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Council position on the CMDI reform

An initial analysis regarding key aspects of the proposed bank crisis management framework

Following the negative reaction from the Commission when the Council published its general approach to the CMDI reform, this briefing provides some initial analysis regarding the key aspects of the public interest assessment, the resolution objectives and resolution funding. Clearly, the Council aims for a narrower scope of resolution in harmonised procedures by the Banking Union authorities than the Commission and potentially narrows the available funding accordingly, potentially privileging action under national frameworks instead. Whether a balance between scope and available funding is achieved, however, will require more in-depth analysis.

In April 2023, the Commission has proposed a **reform of the framework for bank crisis management and deposit insurance ("CMDI")**. The proposal aimed in particular to **apply the resolution framework more widely**, including when smaller and medium sized banks fail. Particular consideration went to banks that are predominantly funded by deposits and to the **protection of uninsured depositors** during the resolution of banks, which regularly requires external funding. In order to fund the resolution of more banks while better protecting depositors, the Commission proposal also seeks to **facilitate the resolution authority's access to funds in deposit guarantee schemes**, basically to build a "bridge" when the required bail-in of the banks' share- and debtholders is still not sufficient to pass the 8%-of-total-liabilities access threshold to the Single resolution Fund (SRF). We have reviewed the Commission's original proposal and its background in a number of briefings; the latest here on the treatment of depositors and here on the public interest assessment.

The **Parliament adopted its first reading reports** on the proposals in April 2024. They can be accessed via the legislative train schedule, which also provides a summary of the amendments that the Parliament pursues. The **Council adopted a general approach** to the proposals in June 2024.

In recent public remarks, the **Commissioner in charge** commented on the Parliament's and Council's amendments. First, she welcomed those of the Parliament. Second, she called those by the Council "*very disappointing*". According to her, the Council's position would neither deliver on the Commission's objectives nor on the objectives formulated by the Eurogroup ministers in a statement preceding the

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Commission's proposal. In particular, she points out that **the Council proposal makes access to funding more difficult** than envisaged by the Commission, in her words adding "*19 new safeguards on top of our proposal*".

Against that background, we recall that an **enlarged scope of resolution naturally has to come with adequate funding** possibilities. Otherwise, there is a risk that the resolution authority cannot pursue a resolution despite it is mandated by law; this is in particular problematic within the concept of the Banking Union, as a funding gap might force the Single Resolution Board (SRB) to pass the handling of a failed bank to national authorities, against the spirit of the legal framework. **This briefings seeks to analyse the most salient changes in the Council text in three interdependent areas of the public interest assessment, the resolution objectives and resolution funding**.

Public interest assessment

The Council adds a new "*first stage*" of the assessment: the resolution authority has to decide whether any of the **resolution objectives would be at risk in case the institution would be wound up under normal insolvency proceedings**. This step precedes those two others that are already required for the resolvability assessment, which the Council leaves as proposed by the Commission: first, to establish whether resolution is necessary to achieve the resolution objectives, and second, to establish whether the same objectives would be even better achieved by insolvency. Against this background, it is not fully clear what the addition of a new "*first stage*" would mean in practice.

Already today, it is **common practice for the SRB to assess, as a first step, whether resolution is necessary** to achieve the resolution objectives – and as mentioned above, the legislation requires the SRB to do so. In other words, the SRB has to assess whether the resolution objectives would be missed in case the bank was not resolved. Notably, any such assessment is done after the bank has been declared failing or likely-to-fail. At this point, the legislation in principle only foresees two alternatives paths for the bank: either resolution or a procedure called winding up "*in an orderly manner in accordance with the applicable national law*." Thus, effectively, it appears that the SRB is required to assess if this latter national procedure does not attain the resolution objectives. These *orderly winding-up procedures* may technically not be the same as insolvency procedures and are in any case not further harmonised at European level.

