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REPORT

From:	Presidency
To:	Delegations
Subject:	- Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme (First reading) - Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions "Towards the completion of the Banking Union" = Progress report (State of play)

PRESIDENCY PROGRESS REPORT ON WORK IN THE AHWP ON STRENGTHENING THE BANKING UNION

I. INTRODUCTION

1. Pursuant to the Council Conclusions on the Roadmap to complete the Banking Union as adopted by the Council on 17 June 2016 (doc. 10460/16, 'June 2016 Roadmap'), and building upon the Progress Reports prepared respectively by the Dutch Presidency (doc. 10036/16), the Slovak Presidency (doc. 14841/16), the Maltese Presidency (doc. 9484/17), the Estonian Presidency (doc.14808/17) and the Bulgarian Presidency (doc. 9819/18), the Council continued to work constructively at technical level on the Commission proposal for the establishment of a

European Deposit Insurance Scheme (EDIS), while monitoring progress on risk reduction and other measures outlined in the June 2016 Roadmap.

2. The Ad Hoc Working Party on the Strengthening of the Banking Union (the 'AHWP'), established on 13 January 2016 (doc. 5006/16), met 4 times under the Austrian Presidency (on 19 July, 17 September, 12 October and 20 November). The constructive work related to the EDIS proposal and was of a technical nature as negotiations at political level on EDIS will start after sufficient further progress has been made on risk reduction measures, in line with the June 2016 Council Conclusions.

3. This Progress Report has been prepared under the responsibility of the Austrian Presidency having regard to the views expressed by delegations and to address various calls for a written record of progress achieved by the Presidency on EDIS and measures to strengthen the Banking Union. This report may not be relied upon as binding on the delegations as it constitutes the Presidency's assessment of the outcome of the discussions held at those meetings. This report is intended to provide continuity and facilitate the task of the incoming Presidency.

II. EDIS PROPOSAL

A) GENERAL CONSIDERATIONS

4. The Presidency followed up on the work of the previous Dutch, Slovak, Maltese, Estonian and Bulgarian Presidencies with the aim of progressing to the extent possible on the pending technical elements, and where necessary also revisiting and building upon past discussions. The Austrian Presidency focused the work on exploring thoroughly the technical issues linked to different alternatives for the initial model of EDIS, including the hybrid model presented by the Presidency. Moreover, the working party discussed transitional aspects in the context of the introduction of EDIS, the impact of EDIS on non-Banking Union Member States, alternative measures and the calculation of risk-based contributions.

5. In parallel, the Austrian Presidency monitored the progress achieved on other risk reduction and risk sharing measures (see section III of this report).

B) MAIN ISSUES

6. It is recalled that the Bulgarian Presidency held several discussions on the technical aspects of liquidity support under EDIS re-insurance based on the ideas expressed in the Commission Communication of October 2017 and mandatory lending between national Deposit Guarantee Schemes (DGS). Two Commission services' non-papers on re-insurance and two Presidency non-papers on mandatory lending provided the basis for exploring their technical aspects. During constructive technical discussions, Member States identified a number of possible advantages and drawbacks. A group of Member States agreed with the proposal to explore further technical features associated with the reinsurance model, while other Member States supported the mandatory lending approach. Overall, no clear consensus emerged on the desirability of their technical features, without prejudice to the outcome of political discussions. Several argued that re-insurance or mandatory lending could only be a model for a possible "first phase" of EDIS and the aim should be a fully-fledged EDIS. A few stressed that expressions like "stages" or "phases" are misleading and should be avoided as they seem to imply that there will be several phases, which has been proposed by the Commission but not been decided yet by the Council.

7. As an alternative, and in order to advance the discussion within the Ad-Hoc Working Party (AHWP), the Presidency proposed to explore the technical features associated with a hybrid option - the combination of two models for liquidity support discussed under the Bulgarian Presidency: re-insurance based on the ideas expressed in the Commission Communication of October 2017 and mandatory lending.

