Removing the regulatory barriers to cross-border banking

Regulatory initiatives to foster banking integration and financial stability in the Banking Union

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Executive summary

The establishment of the Banking Union and the introduction of the European Single Rulebook seek to pave the way for a single banking market and to break the nexus between banks and sovereigns. Ideally, banks should be subject to a common set of rules and do business across the Banking Union without having to comply with different supervisory practices and methodologies. However, there are still loopholes and discrepancies in the legislative framework that cause regulatory fragmentation, among others, by allowing national authorities to take restrictive measures to protect national interests against the common interest.

The present paper[1] analyzes the current obstacles to the free flow of funds within cross-border banking groups operating in the Banking Union, namely the obligation for subsidiaries to meet prudential requirements (capital, liquidity and internal MREL) at individual level and the restrictions to intragroup exposures. This paper proposes some amendments to the Union framework relating to microprudential regulatory intervention and crisis management aiming to achieve a dual objective; to strengthen the banks' capital and funding capacity and to enhance financial integration and consolidation of the banking sector, preferably through a decisive boost to cross-border mergers and acquisitions (M&As). The proposed changes have become more significant today in light of the COVID-19 crisis and its impact on the European banking sector and the European economy. The European Central Bank (ECB) and the Single Resolution Board (SRB) have granted (temporary) relief measures to banks to withstand the effects of the pandemic and continue lending to the economy. Nonetheless, it is necessary to establish a permanent framework to relieve banking groups from the unnecessary capital and liquidity burden placed on them. The aim of the proposed framework is to enhance the banks' ability to generate sustainable profits and, hence, their capacity to absorb losses upon occurrence of external shocks.

The proposed regulatory reform is governed by three (3) principles. Firstly, the introduction of a default approach for the application of reduced prudential requirements to subsidiaries accompanied by the lifting of restrictions to intragroup exposures. Secondly, particular emphasis is placed on the Supervisory Review and Evaluation Process (SREP) and the resolvability assessment carried out by the ECB and the SRB respectively whose outcome may result in an increase of the prudential requirements. Thirdly, the establishment of a credible escalation mechanism to ensure that parent entities will remain committed to providing capital and/or liquidity support to subsidiaries should their financial situation deteriorate. The proposed mechanism serves as a safety net to prevent the failure of subsidiaries and, if that happens, to minimize the negative implications for domestic financial stability and fiscal sovereignty of host Member States.

Under the proposed escalation mechanism, banking groups wishing to take advantage of the proposed capital and liquidity relief measures should sign mandatorily intragroup financial support agreements. Furthermore, the group recovery plan should cover all the subsidiaries enjoying the proposed preferential treatment, irrespective of their materiality for the banking group and/or the host Member State. Once a recovery trigger relevant to a subsidiary is triggered, recovery action should be taken to restore the subsidiary's financial position. If the parent entity is reluctant to respond appropriately to the worsening of the financial situation of the subsidiary, early intervention action should be taken. This action may pertain to the activation of the intragroup financial support agreement, the prohibition of distributions (i.e. dividends, AT1 coupons, bonuses) and placements from the subsidiary to the parent entity, as well as the requirement for collateralization/ prepositioning of the full amount of the internal MREL. As a last resort measure, if a material subsidiary comes into a "failing or likely to fail" situation, the SRB may decide the write-down and/or conversion of internal MREL-eligible instruments into equity either independently or in combination with resolution action.

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Contents

1. The contribution of regulatory deficiencies in the fragmentation of the banking market . 4

1.1 An overview of the key regulatory impediments to cross-border banking 4

1.2 The need for enhancement of the financial integration in the euro area 5

2. Restrictions to transfer of capital and liquidity under the existing regulatory framework. 6

2.1 Lack of cross-border waivers for capital and liquidity requirements 6

2.2 The obligation for material subsidiaries to meet the internal MREL 7

2.3 Restrictions to intragroup exposures 8

3. Proposed framework for reduced prudential requirements for subsidiaries 9

3.1 The proposed approach for reduced capital and liquidity requirements 9

3.2 Establishment of cross-border internal MREL waiver 11

3.3 Lifting of restrictions to intragroup exposures 12

4. Enhancement of the Union crisis prevention framework 13

4.1 Mandatory intragroup financial support agreements 13

4.2 Application of recovery arrangements to all subsidiaries enjoying preferential treatment 13

4.3 Enhanced early intervention measures on a group-wide basis 14

4.4 Recapitalization of subsidiaries at the PONV 16

5. Conclusions 17

6. Bibliography 19

1. The contribution of regulatory deficiencies in the fragmentation of the banking market

1.1 An overview of the key regulatory impediments to cross-border banking

Since the establishment of the European Economic Communities, national authorities were responsible for the micro-prudential supervision of banks. This situation remained unaffected even after the launch of the Economic and Monetary Union (EMU). Home country supervisory authorities were responsible for the supervision of cross-border banking groups at consolidated level, while host supervisory authorities were competent for the supervision of subsidiaries at individual level.

The establishment of the Banking Union changed the architecture for banking supervision and resolution. Significant banking groups located in participating Member States are subject to (consolidated and individual) supervision and resolution carried out by the ECB and the SRB respectively. However, this institutional reform was not accompanied by an amendment of the regulatory framework to treat the Banking Union as a single jurisdiction. Thus, entities belonging to banking groups are still obliged to meet prudential requirements at individual level. The rationale behind this approach is related to the concerns of host Member States about the negative effects on the domestic economy and financial stability that might be triggered by the failure of a subsidiary located in their jurisdiction.

The fragmentation of the banking market is further enhanced by the application of some measures (known as "ring-fencing measures") which restrict the amount of capital and/or liquidity that domestic entities can provide to the parent entity or to any other group entity. Ring-fencing measures became increasingly common in emerging EU countries in the aftermath of the international financial crisis,[2] which highlighted the lack of effective cooperation among supervisory authorities.[3] When problems started to emerge, interests of home and host authorities became divergent and sometimes conflicting. Host authorities started taking ring-fencing measures to protect their national interests ignoring the implications for the other groups' entities and the relevant Member States.

In several host Member States, including some Member States that participate in the Banking Union, ring-fencing measures are still in place. For host supervisory authorities, these measures allow greater control on capital, liquidity and risk management seeking to safeguard national interests in various ways. Firstly, ring-fencing measures intend to protect both domestic creditors from incurring losses and the domestic financial system from the contagion effects that may arise once a bank fails (e.g. due to the use of funds of national Deposit Guarantee Schemes (DGSs) to compensate covered depositors). Secondly, ring-fencing measures safeguard public finances from the costs relating to the provision of public financial support to ailing banks in the form of recapitalization, public guarantees for liquidity or asset impaired measures. Thirdly, such measures address the host Member States' concerns about a potential credit crunch that could hit their local economies if banking groups decided to reduce the lending activity due to transfer of liquidity to other groups' entities that are in need of that.

However, ring-fencing measures come at a significant cost for the financial integration and financial stability at European level. Banking groups face increased cost of funding, as they have to maintain more capital and liquidity at the subsidiary level than if they were allowed to transfer excess resources across borders.[4] Thus, banking groups cannot make optimal use of their funds,

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[2] For more on this issue, see **Lehmann** and **Nyberg (2014)** and **D'Hulster** and **Ötker-Robe (2014)**,

[3] See **D' Hulster (2011)**, pp. 5-6.

