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Subject: Availability of MREL, bail-in of deposits, burden sharing and liquidation aid in resolution and liquidation
- Presidency non-paper



Availability of MREL, bail-in of deposits, burden sharing and liquidation aid in resolution and liquidation

PRESIDENCY NON-PAPER FOR THE 25 OCTOBER 2021 MEETING OF THE
WORKING PARTY ON FINANCIAL SERVICES AND THE BANKING UNION

The resolution regime introduced with the Bank Recovery and Resolution Directive (BRRD) substantially streamlined approaches to bank recovery and resolution in the EU. Nevertheless, as results of the public consultation by the European Commission conducted in 2021 show, there are some areas where the framework could be improved. This non-paper focuses on improvements in two areas. Both relate to situations following a 'failing or likely to fail' (FOLTF) declaration and the public interest assessment (PIA) of a bank, i.e. after the point where decision is taken to either resolve or liquidate the bank.¹

The first area, discussed in sections 1 and 2, addresses the question of how to fund the resolution of banks where mandatory bail-in would include eligible deposits above the coverage limit when this may pose financial stability risks. The proposed solution balances the need for financial stability-consistent resolution financing with the requirement for such banks to exit the market. The second area, discussed in section 3, addresses the question of use of alternative routes to BRRD-enshrined approaches to obtain results that are similar to the BRRD in terms of outcomes for the bank involved (resolution or liquidation) but different in terms of allocation of losses among bank's creditors and in sources used in their financing. The two parts are related, since without proportionate resolvability of all banks within the BRRD framework, incentives for authorities to use alternative routes to resolve some banks in order to preserve financial stability will continue to exist.

Questions to guide discussion are included at the end of the non-paper.

1. Risks of bail-in of deposits

The combination of the 8% total liabilities and own funds (TLOF) threshold and a specific funding structure makes it difficult to resolve under the BRRD banks financed largely with equity and deposits by leaving a funding gap in the resolution financing required.² The 8% TLOF threshold was introduced to maintain for all banks a minimum involvement of internal resources before external funds, private or public, can be called for. The analyses show that large, cross-border banks with diversified funding sources are able to issue adequate loss-absorbing resources to meet this requirement, including both

¹ Measures that are part of current precautionary recapitalisation procedure or preventive measures of Article 11(3) of the deposit guarantee schemes directive (DGSD), i.e. measures that apply prior to FOLTF declaration, are not discussed in this non-paper.

² Banks that are on path to reaching their target level of MREL may also face resolvability limits during the transition. This issue is not subject of this non-paper.

deposits and securities, senior and subordinated. However, it is less suitable for smaller banks that are financed predominately with equity and deposits, including eligible deposits above the coverage limit, and have very limited experience in tapping the bond market. This leaves them with less-diversified liabilities and limited MREL-eligible instruments on their balance sheet beyond regulatory capital. Without any particular critical functions, their typical resolution strategy would be liquidation. Bailing-in eligible deposits above the coverage limit following a FOLTF declaration may, at least in some circumstances, lead to financial instability, in particular when the insolvency regime applicable to the bank does not allow for transactions such as the deposit book transfer.

Depositors differ from investors, even from investors in other bank debt (bonds). Deposits are used to store value and for payment transactions, whereas an investor's perspective implies some inherent downside risk to the investment. Deposits can cause runs when they are not accessible, including runs on banks perceived as similar to a failing bank (indirect contagion). The context of a financial crisis in particular increases depositors' awareness and sensitivity to perceived risks and their readiness to move deposits between banks or into cash. As a result, applying burden sharing to this liability category may trigger systemic risk. In a failure of a bank, where depositors would be at risk to take losses, the resolution authority may therefore be hard pressed to find a solution that would reconcile the resolution objectives, in particular to minimise the use of public funds and protect financial stability.

With the planned more extensive approach to the PIA, the probability that a bank with a current liquidation strategy would be put in resolution would increase. This, however, does not entirely solve the problem, because, due to the particular liability structure of these banks, it is not at all guaranteed that they would have enough MREL to reach the 8% TLOF threshold without resorting to deposits. Simply requiring further, likely even smaller, banks to increase MREL by including a recapitalisation amount to increase their loss absorption capacity could have negative side effects. In particular, given the likelihood that equity would be largely exhausted by the point of failure, and therefore not count towards the 8% TLOF threshold calculation, to have certainty on meeting the said threshold the banks would have to issue other types of MREL eligible instruments. This may in turn force these banks to abandon their business model, adjusting their asset-side policies and risk profile in tandem with changes to their funding structures to meet the increased cost of funding. Reducing the business model diversity of the banking system in the EU could have negative consequences for borrowers in the market niches these banks currently serve. For example, households and SMEs may have less access to financing and/or at an increased cost.

