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Association for Financial Markets in Europe

Crisis Management & Deposit Insurance Framework

Position Paper

October 2022

Introduction

The Association for Financial Markets in Europe (AFME)[1] takes this opportunity to provide views on the prospective Crisis Management and Deposit Insurance (CMDI) framework.

AFME continues to support the development of an effective recovery and resolution framework in Europe and the ongoing work to enhance resolvability. AFME has been closely involved in the development and implementation of the BRRD and SRMR, the development of TLAC, and related issues including deposit insurance, and supports the Eurogroup view that a consistent and effective framework for managing banks in distress is a critical part of the Banking Union.

It is important to emphasise that very extensive progress has been made in enhancing resolvability, particularly with respect to GSIBs and large banks (See GFMA response to FSB consultation on TBTF[2]). Banks in the EU have made very significant progress in recovery and resolution planning, raising MREL and enhancing resolvability. Significant work is underway to further enhance resolvability. It is essential that any reforms to the resolution framework should not prejudice the progress already achieved.[3] It is very important that this progress, especially by G-SIBs and large banks, is recognised by the co-legislators and they are vigilant in avoiding unintended consequences of further reforms or any additional or increased contributions to DGSs or SRF, especially for those banks compliant with the BRRD resolution requirements, as they proceed with the CDMI review. We do not believe that it is necessary to make wholesale changes to the resolution framework and that the focus should be on targeted changes.

We believe that the following key principles should underpin the review of the CMDI framework:

1. The review should not increase contributions to mutualised funds, but better align contributions with the risk that that the institution poses to the fund.
2. Enhance the credibility, predictability and consistency of the CMDI framework, further enhancing financial stability, without adversely impacting the progress made to date on resolution.
3. Minimise risk to taxpayers and moral hazard by ensuring a consistent, harmonised and careful approach across EU member states to the use of common or mutualised funds to absorb losses, subject to the Least Cost Test, supporting market discipline and avoiding competitive distortions.
4. Consistency in the tools and application of the framework at EU level in order to ensure that all banks regardless of their size or country of origin can fail in an orderly manner, have a plan in place to provide for this and have the resources to support it.
5. Support strong cross-border cooperation and minimise fragmentation both within the EU and with third countries.

Any proposals should be carefully assessed against these principles.

[1] The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

[2] https://www.gfma.org/wp-content/uploads/2019/06/gfma-response-to-fsb-on-evaluating-tbtf-reforms.pdf

[3] See Section 3.1 MREL Shortfalls for G-SIIs: https://www.eba.europa.eu/eba-publishes-its-annual-quantitative-monitoring-report-minimum-requirement-own-funds-and-eligible

The remainder of this paper sets out our positions, covering core elements of the Resolution framework that merit consideration, whilst also addressing the broad elements that were agreed upon as underpinning a strengthened CMDI framework in the Eurogroup statement on the future of the Banking Union on 16 June 2022[4]. We note that further steps to complete the Banking Union were put on hold due to divergent views amongst member states and believe that discussions should resume once the CMDI framework has been updated.

The Banking Union was envisaged as one of the main steps in economic integration in the European Union. It is important that the full benefits of the Banking Union are unlocked and that there is recognition for the huge progress already achieved through stronger prudential requirements and more effective supervision and resolution. As such, barriers to the free flow of capital and liquidity across the EU should be removed as they prevent the diversification of risk and pose the risk of introducing systemic fragilities.

