-in should include restoring bank capital position by the loss coverage and recapitalization. That should allow it to continue its activity. At the same time, EU bank resolution regulations (BRRD, art. 34) require the management body and senior management to be replaced after the resolution initiation. The resolution authority takes over the control and runs the bank. At the same time, the bank has new owners (created by the conversion of liabilities to capital) who should

in case of so-called transfer strategies (sale of the business, bride bank, bad bank) combined with closed bank bail-in, the bank under resolution is usually deprived of crucial banking activity, and therefore, the remaining part of the old entity usually does not require banking supervision, since the banking activity is transferred to other entity;

c) To what extent the bank in resolution should be subject to prudential regulations – the problem seems to be like the scope of the supervision: if the resolution takes the form of, e.g., open bank bail-in (if after the bail-in implementation, the bank under the resolution continues the activity) the application and monitoring of prudential requirements is justified. The rules are, however, not adjusted to the situation when the resolution assumes the transfer of an essential part of the entity (mainly constituting critical functions) to another entity. Under such a scenario, applying prudential requirements does not seem appropriate since the bank under the resolution is concentrated on liquidating remaining assets and exiting the market.

2.3 *Crisis management and home-host issues*

As mentioned, some banks are part of the capital groups that can run their activities in multiple countries (cross-border banking groups)[50]. Such a situation creates additional challenges for crisis management since the international character of cross-border banking activity is not aligned with the national character of the financial safety net. Even in the banking union, the deposit guarantee schemes remain local, i.e., national.

Moreover, the interests of national authorities might be divergent since every financial safety net institution would like to plan and conduct crisis management considering the financial stability of the local financial system. The most visible conflict of interest seems to occur when part of the group (some subsidiary or subsidiaries as well

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continue the bank management. The legal provisions do not answer the question of who should be responsible for the bank's further activity.

[50] There are multiple researches about the cross-border bank activity. E.g. DIRK SCHOENMAKER and W. WAGNER, *The Impact of Cross-Border Banking on Financial Stability*, (Tinbergen Institute Discussion Paper, No. 11-054/2/DSF18); M. EVERETT, P. MCQUADE and M. O'GRADY, *Bank business models as a driver of cross-border activities*, (2020) JIMF 108.

as an activity conducted under the freedom of services or freedom of establishment) is assessed as having a systemic impact on the national financial system in the host country. At the same time, however, from the home country's perspective, it is irrelevant, and it should not be subject to any particular interest and treatment. This disproportion is called the home-host problem (home-host balance) and is visible at various stages of crisis management.

The problem might be identified in the supervision and recovery phase. From the point of view of supervision, the crucial issue is the prudential requirements. These include mainly capital (CET1, AT1, TC) and liquidity (LCR, NSFR) requirements introduced by CRR[51]. Home authorities usually seek to supervise the group on a consolidated basis since, under such a scenario, they have control and (direct or indirect) impact on the whole group because the parent company might be the ultimate entity that will bear the brunt of the financial problems in the group.

Also, banking groups usually prefer consolidation of capital and liquidity since centralized financial management might be more economically effective (e.g., advantages of economies of scale). This consolidation is, however, contradictory to the interest of local supervisors, which seek to safeguard as much capital and liquidity at the local level as possible since only nationally prepositioned funding is a reliable safeguard for times of financial difficulties - when obtaining financing from other sources is complex. Ultimately, the financial responsibility for locally active banks rests with local authorities, e.g., deposit insurers.

The described conflict of interest may become visible during the discussion within supervisory colleges established for all internationally active banks. Such colleges are responsible, e.g. for assessing bank recovery plans, including recovery scenarios and options to be implemented when the entity's financial situation deteriorates. The recovery options may, however, foresee that local subsidiaries are no longer sustained (e.g., sold to another counterparty). Therefore, the entity's systemic impact on the local market may

[51] Consolidated version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions, OJ L 176.

disappear for the host country. Consequently, the assessment of the recovery plan (and its options) by the national authorities within the supervisory college may be divergent.

Similarly, crisis management may present home-host conflict during the planning and execution phases. When planning the resolution (creating resolution plans for internationally active banks), it is necessary to:

a) Select the preferred resolution strategy from the point of view of the group (SPE[52] or MPE[53])[54],

b) Agree on the distribution of loss absorption and recapitalization capacity (MREL and TLAC requirements),

c) Select the preferred resolution tool.

When selecting the preferred resolution strategy, home resolution authorities may select SPE since it assumes the centralization of crisis management. The selection of SPE also has significant consequences for the MREL and TLAC requirements since, under the SPE, loss absorption and recapitalization capacity are centralized at the level of the parent company and distributed to host countries (i.e., non-resolution entities)[55].

