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**Presidency note on resolution funding**

*WP CMDI 31-10-2023*

## I. Introduction

At the Council Working Party meeting of September 18th, the Presidency presented a note on funding in resolution with questions and some options. The paper was then discussed by Member States (MS), which also sent written comments by September 28th. The objective of this note is to provide a recap of those discussions and summarise the views of Member States based on the oral interventions and written comments. It also suggests some ideas to deepen into the elements connected to the funding issue in CMDI.

Together with the feedback received on PIA these additional comments on funding could eventually assist the Presidency in putting forward a possible landing zone to be jointly discussed on the most politically sensitive and contentious issues.

## II. Detailed review of MS comments

### 1. MREL for transfer strategies

As stated in a former Presidency note, the Commission proposal introduces a new article 45ca BRRD establishing certain criteria to calibrate the recapitalization amount, in particular, (a) entity size, business model, funding model and risk profile, and depth of the market it operates in; (b) shares and other instruments of ownership; (c) the expected value and marketability of shares and other instruments of ownership; (d) type of transfer strategy to be implemented; and (e) if the asset separation tool will also be used.

In their written comments, most MS agree to include in level 1 text a new article to provide legal support to current practices for transfer strategies leading to market exit. Other MS seem to agree but fear the framework proposed might lead to insufficient MREL and that the criteria included are not sufficiently prudent. They would like to make sure that MREL in transfer strategies is higher (or at least, high enough). Finally other MS disagree with the inclusion of the proposed article because they consider that the current BRRD wording already provides flexibility and the addition is unneeded repetition that might even require RA to change policies.

On the specific criteria included for MREL calibration for transfer strategies, some MS would like more details on some of the criteria and some argue in favor of delegating to EBA for specifying them. Some MS agree with including the “depth of the market” in which the resolution entity operates (understood as the capacity to tap such market for MREL issuance) as a relevant criterion to calibrate MREL for transfer strategies because they believe some institutions would have difficulties accessing such markets, whereas other MS disagree because they cannot accept criteria not linked to resolvability. By the same token, a MS would like to add the expectation to use DGS to “bridge-the-gap” whereas other MS would like to make sure that no external funding is needed. A MS would favour applying this regime to all institutions, whereas other

MS believe it should not benefit large institutions and G-SIBS in particular. Finally some MS argue in favor of more prudent criteria such as (i) appropriate buffers to cater for the uncertainty of the expected balance-sheet depletion effects, potential capital requirements and feasibility of the resolution strategy, (ii) caps on the implied reduction of MREL in comparison to a situation where bail-in would be the resolution strategy, (iii) inclusion of a reference to the 8% minimum threshold for the SRF contribution and addition of qualitative criteria to ensure the quality of eligible MREL instruments, (through the issuance of long-term debt, considering that some deposits might be discretionarily excluded from bail in).

## 2. MREL for liquidation strategies

As stated in a former Presidency note, the Commission proposal introduces, through article 45ca(2) the principle that in the situation where a transfer in insolvency involving the use of DGSs can be foreseen, the eventual recap component of MREL should take into consideration the same criteria as the one proposed for transfer strategies in resolution, with the aim to avoid a different treatment of economically identical situations.

MS have split views. Some MS agree with such inclusion to prevent arbitrage. However, other MS believe that there should be no MREL for transfers in insolvency which are supported by the DGS. These MS argue that insolvency situations, and institutions earmarked for them, differ from resolution scenarios, in terms of moral hazard and the ability to tap markets, and that requiring MREL from them (above the capital requirements) would impair their business models. Moreover, some MS consider that it would prove too difficult to apply the criteria for such transfers in insolvency which, in fact, are not planned beforehand. Finally, some MS consider that requiring MREL for transfers in insolvency is not proportionate because it only helps achieve a more efficient use of DGS (while, it is understood, implies substantial costs), and that, if we follow the same rationale, there could be even a case for requiring MREL in a DGS payout, which would obviously be unwarranted.

## 3. Bridging the possible funding gap and treatment of deposits in the creditor hierarchy

As stated in a former Presidency note, the Commission proposal identifies a funding gap, when the exclusion of some deposits from bail-in is needed for financial stability reasons but the 8% threshold needed to eventually access resolution financing arrangements after such exclusion, has not been met. To close this funding gap, the revised article 109 BRRD of the Commission proposal regulates the so called “Bridge the Gap” (BtG), where funds belonging to national deposit guarantee schemes (DGS) can be used to cover the difference between assets and deposits transferred, and help MREL and other existing and not excluded bail-inable liabilities fulfil the 8% bail-in requirement to access funding by the Resolution Fund (RF) (article 109(2b) BRRD).

