Bank crisis management and deposit insurance

OVERVIEW

On 18 April 2023, the European Commission tabled a package of proposals to amend the bank crisis management and deposit insurance (CMDI) framework. The objective of the reform is to calibrate the latter so as to further deepen harmonisation and reduce the use of taxpayer funding. More specifically, the proposal for a CMDI reform would amend the early intervention procedure and the decision to resolve a failing bank in the public interest. It would also encourage the use of funding from national deposit guarantee schemes in resolution.

The package of proposals is being discussed by the European Parliament and the Council.


Proposals for a directive of the European Parliament and of the Council amending:
(B) Directive 2014/59/EU as regards early intervention measures, conditions for resolution and financing of resolution action;
(C) Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency;

Committee responsible: Economic and Monetary Affairs (ECON)

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Next steps expected: Publication of draft reports

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Ordinary legislative procedure (COD)

(A) COM(2023) 226,
(B) COM(2023) 227,
(C) COM(2023) 228,
(D) COM(2023) 229
Introduction

The EU regulatory framework for banks relies chiefly on three legislative frameworks addressing distinct areas.

- **Prudential framework**: designed to prevent banks' financial distress by imposing pre-emptive rules on them, for instance in terms of capital requirements to absorb losses on banking activities. The framework is set out in the Capital Requirements Directive (CRD, Directive 2013/36/EU) and the Capital Requirements Regulation (CRR, Regulation (EU) No 575/2013).

- **Supervisory framework**: addresses supervisory cooperation, seeking to harmonise the application of the prudential rules. The framework is set out in the Single Supervisory Mechanism (SSM) Regulation (Regulation EU No 1024/2013) complemented by the SSM Framework Regulation, Regulation (EU) No 468/2014).


On 18 April 2023, the Commission tabled four amending proposals aimed to amend the crisis management and deposit insurance (CMDI) rules:

- a proposal for a regulation amending the SRMR, COM(2023) 226
- a proposal for a directive amending the BRRD, COM(2023) 227
- a proposal for a directive amending the DGSD, COM(2023) 228
- a proposal for a directive amending the BRRD and the SRMR as regards certain aspects of the minimum requirement for own funds and eligible liabilities (the daisy chain act), COM(2023) 229.

The CMDI framework sets out the rules for handling all steps of FOLTF banks from the early warning procedures to insolvency or resolution - that is the rescue of the bank, including decision procedures and respective competences. The framework also establishes industry-funded safety-net mechanisms and preventive funds for resolution - 'resolution funds'. Resolution funds are 'industry-funded', i.e. funded by all banks. Last, but not least, the framework requires Member States to establish domestic preventive industry-funded deposit guarantee schemes (DGS).

Existing situation

The EU regulatory framework for banks was mostly adopted in the aftermath of the 2007-2008 subprime (mortgage) crisis. Although it follows the guidelines set within the major international forums for banking regulation coordination such as the Financial Stability Board and the Basel Committee, the new framework was also designed to deepen the financial integration of the EU and strengthen its financial stability. In particular, a major objective is to disentangle the financing interdependence between Member States and their domestic banks, and further rely on EU-level industry-funded and other private sector solutions to cope with failing banks.

To this end, the new framework aims to 'unify' three areas of the EU banking rulebook, each of which constitutes a 'pillar'.

- Pillar 1. single supervision
- Pillar 2. single resolution
- Pillar 3. single deposit insurance

In practice, beyond the rules, the newly established banking union creates single EU-level institutions and industry-funded back-up resources, in order to harmonise application of EU law, on
the one hand, and reduce the involvement of national authority funding, on the other. While pillars (1) and (2) have been adopted and are in force, the third pillar for the creation of a single EU-level DGS – also known as the European deposit insurance scheme, EDIS – has not been completed. The single resolution mechanism comprises the Single Resolution Board (SRB) and national resolution authorities; in addition, it comprises the Single Resolution Fund and national resolution funds (RFs), which are emergency funds used for the resolution of FOLTFT banks.