Host authorities will tend to safeguard as much financial capacity as possible, similarly to capital and liquidity requirements, since only prepositioned funds create viable protection against the necessity of financing the financial problems of such an entity from local financial safety net funds. Planning a resolution strategy and funding might be the phase where conflicts of interest occur. However, this does not mean that the MPE strategy (and related financing plans) will always be optimal. MPE strategy implies that the local authority manages the

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[52] Single Point of Entry – the strategy assumes that there is only one resolution entity in the group, i.e., the entity to which the resolution tool will be applied. It is usually a holding company. Consequently, the group resolution authority will implement the resolution in case of crisis of any group entity (through the transfer of losses and capital).

[53] Multiple Point of Entry – the strategy assumes that there are a few resolution entities in the group, i.e., the entities to which the resolution tools will be applied. Consequently, the resolution is run by national resolution authorities that are responsible for resolution entities.

[54] J. A. FERNÁNDEZ FERNÁNDEZ, *Considerations of the SPE and MPE resolution*, (2020) JBR 21, 278–287.

[55] BRRD, art. 45c-45f.

resolution of the local entity, and the MREL and TLAC requirements are built locally. It means that after the resolution (write-down of capital instruments and conversion of debt – not held by the parent – into the new capital), the bank has new owners, and the relations (including operational) with the parent are broken what might not be optimal from the point of view of operational continuity.

Moreover, new owners might not be interested in holding the capital in the bank as it might be uncompliant with their investment policies. This might encourage them to sell the shares and contribute to the fire sale just after the resolution. Also, selecting the preferred resolution tool for each subsidiary might become a bone of contention. Sustaining the activity of the subsidiary might not be optimal for the parent entity since the locally significant subsidiary might be irrelevant from the point of view of the whole group.

Regarding the resolution execution, further issues should be considered from the point of view of international crisis management and the home-host balance. It should be noted that even if the resolution college agrees on the SPE resolution strategy, from the legal point of view, the activation of resolution is the task of the authorities from the jurisdiction where the failing entity is registered. Moreover, the local authority is the institution that investigates the problems and is aware of potential obstacles that might be faced during the resolution. These obstacles can be local legal provisions, the local market, and the local banking sector's ability to participate—operationally and financially—in the resolution of the bank. Also, the local banking sector will bear the consequences of resolving such a failing bank.

Under such circumstances, the local authority is best equipped with the tools and knowledge to resolve the crisis. It should also be emphasized that the resolution plan agreed upon by the resolution college is not binding[56]. The ultimate intervention is agreed upon as part of the resolution scheme. The decision-making about the resolution scheme foresees that the Member State that does not agree with the group resolution scheme is allowed to refrain from signing the joint decision and following its way of resolution of the local subsidiary[57].

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[56] BRRD, art. 13 and 91-92.

[57] BRRD, art. 91-92.

When the resolution starts, the authority from the jurisdiction where the entity is registered (and regionally operates) has a legal basis and financial stability justification to follow such a resolution that will most benefit the local financial system. SPE strategy is implemented in jurisdictions where subsidiaries operate by the local resolution authority, based on non-binding agreements between the parent and local authority. The local authority will decide to write down and convert capital instruments and eligible liabilities to transfer losses at the level of the parent entity. The rest of the restructuring will be implemented from the parent bank's point of view.

Such a resolution plan might be viable only if the local subsidy has solvency problems not backed by additional structural abnormalities. Usually, this is not the case – the real bank resolution requires loss absorption, recapitalization, and internal restructuring of its management and business. Here, under the SPE strategy, the parent's decisive actions would be needed to heal the subsidiary. The parent entity might not be interested – for purely business reasons – in further restructuring (and engagement of group assets) of a subsidiary that is irrelevant to the whole group. The local resolution authorities of a subsidiary, as assessed as material for the local financial system, cannot afford to depend on such uncertain solutions.

2.4 *Non-banking activities of banks and groups and crisis management*

The banks usually do not limit their activity to purely banking services (loans and deposits). Usually, EU banks offer a much more comprehensive array of products and services since the EU banking sector follows the universal banking model. It often means that entities with banking licenses have other licenses that allow them, e.g., to run investment activities. If it is not done by the bank itself (by the dedicated department or bureau), banks sign agreements with appropriate financial firms to deliver such products[58]. In the case of the whole capital group, it is usually the case that there are dedicated subsidiaries responsible for the creation and delivery of products other

[58] The cooperation between banks and insurance companies is recognized as bancassurance and takes a special place in business and regulation. More about that, e.g., here: P. MARANO, *Vendite abbinate e tutela dell'assicurato nella bancassicurazione. Profili organizzativi*, Pacini Giuridica, 2023.

than banking ones (investment firms, insurance companies, leasing, and factoring entities). Even if such a model is applied, the products are often sold to clients through the banking channel[59].

At the same time, the European resolution framework consists of rules for banks, investment firms, and CCPs, which do not cover the whole financial market and related products delivered to customers, especially retail customers. Moreover, the rules for each sector are usually created as a dedicated package for types of companies. It means that the resolution regimes for financial institutions are primarily like "silos". There needs to be a comprehensive set of rules that should be applied during a crisis of financial institutions, enabling the execution of coherent crisis management actions for the capital groups[60].

