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CMDI reform: What are the implications for depositors?

Reflecting on impacts of bank crisis management reform

Some savers and investors can lose money when a bank fails. The recent proposal for a reform of the EU bank crisis management and deposit insurance (CMDI) framework changes how bank resolution authorities have to treat deposits and how deposits rank in insolvency relative to other claims. These changes may significantly alter outcomes for uninsured depositors. They are not all straightforward and this briefing tries to parse them and their implications systematically.

When a bank fails, European law protects most depositors up to an amount of 100.000 euro. This applies irrespective of whether the failed bank ends up in insolvency proceedings or resolution. Above this amount, deposits may take losses, as may the unprotected deposits from financial and public entities. This happens when losses exceed equity and debt ranking below the deposits.

There are important trade-offs to consider around losses for uninsured depositors. On the one hand, such losses may simply be what results when liquidating or resolving an over-indebted bank. Uninsured deposit can also, as other liabilities, help absorb losses, facilitating the resolution of a failed bank so that its critical functions can continue to operate for the benefit of the wider economy when equity and subordinated debt are exhausted. Moreover, the risk of such losses may make uninsured depositors prudent, giving them incentives to monitor the risks of banks and requiring higher interest from riskier banks or eventually withdrawing deposits from them, which in turn might discipline bank management to avoid excessive risk. Finally, avoiding losses for depositors will typically imply someone else bearing the loss instead.

On the other hand, such losses impose hardship on households and firms, and may be disruptive to their lives and plans. Individuals without regular income might finance their livelihood out of larger deposits and firms may rely on larger deposits for payroll and other larger future payments. Losses on one bank's deposits with another bank might spread trouble across the financial system. Rapid deposit withdrawals might be

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triggered by unfounded concerns and spread to the wider banking system if banks and public authorities cannot re-instil confidence.

There are thus reasons for and against letting uninsured depositors take losses. The current legislation grants a privilege to deposits of up to 100.000 euro. According to recital 21 of the Deposit Guarantee Schemes Directive, this limit seeks to balance, on the one hand, the protection of smaller depositors and a reasonable overall coverage of deposits to protect overall financial stability with, on the other hand, the cost of the deposit protection. It may for instance be argued that owners of larger deposits are wealthier, can more easily diversify their deposits across banks and are more able to monitor the solvency of banks, thus being more able to avoid bad surprises. One might also think those depositors are less of a stability risk if they are more financially literate and do not suddenly withdraw deposits for unfounded concerns. In addition, a harmonised level of deposit protection across the single market supports a level playing field.

However, this compromise in legislation may not fully reflect political preferences in actual bank failures. As we discussed here, for instance the Italian government, in the case of the Veneto banks, found the outcome of limited depositor protection politically unacceptable at the time. Notably, in the same case, the government extended protection beyond deposits to other senior creditors.

Against this background, the present briefing seeks to evaluate the impact of the proposed reform on depositors.