Parliament's starting position

In its most recent report on banking union of 21 June 2022, the European Parliament notes that banking union aligns the supervision and resolution of banks, and constrains EU banks to conduct activities in accordance with the same regulatory framework. The report emphasises that while banking union is essential for the completion of European monetary union and the internal market, it also requires an EDIS to be complete – an EDIS would indeed improve protection for depositors and reduce the sovereign-bank nexus. Parliament also welcomes the activities of the SRB in 2021 finding that banks within its remit have overall made good progress towards resolvability and in building up loss-absorbing capacity. It supports the review and clarification of the PIA framework, so that the single resolution mechanism is applied in a more ‘consistent and predictable manner’ and relies on ‘objective thresholds’. It also calls for the alignment of specific aspects of insolvency law in view of the counterfactual in resolution.

Council starting position

In its statement of 16 June 2022, the Council identified the strengthening of the common CMDI framework for banks as the immediate next step for the completion of banking union. Other important projects, such as the establishment of the EDIS and further progress on market integration, would be reassessed subsequently. In a statement of 18 April 2023 following the publication of the CMDI proposals, Paschal Donohoe, president of the Eurogroup, in a meeting of the finance ministers of euro-area Member States, welcomed the proposals as an 'important step forward' for the completion of banking union. For Donohoe, the proposals were aligned with the Council’s aforementioned agreement of 16 June 2022, and there remained room for building a bank crisis management framework suited for ‘all types of banks operating in the EU, including SMBs’. He emphasised that it was a priority for the Eurogroup that the legislative procedure be completed by the end of the current term in 2024.

Preparation of the proposal

The Commission’s impact assessment identifies some features of the FOLTFT bank cases that occurred under the current CMDI framework that are responsible for the utilisation of taxpayers’ and depositors’ money in resolutions. As Figure 1 shows, 82% of complementary external funding for banks in crisis since the entry into force of the CMDI package has come from public funding. A major area where the framework seems not ‘entirely fit’ is in the handling of the FOLTFT small and medium-sized banks (SMB). The main reason identified by the report relates to SMBs being more extensively funded by deposits, thus less by market instruments. This is due to limited access to financial markets and makes resolution more costly to depositors. Improvement is thus needed in the following areas:

- there is a need for greater legal certainty and predictability with regard to the public interest assessment (PIA), which determines whether resolution is preferable to insolvency;
- industry-based safety nets remain ineffective and conditions for accessing funding in and outside resolution remain divergent;
Depositor protection rules need to be homogenised across EU Member States, and domestic DGS funding requires further scrutiny.

The Joint Research Centre study accompanying the CMDI proposal package presents an assessment of the financial impact of harmonising the coverage of temporary high deposit balances. The analysis shows that an increase of the level of protection up to €500,000 for 6 months might help to protect the wealth of households involved in real estate transactions compared with the current situation, if the bank where the deposit is held fails. This policy option appears to pursue the objective of enhancing depositor confidence while limiting the burden on guarantee funds.

The Commission considered four policy options. Option 1 is the baseline scenario where the current situation is maintained (status quo). Option 2 consists of a slight improvement in funding and scope, while option 3 would substantially improve funding and scope, without addressing the EDIS. Option 4 consists of an ambitious CMDI review, including the EDIS.

The three options considered for improvement focus on three components, namely the PIA, the conditions for the use of internal funding, and the use of DGS funding. In particular, they would all extend the scope of the PIA in order to cover SMBs with potential local effects on the economy. Option 4 includes a fully-fledged EDIS. Given the prevailing stalemate as regards the EDIS legislative procedure and the inability of the Council to come up with a negotiation mandate, option 4 had to be abandoned upfront.

The approach adopted by the Commission for its CMDI package of proposals is option 3.

The changes the proposals would bring

The amending proposals modify the CMDI framework in four main areas, with a view to harmonising application of the EU rulebook and further relying on industry-funded solutions.

Early intervention and warning of failing or likely to fail (FOLTIF)

The conditions for applying early intervention measures, including the removal of management and appointment of temporary managers, are amended to enhance legal certainty. In particular, the proposal provides the European Central Bank (ECB) with a legal basis for the exercise of powers, and the conditions for early intervention are no longer 'prerequisites to start the preparation for resolution or to exercise the related powers'. The proposal strengthens the cooperation between the SRB, the ECB and the national competent authorities, and provides further detail as regards cooperation before resolution. The amendments also include an obligation for the ECB and national competent authorities to notify the SRB sufficiently in advance whenever they consider that there is a 'material risk' that an institution or entity meets the conditions for being assessed as FOLTIF. Although the ECB and national competent authorities would continue exercising their powers during the early warning period and keep the SRB informed, the SRB would be empowered to assess what it considers a reasonable timeframe for the purposes of looking for solutions to prevent the failure. If no solution is found to prevent failure within this timeframe, the competent authority...
should assess whether the institution is an FOLTF entity, and if this is the case, formally communicate this to the SRB.

