The Optional Measures of Deposit Guarantee Schemes: Towards a New Bank Crisis Management Paradigm?

Marco Bodellini*

The role of deposit guarantee schemes is pivotal in banking crises. This role, however, should not be limited to only performing the so-called pay-box function. While this is deposit guarantee schemes' core function, and, as such, needs to be included in the safety net 'armoury' of every jurisdiction, optional interventions, both preventive measures and measures in the context of liquidation, can turn out to be more effective, from a system-wide perspective, to maintain financial stability and to reduce the destruction of value potentially resulting from an atomistic liquidation. Accordingly, the implementation of these measures by deposit guarantee schemes should not be hindered, but rather facilitated by the legal framework. Each European Union Member State should be encouraged (indeed required) to transpose in its domestic regime the provisions of the Deposit Guarantee Schemes Directive which deal with deposit guarantee schemes' alternative measures, thereby paving the way for a new bank crisis management paradigm. Nonetheless, a number of legal obstacles arising from the application of state aid rules and from the extension of the depositor preference rule in the liquidation process to deposit guarantee schemes, combined with a narrow reading of the least cost principle, need to be removed in order for deposit guarantee schemes to be able to successfully carry out optional interventions.

Keywords: deposit guarantee schemes, bank crisis management, resolution, liquidation, DGSD, BRRD

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* Marco Bodellini is an Associate Lecturer in Banking and Financial Law at Queen Mary University of London; e-mail: m.bodellini@qmul.ac.uk. Special thanks to Professor Dalvinder Singh (University of Warwick) and to two anonymous referees for useful comments. All errors are mine.

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I. INTRODUCTION

Deposit guarantee schemes (DGSs) are an important component of the banking system safety net. Their core function is to protect depositors in the event of their bank becoming 'failing or likely to fail' (FOLF) and being liquidated. In such a scenario, by paying out covered depositors, they contribute to maintaining the stability of the banking system, thereby avoiding that the insolvency of one bank can be transmitted to other institutions, which could give rise to widespread failures that can lead to a systemic crisis.[1] This typically happens when banks' debt-holders suddenly request their banks to convert their debt instruments into cash to such an extent that the latter become unable to do so due to the so-called maturity mismatch, that is an important feature of commercial banking. Commercial banks mainly take deposits from the public and make loans. Deposits are, as a consequence, the most common form of financing for commercial banking institutions. The main characteristic of deposits is that they are withdrawable on demand, which makes them short-term liabilities. Typically, banks hold only a fractional amount of the overall value of the

[1] See Giuseppe Boccuzzi, *Towards a New Framework for Banking Crisis Management. The International Debate and the Italian Model* (Quaderni di Ricerca Giuridica della Consulenza Legale della Banca d'Italia 2011) 220.

deposits they take and use the remaining part to make loans. The reason for this is that using deposits to extend loans, by charging higher interests on their borrowers, is their way to make profits. However, the issue in doing so is that whereas deposits are short-term liabilities, loans usually have longer maturity. This creates the abovementioned maturity mismatch. In good times, such a business model works out efficiently. In bad times, however, this is not necessarily the case, since the fractional reserves, the fraction of deposits that the bank has not used to make loans and has invested in liquid – and therefore typically less profitable – assets, might not be enough to meet depositors' withdrawals. This situation in turn might deteriorate very quickly, leading to a phenomenon called bank run. Bank runs constitute a negative externality (i.e. a source of market failure) to the extent that, as they evolve, even solvent banks can face a heavy liquidity strain, which in turn may cause their insolvency.[2]

Against this background, capital is the first line of defence and thus is meant to tackle such a risk thereby protecting the bank. In fact, a bank that is well capitalised is able to absorb the losses resulting from fire sales of illiquid assets, which are executed to meet depositors' withdrawals. By contrast, when a bank is undercapitalised, it is more vulnerable to maturity mismatch. This is because share capital can absorb losses much more effectively than any other instrument. In other words, significant losses can cause a bank run, but if the bank in question holds a proportionally significant amount of capital, it can absorb the losses. If losses are expected to be effectively absorbed by capital, depositors should be less inclined to run on their bank to withdraw deposits. Therefore, given the importance of deposits to the public and the role of banks in maintaining financial stability, banking institutions are subject to minimum capital requirements.[3] Accordingly, capital requirements are a preventive measure, which does not increase moral hazard. But when capital is not enough to absorb losses and a crisis materialises, DGSs are meant to step in and play a pivotal role. In such a

2 See Charles W. Calomiris and Gary Gorton, 'The Origin of Banking Panic Models: Facts and Bank Regulation' in Robert Glenn Hubbart (ed), *Financial Markets and Financial Crises* (University of Chicago Press 1991) 109.

3 See Marco Bodellini, 'The Long "Journey" of Banks from Basel I to Basel IV: Has the Banking System Become More Sound and Resilient than it Used to Be?' (2019) 20 ERA Forum 84.

context, DGSs' primary function is to serve as a pay-box for covered depositors, guaranteeing in this way the default-free character of deposits even in the event of a failure.[4] The importance of this function rests on the assumption that covered depositors should have access to safe and secure instruments allowing them to make payments and to save.[5] These instruments are bank deposits. However, due to the fact that banks, like any other firm, may be exposed to losses and potentially to insolvency, specific legislation on DGSs aims to render bank deposits a safe way to store money for payments and savings.

DGSs usually come into play when a FOLF bank is placed under liquidation,[6] and accordingly its banking authorisation is withdrawn. In such a scenario, DGSs are requested to perform the pay-box function. Accordingly, they assume an explicit obligation since, upon the authorisation withdrawal, they are required to compensate covered depositors, within a pre-specified and reasonably short period of time. Interestingly, the guarantee that DGSs provide is non-discretionary as depositors have in principle a direct claim for compensation against them, regardless of the conditions underlying the bank failure. Still, the level of protection offered is typically limited and the rationale for this limitation is that in this way moral hazard as well as the opportunity cost of building up a deposit guarantee fund that is not invested or used in another way can be mitigated. Furthermore, their way of working complies with the new approach of avoiding the use of taxpayers' money in the context of bank crises since they are funded exclusively by *ex ante* or *ex*

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4 See Christos Gortsos, 'The role of deposit guarantee schemes (DGSs) in resolution financing' (2019) European Banking Institute Working Paper Series no. 37, 6 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3361750> accessed 30 August 2020.

5 See Christos Gortsos, 'Deposit Guarantee Schemes: General Aspects and Recent Institutional and Regulatory Developments at International and EU Level' (2016), Working Paper, 4 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2758635> accessed 30 August 2020.

6 The terms liquidation and winding up are used interchangeably throughout the paper.

post contributions provided by the participating banks, without any support from the government and/or the central bank.[7]

Thus, DGSs certainly play a pivotal function in keeping financial stability in that they are an *ex-ante* form of protection for depositors, who have the guarantee to get their covered deposits back. Their very presence, among the safety-net providers, is in and of itself instrumental to keep depositors' confidence in the system and thereby maintain financial stability. In other words, the credibility that the DGS pay-box function confers to the banking system, by increasing trust and consequently reducing the risk of bank runs, is of paramount importance.[8] On these grounds, banks are requested to become members of a DGS.[9]

The pay-box function is clearly fundamental to prevent, or at least to mitigate, the impact of banking crises and, as such, needs to be included in the bank crisis management legal framework. Nevertheless, the so-called optional functions (i.e. the implementation of alternative measures aimed at preventing a bank's failure and the provision of financial means in the context of liquidation aimed at preserving access of depositors to covered deposits), that DGSs can be empowered to perform pursuant to article 11, paragraphs 3 and 6 of the European Union (EU) Deposit Guarantee Schemes Directive (DGSD),[10] might end up being even more effective, from a system-wide

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7 See Rita Carisano, *Deposit Insurance: Theory, Policy and Evidence* (Dartmouth Publishing 1992) 22-29.

8 See David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) Financial Services Authority (FSA) Occasional Paper Series no. 1, 5 <https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto_2_David_Llewellyn.pdf> accessed 30 August 2020.

9 See Stefan Ingves, 'Remarks Given at IADI Conference on Designing an Optimal Deposit Insurance System' (2017) Keynote Address at IADI Conference, Basel 2 June 2017, 1 <https://www.bis.org/speeches/sp170602.pdf> accessed 30 August 2020.