The added "*first stage*" appears to essentially follow the same principle: the SRB would have to judge, for instance, whether a hypothetical insolvency could result in the disruption of critical functions or put financial stability at risk. Since the text says "*would be at risk*", it will be sufficient to establish that this may happen.

In principle, insolvency proceedings may also lead to the continuity of critical functions and safeguard financial stability even if that is not the stated objective of such proceedings. However, it seems impossible for the resolution authority to predict with certainty what actions national insolvency administrators would take. For instance, certain critical functions might be unprofitable and the insolvency administrator might consequentially decide to stop supporting them, in order to increase the value of the remaining business for stakeholders. It seems **difficult for the resolution authority to project exactly what risks and consequences an insolvency procedure might entail**.

In any case, the specific reference to "*normal insolvency proceedings*" in the newly added text opens another question. If a bank is declared failing-or-likely-to-fail but not yet insolvent, the comparison with normal insolvency proceedings may be inapplicable and the SRB may have to conclude that insolvency - *since it is not imminent* - cannot put the resolution objectives at risk. Would the SRB therefore have to conclude that resolution cannot proceed, making the bank automatically subject to the alternative treatment and to be "*wound up in an orderly manner in accordance with the applicable national law*"? Potentially, that could lead to **less rather than more resolution proceedings**. We cannot judge whether this is really the intended

purpose of the amendment by the Council. Alternatively, one might also **read the Council's amendments as just restating the already existing test** as to whether resolution is necessary to achieve the resolution objectives. However, in that case, it is unclear why the new text sits along the existing test; it is moreover unclear how the first step of the test (whether insolvency is a risk for the resolution objectives) and the last step of the test (whether insolvency achieves the resolution objectives better than resolution) are supposed to interact.

Overall, it is difficult to ascertain what this new "*first stage*" might exactly achieve in practice. It may be fair to conclude – since it is formulated as a hurdle for deciding in favour of resolution – that it **may create some uncertainty and potentially some bias against taking action** on the SRB's side. This would however not reconcile well with the shared objective of Parliament, Commission and Council to ensure that resolution applies more often going forward. That said, the Council leaves the Commission's proposed modification of the last step in the public interest assessment intact. Namely, **resolution can be chosen if it achieves the objectives just as well as insolvency**. In theory, this should lead to more resolution in any cases that are marginal in this specific regard. In practice, and as we have analysed in more detail in this briefing, it may be difficult to envisage a bank of systemic relevance or with critical functions for which a "normal" insolvency procedure can be safely assumed by the SRB to attain the resolution objectives as well as a resolution procedure. We would assume in this context that a "normal" insolvency procedure chiefly aims to safeguard creditors' claims, while the resolution procedure specifically aims at attaining all resolution objectives, under the proviso that the resolution authority can fund its actions appropriately.

Resolution objectives

In our earlier briefing on the public interest assessment, we analysed the **three changes to the resolution objectives** that the Commission has proposed. First, we pointed out that the explicit mention of critical functions at regional, rather than only at national level could be viewed as a mere clarification because the SRB, since 2017, already envisaged considering this element also at regional level under the existing legislation. Second, we felt that privileging industry sources over other public funds would make the choice of resolution - in the context of a relative assessment of public interest - more likely. At the same time, as mentioned above, we noted that the relative assessment has not played a decisive role in past SRB decisions. Moreover, we also noted that in the Veneto banks, where taxpayer money was used in insolvency, this resolution objective regarding protection of public funds was inconsequential in practice. Against that background, it is noteworthy that the Council text maintains those two changes from the Commission proposal but **abandons the third one, which requires to protect all depositors in resolution**. That has consequences on two levels.

First, regarding the **public interest assessment**, it means that **resolution cannot automatically become necessary just because uninsured depositors would otherwise lose more money**. This does however not preclude that the resolution authority might seek to protect uninsured depositors on grounds of financial stability. Nevertheless, it appears that, compared to the Commission's proposal, resolution would become less likely for those failed banks that present little financial stability risks, even though they have taken uninsured deposits because protecting depositors is not an end in itself.

