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From:	Commission services
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés

Subject:	CMDI Review: working party 18.09.23 Item 4: Funding in resolution
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Funding in resolution

Use of DGS in resolution, least cost test, creditor hierarchy

CWP 18 September 2023

Agenda

1. Use of DGS in resolution - Stylised examples
2. Least cost test
3. Creditor hierarchy

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Use of DGS in resolution - Stylised examples

Objectives

- Provide a simple description, with quantitative stylised examples, of the functioning of Article 109 BRRD under the Commission's proposal.
- Highlight the different constraints that may affect the ability of deposit guarantee schemes and resolution funds to intervene in resolution.
- ***Disclaimer: The presentation is meant to illustrate the mechanics of the DGS bridge by providing examples based on a series of assumptions. It does not aim to represent the reality of each bank nor to replicate the findings of the impact assessment accompanying the Commission's proposal.***

Commission's proposal

- Funding in resolution is addressed, among other provisions, via amendments to Article 109 BRRD / Article 79 SRMR governing the rules to use DGS in resolution.
- For transfer strategies leading to market exit:
 - The DGS can be used to cover the difference between the assets and the deposits transferred to a recipient and, where necessary, to contribute to the own funds of the recipient (negative price)
 - All deposits may be included in the scope of the transfer – however, for non-covered deposits, RA must demonstrate that the reasons for their protection are met
 - Other liabilities ranking below deposits may be included in the scope of the transfer, but the DGS can only be used to support the transfer of deposits (i.e. DGS contribution cannot cover other liabilities)
 - The cost of the DGS contribution is limited by the least cost test defined in the DGSD
 - Where non-covered deposits are included in the transfer, the DGS contribution counts towards compliance with the 8% TLOF requirement for accessing the RF/SRF ('bridge function'), and is limited to the amount necessary to meet the 8% TLOF, compensating only for all or part of the losses that would have otherwise been borne by deposits
 - The use of DGS bridge to access the RF/SRF comes with safeguards: case by case decision of the RA (no automatism), only for transfer strategies with market exit, only for non-liquidation entities, only if the protection of non-covered deposits is justified
 - The DGS is covered by the 'no creditor worse off' safeguard

Methodology and assumptions

Balance sheet reaching FOLF

- Fictitious but realistic liability structure using breakdowns from EBA Z.02.00 liability data template: *covered deposits, preferred deposits, non-covered non-preferred deposits, senior unsecured liabilities, senior non-preferred liabilities, other subordinated liabilities, own funds.*
- Hypothetical breakdown of assets made of *cash and liquid assets, loans to financials, loans to businesses, loans to retail (mortgage) and other assets.*
- By default, CET1 depletion (30%) and losses on assets applied proportionally to all asset classes (except cash and liquid assets) leading to an overall implied loss of 10%-14% of total assets.
- All examples assume that the PIA is positive.

Transfer perimeter and residual entity

- By default, transfer of all deposits (covered, preferred, non-covered non-preferred) under the assumption that they are all mandatorily or discretionarily excluded from bail-in.
- Transfer perimeter includes loans to businesses, loans to retail (mortgage) and half of other assets (assumed transferable), by default without haircut. Residual assets go to the residual entity where a 15% haircut is assumed.

Those assumptions reflect a default scenario, necessary to present the stylised examples in a comparable way.

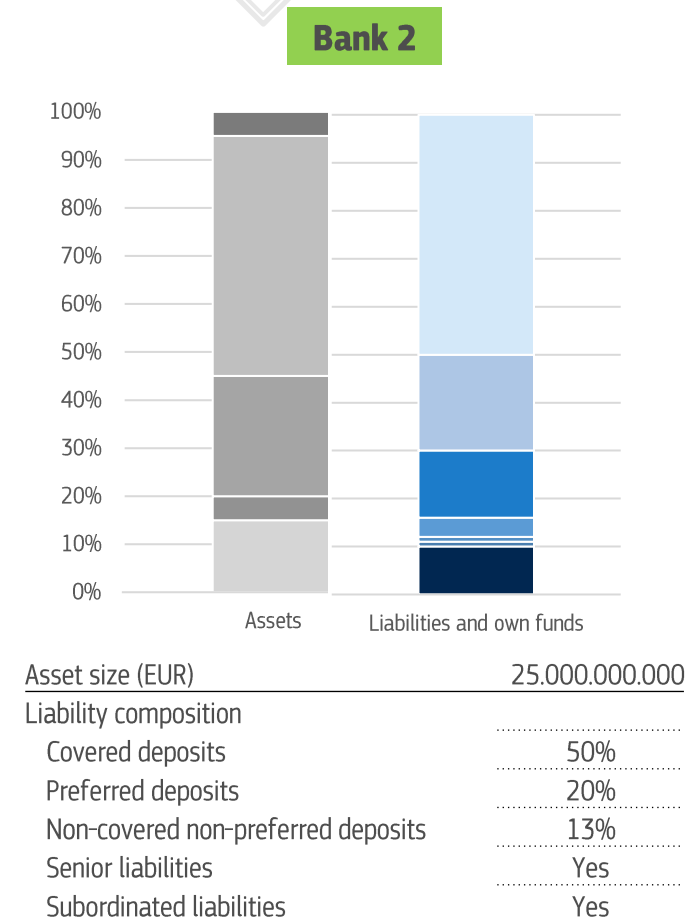
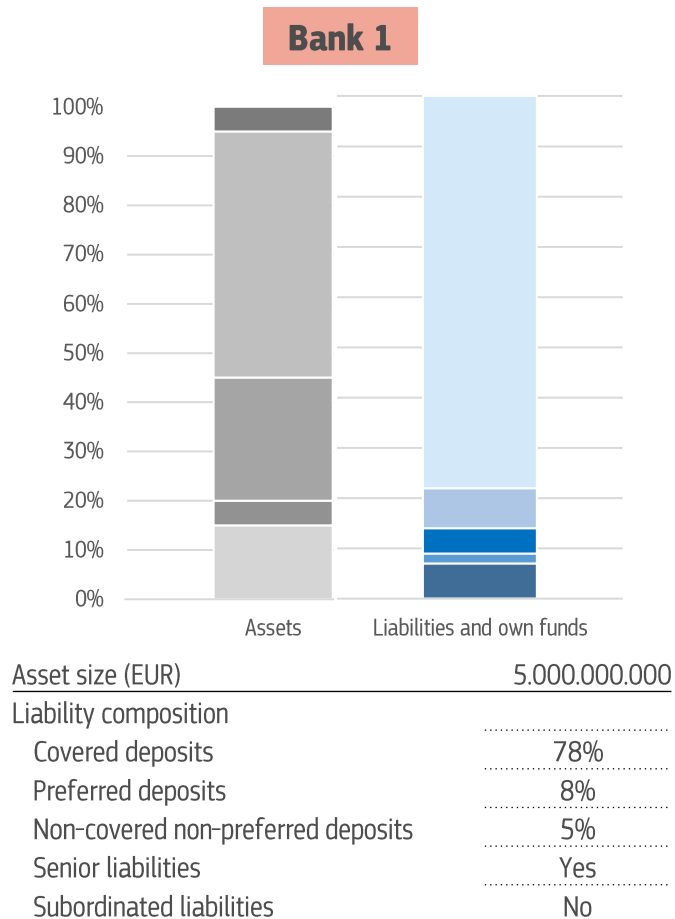
Results may change if the assumptions are tightened or loosened depending on each specific case.

Allocation of losses and interventions by safety nets

- Allocation of losses based on a general depositor preference and a single tier depositor hierarchy
- Interventions of DGS subject to all limits set out in Article 109 BRRD
- Least cost test based on a net approach (gross disbursement minus expected recoveries) using a recovery rate of 85%, and assuming indirect costs (2%)
- Write-down of all liabilities (except deposits) above 8% TLOF before intervention of the resolution fund, i.e. resolution fund can intervene above 5% TLOF if all non-excluded liabilities have been written down/converted
- Resolution fund cannot intervene to support a transfer when only covered deposits are included in the transfer perimeter
- Case where DGS could intervene to support capital neutrality is not reflected.

Cases

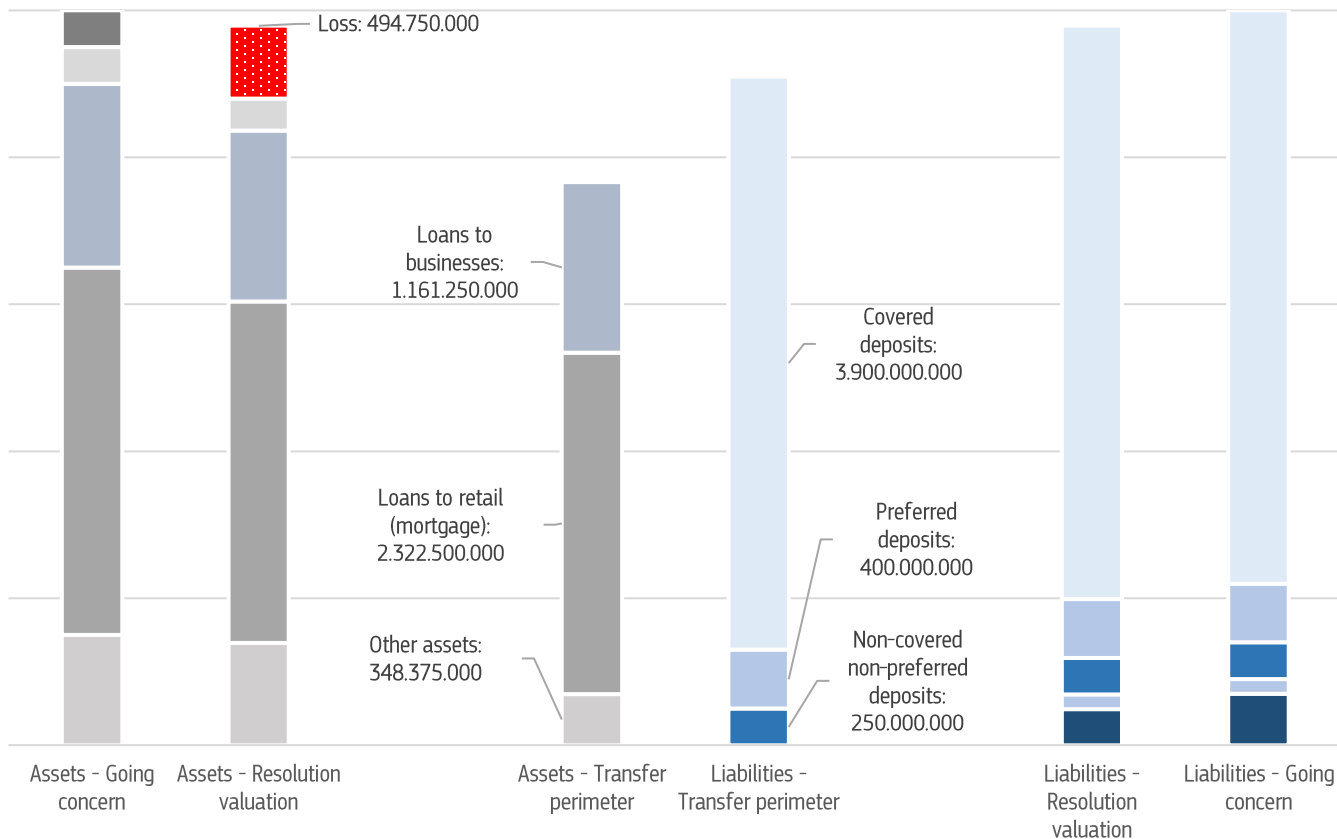
Two fictitious (but reality inspired) cases of small and medium-sized banks, with the same asset composition and different liability structure.