[4] Based on a study of **Cerutti et. al. (2010)** for 25 large European banking groups, the adoption of ring-fencing measures results in 1.5-3 times higher capital needs upon materialization of a systemic shock.

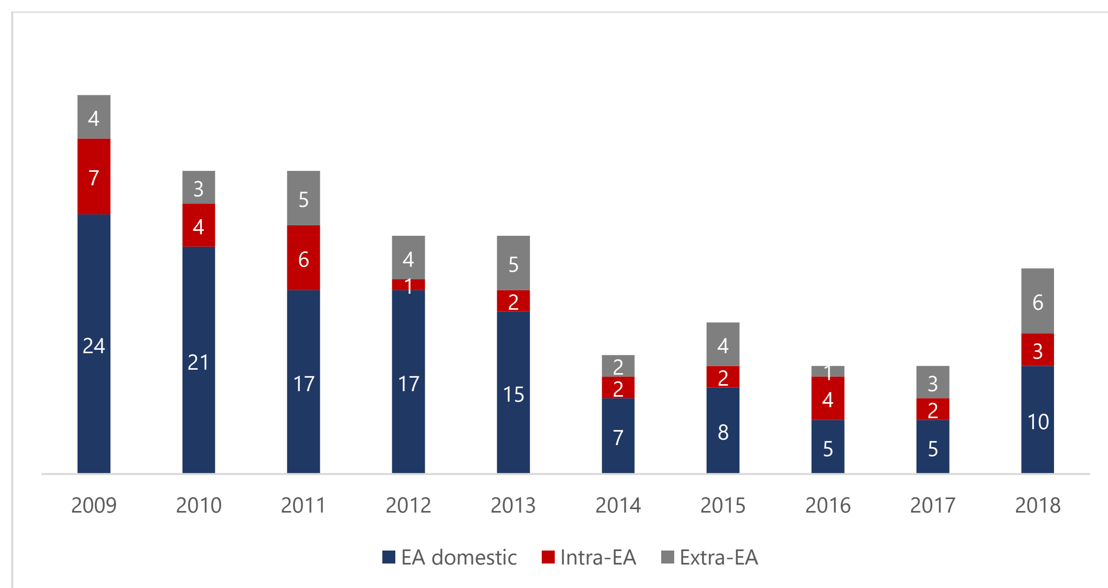
which affects their profitability and their lending capacity with negative implications for the internal market and the European economy. In addition, if such measures are taken amidst a crisis, they result in an increase of the stress both for the banking groups concerned and the financial system as a whole triggering further defaults and amplifying the impact of the crisis.[5]

1.2 The need for enhancement of the financial integration in the euro area

In a fully integrated banking market, banks, corporates and households should have access to loans under the same credit standards and interest rates. However, this was not the case for the euro area during the past years, when the financial integration significantly retreated. Market participants could enjoy neither the same degree of access to the banking market nor equal terms for banking products and services. The lack of an integrated banking market resulted both in the drop of new loans' origination, especially on a cross-border basis, and in significant divergences in the terms and rates of new loans across Member States.[6]

During the great retrenchment period that followed the international financial crisis, the market shares of foreign-owned subsidiaries in Central and Eastern Europe narrowed, as European banks limited their operations outside their home market.[7] This trend has not changed after the inception of the Banking Union, as demonstrated by the reduced volume of cross-border loans and deposits within the euro area and the low number of cross-border M&As.[8]

Figure 1: Mergers and acquisitions in the euro area banking sector



Source: *European Commission (2020), p. 51.*

Based on data as at end-2018, subsidiaries of European banks represent c. 25% of total assets of the European banking sector.[9] In eight (8) Central and Eastern European and Baltic countries,[10] along with Luxemburg, foreign subsidiaries and branches have a prominent role, with combined

Therefore, banking groups subject to ring-fencing measures need to have substantially higher capital buffers at the parent and/or subsidiary level given that they are not allowed to transfer capital and/or profits across their entities.

[5] See **D' Hulster (2011)**, p. 6.

[6] See **European Central Bank (2018),** p. 152.

[7] For bank-specific market share information, see **Ahmad et. al. (2020)** and **Lehmann (2019)**, p. 3.

[8] See **European Central Bank (2020a)**, p. 21.

[9] See **European Commission (2020)**, p. 50.

[10] These countries are: Czech Republic, Lithuania, Croatia, Slovakia, Bulgaria, Romania, Estonia, Latvia. For more information, see **European Central Bank (2020a)**, p. 39.

market shares exceeding 25% of the domestic markets.[11] Nonetheless, for large European banks, the largest part of their operating income and profits comes from their operations in home Member States, while their activities in host Member States represent only a small amount of their profitability. Hence, there is a clear asymmetry between the systemic importance of subsidiaries for host Member States and the irrelevance for the banking groups and the large (home) Member States. This asymmetry results in diverging and in some cases conflicting interests between host Member States and banking groups, which drive host authorities to take ring-fencing measures.[12]

In light of the fact that most of the significant host Member States either participate in the euro area or have started the procedure to join the Banking Union under a close cooperation regime, it is necessary to adopt rules that would promote financial integration and give boost to consolidation of the European banking sector. These rules would incentivize banking groups to expand their activities beyond national borders resulting in enhancement of the financial integration and the breaking of the nexus between sovereigns and banks. In that way, banks could achieve geographical diversification and risk-sharing and increase of their resilience to withstand local shocks.

In addition, the proposed reform would allow economies of scale to be achieved and capital to be allocated to its most productive uses at the European level. Banks would not be urged to adopt a search-for-yield strategy and invest in riskier assets to compensate for the cost of keeping unnecessary liquidity. Therefore, banking groups should have the option to transfer capital and liquidity to their entities needed most, which would imply optimal use of their resources resulting in benefits both for their financial standing and their capacity to finance the European economy. As demonstrated during the COVID-19 crisis, it is critical for banks to build strong capital and liquidity buffers in order to absorb losses and avoid an idiosyncratic or system-wide banking crisis and the best way to achieve that is through the enhancement of their ability to generate sustainable profits.

2. Restrictions to transfer of capital and liquidity under the existing regulatory framework

2.1 Lack of cross-border waivers for capital and liquidity requirements

The existing regulatory framework does not promote the free transfer of funds within cross-border banking groups, since it does not treat the Banking Union as a single jurisdiction, which would allow the application of waivers for individual capital and liquidity requirements. Under **Art. 7 CRR**,[13] supervisory authorities may waive the application to a subsidiary of (individual) capital requirements (and requirements for leverage ratio and large exposures as well), where both the parent entity and the subsidiary are located in the same Member State. The application of that waiver is subject to safeguards ensuring that capital and liquidity are distributed adequately between the relevant entities.

The existing framework provides also supervisory authorities with the discretion to waive, fully or partially, the liquidity requirements at individual level.[14] In this way, the parent entity and its subsidiaries can operate as a single liquidity group. This allowance may be activated, where the parent entity meets the liquidity requirements at consolidated level and has in place adequate arrangements to monitor the liquidity position of its subsidiaries. In addition, the entities concerned must enter into contracts that provide for the free movement of funds between them

[11] See **European Systemic Risk Board (2019)**, p. 6.

[12] See **Ahmad et. al. (2020).**

[13] Any reference made in this paper to CRR, BRRD, CRD4 is on the consolidated versions of the respective legislative acts, as apply after any subsequent amendments.