10 The paper will refer to the two DGSs measures regulated under article 11 paragraphs 3 and 6 of the DGSD as optional or alternative measure(s), optional or alternative intervention(s) or optional or alternative function(s), interchangeably.

perspective, to maintain financial stability and to reduce the destruction of value potentially resulting from an atomistic (or piecemeal) liquidation.[11]

In this regard, the possibility for a DGS to intervene at the first signs of a crisis can be particularly effective in preventing the latter from escalating. In fact, many banking crises, still at an early stage, can be more efficiently solved thanks to the willingness of DGSs to financially help restructure the institutions concerned, avoiding in this way their failure. Likewise, the ability of DGSs to provide financial support in the context of a bank's liquidation might turn out to be particularly important for the latter to be orderly and effective.

Against this background, this paper, applying a qualitative research methodology, but also relying on empirical data resulting from surveys, examines whether there are valid reasons supporting the argument that DGSs' optional functions might prove more effective, from a system-wide perspective, in maintaining financial stability and in reducing the destruction of value than the pay-box function. To do so, this paper analyses the EU legislation, focusing on the four functions that DGSs (can) perform pursuant to the DGSD. Thus, the pay-box function is analysed and discussed *vis-à-vis* the adoption of alternative measures aimed at preventing a bank's failure and the provision of financial means within a liquidation procedure aimed at preserving access of depositors to covered deposits. In this context, the arguments in favour and against the effectiveness of the latter functions are examined also by looking at their implementation in some EU Member States as well as referring to the interesting empirical results of two surveys recently conducted by the European Forum of Deposit Insurers (EFDI) and the European Banking Authority (EBA). Accordingly, a view supporting the relevance of alternative measures is taken and, on these grounds, the legal obstacles in place at the EU level, (i.e. state aid rules and depositor preference rule combined with a narrow reading of the least cost principle),[12] currently hindering the DGSs' ability to perform such functions, are explored. In this regard, the opposite positions of the European Commission and of the

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[11] The terms atomistic liquidation and piecemeal liquidation are used interchangeably throughout the paper.

[12] The expressions 'least cost principle' and 'least cost criterion' are used interchangeably throughout the paper.

General Court of the European Union concerning the state aid framework are taken into account by analysing the *Tercas* case. The application of the least cost principle in light of the new rules extending the depositor preference to DGSs in the liquidation process is discussed as well. Against this backdrop, some reform proposals (namely a revision of the Commission's 2013 Banking Communication as well as of the depositor preference rule and the least cost criterion) aimed at removing the obstacles currently in place are advanced with a view to enabling DGSs to implement such functions when this is considered to be a more effective solution to the benefit of the whole system, thereby paving the way for a new bank crisis management paradigm. Such a new bank crisis management paradigm is, in fact, the result of empowering DGSs both to intervene in the face of the first symptoms of a crisis thereby preventing it from escalating and getting out of control and to provide financial support in the context of a liquidation ensuring, in this way, that the latter is orderly and effective.

Tackling all these issues, this paper aims at contributing to the debate on the role of DGSs in banking crises supporting the view that they should play a pivotal function since their enhanced involvement can turn out to be instrumental from a system-wide perspective to keep financial stability and to reduce the destruction of value often resulting from an atomistic liquidation of the assets. The paper is divided into 7 sections as follows. After this introduction, section 2 focuses on the EU legislation and on the functions that DGSs can accordingly perform. Sections 3 and 4 discuss the potential effectiveness of DGSs' alternative measures aimed at preventing a bank's failure and the potential effectiveness of DGSs' alternative measures in the context of liquidation, respectively. Section 5 looks at the way in which DGSs' optional measures have been implemented over time in some EU Member States. Section 6 analyses the legal obstacles refraining DGSs from implementing optional interventions in banking crises, distinguishing between state aid rules and the depositor preference rule and, accordingly, advances some legislative proposals with a view to removing them. Section 7 concludes.

II. The European Union Legislation and the Functions of Deposit Guarantee Schemes

Directive 94/19/EC introduced the first set of rules dealing with DGSs and it is, therefore, a milestone in the legislation on deposit insurance in the EU.[13] It regulated DGSs' operation on the basis of minimum harmonisation criteria and the principle of mutual recognition. Most notably, it made membership of a DGS mandatory for every bank. In fact, the participation in a DGS was (and still is) a prerequisite for obtaining a banking license. The rationale for the introduction of specific binding rules on DGS membership obviously was (and still is) closely connected to the important function that such schemes are meant to perform, along with the other safety net players, in ensuring confidence in the banking system.

Nonetheless, the global financial crisis of 2007-2009 prompted a lively debate on the need to strengthen and review the structure, financial resources as well as the functions of DGSs. The discussion focused in particular on the role of deposit insurance in the financial safety net. In 2008, accordingly, the European Commission formulated a proposal to promote convergence among Member States' DGSs, which eventually led to the adoption of Directive 2009/14/EC. This Directive represented the first step towards a structural reform of the deposit insurance system. It amended some shortcomings of the previous Directive with a view to achieving greater consistency between European DGSs.

Additionally, at the international level, the International Association of Deposit Insurers (IADI) made remarkable efforts to advance innovative solutions in response to the global financial crisis. In 2010, IADI published the first version (later revised in 2014) of its *Core Principles for Effective Deposit Insurance Systems*, which are the internationally recognised standards governing the operations of DGSs and reflect the need for effective deposit insurance in preserving financial stability.[14]

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[13] See Giuseppe Boccuzzi, *The European Banking Union: Supervision and Resolution*, (Palgrave Macmillan 2016) 132.

[14] See International Association of Deposit Insurers, 'Core Principles for Effective Deposit Insurance Systems' (2014) <https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf> accessed 30 August 2020.

In 2010 the European Commission proposed a recast of the Directive of 2009[15] and, on 12 June 2014, the new DGSD[16] was adopted as part of the new European regulatory and supervisory architecture. The DGSD keeps the legal foundations of the previous Directive in place, and the 100,000 Euro coverage level, already provided for by the Directive of 2009, has been confirmed.[17] The paying-out period, by contrast, has been reduced to seven working days, although Member States have been given the possibility to phase-in this provision over a transitional period of ten years.[18]

The reliability of a DGS results from its funding capability, therefore it needs to be able to rely on adequate financial resources for its interventions. The DGSD introduced a more structured funding system, trying to fix the shortcomings of the previous Directive which had let Member States decide whether their DGSs were to be financed *ex-ante* or *ex-post*.[19] The new provisions on funding create a model based on both *ex-ante* and *ex-post* contributions, through a four-step approach.[20] The first step consists of a solid *ex-ante* fund, set up through the banks' ordinary contributions.[21] The target level of the *ex-ante* fund is at least 0.8% of covered deposits and such a target level is to be reached by 3 July 2024; 30% of the *ex-ante* fund, in turn, can be made up of payment commitments, which have to be fully

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[15] On the need to further amend the legislation in place back then see Rym Ayadi and Rosa Lastra, 'Proposals for Reforming Deposit Guarantee Schemes in Europe' (2010) 11 Journal of Banking Regulation 219.

[16] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, OJ L 173/149 (hereafter DGSD).

[17] Article 6 of DGSD.

[18] Article 8 of DGSD.

[19] See Giuseppe Boccuzzi and Riccardo De Lisa, The Changing Face of Deposit Insurance in Europe: from the DGSD to the EDIS Proposal, in Giampio Bracchi, Umberto Filotto and Donato Masciandaro (eds), *The Italian banks: which will be the "new normal"?* (Edibank 2016) 6.

[20] Article 10 of DGSD.

[21] On this, see European Banking Authority, 'Guidelines on Methods for Calculating Contributions to Deposit Guarantee Schemes (DGSs)' (2015) <https://eba.europa.eu/sites/default/documents/files/documents/10180/1089322/fa336fb5-7264-4381-9eee-cb2144b489e9/EBA-GL-2015-10%20GL%20on%20methods%20for%20calculating%20contributions%20to%20DGS.pdf> accessed 30 August 2020.

collateralized.[22] In addition to the *ex-ante* fund, the Directive also introduced extraordinary *ex post* contributions, which banks are required to provide in the event of a pay-out and when the available financial resources are not sufficient to reimburse depositors. These contributions shall not exceed 0.5% of covered deposits per year.[23] The third form of financing is the alternative funding arrangements. These arrangements are meant to enable DGSs to get short-term funding from the markets, should they need it. Eventually, if all these resources prove insufficient, DGSs may also rely on a mutual voluntary borrowing facility. Accordingly, it is stated that DGSs can borrow funds from other EU DGSs under certain conditions and up to 0.5% of their covered deposits.