In case of a crisis of a financial group where multiple types of companies operate, the intervening authorities must follow numerous rules and treat various companies differently because of various resolution provisions or insolvency rules if the resolution regime for a particular type of company has yet to be created. That might be irrational from the point of view of customers, whose treatment might depend on the kind of financial institution they use.

However, the consequences of varied or non-existent rules for crisis management might be far-reaching for other entities in the group, in the case of the model where various group entities deliver multiple services, or in the financial system, in the case of the model where the bank sells the products of other entities based on the cooperation agreements.

The incomplete crisis management regime may escalate the contagion effects since clients might interpret the failure of the

[59] This concerns usually financial conglomerates. The literature and research about the functioning of financial conglomerates are limited, especially about the resolution of financial conglomerates in the EU. Some thoughts about American framework for financial conglomerates resolution are included in: H. E. JACKSON and S. MASSMAN, *The Resolution of Distressed Financial Conglomerates*, (2017) *The Russell Sage Foundation Journal of the Social Sciences* 3 (1), 48-72.

[60] The analysis conducted by Kokorin confirms our assessment. According to the Author, although the concept of “group solution” in insolvency and resolution was developed, it is still not a coherent and well-defined legal concept. Instead, regulations seem to follow entity-based solutions (separate for various types of institutions). Source: I. KOKORIN, *The Rise of ‘Group Solution’ in Insolvency Law and Bank Resolution*, (2021) EBOLR (22) 781-811.

company that manufactured the product as the failure of the company that sold the products.

2.5 *Summary of identified problems*

Based on the above-presented analysis, it is possible to enumerate the list of identified crisis management problems that the legislators should address to increase the efficiency of the interventions in case of the failure of financial institutions. The identified problems can be summarized as follows: (a) Complicated financial safety net structure, where the mandates of some institutions are sometimes overlapping, and some areas are not covered; (b) Conflicts of interest between the supervisor and the resolution authority[61]; (c) Home-host problems[62]; (d) Lack of a complex and coherent system for the crisis management of the capital groups delivering multiple financial products, including financial conglomerates.

Based on the identified problems, the following chapter will analyze whether and how the upcoming EU regulations on recovery and resolution address these issues.

3. *The proposed changes to the EU regulatory framework on crisis management and their assessment*

In April 2023, the European Commission published the proposal to amend BRRD (analogous changes to be implemented in SRMR applicable to the banking union) and DGSD. The essential (and most controversial) part of the proposal concentrates on modifying financing

[61] These conflicts may relate to (i) Divergent views about the recovery and resolution plans and actions; (ii) Overlapping mandates in case of resolvability of a bank and the removal of impediments to resolvability; (iii) Risk of lack of coordination when the bank is failing or likely to fail; (iv) Uncertainties connected with the supervision of the bank in resolution.

[62] These problems may involve: (i) Divergent views on the prudential requirements from the point of view of home and host authorities; (ii) The inappropriateness of recovery options for home and host authorities at the same time; (iii) Divergent approaches to the selection of preferred resolution strategy; (iv) Divergent approaches to the management of the loss absorption and recapitalization capacity; (v) Divergent approaches to the assessment of the select resolution tool; (vi) Controversies and practical obstacles with the application of SPE and MPE strategies.

mechanisms, which aims to strengthen the use of deposit guarantee schemes in resolution and their overall application in crisis management (in the form of, e.g. preventive and alternative measures). The proposed framework's effectiveness strongly depends on the shape of the national financial safety net. Especially in countries where the deposit guarantee system is separated from the resolution authority and is managed by private entities, there might be a visible reluctance to make modifications. They might be seen as a trial to put the burden of crisis management on deposit insurers. Such institutions are solely national (deposit insurance has yet to be centralized at the banking union level), which adds a political dimension to the reform. The macroprudential policy's purpose and form also have significance in this regard[63]. In crisis management financing, the proposal also includes modifications of extraordinary public financial support to limit the use of public funds outside of resolution. For this purpose, the CMDI review amends the rules of precautionary recapitalization. However, these tools are outside the scope of this essay.

Apart from that, the CMDI review introduces multiple provisions that concern supervisory and resolution issues:

a) Rules regarding the application of early intervention measures have been modified so that, for the supervisor, it should be clear what kind of measures should be treated as typical supervisory measures (based on CRD[64]) and what kind of measures should be treated as early intervention measures (based on BRRD); moreover, duplicated powers (between CRD and BRRD) have been removed from BRRD – these provisions are connected, however with the consistency of legal basis for supervisor's activities and do not address the problems identified in the previous part of the article;

b) New provisions are added to the BRRD which regulate the issue of the cooperation between the supervisor and resolution authority when the situation of the bank starts deteriorating, i.e., when the bank is going to be deemed FOLTF and what is the timeframe for the

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[63] S. W. SCHMITZ, M. POSCH and P. STROBL, *The European Commission's crisis management and deposit insurance (CMDI) proposal increases system-wide liquidity risk and makes more banks systemic*, (SUERF Policy Note No 325), 12-13.