[14] **CRR**, Art. 8(1).

so as to meet their obligations as they become due, while this transfer of funds must not be restricted by any current or foreseen practical or legal impediment.[15] The liquidity waiver can be applied also on a cross-border basis, provided that a joint decision between the relevant supervisory authorities, either on their own initiative or following a non-binding mediation by the European Banking Authority (EBA), is reached.[16]

Aiming to address the limited scope of waivers, in 2016, the Commission submitted a proposal on the amendment of the CRR (hereafter "proposal on CRR2") that aimed at removing obstacles in the intragroup flow of capital and liquidity between groups' entities located in Member States participating in the Banking Union.[17] The Commission's proposal included, among others, provisions on the establishment of cross-border waiver for individual capital and liquidity requirements,[18] where the parent entity committed to supporting the subsidiaries concerned through guarantees for the whole amount of the waived requirement and at least half of that amount was collateralized. As regards the liquidity waiver, the Commission's proposal provided that a supervisory authority could supervise the parent entity and its subsidiaries as a single liquidity group under certain conditions, including a requirement for the parent entity to provide its subsidiaries with a guarantee equal at least to their net liquidity outflows, calculated in accordance with the Delegated Regulation 2015/61 (LCR Delegated Regulation), half of which would be collateralized. However, the Commission's proposals were not adopted in the final text of the CRR2 due to Member States' concerns about the financial stability implications that could arise at domestic level.[19] The rationale behind this objection was related to the pursuit of Member States to protect national interests if parent entities were reluctant to provide financial support to their (ailing) subsidiaries.

2.2 The obligation for material subsidiaries to meet the internal MREL

In light of the concerns raised by host Member States about the inability or unwillingness of parent entities to inject fresh capital to their subsidiaries amidst a crisis, the BRRD2 introduced the internal MREL.[20] This requirement ensures that the parent entity has prepositioned MREL-eligible instruments to its material subsidiaries abroad.[21] The internal MREL fosters loss-absorbing capacity of material subsidiaries through the application of the bail-in tool to the instruments held by the parent entity without the need to take resolution action and impose losses on third parties.[22] The

[15] Based on the Commission's report to the European Parliament and the Council "*on Legal Obstacles to the Free Movement between Institutions within a Single Liquidity Sub-Group*" (pp. 4-5), possible obstacles to the free movement of funds between cross-border banking groups may include i) capital controls imposed by a Member State justified on grounds of public policy/public security in accordance with **Art. 65(1)(b) TFEU** and ii) some national company law provisions that require the management of a bank to protect its interests even at the expense of the wider interests of the banking group, unless the repayment is guaranteed.

[16] **CRR**, Art 8(3).

[17] According to **Draghi (2018)**, "*the requirement to comply with the liquidity coverage ratio at individual level locks up liquidity in cross-border subsidiaries of G-SIBs of up to €130bn. Some of this liquidity could potentially be freely allocated if impediments, such as large exposure limits on intragroup lending, were removed and euro area waivers granted*."

[18] The ECB issued an Opinion on the Commission's proposal asking for additional safeguards to confront the financial stability concerns raised by Member States. Based on the ECB's Opinion, only subsidiaries not falling within the significance criteria set out in the SSMR should benefit from a capital waiver and subject to a floor of 75% of the minimum capital requirements, whereas a guarantee would be needed for the waived part of the capital requirements.

[19] See **Deslandes, et. al. (2019)**, p. 9.

[20] **BRRD**, Art. 45f.

[21] As per the SRB's Policy on MREL (2020), material subsidiaries are defined as the entities providing critical functions and/or representing more than 4% of the resolution group's RWAs, or leverage exposure, or total operating income.

[22] Non-material subsidiaries are not subject to the internal MREL and in case of a "failing or likely to fail" determination, they will be put into liquidation under insolvency proceedings.

claims of the parent entity vis-à-vis the subsidiary are written down or converted into equity, before other creditors (e.g. depositors) bear losses.

Internal MREL-eligible instruments must meet certain eligibility criteria, including that they i) rank, under the national insolvency ranking, below liabilities which are both issued to external parties and not eligible for capital requirements, and ii) can be written down or converted into equity once the subsidiary reaches the Point of Non-Viability (PONV) in accordance with **Art. 59-62 BRRD**. The eligibility criteria seek to ensure that resolution authorities may write down and convert internal MREL-eligible instruments into equity without putting the subsidiary concerned into resolution. In addition, internal MREL-eligible instruments are fully subordinated, which means that the exercise of write-down and conversion powers does not affect operational liabilities and other customer liabilities (e.g. deposits, derivatives). Lastly, this action does not result in change of control of the subsidiary, which would threaten the credibility and feasibility of the preferred resolution strategy for the whole resolution group.

Resolution authorities may waive the application of the internal MREL or allow a subsidiary to cover that requirement fully or partially with guarantees, where both the subsidiary and the resolution entity are established in the same Member State and the resolution entity complies with the MREL.[23] Among others, the guarantee must be collateralized for at least 50% of the required amount and is triggered when the subsidiary is unable to pay its debts or other liabilities as they fall due or a determination has been made to write down and convert into equity its liabilities. As applies to capital and liquidity waivers, the Commission had proposed the extension of the internal MREL waiver also at a cross-border level based on a mix of collateralized and uncollateralized guarantees. Under that proposal, which was rejected by Member States, at least half of the waived internal MREL set for the subsidiary would be covered with collateral.[24]

The establishment of the internal MREL places additional burden on subsidiaries' profitability because they are required to issue MREL-eligible instruments to the parent entity (on an arm's length basis) without needing the received liquidity. Also, capital buffers sitting on top of the internal MREL restrict the capacity of subsidiaries to pay dividends to the parent entity. Hence, the internal MREL makes it more difficult for banking groups to make optimal allocation of their funding and constitutes an additional disincentive for them to expand their operations beyond national borders.

2.3 Restrictions to intragroup exposures

The existing regulatory framework sets two (2) restrictions to intragroup exposures limiting the free flow of funds and centralized liquidity management within banking groups. Firstly, in accordance with **Art. 113(6) CRR**, intragroup exposures may enjoy preferential risk-weighting treatment (i.e. risk weight of 0%) only if they apply to entities located in the same Member State.[25] Secondly, intragroup exposures between entities located in different Member States may not exceed the limit of 25% of Tier 1 capital of the providing entity, after taking into account the effect of credit risk mitigation, unless the relevant supervisory authority permits the (partial or full) exemption of the intragroup exposure from that limit in accordance with **Art. 400(2)(c) CRR**.[26] However, under **Art. 493(3)(c) CRR**, Member States retain (until January 2029) the option to supersede the decision of the supervisory authority to fully or partially exempt intragroup exposures from the limit of 25%. Thus, although the ECB has decided to exempt intragroup

[23] **BRRD**, Art. 45f(4)-(5).

[24] Commission proposal amending BRRD, Art. 45g(4).

[25] Assigning a 0% RW to intragroup exposures entails that these exposures are also excluded both from the large exposure limit in accordance with **Art. 400(1)(f) CRR** and the leverage exposure measure based **on Art. 429(7) CRR**, as introduced by **Art. 1 Commission Delegated Regulation 2015/62**.