Scenario 1

All deposits included in the transfer (1/3)

Read direction



Allocation of losses

Loss on assets is absorbed by own funds and non-excluded liabilities.

Losses that would have been borne by excluded deposits: **EUR 350 million**
 Bank's own resources absorbed losses equal to **7.0% TLOF** -> the threshold to access the resolution fund is not met.

Liabilities and own funds - After allocation of losses		Loss		Exclusions
		EUR	%TLOF	
Covered deposits	3.900.000.000	0	0,0%	3.900.000.000
Preferred deposits	400.000.000	0	0,0%	400.000.000
Non-covered non-preferred deposits	250.000.000	0	0,0%	250.000.000
Senior unsecured liabilities	0	100.000.000	2,0%	0
Senior non-preferred liabilities	0	0	0,0%	
Other subordinated liabilities	0	0	0,0%	
Own funds	0	245.000.000	5,0%	
Total	4.550.000.000	345.000.000	7,0%	
	Unallocated	149.750.000	3,1%	

Transfer perimeter

All non-excluded deposits and some other assets are transferred. The difference between assets and liabilities creates a **funding gap of EUR 718 million** in the transfer perimeter.

*The decrease between 1 and 2 is due to the effect of the CET1 depletion.

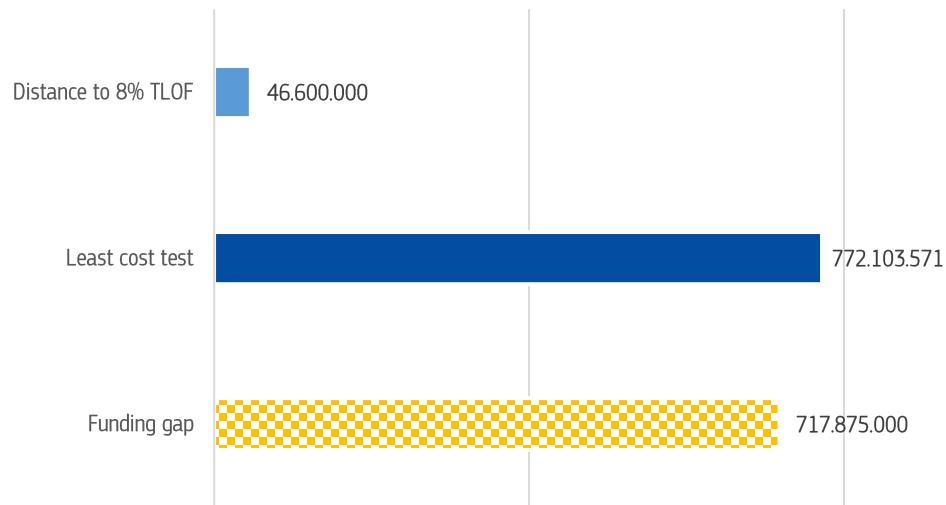
Scenario 1

All deposits included in the transfer (2/3)

Maximum amounts capping DGS interventions

Article 109 BRRD provides for three limits to calibrate the intervention of DGS in resolution: the funding gap, the least cost test, and the distance to the threshold of 8% TLOF.

In this example, the binding cap is the **distance to 8% TLOF**.

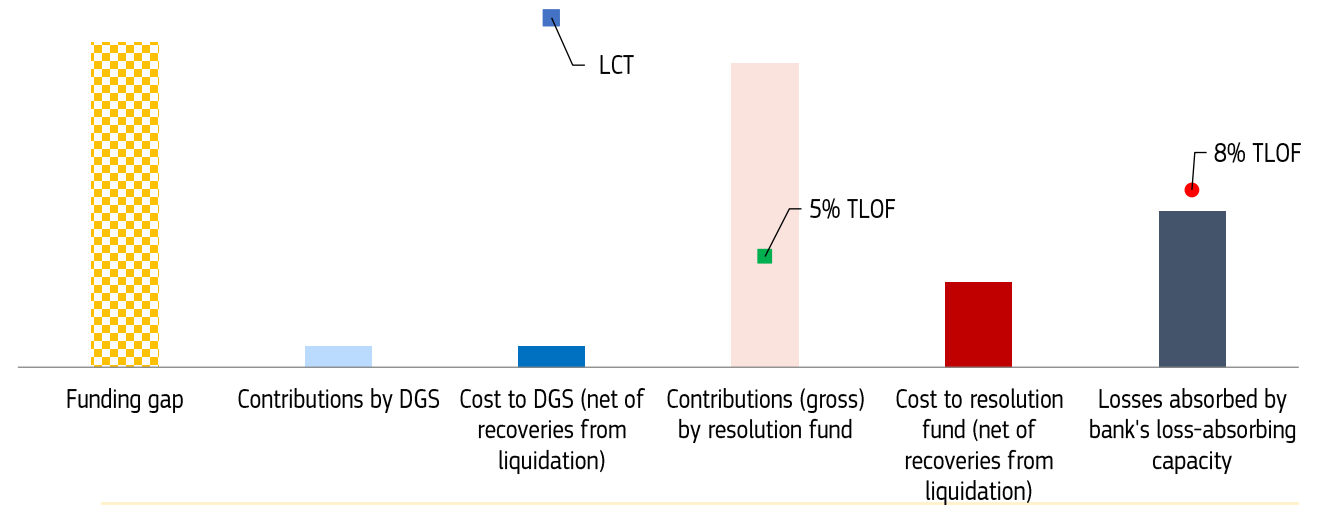


Limits for contribution from DGS	Amounts
	EUR
Funding gap	717.875.000
Least cost test	772.103.571
Distance to 8% TLOF	46.600.000

Interventions by safety nets

Considers the losses already absorbed by the bank's resources, the losses not absorbed because of the exclusion of some liabilities and the amount needed to reach 8% TLOF.

In this example, the DGS contributes **up to the 8% TLOF threshold**. Other financing needs are **covered by the resolution fund** (above 5% TLOF as conditions of Article 44(7) are met).



Loss absorption and contributions from safety nets		Amounts
		EUR
Losses absorbed by bank's loss-absorbing capacity		345.000.000
Reference: 8% TLOF		391.600.000
Contributions by deposit guarantee scheme		46.600.000
Contributions (gross) by resolution fund		671.275.000
Reference: 5% TLOF		244.750.000
Cost to resolution fund (net of recoveries from liquidation)		188.368.750
Cost to DGS (net of recoveries from liquidation)		46.600.000

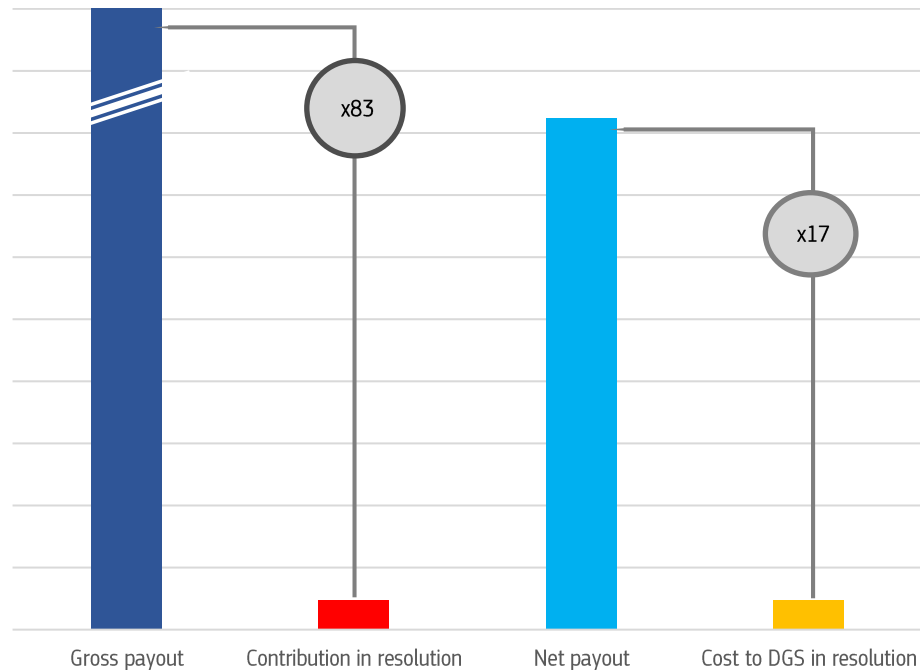
Scenario 1

Comparison with payout (3/3)

Intervention by safety nets

Under the assumption that the bank would be liquidated in insolvency and covered depositors would be paid out, **the contribution from the deposit guarantee scheme, net of recoveries, would significantly exceed the intervention expected to support a transfer in resolution.**

In this example, the deposit guarantee scheme would contribute an amount **83 times** larger in insolvency than in resolution, and the net cost would be **17 times** higher



Insolvency - Losses on DGS and other depositors

The allocation of liquidation proceeds, on the basis of the assumed recovery rate and creditor hierarchy, may lead to losses for the deposit guarantee scheme and other non-covered depositors.

In this example, the recoveries would leave **EUR 809 million** of losses for the deposit guarantee scheme and other depositors, i.e. 18% of the total deposit book.