Second, there are also consequences for **how resolution would be done**. When drawing up a resolution plan or scheme, **in theory no consideration for uninsured deposits for their own sake is necessary**. On the contrary, uninsured deposits can potentially be used to absorb losses, to facilitate realising the other resolution objectives. Again, as noted in the previous paragraph, this does not preclude that the resolution authority decides to protect uninsured deposits in order to serve other resolution objectives.

Overall, compared to the Commission proposal and the Parliament's report, **resolution is less likely under the Council general approach.** And when resolution happens, it is **less likely to lead to comprehensive deposit protection**.

From a policy perspective, **comprehensive deposit protection leads to higher funding requirements in resolution and is also connected with moral hazard risks** on the side of depositors and bankers. At the same time, there can be reasons to provide comprehensive protection anyway. A possible consideration might be **to protect depositors' welfare and business continuity of corporate depositors** beyond the limits of deposit insurance. Moreover, and specifically regarding demand deposits, an economic argument has been made in favour of **broad deposit protection for the sake of financial stability**. We discussed this in more detail here. At this point, it is worth recalling the scenario of the Veneto banks, and also the more recent bank failures in the US of Silicon Valley Bank and others. In those cases, it was decided to spare all depositors from loss participation. Notably, in the Veneto cases, Italian authorities proceeded to bail-out all depositors and other creditors, even though the SRB found that there was no public interest in doing so.

The question arises if, among Member States, there is still a consensus that the current setup of the CMDI framework is appropriate to the extent it effectively leaves the decision to pursue broad depositor protection up to national governments and their financial strength at the time the call has to be made. Alternatively, it may also be the case that Member States now believe they will individually not want to pursue broad deposit protection as in the Veneto case again when the question arises in the future under comparable circumstances. In any case, the underlying economic conflict may resurface, as the failings of some US banks, including Silicon Valley Bank, have highlighted not too long ago when US authorities decided to save all deposits even though the banks in question where as such not of systemic relevance.

One of the objectives formulated by the Eurogroup ministers in their statement preceding the Commission's proposal was a "***broadened application of resolution tools in crisis management at European and national level, including for smaller and medium-sized banks***." Taken together, the analysis of the public interest assessment and of the resolution objectives gives some justification to the Comissioner's view that the Council's general approach **may not fully attain all objectives formulated by the Eurogroup ministers**.

Resolution funding

As mentioned above, the starting point of the Commission's proposal was to facilitate the resolution of small and medium sized banks. At the same time, the Commission tried to ensure that sufficient funding is available for the resolution of those additional banks. The primary source of funding should consist in the equity and debt instruments that have been issued as financing by the bank itself and together form part of the total liabilities that appear on the bank's balance sheet. According to the Commission's impact assessment, smaller and medium sized banks are more reliant on deposit funding than larger banks and often cannot easily place financial instruments on the market that can be bailed-in with good certainty. Considering the Commission's objective to broaden depositor protection, the lack of bail-inable debt at smaller, predominantly deposit-financed banks may be a challenge for resolution funding. **Less deposits can be bailed in, less non-deposit bail-inable financial instruments may be available, and the threshold for accessing the resolution fund may therefore also be hard to reach.** Namely, that threshold requires that 8% of total liabilities have been bailed in before the fund can be used.

The solution proposed by the Commission chiefly consists in a contribution of the national Deposit Guarantee Scheme (DGS) to resolution funding. This is enabled by a change to the hierarchy of claims in bankruptcy. The possible contribution of the national DGS to any resolution is limited by the amount that

the deposit guarantee scheme would lose in a hypothetical insolvency. However, by reducing the DGS' priority in insolvency, **the Commission proposes to increase the DGS' hypothetical loss in insolvency and thus its potential contribution in resolution**. On that basis, the resolution authority would be able to require a contribution from the DGS. Together with the bail-in of equity and debt instruments, this contribution may be large enough to ensure the necessary loss absorption of 8% of total liabilities, which is required to access the resolution fund and obtain additional funding from there.