Key changes for depositors

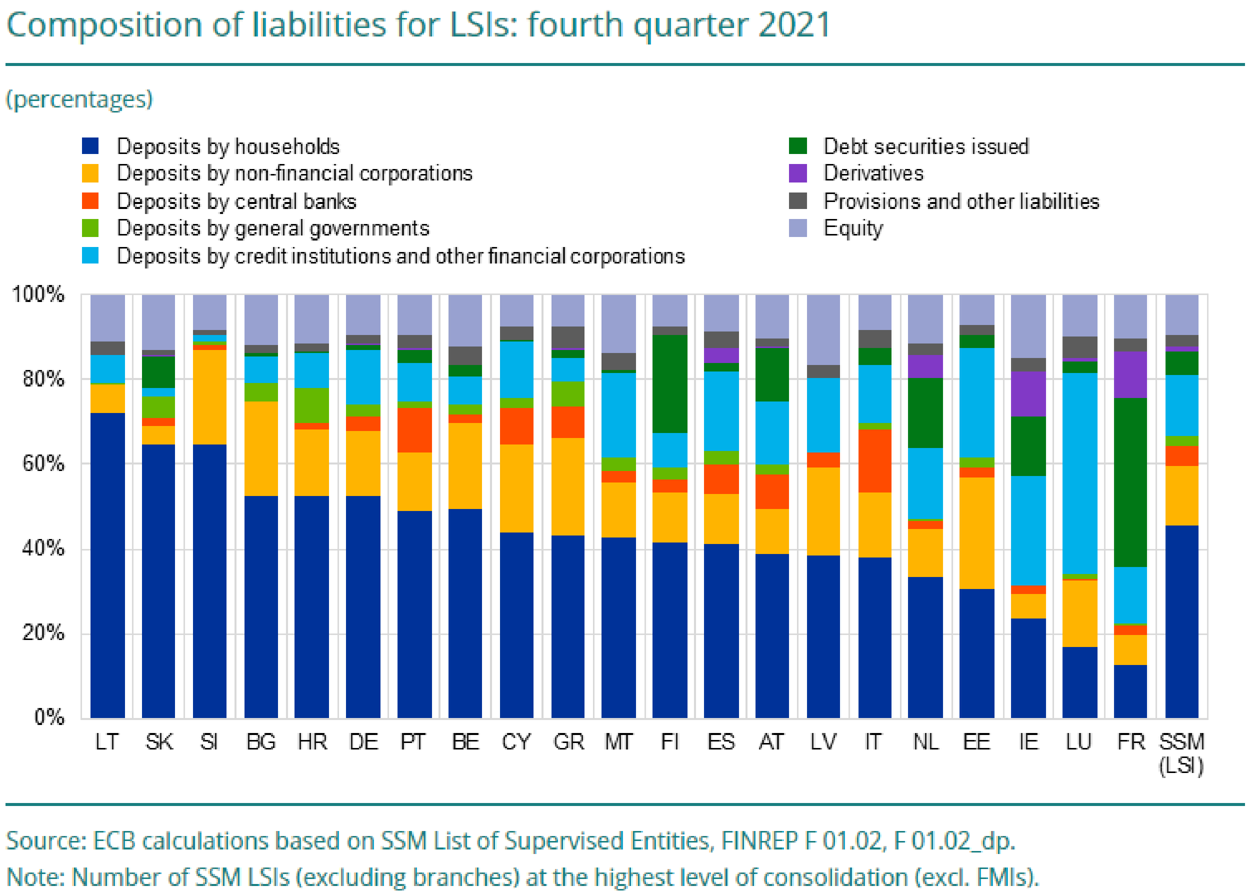
"The proposal facilitates the use of deposit guarantee schemes in crisis situations to ***shield depositors*** *(natural persons, businesses, public entities, etc.) from bearing losses,* ***where this is necessary to avoid contagion to other banks*** *and negative effects on the community and the economy."* This is how the European Commission introduces in its press release the first objective of its proposals to reform the bank crisis management and deposit insurance framework. Accordingly, improved depositor protection should not be an end in itself but should be conditional on wider financial stability concerns in the case of a specific bank. Taken literally, uninsured depositors could thus only count on protection if the failure of their bank risks dragging other banks along - for instance, because their bank is particularly large or interconnected.

In its proposals however, the Commission **makes general depositor protection a resolution objective in its own merit**,[1] while so far, only the protection of insured depositors is. This change could be consequential in two respects. First, the resolution authority should now resolve a failing bank if it thinks that uninsured deposits are not at least as safe in insolvency as they are in resolution.[2] Second, today uninsured deposits are part of the debt that could be written down in resolutions to absorb losses. Going forward, the resolution authority would be required to specifically protect uninsured depositors when resolving a bank and would hence need to force the losses on someone else (e.g. the deposit insurance fund).

[1] See Article 14(2)(d) in the proposed amendments of the SRM Regulation.

[2] Note that currently, the public interest test privileges insolvency when it can satisfy the resolution objectives as well as resolution. The proposals turn this around so that resolution is privileged unless insolvency leads to a better outcome. See this briefing.

Figure 1: Funding structure of small and medium-sized banks in the Banking Union



Source: ECB LSI Supervision Report 2022

As a further change, all deposits are proposed to receive a **preference in insolvency over other senior debt**, while currently, only depositors that enjoy insurance have such preference. At the same time, the insolvency ranking of all deposits is aligned, while currently, insured depositors' claims rank before those of the uninsured.

Beyond these changes that directly concern depositors, the general aim of the proposal is to extend the scope of resolution as opposed to national insolvency procedures when a bank fails (please see this briefing for a detailed discussion of how this is done). **Extending resolution chiefly means to apply it more often to smaller and mid-sized banks.** As figure 1 shows, subject to some wide variation, those banks are on average predominantly funded by deposits. They may also have less access to capital markets funding than larger banks. In tendency, that makes bank resolution without imposing losses on depositors more challenging since quite simply more deposits are exposed to losses. Or, in order to enable the resolution of more and predominantly deposit-funded banks, additional funding sources are needed to shield depositors from losses. We will discuss this important interaction between depositor protection and the wider objectives of the reform when we look into the **funding of extended depositor protection**.