Payout

Gross payout of covered deposits	3,900,000,000
Indirect costs	78,000,000
Expected recovered amount in insolvency (85% recovery rate)	3,740,212,500
Attributed to covered deposits	3,205,896,429
Attributed to other deposits	534,316,071
Amount of deposits in excess of recoveries	809,787,500
18%	
Least cost test	772,103,571

Transfer in resolution

Contributions by deposit guarantee scheme	46,600,000
Amount of deposits in excess of recoveries	0
Cost to DGS in resolution	46,600,000

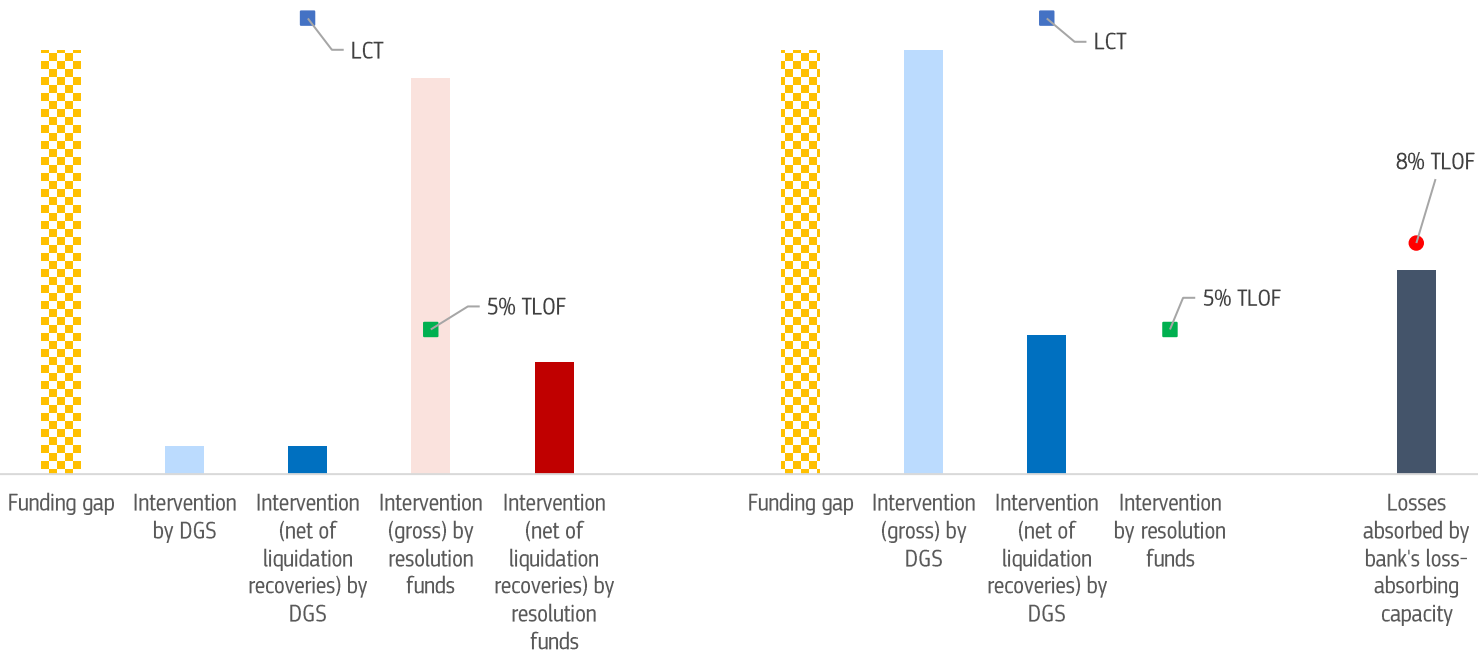
Scenario 2 (hypothetical)

Absence of DGS cap

Interventions by safety nets

Under the assumption that the contribution from the DGS cannot count towards meeting the 8% TLOF threshold (and thus the DGS intervention is not capped by the 8% threshold), the DGS would intervene to cover losses and funding needs up to the maximum of the funding gap needed for the transfer to the extent allowed by the least cost test.

In this example, without the bridge function, the **resolution fund does not intervene** as the 8% TLOF threshold is not reached. The entirety of the funding gap is covered by the DGS, as the net DGS intervention is lower than the least cost test.



Loss absorption and contributions from safety nets	Amounts
	EUR
Losses absorbed by bank's loss-absorbing capacity	345,000,000
Reference: 8% TLOF	391,600,000
Contributions by deposit guarantee scheme	717,875,000
Cost to DGS (net of recoveries from liquidation)	234,968,750
Reference: Least cost test	772,103,571
Contributions by resolution fund	0

DGS counts towards the 8% TLOF

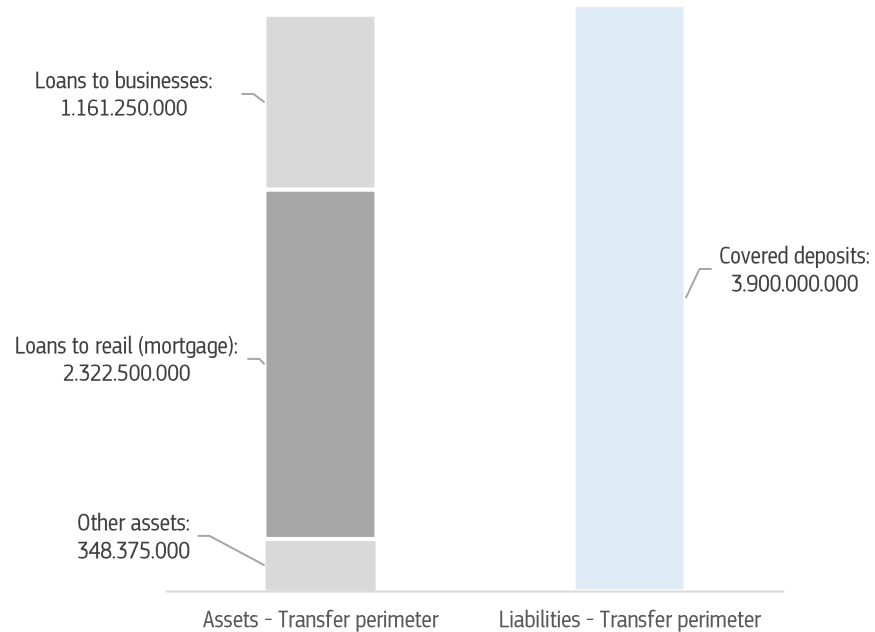
DGS does **not** count towards the 8% TLOF

Scenario 3

Only covered deposits included in the transfer

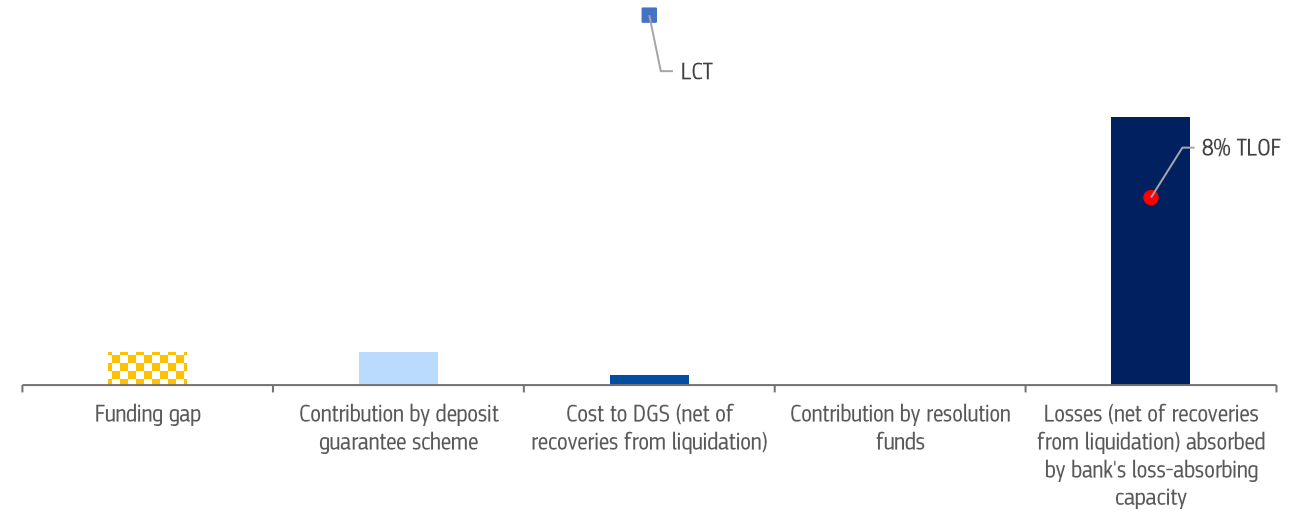
Transfer perimeter

Only covered deposits being transferred. Non-covered preferred and non-preferred deposits are not transferred, i.e. they are not excluded from bearing losses.



Interventions by safety nets

In the case where only covered deposits are transferred, DGS intervention is determined by the funding gap and the least cost test. Other non-covered deposits bear losses on the basis of the recoveries from the insolvency proceedings.



Loss absorption and contributions from safety nets

	Amounts
	EUR
Losses absorbed by bank's loss-absorbing capacity	558,575,893
Reference: 8% TLOF	391,600,000
Contributions by deposit guarantee scheme	67,875,000
Contributions (gross) by resolution fund	0
Cost to resolution fund (net of recoveries from liquidation)	0
Cost to DGS (net of recoveries from liquidation)	20,813,834

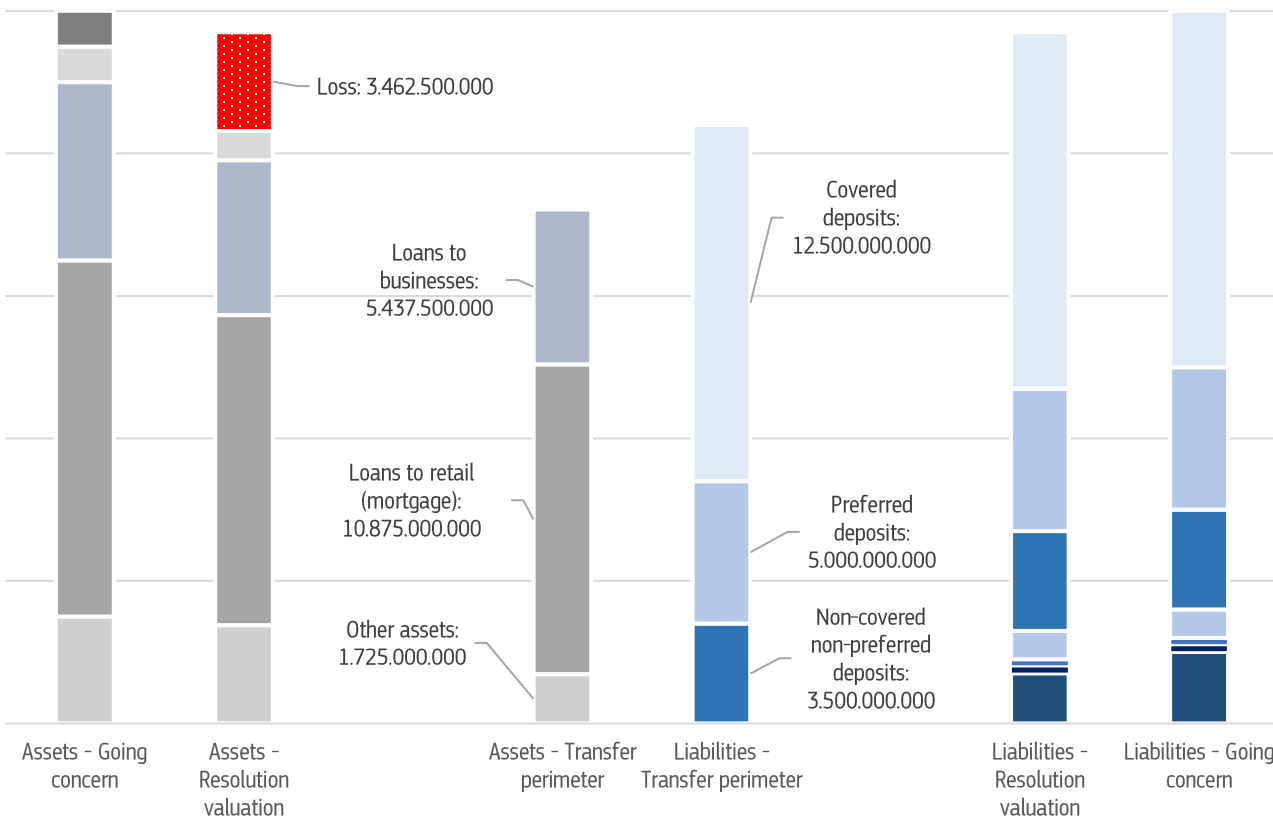
Limits for contribution from DGS

	Amounts
	EUR
Funding gap	67,875,000
Least cost test	772,103,571

Scenario 1

All deposits included in the transfer (1/2)

Read direction



Allocation of losses

Loss on assets is absorbed by own funds and non-excluded liabilities.