Public interest assessment (PIA)

Regardless of the size and category of the FOLTF bank, an important feature in the choice between resolution and insolvency is the PIA. The objectives of the PIA for a bank’s resolution are defined in Article 14 SRMR:

(i) to ensure the continuity of critical functions;
(ii) to avoid significant adverse effects on financial stability;
(iii) to minimise reliance on extraordinary public financial support;
(iv) to protect depositors covered by the DGSD.

Whenever resolution is considered unnecessary to meet either of these objectives – i.e. the PIA has a ‘negative outcome’ – the insolvency proceedings are applied by the Member States’ authorities applying the national framework.

The proposal would first of all extend the PIA to regional economic impacts in the assessment of the objectives. As a result, FOLTF SMBs (small and medium-sized banks) would be more likely to obtain positive PI decisions. The proposal would also amend the PIA procedural rules so that the SRB would have to consider and compare ‘all extraordinary public financial support’ that could be expected to be provided for the institution in resolution against those in the insolvency procedure. If liquidation aid were expected in insolvency, this would lead to resolution (positive PIA outcome). Resolution would also be preferred if the estimated costs of insolvency were higher for the DGS. The procedure for comparing resolution and national insolvency proceedings would also modified to give preference to resolution and broaden the latter. In particular, amendments would make insolvency proceedings preferable only in those cases where they achieve the framework’s objectives ‘better’ than would resolution, no longer ‘to the same extent’ (amendment 19(c)). Finally, the Commission’s proposal stresses that the amendment would ‘lead to an increase in the burden of proof for resolution authorities in demonstrating that resolution is not in the public interest’.

Conditions to access industry-funded safety nets

The amending proposals would modify Article 109 BRRD (use of DGS in the context of resolution) so that in cases of transfer strategies – e.g. sale of business, bridge institution or asset separation – and only in these cases, deposits could be protected, counting towards the 8 % loss on total liabilities required to have access to resolution funds. In practice, the ‘internal funding’ of the bank would still be used first to absorb losses. However, if this was insufficient to reach the 8 % minimum loss threshold to obtain resolution funds, then the DGS funds would be used. The DGS funds would substitute the loss in value resulting from additional transfer strategies that would otherwise be allocated to depositors. For certain banks with a high prevalence of deposits, typically SMBs, reaching 8 % loss of total liabilities may only be possible when imposing losses on depositors, despite compliance with the minimum requirement for own funds and eligible liabilities.

Use of DGS in resolution

Under the current CMDI framework the decision on the use of DGS funds to finance resolution is taken by the SRB after consulting the Member State’s DGS. The DGS contribution is determined by the assessment of the losses that ‘covered depositors would have suffered had they not been shielded from suffering losses’. Article 79 SRMS is amended to specify that the DGS to which the credit institution is affiliated should be used for the purposes and under the conditions laid down in Article 109 BRRD. Responsibility for the calculation of the cost of repaying depositors for the purpose of limiting the amount of the DGS contribution to resolution remains at national level under the responsibility of the DGS based on the least cost test (LCT). The SRB would determine the amount of the contribution to be provided by the DGS only after consulting the DGS on the results of this
calculation. Therefore, the SRB would not be able to determine a DGS contribution to a transaction that would be above the cost of repaying depositors as calculated by the DGS according to the DGSD rules.

### Harmonisation of depositor preference

Current Article 108(1) BRRD (ranking in insolvency hierarchy) creates three levels of deposit seniority in the ranking to bear the losses incurred by banks’ asset value. First and foremost, DGS funds and covered deposits must be given the same and highest seniority rank – i.e. last to bear losses. ‘Eligible but non covered deposits’ hold the second highest seniority ranking, but are higher than that of other liabilities. Finally, the ranking of other deposits is determined by Member States. According to the Commission, the ‘super-preference’ of the DGS has an impact on the outcome of the LCT, which is used to determine the intervention of DGS, and as result, the DGS funds can ‘almost never be used outside the payout of covered deposits in insolvency’.

