Crisis Management & Deposit Insurance Framework

Position Paper

July 2023

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.

[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

We have reviewed the Commission's CMDI proposals against these principles.

The core of the Commission's proposals is expansion of the resolution scope via redefining the public interest assessment (PIA) to be able to apply crisis management tools to small and mid-sized banks. Whilst we are supportive of this in principle, concerns persist regarding the consistency and credibility of the package, with what appears to be lower expectations for small / medium sized banks. It appears implicit that larger banks will need to fund the additional risk from bringing these banks into the scope of the resolution framework, with a review of the calibration of contributions to mutual funds (DGS / SRF) a material omission from the package as it is important that the 'polluter pays' principle is preserved. Furthermore, we highlight the importance of ensuring that non-viable banks exit the market and that more generally, second and third order impacts of proposed changes should be understood before being enacted. We highlight these positions in the key priorities section of this paper, and outline further points under additional priorities.

Key Priorities

1. Consistency and Credibility of the CMDI framework

MREL – 1st line of defence

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.

DGS Contributions

The CMDI review should carefully consider the impact of contributions by banks to 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, as should also be the case for the SRF, 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 . In any case, the MREL stock of each bank needs be taken into account when determining its DGS contributions, since MREL will be consumed first before any call to DGS will be effectuated. The greater the MREL stock therefore, the lower the likelihood that DGS funds will be required. In this respect, we believe a material omission from the package is a review of the methodology for calculating DGS and SRF contributions to take MREL stock into account.

Risk-aligned calibration – 'Polluter Pays' principle

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 i.e. the 'polluter pays' principle. This is necessary to reduce moral hazard (see AFME EDIS paper)[4]. This would become even more important as the proposed revisions to the CMDI framework are likely to increase the use of DGS funds through the widening of the public interest assessment and change to the creditor hierarchy. This increased risk of loss should be borne by the contributions of banks which benefit from such additional potential funding.

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 should help to avoid the alternative routes made available under some 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 and moral hazard.

It should be recognised that, normally, MREL requirements are already calibrated on the basis of the preferred resolution strategy, though large banks are also subject to an additional minimum MREL requirement if the preferred resolution strategy is a transfer strategy. Other than correcting for this discrepancy i.e. setting the same minimum MREL requirement for small and medium size banks where the preferred resolution is a transfer strategy, smaller or medium sized banks should continue to meet MREL requirements appropriately tailored to their resolution strategy. Proportionality in this sense is already present in the regulatory framework, though it may be appropriate to provide additional time for these banks to meet any new requirements they are subject to.

In addition, while very large banks have a resolution plan mostly relying on bail-in, transfer tools are also generally available to them in combination with bail-in. Consequently, their MREL target should also take into account transfers (even if the bank itself would not exit the market) and their post-resolution situation.

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

2. Moral Hazard / Market Exit

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 to avoid keeping non-viable banks alive, and available on the basis of clear conditions which ensure a level playing field between DGSs. To ensure this is the case, for a bank to be eligible to access preventative measures, it should have in place a credible remediation plan demonstrating long-term viability. Furthermore, a bank should only be able eligible for preventative measures in a single instance, thereby avoiding repeatedly extending support to so-called zombie banks.

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 nor than a given percentage of the TLOF) to ensure the DGS is not excessively depleted.

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 however, expect preventive use of DGS funds to remain a valid option if and when economically more advantageous than the reimbursement of that bank's depositors in the event of liquidation according to the Least Cost Test.

Also we urge the Commission to progress with the review of the State aid regulation pari passu with the revision of the CMDI framework, given the multiple interrelations. The review should aim at avoiding diverging consequences for DGSs depending on their legal status and/or governance structure. Indeed, State aid qualification should not be based solely on the evaluation of the DGS' governance arrangements, determining consequently the bank being FOLF, which could ultimately compromise the attempt to pre-empt its failure through the preventive intervention.

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.