In relation to their operation, the DGSD confers upon DGSs four functions. Two of these functions are mandatory, whereas the remaining two are optional as Member States can decide whether they want their DGSs to also perform them in addition to the mandatory ones.[24] These functions are: 1) the pay-box function, to be performed in the context of liquidation, which is mandatory; 2) resolution financing, which is mandatory as well; 3) the implementation of alternative measures aimed at preventing a bank's failure, which is optional; and 4) the provision of financial means in the context of liquidation aimed at preserving access of depositors to covered deposits, which is optional as well.

The pay-box function is exercised in the context of a winding up and aims to protect the covered depositors of a failing bank. It is considered the core function of DGSs.[25] After paying out the covered deposits, the DGS is then entitled to subrogate to the covered depositors' rights in the assets' liquidation process, benefiting now from the same preference given to covered depositors by article 108 of the Bank Recovery and Resolution Directive (BRRD).[26] The granting to DGSs of the same superpriority given

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[22] Article 10, paragraphs 2 and 3 of DGSD.

[23] Article 10, paragraph 8 of DGSD.

[24] Article 11 of DGSD.

[25] Pursuant to article 11 paragraph 1 of the DGSD, the financial means of a DGS shall be primarily used in order to repay depositors pursuant to this Directive.

[26] Pursuant to article 108 paragraph 1 of the BRRD, 'Member States shall ensure that in their national laws governing normal insolvency proceedings: (a) the

to covered depositors in the liquidation ranking makes it more likely for them to recover a substantial part (or possibly all) of the amount used to reimburse the depositors. Nevertheless, this could, in turn, affect the DGS's ability to perform the other functions as further discussed in section VI.2.

The DGS is also meant to finance the resolution of a bank that is FOLF. Such a function is to be carried out according to the conditions laid out in article 109 of the BRRD and makes DGSs act as loss absorbers to the benefit of covered depositors.[27] Thus, the DGS will contribute to the resolution financing to the extent that it would have suffered a loss by reimbursing covered depositors in the hypothetical event of such bank being submitted to ordinary insolvency proceedings. Accordingly, should bail-in be applied, the DGS would be required to provide the bank under resolution with resources equivalent to the amount by which covered deposits would have been written down in the hypothetical scenario of them being bailed-in (so-called virtual bail-in). Similarly, should the other resolution tools be implemented, the DGS would be requested to contribute an amount equivalent to the losses that such covered depositors would have suffered. Yet, performing this function is now made more unlikely due to the introduction of depositor preference pursuant to article 108 of the BRRD, determining that the DGS should make a contribution only when all the

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following have the same priority ranking which is higher than the ranking provided for the claims of ordinary unsecured creditors: (i) that part of eligible deposits from natural persons and micro, small and medium-sized enterprises which exceeds the coverage level provided for in Article 6 of Directive 2014/49/EU; (ii) deposits that would be eligible deposits from natural persons and micro, small and medium-sized enterprises were they not made through branches located outside the Union of institutions established within the Union; (b) the following have the same priority ranking which is higher than the ranking provided for under point (a): (i) covered deposits; (ii) deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency'.

[27] Pursuant to article 11 paragraph 2 of the DGSD the financial means of a DGS shall be used in order to finance the resolution of credit institutions in accordance with Article 109 of the BRRD. The resolution authority shall determine, after consulting the DGS, the amount by which the DGS is liable.

other liabilities ranked below covered deposits are not enough to absorb the incurred losses.[28]

Beside these two mandatory functions, Member States can decide, pursuant to article 11, paragraph 3 of the DGSD, to also permit their DGSs to intervene at an early stage to prevent a bank's crisis by providing different forms of support.[29] Nevertheless, such interventions need to meet some criteria in order to be carried out.[30] The most relevant condition is that these measures must comply with the 'least cost principle', under which they cannot end up being more costly for the DGS than the amount it would have paid to reimburse covered depositors had the bank undergone a piecemeal liquidation.[31] The second optional function that a DGS can perform according to article 11, paragraph 6 of the DGSD is the provision of financial support in the context of a winding up.[32] Such an intervention is to be carried

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[28] See Simon Gleeson and Randall Guynn, *Bank Resolution and Crisis Management. Law and Practice* (Oxford University Press 2016) 173.

[29] The paper will refer to the measures regulated under article 11 paragraph 3 of the DGSD as preventive function(s), preventive measure(s), or preventive intervention(s) interchangeably.

[30] Pursuant to article 11 paragraph 3 of the DGSD, the following conditions need to be met: '(a) the resolution authority has not taken any resolution action under article 32 of BRRD; (b) the DGS has appropriate systems and procedures in place for selecting and implementing alternative measures and monitoring affiliated risks; (c) the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS; (d) the use of alternative measures by the DGS is linked to conditions imposed on the credit institution that is being supported, involving at least more stringent risk monitoring and greater verification rights for the DGS; (e) the use of alternative measures by the DGS is linked to commitments by the credit institution being supported with a view to securing access to covered deposits; (f) the ability of the affiliated credit institutions to pay the extraordinary contributions in accordance with paragraph 5 of this Article is confirmed in the assessment of the competent authority'.

[31] These measures are contemplated also by principle 15 of the IADI Principles for Effective Deposit Insurance Systems, stating that '[t]he deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks'; see International Association of Deposit Insurers (n 14) 21.

[32] The paper will refer to the measures regulated under article 11 paragraph 6 of the DGSD as alternative function(s) in the context of liquidation, alternative

out with the objective of preserving access of depositors to their covered deposits.[33] Nevertheless, even these interventions, like the preventive interventions, must comply with the 'least cost principle'.[34]

The following part of this paper will focus on these two optional functions, starting with a discussion of the arguments supporting that their implementation might prove more efficient than depositors' pay-out, from a system-wide perspective, in maintaining financial stability and in reducing the destruction of value potentially resulting from an atomistic liquidation. The paper will refer to the two DGSs measures regulated under article 11, paragraphs 3 and 6 of the DGSD as optional or alternative measure(s), optional or alternative intervention(s) or optional or alternative function(s), interchangeably.

III. The Potential Effectiveness of Alternative Measures Aimed at Preventing a Bank's Failure

The intervention of a DGS at the first symptoms of a bank's crisis can be particularly effective in preventing the latter from escalating and getting out of control. In fact, many banking crises, still at an early stage, can be more efficiently solved thanks to the ability of DGSs to help restructure the institutions concerned. Such a preventive intervention, in addition, can be

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measure(s) in the context of liquidation or alternative intervention(s) in the context of liquidation, interchangeably.

[33] Pursuant to article 11 paragraph 6 of the DGSD, Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned.

[34] These measures are contemplated also by principle 16 of the IADI Principles for Effective Deposit Insurance Systems, stating that '...In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g. providing depositors with continuous access to their funds and maintaining clearing and settlement activities)'; see International Association of Deposit Insurers (n 14) 22.

seen as beneficial for the whole system that otherwise could be negatively affected both in reputational and economic terms. Indeed, in the context of bank crises, there is always a special public interest to safeguard depositors and, linked to it, to protect the stability of the system. In some cases, this goal can be more successfully achieved through preventive action.

Of course, DGSs are expected to conduct a cost-benefit analysis before performing preventive interventions. The benchmark to consider in conducting such an assessment is the hypothetical cost that they should pay to reimburse covered depositors in the event that the bank in crisis ended up being liquidated without the deposits being transferred to another bank. If such assessment shows that the cost of depositors' pay-out is higher than the cost of restructuring, then the preventive intervention should take place. Obviously, the cost of depositors pay-out is to be calculated also in light of the amount that the DGS expects to recover from the insolvency proceeding after subrogating to the depositors' rights, although, from this perspective, the extension of depositors super priority to DGSs represents a possible obstacle, as discussed in section VI.2.

Yet, experience has shown that preventive measures are generally less costly than the reimbursement of depositors.[35] Nevertheless, there might also be cases where a bank collects only a limited amount of covered deposits, but at the same time performs crucial functions for its group. The failure of such a bank could have terrible effects on the other group members and possibly on financial stability. In such a case, however, the cost of preventive measures might exceed the cost of pay-out of covered depositors, thereby preventing their application.[36]

On these grounds, DGSs can be seen as reactive system-wide tools, funded directly by banks, to be employed at the early stages of a crisis, on the assumption that it is in the interest of the whole banking system to prevent (or at least mitigate) its negative effects. Accordingly, their task should be to

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[35] See European Forum of Deposit Insurers, 'EFDI State of Play and Non-Binding Guidance Paper. Guarantee Schemes' Alternative Measures to Pay-out for Effective Banking Crisis Solution' (2019) 29.