[26] In addition, supervisory authorities may impose stricter large exposure limits based on Pillar 2 powers, particularly in cases that the concentration risk is not properly monitored and addressed.

exposures from the large exposure limit,[27] several Member States have decided to override the ECB's decision and continue applying their own national policy. [28] The aforementioned measures restrict the ECB's discretion to grant liquidity waivers to cross-border banking groups under **Art. 8(3) CRR** and prevent banking groups from making optimal allocation of their funds (e.g. through placements among groups' entities).[29]

3. Proposed framework for reduced prudential requirements for subsidiaries

3.1 The proposed approach for reduced capital and liquidity requirements

The restrictions mentioned above limit the ability of banking groups to transfer funds between their entities resulting in the enhancement of financial fragmentation and the creation of an unlevel playing field among European banks. The establishment of the SSM and the SRM, which apply the Union regulatory framework in a harmonized manner, have rendered national ring-fencing measures obsolete and less reasonable than they were in the pre-Banking Union period. To that end, the regulatory framework should be amended in order to address these deficiencies. The proposed changes aim at striking the right balance between lifting the barriers to free flow of intragroup liquidity and addressing the host countries' concerns relating to the costs of potential banking failures.

Based on the proposed approach, subsidiaries located in participating Member States should meet reduced capital requirements (instead of a full waiver envisaged in the existing regulation for subsidiaries located in the same Member State with the parent entity).[30] Thus, this requirement would provide safety and confidence to host authorities and depositors that subsidiaries have a minimum amount of capital to absorb losses on a going-concern basis. In that vein, subsidiaries should be subject to minimum capital requirements ("Pillar 1 requirements") and additional capital requirements ("Pillar 2 requirements" or "P2R") at individual level, as is the case for each and every bank in the EU. Subsidiaries should be allowed to cover the non-CET1 component of Pillar 1 and Pillar 2 requirements (jointly referred as "SREP requirements") with AT1 and Tier 2 instruments, as currently applied. However, the ECB may require a subsidiary to cover a larger portion of the P2R with CET1 capital, where its SREP assessment has demonstrated that this is necessary in order to cover against identified risks and deficiencies. Under the proposed framework, subsidiaries may cover the non-CET1 component of the SREP requirements with subordinated MREL-eligible liabilities (i.e. senior non-preferred bonds) issued to the parent entity. This proposal is reasonable in light of the fact that the eligibility criteria for those liabilities resemble those of capital instruments[31] ensuring the enforcement of write-down/conversion powers under **Art. 59 BRRD**,

[27] **Regulation 2016/445** of the European Central Bank of 14 March 2016 "*on the exercise of options and discretions available in Union law*", Art. 9(3).

[28] Based on the data published by the EBA, several Member States have not applied this exemption (i.e. Bulgaria, Cyprus, Czech Republic, Ireland, Netherlands, Romania, Sweden, Slovakia), while others have partially applied this arrangement (e.g. Belgium exempts from the large exposures limit the exposures from the parent entity to subsidiaries but not vice versa). For more information on the application of national options and discretions, see https://eba.europa.eu/supervisory-convergence/supervisory-disclosure/options-and-national-discretions

[29] The ECB has repeatedly argued for the abolition of restrictions to intragroup exposures and the introduction of cross-border waivers. Indicatively, see **Nouy (2018)** and **Enria (2020a).**

[30] The scope of this allowance should include also subsidiaries that meet the significance criteria set out in the SSMR.

[31] This refers particularly to Tier 2 instruments (see **Financial Stability Board (2019)**, p. 16). The most remarkable differences apply to AT1 instruments, which provide for automatic conversion to CET1 instruments once a trigger event is breached and discretionary payments of AT1 coupons. For a detailed analysis of the eligibility criteria for capital instruments, as per the CRR, see **Joosen (2015)**.

either independently or in combination with resolution action, when the bank reaches the PONV.[32] In case of exercise of the aforementioned powers without placing the bank into resolution, the distressed bank can be recapitalized on a going-concern basis through the conversion of capital instruments and/or subordinated MREL-eligible liabilities into equity.

As regards the capital buffers, a group-wide approach should be adopted to ensure that risks coming from subsidiaries are captured only at consolidated level. In particular, the capital conservation buffer and the countercyclical capital buffer should not apply to subsidiaries at individual level. Banking groups are required to meet those buffers at consolidated level (over the groups' RWAs), which means that they cover themselves against risks stemming from subsidiaries with CET1 capital held by either the parent entity or subsidiaries (to the extent that this counts towards consolidated capital). Hence, there is no need to place additional capital burden on subsidiaries obliging them to also meet those capital buffers. As regards the systemic capital buffers, national macroprudential authorities are responsible for the determination of the rate and the scope of the systemic risk buffer and the Other Systemically Important Institutions (O-SII) buffer.[33] In relation to a subsidiary for which an O-SII buffer and a systemic risk buffer have been set, the higher of the two (2) buffers must apply.[34] The systemic risk buffer may apply either only to the subsidiary's' exposures to the Member State concerned or to its exposures outside that Member State as well.[35] In the first case, the higher of the O-SII buffer or the systemic risk buffer applies, whereas, under the second case, the systemic risk buffer applies cumulatively with the O-SII buffer at individual level. In line with the group-wide approach mentioned above, where the systemic buffer applied at the subsidiary level (e.g. 2%) is higher than the respective buffer set in relation to the parent entity (1%), the parent entity should apply at consolidated level the weighted-average (based on RWAs) of the systemic buffers set for the two (2) entities.

In addition, subsidiaries should not be subject to a Pillar 2 Guidance (P2G) at individual level, as this capital add-on is imposed on banking groups in order to address supervisory concerns about their ability to withstand the adverse scenario assessed in stress tests. Taking into account that the SSM-wide stress-test is carried out on a consolidated basis, the P2G seeks to cover banking groups against potential losses that all entities within their prudential scope might incur.

Lastly, the liquidity waiver should be applied at cross-border level provided that the conditions set out in the existing regulation are met and the parent entity provides a guarantee to the subsidiary equal at least to the amount of the net liquidity outflows of the subsidiary. The amount of collateralization should be determined on a case-by-case basis in light of the SREP score assigned upon the parent entity and the subsidiaries concerned.[36] The collateralized part of guarantees should not exceed 75% of the net liquidity outflows, which is in line with the approach being applied by the ECB in relation to the cross-border liquidity waiver under **Art. 8(3) CRR**.[37]

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[32] This option is not available for resolution entities for which externally issued MREL-eligible liabilities can be written down or converted into equity only upon entry into resolution.

[33] The G-SII buffer is not relevant to subsidiaries as it applies only at consolidated level.