Depositor protection as a resolution objective

Introducing a new resolution objective has two effects. It gives an **additional reason for resolution** and **it shapes the actions of the resolution authority**. We will look at these effects in turns. Overall, it appears that the depositor protection as a resolution objective would mean that **the resolution authority has to act when depositors' interests are at risk and will have to privilege resolution plans that allow uninterrupted access to deposits**.

Additional reason for resolution

The Single Resolution Board is required to act if it is necessary to achieve the resolution objectives and if the objectives of resolution cannot better be met by national insolvency proceedings.[3] Since depositors often rely on a timely availability of their money, a need to protect them may arise if there is a risk that the bank cannot readily pay out the deposits for a lack of liquidity or for a stay of payments when insolvency procedures are opened. Action to protect the depositors can also be necessary if the losses of the bank are so large that depositors cannot be repaid in full anymore by the bank. Once the authorities have found a bank to be failing or likely to fail, the resolution authority would have to assess *inter alia* if resolution is necessary to protect depositors. Generally speaking, that is likely to be the case: the only possible alternative to resolution are insolvency proceedings once the bank has failed. In insolvency proceedings, insured depositors can rely on more or less uninterrupted access to their money. **However, for uninsured depositors, they are likely to lead to disruptions.**[4] **In other words, resolution may be more likely going forward whenever deposits at a failed bank are at risk**.

Shaping resolution action

Once the authority has decided to resolve the bank, the resolution objectives will also shape the actions the authority will take. **Under the current legislation, the authority would be free to choose a resolution strategy that imposes losses on uninsured depositors if it is helpful for achieving other resolution objectives.** For instance, in order to ensure the continuity of critical functions, the authority could sell the business of lending to SMEs to another bank at a discounted price, while satisfying the claims of uninsured depositors and other creditors out of the sales proceeds - to the extent possible. The funds available would be distributed to creditors in function of their ranking in a hypothetical insolvency, which, under current legislation, means that depositors from the public sector and financial firms take the same loss as senior creditors, while private sector depositors have a privilege over them for the uninsured part of their deposits.

Under the Commission proposal, **the resolution authority appears to be required to opt for a resolution strategy that protects depositors**. Since depositor protection and other resolution objectives are proposed to have the same weight going forward, the authority should seek to reconcile the other resolution objectives, such as the continuity of critical functions, with an uninterrupted access to the deposits. One way to do this could be to recapitalise the bank by writing down sufficient non-deposit liabilities. Writing down liabilities means imposing losses on others, which is not only highly controversial, but as such it is not a cure for a broken business model. Alternatively, **the resolution authority could try to find a buyer for the critical functions that is also willing to assume the failing banks deposit liabilities**, **thus ensuring uninterrupted access to the deposits.** In the best case, this merely means a lower purchase price, reduced by the value of the deposit liabilities, while imposing a consequentially larger loss on the remaining liabilities. The larger the deposit liabilities are, and the larger the losses in the critical functions - say, in the loan portfolio - are, the more likely the purchase price is to effectively turn negative. When it gets to this point, the resolution authority will have to pay the buyer or otherwise support him,

[3] Note that currently, the legislation requires that resolution achieves the objectives better than insolvency, whereas going forward according to the Commission's proposal, it should suffice that resolution is not the worse of the two solutions.

[4] At least unless national authorities would act specifically to protect depositors in insolvency. They would however arguably have to use public funds to that end, which in itself is a reason to start resolution procedures, see here.

which requires external funding. We shall look into the issue of funding after considering further proposed changes that concern the treatment of deposits in insolvency.

An ambiguity might stem from the conditions of the bail-in tool. These remain unchanged by the Commission proposal. If the resolution authority wishes to write down or convert liabilities in order to recapitalise the bank and make it viable again, it is only allowed to spare uninsured deposits subject to certain conditions. Namely, it can exempt liabilities from bail-in if bail-in cannot be realised in good time for those liabilities, when there is a risk either to the continuity of critical functions or to financial stability, or when bail-in results in a disproportionate destruction in value. How can this be married with the resolution objective of depositor protection? One way forward would be to **avoid bail-in and privilege the sale of assets and deposit liabilities whenever bail-in would not allow sparing deposits**. On the one hand, this deprives the resolution authority of one possible resolution strategy, on the other hand, it gives a natural preference to resolution strategies that take the failed bank off the market as a stand-alone competitor (although its production capacity might remain) while keeping its critical functions and deposits whole.