In contrast, the **Council's general approach does not retain the proposed change to the bankruptcy hierarchy. Instead, it introduces[1] a haircut on recoveries**. When the DGS estimates its hypothetical losses in insolvency in order to compare them with the cost of intervening in resolution, a multiplier of 85% should be applied to a so-called "ratio of recoveries". However, the text does not specify how this ratio is supposed to be derived, and thereafter how it is used when the DGS estimates the hypothetical cost of repaying covered depositors. We assume that the intended procedure is that the DGS: (1) is informed by the resolution authority of the value of the bank's assets and of its own position in the creditor hierarchy, (2) assesses the amount that it can obtain if the assets are liquidated at that value, after deducting any senior claims on the assets that are senior to the DGS' own claim, (3) calculates a ratio of that amount to its own gross claim, (4) multiplies that ratio with 85%, and finally (4) multiplies that adjusted ratio with the amount obtained in step (2). So effectively, the amount obtained in step (2), **the amount that the DGS could expect to recover from the bank as it was valued at the point of failure, is subject to a 15% haircut in order to obtain a basis for the comparison with the cost of any DGS intervention in resolution**.

Moreover, the Council text foresees further increasing the DGS' possible contribution by adding to the hypothetical cost of insolvency for the DGS also the hypothetical losses of a subset of the deposits that are so far not legally covered by the DGS. **The effect is comparable to the Commission's proposed single seniority level for all deposits, though not going as far.** The proposed hypothetical loss calculation apparently takes the experience into account that some recent bank failure cases required (for financial stability reasons) to protect deposits that were strictly speaking not covered. In the Council proposal, the hypothetical loss calculation could therefore figure in losses on deposits from natural persons and small companies that exceed 100.000 euro and on other deposits with a remaining maturity of less than one year, provided that depositors would keep access to those deposits during resolution.

It depends on the concrete scenario if the hypothetical loss and thus the potential contribution in insolvency by the DGS is larger under the Commission's or under the Council's text. The former in any case ensures a larger contribution when the amount of large deposits with more than a year maturity is large. The latter might however ensure a larger contribution because of the factor of 85% that the DGS must apply to its recoveries. Thus a hypothetical loss is imposed even if based on the valuation by the resolution authority, the DGS could expect to recover its claim in full. An additional hypothetical loss may by contrast result under the Commission proposal if losses would in particular fall upon large depositors with deposits beyond 1 year maturity. In theory, it appears that either of the Commission and Council approaches could lead to more funding from the DGS for resolution. **In practice, it is difficult to establish *a priori* which approach works better in more of the relevant resolution cases - not least due to the somewhat convoluted workings of both approaches.** In neither approach, the availability of additional funding is linked with whether resolution is in the public interest. **Therefore, neither the Commission proposal nor the Council text can exclude the eventuality that the resolution of a bank is in the public interest while the funding required for that is not available.**

[1] To note that the Commission proposal entails a similar haircut which is however only meant to apply when the DGS decides to intervene to prevent a bank's failure, i.e. not when the banks is already failing or likely to fail.

Moreover, the Commission - as mentioned before - says it has identified **“19 new safeguards” in the Council text** that may limit the ability of the SRB to make use of the DGS as a funding source. In the Council's own words, as in its press release, it aims for:

- **additional safeguards** on the use of DGS or SRF funds to avoid unintended consequences or moral hazard, ensuring in particular that bridging the gap does not replace loss absorption by the failing bank's shareholders and creditors
- an **adequate burden sharing** between the DGS and the SRF, where the latter is tapped within the Banking Union, subjecting their interventions to limits and to a ‘pecking order’, in particular giving the SRF priority for repayment purposes
- **stricter requirements and limitations** on the use of bridging the gap for banks with a balance sheet size between € 30 billion and 80 billion, which will furthermore only be available during the 10-year period after the entry into force of CMDI

Concretely, as regards the actual legal amendments, we were not in a position to quickly identify all of those “19 safeguards”. Further work is needed to evaluate the Commission's findings and gauge the impact thereof. Nevertheless, we find the following points noteworthy. On one then hand, they constitute **limitations for the use of the DGS in resolution**, and on the other hand, **procedural tightening compared to the Commission's proposal**.