Key Priorities

1. Contributions to DGS / SRF

The CMDI review should carefully consider the impact of contributions by banks to the SRF and relevant DGSs. It is important to minimise the impact on those banks who have been already contributing a great deal since the establishment of the Single Resolution Mechanism (SRM). Furthermore, it must be ensured that contributions are aligned with the risk which the bank poses to the relevant fund, including taking due account of the resolution framework and to avoid procyclicality in contributions and minimise cross-subsidisation. Any extension of the scope of resolution entities and DGS use should not lead to higher DGS contribution payments, especially not for banks holding sufficient levels of MREL . The existing SRF contributions create a significant cost for banks and options should be explored to reduce this, for example capping the ex-ante funding target level of the SRF at the end of the build-up phase, change the metric for the target level, and/or increase the availability to use irrevocable payment commitments. In any case, the MREL stock of each back needs be taken into account when determining its SRF and DGS contributions, since MREL will be consumed first before any call to SRF or DGS will be effectuated. The greater the MREL stock therefore, the lower the likelihood that SRF funds will be required.

2. **Broadened application of resolution tools in crisis management at European and national level,** including for smaller and medium-sized banks, where the funding needed for effective use of resolution tools is available, notably through MREL and industry-funded safety nets

It is essential that the review of the CMDI framework retains the overarching principle that taxpayers should not bear losses of failing banks and that these should be borne by investors in the institution. This is vital to maintain the credibility of the framework and minimise moral hazard.

As such, it is important to ensure that a broad range of banks can be placed into resolution in support of the resolution objectives. The application of resolution tools to a failing bank should no longer be seen as an exceptional approach, but this should be readily applied to deal with failing banks of various sizes and business models where this is in the public interest. Whilst we do not believe it is necessary to introduce new tools in the EU resolution framework, it is important to improve consistency in the tools and application of the framework.

[4] https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/

MREL

It is important to recognise that all banks, regardless of size, may produce negative externalities in their failure. The resolution strategy should seek to minimise this, and the MREL requirement that applies should be sufficient to ensure the strategy is credible. Failing to put this in place would reflect a movement away from the long held 'polluter-pays' model and would be economically equivalent to forcing others to pay for the negative externalities of a private actor – be that via mutualised funding sources stepping in, or in the extremis, the state itself. This is moral hazard and may encourage excessive risk taking should the cost of a failure be borne by others. This is not an equitable model for handling the negative repercussions of the failure of a financial institution – regardless of its size. It is why institutions already within scope of resolution are expected to issue and maintain MREL, as well as build-out and maintain capabilities to ensure a credible resolution strategy can be delivered upon should it ever be needed. We therefore view the existing approach to MREL calibration already provides for some proportionality and the same principle should apply to all banks to avoid competitive distortions in the market. At the same time, it should be recognised that access for small or medium size institutions to financial markets may differ between member states depending on the market structure and therefore, an appropriate transitional period should be provided where necessary to provide adequate time to issue eligible liabilities or meet MREL requirements for institutions that are newly captured by the requirements. This should not lead to any additional or increased contributions to DGSs or SRF for those banks, in particular GSIBs and large banks, already compliant with the BRRD resolution requirements.

Sale of business and transfer tools

Applying sale of business and transfer tools in resolution is likely to provide a greater harmonisation of application, and would help to avoid the nuances made available under national insolvency regimes. Especially those that reduce the important role of burden sharing in insolvency, and run counter to the intentions of lawmakers when formulating the original recovery and resolution framework – namely reducing the role of taxpayers in funding the failure of a credit institution. One of the key differences between resolution and insolvency at present is the enforcement of burden sharing measures, and it is important that this is corrected in a fair and proportionate manner to provide a consistent approach to the handling of failed or failing banks throughout the European Union, and eliminate the risk of regulatory arbitrage.

It should be recognised that MREL requirements are already calibrated on the basis of the preferred resolution strategy. This should not change for smaller or medium sized banks, which would be expected to meet MREL requirements appropriately tailored to their resolution strategy. Proportionality in this sense is already present in the framework, though it may be appropriate to provide additional time for these banks to meet any new requirements they are subject to.