Not providing for financing in case resolution is needed leads to usage of alternative routes to meet the resolution objectives outside resolution framework in cases where the failure of such banks needs to be managed orderly, e.g. by State aid. This has clear disadvantages: (i) the use of public funds to resolve banks may go beyond addressing serious disturbance in the economy of a Member State and the criteria of serious disturbance is different from the criteria for PIA; (ii) the bank-sovereign nexus remains intact; (iii) the resolution framework suffers loss of consistency and credibility; and (iv) conditions for banks, their shareholders and creditors would be uneven as burden sharing among

different routes to resolving or liquidating a bank may also be different, raising level playing field issues across the Banking Union.

A possible solution has to address two goals. The first is to increase financial stability protection by lowering the risk of bank runs, including on other banks, after bail-in of eligible deposits above coverage limit at a bank. The second is to reduce the use of public funds and increase the use of the safety nets financed by the banking industry in resolution of banks. Given the nature of the banks and of the risk to be addressed, the solution should be accompanied with a requirement for the banks to exit the market.

2. Proposal to address the funding gap in resolution

As mentioned above, the proposal is without prejudice to the primary function of banks' MREL in providing funding in a case of a failure, which should remain the first line of defence. However, the need to ensure access to external financing and the financial stability implications of a bank failure should be balanced in a proportionate manner, taking due account of business model and level playing field neutrality of the resolution framework.

The protection of deposits beyond covered deposits discussed below would (and should) not result in an increased deposit insurance coverage, i.e. the DGS coverage level would remain the same. Eligible deposits above the coverage limit could be protected in resolution, subject to a positive PIA and available resolution tools.

In this respect it is key to combine the broader protection of deposits with measures that increase the applicability of transfer tools and ability of resolution authorities to use them. The use of transfer tools can lower the cost of resolution and save DGS liquidity. As opposed to deposit pay-outs, which are subject to lengthy recovery from the insolvency estate, some transfer tools may – where found to be less costly – recover liquidity faster (loans), not require the use of it upfront (guarantees) or in a lower amount than in pay-out (upfront cash payment to the buyer). The possibility of including a full customer relationship and not just covered deposits in the transfer would fit well with considerations discussed here. Such transfers are likely to preserve franchise value and depositor confidence. They might also attract more interest from buyers.

The following questions should be answered when designing a solution:

- A. Which deposits above the coverage limit should enjoy protection in resolution?
- B. Under what circumstances would the protection of deposits mentioned under Point A be needed?
- C. At what point would the decision to protect the deposits be made and what banks should be considered?
- D. Where should the financing for the protection of deposits above the coverage limit come from?

Possible answers to these questions are discussed below.

Point A: Which eligible deposits above the coverage limit should be included? Seeking solutions that increase depositor protection by lowering the risk of bail-in of eligible deposits above the EUR 100,000 coverage limit would lower the risk to financial stability that could arise if such deposits, in particular those of natural persons and SMEs (preferred deposits) but also other (non-preferred) eligible deposits, were bailed in. This approach is currently possible under the exemption laid down in Article 44(3) BRRD, but in principle the legislation assumes that the bank will only deal with this issue after having reached the 8% TLOF threshold with other liabilities ranking below deposits. This, in turn, is only possible if sufficient liabilities in these other categories can be issued, which brings back the initial problem described above, as some banks cannot issue them because they lack access to the relevant markets (no rating, too low issuance amounts and thus no regular market presence and high financing costs). Therefore, an improvement of the current rules to allow the possibility to exempt eligible deposits above the coverage limit from bail-in in presence of a financial stability concern, even when the 8% TLOF threshold has not been fully reached with lower ranking liabilities, is one option to address this issue.