[64] Consolidated version of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, OJ L 176.

assessment that supervisory powers (early intervention measures) have been depleted – these provisions address one of the identified shortcomings in the current framework, namely it reduces the risk of lack of coordination at the moment when the bank is failing or likely to fail;

c) Provisions regarding the public interest assessment (PIA) and resolution objectives are modified to broaden the application of resolution (instead of liquidation supported by the budgetary funds) – these amendments are targeted at making the application of the resolution more frequent (do not solve the problems with its execution, especially with regards to the international context as well as potential conflicts with the supervisory powers) and it should be noted that the already existent rules enabled broad application of resolution measures;

d) Further amendments regarding the MREL requirement have been proposed; apart from waiving or streamlining the rules for setting MREL for entities that are earmarked to be liquidated in case of the crisis, the CMDI package foresees further modifications regarding the setting of internal MREL (e.g., possibility to set internal MREL on a consolidated basis for non-resolution entities) – these amendments address to some extent the problem of prepositioned loss absorption and recapitalization capacity at the level of a subsidiary, but do not solve the issue of the conflicts of interest among national resolution authorities and obstacles with the implementation of particular resolution strategies.

Apart from the CMDI package, in September 2021, the European Commission proposed the adoption of the IRRD to establish the recovery and resolution framework for insurance and reinsurance companies. Although it broadly addressed identified shortcomings in the field of crisis management in the (re)insurance sector[65], the general approach to the crisis management of the capital groups (including financial conglomerates) remains incomplete and still mostly sectoral (“silos approach”). Thus, the future legal framework (BRRD, DGSD, and IRRD) must fill the lack of a complex and coherent system for crisis management of capital groups that deliver multiple financial products,

[65] M. REUMERS, M. NELEMANS, *The questionable scope of the Commission’s proposal for a framework for recovery and resolution of (re) insurance undertakings*, (2022) *European Journal of Commercial Contract Law* 31-43, at 34.

including financial conglomerates. The solution for the consistent crisis management framework for the financial system is still missing.

Indeed, the IRRD set forth that Member States shall require authorities exercising supervision and resolution functions and persons exercising those functions on their behalf to cooperate closely in the preparation, planning, and application of resolution decisions, regardless of institutional setup.[66].

However, the IRRD claims for coordination between authorities in charge of the (re)insurance sector and the banking and investment firms' sector if they form or are parts of the financial conglomerate. Indeed, the supervisory authorities are those defined in Directive 2009/138/EC (Solvency II), namely, the national authority or the national authorities empowered by law or regulation to supervise insurance or reinsurance undertakings[67]. Meanwhile, the resolution authorities are those empowered to apply the resolution tools and exercise the resolution powers under the IRRD[68], which lays down rules and procedures for the recovery and resolution of all the entities listed in its provisions[69]. Analogous rules are applied in the case of BRRD. The only case where both authorities cooperate within the resolution college is when entities form a financial conglomerate.

Consistent with the above, the relevant "group" for the IRRD includes solely the entities listed in that directive referring to the terms "group" and "group supervisor", which are those provided by the Solvency II Directive[70], and "group resolution authority", which is

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[66] IRRD, art. 3(6).

[67] IRRD, art. 2, n. 8, and Solvency II, art. 13, point 10.

[68] IRRD, art. 2(2) n. 7.

[69] IRRD, art. 1.

[70] IRRD, art. 2, para. 1. Thus, 'group' means a group of undertakings that:

(i) consists of a participating undertaking, its subsidiaries, and the entities in which the participating undertaking or its subsidiaries hold participation, as well as undertakings linked to each other by a relationship as set out in Article 12(1) of Directive 83/349/EEC; or

(ii) is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, and that may include mutual or mutual-type associations, provided that:

- one of those undertakings effectively exercises, through centralized coordination, a dominant influence over the decisions, including financial decisions, of the other undertakings that are part of the group; and,

introduced under the IRRD[71]. Thus, the IRRD delimits the entities for which the resolution authorities can intervene as it sets forth that the "group resolution" means either of the following: (a) the taking of resolution action at the level of a parent undertaking or of an insurance or reinsurance undertaking subject to group supervision, or (b) the coordination of the application of the resolution tools and the exercise of the resolution powers by resolution authorities concerning group entities.

Looking at the entities falling into the scope of the IRRD, mixed financial holding companies and parent mixed financial holding companies established in a Member State and Union parent mixed financial holding companies are those included in the scope of the resolution framework. The IRRD defines 'Union parent mixed financial holding company'[72]. In contrast, the **Directive 2002/87/EC of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate** ultimately provides the definitions of the other entities[73]**.**

- the establishment and dissolution of such relationships for [group supervision] are subject to prior approval by the group supervisor,

The undertaking exercising the centralized coordination shall be considered the parent undertaking, and the other undertakings shall be considered subsidiaries.