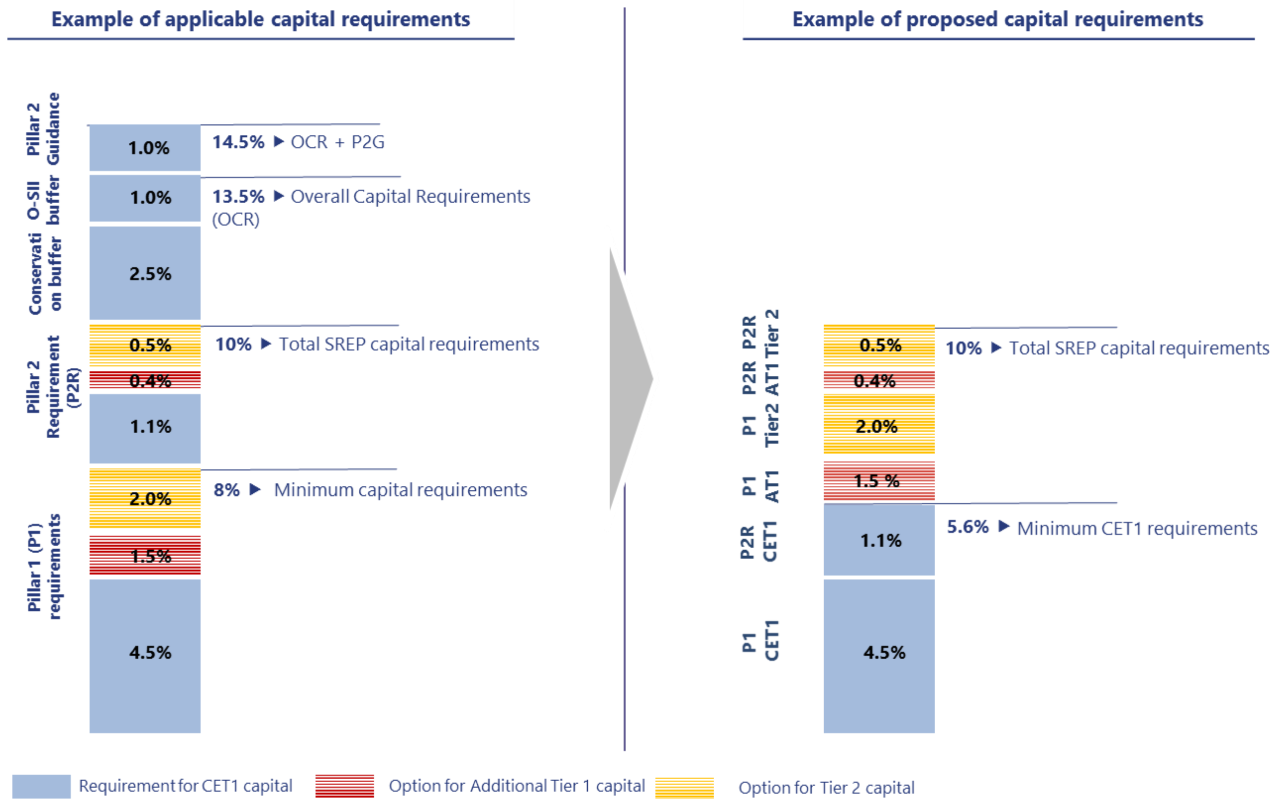
[34] **CRD4**, Art. 133(4).

[35] Out of the 9 EU Member States applying a systemic risk buffer, only two (2) Member States apply that buffer only to domestic exposures. For more information, see https://www.esrb.europa.eu/national_policy/systemic/html/index.en.html

[36] For instance, for banks with SREP scope of "1" no obligation for collateral could be set, while for banks with SREP score of "2", "3" and "4", the level of collateral could reach 25%, 50% and 75% respectively of the guaranteed amount.

[37] The ECB has issued the Guide on "*options and discretions available in Union law*" specifying the conditions and the documentation based on which it assesses whether banks are eligible for capital and liquidity waivers. For more details, see **European Central Bank (2016)**, p. 13.

Figure 2: Proposed approach for the determination of capital requirements for subsidiaries



3.2 Establishment of cross-border internal MREL waiver

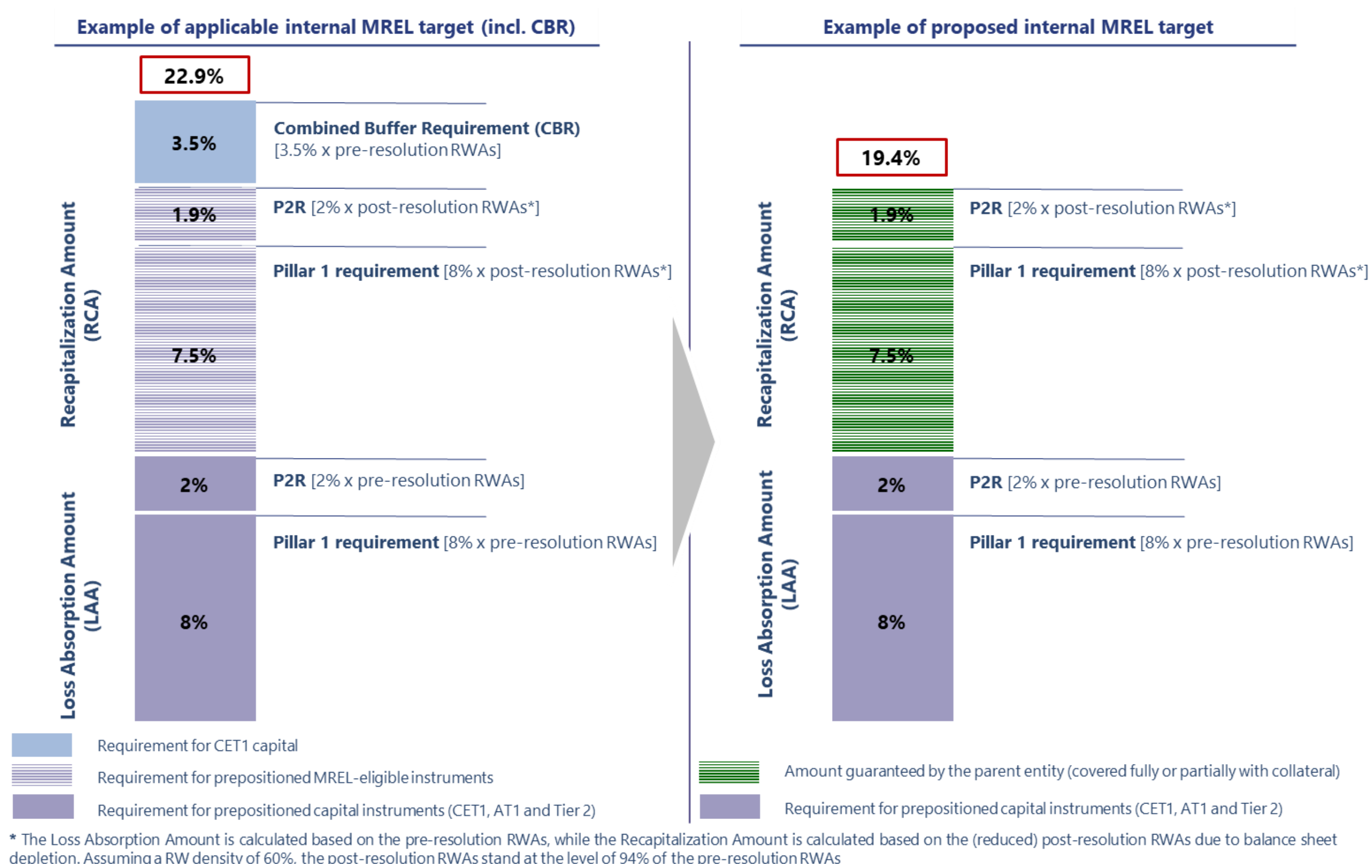
The application of the internal MREL to material subsidiaries is critical to ensure their timely and orderly recapitalization once the PONV is reached. The approach for the determination of the internal MREL should follow the approach applied to resolution entities with some allowances that reflect the specificities relating to subsidiaries. In particular, there is no need for the internal MREL to include a Market Confidence Charge (MCC) given that subsidiaries are not required to sustain market confidence in the post-resolution phase to ensure access to the wholesale market for funding purposes, as is typically the case for resolution entities.[38] Furthermore, in line with the proposal mentioned above for subsidiaries to not meet the capital buffers at individual level (see above, under **3.1**), the restrictions to distributions (i.e. dividends, AT1 coupons, bonuses), as set out in **Art. 16a BRRD**, should not apply to material subsidiaries.