[36] Ibid.

play a central role in preventing banking crises by disbursing, at an early stage, the resources provided by other banks.

IV. THE POTENTIAL EFFECTIVENESS OF ALTERNATIVE MEASURES IN THE CONTEXT OF LIQUIDATION

The ability of DGSs to provide financial support in the context of a bank's winding up is particularly important for the latter to be orderly, as requested by the BRRD, and effective. According to article 32(b) of the BRRD, indeed, Member States shall ensure that a FOLF institution in relation to which the resolution authority considers that all the conditions for resolution are met, except for the resolution action being in the public interest,[37] shall be wound up in an orderly manner in accordance with the applicable national law.[38]

The final objectives of the winding up procedure are the liquidation of the assets and the payment of creditors, which are to be carried out by the liquidators. This means that the creditors' interest to be repaid should drive the action of both the authorities and the liquidators. Nevertheless, a number of other extremely relevant interests should be taken into due consideration in running the procedure in order for it to be orderly and effective. Chief among them are the stability of the system, the confidence of depositors and investors and the safeguarding of the going concern value of the FOLF bank.

To this end, normal corporate insolvency proceedings, (typically run by law courts), which apply to non-financial firms, are often not considered adequate for banks.[39] This results from the fact that these proceedings are

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[37] On public interest, see Marco Bodellini, 'Impediments to Resolvability: Critical Issues and Challenges Ahead' (2019) 5 Open Review of Management, Banking and Finance 52.

[38] Article 32(b) has been introduced within the BRRD by Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019, amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, OJ L 150/296 (so-called BRRD 2).

[39] See Thomas F. Huertas, 'The Case for Bail-ins' in Andreas Dombret and Patrick S. Kenadjian (eds), *The Bank Recovery and Resolution Directive. Europe's Solution for 'Too Big to Fail'?* (De Gruyter 2013) 167-168; Randall Guynn, 'Are Bailouts Inevitable?' (2012) 29 Yale Journal on Regulation 121, 137-140; Wolf-Georg Ringe,

usually lengthy and slow and primarily aimed at (simply) liquidating the assets. The proceeds arising from the sale of the assets are then used to pay (typically, only some of) the creditors.[40] As a consequence, the continuation of the FOLF bank's activities would not be guaranteed, possibly provoking destruction of value.[41] The interruption of the activities in turn can have a potential destabilising impact on the bank's counterparties and, more broadly, on the banking and financial system as well as, sometimes, on its geographical area of operation.

Accordingly, even though the final objective of the winding up procedure is the assets' liquidation and the payment of the bank's creditors, still atomistic liquidation is seldom considered an effective and efficient crisis management procedure for FOLF banks, mostly because it does not ensure the continuation of critical functions, thereby potentially affecting the bank's counterparties. This in turn might end up destroying the going concern value of the good parts of the bank in crisis and therefore can be detrimental for both the bank's creditors and the system as a whole.

To avoid these negative outcomes, the liquidation procedure should then take forms resembling – to a certain extent – the resolution procedure. This can be achieved through the use of legal instruments similar to the resolution tools now regulated by the BRRD. Thus, the main tool to use in the winding up procedure with a view to continuing (at least some of) the FOLF bank's critical functions would be an instrument similar to the sale of business tool, which I define as 'sale of business-like tool'.[42] The latter would allow to

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'Bail-in between Liquidity and Solvency', (2006) University of Oxford Legal Research Paper Series No. 33/2006, 6 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2782457> accessed 30 August 2020.

[40] Marco Bodellini, 'Greek and Italian "Lessons" on Bank Restructuring: Is Precautionary Recapitalization the Way Forward?' (2017) 19 Cambridge Yearbook of European Legal Studies 145.

[41] See Rosa Lastra, Costanza Russo and Marco Bodellini, 'Stock Take of the SRB's Activities over the Past Years: What to Improve and Focus on?' (2019) Study Requested by the ECOM Committee of the European Parliament, 11 <https://www.europarl.europa.eu/RegData/etudes/STUD/2019/634392/IPOL_STU(2019)634392_EN.pdf> accessed 30 August 2020.

[42] Pursuant to article 2, paragraph 1, number 58 of the BRRD, the sale of business tool is 'the mechanism for effecting a transfer by a resolution authority of shares

transfer both assets and liabilities of the bank under liquidation to another bank at market prices (which are expected to be higher than liquidation prices), thereby allowing for the continuation of (at least some of) the activities of the FOLF bank through the purchasing institution and safeguarding in this way the going concern value of the FOLF entity.

In this way, the winding up could become a means to allow for the continuation of (some of) the failing bank's activities through a different bank, thereby merging together the dissolving function of the liquidation procedure with the business continuity character of the sale of business tool. The outcomes which could be achieved through the application of the 'sale of business-like tool' in a winding up procedure would be the following: 1) deposits could be moved to the purchasing bank and depositors, therefore, would be fully protected, thereby avoiding runs on other banks and possibly systemic risk; 2) borrowers would keep on accessing financial means provided by the purchasing bank, avoiding to negatively affect the real economy; 3) assets and liabilities (or at least some of them) would be transferred to the purchasing bank, thereby allowing for the continuation of the business activity and maintaining the going concern value.

Yet, even if liquidators manage to find another institution willing to purchase all (or a part of) the assets and liabilities of the bank under liquidation, the value of the liabilities to transfer to the purchasing bank would still, fairly obviously, exceed the value of the assets. In such a scenario, DGSs can play a pivotal role to successfully help run the liquidation procedure. Indeed, they might provide funds to be used to compensate the purchasing bank for taking on such a negative balance between assets and liabilities. Nonetheless, such an intervention is to take place only if the amount of resources to provide is estimated to be lesser than the amount that the DGS should pay to covered depositors in the event of an atomistic liquidation without the transfer of

or other instruments of ownership issued by an institution under resolution, or assets, rights or liabilities, of an institution under resolution to a purchaser that is not a bridge institution ...'. According to article 38 paragraph 1 of the BRRD, 'Member States shall ensure that resolution authorities have the power to transfer to a purchaser that is not a bridge institution ... (b) all or any assets, rights or liabilities of an institution under resolution'.

deposits to another bank. In this regard, EFDI has taken the view that the least cost evaluation should

> consider a comprehensive range of elements, including the direct (financial, operational, etc.) and indirect costs (missing return on liquidity, increasing cost of funding, etc.) of pay-out, adequate haircuts on the expected recovery side, and also contagion and reputation risks which may lead to further reimbursements; on the other side, the costs of 'interventions in liquidation' for the DGS, entailing refundable or recoverable disbursements and guarantees, are proposed to be calculated to the extent of expected losses estimated at the date of the intervention.[43]

Against this background, the application of the 'sale of business-like tool' during the winding up procedure can be seen as an alternative to the bank's atomistic liquidation. The choice between these two alternatives (i.e. atomistic liquidation *vis-à-vis* application of the 'sale of business-like tool') should be based on a comparative assessment. Accordingly, the authorities should run a counterfactual scenario on the basis of which the liquidation strategy is to be informed.

In developing this counterfactual scenario, it should be assumed that in the event of a piecemeal liquidation: 1) the assets will be sold at discounted prices over a relatively long period of time; 2) the bank's activities will be immediately interrupted; 3) the pledged performing assets will be seized and enforced by the secured creditors; 4) the DGS will have to step in to protect covered depositors; 5) the contractual relationships will be immediately terminated with liquidators calling back all the loans and credit lines previously extended to the bank's borrowers.

In practical terms, this would cause enterprises and households to be obliged to pay back their loans to the liquidators overnight. This, in turn, could create a domino effect triggering a significant number of failures affecting many more counterparties. Uninsured depositors and unsecured creditors would have to wait for the winding up procedure timeframe to try and get (likely, only a part of) their money back. The DGS should immediately reimburse the covered depositors and after that it could exercise the subrogation right to the depositors' rights in the liquidation procedure. Nevertheless, due to the limited amount of immediately available resources, in some cases, the DGS

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43 See European Forum of Deposit Insurers (n 35) 6.

will likely have to ask its member banks for extra contributions. Also, the guarantees released by guarantors, if any, would be immediately enforced. As a consequence, the guarantors would have to pay immediately the guarantee-holders before being able to exercise the ensuing subrogation right in the liquidation procedure.

