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REPORT

From:	Presidency
To:	Delegations
Subject:	Presidency progress report on the strengthening of the Banking Union

Summary

As a contribution to the holistic work on outstanding elements to complete the banking union, the Ad hoc Working Party on the strengthening of the Banking Union (AHWP BU) under the Portuguese Presidency focused on the technical discussions on the design of the European Deposit Insurance Scheme (EDIS). The Portuguese Presidency has used a reference hybrid model and has addressed the scope of EDIS and the treatment of the Options and National Discretions (ONDs) provided for in the Deposit Guarantee Schemes Directive (DGSD), including the preventive and alternative measures. The articulation between EDIS and the crisis management framework was also analysed, as were risk-based contributions (RBC). Discussions took place under a set of guiding principles.

A ***hybrid model*** *that entails the access by national Deposit Guarantee Schemes (NDGSs) to additional financial resources provided by a central Deposit Insurance Fund (DIF) and via mandatory lending from other NDGSs was presented for discussion as a potential compromise model for launching EDIS, starting with liquidity provision only.*

This setup offers the flexibility needed to evolve into a model with a component of loss sharing up to a fully fledged EDIS in the steady state. In this regard, views were divergent, with several members advocating for a fully fledged EDIS with loss sharing, while some members argued that EDIS would not require different phases or loss coverage, claiming that these would be contingent on a political agreement also involving preconditions. The need for a simple and efficient model which promotes the alignment of liability and control was broadly supported.

Several dimensions of the hybrid model at its initial stage were explored. Many members supported an ***EDIS design*** *where, in addition to the pooling of funds at central level, the national funds available for mandatory lending would also be deposited in individual compartments next to the DIF, as it would be administratively less complex and more likely to ensure timely support. The introduction of a cap at national level for mandatory lending gained significant support, while the introduction of a cap on the DIF was more contentious.*

Several members were of the opinion that ***non-CRD/CRR entities*** *and* ***Institutional Protection Schemes (IPSs) recognised as DGSs*** *should be included in the scope of EDIS. The inclusion of non-CRD/CRR entities could be dependent on the use of proportionality provisions, by including these entities in the CRD/CRR, or on the implementation of a conformity test at European level. The majority of members supported the inclusion of IPSs recognised as DGSs and all members of IPSs in the scope of EDIS. One member supported their exclusion on the basis that, in its view, such IPSs are different from other DGSs and cost-neutrality can only be achieved through their non-inclusion. A harmonised equivalence test may be a way forward to ensure a level playing field for* ***third-country branches****, although there was no consensus on their inclusion in EDIS. The inclusion of such entities in the scope of the CRD/CRR was also mentioned.*

Apart from the scope of entities, the discussions on the harmonisation of ***ONDs*** *and their possible coverage by EDIS proved important to frame the discussion on the allocation of funds between the NDGSs and the DIF. In fact, the majority of members considered that ONDs should, whenever possible, be harmonised and covered, at least to a certain degree, by EDIS. As discussed, an increase of EDIS coverage is expected to be accompanied by the gradual build-up of the DIF. A few members considered that all ONDs should remain as national options and be covered at national level only (i.e. with no possibility to resort to the DIF's financial support), possibly with additional funds.*

Aligning the three pillars of the banking union and establishing a uniform level of depositor protection were broadly underlined as important common elements with regard to non-CRD/CRR entities, IPSs, third-country branches and ONDs.

Several members argued in favour of harmonising the substantive regimes on the use of ***preventive and/or alternative measures in EDIS****, in particular as concerns the least-cost test, with some also expressing concerns about the need to ensure that, in the overall framework revision, the tools created can effectively be used and that there is a level playing field in the European Union (EU) crisis management framework when using these measures. With regard to the coverage of these measures by EDIS, members were divided between allowing coverage by EDIS and maintaining these measures at national level only. Some members supported that the inclusion of these measures under EDIS would require a larger DIF, while a few noted that the possible increased efficiency that could be achieved by providing for such measures may not require a larger DIF, as long as the least-cost test is harmonised.*

The discussion on the potential ***articulation between EDIS and the current review of the Crisis Management and Deposit Insurance (CMDI) framework*** *confirmed divergent views, both on the role of the DGSs in crisis management (with several members favouring its extension, while several others argued that the primary function of a DGS is the protection of covered deposits through pay-out) and on the inclusion in EDIS of any extension of DGSs' functions. Views also diverged on whether EDIS and CMDI should be discussed together or should be disentangled.*

*As concerns the **build-up of the DIF**, since all NDGSs are currently on track to reach their target level, several members supported a model involving up-front direct contributions from NDGSs, with the majority of members indicating a preference for contributions being benchmarked at the level of the banking union from the outset. Although the highly political nature of the issue was acknowledged, many members were open to the idea of providing EDIS with an external funding capacity, some of them through the introduction of a common backstop. Some other members did not support any external funding that involves public money.*

*The possibility of adding **indicators based on sovereign exposures** to the methodology for the calculation of **RBC** was considered by several members as part of the political discussion on the regulatory treatment of sovereign exposures (RTSE). While there was some support for using indicators based on concentration exposures, the idea of relying on indicators based on credit risks raised concerns, in particular due to the adverse impact on smaller markets and the fact that external ratings are prone to exacerbate pro-cyclicality and financial stability risks.*

*The Portuguese Presidency also explored the concept of loss sharing and its interaction with several parameters of the hybrid model during the **transition to a steady state** with full loss coverage, although some members recalled that an agreement is pending. A design where the DIF and the NDGS would intervene in parallel and where the share of the DIF's intervention would be considered towards the absorption of potential losses was supported by several members. Moreover, there was relatively broad support for a solution whereby, during the transitional phase, the proportion of funds allocated to the DIF would increase and the proportion of funds for mandatory lending and for national uses would decrease.*

The main positions and takeaways mentioned above are without prejudice to the more comprehensive description of the discussions held at the AHWP BU presented in this report.