The issue of moral hazard has been raised in connection with a higher level of depositor protection achieved by prioritising resolution to pay-out in liquidation. For moral hazard to arise, the subject involved has to be able to assess risks. In principle, depositors do not have the same capacity as investors to take informed decisions about the financial situation of a bank in order to assess the risks and to react to them in a timely and deliberate way. Instead, they rely on the banking supervisor. However, depositors would follow the crowd once systemic panic sets in and thus precipitate a bank run. It is true that in terms of their ability to assess risks not all eligible depositor categories are equal and there are differences within categories of depositors (and professional advisors can be hired, provided enough money is at stake). Importantly, such possibilities would only be available in a transfer strategy, where market exit would be assured, addressing some concerns around moral hazard, given only the relevant depositors would benefit and the bank would cease to exist as such. A narrower protection, e.g. on deposits of natural persons and SMEs above EUR 100,000, may further reduce residual moral hazard concerns. These 'preferred deposits' are in particular already mentioned in Article 44(3)(c) BRRD as those where exclusion from bail-in may be warranted for reasons of preserving financial stability. Arguing for a broader transfer of deposits, however, is a possible destruction of franchise value of a deposit business of a bank if only a narrower transfer of deposits is allowed. A limitation on what can be transferred in a concrete case would come from existence of a buyer and available funding, see Points B and D below, respectively.

Point B: Under what circumstances? A situation where resolution objectives would most likely be better met in resolution than in liquidation when the focus is on the bail-in of deposits, is likely to be one where financial stability risks stem from the lack of confidence by depositors in a banking system in general. A loss of confidence may result from a widespread perception by the public of vulnerability in the banking system. In such an environment, bailing in deposits may trigger a wider deposit run on other banks, which are not failing or even ailing. Such a risk of indirect contagion would be a clear case for allowing resolution to effectively address financial stability risks, with financing from resolution funds/SRF and DGS as proposed in Point D below to cover the gap to reach the 8% TLOF threshold.

In general, when (a) the PIA at the point of FOLTF concludes that the financial stability would be better preserved in resolution than in liquidation; (b) the 8% TLOF threshold can only be reached by bailing in eligible deposits above the coverage limit, or some sub-set of these, subject to considerations under Point A; (c) application of a transfer tool is possible; and (d) market exit of the bank is assured, sources of financing under Options 1 or 2 of Point D could be used to cover the gap to 8% FOLTF threshold instead of eligible deposits above the coverage limit. The framework for assessing (a) already exists in the Commission Delegated Regulation 2016/860.³

Given that the grounds for resolution in this case come from financial stability implications of a bank's failure and not, for example, from the implications of its demise for the availability of an essential service, the resolution should lead to the bank exiting the market (closed bank scenario).

Point C: How and at which point to determine whether protection is needed? At point of FOLTF PIA, based on comparison of meeting the resolution objectives in resolution and in liquidation, the resolution authority may arrive at a different assessment for a bank than at the planning stage. The resolution strategy may at that point change from liquidation to resolution, based on the considerations explained under Point B above.⁴ So, for instance, for a small to medium-sized deposit-funded bank this may mean that it does not have enough bailinable liabilities – excluding deposits – to meet the 8% TLOF threshold, opening up the kind of issues pointed in section 2. The hypothetical scope of banks that may find themselves in such a situation is large. As explained in recital 29 BRRD, in order to maintain financial stability it is important that resolution authorities have the possibility to resolve any bank. When banks fail, a very large majority of them will of course not endanger financial stability and will be liquidated. It is important, however, to have the ability to resolve them if they do pose a threat to financial stability.

An alternative could be to set criteria to define in advance the banks where protection would be possible. This could include banks' total assets below certain amount, share of deposit funding in total funding above a certain level and/or a resolution strategy with transfer tools in the resolution plan. The advantage would be that by ex ante limiting the banks where eligible deposits above the coverage limit would be protected, the potentially required financing to close the funding gap would be lower. The requirement of positive PIA at the point of FOLTF would still apply. However, in addition to being contrary to demands of recital 29 BRRD, the drawbacks of invariably leaving out some banks that may have the same problem and the arbitrariness of using any criteria that is not based on resolution objectives, point to serious level playing field issues of such an approach.

³ The COMMISSION DELEGATED REGULATION (EU) 2016/860 of 4 February 2016 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under Article 44(3) of Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms details the application of bail-in exemptions of Article 44(3) BRRD.

⁴ In addition, not all banks which have a positive PIA in their resolution plans (i.e. are earmarked for resolution) have an MREL requirement above 8% TLOF. BRRD requires 8% TLOF for G-SIBs, top-tier banks and certain other banks at the discretion of the resolution authority.