Losses that would have been borne by excluded deposits: **EUR 212.5 million**
 Bank's own resources absorbed losses equal to **13.4% TLOF** -> the threshold to access the resolution fund is met.

Liabilities and own funds - After allocation of losses		Loss		Exclusions
		EUR	%TLOF	
Covered deposits	12.500.000.000	0	0,0%	12.500.000.000
Preferred deposits	5.000.000.000	0	0,0%	5.000.000.000
Non-covered non-preferred deposits	3.500.000.000	0	0,0%	3.500.000.000
Senior unsecured liabilities	0	1.000.000.000	4,1%	0
Senior non-preferred liabilities	0	250.000.000	1,0%	
Other subordinated liabilities	0	250.000.000	1,0%	
Own funds	0	1.750.000.000	7,2%	
Total	21.000.000.000	3.250.000.000	13,4%	
	Unallocated	212.500.000	0,9%	

Transfer perimeter

All deposits are transferred. The difference between assets and deposits creates a **funding gap** of **EUR 2.96 bn** in the transfer perimeter.

*The decrease between 1 and 2 is due to the effect of the CET1 depletion.

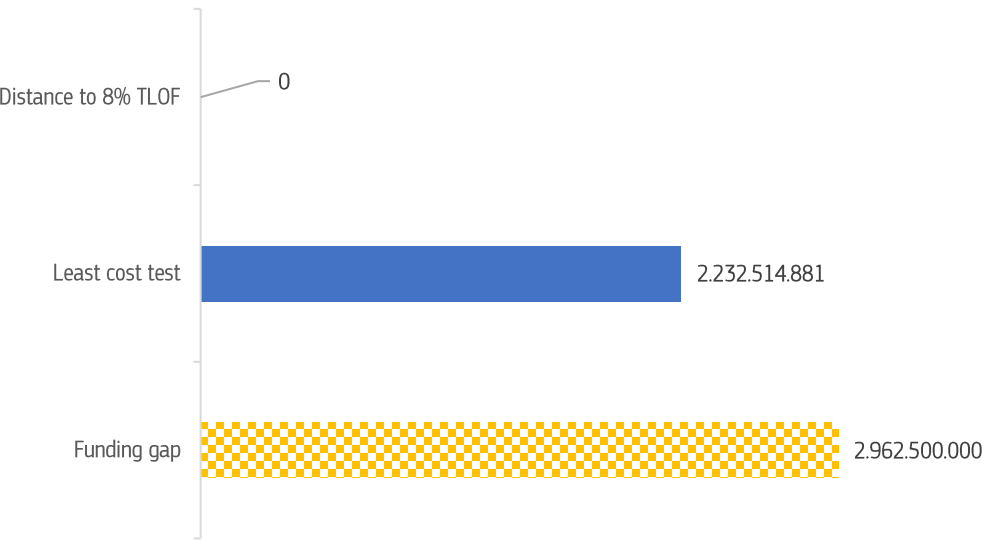
Scenario 1

All deposits included in the transfer (2/2)

Maximum amounts capping DGS interventions

Article 109 BRRD provides for three limits to calibrate the intervention of DGS in resolution: the funding gap, the least cost test, and the distance to the threshold of 8% TLOF.

In this example, the binding cap is the **distance to 8% TLOF**.



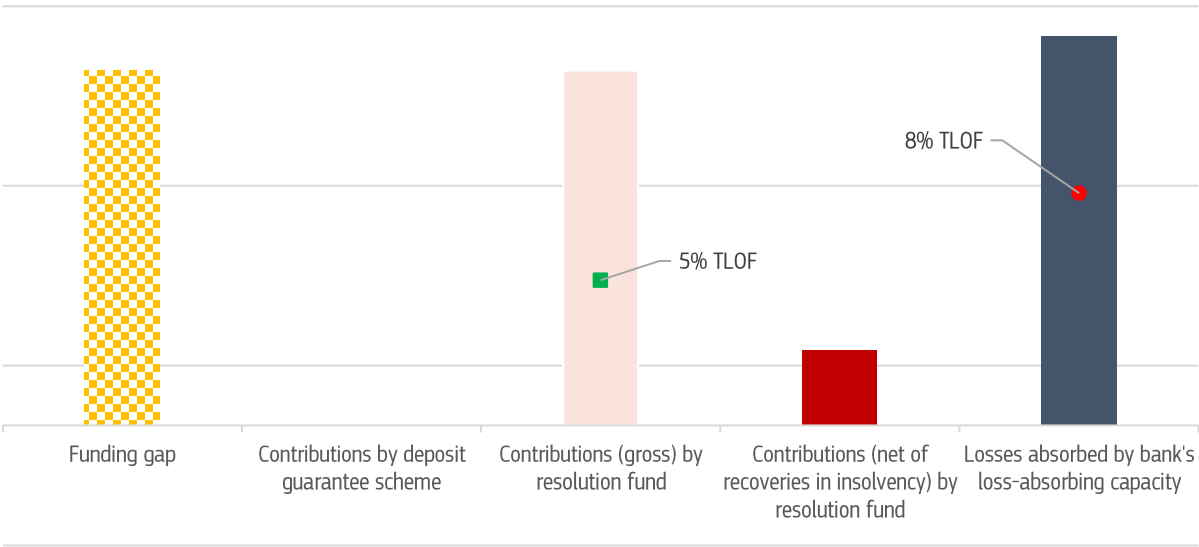
Limits for contributions from safety nets

	Amounts
	EUR
Funding gap	2,962,500,000
Least cost test	2,232,514,881
Distance to 8% TLOF	0

Interventions by safety nets

Considers the losses already absorbed by the bank's resources, the losses not absorbed because of the exclusion of some liabilities and the amount needed to reach 8% TLOF.

In this example, the DGS does not contribute because bank's own resources exceed **the 8% TLOF threshold**. Other financing needs are **covered by the resolution fund** (above 5% TLOF as conditions of Article 44(7) are met).

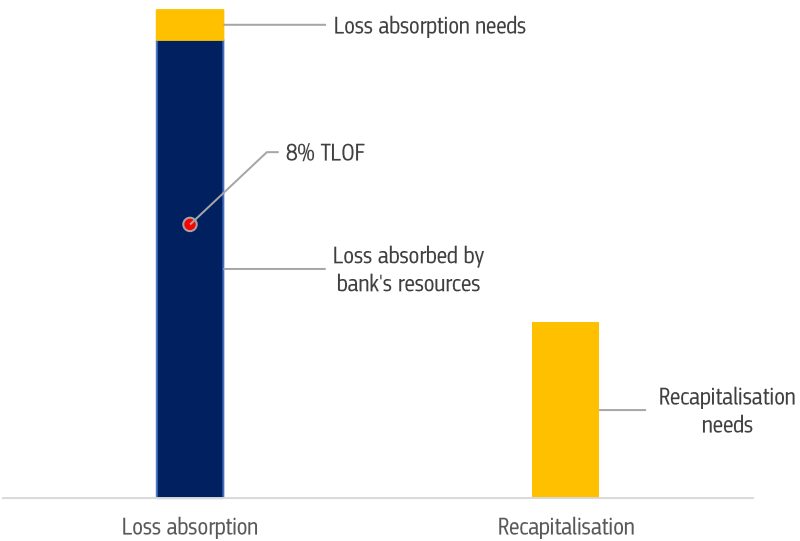


	EUR
Losses absorbed by bank's loss-absorbing capacity	3,250,000,000
Reference: 8% TLOF	1,940,000,000
Contributions by deposit guarantee scheme	0
Contributions by resolution fund	2,962,500,000
Reference: 5% TLOF	1,212,500,000
Cost to resolution fund (net of recoveries in liquidation)	625,000,000

Bail-in strategy

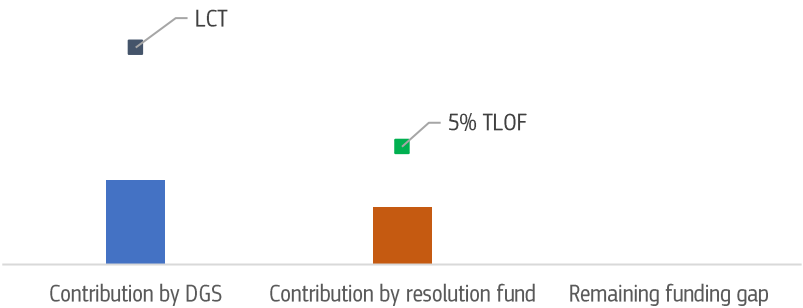
Bail-in

Assume an open bank bail-in strategy, with a recapitalisation of the bank up to a level of own funds equal to 12% TREA.



Interventions by safety nets

DGS may intervene only with respect to covered deposits. As per the Commission’s proposal, these contributions do not count towards the 8% TLOF. The single tier deposit preference implies that DGS intervenes proportionally to the share of covered deposits (over all deposits ranking *pari passu*) alongside the resolution fund if the 8% TLOF is met using the bank’s own resources.



Bail-in	
Loss absorption needs	3.462.500.000
Loss absorbed by bank's resources	3.250.000.000
Reference: 8% TLOF	1.940.000.000
Recapitalisation needs	1.247.250.000
Conversion of bank's resources	0
Contribution by DGS	868.898.810
LCT	2.232.514.881
Contribution by resolution fund	590.851.190
Reference: 5% TLOF	1.212.500.000
Remaining funding gap	0

Concluding remarks

- The DGS 'bridge function' is necessary to ensure that **a larger number of banks with positive PIA can have access to funding** in the amount sufficient to deliver on the resolution objectives.
- The bridge function would work in a **selected number of cases**, where MREL at the time of crisis is not enough to meet the access conditions to the SRF. It is subject to several stringent safeguards and is only available to banks that have not been earmarked for liquidation.
- In the stylised examples presented here:
 - The amount needed to bridge to 8% TLOF is **not high** and is in any case **lower than the LCT**;
 - A large part of the **SRF contribution is recouped** through the recoveries in the liquidation of the residual entity, in part due to high insolvency ranking granted to the SRF;
 - Where all deposits are transferred but the bridge function is not introduced: the SRF could not intervene, but the **DGS could fund** the entire difference between assets and liabilities without breaching LCT. However, the loss to the DGS **increases significantly**;
 - In a **payout**, the gross **contribution** of the DGS shown in this example would be 83 times higher than the gross DGS contribution in resolution (DGS bridge), while the net **losses** would be 17 times higher;
 - Transferring **only covered deposits** would cause a deviation from *pari passu* in a single-tier depositor preference, with NCWO issues for the non-transferred deposits.