1. Introduction

Pursuant to the Council Conclusions on the roadmap to complete the banking union, as adopted by the Council on 17 June 2016 (10460/16), and building upon the progress reports prepared by the Dutch Presidency (10036/16), the Slovak Presidency (14841/16), the Maltese Presidency (9484/17), the Estonian Presidency (14808/17), the Bulgarian Presidency (9819/18), the Austrian Presidency (14452/18), the Romanian Presidency (9729/19 ADD1), the Finnish Presidency (14354/19 REV1), the Croatian Presidency (8335/20 ADD1) and the German Presidency (13091/20), the Portuguese Presidency continued to work constructively at technical level on the European Commission proposal for the establishment of EDIS.

The Portuguese Presidency organised five meetings of the AHWP BU – on 2 February, 23 February, 22 March, 27 April and 27 May 2021.

This progress report summarises the discussions held during the semester and was prepared taking into account the views of the AHWP BU members, but under the responsibility of the Portuguese Presidency. It is intended to provide continuity and to facilitate the task of the incoming Presidency, and should not be considered binding, as it constitutes the Presidency's assessment of the outcome of the discussions held.

The discussions were centred on the advancement and strengthening of the banking union. The main focus was on the technical elements of the design of a credible and effective EDIS, building upon the previous discussions and recent political guidance, such as the letter of the President of the Eurogroup to the President of the European Council ahead of the Euro Summit in December 2020.

The aim of the work carried out by the Portuguese Presidency was to clarify the main issues. Using a set of guiding principles as a backdrop, the Portuguese Presidency initially assessed the design of the hybrid model based on a liquidity-only EDIS that covers the mandatory functions of the DGSs set out in the DGSD (i.e. pay-out and the use of NDGSs in resolution).

Subsequently, following a block-by-block approach, several other building blocks were addressed, namely: (i) the treatment of different entities (non-CRD/CRR entities, third-country branches, and IPSs and their members); (ii) the interaction between EDIS and the ONDs provided for in the DGSD; and (iii) the inclusion of preventive and alternative measures in the scope of EDIS. The latter was complemented by a debate on the possible articulation between EDIS and the revision of the CMDI framework. Finally, the RBC under EDIS were also discussed, including the question of adding potential sovereign exposures indicators to their calculation methodology.

On this basis, members were invited to discuss the inclusion of additional elements of increasing complexity in the hybrid model, and finally to discuss the interaction between them in the transitional phase with loss coverage, while possibly converging to a fully-fledged EDIS in the steady-state, still depending on a political decision.

The Portuguese Presidency shares the view that the discussions held during the semester may be framed in the wider context of the political discussions of the High-Level Working Group on EDIS (HLWG) regarding three (EDIS, crisis management and RTSE) of the four work streams included in the holistic approach, and of the European Commission's CMDI Review expected by the end of 2021. Some members noted that advancements in EDIS should progress with other work streams.

A regular debriefing of the discussions took place at the HLWG meetings.

2. Guiding principles

In the first meeting, which took place on 2 February 2021, the Portuguese Presidency proposed a number of **guiding principles** for the subsequent discussions on further strengthening the banking union, including EDIS, with one non-paper from the Portuguese Presidency as a background document.

These guiding principles were the following:

1. ensuring financial stability at both banking union and national level;
2. ensuring a high and uniform level of depositor protection, regardless of the location of the bank;

3. ensuring an adequate balance between control and liability at the banking union level;
4. aligning incentives in a uniform and harmonised deposit guarantee framework;
5. breaking the reliance on national backstops and on taxpayers' money;
6. ensuring equal treatment for NDGSs with mitigation, in the transitional phase, of the first-mover advantage;
7. developing a setup for EDIS as simple as possible.

The majority of members expressed their general agreement with the seven principles proposed by the Portuguese Presidency and considered them useful for framing the discussions, while some considered that the discussion of high-level principles should be reserved for the political level.

In particular, among the principles presented, some members emphasised the need to ensure depositors' protection and trust in the system. Moreover, some members expressed concerns about: (i) the lack of a common understanding as to what some of the principles mean and how to interpret them; (ii) the need for interaction between the crisis management and EDIS frameworks and the policy choices to be made therewith; as well as (iii) the principle of alignment of control and liability. A few members also mentioned the importance of these principles appropriately addressing the treatment of national specificities, such as ONDs and IPSs. A few members also emphasised the importance of banks' risk when entering EDIS.

