Key problems with the current resolution framework for resolvability of smaller banks and possible solutions in the context of CMDI Package

I. Purpose and intention

The aim of this Non-Paper is to present the practical experience of the Polish Resolution Authority – the Bank Guarantee Fund („the BGF")[1] and provide a short description of real problems that the BGF had to face while carrying out resolution under current framework. It is also to refer to key aspects of the crisis management framework in CMDI proposal as a possible solution from this perspective. We hope this can be a valuable contribution to look at the CMDI package also from the practical point of view with real cases.

The BGF acts as the deposit insurer and the resolution authority in Poland, as one of the few has experience and well-grounded know-how in both reimbursement of covered deposits, application of resolution tools and usage of alternative measures referred to in Article 11(6) DGSD for orderly liquidation of credit unions. The BGF has carried out pay-outs for depositors from more than 100 banks and credit unions (since 1995 when it was established), has supported transfers of covered deposits within restructuring of credit unions (since 2014) and has executed resolution tools in relation to 4 banks (in years 2020-2022), both commercial and smaller cooperative banks. Therefore views expressed below are based on the practice and lessons learned from the above-mentioned affairs.

II. General remarks

The Bank Recovery and Resolution Directive (BRRD[2]) introduced into EU legislation a common procedure called resolution that harmonized at the EU level the existing in Member States different crisis management mechanisms for credit institutions threatened with insolvency, maintaining at the same time normal insolvency proceedings as a default option for dealing with failing banks. The experience so far (including practical) indicates that such a shape of EU crisis management framework is not optimal. This non-paper presents main issues that need to be addressed in order to ensure greater consistency, effectiveness, and credibility of EU crisis management framework. The topics reviewed in the document focus on public interest assessment (PIA), MREL for smaller banks, funding arrangements in resolution and DGS role in resolution (other than just paybox in liquidation), with reference to the newly-proposed crisis management framework. It also provides examples of real resolution cases to illustrate the relevant issues.

We welcome the clarifications made in the CMDI Package of some aspects as well as – to a certain extent – solutions aimed at expanding the scope of resolution (provided that this is the most suitable solution for preserving financial stability and protecting depositors) and strengthening the funding in resolution by complementing the internal loss-absorbing capacity of institutions with the use of DGS funds in resolution to help access resolution funds in certain specific cases and subject to well defined conditions and safeguards without imposing losses on depositors. This solution will be particularly important in the case of smaller deposit-funded credit institutions. We are of the opinion that improvements in crisis management framework are necessary in order to make it credible and working effectively for all banks, regardless of their size and business model (so for both, resolution

[1] https://www.bfg.pl/en/

[2] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

and liquidation entities). Therefore, appropriate tools and arrangements, including optimal financing model, for this purpose should be developed.

III. Public Interest Assessment (PIA)

- Current Framework

First of all, in our view, the current wording of Article 32(5) BRRD is already appropriate and allows the application of resolution to a wide range of institutions as the construction of PIA – based on the evaluation of accomplishment of resolution goals and comparison with the outcome of winding down the entity within national insolvency procedure – allows for taking into account a wide range of factors, including size, business model, etc. (in case of PL the only alternative under national insolvency procedure is piecemeal liquidation which as result facilitates the comparison to tilt towards resolution). For that reason, it seems that prospective changes to the provision concerning PIA shall focus on making the regulation easier to understand and **not on amending its legal sense**. The most important issue here is to maintain appropriate flexibility, which we try to make clear with the practical examples below.

One of core criteria in the assessment of public interest is continuity of critical functions. Whereas in the biggest cities most of financial services can be easily maintained, since it is possible to replace them in an acceptable manner and within a reasonable timeframe by competitors, in smaller or less developed areas/regions it is not possible. Consequently, piecemeal liquidation of a bank that is failing or likely to fail in standard insolvency procedure (where the DGS intervenes only through its paybox function) may lead to the financial exclusion of the local society (i.e., households, firms, local authorities won't be able to access banking services; uncovered depositors would be unable to meet their payment obligations, to spend or to invest, firms would face liquidity problems that can easily turn into a solvency problem) and this, in turn, may impact the economy of that area and risks spreading the problem. In other words, the result of the criticality assessment for the same function can differ depending on the area where its provider operates – **these are the issues Polish RA had to face in practice in the case of resolutions of cooperative banks in less banked regions, which were very important for the local community and local government units.**

As an example, we can give the resolution of the Podkarpacki Bank Spoldzielczy (PBS)[3] – cooperative bank based in Sanok (town in Podkarpackie Province, South East part of Poland) with total assets approx. EUR 0,65 bn. (PLN 2,8 bn.) (exchange rate at the date of resolution decision issuance). The Tier 1 capital ratio decreased from 7.56% to 0.32% over 12 months, while the minimum requirement is 6%.