Early Intervention Triggers

Early intervention constitutes a key component of supervisory action and is defined by the Basel Committee on Banking Supervision 'Core Principles for Effective Banking Supervision' in the following way: 'adopting a forward-looking approach to supervision through early intervention can prevent an identified weakness from developing into a threat to safety and soundness. This is particularly true for highly complex and bank-specific issues (e.g. liquidity risk) where effective supervisory actions must be tailored to a bank's individual circumstances'.[5]

As such, the EBA developed guidelines on triggers for use of early intervention measures. However, due to the bank specific and judgement based nature of these guidelines, there is the risk that early intervention does not take place soon enough. As such, a consistent trigger should be defined such that if certain metrics are

[5] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1067473/f6234078-a8cb-40a1-88f1-f22d446ca394/EBA-GL-2015-03%20Guidelines%20on%20Early%20Intervention%20Triggers.pdf?retry=1

breached e.g. MREL plus combined buffer requirements (CBR) are not met for 9 months, without a breach of minimum capital requirements, a review by the supervisor of the whether the firm is in recovery phase is automatically triggered. This could be coupled with a subsequent review after a specified period assessing the firms FOLF status and the need for further action. This will help facilitate orderly transfers / exits if required.

3. Creditor Hierarchy / Depositor Preference

Change in 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.

We agree that in certain cases a consistent creditor hierarchy across the EU could simplify the application of cross-border resolution actions. However, this first requires very carefully consideration and assessment of potential disruption and impact arising from such changes that could have a significant impact on existing claims and funding e.g. the impact of changes to rating of bank issuances and related costs. We view the implications as likely to outweigh any potential benefits from making changes to the creditor hierarchy.

Expanded use of DGS

As the CMDI proposals are intended to affect a greater use of DGS, including for a broader depositor base akin to effectively mandating 'full' depositor protection i.e. assigning unsecured depositors the same level of depositor preference as covered deposits, for which 2nd and 3rd order impacts have not been fully explored.

As such, in the case of both the change in the hierarchy and from exposing the DGS to greater losses, the potential impacts - direct and indirect - should be explored before making changes in these areas.

Additional Priorities

1. Callability of Irrevocable Payment Commitments (IPCs)

Provisions that require a call of IPCs on return of a banking licence should be reconsidered. A return of a banking licence necessitates that such an entity can no longer benefit from DGS or SRF funds. At the same time, the bank is not refunded contributions made to date. As such, the bank in question has in effect prefunded the remaining banks within the scope of BRRD/SRMR. Therefore, calling the IPC is an unwarranted depletion of the entity's capital.

We also note that this provision would make it more likely that banks would be required to expense the IPCs (P&L impact). Such an outcome would not only render IPCs no longer viable going forward (as they would be an equivalent to the cash contributions from the accounting perspective), but it could also require banks to fully expense already outstanding IPCs from the previous years (material one-off P&L impact for many European banks).

2. SRF Target Level

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.

Similar to the case of DGS contributions, the MREL stock of each back needs be taken into account when determining its SRF contributions, since MREL will be consumed first before any call to SRF will be effectuated. The greater the MREL stock therefore, the lower the likelihood that SRF funds will be required. This will help preserve the 'polluter pays' principle and ensure that contribution are aligned with the risk that a banks poses to using the fund.

3. 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 own 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 the industry or 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 liquidity or 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.

4. Further improvements to and harmonisation of the use of national deposit guarantee funds in crisis management

Further improvements to and harmonisation of existing DGSs is an important step in advancing the Banking Union by creating a more robust common protection framework for depositors. In doing so, it is important to ensure a level playing field between banks through consistent burden sharing for all. As such, in additional to risk-aligned contributions that we cover earlier in the paper, 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

Portability 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. This is also an important feature of furthering the Banking Union.

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 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.

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.

AFME Contacts

Sahir Akbar

Managing Director, Head of Recovery & Resolution

Sahir.Akbar@afme.eu

Stefano Mazzocchi

Managing Director, Deputy Head of Advocacy

Stefano.Mazzocchi@afme.eu