In their written comments, most MS agree that imposing losses on some deposits can be detrimental to resolution objectives. Among these, some MS, at the same time, remark that this should not mean that uncovered deposits have to be always excluded

from bail-in. Other MS believe the question is unclear and that key questions have to be answered first, such as what deposits should really be protected, or why, and what effects changing the fundaments of the current framework would have.

Moreover, most MS agree that a funding gap might need to be addressed. However, some MS believe there is no evidence of this funding gap, since uncovered deposits should be able to suffer losses without financial stability implications and that acting otherwise would be equivalent to a bail-out. Nonetheless, among these, some MS remain open to discuss that there are specific "more protection-worthy deposits" beyond covered deposits.

Most MS agree that the use of industry funds is preferable to taxpayer funds. Among these some MS remark that such funding gap should be/have been addressed through higher MREL that tackles the moral hazard and that the use of DGS must be the exception (limited in amount and which should be recovered afterwards). Other MS believe that lowering the 8% threshold for small and medium banks, or including a greater share of historical losses would solve it. Finally, some MS believe that the funding gap should not be closed at the expense of DGS funds and the covered deposit superpreference. One MS suggests using new additional funds, possibly integrated in the DGS. On the use of DGS resources to fund a potential gap, most MS accept such use of DGS with enough safeguards and MREL. Among those MS, some MS agree on limiting such use to transfer strategies, while others believe that any BtG DGS use should also be available to other resolution strategies. Finally, some MS do not support the use of DGS funds to bridge the gap in the current set of circumstances.

Some MS, believe the key question is not the distinction between industry funds and taxpayers funds, but rather whether shareholders and creditors would adequately bear the risks they are supposed to. One MS considers that the important issues are rather (i) the question of the pooling of risk between the national and the European level in order to avoid systematic cross-subsidisation across Member States and (ii) the appropriate level of contribution to industry funds by the banking sector in the various Member States.

Views are split on the necessity to reinforce the idea that the bailing-in of uncovered deposits, as any other non-excluded liability, is the default rule. Some MS agree to reinforce this idea of bail-inability of certain uncovered deposits, because they believe that the Commission proposal implies a guarantee of all deposits being shielded from losses, but, at the same time, some of them would allow specifying that the latter is not incompatible with a limited and extraordinary exclusion of some uncovered deposits for financial stability reasons. At the other end of the spectrum, other MS believe that any clarification on the bail-inability of deposits is not needed. However, the reasons they put forward differ: some MS consider that such clarification would have negative consequences by limiting the flexibility RA needs to exclude deposits or by encouraging bank runs in times of stress, while other MS believe it is already clear in the current text. More generally, one MS considers that investors and depositors should not assume or expect support from industry funds.

Finally, regarding the limited average impact estimated by the SRB on the use of DGS and the SRF, most MS agree with the assessment. On the contrary, other MS disagree because they consider the assumptions too optimistic because the study only incorporates institutions currently earmarked for resolution with likely high MREL. To cater for those comments, the SRB study was later updated taking into account the concerns expressed by these MS, still concluding a limited impact on these industry funds, even when expanding the scope of institutions currently in liquidation that currently lack recap-MREL and considering full protection of uncovered deposits. One MS would like to repeat the estimations with a two-tier depositor preference.

**4. Creditor Hierarchy**

As stated in a former Presidency note, the Commission proposal amends article 108 BRRD to establish a single tier general depositor preference. This implies that (i) all deposits would be considered senior to unsecured senior liabilities and (ii) that all deposits would share the same insolvency ranking.

In their written comments, some MS agree that putting depositors above (better-off) senior debt in the insolvency hierarchy facilitates bail-in capacity, but at the same time, some of these MS remark that this does not require the *pari passu* of all depositors. On the other hand, other MS disagree because they believe senior debt is already bail-inable, although they recognize it helps the operationalization of bail-in. For one MS, the new regime could complicate even the bail-in because some deposits in its jurisdiction have currently a subordinated status (even equivalent to an AT1 instrument), and thus, a general deposit preference would force this MS to bail-in operational liabilities like derivatives instead.