- **Hybrid Model**

8. In the hybrid model for liquidity support under EDIS, the deposit guarantee scheme remains anchored at the national level while including a component on the European level as well as features from the mandatory lending concept. The model incorporates features that have been laid out in the non-papers of the Bulgarian Presidency and the Commission services, while taking Member States' comments into account. Like these two models, a hybrid model would provide liquidity support, but no loss coverage.

9. This model would entail a split between the Deposit Insurance Fund (DIF) held at central level and funds remaining with the national DGSs. National DGSs would build up their funds until a target level that would be set by political guidance, for instance 0.4% of the covered deposits. Then, the national DGSs would start transferring contributions to the DIF until a combined target level of 0.8% is reached according to a predefined funding path. In this model, the Single Resolution Board (SRB) would calculate and manage the contributions to the DIF, while national DGSs would invoice and collect DIF contributions and transfer them to the DIF.

10. The calculation of risk-based contributions to the national DGS would be based on the risk incurred by the bank relative to all banks affiliated to the national DGS. The calculation of risk-based contributions to the DIF would be based on the risk incurred relative to all banks in the Banking Union.

11. A national DGS that encounters a liquidity shortfall would be able to request liquidity from the DIF after first depleting its own funds up to the required target level. If the DIF is depleted, the SRB could request additional liquidity for the DIF through mandatory lending by the other national DGSs. The SRB would coordinate, collect and manage the loans of the other national DGSs to the DIF and disburse the financial means to the national DGS in need. As a last resort, the SRB could also be given the possibility to borrow on capital markets.

12. Subject to political guidance, caps could limit the amount of liquidity support that a national DGS in need can request from the DIF and/or caps could limit the national DGSs' commitments through mandatory lending. Likewise, interest could be charged for liquidity support.

13. A national DGS would have to repay any liquidity support received in the following order: first to the DIF, which would repay the other national DGSs that have provided liquidity through mandatory lending. Second, the DIF funds themselves would be replenished. Finally, the national DGS would replenish its own funds. It would be required to raise ex-post contributions as well as use recoveries from the insolvency proceedings..

14. Under the hybrid model, Member States that accede to the Banking Union at a later stage would be required to fulfil all relevant legal requirements and transfer financial means in line with the current funding target for the DIF. Several Member States stated their preference for a design that would guarantee equal treatment for newly acceding countries.

15. The Commission services and several Member States welcomed the discussion on the model which was considered as helpful to move forward the negotiations. Some Member States emphasized the need to focus discussions in the working party on a 'pure liquidity' solution. Several Member States declared their willingness to discuss further the hybrid model of EDIS only if it were to be seen as a transitional stage leading to a fully fledged EDIS with a clear deadline for its implementation being set at a political level. Some Member States highlighted that any possible EDIS model should not lead to a lower protection of depositors than in the current solution of national DGSs. A few Member States criticized the complexity of the hybrid model and preferred discussing a model that can lead smoothly to full mutualisation.

16. Technical details of the hybrid model were subject to diverging views. Member States agreed with the Presidency that the setting of parameters is crucial for the model and an issue for discussion at the political level.

- **Transitional aspects**

17. The Commission Communication of October 2017 put forward the idea that the gradual introduction of EDIS and the start of loss coverage in the second phase of EDIS could be linked to certain conditions to be assessed, possibly through a targeted Asset Quality Review (AQR) to address Non-Performing Loans (NPLs) and Level 3 assets.[1]

18. This issue was discussed in the following sequence. Firstly, on the basis of a Presidency non-paper, different transition models in the wake of the targeted AQR were discussed. Taking the assessment of conditions into account, EDIS could start on a bank-by-bank basis, on a Member State-by-Member State basis or through a joint transition. Most Member States supported the idea of having a common start in order to avoid fragmentation of the Banking Union. The Commission services signalled that a joint transition is the only option compatible with the fundamental principles of the Banking Union.

