

A blueprint for the CMDI framework review

Moving towards EDIS

- **EDIS as end-goal:** In any reform of the crisis management and deposit insurance (CMDI) framework in Europe, the priority must be the completion of the Banking Union (BU). The European Deposit Insurance Scheme (EDIS) is indispensable to enhance financial stability, to overcome the sovereign-bank doom-loop and to avoid financial fragmentation in the BU. As long as we do not have a fully-fledged EDIS, the originally envisaged third pillar, the BU will remain incomplete and therefore still exposed to financial stability issues. In combination with the SRF, EDIS would also significantly increase the firepower and agility to deal with ailing banks in a consistent and efficient manner under the second pillar. A transition from the current national DGS systems to EDIS could be achieved in 5 years, with an initial degree of mutualisation (e.g. 20%), and gradually centralising funds to reach full mutualisation.
- **Moving towards the steady state:** We appreciate the need to achieve gradual progress and political compromises to overcome the existing deadlock¹. This is why the CMDI review should enshrine the hybrid model of EDIS into law, but with a time-bound transition period (e.g. 5 years) towards the steady state, i.e. full mutualisation. If this is not the case, we risk finding ourselves in a never-ending transitional period that could de facto perpetuate the national management of most banks' failures, potentially resulting in further diverging national solutions. This could leave not only the third pillar, but also the second pillar, incomplete and would ultimately lead to a more fragmented BU (and banking market) and exacerbate the bank-sovereign doom-loop.
- **Governance and SRB role:** In the steady state, the SRB should act as the central authority with powers to manage all bank failures in the BU, handling both EDIS and the SRF (which could eventually be merged to exploit economies of scale). In the interim period, the SRB could: (i) use, in particular, transfer tools at BU level (the combined use of SRF-DGS could be explored) to find potential acquirers, maintaining the franchise value of failing banks under the SRB's remit; and (ii) play a coordinating role (which would increase step-wise) in the application of national DGS alternative measures. The latter role would ensure the consistent use of a stringent and harmonised least cost test (LCT), and that ailing banks ultimately exit the market, minimising the overall costs for the system.

Main elements of the CMDI framework

- **The Public Interest Assessment (PIA):** Resolution is justified when managing a bank failure through regular insolvency procedures does not meet the resolution objectives to the same extent. This is assessed through the PIA. The SRB is enhancing its PIA analysis, and ensuring all relevant factors will be accounted for, in particular a system-wide stress scenario. This might expand the number of banks falling under resolution tools. The current expectation (in resolution planning) is that **nearly all banks under SRB direct remit will have a positive PIA**. However, this is

¹ The letter of the President of the Eurogroup to the President of the European Council of 4 December 2020 states, "a hybrid model, relying on the existing national deposit guarantee schemes, complemented by a central fund to re-insure national systems, emerges as the most promising avenue for further work".

not a set-in-stone expectation because the decisive PIA is carried out following the FOLTF declaration and takes into account the situation at that point in time.

- **Banks with positive PIA – resolution:** To be resolvable, banks must fully incorporate the guidance developed in the SRB Expectations for Banks (in all its resolvability dimensions) and **build up the necessary MREL levels to support the implementation of the resolution strategy**. This is important not only for bail-in but also for transfer strategies, which can be suitable solutions to resolve, in particular, small-to-medium-sized banks with positive PIA.
- **External funds:** When it comes to the use of funds external to the banks, the SRMR-BRRD includes two possible sources of additional funds in resolution:
 - 1) Use of the SRF, which for capital support is subject to the 8% TLOF bail-in requirement; this may prove too high a hurdle for some small-to-medium-sized banks (without bailing-in sensitive liabilities such as certain non-covered deposits, thereby potentially reducing franchise value and thus undermining the chances of success in a transfer strategy).
 - 2) Using DGS funds, as per Article 79 SRMR and Article 109 BRRD; however, the super priority of DGS makes it de facto unrealistic to use DGS funds in resolution.
- **Use of DGS in resolution:** The use of the SRF in resolution, both for capital and liquidity support, is possible in accordance with the conditions set out in the SRMR, as the Eurogroup² has recently recalled. In contrast, as noted above, use of DGS funds in resolution is severely restricted by the rigid conditions set out in the SRMR. A review of such conditions seems warranted. The way forward to facilitate the use of DGS funds in resolution is to remove their super priority and adopt a general depositor preference³. Together with a stringent and harmonised LCT, including relevant quantifiable costs⁴, this revised framework would enable a more open-ended test of whether the use of DGS funds to support an SRM-wide transfer strategy is less costly than the DGS paying out deposits. This would help to achieve all the resolution objectives, including minimising the use of public funds, and avoiding further value depletion. Also, one could explore the feasibility of the suggestions made from some stakeholders to use DGS funds to bridge the gap until use of the SRF is possible (e.g. using DGS funds where necessary to reach the 8% TLOF for capital support), or the DGS receiving SRF liquidity support where needed.