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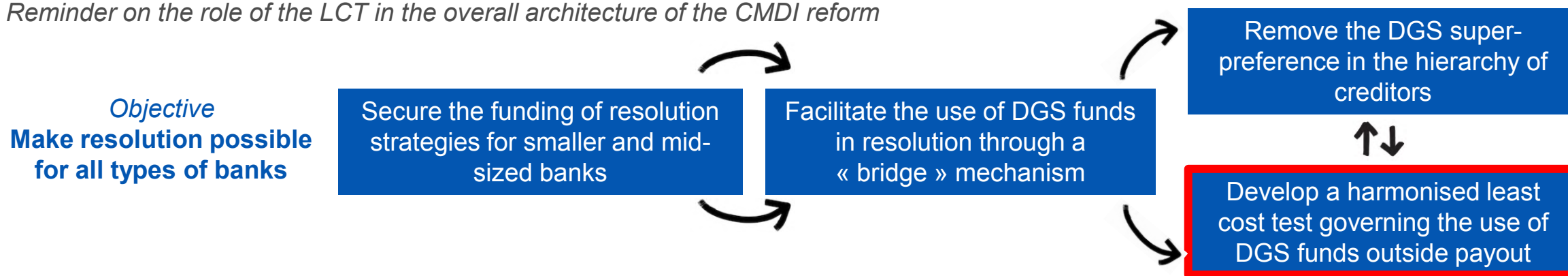
Least cost test

Reminder on the principle of the LCT

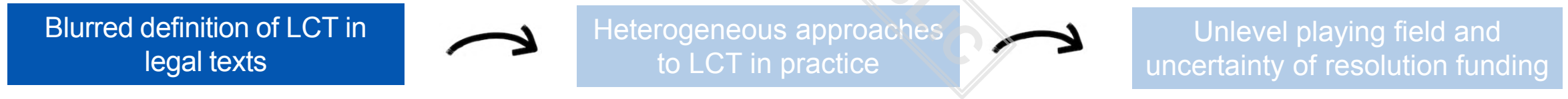
Original intention: The DGS may only intervene outside payout if the cost of such intervention does not exceed the cost of compensating covered depositors of the institution in case of payout and liquidation. Key principle to ensure sound use of DGS funds.

Role of the LCT in the CMDI reform: the harmonisation of the LCT is a prerequisite to fulfil the CMDI overarching goal to facilitate recourse to resolution for smaller and mid-sized banks when this is the most cost-efficient solution.

Reminder on the role of the LCT in the overall architecture of the CMDI reform



Problem definition (1/4)



Problem n°1: in legal texts in force, the LCT principle is **worded differently** for each use of DGS funds:

- For preventive measures, under Art. 11(3) DGSD: *“The costs of the measures [shall] not exceed the costs of fulfilling the statutory or contractual mandate of the DGS”.*
- For alternative measures in insolvency, under Art. 11(6) DGSD: *“The costs borne by the DGS [shall] not exceed the net amount of compensating covered depositors at the credit institution concerned”.*
- For use of DGS funds in resolution, under Art. 109(5) BRRD: *“In any circumstances, the deposit guarantee scheme’s participation under this Directive shall not exceed the losses it would have incurred in a winding up under normal insolvency proceedings”.*

Problem n°2: In all cases, there are **no detailed rules** on the least cost test calculation and methodology. No guidelines nor L2 material has been issued to further detail the rules applicable to the LCT.

Problem definition (2/4)

Blurred definition of LCT in legal texts



Heterogeneous approaches to LCT in practice



Unlevel playing field and uncertainty of resolution funding

As a consequence, the LCT is **executed differently**...

- ...across the different Member States;
- ...and across the different uses of DGS funds (so far, for preventive measures and alternative measures in insolvency).



See the list of past uses of DGS funds across EU Member States in the IA on pp. 349-352.

Source: EFDI, Cost-benefit analysis and least-cost calculation for decision making process of deposit guarantee schemes, 11/2021

Outcome of EFDI survey on the national transpositions of the LCT requirement

Country	DGS details	Article 11.6			Article 11.3		
		Cost criterion reference in the Statute or Regulation	standardised methodology	real-life cases	Cost criterion reference in the Statute or Regulation	standardised methodology	real-life cases
BELGIUM		✓					
DENMARK		✓		✓			
FINLAND		✓					
FRANCE		✓		✓	✓		✓
GERMANY	BVR (cooperat. IPS/DGS)				✓		✓
GREECE		✓					
ITALY	both FGD and FITD	✓	✓	✓	✓	✓	✓
MALTA					✓		
NORWAY		✓			✓		
POLAND		✓		✓			
SPAIN					✓		
TURKEY				✓			

Problem definition (3/4)



See examples of completion of LCT for preventive measures in the IA on pp. 230-231.

Blurred definition of LCT in legal texts



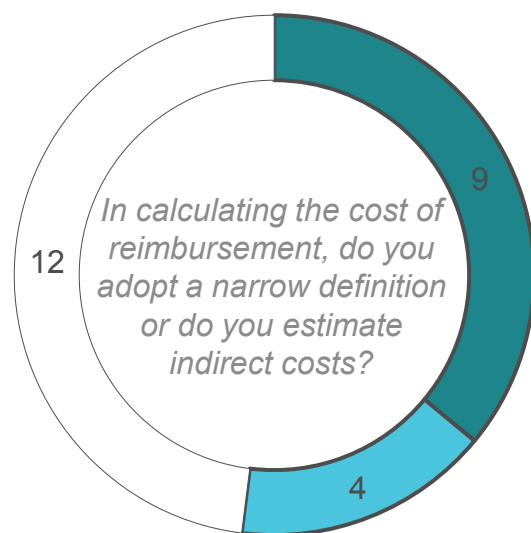
Heterogeneous approaches to LCT in practice



Unlevel playing field and uncertainty of resolution funding

Examples of different approaches to calculating LCT

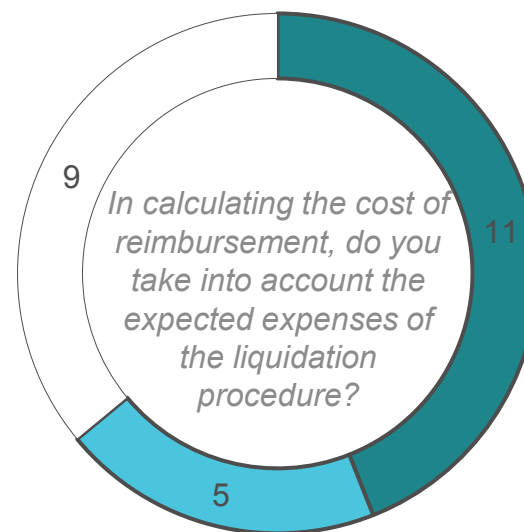
1) Indirect costs



■ Direct costs only
 ■ Direct + indirect costs
 □ Non-respondents

Source: EFDI survey, 11/2021

2) Operational costs



■ Yes
 ■ No
 □ Non-respondents

Source: EFDI survey, 11/2021

3) Zoom on the interpretation of the LCT condition in the context of preventive measures

PL

Very detailed legal rules on the provision and certification of information needed to perform the LCT

IT

Maximum cost of the measure must not exceed the cost which the system would have to bear in order to carry out other interventions

HR

Maximum cost of the measure below 50% of the amount of covered deposits

DE IPSs

The cost of fulfilling the DGS/IPS mandate is not limited and the payout counterfactual is not considered in such a context

Other relevant Member States

Transposed literally the condition under DGSD without specifications on the calculation

Source: CEPS study, 11/2019

Problem definition (4/4)

Blurred definition of LCT in legal texts



Heterogeneous approaches to LCT in practice



Unlevel playing field and uncertainty of resolution funding

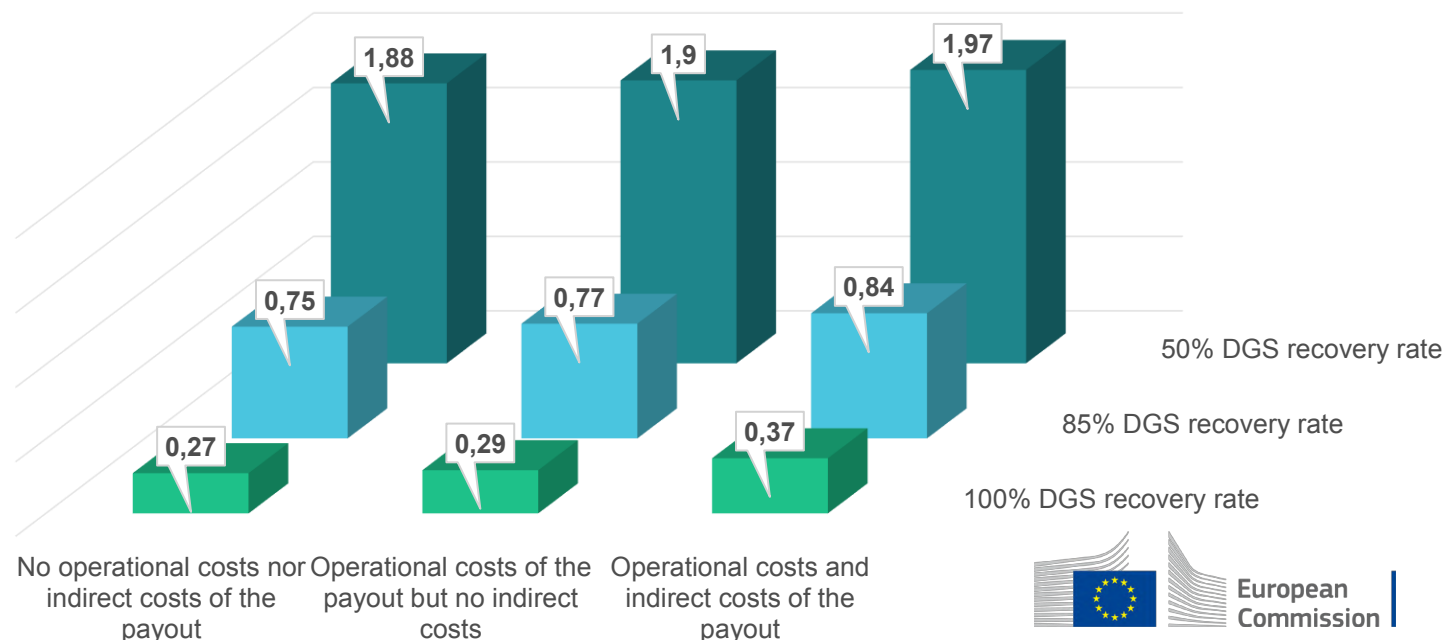
The uncertainties around LCT methodology jeopardise the funding of DGS measures outside payout as the varying parameters of the LCT can greatly affect its quantitative outcome.

