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***Deposit guarantee schemes and crisis  
management: challenges arising from the actual  
EU legal framework***

***Bank resolution in times of COVID-19***

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## ***No one ever said it would be this hard...***

- The covid-19 crisis
- The role of banks in keeping the real economy afloat
- Potential further losses in the near future (weak banks, npls)
- ***Resolution is for the few, not the many***
  - LSIs and SI not subject to resolution will have to be liquidated through the not-yet-harmonized applicable national insolvency procedure
  - The role of DGSs

## *Oh take me back to the start...*

DGSs play a fundamental role in the financial safety net in three ways

- 1) they prevent bank runs by assuring depositors they will have immediate access to their insured funds even if their bank fails (deposit pay-out)
- 2) they avoid banks' disorderly liquidation through a variety of measures (capital support, guarantees, etc)
- 3) they provide financial support to solutions ultimately aimed at preserving depositors' access to covered deposits in the context of insolvency proceedings finance (through transfer of assets and liabilities and deposit book transfer)

These 3 functions are replicated in the Directive 49/2014 (DGSD)

### **1) Compulsory measures** (Article 11(1)(2))

- deposit payout in liquidation + resolution financing (fictional payout)

### **2) Preventive measures** (Article 11(3))

- Aimed at avoid liquidation/resolution + least cost criterion

### **3) Alternative measures** (Article 11 (6))

- only liquidation + least cost criterion

## DGSs mandate

DGSD allows 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 (see recitals 3 and 16 DGSD)

### **Legal constraints arising from the current regime (DGSD+BRRD+ Banking Communication 2013) – two types**

#### **1. State aid rules**, which affect in turn

- ✓ status and/or governance structure of DGSs
- ✓ DGSs' intervention and the FOLTF assessment

#### **2. Super priority rule coupled with the least cost criterion**

# State aid rules and the governance of DGSs

**The Tercas case - EC, State aid SA.39451 + General Court Joined Cases T-98/16, T-196/16 and T-198/16 + Opinion Advocate General Tanchev 29.10.2020**

EC → DGS's interventions other than payout constitute a state aid when

a) the State has the power to control the DGS and/or to exercise a dominant influence over its decisions and operations (*imputability to the State*) → *the organizational and decision-making independence of a DGS, never deemed relevant by the EU law, is nowadays a condition for using preventive measures;*

b) The DGS's resources are deemed public based on

- compulsory membership
- contributions are «mandatory and determined by law up to a predetermined level»

➡ despite the fact that the DGS is private and financed by its members



- DGSs are bodies imposed by EU law to the twofold goal of protecting depositors and financing resolution + preventive and alternative interventions, where permitted under national law
- Membership and contributions are imposed by EU law

## Running in circles: the FOLFT assessment

EBA (2020) [t]he EU framework should be clarified to the effect that the use of DGS funds in line with Article 11(3) does not in itself cause the determination that the institution is failing or likely to fail...



**Art. 32(4)(d) BRRD:** *an institution shall be deemed to be failing or likely to fail when an « extraordinary public financial support is required»*



Then, if the use of DGS funds for failure prevention are considered an “extraordinary public financial support”, the preventive measures – even worse, the proposal to undertake them -, paradoxically require the authorities to deem that the institution is failing or likely to fail



two alternatives (Article 32.b, Directive 2019/879):

- resolution (the 4 Italian banks) when applicable...



- (disorderly) liquidation....






## Constraints resulting from the least cost principle (financial cap) and the super priority rule



- **Preventive measures** – cap: «the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS» (Article 11(3)(c) DGSD)
- **Alternative measures** – cap: «costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned» (Article 11(6) DGSD)
- **super-preference of covered deposits (Art. 108(1)(b) BRRD)**: insured depositors are preferred to any of the bank's other unsecured creditors in the creditor insolvency hierarchy
- **if insured depositors are reimbursed, the DGS subrogates to the right of the insured depositors against the liquidation procedure with their same super-senior status (Art. 9(2) DGSD)**

### Effects

1. It is widely accepted that the combination of the above rules, significantly hinders the implementation of alternative measures by a DGS, due to the potential high recovery rate in the bank liquidation....and  

2. also reduces the amount of the DGS contribution to resolution (**Art. 109(1)(5) BRRD**): «the liability of the deposit guarantee scheme shall not be greater than the amount of losses that it would have had to bear had the institution been wound up under normal insolvency proceedings»

## Some proposals

1. Replacing the current super-priority of covered deposits with a general depositor preference: covered and non-covered deposits rank senior to other liabilities, but *pari passu* with each other ➡➡ problem of financing the sale of business of banks with large amounts of uncovered deposits
2. Increasing the deposit insurance threshold (from 100,000 to 200,000 euros)
3. Relaxing the method of assessment of the least cost: the indirect costs

**Legal base** ➡ **Art. 11(3)(6) and recitals 3 and 16 DGSD:** *«it is desirable not only to make provision for reimbursing depositors but also to allow Member States sufficient flexibility to enable DGSs to carry out measures to reduce the likelihood of future claims against DGSs»* (recital 3), aimed *«to prevent the failure of a credit institution with a view to avoiding the costs of reimbursing depositors and other adverse impacts»* (recital 16)

**Indirect costs:** *«the costs of the failure of a credit institution to the economy as a whole and its adverse impact on financial stability and the confidence of depositors»* (recital 3)



## Concluding remarks

- A rigorous application of the State aid discipline does not seem appropriate in the case of use of DGS funds because it prevents them from fulfilling their traditional function of preventing and managing banking insolvency
  - ➡ amendment of the BC 2013 differentiating among DGSs with public and private legal status and/or governance structures
  - ➡ It's desirable for the ECJ to reform both the EC and the General Court decisions, stating that no State aid is granted when the resources come from private banks, due to obligations (DGS membership and financing) imposed by EU law, and not by the Member States
- BRRD: it is necessary to distinguish between “extraordinary public financial support” and “use of DGS funds”, clarifying that the use of DGS resources for interventions other than pay-out would not itself cause the FOLTF assessment
- Financial cap + super priority rule: It's recommended (*inter alia*) a broad flexibility in the least cost assessment: possibility to consider direct and indirect costs