Point D: What are the financing possibilities? In order to reach the envisaged benefit of resolving banks under the BRRD framework, it would be preferable to use resolution and deposit guarantee funds which are the safety nets financed by the banking industry via risk-based contributions, thus minimising the use of public funds.

Option 1: One possibility would be to draw on DGS financing up to the amount allowed by the least cost test (LCT) and use resolution funds/SRF for the remainder, if necessary. In the Banking Union, this sequence of covering the financing gap may be more acceptable politically as it places a higher weight on the non-mutualised part of the needed external financing: it would largely come from DGS and not from the (increasingly mutualised) SRF. This approach would allow for DGSs to bridge up to the 8% TLOF needed for resolution funds usage (where possible under the LCT), without changing the 8% TLOF safeguard.

The limits to the external funding provided in order to protect deposits more broadly are embedded in the conditionalities attached to the use of each safety net. In resolution, for DGS funds, the LCT indicates the maximum amount that the DGS could provide, capped at 50% of the DGS target financial means. For the resolution fund/SRF, the maximum amount that could be provided is 5% of bank's TLOF.

As the current ability of DGS to intervene to underpin financing in resolution is limited, this approach would necessitate further changes to the resolution framework to increase the amount of financing by DGS. This could be done by changing the hierarchy of different depositors in insolvency, which would increase the likelihood of losses for the DGS in the LCT's counterfactual of piecemeal insolvency.⁵ Changing the depositor hierarchy in insolvency has been discussed in the AHWP and EGBPI before. This could be a deposit ranking that places covered deposits as well as deposits of natural persons and SMEs beyond the EUR 100,000 covered deposit limit at the same level, or a single-tier deposit ranking that places, in addition, at this level also other eligible deposits.

With a larger potential engagement of DGSs in financing resolution, DGSs, in particular smaller ones, might face liquidity shortfalls. An increased target level of the DGS could address the issue and a number of Member States already have financial means above 0.8% of covered deposits. However, this may also lead to contributions that are no longer sustainable for the banking industry at Member State level. Moreover, in a system where the SRF funds have been accumulating over the years but have never been used, increasing the DGS target levels may be difficult to explain to the banking industry. Therefore, another, more proportionate solution, would be a backing by a common liquidity backstop. The AHWP under the previous Presidency discussed various possible articulations of EDIS, in particular hybrid EDIS. Such common liquidity backstop would reassure depositors that liquidity available to cover future bank failures is there.

⁵ Another possibility would be changes to the LCT so that it would allow DGS involvement in a larger number of cases, e.g. by including additional (indirect) costs of insolvency in the counterfactual of the LCT. However, indirect costs alone may not fill the funding gap and this change may need to be combined with changes to depositor hierarchy.

Option 2: Another possibility would be for the resolution fund/SRF to cover the whole amount, up to a maximum of 5% of bank's TLOF. This could be justified by the fact that the reasoning for the intervention comes from financial stability considerations, thus from resolution's remit. The role of DGS is generally limited to handling the liquidation process. This option would weaken the bank-sovereign link to a larger extent than Option 1 in a situation, as it is now, where DGSs rely on national banking systems and ultimately on the sovereign to pick up any possible shortfall in financing. However, unlike Option 1, it would amount to a departure from the 8% TLOF threshold requirement.

As a complement to either of Options 1 or 2, one might approach the problem also from the opposite angle, i.e. by trying to broaden the ex ante loss absorption capacity of at least some of the banks discussed here in a manner proportionate to their business model. This would mean that some of their typical liabilities that are currently bailinable but do not count as MREL would count toward the 8% TLOF threshold for resolution planning purposes, as they would in case of actual resolution. Resolution authorities could instruct the bank to hold eligible (bailinable) non-retail liabilities up to the amount of 8% TLOF, if resolution strategy would include resolution fund financing. Requiring non-MREL eligible but bailinable liabilities up to 8% TLOF would be less costly compared to issuance of MREL instruments, and would be, by resorting to instruments it already uses, e.g. liabilities with maturity less than one year, or other liabilities which are bailinable but do not fully comply with all the MREL eligibility criteria, e.g. senior instruments. This approach would be a complement to Options 1 or 2 and would reduce the funding gap. Such 'extended' MREL is not substitute for 'real' MREL as there would be no guarantee it would be in bank's balance sheet at the point of FOLTF declaration.