19. However, views were split on a targeted AQR in the context of EDIS.

20. The Commission services presented a non-paper suggesting a targeted approach regarding the participating banks, to be selected on the basis of criteria of efficiency and effectiveness of the AQR, riskiness and banks' representativeness of the system of the Banking Union.

[1] Level 3 assets and liabilities are financial assets and liabilities that are not quoted in an active market and are valued using significant unobservable inputs.

21. A number of delegations recalled the need for sufficient risk reduction in the banking system in line with the June 2016 roadmap before considering any transition and recalled that an AQR could bring credibility and transparency to markets. Other Member States considered the discussion on AQR premature, since no political agreement on the design of EDIS or possible stages has been reached so far, while two Member States opposed any discussion on AQR in the context of EDIS at all.

22. Views of the Member States were split on the proposed approach itself. Some Member States considered that the proposed AQR exercise would ensure a level playing field of banks participating in EDIS. In their view, the differences in the banking sectors across Member States in terms of asset riskiness were one of the main obstacles to the establishment of EDIS. Other Member States objected to any AQR leading to differentiated transition and consequently aggravating financial fragmentation emphasising the need for a joint transition for all participating Member States.

23. Member States' views differed on the scope and on the suggested selection criteria as well. Most Member States agreed on a strong role for the ECB in carrying out of a possible AQR, while some added the need for involvement of national competent authorities.

24. No immediate follow up to this particular discussion was agreed, in order to wait for the outcome of political discussions on the design for EDIS.

- **Depositor preference**

25. Article 108 of the Bank Recovery and Resolution Directive (BRRD) brought an important change to the insolvency hierarchy of banks under resolution by introducing a preference for covered deposits and deposit guarantee schemes to ordinary unsecured liabilities and eligible deposits.

26. The depositor preference has significantly increased the chances for national DGSs to recover their claims in insolvency in their entirety. It has therefore important implications in the context of EDIS and more specifically as regards pay-outs in insolvency, as it could reduce or eliminate the losses by increasing its chances of recovering all funds during insolvency proceedings.

27. In this context, the AHWP discussed the Commission services' non-paper on the impact of the preference for covered deposits as a safeguard for the deposit insurance.

28. The Commission services explained the relative position of DGS claims in the creditor hierarchy in respect of the claims that enjoy higher ranking, and thus more preferential satisfaction from the bankruptcy estate. It also provided additional analysis based on the liability structure of banks, which illustrated a high likelihood for recovery of such insolvency claims.

29. In view of limited reactions from delegations on this topic, the Austrian Presidency has decided not to follow up at the next AHWP meetings in 2018.

- **Alternative measures**

30. Under the Austrian Presidency and following up on the work under previous presidency, the discussion continued on the alternative measures under Art. 11(6) DGSD. Under this provision, Member States may also allow their DGSs to finance measures to preserve access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institutions concerned.

31. Following the request from a few Member States at the AHWP under the Bulgarian Presidency, the SRB presented its analysis regarding whether the transaction to finance alternative measures can be less costly for the DGS as opposed to pay out liquidation.

32. The SRB concluded that, particularly in the case of banks with a strong deposit base and depending on the extent of losses, there might be circumstances under which the least-cost test would be met and, therefore, alternative measures would be a useful addition to the DGS toolkit in the EDIS context. The Commission services and a few Member States shared this view, while other Member States remained opposed to financing alternative measures with European funds and emphasized that possible funds at European level must only be used to fund pay-outs of covered deposits.

- **Risk-based contributions methodology**

33. The Presidency continued work on the development of a methodology for calculating risk-based contributions based on a data collection launched by the Commission services. It explored the functioning of the risk-based contribution methodology under the re-insurance phase.

34. Member States discussed the issue of the reference measure under the Austrian Presidency. In the discussion, most Member States supported the national reference measure in line with the 2015 proposal. However, some Member States preferred to apply the Banking Union reference in the re-insurance phase. One Member State suggested using a "hybrid reference measure" based on both a national and a Banking Union reference, and several Member States showed their openness to discussing such an option further.