Some members mentioned the need to also consider other principles, such as: the promotion of cost-effectiveness and cost-efficiency, the need to ensure cost-neutrality for the banking sector, the avoidance of systematic cross-subsidisation, the reduction of moral hazard and an improvement of risk reduction. Some members also underlined the need to align the three pillars of the banking union, to break the sovereign-bank nexus, to ensure equivalent treatment across all participating Member States regardless of whether they use the euro, to more effectively ensure a level playing field and to preserve the integrity of the internal market. The importance of making swift progress towards a fully fledged EDIS as an end goal was also emphasised by some members, while a few members were of the opposite view.

The Portuguese Presidency considered that most of the suggestions proposed by the members were already inherent in the seven principles presented.

3. The hybrid model

Members of the AHWP BU discussed the **operationalisation of the hybrid model** at the meetings of 2 and 23 February 2021, on the basis of two non-papers from the Portuguese Presidency.

The Portuguese Presidency focused the debate on the main elements of the hybrid model: (i) the allocation of funds and the size of the DIF; (ii) the mandatory lending mechanism; (iii) the caps on the DIF and on mandatory lending; (iv) the build-up and financing of the DIF; (v) access to external funding; (vi) the concept of liquidity shortfall; (vii) the repayment of liquidity support (including interest rates and maturities of the loans); and (viii) EDIS's governance.

For the purpose of the above elements, the Portuguese Presidency envisaged a simple setup, a so-called "reference model". This reference model was characterised by liquidity provision encompassing only the pay-out of covered deposits and the contribution to resolution financing in the amount of losses that would be borne by covered deposits.

With regard to the **allocation of funds**, the majority of members supported a small or medium-sized DIF. Some argued that the reference model has a limited scope relative to its interventions and that extending the scope could, however, require a larger DIF. Many members were also open to increasing the DIF's size over time. Some members mentioned the potential impact on the allocation of funds of the final design of the CMDI framework.

Two options were presented for the **mandatory lending** mechanism: one where funds that can be mobilised for mandatory lending are maintained next to the NDGSs and another where these funds are deposited in individual compartments next to the DIF (one compartment for each Member State). The latter option was supported by many members who noted that it is administratively less complex and more likely to ensure a timely support from the DIF. Some members expressed their preference for the former option, emphasising the importance of the funds being under direct national control.

A few members proposed an alternative option, where the central fund would be entirely composed of individual compartments, thus departing from the hybrid model. Moreover, one of these members advocated for a model without the element of mandatory lending, which, in its view, would be more efficient than the hybrid model. One other member stated that, in its view, a model with only mandatory lending could also be a form of an EDIS.

Many members preferred the **cap** on the DIF to be defined as a percentage of the DIF's target level, while others opposed the existence of a cap. Some argued against the need for the cap on the grounds that adequate external financing arrangements are in place and because of the importance of the overall firepower of the system. Only a few members preferred a cap that would vary with the financial means available in the DIF at the moment of the request. Furthermore, a few members proposed that the cap should take into consideration the size of the national banking system, as this affects the repayment capacity of the NDGS in need.

The cap on mandatory lending received broad support, although members had differing opinions on its implementation. Many members preferred the cap to be defined as the proportion of national funds exclusively available for national uses (calculated as a percentage of NDGSs' target level), while some members preferred a cap defined as a percentage of the available financial means placed next to the NDGS at the moment of the request.

The proposal of the Portuguese Presidency to **build up the DIF** through up front direct contributions by NDGSs was supported by several members, since all NDGSs are currently on track to reach their target level. In addition, a few members preferred RBC to be benchmarked at national level during the liquidity phase, while the majority of members argued that the banking union benchmark should be used from the start of EDIS. One member supported the idea of differentiating NDGSs' target levels in order to ensure that a risk-based national first loss would be borne by the NDGSs before the DIF could be used, since, in its view, building-up the DIF through upfront transfers from NDGSs would not make it possible to have banking-union-wide RBC. Some members asked for a quantitative analysis by the European Commission.

Although the highly political nature of the issue was acknowledged, many members were open to the idea of providing EDIS with **external funding capacity** to increase its firepower and reduce the reliance on national backstops, some of them through the introduction of a common backstop. Some other members did not support any external funding that involves public money.

Under this discussion, different positions were raised. The introduction of a common backstop to EDIS, similar to the Single Resolution Fund (SRF), received some support. The remaining options presented by the Portuguese Presidency, namely setting up voluntary financing among NDGSs and lending from industry, were also favoured. It was pointed out that these options already exist for the SRF, which speaks for their use in EDIS. A few members further mentioned the possibility of the SRF lending to EDIS, thus taking advantage of synergies between them, while others emphasised the need to have a full picture of EDIS before making a stand. Further analysis of the potential funding needs was also proposed, in order to better assess the policy options on the hybrid model.

Under the hybrid model, the NDGS is firstly required to exhaust its available financial means (up to the target level), then, if any shortfall remains, the DIF may lend up to that amount. In view of this, the **concept of liquidity shortfall** and the role of extraordinary contributions were discussed, namely whether these contributions should be raised before NDGSs have access to the DIF (thus reducing the shortfall amount). The majority of members agreed that the concept of the liquidity shortfall to be financed by EDIS should not entail extraordinary contributions.