By establishing a single ranking for all deposits – named by the Commission as a ‘single-tier’ ranking – the amendments would address the issue. The single-tier ranking would thus remove the seniority of covered depositors and DGS funds over other deposits. All deposits, including eligible deposits of large corporates and excluded (uninsured) deposits, would rank above all other banks’ liabilities. All deposits would rank at the same seniority level amongst themselves.

### Advisory committees

The European Economic and Social Committee (EESC) is planning to adopt its opinion during its July plenary session.

### National parliaments

The deadline for the submission of reasoned opinions on the grounds of subsidiarity is set for 4 September 2023. No subsidiarity concerns have been raised so far.

### Stakeholder views

In a statement on 27 April 2023, Dominique Laboureix, Chair of the SRB, declared that the CMDI framework needed enhancement. Overall, in the context of a missing EDIS, national DGS must be a key part of the financial safety net. Laboureix identified two key problems with the current framework: ensuring the options needed to manage SMB failures, and ensuring a harmonised framework for banks of all sizes. While resolution tools may be broadened to cover SMBs, the way these tools should be financed remains controversial, and their ability to raise loss-absorbing capacities to support a resolution under question. DGS funds could be used, once shareholders and creditors have been bailed in and before accessing (single) RFs – where needed for the public interest. The second key issue Laboureix identified was the varying approaches adopted for the crisis management of small bank failures. This prevents a level playing field, let alone the predictability of crisis management. According to Laboureix, there is substantial discretion, particularly as regards the treatment of creditors and the use of DGS funds. This is why the CMDI framework must harmonise the creditor hierarchy and determine a single set of criteria for the use of DGS funds. This requires a robust framework for the LCT and the various possible interventions.

A policy note published in October 2022 by a group of prominent European academics meanwhile acknowledges that although substantial progress, probably more than expected, has been achieved since the financial crisis, banking union remains incomplete. The authors identify important gaps and deficiencies, among which the supervision and resolution of SMBs. In some countries, less significant institutions are organised in financial networks or groups with mutual support arrangements that entail regulatory advantages and are known as institutional protection schemes. The favourable treatment of institutional protection schemes and their member banks is notable, not only because they represent the majority of less significant institutions and about half of their
assets, but also because the networks share common features with large systemic institutions in terms of pooled size.

A second major issue identified by the authors is the lack of progress on the EDIS, meaning that CMDI competencies remain divided between the Member State and EU levels, and the latter is fragmented between the Commission and the Council. The fragmented decision and implementation architecture eventually prevents efficient decision-making. Furthermore, the current fragmented environment leads to deposits having an uneven (expected) value across Member States.

The authors argue that most Member States are seeking to ‘maintain control over their banking systems, limit cross-border exposures to liquidity needs in times of crises, protect national or regional banks against foreign competitors, and leverage the domestic banking systems to facilitate government financing in times of stress’.

**Legislative process**

The proposals were tabled by the Commission on 18 April 2023. The files are in the preparatory phase in Parliament, with the Economic and Monetary Affairs Committee (ECON) in the lead. The Council meeting on 28 April 2023 discussed banking union and included a first political exchange on the CMDI legislative proposal.
EUROPEAN PARLIAMENT SUPPORTING ANALYSIS


OTHER SOURCES

Early intervention measures, conditions for resolution and funding of resolution action, 2023/0111(COD), Legislative Observatory (OEIL), European Parliament.

Early intervention measures, conditions for resolution and financing of resolution action, 2023/112(COD), Legislative Observatory (OEIL), European Parliament.

Certain aspects of the minimum requirement for own funds and eligible liabilities, 2023/113(COD), Legislative Observatory (OEIL), European Parliament.

Deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency, 2023/0115(COD), Legislative Observatory (OEIL), European Parliament.