A single preferred bankruptcy treatment for all depositors

Under the current legislation, **Member States are required to respect certain privileges for some deposits**, but not for others, in their insolvency laws. In particular, depositors eligible for the deposit guarantee rank before other senior debt. The part of their claims up to 100.000 euro, which is covered by the deposit guarantee, enjoys a yet higher preference. In practice, this means that the deposit guarantee scheme has to be reimbursed first in insolvency since it inherits the claim of the depositors that it has reimbursed. The money that is left first reimburses the insured depositors for the part of their deposits that exceeded the 100.000 euro. And what is left thereafter goes to other senior creditors including the uninsured depositors at equal terms.

The Commission now proposes to **give a single preferred position to all depositors and the deposit guarantee fund**,[5] replacing the current hierarchy of claims among them. If a bank actually goes into insolvency despite the changes discussed in the previous section, its assets would be used to equally satisfy all depositors and the deposit guarantee fund. If the estate is insufficient to do that in full, those parties would all - to the extent not covered by the deposit guarantee - receive the same quota of their claims back. If it ever gets to this point, the position of the depositors excluded from the deposit guarantee scheme - essentially, financial firms and public sector entities - would be markedly improved compared to current legislation.

That improvement would come, however, at the expense of other senior creditors who currently rank at the same level as uninsured depositors and who would now lose everything before uninsured depositors lose anything. It would also be at the expense of the claims that were previously higher ranking than the excluded deposits. That is, if the resolution authority would not intervene and ensure that all deposits are assumed by another bank. In fact, since it appears resolution rather than insolvency is going to be the standard procedure going forward, **these changes would rarely come to bear in actual insolvency proceedings**. They are nevertheless important for how the Commission proposes to fund resolution in the future.

[5] See Article 108(1) in the proposed amendments of the BRRD.

How to fund extended depositor protection in resolution

Funding will be the key challenge for resolution strategies that protect depositors. Both the ability to recapitalise the bank and the ability to sell critical functions together with deposit liabilities hinges on the existence of sufficient non-deposit liabilities that can be written down. As Figure 1 suggests, the high share and variability of deposit funding among smaller and medium-sized banks can mean that additional funding from external sources will be needed. In the Banking Union, the Single Resolution Board has the Single Resolution Fund at its disposal for this purpose. **Access to the resolution fund is thus more likely to be needed when depositor protection is a resolution objective than when it is not.**

However, there is a legal limit on the access to the Single Resolution Fund and the Commission does not propose to change that. It requires that 8% of the own funds and total liabilities of the failing bank are bailed-in before the fund can be used. **Conversely, if - at the point of failure - the sum of remaining equity and non-deposit unsecured liabilities is less than 8%, an alternative source of funding is needed.** Without that, the revised legislation would give the resolution authority an expanded mandate without the means to fulfil it. This would result in ambiguity as to whether the resolution authority would have to compromise on some of the resolution objectives or step back from resolution altogether since the mandated "correct" resolution approach could not be implemented.

The idea of the Commission is that **the resolution authority could tap the respective national deposit guarantee scheme**. **The proposal requires the deposit guarantee scheme to contribute**…[6]

a) …to a **resolution through bail-in**: the liabilities of the failed bank are extinguished by the resolution authority to an extent that is necessary to make the bank well capitalised and viable again. In this case, **the deposit guarantee scheme would have to pay an amount corresponding to the covered deposits that would have to be extinguished** to this end, observing the priority order in insolvency.

b) …to a **resolution that involves a sale** of some or all of the bank's business: the buying bank may have to be compensated for assuming the deposit liabilities of the failed bank, which may exceed the value of the assets and thus lead to a negative purchase price. In this case, the deposit guarantee scheme would pay **the difference between deposits and the assets that are transferred** plus, if necessary, an amount that neutralises the impact of the transaction on the buyer's capital.