With regard to the policy options presented by the Presidency on this topic, the majority of members agreed with the idea of giving the NDGSs full flexibility to decide whether to raise extraordinary contributions after liquidity support has been provided, in order to avoid placing an excessive burden on the national banking system and therefore to contribute to preserving financial stability. Some members, however, preferred a minimum amount to be collected within a pre-defined timeframe. A few members stressed the importance of extraordinary contributions being raised after liquidity support is received as a timely way to repay loans. A few members also noted that, in their view, changes in the automaticity of the collection of the extraordinary contributions would mean deviating from the current DGSD. Also in this context, some members mentioned the importance of preserving the level playing field between members and non-members of the banking union.

Regarding the **repayment of the liquidity support**, several members concurred on the need for flexibility in establishing the repayment plan, mainly to avoid pro-cyclicality and to limit the negative impact on the banking system. There was also some support for having guiding provisions in the law in order to ensure predictability, transparency and quickness of negotiations between the NDGS and the central authority. Other members preferred a stricter and less flexible approach, arguing that it is necessary to ensure a level playing field and to provide clarity and certainty, including for the beneficiary NDGSs.

The majority of members were supportive of charging interest on the loans granted by EDIS, advocating for a simple and pragmatic methodology, while a few members disagreed with the idea of charging interest, on the basis that the objective of the mechanism should be to preserve financial stability without imposing excessive burden on the NDGSs and ultimately on the national banking system. Supporters of charging interest rates also agreed that the interest rates would result from the combination of the opportunity costs of the various funding sources. Indeed, many members agreed with the idea of aligning the interest rate applicable to funds coming both from the DIF and from mandatory lending, arguing that this reflects the likely equal opportunity cost of these sources, mitigates first-mover advantage and is simple and straightforward to apply. A few members favoured non-zero and differentiated interest rates, reflecting different opportunity costs, notably between euro area and non-euro area participating Member States. Lastly, several members were open to exploring the idea of using the European Central Bank (ECB) deposit facility rate as a benchmark.

With regard to the maturity of the loan granted to the NDGS in need, several members underlined the need for sufficient time to repay such loans to avoid placing an excessive burden on the banking system and creating pro-cyclicality, while ensuring an adequate pace of replenishment. The Presidency's proposal to introduce a maturity mismatch between loans granted and loans raised did not gain much support, in particular given concerns around the challenges of funding such a mismatch.

With regard to **governance-related issues**, some members underlined the importance of the alignment of liability and control. A few members asked for a role for NDGSs in the decision-making process, while others mentioned that NDGSs' access to their individual compartment must not depend on authorisation from the central authority. There was no opposition to designating the Single Resolution Board (SRB) as EDIS central authority and some members referred that the governance arrangements depend on the design of EDIS as well as the broader discussions on crisis management. The need for the governance not to be overly complex in order to allow effective decision-making was also emphasised.

To support the discussions on the hybrid model in the liquidity phase, the European Commission's Joint Research Centre presented the preliminary results of its ongoing quantitative analysis of **the effectiveness and the pooling effect of EDIS**. This analysis shows that the hybrid model and a full liquidity pooling model would be more effective and efficient in preventing liquidity shortfalls in crisis situations than the current status quo. The findings also highlighted the synergies created by pooling resources in terms of the firepower of the model. A few members questioned the analytical conclusions.

4. Non-CRD/CRR entities

The discussion around the scope of EDIS started in the meeting of 23 February 2021 with the potential inclusion in EDIS of **non-CRD/CRR entities**, which was based on the Portuguese Presidency's non-paper on the treatment of non-CRD/CRR entities under EDIS.

Upon invitation of the Portuguese Presidency, members where non-CRD/CRR entities represent a material part of the banking system presented a short description of the quantitative and social importance at national/regional level of such entities in their jurisdiction. Despite the limited size of these entities at banking union level, those members described the importance of such entities in their banking system and shed some light on the relative risk presented by those entities.

Several members expressed their preference for aligning the three pillars of the banking union by including non-CRD/CRR entities in the scope of EDIS and in the CRD/CRR framework, taking into account the proportionality provisions already envisaged. Nevertheless, other members stressed that the current proportionality provisions may not be suitable for all non-CRD/CRR entities. The implementation of a conformity test, at the European level, on the regulation and supervision of these entities as a condition for their inclusion into the scope of EDIS was supported by other members.

The non-inclusion of non-CRD/CRR entities in the scope of EDIS was supported by a few members, while one member suggested an alignment with the treatment of third country branches where inclusion into the scope of EDIS could be attained through an adjustment of risked-based contributions.

5. Third-country branches

The inclusion of **third-country branches** in the scope of EDIS was another element addressed during the 23 February meeting, and the discussion was based on the Portuguese Presidency’s non-paper on the treatment of third-country branches under EDIS.

The EBA shared its work on the third-country branches carried out in the context of the EBA Opinions on the implementation of the DGSD. Its analysis showed that the majority of third-country branches in the European Union are members of a NDGS, as their national schemes were not considered equivalent.

Considering that the equivalence tests are not harmonised under the current framework, the majority of members agreed on the implementation of a harmonised equivalence test as a way to ensure a level playing field, while a few pointed out that it may be a rather complex and time-consuming exercise given the small number of institutions concerned and their poor quantitative relevance.