- **Impact of EDIS on the Single Market**

35. At the meeting of the AHWP on 19 July 2018, the Commission presented an outline on the quantitative and qualitative elements of the analysis on the impact of EDIS on non-Banking Union Member States. It followed a request addressed to the Presidency by several delegations for insuring an equal treatment of euro area and non-euro area Member States in the EDIS proposal. All Member States welcomed the proposed outline.

36. At the meeting of the AHWP on 20 November, the Commission and the Joint Research Centre (JRC) presented first results of the quantitative analysis which indicated that Non Banking Union Member States would benefit from the diversification generated under EDIS and that the number of liquidity shortfalls would be significantly reduced. This analysis was based on data collected by the Commission for the development of the methodology for calculating risk-based contributions. In the discussion within the AHWP, Member States welcomed the presentation from the Commission as a first step in analyzing the effects of EDIS on the single market but questioned the assumptions of the analysis, in particular that for the purpose of the simulation, the minimum target level of 0.8% of covered deposits as set out in the DGSD, and not the actual funding level, was taken into account, which is in some Member States above the minimum target level. Furthermore, several Member States requested that the further analytical work should focus on the impact of EDIS on the single market as a whole and not on the impact for the individual non-Banking Union Member States. A few Member States also called for analyzing the effects of different EDIS design options on the single market as well as supplementing the analysis of liquidity shortfalls with the analysis of losses. Following the outline agreed in the July meeting of the AHWP the Commission also presented plans for the qualitative part of the analysis.

- **Contribution to discussion on the roadmap to start political discussions on EDIS**

37. The AHWP discussed a Presidency non-paper, which compared all three liquidity support models analysed so far in the AHWP: the reinsurance phase as in the Commission Communication of October 2017, the mandatory lending as presented by the Bulgarian Presidency and the hybrid model as presented by the Austrian Presidency. The non-paper also provided some indication on a possible way forward and evolution of each model. The report had been requested by the chair of the EFC/EWG as a contribution to "discussions on the roadmap to start political discussions on EDIS" and as a follow-up to the Euro Summit of June 2018.

38. It is worth noting that the three models share a number of features. These include the requirement for national DGSs to deplete their funds at national level (up to the amount established by the funding path) first before they can request liquidity support. Access to liquidity support is also conditioned on compliance with the applicable legal framework, while the repayment period is subject to regular monitoring.

39. Several key conclusions emerged from the non-paper. While the three models are conceptually distinct, the main differences among their economic aspects arise from the setting of the parameters. The allocation of funds between the national and European level and/or the setting of caps determine the character of the model to a large extent. Regarding operational aspects and the effects on depositor confidence, the availability of funds at a central level would conceivably enhance robustness in a pay-out event as recognised by several Member States. However, such a central fund would potentially entail higher implementation and operational costs than mandatory lending with a network of national DGS. The three models diverge with regard to their potential for evolution towards loss sharing, which may be easier to implement with models with an existing fund at central level. A thorough analysis of the evaluation towards loss sharing was however not part of the discussions within the AHWP.

40. The comparison of the discussed liquidity support models under EDIS featured in in the EWG+ on 25 October and the Eurogroup + on 5 November, but no progress on the design for EDIS was reached on that occasion.

III. MONITORING PROGRESS ON RISK REDUCTION MEASURES UNDER THE 2016 ECOFIN ROADMAP

A) BANKING PACKAGE

41. On 23 November 2016, the Commission presented a Risk Reduction Measures Legislative Package (the 'RRM Package' or 'RRM Proposals') comprising the following 5 proposals to amend existing legislation:

- a draft Regulation amending Regulation (EU) No 575/2013 (the 'CRR') as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements (the 'CRR Proposal');

- a draft Directive amending Directive 2013/36/EU (the 'CRD') as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (the 'CRD Proposal');

- a draft Directive amending Directive 2014/59/EU (the 'BRRD') and other Directives on loss-absorbing and recapitalisation capacity of credit institutions and investment firms (the 'BRRD Proposal');

- a draft Directive amending the BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy (the 'Bank Creditor Hierarchy Proposal');

- a draft Regulation amending Regulation (EU) No 806/2014 (the 'SRMR') as regards loss-absorbing and Recapitalisation Capacity for credit institutions and investment firms (the 'SRMR Proposal').