Based on the proposed approach, subsidiaries should cover more than half of their internal MREL target (equal to the Loss Absorption Amount) with prepositioned MREL-eligible instruments due to their obligation to meet the SREP capital requirements. The recapitalization amount should be met with guarantees granted by the resolution entity. In line with the proposed approach for the liquidity waiver, the SRB may decide to require part of the guarantees to be collateralized, which would provide regulatory assurance for resolvability purposes. The SRB should determine the level of collateralization based on the riskiness (i.e. SREP score assigned by the ECB) and the resolvability of the banking group and the subsidiary concerned, including the progress achieved by the resolution entity to meet the external MREL target.

[38] This approach is reflected in the SRB's MREL Policy. The only exception refers to i) an operating bank that is direct subsidiary of a holding company identified as a resolution entity, or (ii) a subsidiary whose complexity and strong reliance on wholesale funding requires market confidence after resolution.

From a prudential perspective, this approach is more conservative than the Commission's proposal for the internal MREL, which provided for a full cross-border waiver of the internal MREL, as applies to subsidiaries located in the same Member State with the resolution entity. The proposed approach serves three (3) objectives. Firstly, it provides capital relief to subsidiaries by waiving their obligation to cover the recapitalization amount with prepositioned MREL-eligible instruments. Secondly, it avoids high prepositioning of MREL-eligible instruments, which may make banking groups less resilient to withstand shocks in multiple jurisdictions, as they would have enough resources to offset losses and recapitalize one subsidiary but they would be unable to move the resources across the group to where they are needed.[39] Thirdly, this approach incentivizes banking groups to take the necessary measures in order to address the deficiencies and risks of subsidiaries and to enhance their resolvability, which could result in (partial or full) exemption from the obligation for collateralization of guarantees.

Figure 3: Proposed approach for the determination of the internal MREL target



3.3 Lifting of restrictions to intragroup exposures

The establishment of cross-border waivers for prudential requirements should be accompanied by the lifting of the restrictions to intragroup exposures (see above, under **2.3**). Firstly, the lifting of those restrictions is precondition for the application of the cross-border liquidity waiver, which would allow the parent entity and the relevant subsidiaries to operate as a single liquidity group. Secondly, banking groups would be allowed to make optimal allocation of their funding through liquidity placements to the entities that are in need of that without any capital burden (0% RW for intragroup exposures). Thirdly, the adoption of this measure would alleviate to some extent the burden placed on subsidiaries subject to the internal MREL, since they would be allowed to return to the parent entity the liquidity received through prepositioned MREL-eligible instruments. This

[39] See **Financial Stability Board (2020)**, p. 65.

option will be feasible once the BRRD2 is transposed into national laws. In particular, under **Art. 44(2)(h) BRRD**, intragroup liabilities are excluded from bail-in provided that they rank at least *pari passu* with ordinary unsecured liabilities based on the national insolvency ranking, as is typically the case for interbank placements. Thus, intragroup liquidity placements will have no risk of bail-in upon resolution of the parent entity.

4. Enhancement of the Union crisis prevention framework

4.1 Mandatory intragroup financial support agreements

The BRRD introduced an innovative element in the Union crisis prevention framework aiming to ensure that entities belonging to a banking group may assist each other in times of stress through the provision of financial support. To that end, the parent entity and its subsidiaries in other (participating and non-participating) Member States may enter into an agreement to provide financial support to any other party to the agreement. The intragroup financial support may be in the form of loans, guarantees, assets for use as collateral, or any combination of those forms of financial support. Financial support may be provided in order to safeguard the group's financial position without putting in danger the solvency or liquidity of the entity providing the support.[40] Therefore, an intragroup financial support agreement may enter into force, only if both the involved supervisory authorities (for participating Member States only the ECB) and the shareholders of the entities concerned have provided an ex-ante approval. The management body of the entity providing the support is responsible for taking the decision to provide group financial support, when the conditions for early intervention are met and the approval of the supervisory authority is received. Based on the process and conditions set out in the existing framework, it can be reasonably stated that the significance of the intragroup financial support agreements is limited, given that the supervisory authority of the entity providing the support may prohibit the activation of the agreement and, thus, the provision of the assistance.

Whereas the existing regulatory framework leaves at the banking groups' discretion the signing of an intragroup financial support agreement, under the proposed framework banking, groups wishing to take advantage of the cross-border waivers must enter into intragroup financial support agreements on a mandatory basis. Furthermore, the requirements for the activation of intragroup financial support agreements should be amended in order to ensure that the financial support will be provided under any circumstances, including the case in which the activation of the agreement would jeopardize the solvency or liquidity situation of the parent entity. Thus, upon entry of the subsidiary concerned into the early intervention area, the parent entity should provide the receiving entity with the form of financial support needed (e.g. capital injection to cover losses, loans and/or assets for collateral to cover liquidity needs).[41] The fact that the provision of financial support may result in the breach of the parent entity's capital requirements (i.e. P2G threshold, combined buffer requirement) should not constitute a reason to avoid the activation of the agreement. In that way, it can be ensured that any capital and/or liquidity needs that may arise at the subsidiary level will be covered by the parent entity in a timely and effective manner.

4.2 Application of recovery arrangements to all subsidiaries enjoying preferential treatment

The BRRD requires banking groups to plan in advance for restoration of their financial position, once a significant deterioration occurs, by developing group recovery plans. The aim of group recovery plans is for banking groups to establish a credible governance framework based on which they can identify any deterioration of their financial position and take prompt action to address it. To that end, banks are obliged to establish and maintain effective recovery arrangements to ensure

[40] **BRRD**, rec. 38.
[41] See **Enria (2018).**

that they will take action early enough to avoid the further worsening of their financial position (in terms of capital adequacy, liquidity availability, profitability, asset quality) that would make supervisory action unavoidable. Pursuant to **Art. 7(1) BRRD**, the parent entity draws up and submits to the consolidating supervisory authority (the ECB for significant banking groups) a group recovery plan that covers extensively and in detail all group's entities whose activities are material for the banking group and/or the host Member State.[42]

Based on the proposed framework, the group recovery plan should mandatorily cover all subsidiaries having opted for cross-border waivers irrespective of their materiality. Among others, the group recovery plan should determine the recovery indicators, which should be monitored by each subsidiary in order to assess if and when recovery action must be taken. Setting strong and trustworthy recovery indicators is the cornerstone for having an effective recovery plan, as they constitute the basis for identifying risks to viability and for activating the necessary measures to restore financial soundness prior to entry into the early intervention area. To that end, subsidiaries must establish a set of recovery indicators that are monitored on a regular basis seeking to ensure that significant deterioration of the financial situation will be captured in a timely manner.

In that context, subsidiaries should employ the traffic light approach using progressive metrics in order to signal to the senior management (and to the parent entity as well) that recovery triggers might be breached. Under the traffic light approach, for each recovery indicator an early warning threshold and a recovery trigger are set. Recovery triggers constitute the points at which the escalation process is enacted and a decision on the activation (or not) of the recovery plan is taken by the subsidiary itself. Recovery triggers should be calibrated in such a way to ensure that they stand sufficiently above the minimum regulatory thresholds. Indicatively, if the SREP requirement for CET1 ratio is set at 5.6% of RWAs, then the recovery trigger could be set at 8%. If the CET1 ratio falls below that level, the escalation process must be activated and the subsidiary's competent body should decide on the need to implement recovery options, including share capital increase, cancellation of distributions, issuance of senior bonds, intragroup takings, securitization/sale of loans and reduction in operating expenses. Typically, most of the (capital and liquidity) recovery capacity of a subsidiary is dependent on the willingness and ability of the parent entity to provide financial support. Should the parent entity refuse to take action to restore the financial situation of the subsidiary, the ECB should take early intervention measures, which would have significant financial and reputational impact both on the parent entity and the subsidiary.