As to point b) the proposal is somewhat ambiguous regarding **whether the obligation of the deposit guarantee scheme covers all deposits or only the insured deposits**. This is quite a **material question** as it makes a difference, on the one hand, for the finances of the deposit guarantee scheme and, on the other hand, for the resolution authority to be able to attain the resolution objectives. In this regard, the proposal sets out a **special case** when the scheme is clearly obliged to fund the transfer of all deposits: that is, when there are **important reasons beyond depositor protection** for transferring uninsured deposits, such as an imminent risk of contagion to other banks. In the **general case**, however, when such reasons are not given, the scheme is still obliged to fund the transfer of covered deposits "and other liabilities of the same or higher priority ranking". Since all deposits have the same ranking, this obligation might in our reading also include uninsured deposits. However, the construction of the text with a special and a general case suggests that it may be intended to limit the obligation of the deposit guarantee scheme in this general case. The question to consider then is if and how the resolution authority should fund a transfer of uninsured deposits without the scheme's contribution and whether resolution rather than insolvency would go ahead at all if not.

[6] See Article 109(1) in the proposed amendments of the BRRD.

Consistent with the general principle that no creditor should be worse off in resolution than in insolvency, **the contribution of the deposit guarantee scheme is limited to the hypothetical loss that the scheme would make in insolvency**. Notably, the payment obligation - i.e. the amount determined under point a) or b) above - of the deposit guarantee scheme is determined by the resolution authority, while the **limit or cap is determined by the deposit guarantee scheme itself**.

The **changes to the bankruptcy treatment of deposits** will only rarely have an effect in actual insolvency procedures if the resolution authority steps in, pursuing the resolution objective of depositor protection. However, they do **have their actual meaning and impact in resolution**, which is twofold:

First, the changes **subordinate senior unsecured debt to deposits from the financial and public sectors**, while both currently rank *pari passu*. This means other senior debt can be bailed in while leaving deposits untouched, supporting either the recapitalisation of the bank or absorbing some of the compensation for the buyer who assumes the deposit liabilities. Essentially, **senior unsecured liabilities would absorb some of the cost** of keeping depositors from harm.

Second, the changes **put all deposits at the same position in insolvency**. This **alleviates the constraint of the least-cost-test**. Since the deposit guarantee scheme would in a hypothetical insolvency share losses with other depositors, it will also be obliged to pay a correspondingly higher amount to the funding needs in resolution. Moreover, since the Commission's proposal defines the contribution as the difference between covered deposits and other deposits of the same ranking, the payment obligation is higher than without these changes.

Consequentially, the senior non-deposit liabilities and the deposit guarantee schemes directly solve a part of the funding problem. Then again, both funding sources have their limitations. The first depends on how much senior non-deposit funding a given bank has, considering that among smaller banks, deposit funding is predominant. As to the second, the limiting factor of deposit guarantee schemes' contribution remains the least-cost-test. Clearly, with the changes proposed the test will be less binding than before, but the deposit guarantee scheme is still limited to contributing some fraction of the insured or covered deposits, while the funding needs arise from the combined sized of insured and uninsured deposits. Thus, **the higher the share of uninsured deposits, the smaller will be the contribution of the deposit guarantee scheme** relative to the funding needs.

However, non-deposit liabilities and the deposit guarantee scheme do not have to solve the funding problem alone if their contributions are sufficient to reach, together with the remaining equity and any subordinated liabilities, the 8% threshold for access to the resolution financing arrangement. **If this is the case, any remaining funding needs could be fulfilled by the Single Resolution Fund.**

An interesting aspect of the proposal consists in the **interaction of the Single Resolution Fund and the national deposit guarantee scheme** of an individual bank. If the funding needs can be fulfilled by the funding from the deposit guarantee scheme without accessing the Single Resolution Fund, **the national deposit guarantee scheme becomes effectively the only resolution financing source**. And if access to the Single Resolution Fund in the individual case is possible, the national deposit guarantee scheme would nevertheless first contribute up to the amount it is obliged to. In a way, in resolution, the national deposit guarantee scheme becomes an additional resolution financing arrangement which mitigates the financing needs from the Single Resolution Fund, **moving the balance of resolution financing sources in tendency to the national level**.