42. On 25 October 2017, the Council and the European Parliament reached a political agreement on two elements of the package that were fast tracked: a draft Directive amending the BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy and a draft Regulation on transitional arrangements for IFRS 9 and large exposures.

43. The Council reached a General Approach on the rest of the legislative proposals in the package at the ECOFIN meeting on 25 May 2018.

44. The European Parliament adopted its political mandate on the "RRM Proposals" in its June 2018 Plenary. The first trilogue with the Parliament started on 11 July.

45. The last trilogues on the banking package took place on the 21 and 22 November.

46. The Ecofin Council will be invited to endorse the results for the trilogues at its meeting of 4 December.

B) MEASURES TO TACKLE NPLS

47. In response to the call by the Council for further measures to address the problem of non-performing loans in the EU as set out in its action plan to tackle non-performing loans in Europe of July 2017, the Commission proposed in March 2018 a package of measures to address the NPLs issues, including:

- a draft Regulation amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures for newly originated loans that become non-performing ('NPLs prudential backstop proposal). This measure will make banks set aside funds to cover the risks associated with future NPLs;

- a draft Directive on credit servicers, credit purchasers and the recovery of collateral. This measure aims at providing banks with an efficient mechanism of out-of-court value recovery from secured loans and encouraging the development of secondary markets where banks can sell their NPLs to investors and make use of specialised credit servicers;

- a Commission services' staff working document containing a blueprint on the set-up of national asset management companies (AMCs). The document provides non-binding guidance to national authorities on how they can set up AMCs dealing with NPLs.

48. The Financial Services Working Party started the discussions on the legislative elements of the NPL package on 20 April 2018.

49. Concerning the NPL prudential backstop proposal, the Austrian Presidency continued discussions started under the Bulgarian Presidency. Member States agreed on a general approach on the proposal on 31 October 2018 (ST 13570/18). Negotiations with the European Parliament should start as soon as the Parliament political mandate has been adopted.

50. The Commission proposal for a directive is still under discussion in the Council working group. Member States expressed some support for the establishment at the EU level of the accelerated out-of-court enforcement mechanism for the recovery of collateral, however, more work involving judicial experts is still necessary.

51. As regards the development of the secondary markets for selling and buying loans, including non performing loans, and encouraging credit servicing on a cross border basis, most Member States are in favour of the Commission proposal. The Austrian Presidency intends to make as much progress possible on this part of the Directive in a view of reaching a partial general approach by the end of the year.

C) MONITORING PROGRESS ON OTHER MEASURES

In addition to discussion the EDIS proposal, the AHWP party, in line with its mandate, was monitoring work on other measures aiming at strengthening of the Banking Union:

- at its meeting of 17 September and 12 October, the Presidency presented a state of play on the 'banking package;
- at its meeting of 12 October, the Presidency invited the Commission to update the working party on the work related to the "insolvency directive"[2] ; the Justice Ministers successfully reached an agreement on a partial general approach on the "insolvency directive" in their Council meeting of 4 June;
- finally, the AHWP was updated on the state of play of discussion in the Financial Services Committee on the indicators to measure the progress in risk reduction in the context of the introduction of the backstop to the Single Resolution Fund (SRF) ahead of the end of the transition period, as called for in President Centeno's letter of 25 June 2018 to President Tusk.

[2] Proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU

IV. CONCLUSIONS

The Austrian Presidency invites the Council to take note of this Report, with a view to progressing work further.

The Romanian Presidency is invited to build on the progress made when taking over and continue to work towards strengthening the Banking Union, addressing its various work-streams as agreed in the June 2016 Roadmap.