Moratorium tool

Further deterioration of the competitiveness of European banks must be avoided by any potential extensions of the moratorium tool. The moratorium tool is the power of resolution authorities under the current resolution framework to pause/stay contract payments for 48 hours during the bank resolution. This tool is used by resolution authorities across the world, it is supported by global resolution standards, and is covered by ISDA master agreements. The length of the moratorium tool was discussed in detail during BRRD2 negotiations. However, co-legislators agreed that 48 hours was appropriate, taking into account that any further extension of a moratorium in resolution would cause significant contract uncertainty, cost for pricing-in the related risks and affects especially the international competitiveness. As such, the CMDI review should not seek to revisit the length of the stay and should avoid undermining the decisions of the co-legislator in this area. Please see AFME's paper "Extending the moratorium tool – a detriment to resolution" for more detail on the detrimental impacts of extending the tool.

Industry-funded safety nets

Regarding DGS preventive measures, we would like to stress that a DGS' primary role is to protect covered deposits. However, the range of options for the use of DGS as specified by the DGSD is not available to all member states. We believe that the full range of options, including specified preventative measures, should be equally available to all Member states, while making sure that any such measure is not used to keep non-viable banks operating. It is important to avoid creating competitive distortions and moral hazard, and to ensure that banks can exit the market in an orderly and safe manner. In any event the least cost principle must apply.

3. Further improvements to and harmonisation of the use of national deposit guarantee funds in crisis management, while ensuring appropriate flexibility for facilitating market exit of failing banks in a manner that preserves the value of the bank's assets

Further improvements to and harmonisation of existing DGSs is an important step in advancing the Banking Union by creating a more robust common protection for depositors. In doing so, it is important to ensure a level playing field between banks through consistent burden sharing for all. As such, we outline a number of areas where we believe further improvements to the existing framework can be made with the caveat that any consequential changes should avoid unintended consequences and increase the risk of DGS losses.

Improving existing DGSs

Risk-aligned calibration. It is very important to ensure that the funding of DGS is updated to reflect the resolution framework. For banks that would be placed into resolution, risk-based contributions should reflect the resolution plan and likelihood that the contributing bank incurs losses for the DGS. This is necessary to reduce moral hazard (see AFME EDIS paper)[5]. This would become even more important if the CMDI framework is amended in a way which is likely to increase the use of DGS funds in resolution or insolvency proceedings. This increased risk of loss should be borne by the contributions of banks which benefit from such additional potential funding.

Enhance transparency. The DGS Directive should define and ensure national authorities are more transparent when communicating the annual contribution to banks.

On the one hand, as per article 10.4 of the DGSD, Members States can raise financial means through mandatory contributions from credit institutions in its territory for the purpose of covering the costs related to systemic risk, failure, and resolution of institutions. And on the other hand, as per article 13.2 of the DGSD, DGSs may use their own risk-based methods for determining and calculating the risk-based contributions by their members. The calculation of contributions shall be proportional to the risk of the members and shall take due account of the risk profiles of the various business models. We understand some elements of the risk-based contributions cannot be disclosed to other banks. However, we believe this calculation should be as transparent and predictable as it could be, e.g., using defined buckets as is the case for the calculation of GSII buffers at the FSB.

We may take the efforts of the Single Resolution Fund as a step in the right direction, as they document banks' contributions with much more detail than national DGSs. Starting in 2021, banks were able to approximate a recalculation of their annual contribution and participate in a consultation. We believe the DGSD should require national authorities to explain and justify any additional and unexpected increases in the

[5] https://www.afme.eu/Portals/0/globalassets/downloads/consultation-responses/AFME-RRN-PRD-paper-on-the-proposed-European-Deposit-Insurance-Scheme-EDIS.pdf

contributions. Contributions are very costly for institutions and we believe the Directive should require national authorities to anticipate as much as they can if any events will trigger a raise in the upcoming contributions. We would like to highlight that any deviation from the banks´ assumptions based on historical data would have a direct cost in the Profit and Loss account.