Main LCT parameters	
Asset size (EUR)	5.000.000.000
Covered deposits	70% of liabilities (3.500.000.000)
Operational costs (when considered)	Assumption of 0.5% of CD (17.500.000)
Indirect costs (when considered)	Assumption of 2.0% of CD* (70.000.000)
DGS recovery rate	From 50% to 100% of the DGS gross payout amount

* Equals to interests on alternative funding tools (assumption of a recourse to alternative funding tools in 50% of payout cases under a nominal interest of 4%).

These simulations are based on **the same assumptions in terms of loss on assets of the FOLF entity and structure of the deposit book** as those described for Bank 1 in the “Use of DGS in resolution and stylised examples” section of the presentation.

Simulations of LCT outcomes under varying parameters (in EUR bn)



Call for LCT harmonisation

From
practitioners



*“The so called “least-cost criterion” is currently interpreted **in a broad spectrum** among experts [...] A harmonized methodology of costs comparison to the pay-out is **welcome and necessary**”*

EFDI, “Cost-benefit analysis and least-cost calculation for decision making process of deposit guarantee schemes”, 11/2021
<https://www.teke.gr/pages/NEWS/files/211110%20Least%20Cost.pdf>

From resolution
authorities



*“The way forward to facilitate the use of DGS funds in resolution is to remove their super priority and adopt a general depositor preference [...] together with a stringent and **harmonised LCT**, including relevant **quantifiable costs**”*

SRB, “A blueprint for the CMDI framework review”, 05/2021
https://www.srb.europa.eu/system/files/media/document/2021-05-18_srb_views_on_cmdi_1.pdf

From
supervisors



*“DGS preventive measures have proven to be a useful crisis management tool which should be kept and extended across the EU in a **harmonised way**. [...] Key ways to achieve a broader use of DGS include clarifying and harmonising the least-cost test while taking into account a broader concept of the costs of a pay-out scenario, or removing the DGS super-preference”*

ECB, “ECB contribution to the European Commission’s targeted consultation on the review of the crisis management and deposit insurance framework”, 2021
https://www.ecb.europa.eu/pub/pdf/other/ecb_consultation_on_crisis_management_deposit_insurance_202105~98c4301b09.en.pdf

From Member
States

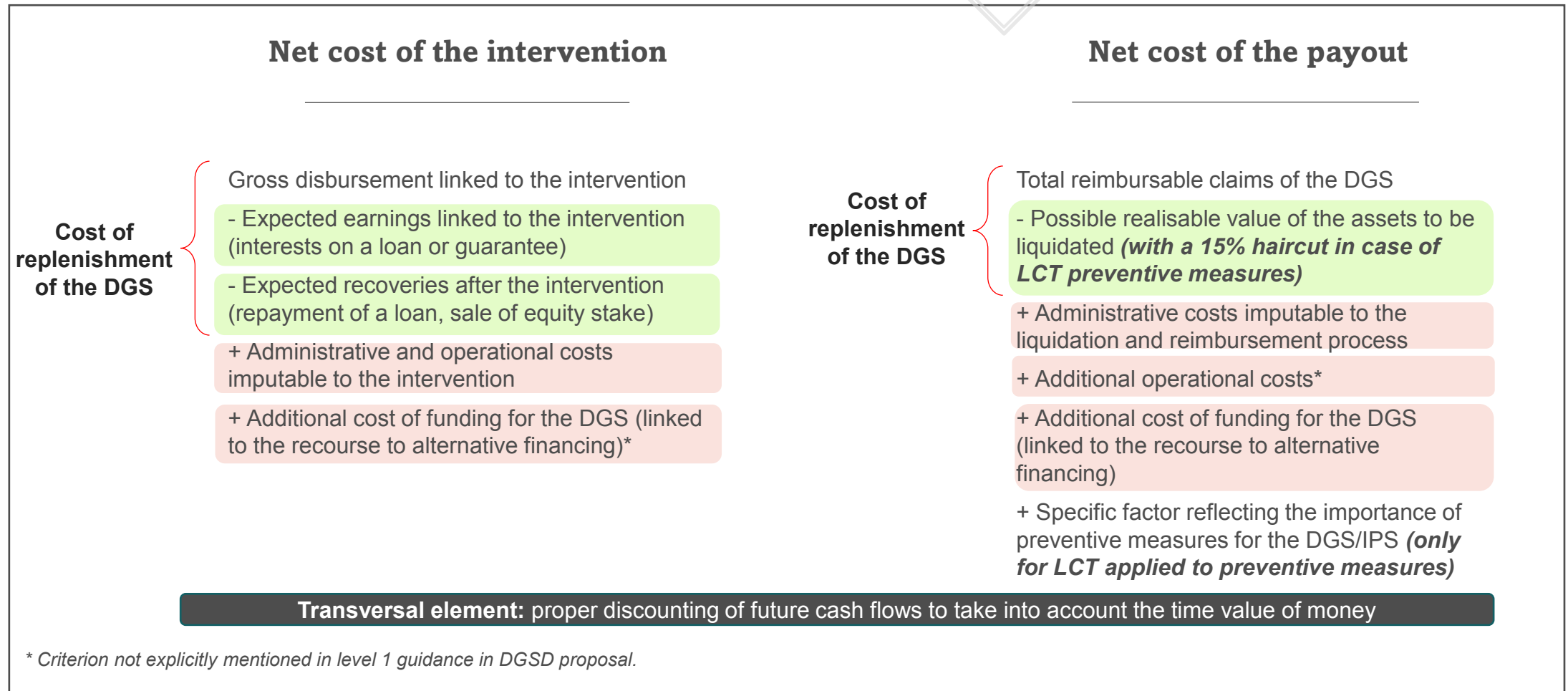


*“A **harmonised least-cost test**, administered by national authorities, **to govern the use of DGS funds** outside payout to covered depositors, to ensure consistent, credible and predictable outcomes”*

Eurogroup, “Eurogroup statement on the future of the Banking Union of 16 June 2022”, 06/2022
<https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/>

Breakdown of the LCT equation

The DGSD proposal does not provide a detailed quantitative LCT equation but rather rules that the EBA should take into account when designing the precise LCT formula.



The LCT in the CMDI reform

Main building blocks of the LCT

Net costs approach

DGS interventions that entail upfront disbursement but no/limited long-term losses remain possible as recoveries are taken into account when computing the costs of the DGS intervention and the payout counterfactual

Lesser cost test principle

The payout remains the point of comparison for all uses of DGS funds

Governance

The DGS is in the driving seat to perform the LCT

Quantifiable and DGS-centric indirect costs

As the LCT governs the use of DGS funds, the direct and indirect quantifiable impacts on DGS funds should be factored in the LCT equation

Interactions with other bits of the CMDI proposal

Special LCT adjustments for specific circumstances

In line with the EG statement and to avoid having unequally lenient avenues to use DGS funds, one consistent LCT for all measures and Member States, with proportionate tweaks applicable to specific measures (use of DGS funds for preventive measures) or stakeholders (IPSS)

Coexistence with other quantitative caps

Two other caps on the use of DGS funds outside payout: (i) 8% TLOF in case of use of the DGS for transfer strategies and (ii) no preventive measures whose amount exceeds covered deposits

A LCT based on a new creditors hierarchy

The new LCT methodology integrates the revised creditor hierarchy, without DGS super-preference

LCT building blocks

Net costs approach

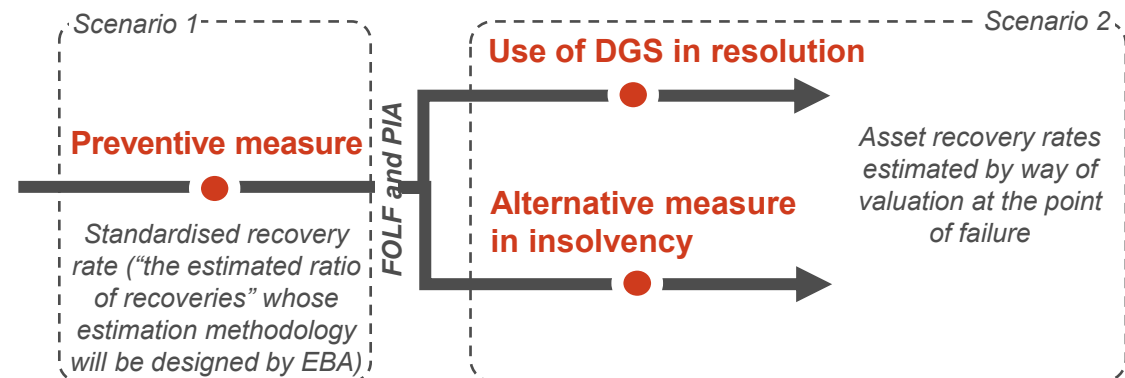
Principle	The LCT does not only consider the DGS disbursement of funds but rather the end costs of the DGS intervention. To ensure the parallelism of the LCT equation, both costs of the measure and costs of the payout counterfactual, net of expected recoveries , are taken into account.
CMDI proposal	<i>“When considering the use of DGS funds for the measures referred to in Article 11(2), (3) or (5), Member States shall ensure that DGSs make a comparison of the following: (a) the estimated cost for the DGS to finance the measures; (b) the estimated cost of repaying depositors” (Art. 11e(1) of the DGSD proposal).</i>
Objectives	1) Taking into consideration the cost puts on equal footing DGS interventions in the form of guarantees (with no upfront disbursement) or in the form of loans (with an upfront disbursement). 2) Ensuring the comprehensiveness of the LCT by factoring in the LCT equation a holistic set of DGS’ cost components (integrating potential earnings and recoveries). 3) Maintaining the credibility of the LCT safeguard (a LCT governed by a gross approach – ignoring payout recoveries – would be always positive considering the disbursements linked to payout event).

Preventive measures specified in national laws

	Subsidy	Capital	Loans	Acquire A&L	Bridge institution	Guarantee	Third-party claims
HR		X		X		X	
FR		X		X	X	X	
DE	X	X	X	X		X	X
IT		X	X	X		X	
PL		X	X	X		X	X
ES	X	X	X	X			

Source: CEPS study, 11/2019

Two scenarios for the estimation of DGS recoveries in LCT



LCT building blocks

Quantifiable and DGS-centric indirect costs (1/2)

Principle	When computing the payout counterfactual, some indirect costs should be taken into account as long as they are quantifiable, connected to the DGS situation and computed in accordance with rules to be designed by the EBA.
CMDI proposal	<i>"To give a fair and more comprehensive picture of the actual cost of depositors' repayment, the estimation of the loss incurred due to the reimbursement of covered deposits should include costs indirectly related to the reimbursement of depositors. Such costs should include the cost of replenishment of the DGS and the cost that the DGS might bear due to the recourse to alternative financing"</i> (Recital 31 of the DGSD proposal)
Objectives	1) Giving a fair picture of the financial impact of a DGS intervention on its financial soundness 2) Avoiding circumvention of the LCT outcome.