On the other hand, "group supervisor' means the supervisory authority responsible for group supervision, determined under art. 247 of Solvency II.

[71] Based on IRRD, art. 2, para. 2, n. 27, "group resolution authority" means the resolution authority in the Member State where the group supervisor is situated.

[72] Based on IRRD, art. 2, n. 5, 'Union parent mixed financial holding company' means a parent mixed financial holding company in a Member State that is not a subsidiary undertaking of an undertaking authorized in any Member State or of another insurance holding company or mixed financial holding company set up in any Member State.

[73] Indeed, the IRRD refers to a list of definitions in art. 212 of Solvency II. Among others, these definitions provide that 'mixed financial holding company' means a mixed financial holding company as defined in *Article 2(15) of Directive 2002/87/EC* [emphasis added], under which "mixed financial holding company" shall mean a parent undertaking, *other than a regulated entity*, which together with its subsidiaries, at least one of which is a regulated entity which has its head office in the Community, and other entities, constitutes a financial conglomerate (Article 2, n.15) (emphasis added); while 'parent mixed financial holding company in a Member State' means a mixed financial holding company as defined in Article 212(1), point (h), of Directive 2009/138/EC which is established in a Member State, which is not itself a subsidiary

Although the IRRD recognizes the importance of the connection between entities operating in the financial system for financial stability[74], it includes supervised entities, such as banks or investment firms, only if they are parts of the financial conglomerate. Not all capital groups providing multiple financial products (including insurance and banking) are considered financial conglomerates. Therefore, the solution is minimal, and a comprehensive crisis management system for diversified capital groups needs to be created.

In conclusion, the IRRD pursues harmonization in matters of cooperation between authorities other than the (re)insurance ones, which is limited to the provision under which Member States *may* authorize the exchange of information, among others, national authorities responsible for overseeing payment systems, the authorities responsible for ordinary insolvency proceedings, the authorities entrusted with the public duty of supervising other financial sector entities, the authorities responsible for the supervision of financial markets, credit institutions, and investment firms, the authorities of Member States responsible for maintaining the stability of the financial system in the Member States through the use of macroprudential rules, the authorities responsible for protecting the stability of the financial system, and persons charged carrying out statutory audits[75].

Furthermore, the IRRD also aims to facilitate coordinated actions in the event of cross-border group failure by attributing the same intervention tools to the resolution authorities in various Member

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undertaking of an insurance or reinsurance undertaking, an insurance holding company or mixed financial holding company authorized or set up in that same Member State. Thus, Article 212, para 1, let. h) Solvency II states that "mixed financial holding company' means a mixed financial holding company as defined in Article 2(15) of Directive 2002/87/EC, *i.e.*, an undertaking other than a regulated entity.

[74] IRRD, art. 1, provides that «Resolution authorities and supervisory authorities shall, when establishing and applying the requirements laid down in this Directive and when using the different tools at their disposal in relation to an entity referred to in the first subparagraph, take account of the nature of the business of that entity, its shareholding structure, legal form, risk profile, size, legal status, *interconnectedness to other institutions or to the financial system in general*, and the scope and complexity of the entity's activities» [emphasis added].

[75] IRRD, art. 64, para 5., let. c).

States[76]. Therefore, group resolution authorities shall establish resolution colleges to carry out the tasks and, where appropriate, to ensure cooperation and coordination with third-country resolution authorities. The supervisory authorities of the resolution college are the group supervisors and the supervisory authorities of each Member State, where the resolution authority is a member of the resolution college. The resolution college is only sometimes joined by the resolution authorities of banks and investment firms. In many capital groups (especially not formally recognized as financial conglomerates) the provisions will re-propose a silos approach also to cross-border activities.

The IRRD introduces the restructuring tools and powers the resolution authority might apply in a crisis. Moreover, other tools adjusted to the insurer's character will be possible if convergent with the resolution objectives. It should be noted, however, that insurers' business and risk profiles differ from those of banks[77]. Therefore, the application of resolution tools should be distinct from the existing banking examples and adjusted to the insurance sector and its specific role in the financial system, the economy, and particular crisis conditions.

Insurance companies are less financially connected than banks, for which shocks may spread quickly through the interbank market[78]. In the

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[76] IRRD, whereas No. 65.

[77] M. REUMERS, M. NELEMANS, *The questionable scope of the Commission's proposal for a framework for recovery and resolution of (re) insurance undertakings*, (2022) *European Journal of Commercial Contract Law* 31-43, at 37 ff.; MAGDALENA KOZIŃSKA, *Resolution in the insurance sector – premises, model solutions and challenges*, (2022) *Insurance News* 4/2022, 45 ff.; C. THIMANN, *How Insurers Differ from Banks: A Primer on Systemic Regulation. Systemic Risk Centre Special Paper No 3*' (London: London School of Economics and Political Science 2014) 4 ff.; H. CHEN, D. J. CUMMINS, K. S. VISWANATHAN, and M. A. WEISS, *Systemic Risk and the Inter-Connectedness between Banks and Insurers: An Econometric Analysis*, (2012) *Journal of Risk and Insurance* 81, 623–652. See also BIPARTISAN POLICY CENTRE, *The Business of Insurance and Banking Understanding Two Different Industries* (Washington: BPC 2019) 14; ERSB, Report on systemic risks in the EU insurance sector (December 2015) https://www.esrb.europa.eu/pub/pdf/reports/2015-12-16-esrb_report_systemic_risks_EU_insurance_sector.en.pdf accessed 6 August 2024.