Harmonise target levels of national DGSs – Whilst the DGS Directive art 10(2) indicated a target level of 0.8%, we do not expect a harmonised fully loaded state around that level in all Member States by 2024. Firstly, The DGS Directive allows for lowering the target level down to 0.5% upon conditions and European Commission approval and secondly, many Member States have set higher target levels or do not set target levels at all. We believe it would be better for the DGS Directive to introduce a fixed range between which national DGSs should set their target level, starting at 0.5%. This will provide more predictability and force all Member States to set a target level that is subject to a cap. Furthermore, the structure of the banking market should be mandatorily included in the criteria to set the target level. Consideration should also be given to adjusting the actual target level to a risk based calculation, such that factors impacting the likelihood of accessing the DGS are taken into account e.g. the level or MREL and the excess of MREL beyond the regulatory requirement, the level of capital and excess of capital beyond the regulatory requirement, resolvability and preferred resolution strategy. A risk based target would reflect a harmonised approach to the risk-based contributions to DGS consulted on by the EBA[6].

Irrevocable Payments Commitments. Article 10.2 of the DGSD states that the available financial means to be taken into account in order to reach the target level may include payment commitments. In order to ensure a level playing field, the way banks are able to contribute to the Fund should be harmonised. Therefore, national discretions regarding the acceptance of Irrevocable Payment Commitments (IPCs) should be avoided, and the directive should be clear that IPCs are a permissible form of payment. Some Member States have not transposed this into their national legislation, up to the level of 30% foreseen in the current EU legislation.

Transferability of funds – Under the current DGS Directive (art 14(3)), a bank that wants to switch between EU DGS, for example because of a changing corporate structure, or when it sells or acquires a business, can only recoup and transfer the contributions paid in the previous 12 months to another EU DGS.

All other funds paid into the DGS over the years cannot be transferred. The DGS to which the bank transfers covered deposits will rightly want to ensure adequate financing of the additional covered deposits under its purview. This means the bank could pay twice for insuring the same deposits. This provision strongly disincentivises cross-border consolidation as well as branchification strategies. We believe banks should be able to transfer contributions from one EU DGS to another, commensurate with the risk being transferred.

Conditions for the application of DGS preventive measures

It is important to ensure a consistent approach to any use of DGS funds for preventive measures. It is also important to bear in mind that deposit insurance is there to protect covered depositors, not to absorb losses that should otherwise be borne by the shareholders and other creditors of a failing bank.

We believe that preventive measures should be clearly framed, and available on the basis of clear conditions in order to avoid keeping non-viable banks alive. To reduce further the burden on other banks and minimize moral hazard as well as competition distortions, appropriate burden sharing should be imposed on the failing bank's shareholders and creditors, (i.e., through the write-down of equity and subordinated debt instruments), when the relevant DGS deploys preventive measures to assist a distressed bank. This should hold whether the DGS intervention is subject to state aid restrictions or not. In addition, each preventive measure should be subject to the least-cost test and to a numerical cap (for instance, it cannot be higher than a given percentage of the outstanding size of the DGS) to ensure the DGS is not excessively depleted.

[6] https://www.eba.europa.eu/calendar/consultation-draft-revised-guidelines-methods-calculating-contributions-deposit-guarantee

It is important that any preventative measures do not undermine the core principles of the crisis management framework, i.e., that all banks can fail in an orderly and safe manner. We would in any event expect preventive use of DGS funds to remain exceptional.

Where the DGS is used to finance the resolution of a bank, it is important that the framework clearly establishes the roles of the relevant authorities and ensures close coordination between them. Speed is likely to be of the essence and coordination between relevant authorities should be considered in advance as part of resolution planning. We are also strongly opposed to the idea that DGSs' funds could be used to reach the threshold of 8% of bail-in/burden-sharing and open access to the SRF. In our view, that would clearly distort competition, generate moral hazard and come down to a double bail-out by other institutions, first at national and then at Banking Union level. Smaller institutions should instead be given adequate time to meet the 8% threshold, rather than lowering the standard.