The discussion has not resulted in a consensus on a preferred option as to the treatment under EDIS of third-country branches whose protection scheme is not equivalent. Some members preferred to adjust the contributions of these branches to EDIS by a specific extra risk factor, while other members advocated the inclusion of such entities in the scope of the CRD/CRR but requested that an analysis of the broader consequences be carried out. A few members preferred these branches to be covered at national level only, given the lack of supervisory tools available to the host country, while others warned that, although third-country branches currently represent a small proportion of covered deposits in the EU, this might change in the post-Brexit context.

6. Institutional Protection Schemes

An IPS is defined in the Capital Requirements Regulation (CRR) as a contractual or statutory liability arrangement of a network of credit institutions, which protects its members and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary. Some IPS are officially recognised as DGSs under the DGSD.

Given the significant proportion of the covered deposits of the members of IPSs recognised as DGSs in the banking union (20.8 % in 2019, according to the EBA database), the discussions on IPSs are crucial for developing a clear definition of the scope of EDIS. To support these discussions, which took place on 22 March and 27 April 2021, the Portuguese Presidency:

1. invited two representatives of IPSs, one from Germany and one from Austria, to present their activities;

2. invited the European Commission to present an overview of IPSs in the EU;

3. invited the ECB to present its monitoring of IPSs;

4. prepared as a background document a non-paper on the treatment of IPSs and their members in the context of EDIS.

To clarify the functioning of these schemes, the **National Association of German Cooperative Banks** and the **Austrian Savings Banks** presented the organisation and functioning of their IPSs.

The **European Commission** summarised the applicable legal framework and the key factual information concerning IPSs, focusing on IPSs recognised as DGSs and on the impact of the membership of IPSs (not recognised as DGSs) in the RBC in some Member States. In this context, a few members requested further clarifications regarding: (i) the predictability of and automaticity of the support provided by IPSs to their members, (ii) the assessment of a risk mitigation factor in EDIS, (iii) the IPSs' eligibility under the CRR, (iv) the segregation of IPSs' funds from those used for DGSs' functions, and (v) the supervision of IPSs.

The presentation on the **monitoring of IPSs by the ECB** addressed the regulatory and supervisory context of IPSs as well as IPSs-related capital benefits and the economic support capacity of hybrid IPSs whose monitoring is conducted jointly by the ECB and the national competent authorities. In particular, the ECB explained that the differences in the capital benefits and waivers across IPSs are related to differences in the IPSs' structure and organisation, mirroring the extent to which there are intragroup relations in terms of funding or capital holdings. It also clarified that some IPSs recognised as DGSs are required to support their members, while others have no mandatory commitment. In addition, the ECB highlighted some best practices for the functioning of IPSs, in particular: (i) robust rules that ensure a swift decision-making process, with clear escalation ladders in the various bodies of the IPSs; (ii) stricter segregation of IPSs' funds from those used for DGSs' functions; and (iii) efficient processes to ensure appropriate monitoring at central level and the timely application of measures. The ECB also noted the role that IPSs can have in ensuring improved risk management practices, better monitoring and further consolidation of less-significant institutions. However, a few members pointed out that the absence of a legal obligation for financial support within certain IPSs may detract from the credibility and alleged lower risk of such schemes.

In order to advance the debate on the policy options under the EDIS hybrid model for the treatment of: (i) IPSs that are recognised as DGSs, and (ii) the OND on lower contributions for members of IPSs that are not recognised as DGSs, the Portuguese Presidency prepared a non-paper on the **treatment of IPSs and their members in the context of EDIS**.

Regarding the treatment of IPSs recognised as DGSs in the context of EDIS, the majority of members preferred including the IPSs and their members in the scope of EDIS, under the same terms as other DGSs, including for preventive measures. These members considered this option to be consistent with the objective of aligning the three pillars of the banking union and with harmonised depositor protection. They also argued that excluding IPSs from the scope of EDIS would diminish EDIS' firepower, given that IPSs represent a large proportion of covered deposits in the banking union. It was also argued that this option promoted more consistent treatment with regard to the inclusion of preventive measures in EDIS, thus more effectively ensuring a level playing field.

Moreover, a few members supported the inclusion of IPS and their members in the scope of EDIS, with preventive measures being fully financed at national level only, either through additional funds above the target level or combined with specific treatment for IPSs (as concerns the transfer of a smaller proportion of funds to the central fund when compared to other DGSs). These members stated that such an approach would reflect the features of IPSs recognised as DGSs. One member supported the exclusion of IPSs from the scope of EDIS on the basis that, in its view, IPSs are different from other DGSs as they reduce the probability of insolvency and pay-out, and cost-neutrality can only be achieved through their non-inclusion.

The majority of members expressed their preference for the full harmonisation of the OND on lower contributions for members of IPSs not recognised as DGSs, possibly combined with the payment of harmonised RBC to the DIF, reflecting the risk profile of IPSs' members.

Overall, some members were open to discussing a harmonised methodology for the calculation of contributions, preceded by an assessment of the risk profile of the members of IPSs to ensure a level playing field.