For all these reasons the application of the 'sale of business-like tool' is often to be considered more efficient than a piecemeal liquidation, since it is able to allow, on the one hand, for the continuation of the bank's most critical functions and, on the other hand, for the protection of the FOLF bank's going concern value. Consequently, the atomistic liquidation with the DGS reimbursement of covered depositors should be activated only in cases in which the sudden interruption of the bank's activities and the destruction of the going concern value are not considered able to negatively affect the system. Still, for the 'sale of business-like tool' to be successfully employed in the context of a bank's liquidation, the DGS needs to be involved in order to finance the transaction(s).

V. The Implementation of Deposit Guarantee Schemes' Optional Measures in European Union Member States

The implementation of DGSs' optional measures has been common practice in several EU Member States, thereby showing that there is consensus (at least in some countries) on their effectiveness. According to a survey recently conducted by EFDI on its members, 14 DGSs (of which 8 are private and 6 public) are empowered to implement preventive measures pursuant to article 11, paragraph 3 of the DGSD.[44] The EBA recently conducted a similar survey according to which 'fourteen respondents from fourteen Member States reported that the use of measures under Article 11(3) was allowed in their jurisdiction'.[45] With regard to the measures under article 11, paragraph 6 of

44 Ibid 15, pointing out that within the European Union such interventions can be performed in Austria, Croatia, Denmark, France, Germany, Ireland, Italy, Malta and Spain.

45 See European Banking Authority, 'Opinion of the European Banking Authority on Deposit Guarantee Scheme Funding and Uses of Deposit Guarantee Scheme Funds' (2020), 76, EBA/OP/2020/02 <https://eba.europa.eu/sites/default /documents/files/document_library/Publications/Opinions/2020/EBA%20Opin

DGSD, the EFDI survey pointed out that 17 DGSs (of which 6 are private and 11 public), according to their statute, can carry out alternative interventions in the context of liquidation as well.[46] Both preventive measures and optional measures in the context of liquidation have been frequently employed by several DGSs in some EU Member States and, over time, have proven to be effective.[47]

According to the EFDI's survey, the most common preventive measures adopted by DGSs pursuant to article 11, paragraph 3 of the DGSD were: 1) guarantees provided by the DGS on equity instruments issued for the purpose of bank recovery; 2) subscription by the DGS of equity instruments issued for the purpose of bank recovery; 3) acquisition by the DGS of non-performing loans of the distressed bank; 4) direct financing by the DGS; 5) guarantees provided by the DGS on loans granted by third parties; 6) guarantees provided by the DGS in the context of asset protection schemes; 7) interest rate allowance (e.g. on loans received by the distressed bank); 8) other forms of contribution (e.g. consultancy costs and management tutoring cost, reduction by incentives to retirements, personnel training, IT upgrade costs).[48]

Likewise, the most common alternative measures in the context of liquidation adopted by DGSs pursuant to article 11, paragraph 6 of the DGSD were: 1) full transfer of assets, liabilities and other contracts of the bank under liquidation to another bank; 2) partial transfer of assets and liabilities; 3) imbalance and liquidation costs to be covered; 4) guarantees provided by the

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ion%20on%20DGS%20funding%20and%20uses%20of%20DGS%20funds.pdf > accessed 30 August 2020.

46 See European Forum of Deposit Insurers (n 35) 15, pointing out that within the European Union such interventions can be performed in Austria, Croatia, Denmark, Finland, Greece, Ireland, Italy, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovenia and United Kingdom (which at that time was still an EU Member State).

47 Ibid 16-19, pointing out that before the approval of the DGSD in 2014, 14 DGSs had implemented preventive measures. 8 of these DGSs were private and 6 were public schemes; similarly 7 DGSs had implemented alternative measures in the context of liquidation as well. 3 of these DGSs were private and 4 were public schemes.

48 Ibid 18.

DGS on equity instruments issued by the purchasing bank; 5) subscription by the DGS of equity instruments issued by the purchasing bank; 6) acquisition by the DGS of non-performing loans of the bank under liquidation; 7) guarantees provided by the DGS on assets transferred to the purchasing bank; 8) allowances to the acquiring bank.[49]

Italy, for example, has for a long time had in place rules allowing its domestic DGSs to perform both optional functions.[50] Interestingly, these optional measures were carried out much more often than the mandatory pay-box function because they were considered more effective than the latter.[51]In practice, instead of paying out the amount of covered deposits in the event of a piecemeal liquidation, the Italian DGSs used: 1) to finance in several ways their member in trouble, typically in the context of early intervention measures, to prevent the situation from escalating and becoming an irreversible crisis, typically a) by financing the acquisition of the troubled bank by another bank; b) by recapitalising it; c) by providing guarantees; d) by purchasing shares; e) by taking on the mismatch between liabilities and assets to be transferred; and 2) to provide different forms of financial support in the context of liquidation with the goal of preserving access of depositors to their covered deposits, typically a) by financing the acquisition of the troubled bank by another bank or b) by taking on the mismatch between liabilities and assets to be transferred. The Italian DGSs informed their decisions through a preventive assessment of both the potential success of the intervention and

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49 Ibid 21.

50 See Giuseppe Boccuzzi (n 1) 234.

51 Similarly, see Augustìn Carstens, 'Deposit Insurance and Financial Stability: Old and New Challenges' (2018) Keynote Address at the 17th IADI Annual General Meeting and Annual Conference on Deposit Insurance and Financial Stability: Recent Financial Topics, Basel 18 October 2018, 3 <https://www.bis.org/speeches/sp181024a.pdf> accessed 30 August 2020, arguing that the deposit insurer may require a wider range of instruments, beyond conventional liquidation actions which are 'needed to protect deposits as well as to manage and sell the bank's assets in a way that minimises the cost to the deposit insurance funds and maximises value for creditors'; for an overview of liquidation cases with DGS pay-outs across the EU, see Dalvinder Singh, *European Cross-Border Banking and Banking Supervision* (Oxford University Press 2020), appendix 6, table 6.2.

its cost *vis-à-vis* the amount they should have paid to covered depositors had the bank been submitted to a piecemeal liquidation ('least cost principle').

From 1988 to 2018, the main Italian DGS (*Fondo Interbancario di Tutela dei Depositi*) intervened twelve times: in eight cases, the intervention was conducted to allow for the transfer of assets and liabilities to another bank in the context of a liquidation, thereby avoiding an inefficient piecemeal liquidation. In two cases, the intervention supported banks at the early stage of a crisis and only in two cases the DGS simply reimbursed covered depositors in the context of a piecemeal liquidation.[52] In the last two years the Italian DGS intervened two more times by subscribing to very large increases of capital to the benefit of *Cassa di Risparmio di Genova* and *Banca Popolare di Bari*, both placed under temporary administration.[53] In line with such an approach, between 1997 and 2015 the mutual bank's DGS (*Fondo di Garanzia dei Depositanti del Credito Cooperativo*) intervened eighty times and

[52] See Fondo Interbancario di Tutela dei Depositi, 'FIDT's Interventions, Interventions Report' (2020) <https://www.fitd.it/Cosa_Facciamo/Interventi> accessed 30 August 2020, according to which the total amount disbursed over time by the Italian DGS was EUR 1,249.30 million, of which only EUR 77.3 million for depositors pay-out.

[53] See Ilsole24ore, 'Carige, Firmato l'Accordo per la Soluzione Privata di Salvataggio', *Ilsole24.com* (10 August 2019) <https://www.ilsole24ore.com/art/carige-firmato-l-accordo-la-soluzione-privata-salvataggio-ACbF7Be> accessed 30 August 2020; Giuseppe Fonte, 'Italy in Talks with EU over Popolare Bari Rescue', *Reuters* (9 January 2020) <https://www.reuters.com/article/us-italy-banks-popolare-di-bari-idUSKBN1Z813J> accessed 30 August 2020; see also Francesco Capriglione, 'Banking Crises and Systemic Crises. The Italian Case' (2019) 8 Law and Economics Yearly Review *passim*; Cristina Dias, Jérôme Deslandes and Marcel Magnus, 'Recent Measures for Banca Carige from a BRRD and State Aid Perspective' (2019) European Parliament Briefing, <https://www.europarl.europa.eu/RegData/etudes/BRIE/2019/624413/IPOL_BRI(2019)624413_EN.pdf> accessed 30 August 2020, underlining that the funds provided by the Italian DGS in the recapitalization of Carige amounted to EUR 238.8 million in addition to another EUR 313.2 million previously provided by its voluntary arm. The funds provided by the Italian DGS in the recapitalization of Banca Banca Popolare di Bari amounted to EUR 310 million with the DGS commitment to further inject EUR 390 million, if needed.

only in one case it reimbursed covered depositors within an atomistic liquidation procedure.[54]

That is why the role of DGSs should not be limited to just performing the pay-box function and the implementation of the optional functions should, therefore, not be hindered, but rather facilitated. In this vein, each Member State should be encouraged (indeed required) to transpose into its domestic framework the provisions under article 11, paragraphs 3 and 6 of the DGSD in order for DGSs to be empowered to carry out such functions at the early intervention stage as well as at the liquidation stage, thereby paving the way for a new bank crisis management paradigm.