Finally, it is possible that the sum of remaining equity, non-deposit liabilities and the contribution from the deposit guarantee scheme is insufficient to reach the threshold of 8% to access the Single Resolution Fund, so that the resolution still cannot go ahead as required for public interest purposes. The Box tries to illustrate the risk of such gap emerging. **The proposal of the Commission does not clarify what the resolution authority should do in such case of a "remaining gap".** Legally, it cannot simply stand back from resolving the bank since the public interest in resolution persists despite the lack of financing capacity. Nevertheless, **there is a certain risk that the resolution authority might leave the case to national insolvency authorities** if it cannot achieve an appropriate outcome; the resolution authority would in this case have to amend its assessment to demonstrate the absence of public interest. Notably, the proposed changes [make this more difficult](), on the whole. We consider that a risk for two reasons: First, the national insolvency authorities may not aim to achieve or may be unable to achieve the resolution objectives set by the legislator. Second, the national authorities might aim at the same level of continuity of critical functions and depositor protection, but may lack the European funding to do so and thus resort to local taxpayer money.

Box: Minding the gap

Take the extreme case of a bank funded completely by equity and deposits. At the point of failure, let remaining equity be valued at 3% of the total assets. It may turn out that the assets constitute "critical functions" and can be sold to a buyer for 90% of their book value. The buyer will therefore require 7% of total assets as compensation for assuming all deposit liabilities at face value.

The contribution of the DGS is capped at the hypothetical loss of covered deposits in insolvency, which the DGS has to estimate itself. For this purpose, the DGS might assume that also in insolvency, the assets can be sold for 90% of their book value, imposing a loss of 7% on all depositors. If 50% of total deposits are covered deposits, 3,5% of total assets would be the upper limit for the DGS' contribution to the resolution. However, taken together with 3% equity, this falls (just) short of the total funding need of 7% and also of the access threshold of the resolution fund at 8%. Would this gap mean that resolution cannot go forward?

Alternatively, **the resolution authority could seek additional funding from the outside**. Given the public interest in continuity of critical functions and deposit protection, other banks, collectively, or the local government may well be incentivised to help. And their incentives may be reinforced if resolution is the only legal way forward, so that national insolvency proceedings are unavailable in a given case. Government funding remains of course problematic in this context, and the CMDI framework obliges the resolution authority to minimise it. However, the resolution framework at least shows a clear path to reduce the government's role by bailing in non-deposit liabilities and involving the deposit guarantee scheme's contribution. In fact, **the role of government funding could be reduced** relative to national insolvency proceedings with liquidation aid if government funding only had to bridge a "remaining gap" to access the Single Resolution Fund. Such an intervention would nevertheless have to be authorised under the [State aid framework](); whether this is acceptable - in comparable ways as liquidation aid - would need to be clarified.

Concluding observations

The proposals of the Commission for CMDI reform leave the level of formal deposit guarantees largely unchanged at 100.000 euro and they continue the existing exemptions from deposit guarantees. Nevertheless, **depositors, including those currently excluded, could expect a largely extended protection** since general depositor protection would become a resolution objective and resolution is intended to apply more often. The proposal also goes a long way to ensure that there is funding for such enhanced protection. **Overall, it would reduce the risk that resolution authorities see a need to take action but shy away from doing so because of an unclear mandate or insufficient means.** Yet, the strengthened divide between depositors and other creditors may conflict with political preferences in some

Member States, keeping in mind that in past bank failures, governments have sought to protect also some senior non-deposit creditors from losses.

Despite the proposed enhancements of resolution funding, **some gaps may emerge in practice between the Deposit Guarantee Scheme's contribution and the threshold for access to the resolution fund**. Ultimately, they could open up surprisingly in individual bank failures and may be difficult to fill *ad hoc* if no advance planning is in place as to whether and how to fill them. It may necessary to do further research on the potential extent of such gaps. Moreover, it may be desirable to **clarify how the resolution authority should react** if a funding gap emerges that prevents it from reaching the resolution objectives.

Overall, **access to the resolution fund is more likely to be needed** when depositor protection is a resolution objective than when it is not. From the Banking Union perspective, an interesting element of the proposals is that it places **more responsibility for resolution funding at national level**. But the amount of funding needed from the resolution fund would be mitigated by mandatory contributions from the deposit guarantee schemes, financed by local member banks and with a national government backstop (a wider question, not covered here, is whether or to what extent the obligation of national deposit guarantee schemes to participate in resolution cases might deplete their funds and impinge on their capacity to fulfil their core mandate, protecting insured depositors).