7. Options and national discretions

At the meeting of 23 February 2021, the Portuguese Presidency further discussed the treatment of ONDs in the context of EDIS other than those addressed in other sections of this report (third-country branches, lower contributions for members of IPSs that are not recognised as DGSs, and preventive and alternative measures).

The EBA presented its policy recommendations from the **EBA Opinions on the implementation of the DGSD**, the aim of which was to reduce divergences in favour of a more harmonised system. In this regard, some members highlighted the importance of creating as simple and harmonised a system as possible in order to preserve the level playing field across Member States. Others emphasised the need for flexibility at national level in order to preserve national specificities and discretion and to ensure depositors' protection and trust in the system. In this context, some members reaffirmed their position regarding the final design of EDIS by outlining the importance of developing a setup that works in the steady state based on a fully fledged EDIS with mutualisation of losses. A few members, meanwhile, stated that the hybrid model, with no or less loss sharing, appears to be a suitable design for the treatment of ONDs.

To frame the discussion, the Portuguese Presidency presented a non-paper on **the treatment of ONDs in the context of EDIS**, which addressed different policy options under the reference model mentioned above. It also presented an overview of a possible way forward for each OND (22 in total) in the context of EDIS, by focusing on the impact of the ONDs on EDIS and on the relevance of ONDs for Member States.

Although an individual assessment of each OND was not carried out, with regard to the policy options presented by the Presidency, the majority of members considered that ONDs should, whenever possible, be harmonised and covered at least to a certain degree by EDIS. Among these members, some also supported the idea that the partial harmonisation of ONDs would be partially or fully covered by EDIS or by NDGSs at national level only, with additional funds in excess of NDGSs' target levels, in particular during the transitional phase.

Others considered that ONDs could remain optional where harmonisation cannot be achieved, while being covered by EDIS or by the NDGSs at national level only, possibly with additional funds in excess of their target levels. A few members considered that all ONDs should remain as national options and be covered at national level only, possibly with additional funds. In their view, this would not increase costs for EDIS and would allow additional flexibility at national level. Finally, a few members were willing to consider the elimination of ONDs.

Moreover, several members expressed an interest in exploring how to reflect the amount of covered deposits or the risks associated with ONDs in the methodology for the calculation of contributions to EDIS. However, a few members were sceptical about the concrete parameters that could be used to achieve this objective.

8. Preventive and alternative measures

The treatment of ONDs as regards preventive and alternative measures in the context of EDIS is also of key importance for the scope of EDIS. In addition to the two mandatory functions of DGSs, i.e. pay-out and contribution in resolution, the DGSD provides that Member States may also allow DGSs to finance: (i) measures aiming to prevent the failure of a credit institution (preventive measures), and (ii) measures taken in the event of insolvency to preserve depositors' access to covered deposits (alternative measures).

At the meeting of 22 March, the European Commission presented the key highlights of the recent **decision by the Court of Justice on the Tercas case** and provided a brief **assessment of the impact of this ruling for DGS interventions** and of the interaction between DGSD and BRRD concerning the application of preventive measures and its financing by the DGSs (and possibly by EDIS), which may warrant clarification as part of the ongoing CMDI review.

To support the discussions, the Portuguese Presidency presented a non-paper on the **treatment of preventive and alternative measures in the context of EDIS** and promoted a discussion on different policy options for the treatment of these measures in the context of EDIS as well as on their impact in the hybrid model design, in particular in the liquidity phase of EDIS.

Members views were split with respect to policy options for the treatment of these measures in the context of EDIS. Some preferred a harmonised regime for both measures and favoured their coverage by EDIS. Others supported a regime in which measures would remain at national level only, to be financed by funds either counting towards the target level or above the target level, with EDIS focused on the two mandatory functions provided for in the DGSD only. In general, members who supported the coverage of both measures by EDIS highlighted: (i) its perceived advantages of efficiency in protecting depositor confidence and in the use of funds; (ii) its coherence with the overall regime for intervening in distressed or failing banks; (iii) its flexibility and predictability; and (iv) its ability to promote level-playing field among Member States by ensuring depositors' protection, which would justify providing the same coverage from the central fund and from mandatory lending as in the case of pay-out. Among these members, some agreed with the need to harmonise substantive regimes on the use of such measures (notably concerning the least-cost test). The members who were in favour of keeping these measures at national level raised the following concerns: (i) moral hazard; (ii) the interaction with the ongoing review of the CMDI framework, which may impact the discussions on the treatment of these measures in EDIS; and (iii) the fact that the failure of institutions should be dealt within the resolution framework and not primarily through these measures. Among these members, some also mentioned that EDIS should be limited to pay-out interventions. A few members preferred keeping such measures as a national option, notably for alternative measures, and covering them by EDIS. A few members also favoured the provision for stricter conditions on the application of these measures at national level, in order to ensure a level playing field in the EU crisis management framework.

Some members also mentioned the impact of the various policy options on the features of the hybrid model design, notably regarding the allocation of funds (with some members indicating that the inclusion of these measures could require a larger DIF), while a few noted that the possible increased efficiency that could be achieved by providing for such measures may not require a larger DIF, as long as the least-cost test is harmonised) and on contributions to the DIF (in general, members who mentioned this aspect did not favour any change to the contributions to be paid by members of the DGSs which use such measures).