Creditor Hierarchy / Depositor Preference

We agree that in certain cases a consistent creditor hierarchy across the EU could simplify the application of cross-border resolution actions. However, this has to be very carefully considered and assessed against the disruption and impact of any changes to the creditor hierarchy which could have a significant impact on existing claims and funding. We view the implications as likely to outweigh any potential benefits from making changes to the creditor hierarchy.

From the perspective that the primary function of DGS funds is to protect depositors, we do not believe that the current depositor preference introduced under the BRRD should be amended to further facilitate the use of the mutualised DGS funds in resolution or insolvency.

Any proposal to change the creditor hierarchy would require very careful examination as it would impact other areas and potentially expose DGS to greater losses.

As we have long argued, MREL requirements should be clearly tailored to the relevant resolution or wind-down strategy, and the conditions to access the SRF/national resolution funds should apply equally to all banks.

4. **A harmonised least-cost test,** administered by national authorities, to govern the use of DGS funds outside payout to covered depositors, to ensure consistent, credible and predictable outcomes

We support the flexible use of DGS in resolution or insolvency proceedings to support transfers of insured deposits to a purchaser or bridge bank where this would result in a better outcome for the DGS fund than a liquidation pay-out to covered depositors.

However, it is very important to retain the condition that any such use is of least-cost to the DGS fund, taking into account its current super-preference, than a liquidation pay-out. This is necessary to reduce moral hazard and minimise losses to the fund and potential contagion to other banks - it is also important to review the funding of DGS for this reason. To reduce further the burden on other banks and minimize moral hazard as well as competition distortions, appropriate burden sharing should be imposed on the failing bank's shareholders and creditors (as argued for above), and the least-cost test itself should be clearly defined in the EU legislation.

Were the Commission minded to legislate further on the use of DGS funds prior to the failure of a bank, we would encourage preventative measures not to be made mandatory, enabling resolution authorities to choose whether or not to engage in preventative measures.

Additional Priorities

1. A clarified and harmonised **public interest assessment**

We consider that the current public interest assessment has been interpreted often too narrowly but also diversely in the Banking Union and has not resulted in a consistent application of the framework. We would support a review of the public interest assessment to ensure that a broader range of institutions can be placed into resolution. The application of resolution tools to a failing bank should no longer be seen as an exceptional approach, but should be readily applied to deal with failing banks of various sizes and business models where appropriate. Clear criteria to assess public interest should be defined at EU level.

In addition to the legislative framework, it would be beneficial for the SRB/NRAs to provide additional guidance on their approach to the PIA and which categories of banks fall within each type of resolution strategy/insolvency proceedings. For example, the Bank of England has provided indicative guidance as to the categories of banks it would expect to apply the bail-in tool, a transfer tool and which would be placed into the UK's modified insolvency procedures for banks. This is likely to enhance the understanding of the CMDI framework by investors, creditors, depositors and other stakeholders.

In revisiting the PIA, we consider that the regional impact of failure as well as the risk to financial stability should be explicitly captured in the PIA in the Banking Union e.g. by assessing the risk of local contagion and depositor confidence. This would de facto extend the scope of resolution to capture more mid-sized banks, bringing the framework closer to what was originally envisaged in 2010 and minimizing competition distortions in the internal market.

We also consider that the future legislative text should make clear that resolution authorities shall not take into account in the PIA external resources such as State aid or any interventions that could be qualified as State aid) in the counterfactual scenario in liquidation. This would avoid liquidation procedures in cases where measures such as sale of business could be pursued more efficiently.