PBS case - important bank at the regional level

PBS operated as a universal bank mainly in the Podkarpackie Province through a network of 52 bank branches and subsidiaries and was not a member of the Institutional Protection Scheme (IPS). In the BGF opinion a resolution action was necessary in the public interest to ensure the continuity of critical function that bank had in case of deposits for local institutions like hospitals & public health service, municipalities, unions and associations, foundations, fire brigades, housing association, parents councils, school's funds, sports clubs, churches, chambers of commerce and forestry units etc. The bank was irreplaceable also due to the fact that in Poland local institutions

[3] In 17 January 2020, resolution was initiated against PBS and the bridge institution tool was applied. The bridge institution was established in Q4 2019 under the name Bank Nowy BFG S.A. The BGF equipped Bank Nowy BFG S.A. with an initial capital of PLN 100 million from the resolution fund. The BGF also applied to the Warsaw Stock Exchange to suspend trading in bonds issued by PBS.

(mentioned above) often need a person to person customer service (this is also very important for older people) and quick access to cash and there was no alternative for these functions in the area where PBS operated (digital services offered by larger banks are unfortunately not an alternative here).

In our opinion, no country can afford to exclude seniors (skeptical or unable to use digital solutions) as well as local community important units and grassroots initiatives from banking and access to current liquidity - banking services in cash (person to person). In case of PBS because of the resolution **its branch operations had to be suspended only for 4 days, still it significantly upset local community** and required time-consuming collaboration between central and local government to discuss the situation and provide explanations. Moreover, after this 4 days suspension, there was a **significant outflow of deposits** (box below - PBS case - liquidity crisis).This is not only due to suspension in availability of deposits, but above all the result of the event that some uncovered deposits has been bailed-in. In such circumstances, even prior common awareness, if it truly exists, of risk related to uncovered deposits would not help to calm down the moods of savers who simply loose their money.

We would also like to point out a very interesting case of how important PIA flexibility is. We can provide here an example of proceeding for issuing a decision on the initiation of resolution of Bank Spoldzielczy in Przemkow[4] – cooperative bank based in Przemkow (town in Lower Silesian Province, South-West part of Poland) with total assets approx. EUR 25 mln (PLN 115 mln) (exchange rate at the date of resolution decision issuance). The resolution decision was made in the middle of the Covid-19 pandemic during the lockdown so the government had to be extra careful not to provoke bank run i.e. to avoid queues and crowds of people wanting to withdraw cash and preventing bank bankruptcy during the time of pandemic, which - taking into account the social sentiment at that time (uncertainty about the future economic situation and widespread lockdown) could have led to the disruption of the stability of the banking sector. **Flexibility regarding PIA (already provided by the BRRD) made it possible to adapt to even such an unpredictable situation as a pandemic and, as a result, avoid disrupting the financial system in an uncertain time while also protecting people's health and life (even though the bank was actually very small)**. No one could have predicted the pandemic, just as no one can predict what the future will bring. This is why the legal framework have to be flexible and enable to react to every possible situation appropriately.

But the flexible shape of public interest under the current resolution framework allows for applying resolution procedure also for bigger banks. In Poland, two resolution cases of medium-sized banks were conducted – Idea Bank and Getin Noble Bank. In case of Idea Bank[5], although the bank did not perform critical functions to be sustained, the standard bankruptcy would highly-probably trigger negative financial stability impacts on the financial system due to the interdependencies (thorough the ownership structure) with another bank (Getin Noble Bank, which was also resolved later).

Idea Bank case – resolution without critical function

Idea Bank was a medium-sized commercial bank that did not perform critical functions. However, there were significant interdependencies between Idea Bank and Getin Noble Bank resulting from the same one owner (physical person). The bank run that occurred in case of Idea Bank in 2018 resulted also in the liquidity problems of Getin Noble Bank. It was therefore evident that the potential problems of Idea Bank negatively impact also Getin Noble Bank. The simultaneous collapse of both

[4] On 30 April 2020, under the decision of the BFG of 28 April 2020, resolution was initiated against Bank Spoldzielczy in Przemkow and the sale of business tool was applied. The acquiring bank was SGB-Bank S.A. The acquiring bank was chosen in accordance with the principles set out in Article 178(1) of the BFG Act.

[5] On 31 December 2020, under the decision of the BGF of 30 December 2020, resolution was initiated against the Idea Bank SA and the sale of business tool was applied. The acquiring bank was Pekao SA. The acquiring bank was chosen in accordance with the principles set out in Article 178(1) of the BFG Act.

of them would be impossible to manage from the perspective of deposit guarantee scheme. **At the same time, the estimated costs of restoration of DGS funds after the failure of only Idea Bank (and subsequent pay-out of guaranteed deposits) would burden the banking sector with significant contributions. The impact of such hypothetical action was far higher than the cost of resolution.**

We would like to emphasize very clearly here that the failure of Idea Bank alone would have had significant impact on the public (DGS) funds even before taking the possible contagion effect into account. Based on Valuation 2 the costs for the system in case of payout was indicated (ca. PLN 13 bn), this amount is incomparably higher than the cost of resolution, which will potentially (the process is still ongoing) amount to less than half a billion PLN.