4.3 Enhanced early intervention measures on a group-wide basis

The Union crisis management framework has conferred extensive powers upon supervisory authorities to address stress situations in which banks have come. Supervisory authorities are able to remedy the deterioration of banks' financial situation before they reach the PONV. In the context of an escalation procedure, supervisory authorities may exercise early intervention powers in a sequential manner initiating from milder to more intrusive measures. Thus, early intervention measures include preventive measures (Pillar 2 requirements), corrective measures (e.g. mandatory implementation of recovery options, changes in the internal organization, restructuring of debt) and extraordinary measures (i.e. removal of senior management/management body, appointment of temporary administrator).

The timely application of early intervention measures plays a crucial role in the effectiveness and credibility of the proposed mechanism for cross-border waivers. To that end, more clarity is needed with respect to the trigger point at which early intervention measures are expected to be

[42] In accordance with the EBA's Recommendation on "*the coverage of entities in a group recovery plan*", the group recovery plan should not cover in an extensive manner the entities that are not relevant for the banking group or for the economy of the host Member State.

taken.[43] In line with **Art. 27 BRRD**, a trigger for early intervention measures could be set at the level of 1.5 percentage points above the SREP CET1 requirement whose breach would demonstrate that the bank is likely to infringe in the near future the minimum SREP requirement in terms of CET1 capital. In that case, the supervisory authority could exercise its early intervention powers to address this situation by requiring the bank concerned:[44]

- to implement the measures provided for in its recovery plan (e.g. capital increase, conversion of AT1 instruments to common shares, issuance of AT1/Tier 2 instruments),
- to convene a meeting of the shareholders and certain decisions to be considered for adoption by the shareholders,
- to replace one or more members of the management body or senior management should they be unfit to perform their duties,
- to draw up a plan for negotiation on restructuring of debt with some or all of its creditors, and
- to make changes in the business strategy and legal or operational structure of the bank.

As mentioned above, upon entry of the subsidiary into the early intervention territory, the intragroup financial support agreement should be activated to provide capital and/or liquidity support, where relevant, to the subsidiary concerned. In addition, the ECB should prohibit the subsidiary from making distributions (i.e. dividends, AT1 coupons and bonuses), where such measures have not been taken at a previous phase or as a follow-up to the SREP assessment in accordance with **Art. 104(4) CRD4** or **Art. 16 SSMR**. Also, the ECB may require the subsidiary to not renew any placements to the parent entity seeking to address liquidity problems. Furthermore, at the time the ECB takes early intervention measures, the SRB should require from the parent entity to cover with collateral or prepositioned MREL-eligible instruments the uncollateralized part of the guarantees for the internal MREL. The execution of this mechanism will allow the SRB to effectively exercise its write-down and conversion powers under **Art. 59 BRRD** once the subsidiary reaches the PONV.

In line with the BRRD, supervisory authorities may take more extended and radical (than the aforementioned) measures to address a non-cooperative stance from the subsidiary and/or the parent entity in relation to the implementation of the required measures. In that case, the ECB may remove the senior management and management body of the subsidiary and extend the early intervention measures also to the parent entity. If the replacement of the senior management or management body is deemed insufficient to address this situation, the ECB may appoint one or more temporary administrators to the subsidiary and/or the parent entity.

The early intervention measures described above would function as a threat to banking groups to take themselves at an early stage the necessary action to restore the financial position of subsidiaries prior to their entry into the early intervention phase. Admittedly, parent entities would have strong incentives to provide financial support to subsidiaries not only for financial reasons, but also to avoid the reputational damage that can be caused by the application of early intervention measures against the subsidiary, let alone against the parent entity. Consequently, parent entities would be expected to remain committed to supporting at their own initiative their subsidiaries avoiding, thus, any negative effects on the economy and the financial stability of the host Member States that could be triggered from the failure of the subsidiaries.

[43] The EBA Discussion Paper "*on the application of early intervention measures under the BRRD*" proposes certain amendments to the framework for early intervention measures, including the conditions and the triggers for early intervention, the overlap between early intervention and supervisory powers under the CRD4/SSMR and the disclosure requirements.

[44] **BRRD**, Art. 27(1).

4.4 Recapitalization of subsidiaries at the PONV

Once a material subsidiary incurs significant losses driving at once the CET1 ratio below the SREP requirement and there is no alternative private sector measure or supervisory action to address this situation, the subsidiary reaches the PONV. Thus, based on a determination made by the ECB that the subsidiary is "failing or is likely to fail",[45] the SRB has two (2) options to deal with the non-viability of the subsidiary. In particular, the SRB may instruct the NRA concerned to write down and/or convert the MREL-eligible instruments into equity, where the amount of losses is of such level that this action would restore the solvency and viability of the subsidiary. Alternatively, if the exercise of the write-down and conversion powers solely to the MREL-eligible instruments is not sufficient to prevent the failure of the subsidiary, the SRB may decide to take resolution action, which entails that other creditors, including depositors, would incur losses. Both options ensure the recapitalization of the subsidiary through recourse either solely to intragroup funding means or to third-party claims as well. The establishment of a credible mechanism to upstream losses from (material) subsidiaries to parent entities and recapitalize the former is expected to foster confidence to Member States that the failure of a subsidiary will have limited, if any, impact on the domestic economy and financial system.