ENDNOTES

1 A bank is typically financed through deposits, debts and stocks (also known as shares); it produces value through its assets, typically loans. Debt liabilities and deposits receive remuneration typically through interest payments, while stockholders receive the profits net of all other liability payments. If assets are liquidated, liabilities are repaid according to their rank, known as ‘seniority’, and stocks/shares have the lowest rank, thus ‘absorb first losses’.

2 The four proposals are accompanied by a communication (COM(2023) 225) on the review of the CMDI and an impact assessment report (SWD(2023) 225 and its executive summary (SWD(2023) 226).

3 The Commission defines bank resolution as competent authorities deciding that a failing bank will not undergo insolvency proceedings because it would harm ‘public interest and cause financial instability’. Although the bank as a whole would benefit from resolution, some of its activities may still go through insolvency proceedings.

4 DGS funds are managed at Member State level, while the CMDI framework provides for an EU-level ‘single resolution fund’ for large systemically significant banks, and domestic resolution funds for medium and small banks. Although the rules regarding the decision between resolution and insolvency are set by the CMDI framework, the EU and the Member State may come up with opposite opinions. Finally, it is noteworthy that the rules for insolvency proceedings are determined by the Member States. For a recent overview of the DGS, see K. G. Spitzer, Funding of national Deposit Guarantee Schemes in the EU – State of Play, Internal Policies Economic Governance unit, European Parliament, October 2022.


6 The Commission tabled a proposal for the EDIS in 2015, but the proposal is still being discussed by the co-legislators.

7 The public support breaks down into precautionary public support (31 % of total complementary funding €71 billion) and aid (19 %). The precautionary public support is itself split into liquidity support (28 %) and recapitalisation (11 %). The impact assessment uses both internal and non-public information.

8 M. Bellia, L. Calès, F. Di Girolamo, E. Joossens and M. Petracco Giudici, Quantitative analysis on selected deposits insurance issues for purposes of impact assessment, European Commission Joint Research Centre (JRC), April 2023. See also, the executive summary. The study adopts a simulation methodology based on the Systemic Model of Banking Originating Losses (SYMBOL) developed by the JRC.

9 Temporary high deposit balances stem from real estate transactions (e.g. sale of a house) as well as from some specific life events (such as marriage, divorce, retirement, etc.). Although limited in time, temporary high deposit balances benefit from higher coverage, i.e. beyond the €100 000 coverage level.

10 The proposal would substitute Article 13 SRMR with a new article mirroring Articles 27 and 29 of the BRRD.

11 Transfer strategies include selling the business, setting up a bridge institution and using an asset separation company to deal with impaired assets. These tools are essential tools for SMBs and an essential component of the resolution powers granted to the SRB. The costs are borne primarily by shareholders and creditors and, if the access requirements are met, financing by the (single) resolution fund will be available.
Including deposits not covered by DGS.

There are essentially three types of bank liability: deposits, debts, and equity. The ‘transfer’ – i.e. the sale – of an asset of the bank to third parties may result in a loss (or gain) due to the difference between the effective sale price and the accounting value of the asset in the books of the bank before its transfer. The loss (or gain) is allocated to the liabilities following a ‘seniority’ ranking. This ranking ranges from most junior (first affected, typically equity) to most senior (last affected, typically deposits covered by DGS).

Minimum requirements for own funds and eligible liabilities – also known as MREL – is the minimum amount of equity and debt that a bank is required to meet in order to be able to absorb losses; it thus constitutes the main ‘bail-in’ tool. The establishment of bail-in mechanisms was identified as essential to disentangle bank-sovereign interdependence and reduce the risk that market participants fund failing banks with the expectation that the national official authorities would rescue the bank with taxpayers’ money – the ‘bail-out’. SRB provides an overview of resolution tools with an emphasis on bail-in versus bail-out.

Eligible non-covered deposits are eligible deposits from natural persons and micro, small and medium-sized enterprises that exceed the coverage level.

Large non-financial firms’ non-covered deposits, and excluded deposits of financial firms and other authorities.

According to the evidence brought forward by the Commission’s impact assessment Annexes 7 and 8 (section 2), the single-tier ranking would (a) protect deposits in resolution by reducing the amount that would be otherwise discounted for losses to reach 8% of total liabilities and have access to the (single) resolution funds and (b) unlock DGS funding apart from the payout of covered deposits under the least cost test.

This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under ‘European Parliament supporting analysis’.