VI. The Legal Obstacles to Deposit Guarantee Schemes Optional Interventions in Banking Crises and Some Proposals to Remove Them

Despite the benefits of having DGSs that are empowered to perform optional functions, there are a number of legal constraints at the EU level affecting their capability to implement such measures. A combination of different rules with a different rationale can, indeed, make DGSs' optional interventions very difficult to be put in place. These provisions are: 1) state aid rules, particularly the 2013 European Commission Banking Communication, paragraph 63; 2) depositor preference pursuant to article 108 of the BRRD, which applies also to DGSs when subrogating to depositors' rights in insolvency proceedings, combined with a narrow reading of the 'least cost principle'.

1. The Obstacles Resulting from the State Aid Framework

The first issue arises from paragraph 63 of the 2013 European Commission Banking Communication, which states that when a DGS provides funds with a view to helping restructure a bank in crisis, for the intervention to comply

54 See Francesco Baldi, Marcello Bredice and Roberto Di Salvo, 'Bank-Crisis Management Practises in Italy (1978-2015). Perspectives on the Italian Cooperative Credit Network' (2015) 2 The Journal of European Economic History 144-145, recalling that the total amount disbursed over time by the Italian Mutual Banks' DGS was EUR 1,363 million.

with the state aid rules, regardless of the private nature of the resources, such resources must not be under the state's control and the decision to intervene must not be imputable to the state.[55] When this is not the case, the intervention will be considered a provision of state aid measures and will need to be authorised by the Commission.[56] In order to be authorised by the Commission, burden sharing measures typically have to be implemented as well. This, in turn, can create further issues since the DGS as such does not have any power to apply the burden-sharing mechanism.[57] Additionally, there are cases where the application of burden sharing measures might end up being counterproductive since they could give rise to knock-on effects.[58]

This provision is particularly critical also in light of the fact that a bank receiving assistance, which is qualified as extraordinary public financial support, would be consequently considered as FOLF under article 32 of the BRRD. As a consequence, the determination of the bank being FOLF would compromise the DGS's attempt to avoid its failure through the preventive intervention.[59] Against this background, the EBA has stated that 'there may be merit in clarifying in the EU framework that the use of DGS funds for

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55 2013 European Commission Banking Communication, paragraph 63 reads as follows: 'Interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes [...] do not constitute State aid [...] However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State ... The Commission will assess the compatibility of State aid in the form of such interventions under this Communication'.

56 Interestingly, pursuant to the 2013 Banking Communication, paragraph 63, on the contrary, performing the pay-box function does not qualify as a provision of state aid measures.

57 See European Forum of Deposit Insurers (n 35) 5.

58 This is why paragraph 45 of the 2013 Banking Communication empowers the Commission to exclude the application of the burden sharing mechanism when this would endanger financial stability or lead to disproportionate results.

59 See Concetta Brescia Morra 'The New European Union Framework for Banking Crisis Management: Rules versus Discretion' (2019) 3 European Company and Financial Law Review 365.

failure prevention would not in itself trigger the determination that the institution was failing or likely to fail'.[60]

The European Commission had the opportunity to apply the 2013 Banking Communication rules on DGSs in the *Tercas* case in which it took the view that the measures implemented by the Italian DGS to rescue that institution qualified as a state aid pursuant to article 107 of the Treaty on the Functioning of the European Union (TFEU). This interpretation was eventually confirmed on 23 December 2015 on the basis of: 1) the alleged public nature of the resources owned by the scheme; 2) the public mandate exercised by the Italian DGS in the operation; and 3) the role played by the Bank of Italy in the approval of the intervention.[61]

Nevertheless, Italy, *Banca Popolare di Bari* and the Italian DGS, with the intervention of Bank of Italy, challenged the European Commission's decision, bringing a legal claim before the General Court of the European Union for its annulment. The claim was based on the alleged infringement of article 107 TFEU for erroneous reconstruction of the facts concerning: 1) the public nature of the resources; 2) the imputability to the State of the contested measures; 3) the granting of a selective advantage and 4) the assessment of the compatibility of the alleged state aid with the internal market.[62]

On 19 March 2019, the General Court of the European Union issued the judgment in Joined Cases T-98/16, T-196/16 and T-198/16 and annulled the

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[60] See European Banking Authority (n 45) 80, also suggesting that '[t]he wording of Article 11 of the DGSD should be clarified to ensure that measures mentioned in Article 11(3) are referred to as "preventive measures" and those in Article 11(6) are referred to as "alternative measures", because currently the measure under Article 11(3) is referred to as an "alternative measure", which could create confusion about the purpose of such measures'.

[61] European Commission, 'Decision on the State Aid' SA.39451 (2015/C) (ex 2015/NN) implemented by Italy for Banca Tercas, Brussels, C (2015) 9526, 23 December 2015.

[62] See Andrea Vignini, 'State Aid and Deposit Guarantee Schemes. The CJEU Decision on Tercas and the Role of DGSs in Banking Crises' in *The Role of the CJEU in Shaping the Banking Union: Notes on Tercas (T-98/16) and Fininvest* (Quaderni di Ricerca Giuridica della Consulenza Legale della Banca d'Italia 2019) 21.

Commission's decision.[63] The Court argued that the Italian DGS was not carrying out any public mandate, since these optional measures, which are never mandatory, were adopted by the DGS only in order to avoid the more costly financial consequences of reimbursing covered depositors.[64] This would have occurred in the event of a piecemeal liquidation. This argument was further supported by the fact that the DGS intervened on the premise that its measures were compliant with the least cost principle.[65]

The Court highlighted that the Italian DGS is a private consortium of banks, which acts on behalf and in the interest of its members (i.e. the Italian banks) and its bodies are composed of the banks' representatives who are appointed by the DGS's members themselves.[66] Similarly, the Court rejected the argument that the Bank of Italy could exercise control over the DGS activities by attending its meetings through one of its officials as an observer with no voting rights.[67]

The Court also reached the conclusion that the DGS's intervention was the result of the free will of its members, autonomously deciding: 1) to make the DGS carry out those preventive measures and 2) to finance the support granted to *Tercas*, pursuing their own private interest of avoiding the more expensive reimbursement of covered depositors, which would have been carried out in the event of a piecemeal liquidation.[68] In the Court's view, the Commission failed to prove sufficiently that the resources were under the control and at disposal of the Italian public authorities.[69] All these elements and considerations, accordingly, drove the Court to annul the Commission's decision on the grounds that the intervention concerned did not violate the state aid framework. Nonetheless, the European Commission appealed

63 Joined Cases T-98/16, T-196/16 and T-198/16 *Italian Republic and Others v European Commission* EU: T:2019:167.

64 Ibid paragraph 97.

65 Ibid paragraph 104.

66 Ibid paragraph 113.

67 Ibid paragraph 121.

68 Ibid paragraph 159.

69 Ibid paragraph 161.

against the judgment of the General Court before the Court of Justice and the case is still pending.[70]

The decision of the General Court shed some light on the interplay between state aid rules and DGSs' optional interventions, thereby opening up the possibility of putting these DGSs alternative interventions in place where the conditions highlighted in the judgement are met. However, DGSs with a decision-making process based on the involvement of public authorities might be barred from implementing those measures since they could be qualified as state aid. This interpretation could be grounded on the assumption of their decisions being considered imputable to their state and their resources being regarded as under their state's control.[71] But if this will be the case, such a reading of the Banking Communication rules, in turn, could affect the level playing field between DGSs (and, as a consequence, between their domestic banking systems) established in different Member States on the basis of their governance arrangements, threatening in this way competition in the EU single market. Indeed, in this case the intervention of a public DGS would be qualified as state aid and therefore it could be implemented only after being authorised by the European Commission. The latter is empowered to authorise similar interventions when burden-sharing measures involving shareholders and subordinated creditors are put in place as well. The application of burden-sharing measures, however, might be sometimes detrimental, thus in such cases it should not take place.[72] Additionally, the application of the burden sharing mechanism to equity

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[70] Case C-425/19 P <http://curia.europa.eu/juris/document/document.jsf?text=&docid=216205&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=8873673> accessed 23 February 2021; the appeal states: 'The Commission considers that the judgment under appeal is based on incorrect legal considerations and distortion of the facts, which irremediably invalidate its findings and the operative part of the judgment'.