Costs related to payout

Direct cost of replenishment for the DGS <i>Payout amount for all covered deposits in the failed bank, net of recoveries</i>		
	Costs related to the payout to be factored in the LCT equation	Costs potentially related to the payout NOT to be factored in the LCT equation
	• Operational costs • Administrative costs imputable to the liquidation and reimbursement process • Additional cost of funding for the DGS (linked to the recourse to alternative financing)	 • Opportunity costs on the DGS and member banks • Systemic costs on the DGS and member banks

LCT building blocks

Quantifiable and DGS-centric indirect costs (2/2)

Approach to indirect costs in LCT counterfactual among international peers

Jurisdiction	Direct costs – payout amount	Operational expenses	Consequential expenses of payout for the DGS	Systemic costs
Brazil	✓	✗	✗	✗
Canada	✓	✓	✓	✓
Colombia	✓	✓	✗	✗
Indonesia	✓	✓	✗	✗
Japan	✓	✓	✗	✗
Malaysia	✓	✓	✓	✓
Mexico	✓	✓	✗	✗
Turkey	✓	✗	✗	✗
Uruguay	✓	✓	✗	✗
USA	✓	✓	✗	✗

Source: Financial Stability Institute, “FSI Insights on policy implementation No 45 Counting the cost of payout: constraints for deposit insurers in funding bank failure management”, 07/2022, <https://www.bis.org/fsi/publ/insights45.pdf>

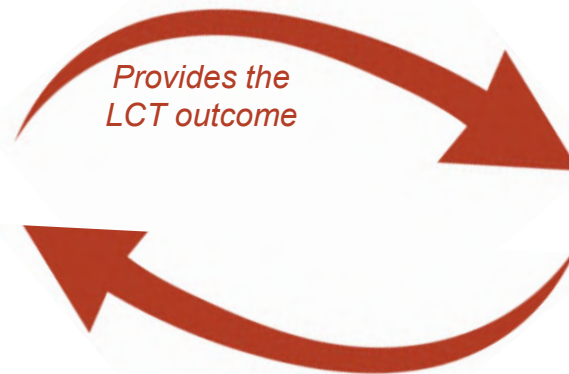
LCT building blocks

Governance

Principle	The DGS is responsible to perform the LCT, also based on the information provided by the resolution authority . It informs the resolution authority about the LCT outcome. The resolution authority is bound by the LCT outcome when deciding on the amount of the DGS contribution as part of the chosen resolution strategy.
CMDI proposal	<i>“Member States shall ensure that the competent and resolution authorities provide the DGS with all information necessary for the comparison referred to in paragraph 1. Member States shall ensure that the resolution authority provides the DGS with the estimated cost of the DGS contribution to resolution of a credit institution as referred to in Article 11(2)” (Art. 11e(4) DGSD).</i>
Objectives	1) Respecting a “who owns decides” principle by mandating the DGS to perform the LCT 2) Putting at the disposal of the DGS all necessary information to perform the LCT in good conditions 3) Acknowledging that the resolution authority is best positioned to decide whether to place a bank in resolution on the basis of the PIA, and to determine the exact amount of DGS contribution, as part of the resolution strategy.



DGS



Resolution and
competent authorities



Provides the relevant info to perform the LCT and the amount of the DGS contribution to resolution, including the relevant valuations of the FOLF entity (when applicable)

Interactions with other parts of CMDI proposal

Special LCT adjustments for specific circumstances

Use of DGS funds for preventive measures

“For the measures referred to in Article 11(3), when estimating the cost of repaying depositors, the DGS shall multiply the estimated ratio of recoveries calculated in accordance with the methodology referred to in paragraph 5, point b, by 85 %”.

Art. 11e(2) point d of the DGSD proposal

Objectives:

- 1) Taking into account the absence of valuation in liquidation (including an estimate of creditors' recoveries) at the point in time when preventive measures are adopted.
- 2) Based on empirical evidence, guaranteeing a systematic 100% recovery rate in all DGS payout cases is unlikely. To take into account such uncertainty, a flat haircut is applied to the recovery rate for DGS recoveries in the case of preventive measures.

Use of DGS funds by IPSs

“For the calculation of the estimated cost of repaying depositors as referred to in paragraph 1, point (b), in the case of preventive measures, the methodology referred to in point (b) shall take into account the importance of preventive measures for the statutory or contractual mandate of the DGS, including IPS referred to in Article 1(2), point (c)”.

Art. 11e(5) of the DGSD proposal

Objective:

- 1) Factoring in the LCT methodology designed by EBA the importance of preventive measures for the DGS, and in particular for IPS' business model.



When assessing the impact of the removal of the DGS super-preference on the LCT outcome, simulations run in the CMDI Impact Assessment (see p.57) apply an 85% recovery rate (a 15% average haircut on all assets), on top of the entity's losses in insolvency.

Interactions with other bits of the CMDI proposal

A LCT based on a new creditor hierarchy

Disclaimer: this slide does not incorporate the cap on the DGS contribution up to 8% TLOF, where relevant.

- **Yellow dotted line** illustrates the situation in resolution scenario and the losses that the DGS would be expected to shield deposits from bearing losses
- **Red dotted line** illustrates the liquidation / insolvency counterfactual and indicated the LCT limit.

With the super-preference of the DGS:

- The DGS would need to contribute up to **200** (180 of uncovered + 20 of covered) to protect all deposits from bearing losses.
- LCT allows a contribution of **120** (DGS loss in liquidation to protect covered deposits).

⇒ **Consequence: DGS cannot be used to shield all non-covered deposits from bearing losses where necessary.**

Without the super-preference of the DGS:

- The DGS would need to contribute up to **200** (40 of uncovered + 160 of covered) to protect all deposits from bearing losses.
- LCT allows a contribution of **240** (DGS loss in liquidation to protect covered deposits).

⇒ **Consequence: DGS can be used to shield all non-covered deposits from bearing losses where necessary.**

Asset valuations				
Asset valuation, initial 1,000				
Valuation under resolution / P&A: 700		Loss under resolution / P&A: 300		
Valuation under liquidation: 600		Loss under liquidation (NCWO): 400		
The amount of losses		Liability Structure		
Two-tier depositor hierarchy				
Covered deposits: 720	120	20	Uncovered deposits: 180	Debt 40 Equity 60
Pari passu rank un/covered				
Covered deposits: 720	240	160	Debt 40 Equity 60	
Uncovered deposits: 180	60	40		

Concluding remarks

- **Divergences among Member States** in their approach to LCT completion justify the harmonisation of its underlying methodology for all uses of DGS funds.
- In combination with the new design of the hierarchy of creditors, this harmonisation of the LCT is a prerequisite to **secure DGS margin for intervention outside payout** and level the playing field among Member States for the use of DGS funds.
- This LCT would **only apply to the use of funds regulated under DGSD** and not to other types of funds (segregated funds held by IPSs recognised as DGSs, IPSs not recognised as DGSs).
- Level 1 text does not aim at defining the precise calculation or parameter determination of each LCT component. However, it provides rules for the LCT's overarching building blocks: (i) **lesser cost test design**, (ii) **net costs approach**, (iii) **targeted set of indirect costs** and (iv) **leading role of the DGS for its completion**.

Annex: EU LCT vs. US LCT

Two possible designs of the LCT

“Lesser cost”



“Least cost”



The intervention must be...	...less costly than liquidation	...less costly than liquidation AND the least costly choice among resolution tools
Options compared	Cost of the DGS payout vs. all other uses of DGS funds (resolution, alternative measures in insolvency and preventive measures)	Cost of supporting the various bids from different potential purchasers of the failing institution within resolution
Impact assessed on...	...DGS funds (not resolution funds)	...FDIC fund (unique pre-financed safety net)
Possibility to switch off the LCT?	No	Yes, through the systemic risk exemption
Computation of the liquidation cost	Liquidation cost = payout minus estimated recovery of costs incurred (so called “payout counterfactual”) The same for all creditors – depending on the liquidation hierarchy	
Type of information required	Essentially the same information is required to meet either of the two cost tests: the amount of covered deposits, estimated net recoveries on assets, off-balance-sheet assets and liabilities, claims of uncovered depositors and other creditors (including claims arising from litigation and off balance-sheet liabilities), and any premium that may be offered by a potential acquirer of the failed bank.	

Annex: Systemic exemptions

Jurisdiction	Systemic exemption clause available
Brazil	✓
Canada	✓
Colombia	✓
Indonesia	✓
Japan	✓
Malaysia	NA
Mexico	✓
Turkey	✓
Uruguay	✗
USA	✓

Source: Financial Stability Institute, "FSI Insights on policy implementation No 45 Counting the cost of payout: constraints for deposit insurers in funding bank failure management", 07/2022, <https://www.bis.org/fsi/publ/insights45.pdf>

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Creditor hierarchy

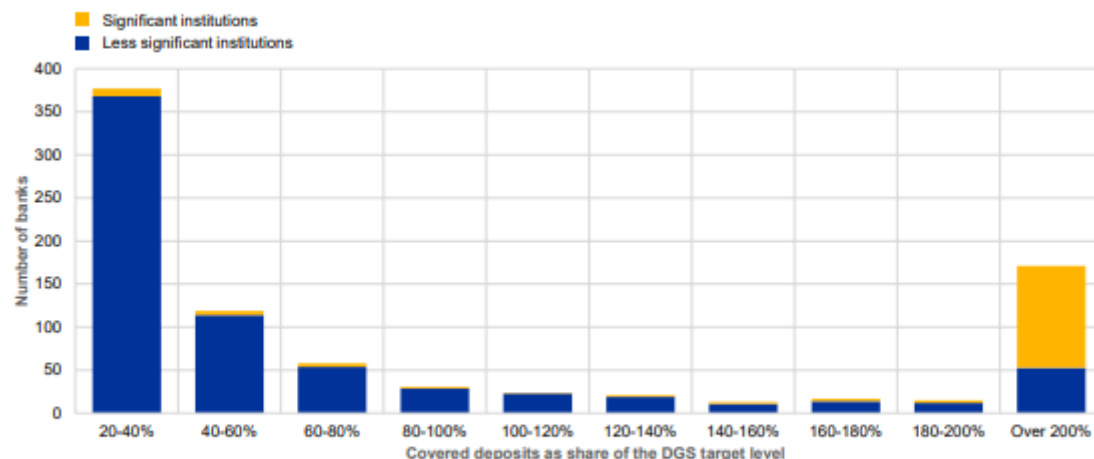
Effects of the DGS super-preference

- Impacts the results of the LCT in a way that the DGS funds can almost never be used outside the payout of covered deposits in insolvency.
- Protects the banking industry, being among the first creditors to recover from the insolvency proceeds. But does not necessarily lead to less frequent need for replenishment of the DGS:
 - This higher priority leads to a more frequent use of DGS resources for payout than for other, more cost effective measures
 - A payout requires using the DGS available financial means to cover the gross amount of covered deposits, which may often exceed the DGS available financial means (higher contribution by banks to replenish)
 - A payout always requires a cash disbursement, while a contribution in a transfer can also take the form of guarantees.
 - A liquidation in insolvency damages the franchise value of assets compared to other measures (e.g. sale of business)
 - Time lag between the payout and recovery proceedings, in sometimes lengthy insolvency proceedings
- Explains higher recoveries for DGS in insolvencies in some cases, if the asset quality of the liquidated bank allows for it.
- Tilts the optionality for action towards national insolvency regimes even if resolution may be economically more effective and hinders the operationalisation of transfer strategies for smaller/mid-sized banks
- Worsens the prospects for non-covered deposits, by hindering a transfer in resolution and leading to loss of value in insolvency.