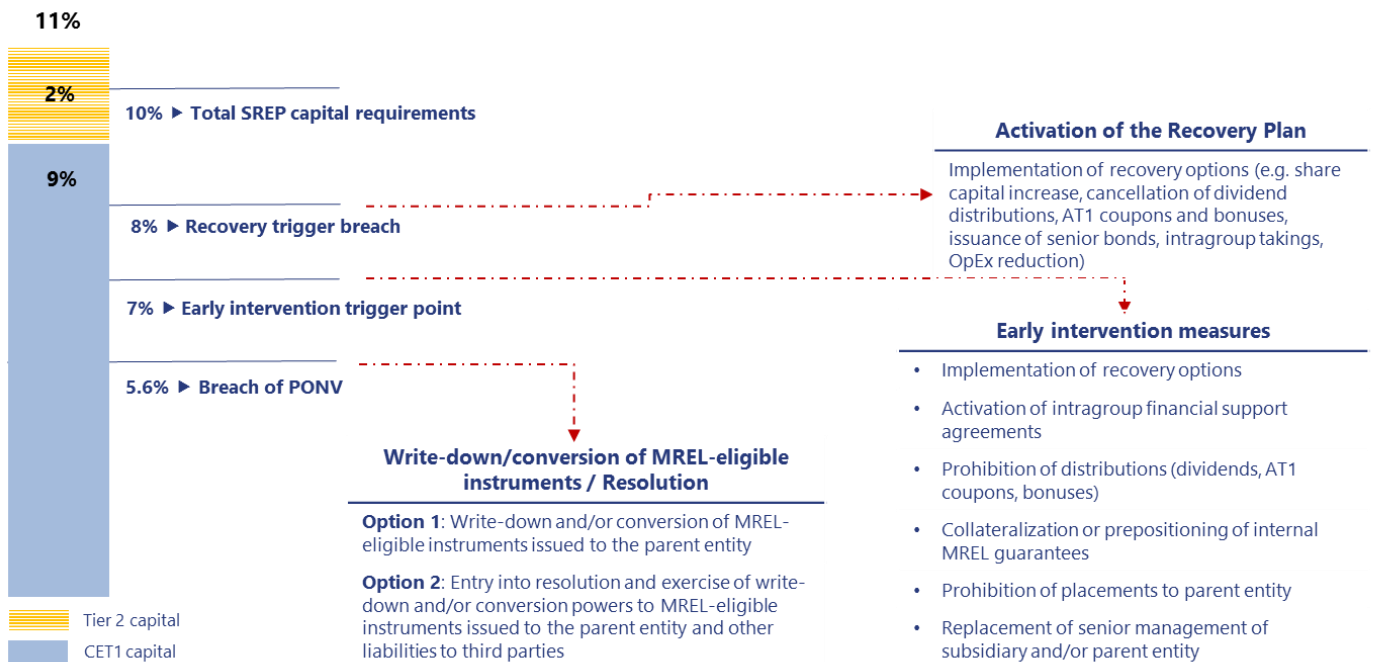
The upstream of losses to the parent entity may trigger financial difficulties for the latter, particularly if the amount of losses is significant in relation to the capital held by the parent entity. Thus, the parent entity should take action to address a potential breach of the prudential requirements at consolidated level (i.e. P2G threshold, combined buffer requirements, recovery trigger). Under extreme circumstances, the upstream of losses and the recapitalization of the subsidiary could bring the parent entity to a "failing or likely to fail" situation triggering, thus, the exercise of the write-down and conversion powers to the externally issued MREL-eligible instruments and, other bail-inable liabilities, if needed.[46]

As mentioned above, non-material subsidiaries are not required to meet an internal MREL target. Thus, upon a "failing or likely to fail" determination, the SRB may decide to write down and/or convert the capital instruments issued by the subsidiary to cover the non-CET1 component of total capital requirements. This option is possible only if the losses incurred are limited and the exercise of write-down and conversion powers can restore the viability of the subsidiary concerned. On the contrary, if the recapitalization capacity of the outstanding capital instruments is not sufficient, the SRB is expected to decide that resolution action is not necessary on the basis of the public interest criterion. Thus, the subsidiary will be put into liquidation under national insolvency proceedings and the national DGS will be activated to compensate covered depositors.

[45] As mentioned by **Enria (2020c)**, the "failing or likely to fail" assessment is based on a forward-looking assessment of the bank's compliance with Pillar 1 and Pillar 2 requirements. The supervisory authority may make a "failing or likely to fail" determination also for liquidity reasons, namely i) the assets of the subsidiary are, or will in the near future be, less than its liabilities, and ii) the subsidiary is, or will in the near future be, unable to pay its debts or other liabilities as they fall due.

[46] For a critical assessment of the rules set out in the BRRD/SRMR regarding the implementation of the bail-in tool, see **Hadjiemmanuil (2015), Tröger (2017)**, **Gortsos (2019)** and **Gortsos (2020).**

Figure 4: Indicative example of the escalation mechanism for regulatory action



5. Conclusions

Banks entered the COVID-19 crisis with stronger balance sheets and higher capital and liquidity buffers compared to past crises.[47] Thus, they managed to absorb the external shock and continue lending to the economy assisted by the significant relief measures taken by the ECB and the SRB.[48] In that vein, the primary objective for European policymakers should be to enhance the ability of European banks to generate profits at a sustainable mode, which would allow them to retain in the long-term strong capital, liquidity and MREL buffers against any future external shock.

To that end, this paper proposes a revision of the regulatory framework to remove the current Member State dimension and treat the Banking Union as a single jurisdiction. Banking groups should enjoy preferential capital and liquidity treatment for their entities located in participating Member States. Also, it is necessary to abolish the existing restrictions to intragroup exposures, including the national option granted to Member States. On the other hand, the prudential safeguards should be enhanced to ensure that corrective action will be taken, if needed, either by banking groups themselves or by regulatory authorities. The enhancement of the crisis prevention framework aims to minimize both the possibilities for banking failures and, if these happen, the repercussions thereof on the financial stability and economy of host Member States.

The amendments to the regulatory framework seek to remove the existing barriers to cross-border banking and allow banking groups to expand their operations beyond national borders. The introduction of the proposed arrangements could promote free flow of funds and foster financial integration ensuring efficient capital and liquidity management by banking groups. The latter could achieve optimal allocation of funding and achieve economies of scale resulting in enhanced

[47] In accordance with **Enria (2020b)** and **Financial Stability Board (2020)**, the improved financial situation of banks and the significant progress regarding the reforms in the financial system achieved during the past years have allowed banks to act as a shock absorber rather than as a shock amplifier, as occurred in past crises.

[48] For more information on the relief measures provided by the ECB and the SRB due to the COVID-19 pandemic, see **European Central Bank (2020b)** and **Single Resolution Board (2020a)** respectively.

profitability allowing them to compete with global peers. Furthermore, the adoption of the proposed measures would allow banking groups to achieve geographical diversification and risk-sharing contributing to limitation of the home bias in their balance sheets, particularly with respect to sovereign debt, and increase of their resilience to withstand local shocks. Thus, the proposed measures promote an optimized functioning of the internal market and contribute to breaking the vicious circle between banks and sovereigns ("doom loop").

From a financial stability perspective, the (additional) powers conferred upon the ECB and the SRB are expected to improve the European crisis management framework in a dual manner. Firstly, banking groups are incentivized to cater even more for the soundness of their subsidiaries, as the level of prudential requirements will be linked to their riskiness and resolvability. Secondly, banking groups are forced to take at their own initiative corrective action to address a potential deterioration of their subsidiaries' financial position before early intervention measures are taken. Also, the lifting of the regulatory restrictions to free flow of funds could improve the banks' capabilities to confront any liquidity shortages both in going-concern and resolution/post-resolution phases through mobilization of collateral held by subsidiaries. Taking into account that secured funding will be most likely the only source of funding in the post-resolution phase, it is necessary for banking groups to have the capacity to maximize their capabilities to generate liquidity through mobilization of collateral, which could be pledged as collateral in secured funding transactions.

Ideally, the proposed regulatory initiatives should be accompanied by some reforms at institutional level to address the remaining concerns of host Member States. The establishment of the EDIS would alleviate any concerns of Member States for the losses that national DGSs would incur due to compensations to covered depositors of non-material subsidiaries that have been put into liquidation. Where the available financial means of a DGS are not sufficient, ex-post contributions may be required from other domestic banks, which could jeopardize domestic financial stability.[49] Also, the assignment upon the ECB of the function of the lender of last resort for significant banking groups[50] would address the concerns of host Member States for the fiscal costs that national central banks might incur upon failure of subsidiaries. The centralization of the Emergency Liquidity Assistance (ELA) along with the establishment of a backstop to the SRF would push forward the completion of the Banking Union, as they would ensure that credible public backstop funding mechanisms are in place to provide liquidity in resolution.

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[49] See **Hakkarainen (2020)**.

[50] For more details on this proposal and how it can be achieved, see **Gortsos (2015)**, **Lastra** and **Goodhart (2016)**, **Ringe (2017)** and **Zilioli (2015)**.

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