Most MS do not support a single-tier deposit preference. Some MS argue that it would hinder DGS recoveries in payout scenarios, other MS refer to the moral hazard it would create because such insolvency hierarchy would imply an implicit guarantee to all deposits, other MS consider that there is not enough information, other MS signal a possible inconsistency between general deposit preference and deposits being MREL-eligible, and finally one MS stresses that losing the current covered deposits superpreference would make DGS lose the ability to pay directly covered depositors from the insolvency estate of a defaulting bank. On the other hand, some MS can support the single-tier preference for the sake of expanding funding resources to bridge the funding gap.

At the same time, most MS agree to discuss a two-tier preference hierarchy for deposits, where some deposits, meriting less protection, could be included in the junior tranche and without implying that any protection is absolute. That said, some MS consider that the implications of this 2-tier should be carefully studied. On the other hand, other MS believe this possible 2-tier system would not suffice or would prefer maintaining their current 3-tier.

Finally, considering that without the single-tier preference, the proposed use of DGS to bridge the funding gap might not be fully successful, some MS suggest alternatives

such as (i) amendments to the LCT, (ii) waiving LCT altogether when financial stability is at risk, (iii) establishing additional funds that complement DGS current resources.

### 5. Least-cost test

As stated in a former Presidency note, the new rules of the Commission proposal regulate in article 11e DGSD the least cost test (LCT) in a consistent and harmonized way for the different possible uses, different to the paybox function, in particular the use of DGS in resolution (article 11(2) DGSD), for preventive measures (article 11(3) DGSD) and for alternative measures (article 11(5) DGSD). In order to make the calculations in a homogeneous manner, the Commission proposal sets out the LCT´s building blocks: (i) lesser cost test design, (ii) net cost approach, (iii) set of indirect costs and (iv) calculation of the LCT.

In their written comments, all MS agree with the intention to harmonise, although one MS believes the regime should not apply to IPS that act as DGS. In addition, some MS believe, more detailed regulation should be in level 1 and not in a EBA draft RTS, one MS specifically argues in favour of flexibility and the convenience of having EBA guidelines instead of draft RTS, and the rest of MS remain silent on this issue. Regarding indirect costs, some MS consider that they should not be included while most agree with the current text. Interestingly, while agreeing with the LCT framework, and conscious that it might compromise DGS support in funding in resolution, especially if covered deposit superpreference is not scrapped, some MS suggest waiving the LCT (and/or access conditions to the RF/SRF) when financial stability is at risk. Finally, some MS raise governance issues with the use of DGS and another MS suggests publishing the LCT calculations.

## III. Ideas to foster a possible compromise and questions to Member States

Based on the existing feedback explained above, the Presidency considers that:

1. **On MREL for transfer strategies,** all MS agree that MREL is the first and main line of defence. Besides, there is broad support to include article 45ca in the BRRD. However, there is less agreement on the criteria to be included and whether more safeguards should be included to ensure MREL is adequate. Finally, some MS would like more details on some of the criteria and some argue in favor of delegating to EBA for specifying them.
2. **On MREL for liquidation strategies,** the Presidency considers that MS still have split views on the need to require an MREL add-on for liquidation entities outside resolution based on the same list of criteria as in MREL for transfer strategies.
3. **On bridging the possible funding gap**, the Presidency considers that MS broadly agree with the existence of a possible funding gap but disagree with the means to close it: some MS favour higher MREL, others believe the 8% threshold to access the RF should be revisited. However, most MSs seem to

accept the use of DGS resources to bridge the funding gap if enough safeguards (and MREL) are set.

4. **On creditor hierarchy**, the Presidency believes that most MS would prefer to discuss a two-tier depositor preference. However, at the same time, some MS still support the single-tier proposal because it is instrumental to unlocking the most funds from the DGS to close the potential funding gap which is, in turn, supported (or accepted by most).
5. **On LCT**, the Presidency considers that there is broad support to harmonise the LCT for all DGS intervention outside payout (preventive, alternative and resolution measures). Some MSs see leeway to amend the proposed LCT to ensure that, even with a 2-tier deposit preference framework, DGS can provide funding for a potential BtG (and for preventive and alternative measures).

**Q1: Do Member States agree with the description of the current state of affairs?**

The Presidency believes that the overarching objective of the CMDI review is to enable the application of resolution tools, in particular transfer strategies, to any bank, including to smaller/mid-sized banks, where resolution objectives are at risk, resolution is proportional, and resolution achieves those objectives better than insolvency. When debating Member States views and reflecting on a possible way forward, the Presidency believes that it is important that the Council tackles as a whole the various elements of funding equation mentioned above.