Key findings from the impact assessment

Chart A

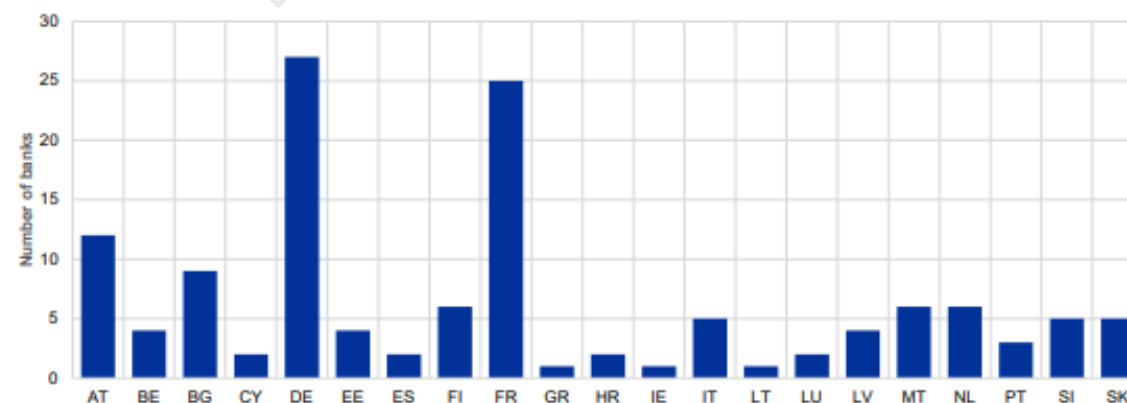
Payouts can deplete significant shares of a DGS's target level



Notes: The chart compares the covered deposits of banks, banking groups and their hosted subsidiaries within the banking union with the target level of the relevant national DGSs in the banking union. Entities within one banking group that are members of the same DGS are treated as one entity. 1,562 banks, banking groups and their hosted subsidiaries that would deplete 0-20% of their respective DGSs' target levels, corresponding to 64% of the banks in the sample, are excluded from the graph for ease of reading.

Chart B

In each Member State in the banking union, at least one less significant institution can deplete its fully filled DGS with a single depositor payout



Note: The chart counts the number of LSIs, LSI groups and LSIs' hosted subsidiaries per Member State whose covered deposits match or exceed the target level of the relevant DGS.

Source: ECB Occasional paper series - Protecting depositors and saving money (October 2022)

Many banks would significantly deplete their DGSs if their individual failures resulted in depositor payouts

- 132 LSIs or their hosted subsidiaries also have covered deposits exceeding the target level of their DGSs
- Each Member State in the Banking Union has at least one LSI that could deplete its DGS.

Commission's proposal

- Amendments to the creditor hierarchy are introduced in **Article 108 BRRD**, with two changes applied to the upper and lower end of the depositor hierarchy:
 - Upper end of the depositor hierarchy: removing the super-preference of DGS claims (and covered deposits) and placing them on the same rank with all other deposits
 - Lower end of the depositor hierarchy: general depositor preference achieved by lifting the ranking of all deposits higher relative to ordinary unsecured claims
- The proposal also amends the LCT by including indirect costs in the insolvency counterfactual.
- The proposal **does not amend** the:
 - Protection currently enjoyed by covered depositors (which does not depend on their ranking in the creditor hierarchy). Always insured under the DGSD in case their deposits become unavailable and under the BRRD through the mandatory exclusion from bearing losses in resolution.
 - DGS coverage level (100,000 EUR) and the DGS target level (0.8% of covered deposits)
 - LCT insolvency counterfactual costs are related to covered deposits.

Key findings from the impact assessment

- **Baseline (3-tier depositor preference with DGS super-preference):**
 - Deposits in 25% of banks (91 out of 368 banks) located in 20 MS would suffer losses up to an aggregate of EUR 18.3 bn (Q4 2019 data) when allocating losses to reach 8% TLOF.
 - Under more severe scenarios of equity depletion, the share of affected banks would increase significantly: assuming a 75% depletion of capital buffers means affected deposits in 71.7% of banks (246 out of 368 banks) for an aggregate EUR 83.1 bn (62.5% of banks (117 out of 187 banks) with resolution strategy as of end 2019 for an aggregate EUR 71.6 bn of affected deposits).
 - The LCT does not allow the DGS fund to intervene in resolution, except in 3 out of 368 banks.
- **Single-tier depositor preference:**
 - Preferring all deposits versus ordinary unsecured claims reduces the number of banks where deposits would be impacted from 91 banks (baseline) to 48 banks (out of 368 banks).
 - Unlocks contribution of DGS funds under LCT in a most significant manner: out of 48 banks with affected deposits, the DGS would be able to intervene under the LCT for 41 of these banks with an amount that would be sufficient to reach 8% TLOF without touching deposits in 31 of cases (76% of cases when considering the entire sample and in 88% of cases for banks with resolution strategy).
 - Tail risks remain: some deposits in a number of banks would not be shielded from losses in case 8% TLOF needs to be met, even under a single-tier depositor preference.

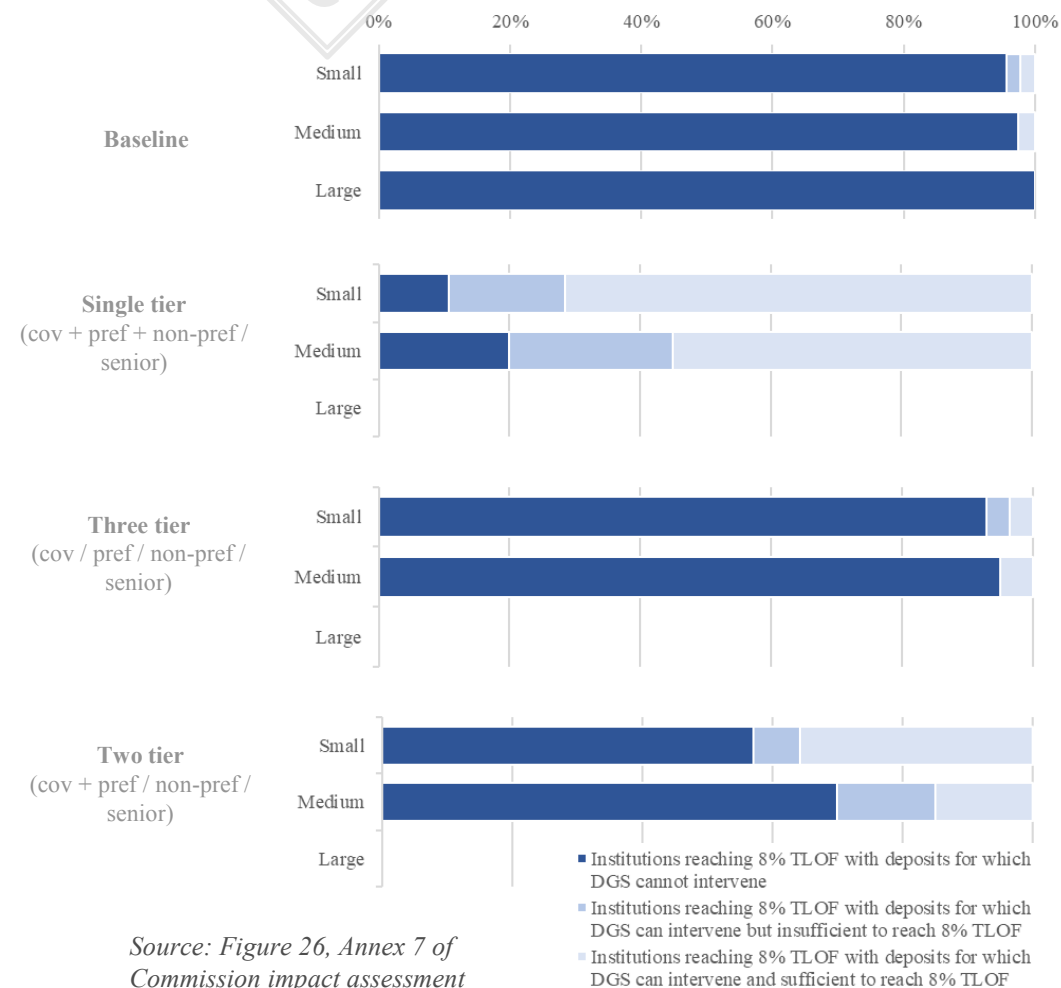
Key findings from the impact assessment

Using DGS in resolution (current situation)

	N.	Institutions reaching 8% TLOF with deposits, requiring DGS contribution	Of which: Institutions for which DGS can intervene (positive LCT)	Of which: Institutions for which DGS interventions under the LCT are sufficient to reach 8% TLOF
		Count	Count	Count
Small	195	46	2	1
Medium	124	39	1	1
Large	49	6	0	0
Total	368	91	3	2

Source: Table 17, Annex 7 of Commission impact assessment

Using DGS in resolution (impact of changes of depositor preference)



Source: Figure 26, Annex 7 of Commission impact assessment

Benefits of single-tier ranking for deposits

- Greatest potential in **unlocking the LCT** because it places other deposits on the same rank with the DGS claims (IA: x20 vs current three-tier depositor preference, x4 vs two-tier depositor preference).
- Significant reduction of the number of banks where **deposits** would be bearing **losses** in order to reach **8% TLOF** to access the RF/SRF (IA: from 91 to 48 out of a sample of 368 banks).
- **Safeguards the DGS financial means** by creating the flexibility for using DGS funds in resolution with much improved **economic efficiency** if shielding non-covered deposits from losses is necessary to protect financial stability. Expected amount of DGS contribution in resolution is much **lower** than under a payout (total value of covered deposits paid out by DGS plus the loss of value on all other creditors).
- Preserves **client relationships** and continued **access** of depositors to their accounts without any interruption of services, an important aspect in digitalised economies.
- **Excluding some deposits** from a transfer transaction may likely lead to the **withdrawal of the buyer's interest**, as those depositors would run on the bank, heightening risk of contagion.
- Facilitates bail-in of ordinary **unsecured claims** and **reduces the risk of NCWO** if safeguarding non-covered deposits is justified given operational, technical and financial stability difficulties to bail-in non-covered deposits.
- Improves the **level playing field** and smoothens the **execution** of resolution in a cross-border context.

Thank you

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