Thus, bankruptcy would be at least (assuming no contagion effect) 16 times more expensive for public funds than resolution (PLN 13 bn payout vs. PLN 0,8 bn resolution!)

In case of Getin Noble Bank[6], public interest was assessed positive, due to (among others) the performed critical function – deposit-taking of local government units.

Getin Noble Bank – deposits of local government units as critical function

In case of Getin Noble Bank, one of the reasons for initiation of resolution procedure was performing a specific critical function (apart from the negative impact on financial stability and necessity to protect public funds). This critical function was associated with the servicing deposits of local government units. BGF identified a few districts and cities for which the average annual level of deposits exceeded the critical level of 80 mn PLN (amount set by the BGF in its methodology of critical function). The deposits of local government units are not however subject to deposits guarantees (over EUR 100.000) and even if they were – the potential write-down would be significant, depriving local institutions of funds necessary to meet basic communities' needs (e.g. financing hospitals, nurseries etc.).

In addition, current rules on PIA provide resolution authorities with sufficient flexibility that allows them to apply resolution tools in relation to a broad scope of institutions. **Lower tendency to trigger resolution instead of bankruptcy proceedings does not result from any malfunction of PIA, but in our opinion is mainly the consequence of concerns about availability of adequate funding (once internal loss absorption capacity has been exhausted but is insufficient) as well as the high diversity of alternatives to resolution based on different insolvency frameworks across the EU.** In some Member States DGS alternative measures that enable the DGS to provide funding to support a transaction to the extent that this is necessary to preserve access to covered deposits, shaped similarly to P&A transactions, are in place whereas in others normal insolvency procedure in any case assumes just pure deposits pay-out. Moreover, these discrepancies are increased by the fact that recovery rates from bankruptcy estate for DGSs differ significantly (for example in Poland, based on historic data, the recovery rate was very low). **Therefore, in many cases, payout is not a suitable solution even for DGS itself.**

In such a case the resolution can be impossible as it requires the bail-in of uncovered depositors which can affect the confidence and create **a risk of bank runs – liquidity crisis, and not protecting financial stability**.

[6] On 30 September 2022, under the decision of the BGF of 29 September, resolution was initiated against the Getin Noble Bank SA and the bridge bank tool was applied. Part of the bank was transferred to the bridge institution acting under the brand Velobank.

PBS case – liquidity crisis

To carry out the process of deposit write down, the whole bank activity had to be suspended for 4 days. The BGF had to cut off e.g.: access to electronic banking, account administration (no debit/no credit status), execution of FX Treasury transactions, transport and cash handling, ATM transactions, card transactions (Visa), mobile and internet payment (pay by link), and access to the whole system.

Three and half days later after renewal of the authorization, all the services were fully available again, but following the re-launch of electronic banking and the re-opening of the bank branches, **liquidity began to deteriorate rapidly. There was 50% deposits outflows within first week of resolution and 65% within month.** To safeguard the bank's liquidity on 28 January 2020 loan for PLN 500 million for one year was granted (loan was secured by resolution authority).

This weakens significantly resolution regime and constitutes a substantial impediment to achieve its aim specified in recital (45) BRRD that *any failing institution should be able to exit the market, irrespective of its size and interconnectedness, without causing systemic disruption*.

Last but not least, it should not be forgotten that broadening of the number of resolution-entities would entail increase in the number of institutions subject to recapitalization amount in terms of MREL and higher costs for preparing to resolution. Costs that many small and medium-sized banks are not able to withstand.

It is also worth emphasizing and bowing to other Member States than while for Poland the flexibility may be sufficient, for other Member States it may be necessary to better frame the conditions of the PIA as proposed by the Commission, otherwise we will not be able to achieve the objectives of the CMDI reform for the EU as a whole.

- <u>CMDI Proposal</u>

When it comes to CMDI proposal, the European Commission (EC) adds a reference in the definition of ‘critical functions’ to the ‘regional level’ of the impact of the disturbance of their discontinuation to the real economy or to financial stability (Article 2(1), point (35)); proposes a change in Article 32(5), 2nd subparagraph, on the procedural rules on PIA, requiring the resolution authority to consider and compare all extraordinary public financial support that can reasonably be expected to be provided to the institution in resolution and in the insolvency counterfactual, and proposes to amend Article 32(5), first subparagraph, to clarify that national insolvency proceedings should be selected as the preferred strategy only when they achieve the framework’s objectives better than resolution (and not only to the same extent).