[78] The financial factors that explain the systemic importance of banks include interbank lending, correspondent banking, investments in shares and bonds, and mutual lending.

case of co-insurance, i.e. a risk faced by a policyholder and underwritten by two or more insurance undertakings, the insolvency of a co-insurer affects only the insured person. It does not oblige the other co-insurers to provide a share of the benefit owed by the insolvent insurer[79], although such insolvency may influence the policyholder. Therefore, one insurer's crisis may have a less significant effect on the other insurers, which for some insurance products could also easily replace it in providing insurance coverage to its customers. Nevertheless, insurance companies are not immune to systemic risk[80] and the materialization of other types of risk that might be seen as specific for banks (e.g., liquidity risk)[81].

The legislative choice to extend resolution and recovery tools to the insurance sector probably also depends on the current and prospective relevance of factors exogenous to a financial crisis, such as the damage caused by climate change, the COVID-19 pandemic, the European Green Deal, the Capital Markets Union (CMU)[82] and, according to some authors, the political desire to stimulate insurers into making (cross-border) investments[83].

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[79] Article 190 Solvency II lists the conditions to classify as community co-insurance operations, including «the risk is covered by a single contract at an overall premium and for the same period by two or more insurance undertakings *each for its own part as co-insurer*, one of them being the leading insurance undertaking» [emphasis added].

[80] A. DENKOWSKA and S. WANAT, *Dependencies and systemic risk in the European insurance sector: New evidence based on Copula-DCC-GARCH model and selected clustering methods*, (2020) EBER 8(4), 7-27.

[81] ECB, *Financial Stability Report*, (June 2009) 122-124.

[82] Communication from the European Commission to the European Parliament and the Council on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recovery, COM(2021) 580 final, para 1; Proposal amending Solvency II, Explanatory Memorandum, 1.; M. REUMERS, M. NELEMANS, *The questionable scope of the Commission's proposal for a framework for recovery and resolution of (re) insurance undertakings*, (2022) *European Journal of Commercial Contract Law* 31-43, at 33 f and 37.

[83] M. REUMERS, M. NELEMANS, *The questionable scope of the Commission's proposal for a framework for recovery and resolution of (re) insurance undertakings*, (2022) *European Journal of Commercial Contract Law* 31-43, at 33. However, the authors should explain how resolution system would inspire insurers to make cross-border investments.

Moreover, EIOPA repeatedly reported an exposure of insurers towards banks[84], which could reach a materiality threshold capable of causing, in the event of a crisis, a danger to the financial system's stability, becoming a channel of risk contagion and transmission[85]. This materiality threshold usually concerns larger insurance groups and insurers of particular importance for the financial system or economy, but not all insurers. The application of the IRRD should be subject to the principle of proportionality, which the IRRD embeds. However, the actual application depends on the policy of the national resolution authority. It will play a key role in differentiating the burdens on insurers resulting from implementing the IRRD.

Therefore, the emphasis on financial stability should have led to rules that addressed bank-insurance groups (not only formal financial conglomerates) where the coordinated action of the multiple - supervisory and resolution - authorities concerned about the various activities carried out by the group companies can guarantee better protection of financial stability. The risk of contagion within the group can threaten this stability regardless of the occurrence of exogenous or endogenous factors as determinants for the group's financial crisis.

The above coordination is not entirely addressed in the revision of the CMDI and the IRRD proposal, which came out two years later. Both legislative proposals presented a mostly silos approach, which appears to be a political compromise to reach an intermediate step - the existence of resolution/recovery tools in both sectors - in building an effective integration between the banking and insurance regulatory frameworks on recovery and resolution. In the meantime, there are bancassurance groups that do not qualify as financial conglomerates, for which coordination problems inherent to the silos approach arise.

In conclusion, comparing the identified shortcomings and the scope of the CMDI review and other regulations that will be implemented shows that the European overall crisis management framework still

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[84] EIOPA, *Financial Stability Report*, (December 2021), 12 ff. https://www.eiopa.europa.eu/system/files/2021-12/financial-stability-report-december-2021_1.pdf accessed 6 August 2024.

[85] EIOPA, *Financial Stability Report*, (June 2023), 71 https://www.eiopa.europa.eu/system/files/2023-06/EIOPA-BOS-23-209-EIOPA%20Financial%20Stability%20Report%20June%202023.pdf accessed 6 August 2024.

needs to be completed. The following chapter aims to identify some regulatory solutions and evaluate their suitability for addressing the issues that the current (and future) regulatory framework should adequately tackle.