Ensuring access to funds in the resolution of small-to-medium-sized banks with positive PIA through the DGS could facilitate the use of transfer strategies and entail a more consistent and predictable management of these bank failures. The DGS would contribute to resolutions in a way comparable to other creditors, in accordance with the creditor hierarchy. While this would likely be a limited contribution, given the DGS would continue to rank above most creditors (even without super-priority), it aligns to the broader responsibilities of the DGS in subrogating to the rights of the covered depositors.

² The Eurogroup Statement of 30 November 2020, paragraph 1 and footnote 14.

³ This would de facto imply a subordination of senior debt to all deposits, reducing potential NCWO risks.

⁴ Such as present values of DGS, fees.

- **Banks with negative PIA – liquidation:** Most banks in the BU (in terms of the individual number of licenced banks) are small entities (small LSIs) and are likely to be liquidated under normal national insolvency proceedings (NIPs). However, the latter are often ill suited for bank failures. They vary widely across Member States (MS), leading to different outcomes and low predictability. Thus, there would be value in some harmonisation of administrative liquidation procedures, allowing for the transfer of covered deposits in the context of NIPs, as some MS have already adopted in line with Article 11(6) DGSD. This should not be designed in a way that perpetuates the national management of banking crises: it would otherwise not be an effective transitional measure and it could well undermine the progression to a steady state with centralisation of funds (EDIS) and governance (i.e. national “resolution-like” powers and use of national funds would become the norm). Rather, a degree of harmonisation of alternative measures, including for the LCT(s) and removing EDIS/DGS super-priority, should be introduced in parallel with the progressive mutualisation of DGS funds and centralisation of governance.
- **Governance:** During the transitional period, clear governance arrangements within the SRM need to be implemented, to ensure that the SRB (plus NRAs) and DGS work jointly to use DGS funds in the most efficient way in resolution, or when supporting alternative measures. The latter would be harmonised in the transition period and then progressively centralised in parallel with the move to EDIS in the steady state. More concretely, for the interim-period:
 - **In resolution:** the SRB would be supported by DGSs and NRAs in the preparation for transfer of assets and liabilities, e.g. via partial sale of business.
 - **Outside resolution:** the SRB’s role would increase stepwise and progressively to a central role in the application of DGS alternative measures, ensuring the consistent use of a harmonised LCT, and that ailing banks ultimately exit the market minimising the overall costs for the system. In addition, the CMDI framework could replicate the powers currently available (in resolution) to manage the failure of LSIs also in liquidation⁵. This is why the SRB needs to play a strong coordination role from the beginning: to avoid ending up with a myriad of national solutions to banks’ crises, which undermine the overall consistency of the framework (possibly at the expense of the public purse).

National authorities would benefit from this design because: (i) removing the DGS super-priority enables a more efficient use of DGS funds, both in resolution and through alternative measures (and particularly if the Banking Communication is updated and aligns the uses of the DGS); (ii) gaining access to a DIF under the hybrid EDIS (increasing overall firepower even in the interim period); and (iii) reaching a fully mutualised EDIS as soon as possible (as end-state).

- **In the long term,** both resolution and liquidation powers would be combined at BU level, with the SRB (and SRM) having a powerful toolkit (resolution for banks with positive PIA, EDIS for pay-outs and alternative uses of DGS funds) at its disposal and a single fund (SRF+EDIS), leading to efficiency gains and a much more competitive Banking Union.

⁵ As per Article 7.4 SRMR, enabling the SRB to exercise directly relevant powers where necessary to ensure a consistent application.

- **Banking Communication update:** The transfer of assets and liabilities and liquidation of a bank cannot be, in principle, more expensive to taxpayers (and therefore cheaper for the bank's creditors) than the uses of DGS or SRF for similar purpose (in resolution or alternative measures). This would otherwise provide wrong incentives, e.g. for potential bidders, and escape avenues. Therefore, updating the Banking Communication and aligning it with the BRRD/SRMR should be an urgent priority of the CMDI review. This is essential to support the above-mentioned features of a revised toolkit, to ensure liquidation aid becomes a truly residual tool (e.g. for very small entities), and ultimately to minimise the use of public funds.

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