In addition, a few members shared their views on the inclusion of these measures in EDIS in the transitional phase and in the steady state, having raised governance-related issues (namely a possible concurrent strengthening of the role of the central authority as the stepping stone for a steady-state EDIS). They also mentioned that when a fully fledged EDIS is achieved, it will be important to ensure harmonisation and application of the same conditions to all. Until then, in their opinion, harmonisation should be calibrated differently between the various phases.

9. Crisis management and EDIS

Considering that some of the potential changes discussed in the context of the review of the CMDI framework foresee enhanced DGS intervention in crisis management scenarios, at the meeting of 27 April 2021, the Portuguese Presidency opened a discussion on the role of EDIS in that regard. The Presidency non-paper on **CMDI revision and its articulation with EDIS** framed an exploratory discussion on the potential role EDIS might play following changes to the crisis management framework and sought to shed some light on the extent to which the CMDI revision is contingent on the setup of EDIS and vice versa. The discussion confirmed the divergent views of members, including on the pertinence of the connection between the CMDI review and EDIS. While a few members argued that the two issues are closely interconnected, some members considered that they should be disentangled from one another.

With regard to the changes to be provided for under the CMDI revision, some members favoured an option in which resolution and other harmonised tools to deal with the failure of institutions (such as the 'orderly liquidation tool' (OLT)) coexist. Some others voiced their preference for a broader scope for resolution, arguing that if an institution is not resolved, no alternative measures should exist or at least no alternative measures which are perceived as more favourable than resolution, and normal insolvency proceedings should apply, even if it implies a pay-out reimbursing covered deposits. A third current of thought, while supporting broader resolution, did not oppose alternative measures being maintained when normal insolvency proceedings with depositor pay-out are not adequate or are less efficient.

Moreover, with regard to the role that DGSs, in the abstract, could take on under such a revision, members were also divided as to the role they should play in crisis management, with several members favouring extending their involvement (a few arguing that such enlargement should take place only in resolution in exchange for less possibilities to use them outside resolution), while some argued that the primary function of DGSs is the protection of covered deposits through pay-out, and that any extension could endanger that purpose as well as depositor confidence. Some members voiced their opposition to the elimination of the super-priority of covered deposits and DGSs, while a few highlighted that an enlargement of the DGS's role in the current framework will require some amendments, notably the elimination of the super-priority. While recognising that a combination of funding mechanisms can be envisaged, a few members expressed their concerns on the need to reflect on the primary role of each mechanism.

Finally, as concerns the articulation with EDIS, members' views differed as to whether changes in DGSs' role should be included in the scope of EDIS. Some members argued that it is necessary to include them in order to ensure a coherent system in light of the three pillars of the banking union, and to ensure consistent responses to banking crises. Conversely, some members took the view that any new potential role for DGSs in crisis management should remain at national level, i.e. not be centralised in EDIS, whose role should be limited to pay-outs.

10. Risk-based contributions

Given that RBC are a key element of EDIS, during the meeting of 27 April 2021, the European Commission updated the AHWP BU members about the ongoing developments on the design of the methodology for calculating **RBC under EDIS**. The analysis conducted by the Joint Research Centre showed the impact of applying the RBC at banking union level to the amount of contributions relative to non-risk-based contributions. It also included the possible sovereign exposures indicators, thus contributing to discussions on the RTSE.

The majority of members favoured the use of RBC in EDIS, with several members advocating the benefits of a simple and transparent methodology.

Members expressed divergent views regarding the possibility of adding potential indicators based on concentration and/or credit risk of sovereign exposures to the calculation of RBC, with several members considering this topic as a component of the **RTSE discussion**. Specifically, some members were in favour of using both types of indicators, while a few members opposed both indicators, arguing that the significant impact on contributions would have implications for financial stability. Some members only agreed to include indicators based on concentration exposures and expressed concerns regarding the reliance on indicators based on credit risks, taking into account the adverse impact on smaller markets, and on external ratings prone to exacerbating pro-cyclicality and financial stability risks. Some of these members also suggested that an indicator based on concentration exposures should only be introduced in the transitional phase. A few members underlined that the weight of these indicators in the methodology for the calculation of RBC should be lower than that of the other risk indicators in order to reflect their limited importance. A few members expressed the view that RBC with sovereign exposures indicators are not a substitute for RTSE, while some other members argued that such RBC are an alternative to other forms of RTSE.

In addition, some members called for further technical analysis as the scope of EDIS becomes clearer. Others identified other indicators that could be part of the analysis, possibly as an alternative to using indicators based on concentration and/or credit risk of sovereign exposures. A few members suggested using risk indicators based on level 2 and level 3 financial instruments and another member highlighted the need to account for the fact that banks building-up MREL and contributing to the SRF with resolution strategies should be acknowledged as posing a smaller risk to a DGS. The European Commission clarified that other indicators may be added, providing data are available, but underlined that the addition of indicators implies a rebalancing of the weights of the core indicators (reducing their relative importance in the whole equation).

As part of this discussion, the recent ruling of the EU General Court on the contributions to the SRF set by the SRB was also mentioned, which highlighted the importance of balancing the benefits of introducing additional indicators against the risks of increasing the complexity and non-transparency of the methodology. It was also noted that complex calculation methods may not have a material impact on banks' incentives.