4. *Unresolved gaps and proposals for a more comprehensive regulatory framework*

The analysis carried out in the previous chapter highlighted the persistence of some gaps in the European regulatory framework in managing financial crises. The following pages intend to provide some regulatory solution hypotheses that further research could support (or counter).

First, the financial safety net for crisis management should be streamlined. While separation of supervision and resolution is justified, the crisis management authorities (resolution authorities, deposit guarantee schemes, and the respective funds) could be combined. This combination could also streamline the rules for financing the resolution process. The creation of one combined fund for crisis management (instead of two funds: resolution and DGS funds) would exclude the problem of usage of DGS in resolution and their inactiveness in situations when banks are mostly resolved (instead of being wound down). Such a solution would also limit doubts connected with the priority of the funds' usage. Apart from procedural streamlining, combining authorities of similar tasks (objectives) in one institution limits costs and concentrates skills and knowledge in crisis management in one authority. In some Member States, however, there might be some hurdles for such an institutional setup. Gathering crisis management functions (resolution and guarantees) in one entity may suggest that the responsible authority should be public instead (to exclude the situation that the financial institutions decide about the future of one of their competitors). In some countries, deposit guarantors are private institutions (privately governed) entrusted with the public task. The far-reaching reform of the institutional shape of the financial safety net might be thus politically challenging to implement. At the same time, the elements of the safety net that are lacking should be completed. This issue consists mainly of the provision of liquidity in times of crisis. The role of the central bank could be explored more, and

appropriate mechanisms seem justified in being prepared (e.g., central banks as lenders of last resort (LoLR) – facilities for at least bank resolution). Creating a resolution LoLR function should not increase the level of moral hazard. Therefore, the optimal solution seems to be to ensure the legal framework for the viable provision of liquidity in resolution and, simultaneously, to follow the rules of constructive ambiguity and the central bank's discretion. The provision of liquidity by central banks (even in the form of the "resolution emergency liquidity assistance") should still not be assumed as the source of financing in the recovery and resolution plans. It should be treated as a last resort solution to be implemented in case there are no other market sources, and there is a risk of contagion (systemic risk materialization).

The overlapping powers between supervisor and resolution authority are challenging to address because they have "institutionally" different approaches – supervisor is going-concern, and resolution authority is gone-concern[86].

However, it seems that the overlapping could be reduced if the crisis management preparation concentrated on preparing one consistent crisis management plan (and its testing), including both the recovery and resolution phase[87] – like American living wills prepared by the large banks in cooperation with FDIC, Federal Reserve and Financial Stability Oversight Council (which are engaged in resolution planning)[88]. Such a plan could be developed in cooperation[89] between institutions and authorities. To make the plan genuinely comprehensive

[86] Our analysis confirms that the legal framework enables cooperation between the engaged authorities (*i.e.* there are no legal barriers to cooperate). In this regards our research is consistent with the works of Binder (more here: J.-H. BINDER, *Inter-agency Cooperation Within the SRM: Legal and Operational Challenges for the Cooperation Between Banking Supervision and Resolution Authorities in the EU and With Third-country Authorities*, ECFR 2022, 916). However, the necessity to safeguard national financial systems (*i.e.* national interests) and the different perspectives of the analysis (supervision and resolution) may limit the willingness to agree on the solutions proposed on the group level.

[87] E. AVGOULEAS, C. GOODHART and D. SCHOENMAKER, *Living Wills as a Catalyst for Action*, (DSF *Policy Paper Series* No. 4 2010) 2.

[88] Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec. 165.

[89] As proposed by Binder (more here: J.-H. BINDER, *Cross-border coordination of bank resolution in the EU: All problems resolved*?, (2016) ECFR, 591–582, but in the broader scope (recovery and resolution, not just within the resolution).

in the case of capital groups, it should cover all types of entities within the group (treatment and planned measures for such entities should naturally be adjusted to the type of entity's business and regulatory status). The challenge might be organizing and preparing a comprehensive plan since multiple entities must be engaged. Therefore, it could be acceptable that the comprehensive crisis management plan is not only one document but a set of documents. Apart from that, preparing a comprehensive crisis management plan could create the opportunity to solve the problem of the viability of crisis management options (e.g., planning to resolve the sale of assets that have already been sold in the recovery).

The provisions regarding the supervision of banks in resolution should be clarified. The entity should be further subject to fully-fledged supervision only when it continues its activity in the previous scope and the resolution authority has not taken control over the company. Such a situation usually occurs when there is an open bank bail-in. Otherwise, it seems that the supervision – at least in the full scope – is unjustified. Solutions for the supervision of resolved banks should at least be worked out to exclude potential conflicts of interest or situations when the ultimate recipient of the supervisory requirements is another authority (i.e., resolution authority or guarantor). Also, the framework for requirements should be adjusted to the situation, *i.e.* the level of capital and liquidity requirements for bridge institutions that should be covered in the target scope primarily by the ultimate acquirer and not the resolution authority.