The potential outcome of the proposed legislation consists of the *explicit* deposit guarantee on the one hand, and an extended *de facto* depositor protection on the other hand. Going down this route is a departure from harmonised depositor protection limited to 100.000 euro and thus deserves careful analysis in terms of any **impact on incentives for bank creditors**. First, there is a risk of distorting the **playing field among banks** if uninsured depositors perceive that they are likely to be better protected at some banks than at others. Second, bank creditors may **prefer deposits over other liabilities**. A possibly diminished market discipline over banks by larger depositors might also be an element worth considering in this context. Finally, one might **compare the proposed solutions with the one in the USA**, which *in theory* limits formal depositor protection to 250.000 USD but entails a systemic risk exception which allows the local deposit insurer to make all depositors whole out of the bank-financed deposit insurance fund in order to guard against adverse effects on economic conditions and financial stability. *In practice*, this exception has been used only a few times, but also when it has not been used, uninsured depositors in US banks hardly ever incurred losses.

The figure in the Annex provides a high-level illustration of the proposed reform. It is taken from the Commission's fact-sheet, enriched with clarifying comments

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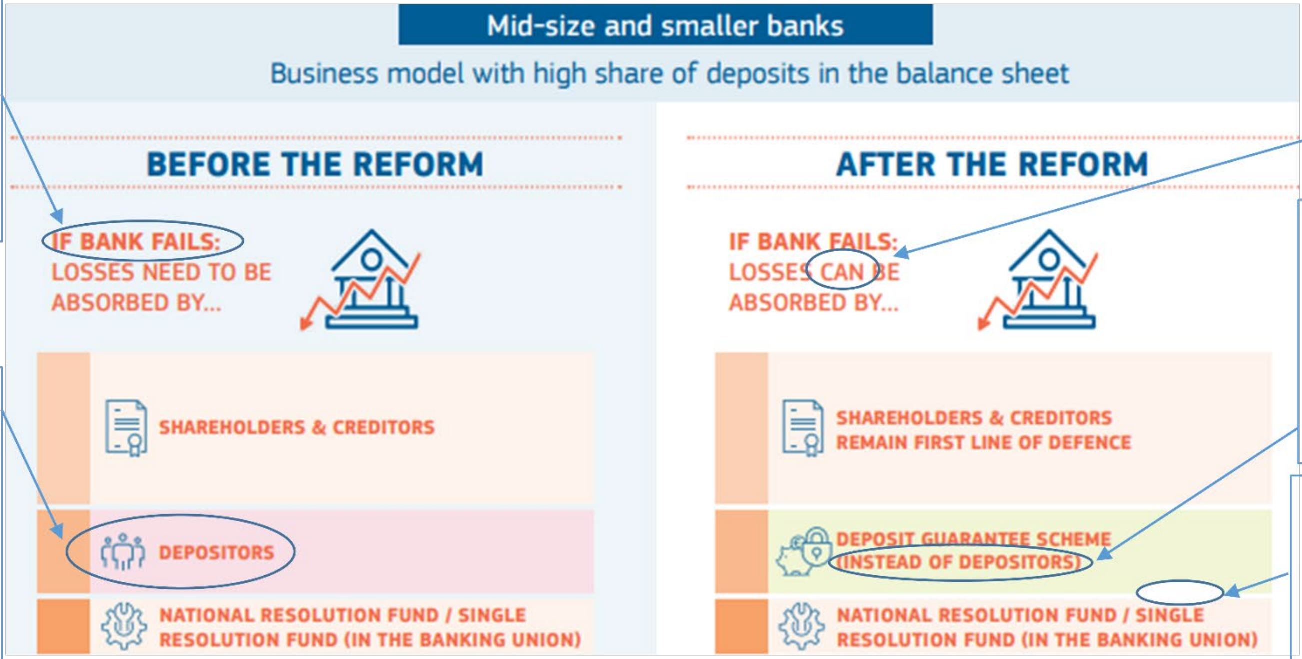
ANNEX: Commission's graphic presentation of the reform outcome (with comments added)

This seems to cover only resolution; bank failure can also lead to insolvency, where, different outcomes are possible, as evidenced in the Veneto banks' case

In any case, insured deposits do not take any loss today and the resolution authority can exempt deposits from bail in if necessary – and if funding is available.



The contribution from the deposit guarantee scheme is mandatory.

The contribution from the deposit guarantee scheme is limited to the amount covered depositors would lose in the absence of insurance.

There may still be a gap between the contribution from the deposit guarantee scheme and the 8% threshold for fund access.