11. Transition to the steady-state

In line with the approach set by the Portuguese Presidency for the semester, during the meeting of 27 April 2021, the Portuguese Presidency discussed the transitional period **from the hybrid model to the steady state**, taking into account the positions expressed by AHWP BU members in earlier discussions.

The Portuguese Presidency recognises that EDIS is the necessary third pillar to complete the banking union, together with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The establishment of EDIS, with the creation of a DIF at European level, promotes the alignment of control and liability in deposit insurance. Consistency in its design involves the pooling of both governance and risks/liabilities from national level to the central level in a balanced way, until full centralisation is achieved in a fully fledged EDIS, if this is agreed at political level. The misalignment that would be created by pooling risks/liabilities without pooling governance may result in unwanted incentives to increase risks at national level and in operational challenges in the wake of a crisis. Conversely, the misalignment that would be created by pooling governance without pooling risks/liabilities may lead to the ultimate fiscal backstop of EDIS being the national treasuries. EDIS would be key to aligning incentives and would contribute to achieving a uniform level of depositor protection for all depositors, regardless of the geographical location of the bank, to promoting financial stability and to limiting the bank-sovereign nexus, including the use of taxpayers' money, which were the core milestones underlying the banking union project.

Building on the work of previous Presidencies, EDIS could start with a liquidity phase, while building trust and preparing the ground for a fully fledged system in the steady state, with liquidity and loss coverage«. The flexibility of the hybrid model allows for a gradual introduction of mutualisation and loss sharing. Therefore, during the transitional phase, the DIF's support could include a loss coverage component that would evolve to a gradually increasing extent.

In this context, the Portuguese Presidency explored the concept of loss sharing as well as how the introduction of this concept could interact with the following parameters of the hybrid model: (i) the allocation of funds and the size of the DIF; (ii) the build-up, financing and replenishment of the DIF; and (iii) the EDIS' governance.

During the discussions, there was no consensus on the Presidency's approach. Several members referred to the importance of a transitional phase that builds up towards a fully fledged EDIS as an end goal, with a few stressing the need for a clear progression path. Some members emphasised that EDIS would not require different phases or loss-coverage, arguing that these would be contingent on a political agreement also involving preconditions.

On the concept of loss sharing, several members favoured the DIF and the NDGS intervening in parallel and the share of the DIF's intervention being counted towards the absorption of potential losses, while one member preferred a loss-sharing component in the form of a percentage of the shortfall amount. A few members expressed a middle-of-the-road position, finding both options acceptable provided a gradual level of loss sharing is introduced. Some Members supported having a clear and certain timeline for moving towards loss sharing, while others reiterated that EDIS should only provide liquidity support.

Regarding the allocation of funds, some members supported the idea that, during the transitional phase, the proportion of funds allocated to the DIF would increase and the proportion of funds for mandatory lending and for national uses would decrease. The alternative where the proportion of funds for national uses is kept constant and the proportion of funds for mandatory lending decreases received less support. A few members highlighted that both options may be adequate, depending on circumstances, namely on the scope of EDIS.

The majority of members reiterated their preference for the DIF being funded through contributions benchmarked at banking union level from the start of the liquidity phase. A few members expressed their preference for the DIF being funded through contributions benchmarked at national level at the starting point, with the banking union benchmark being introduced at the beginning of the transitional phase, when loss sharing starts. A few members expressed a preference for the banking union benchmark being correlated with the rhythm of mutualisation of the DIF.

One member supported the possibility of introducing a safeguard to replenish the DIF when its available financial means fall below a pre-defined minimum threshold. Another member stressed the importance of a deferral period to mitigate excessive pressure on the national banking system that may trigger pro-cyclicality and hamper financial stability.

As concerns the governance of EDIS, a few members mentioned the need for a simple and efficient model, although more specific references were also made to the importance of promoting the alignment of liability and control, as well as to the need for a model that gives due consideration to the role of a strong central authority, while also being flexible enough to accommodate specific Member State concerns, in close cooperation with NDGSs.

When designing a possible way forward, the Portuguese Presidency also briefly addressed the treatment of other building blocks of EDIS mainly related to: (i) the entities that could be covered by EDIS; and (ii) the possible use of EDIS to finance preventive and alternative measures, as well as ONDs. In this regard, a few members favoured the gradual inclusion of these building blocks in EDIS at different points in time (in the set-up of EDIS, during the transitional phase or in the steady state), depending on the progress with the implementation of the conditions identified to allow for such inclusion. Conversely, some members preferred these building blocks to be included/excluded from the beginning. Other members argued that discussions on certain building blocks (notably the use of EDIS to finance preventive and alternative measures) should be prioritised, due to their impact on other parameters in the model. The importance of aligning the three pillars of the banking union and of reducing fragmentation was also stressed.

Since the inclusion of the above-mentioned building blocks in EDIS may impact the coverage level, the collection and use of the available financial means and the calculation of contributions, during discussions, some members were open to accounting for these facts in the calculation of the RBC using a harmonised methodology.

12. Final Remarks

The Portuguese Presidency invites the Council to take note of this Report, with a view to making further progress with this work. The Slovenian Presidency is also invited to build on the progress made and to continue to work towards strengthening the banking union.