Suppose the crisis management framework in the international context is not entirely centralized. In that case, the problem of home-host balance is challenging to address since national authorities will always follow their national interests. It is justified since local entities and authorities must cover the ultimate responsibility for the problems in the national financial system. Even in the complete centralization of powers and tools for crisis management, the competing interests of, e.g., main contributors to the funds may influence how the crisis management measures are used. There are multiple arguments for and against complete centralization and "nationalization" of safety nets, e.g., while local authorities seem to know better the local specificity and the actual condition of the company, the centralized authority might be more independent from the influence of financial institutions as not

having the direct and constant contact with them. However, this might not be the case for big international financial corporations that heavily invest in lobbying at all levels. Undoubtedly, all regions where the financial capital group operates should be evenly secured against the risk of default to ensure the equal protection of clients and a level playing field for institutions' competition.

At the same time, approaches of the resolution colleges should be amended so that the SPE strategy is provided only for entities domiciled in one jurisdiction. Only under such circumstances can SPE be thoroughly and reliably applied, as evidenced above – although its application is not certain since, even within one jurisdiction, the SPE strategy has not been followed in practice in the case of the Sberbank crisis. This might relate to the fact that the problematic entity usually needs direct and decisive intervention from the financial safety net institutions instead of intervention from other group entities instructed/influenced by the financial safety net institution. Also, loss and capital transfer mechanisms are limited, usually to the subscribed capital and prepositioned debt level. Doubts about the viability of the SPE strategy cast a shadow on the idea of centralising the crisis management system and increasing the significance of the home-host problem. At the same time, current experiences suggest that the national authorities usually intervene.

Moreover, the legislation should include crisis management rules for financial institutions other than banks, investment firms, and insurers. The current crisis management framework should be made universal and expanded to the whole (regulated and supervised) financial sector, allowing the authorities to manage financial crises comprehensively[90].

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[90] In this regard, it is worth considering the thoughts of Busch and Rijn (D. BUSCH, MIRIK B.J. VAN RIJN, *Towards Single Supervision and Resolution of Systemically Important Non-Bank Financial Institutions in the European Union*, (2018) EBOLR (19) 301-363) about the non-bank systemically important financial institutions and the need to create a single supervisory and resolution framework for them. They indicate the risk of gaps in the financial safety net, level-playing field issues and regulatory arbitrage under the current regulatory environment. It should be noted, however, that their proposal for creating a single body that identifies and monitors non-bank financial institutions that are systemically important might be challenging to implement due to the existing national authorities that may already have some powers in this regard. The first step should be to create a legal basis for the supervision and resolution of capital groups that would be harmonized among EU countries.

This extension is justified because the crisis management tools are similar in all industries; namely, the institution is usually transferred to other entities or liquidated. Additionally, sector-specific tools could be further developed for financial institutions other than banks to address their specificities.

5. *Conclusion*

The critical review of the applicable crisis management framework suggests that the topic of the banking crisis is like Pandora's box – the following examples and new dimensions of crises open the next challenges that the financial safety net institutions dealing with crisis management might suffer.

The article should have analyzed the full scope of challenges in crisis management that have yet to materialize visibly in crises under the current legal framework. In our approach, we go beyond the lessons learnt from the recent banking crises of Signature Bank, Silicon Valley Bank, First Republic Bank and Credit Suisse, trying to identify issues that may pose obstacles in the practical implementation of the crisis management framework, but they haven't materialized so far. Nevertheless, even such a focused analysis provides a list of shortcomings that impede the smooth functioning of the crisis management framework. These are (*a*) Complicated financial safety net structure, where the mandates of some institutions are sometimes overlapping, and some areas are not covered; (*b*) Conflicts of interest between the supervisor and the resolution authority; (*c*) Home-host problems; (*d*) Lack of a complex and coherent system for the crisis management of the capital groups delivering multiple financial products, including financial conglomerates.

The upcoming EU legal acts (CMDI package, IRRD) address some identified shortcomings to a certain level, usually partially. Therefore, the outcomes arising from the essay suggest implementing further changes: (*a*) Streamlining the financial safety nets; (*b*) Combining the recovery and resolution planning and preparation into one coherent stage in crisis management; (*c*) Clarifying the provisions regarding the supervision over the bank in resolution; (*d*) Limiting the possibility to apply SPE strategy only to one jurisdiction; (*e*) One single crisis management legal framework should be created.

The proposed solutions include only some of the identified obstacles in resolution. Some of them are difficult to address due to the existence of national and institution-specific divergent interests. Also, most of the identified critical obstacles in crisis management (e.g. implementation of bail-in, funding in resolution), apart from the issues connected with the ongoing supervision, are not addressed; this has been proved, for example, by the 2023 bank tensions in the US and Switzerland.