As to **limitations on the use of the DGS in resolution**:

- A contribution of the DGS to resolution would in principle be limited to institutions with up to 30 bn balance sheet;
- During a transition period of 10 years, also the resolution of banks between 30 and 80 bn total assets can receive support unless
  - the bank had less than 8% of own funds and bail-in eligible liabilities 12 months before its failure; or
  - the bank is funded by deposits for less than 65%;
- The DGS cannot contribute if the bank had breached its own funds requirements during a period of 8 to 36 months before the bank is declared “failing or likely to fail”;
- Moreover, the contribution of the DGS is limited to 2.5% of total liabilities for banks up to 30 bn total assets, and 1,25% for larger banks;
- In parallel, creditors and shareholders must have carried losses in resolution and the preceeding 12 months of at least 6.5% of total liabilities for banks up to 30 bn total assets and 8% for larger banks;
- It would only be possible to count the DGS' contributions towards the threshold for accessing the Single Resolution Fund if
  - the SRB has not excluded from bail-in, for instance out of financial stability concerns, more than 2.5% of the required liabilities that can be bailed in; and
  - the residual of the failed bank is liquidated after its assets have been transferred and also a possible bridge bank is terminated as soon as possible.
- Finally, the recitals envisage a “maximum contribution” by the SRB over a three-year period towards resolutions where the DGS also contributes; the exact quantification and the legal effects would need to be further assessed.

Moreover, we note that Member States may limit the contribution of the DGS to 62.5% of its target level; since that would be done via national law, it would need to be investigated whether that also limits decisions at Banking Union level or whether that is only a constraint for national authorities.

At the level of **procedural tightening**, the Council would have to endorse any use of the Single Resolution Fund following support from the DGS when the bank is larger than EUR 30 bn. For context, see also this briefing where we discuss accountability and the decision making procedures for resolution in the Banking Union. Before it gets to the endorsement by Council, the resolution of a bank larger than EUR 30 bn with a DGS contribution would require a qualified majority decision by the Board of 5 out of its 6 full-time members.

It is important to note that these changes may or may not stand in the way of a resolution scheme in any given case in practice, in function of the parameters of the individual case. **However, the way the crisis management framework is designed, it is conceivable that at times resolution schemes will be clearly required by the legislation since they attain the resolution objectives best, while funding is not sufficiently available. The framework does not provide a clear and legal way out for such situation.** The actors, SRB, Commission and Council, would have to give up the legally required resolution scheme and leave the bank to national procedures, even though this step is at this point not envisaged in the framework.

At the same time, we observe that effectively, the impact of the reduced expansion of resolution funding suggested by the Council is mirrored by the reduced expansion of the required scope of resolution. Whether a balance between these two factors is achieved would require a **detailed and challenging impact assessment**. Since the SRB has done some work in that direction for the Commission proposal, even if imperfect, as discussed in this briefing, the SRB could also be requested by the legislator to assess the Council's changes. The Council says it puts forward its amendments to "*avoid unintended consequences or moral hazard*". It is true that the Council's changes subject the use of the DGS to some additional discipline by **requiring enough private sector engagement beforehand** – and effectively **tying the SRB's hands** when that is not given. Yet one needs to be mindful that tying the SRB's hands in a Banking Union context does not per se guarantee a specific outcome for a given failed bank, but may in practice rather result in **a non-harmonised national procedure to apply**.

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