[71] The European Forum of Deposit Insurers, for example, distinguishes among its members between publicly managed DGSs and privately managed DGSs on the basis of a self-assessment that the members conducted by focusing on corporate status (in the national jurisdiction) and/or corporate governance mechanism (appointment of directors, decision-making powers); see European Forum of Deposit Insurers (n 35) 15.

[72] See Marco Bodellini, 'To Bail-In, or to Bail-Out, That Is the Question' (2018) 19 European Business Organization Law Review 377.

instruments and subordinated debt instruments falls outside the DGS mandate and therefore requires a specific decision of the resolution authorities. In this regard, it has been observed that the inability of DGSs to implement burden-sharing measures 'reflects an asymmetry with the resolution authorities' powers', thereby creating coordination issues.[73]

The *Tercas* case is rather informative in this regard, since it clearly shows how the European Commission reads and interprets its 2013 Banking Communication rules. The European Commission decided that a private law consortium that is privately funded and managed, like the Italian DGS, granted state aid measures to *Tercas* because its intervention was influenced and directed by the Italian public authorities (mostly the Bank of Italy). This reading of the facts has been criticised[74] and eventually the Commission's decision was overruled by the General Court of the European Union.[75] The decision of the General Court is therefore very relevant. Nonetheless, in order to clarify the regime in place, avoid legal uncertainties, and remove the risk that optional measures can be implemented only by some EU DGSs, it seems that a review of the 2013 Banking Communication rules on DGS's optional measures and state aid provision would be needed.[76]

The need for a review of the Banking Communication is based on a number of considerations. From a systematic perspective, it is worth noting that the main goal of the post-global financial crisis bank crisis management regime

[73] See European Forum of Deposit Insurers (n 35), 5, pointing out that since article 11 paragraph 3 of the DGSD provides that since 'the DGS shall consult the resolution authority and the competent authority on the measures and the conditions imposed on the credit institution, it might be appropriate to provide for an explicit pro-active role in this regard in favour of the DGS when packaging the entire intervention, also in order to clarify the roles and responsibilities of each player involved'.

[74] See Salvatore Maccarone, 'La Sentenza del Tribunale Europeo sul Caso Tercas' (2019) 3 Bancaria 20.

[75] Joined Cases T-98/16, T-196/16 and T-198/16 *Italian Republic and Others v European Commission* EU: T:2019:167.

[76] Accordingly, see European Banking Authority (n 45), 81, stating that '[s]ubject to the outcome of the Commission's appeal in the *Tercas* case, the EBA invites the Commission to consider if there is a need to amend the Banking Communication and the potentially different consequences for DGSs depending on their legal status and/or governance structure'.

is, according to the Financial Stability Board 'Key Attributes of Effective Resolution Regimes for Financial Institutions', to handle a bank's crisis without using public money while simultaneously avoiding the creation of financial instability.[77] This in itself is a very difficult goal to achieve.[78] But if this is the objective, then it is should be seen as conceptually incoherent to render the use of private resources, like the ones of DGSs, more complicated. This holds true even when a public authority, such as the banking supervisor or the ministry of finance, considers it appropriate to exercise a form of moral suasion on the banking industry participants to orchestrate, coordinate, and implement an effective solution in the interest of the system as a whole based on the intervention of the DGS. Such a position rests on the consideration that the use of private resources by definition should not be qualified as state aid provision. Even more so, in a context where resources are by nature finite and where public intervention is discouraged, any possible privately funded solution should be facilitated. Accordingly, the International Monetary Fund (IMF), in its 2018 Financial Sector Assessment Program (FSAP) for the Euro Area, has pointed out that 'deposit and asset transfers funded by DISs could likewise be granted a presumption of compliance when provided on a least cost basis according to agreed open procedures and subject to European-level oversight, thus minimizing competition concerns'.[79]

Such a revision of the 2013 Banking Communication rules, based on the arguments advanced by the General Court of Justice in the *Tercas* case, should

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77 Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (2014) <https://www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 30 August 2020, 1, stating that the implementation of the Key Attributes 'should allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions'.

78 See Biljana Biljanovska, 'Aligning Market Discipline and Financial Stability: A More Gradual Shift from Contingent Convertible Capital to Bail-in Measures' (2016) 17 European Business Organisation Law Review 105-106, arguing that 'market discipline and financial stability cannot be achieved simultaneously'.

79 See International Monetary Fund, 'Euro Area Policies, Financial System Stability Assessment', (2018) IMF Country Report no. 18/226, 28 <https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-System-Stability-Assessment-46100> accessed 30 August 2020; similarly see European Forum of Deposit Insurers (n 35) 25.

determine that the optional functions implemented by those DGSs that comply with the least cost principle do not qualify as state aid measures, regardless of their governance arrangements and decision-making process.[80] In this way, the risk of different treatments depending on the legal structure of the DGS would be removed and it would also be possible to resolve the friction between article 11 of the DGSD, the Banking 2013 Communication rules and article 32 of the BRRD, stating that the provision of extraordinary public financial support would make the bank FOLF. Indeed, if such measures no longer qualify as a state aid provision, their implementation will not cause the recipient bank to be considered FOLF and therefore the DGSs intervention, as regulated under article 11 of the DGSD, could take place. Also, such a review would permit a deviation from the mandatory implementation of burden-sharing measures, which, as discussed, in some cases might be counterproductive.

2. The Obstacles Resulting from the Granting to Deposit Guarantee Schemes of a Super Priority in the Bank's Liquidation and the Narrow Reading of the 'Least Cost Principle'

The second issue arises from the introduction of the depositor preference rule in the BRRD. This super priority, indeed, also applies to DGSs subrogating to depositors' rights in the insolvency proceedings. Such a rule, coupled with a narrow reading of the 'least cost principle', could end up making every DGS optional intervention very difficult, if not impossible. The granting of this super priority to DGSs impacts the optional interventions in that they are allowed only to the extent that the DGS does not end up spending more money than the amount it would have had to pay in order to reimburse covered depositors in the context of a piecemeal liquidation according to the 'least cost principle'. The critical aspect is that, due to the super priority, it is unlikely that the DGS will be called on to bear losses at all.

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80 Accordingly, see European Banking Authority (n 45) 81, stating that 'Subject to the outcome of the Commission's appeal in the *Tercas* case, the EBA invites the Commission to consider if there is a need to amend the Banking Communication and the potentially different consequences for DGSs depending on their legal status and/or governance structure'.

This could occur only when losses are so significant that all the other liabilities ranked below deposits are not enough to absorb them.

It is true that when only focusing on a single crisis, the DGS might seem better off as it will recover all (or a relevant part of) the resources provided to reimburse the affected covered depositors, due to the extension of the depositor preference. Nonetheless, this is not necessarily the best possible outcome for the system,[81] which would be the overall cheapest and safest solution, also taking into account the interests of taxpayers.[82] Yet, due to the depositor preference extended to DGSs, it will be almost impossible for them to provide any form of assistance aimed at preventing the bank's failure as well as to finance measures in the context of liquidation, in contrast with the US framework.[83] As a result, typically only a piecemeal liquidation can take place, which will cause the destruction of much more value, negatively affecting both the other unsecured creditors and potentially the banking system as whole. Indeed, a disorderly liquidation can trigger a crisis of confidence, entailing massive shifts of deposits across institutions, and in particularly serious situations even deposit runs. Should the crisis spread to other banks as well, then the costs for the DGS of reimbursing covered depositors could become much higher than originally foreseen.[84] Even more interestingly, piecemeal liquidation often would be neither beneficial for the system nor in the interest of the DGS itself. This is because the interest of the banking system and the interest of the DGS are typically aligned. Since the interest of the DGS is the interest of its members, which are the banks

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[81] See Alessandra De Aldisio and others, 'Towards a Framework for Orderly Liquidation of Banks in the EU' (*Notes on Financial Stability and Supervision of Banca d'Italia 2019*) 6, who use an example to demonstrate that even when an optional measure implemented by the DGS ends up being more expensive for it than depositors pay-out, such a strategy is typically more effective from a system-wide perspective.

[82] See European Forum of Deposit Insurers (n 35) 25.