3. Resolution, liquidation aid and burden sharing

Another identified deficiency of the current crisis management and deposit insurance framework is that it did not prevent the use of public funds to the extent it was intended to when it was introduced. There were occasions when for a bank the PIA did not find grounds for public interest to be better protected in resolution than in insolvency, the bank was not resolved, but did receive public support in the form of liquidation aid anyway.

When protecting eligible deposits above the coverage limit from the BRRD's mandatory bail-in is necessary for financial stability reasons and the financing from resources foreseen by BRRD is not possible without such bail-in but only by using public resources, adopting the solutions proposed in section 2 would remove the need for liquidation aid. Making financing available within the resolution framework for all cases where resolution is in public interest would reduce incentives for applying resolution measures outside the BRRD framework. More proportionate and realistic access conditions to external funds for transfer tools would increase the overall credibility of the resolution framework, reduce financial stability concerns, and thereby lower the incentives for looking for options outside resolution. They would be unlikely to eliminate them entirely, however, as there are additional motives and incentives to use liquidation aid instead of the BRRD framework.

In addition to availability of financing, the routes to deal with a bank failure may also differ in terms of conditions of financing, including the conditions of mandatory burden sharing by shareholders and creditors beyond depositors, in particular the senior creditors. The mandatory burden sharing requirement in the BRRD to access resolution financing is the 8% TLOF threshold. Different requirements in the Commission's 2013 Banking Communication from those in the BRRD/SRMR allow liquidation aid with less onerous burden sharing, e.g. sparing senior bondholders, thereby skewing incentives. The use of State funds to support, for instance, the transfer of the deposits in liquidation of a bank should not be less expensive (to the bank) than the uses of resolution funds/SRF (built by banks' contribution) for similar purpose. This would also provide wrong incentives, e.g. for potential bidders.

If the PIA is negative there should be no bank-preserving resolution, inside or outside BRRD, and the bank should be liquidated by a winding-up, i.e. exit the market within a reasonable timeframe. In the BRRD there are no burden sharing conditions foreseen for liquidation. However, some of the resolution-like tools are effectively available also in liquidation, under alternative measures of Article 11(6) DGSD, e.g. sale of business and asset separation (in the Member States that have chosen to implement this option). The result of any liquidation should be that the bank exits the market. The access condition for alternative measures is the LCT. It limits the amount of intervention by DGS to preserve access to covered deposits to the savings that are possible as result of using an alternative measure relative to situation of covered deposit pay-out. There is no burden sharing condition for the use of DGS funds to finance alternative measures. As an alternative measure can only result in spending less than in a counterfactual covered deposit pay-out mandated by liquidation, there are no additional funds involved relative to what the DGS would have spent without the alternative measure. So applying a burden sharing-requirement seems disproportionate. In addition, a burden sharing-requirement that would involve liabilities that are ranked *pari passu* in insolvency with any of the deposits that the liquidation administrators intend to transfer would limit their ability to do so due to unequal treatment of creditors. This could limit the DGS in using the means it has at its disposal for lowering cost of covered deposit protection and which benefit the bank's creditors (including depositors) as well as the DGS. Such an approach may intensify financial stability concerns when bank is wound up.

However, a situation where liquidation aid is used is different from using the DGS. It represents the use of external funds. The framework that applies to liquidation aid is the State aid framework, and the question of incentive-compatible alignment of burden sharing would be best addressed there.

Questions for discussion

1. Do you consider that changes to the BRRD framework with the aim to protect eligible deposits above the coverage limit in resolution in a proportionate way are needed? If so, do you see additional arguments to those in the non-paper why this is necessary? If you do not consider

such changes necessary, how should in your view the financial stability – resolution funding access trade-off be resolved?

2. What are your views regarding the proposed solutions in the non-paper on:
 - (A) Which eligible deposits above the coverage limit should be included;
 - (B) Under what circumstances;
 - (C) How and at which point to determine whether protection is needed; and
 - (D) Financing possibilities.
3. Do you consider that making access to industry-funded schemes, in cases where bailing in eligible deposits above the coverage limit would endanger financial stability, as proposed in the non-paper, would lessen the need for liquidation aid? What other incentives for the use of liquidation aid do you currently see?
4. In terms of alignment of burden sharing in resolution and liquidation, do you consider that financing by DGS of alternative measures, where available, should remain distinct from the use of liquidation aid? Do you think that there is a need for alignment beyond the State aid framework and in relation to what elements?