**For this purpose, after considering MS's feedback referred above and to seek additional views the Presidency is putting forward a set of coherent packages of options across all these elements**. These should not be understood as rigid landing zone proposals. They are rather a means to refine previous ideas and test grey areas while **maintaining a coherent proposal/package**. They present some preliminary elements whose discussion should contribute to the final mix we would like to present in a future Working Party. Each of the packages represents consistent examples on possible preferred ways forward. While the Presidency welcomes any views on the different elements, it suggests MS to keep in mind the need to preserve the necessary consistency in any proposed approach.

The Presidency is proposing a set of 2 coherent packages of options which include three elements: (A) MREL calibration, (B) DGS bridge safeguards and (C) the creditor hierarchy enabling DGS contributions under the LCT.

**Option 1:** (A) retains the single-tier depositor preference as proposed by the COM to expand the possibility for DGS involvement in bridging the funding gap in resolution under the harmonised LCT; in turn it proposes (B) a stronger and tighter calibration of MREL requirements for transfer strategies and (C) additional safeguards for the DGS bridge to take into consideration concerns raised by MS opposing the single-tier.

**Option 2:** (A) proposes a 2-tier creditor hierarchy differentiating among depositors on the basis of elements that might warrant more/less protection in line with the FR July non-paper (the profile of depositors, size, maturity, potential to be MREL eligible, etc). It is also aligned with other MS suggestions. Such criteria would then need to be

discussed in detail. Under this option, (B) the MREL calibration is maintained on the basis that it responds to the need of the resolution strategy, (C) while the DGS bridge mechanism maintains its functionality by partially compensating its narrower capacity to intervene because of the creditor hierarchy change through modifications to the LCT.

**Option 1. Single-Tier with strengthened MREL and DGS safeguards.**

| MREL calibration | DGS Bridge | Creditor Hierarchy/LCT |
|---|---|---|
| **Considerably stricter:**<br>○ Narrow scope of application of MREL calibration for transfer strategies to smaller banks (not G-SIIs, top-tier and fished banks).<br>○ Remove 'market depth' criterion.<br>○ Apply a floor on MREL level for transfer strategies (relative to bail-in standard calibration, absolute minimum MREL, other)<br>○ MREL for alternative measures: delete paragraph 2 of Art 45ca. | **Safeguards considerably stricter:**<br>○ Restrict DGS bridge in a transitional period for "newcomers".<br>○ Strengthen wording on the exceptional nature of the usage (even clearer link with Art. 44(3) BRRD).<br>○ Cap DGS intervention with possibility for national DGS authority to waive the cap under specific circumstances if needed. | **COM proposal:**<br>○ Single-tier general depositor preference.<br>○ LCT as proposed by COM, EBA RTS/Guidance mandate, transparency on indirect costs. |

**Option 2. Two-tier with a more flexible LCT**

| MREL calibration | DGS Bridge | Creditor Hierarchy/LCT |
|---|---|---|
| **Strengthened:**<br>○ Narrow scope of application of MREL calibration for transfer strategies to smaller banks (not G-SIIs, top-tier and fished banks).<br>○ Remove 'market depth' criterion.<br>○ MREL for alternative measures: delete paragraph 2 of Art 45ca. | **Slightly strengthened:**<br>○ Strengthen wording on the exceptional nature of the usage (even clearer link with Art. 44(3) BRRD). | **Differentiation among depositors: Two-tier deposit ranking**:<br>○ Upper deposit tier: covered, preferred non-covered, non-preferred non-covered except all non-eligible and corporate deposits with maturity above 1Y.<br>○ Junior deposit tier: all non-eligible deposits and corporate deposits with maturity above 1Y.<br><br>Note: Deposits with an explicit subordination clause would rank according to their contractual arrangements.<br><br>**LCT modified principle:**<br>○ For example, including indirect costs to economy, on a case-by-case assessment (suggested proxy could be |

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| | | expected loss in liquidation corresponding to the NC deposits that would be protected from losses in a transfer)<br>○ Or by truncating the recoveries in insolvency with a factor to be determined. |

**Q2: Would Member States kindly comment on the above two packages? Which option do Member states agree more with and why? Would they support both? How should safeguards/individual elements be actually framed (i.e. MREL cap, LCT capped recoveries, junior depositor tier…)? Do you see other possible options that would achieve the objectives of unlocking funding in resolution?**