2. Liquidity funding in resolution

It is essential that the CMDI framework minimises moral hazard and strengthens market discipline to ensure that equity accurately reflects risk and to incentivise banks to improve resolvability. Use of public or mutualised funding sources should therefore be minimised and limited to where these are necessary to ensure financial stability. It is important that the framework imposes market discipline and sends the clear message that it is the primary responsibility of each bank to ensure that it has the loss-absorbing resources available to manage its failure in an orderly manner. However, as we have previously commented on, it is nevertheless important to separately consider the availability of liquidity and the external sources that will in most scenarios need to be obtained. Therefore, as part of, or alongside, the review of the CMDI framework, work should continue with the objective of clarifying access to the public sector backstops for temporary liquidity in resolution. These measures would strengthen and improve the overall framework.

It is important to ensure that a consistent approach is applied to all banks, regardless of size. However, we do believe that solvency support should be considered separately from liquidity provision in cases where a timely repayment of such liquidity can be expected for banks that are being credibly resolved and losses have been born by shareholders and creditors. Provision of liquidity via a public backstop, on appropriate terms, should not per se foster moral hazard or distort competition in the same manner as mutualising losses or placing that burden onto taxpayers.

As for the use of DGS funds in resolution, the current provisions under Article 109 BRRD are already sufficient but should be further clarified.

Where additional sources of funding are concerned for loss-absorbency purposes, mutualised sources of funding (DGS/SRF) should not be, and cannot be, relied upon. Where liquidity funding is concerned, we strongly believe that the use of temporary public backstops, under appropriate conditions, should be clarified.

3. **Harmonisation of targeted features of national bank insolvency laws** to ensure consistency with the principles of the European CMDI framework

We see potential merit in introducing some targeted harmonisation in national insolvency regimes for banks to provide a common, consistent framework for the liquidation of banks which do not meet the public interest test for resolution. A common framework would also avoid inconsistencies in national approaches to insolvency processes which have undermined the effectiveness and credibility of the current framework. It may also improve the likelihood of larger banks being able and willing to purchase business from the failing bank and help provide a more consistent approach to the public interest assessment for resolution.

FOLTF triggers, Article 32b BRRD, triggers for resolution and insolvency (withdrawal of authorisation, alignment of triggers for resolution and insolvency)

It is very important to avoid the possibility of a gap between a failing-or-likely-to-fail (FOLTF) declaration and the ability to open insolvency proceedings. Where a bank has been declared FOLTF, it is essential that depositors, creditors, shareholders, employees and all stakeholders are immediately clear on the plan to manage the failure of the bank. The relevant authorities (including authorities in other relevant third countries) should coordinate prior to the FOLTF declaration so that a clear plan can be communicated concurrently. This is important to support an orderly resolution or winding up of the institution.

We therefore support a FOLTF declaration being made a trigger for insolvency proceedings across the EU (unless the institution goes into resolution). We note the Dutch and Italian frameworks are already aligned in this manner.

A targeted harmonised liquidation proceeding should recognise that banks are different from other corporates and would benefit from modified insolvency processes, ensuring that they can be wound down effectively. Consideration could be given to examples such as the UK, which has specific modified insolvency procedures for banks including bank administration, bank insolvency and investment bank special administration regimes.

However, it is essential that any revised insolvency framework does not distort competition or increase moral hazard through enabling easier access to mutualised resources. Care should also be taken to ensure that any changes do not have unintended implications for the resolution of larger banks through a change to the no-creditor-worse-of-than-in-liquidation (NCWOL) counterfactual analysis.

Sources of funding available in insolvency

It is important to promote alignment in the conditions for accessing external funding in insolvency and resolution. Greater consistency between insolvency and resolution is important to avoid distortions and to ensure that insolvency cannot be used to avoid the relevant conditions which apply in resolution. In order to enhance consistency, it is important to ensure that the least-cost test is strictly and consistently applied and sufficient burden-sharing requirements are appropriately applied, through the write-down of equity and subordinated instruments. In our view this should apply in both resolution and insolvency when mutualized DGS resources are mobilised, whether the DGS intervention is subject to state aid restrictions or not.

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