[83] See Fernando Restoy, 'How to Improve Crisis Management in the Banking Union: a European FDIC?' (2019) CIRSF Annual International Conference on 'Financial Supervision and Financial Stability 10 Years after the Crisis: Achievements and Next Steps', Lisbon 4 July 2019, 4, <https://www.bis.org/speeches/sp190715.pdf> accessed 30 August 2020.

[84] See De Aldisio and others (n 81) 9.

composing the banking system, the interest of the DGS is the interest of the banking system at large.

Moving from this assumption, the 'least cost principle' should be rethought in light of the overarching interest of the system and without just considering the cost paid by the DGS in performing optional measures in the crisis concerned.[85] Therefore, the amount to be paid should be compared to the sum of direct and indirect costs for the banking system – and potentially for the real economy – arising from an atomistic liquidation.[86] In other words, disregarding the 'indirect costs' for the system would lead to a partial result which is not able to point out the best possible solution.

This reading of the rules, in turn, is in line with the rationale behind the DGSD, which clearly provides the possibility for DGSs to intervene by carrying out optional measures.[87] It would be irrational to provide such a possibility and then to introduce other rules in different legislative acts substantially hindering the performance of such measures. Furthermore, this is the very essence of the Financial Stability Board's 'Key Attributes of Effective Resolution Regimes' that require authorities to resolve FOLF banks without using public money, while avoiding the creation of negative systemic effects.[88] Given that the resources of a DGS are those provided by

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85 On this see European Banking Authority (n 45) 81, stating that 'There is a need to provide more clarity on how to assess that: the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS (as per Article 11(3)); the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned' (as per Article 11(6)). There is also a need for more clarity on what kind of costs should be taken into account in the abovementioned assessments (only direct or also indirect costs – and what costs constitute indirect costs), particularly because the current lack of clarity poses the risk that different authorities will take different approaches to the least cost assessment; such clarifications should be made in a legal product that provides sufficient legal certainty for DGSs'.

86 See European Forum of Deposit Insurers (n 35) 6.

87 According to recital 16 of the DGSD 'It should also be possible, where permitted under national law, for a DGS to go beyond a pure reimbursement function and to use the available financial means in order to prevent the failure of a credit institution with a view to avoiding the costs of reimbursing depositors and other adverse impacts ...'.

88 See Financial Stability Board (n 77) 1.

the banks, their use in handling crises should be facilitated on the grounds that otherwise the whole system, and thereby the public, could be negatively affected.

Accordingly, the scope of the least cost principle should be enlarged in order to enable the performance of system-wide driven solutions based on the DGSs' optional interventions, since, as it is, the legislative framework makes a strategy that is often not efficient (i.e. a piecemeal liquidation with the DGS's reimbursement of covered depositors), the only practically possible one. For this proposal to properly work without creating legal uncertainties, article 11, paragraph 3 and article 11, paragraph 6 of the DGSD should be amended by clearly spelling out how such a revised principle should be applied in practice, namely by stating which (direct and indirect) costs should be taken into account and compared with the amount of depositor pay-out.

The counterargument to this line of reasoning could be that a system-wide interpretation of the least cost principle would be either arbitrary and inaccurate or practically impossible. Nevertheless, in this regard it has been stated that even though the calculation of indirect costs would not be easy, still according to previous experiences these costs can be material. Therefore, a methodology to calculate them could be developed.[89]

In any case, if such a different and broader application of the 'least cost principle', aimed at taking into account the overarching interest of the system, was to be considered as practically impossible, then a more radical solution would be the abolition *sic et simpliciter* of the extension to the DGSs of the super priority in the exercise of their subrogation rights within the insolvency proceedings.[90] In substantive terms, the result would be the same, as DGSs would be allowed to also perform the optional measures under article 11, paragraphs 3 and 6 of the DGSD. Given that the interests of the

[89] In this regard, De Aldisio and others (n 81) 9, argue that 'even if it is more difficult to quantify these costs than it is to quantify direct costs, experience shows that they can indeed be material, as the history of crises is full of contagion episodes. It would not be overly difficult to identify a methodology to estimate these additional costs'.

[90] Ibid 8, arguing that 'to broaden the number of cases in which the DGS may carry out alternative interventions, the super-priority rule could be eliminated for subrogated DGSs (it could still be applied to insured depositors)'.

system and the interests of DGSs are equivalent, the latter should not raise any opposition to such a legislative amendment, which, in turn, would align the EU regime with the US one.[91]

VII. Concluding Remarks

DGSs are a fundamental component of the banking system safety-net. They play a pivotal role in maintaining financial stability since they are an *ex-ante* form of protection for depositors, who, due to them, have the guarantee to get their covered deposits back in any case. Accordingly, their presence is in itself instrumental to keep depositors' confidence in the system and, consequently, to maintain its stability. Their essential purpose is the performance of the pay-box function that, as such, needs to be included in the bank crisis management legal framework. Yet, the optional functions (i.e. the implementation of alternative measures aimed at preventing a bank's failure and the provision of financial means in the context of liquidation aimed at preserving access of depositors to covered deposits) might be even more effective, from a system-wide perspective, in maintaining financial stability and reducing the destruction of value potentially resulting from a piecemeal liquidation procedure, than the pay-box function.

In this regard, the possibility for a DGS to intervene in the face of the first symptoms of a crisis can turn out to be particularly effective to avoid that the latter further escalates by getting out of control. In fact, many banking crises, still at an early stage, can be more efficiently handled through a DGS intervention aimed at helping the restructuring of the institutions concerned. Likewise, the ability of DGSs to provide financial assistance in the context of a bank's liquidation might render this process orderly and effective. That is why the role of DGSs should not be limited to just performing the pay-box function. In this regard, moving from the analysis of the effectiveness of the optional functions in some Member States and relying on empirical data resulting from surveys conducted by EFDI and EBA, this paper has advanced the argument that the implementation of the optional functions should not be hindered, but rather facilitated. In this vein, each EU Member State should be encouraged (indeed required) to transpose

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[91] See Restoy (n 83) 4.

in its domestic framework the provisions under article 11, paragraphs 3 and 6 of DGSD regulating the DGSs optional measures in order for them to be empowered to carry out such functions at the early intervention stage as well as at the liquidation stage.[92]

Still, since currently the implementation of both these functions in the Member States is hindered by a number of legislative obstacles, this paper, after analysing the legal regime in place, has advanced some reform proposals aimed at removing them. Accordingly, with regard to the state aid framework, this paper has argued in favour of a revision of the 2013 Banking Communication rules aimed at ensuring that the optional functions implemented by those DGSs that comply with the least cost principle do not qualify as state aid measures, regardless of their governance arrangements and decision-making process. In this way, the risk of different treatments depending on the legal structure of the DGS would be removed and it would also be possible to resolve the friction between article 11 of the DGSD, the 2013 Banking Communication rules and article 32 of the BRRD, stating that the provision of extraordinary public financial support would make the bank FOLF. Indeed, if such measures no longer qualify as a state aid provision, their implementation will not cause the recipient bank to be considered FOLF and therefore the DGSs intervention, as regulated under article 11 of the DGSD, could successfully take place. Such a review would also permit a deviation from the mandatory implementation of burden sharing measures, which in some cases might be counterproductive.

In relation to the extension of depositor preference to DGSs and the least cost principle, by contrast, this paper has supported a rethinking of the principle, bearing in mind the overarching interest of the system and without just considering the cost paid by the DGS in performing optional measures in the crisis concerned. To do so, the amount to be paid to reimburse covered depositors should be compared to the sum of direct and indirect costs for the banking system – and potentially for the real economy – arising from an atomistic liquidation. Such an approach would enable an implementation of

[92] See European Forum of Deposit Insurers (n 35) 24, arguing that some EU Member States did not transpose into their domestic legal systems the provisions of Article 11 paragraph 6 of the DGSD due 'to the rigidity of the existing court-based insolvency proceedings'.

the most effective solutions from a system-wide perspective in terms of both keeping financial stability and reducing the destruction of value potentially arising from atomistic liquidation procedures, thereby leading to the adoption of a new bank crisis management paradigm. Such a new bank crisis management paradigm would be the result of empowering DGSs both to intervene in the face of the first symptoms of a crisis, thereby preventing it from escalating, and to provide financial support in the context of a liquidation ensuring, in this way, that it is orderly and effective. This, in turn, could also pave the way for the establishment of a European Deposit Insurance Scheme (EDIS), with a centralised decision-making at European level and funding sources mutualised within the Banking Union.[93]

[93] On the European Deposit Insurance Scheme, see Dirk Schoenmaker, 'Building a Stable European Deposit Insurance Scheme' (2018) 4 Journal of Financial Regulation 314.