In the context of our practical experience we fully support the clarification of the definition of critical functions by reference to impact at “regional level” (Article 2(1) point (35)). This constitutes the current approach and how PIA has been applied. Similarly, **we agree that one of resolution objectives should be a protection of all deposits including not covered deposits (Article 31(2)(d)),** also in view of the impact that their bail-in might have on the financial stability. Nonetheless, on the resolution objective to protect all deposits as a second best alternative - that the protection of depositor's confidence was made a clear resolution objective - for example replace Article 31(2)(d) by: “*(d) to avoid loss of depositor’s confidence, including by protecting depositors covered by Directive 2014/49/EU and preventing adverse impacts on other depositors, and to protect investors covered by Directive 97/9/EC*.”

Current wording of Article 32(5) leads to the application of normal insolvency proceeding when the objectives of resolution would be achieved to the same extent as in resolution; thus, resolution is to be preferred only when it would be **more effective** in allowing to meet the resolution objectives (but, as we said earlier, the current wording is flexible enough, the Commission proposal would make it more difficult opting for liquidation - current rules on PIA provide resolution authorities with sufficient flexibility that allows them to apply resolution tools in relation to a broad scope of institutions). Last but not least, when it comes to Article 32(5) second subparagraph in BRRD proposal, we are of the opinion that the provision on requiring the RA to consider "*all extraordinary public financial support that can reasonably be expected to be granted to the institution, both in the event of resolution and in the event of winding up in accordance with the applicable national law*" **should not be added to the Article 32(5)** since it would create unnecessary additional administrative burden on RA, while not creating any additional value added for the process. We also find the application of that provision may be problematic at the operational level and make it difficult to carry out resolution action quickly and effectively.

Moreover, as a rule we support the direction of minimizing DGS losses, however we believe that it is not necessary to frame this directly in the provisions. Financial stability should remain the ultimate goal while minimization of DGS losses will be ensured enough by least cost test (LCT). Alternatively we would suggest a middle ground solution to add a new subparagraph in Article 31(2): *When pursuing the above objectives, the resolution authority shall seek to minimize the costs of failure, unless otherwise necessary to achieve the resolution objectives.*

Then LCT does not protect the DGS from a non-resolution decision taken by the RA/SRB. We understand that this is more of a problem for SRM members, but without this rule liquidation might be significantly more expensive and still be chosen. For us, it is becoming increasingly clear that the decision to resolve or not resolve should also be guided by an overall cost-minimization principle, including both the DGS and NRF/SRF.

Presidency proposals in the field of PIA – CMDI meeting on October 9, 2023

When it comes to options presented by the Presidency, we think that each of them limits the flexibility in comparison to the Commission proposal and the above examples that we presented clearly showed how important flexibility is.

The most preferable approach is to keep the wording proposed by the Commission.

IV. Funding and DGS Bridge

- Current Framework

Looking at the crisis management framework as a complete toolkit to support the financial stability, we are of the opinion that wide range of tools should be available for Member States to deal with banks threatened with insolvency. Adoption of such measures (e.g. P&A transactions outside resolution) towards banks for which resolution is not a suitable solution (for reasons like lack of funding and problematic bail-in) could reduce the number of reimbursements of covered deposits by DGSs (and so its overall cost) and would have less adverse effects for depositors and their confidence (also by maintaining the continuity of access to deposits and the bank's franchise value, so with no destruction of value). Therefore, we find reasonable to maintain alternative measures within national insolvency proceedings for small and medium-sized banks with the use of DGS funds based on relevant provisions of Deposit Guarantee Scheme Directive (DGSD). However, to make it possible, we need to consider the reasonable approach to issue of the DGS super-priority and maybe create a single-tier general depositors' preference with same safeguard for DGS. We are aware that super-priority may in many cases limit the ability to use DGS in resolution, however, on the other hand, there can be a group of Member States (for example Poland), where recovery rates (even in the current framework with super-priority) are not high. Everything depends on the asset quality (mainly) and the bankruptcy procedure in a given Member States and we must bear this in mind.

In terms of potential amendments to DGSD and national insolvency law we find the Italian approach (Compulsory Administrative Liquidation) as optimal and proportionate in relation to small and mid-sized banks. The BGF experiences with restructuring of failing credit unions in the form of compulsory takeovers, where the BGF provided subsidy or guarantees for the benefit of business in a given credit union in case of takeover or acquisition, also indicate high usefulness of such tools. However, it might not be sufficient and there should also be other mechanisms.

Furthermore, in relation to small and medium-sized banks flexibility of **PIA should be associated with a wider possibility of the DGS utilization (for example to cover the gaps in bail-in)** as in case of small banks it may not be possible to use resolution financing arrangements due to inability to meet the 8% of write down or conversion requirement. They cannot raise MREL instruments on the wholesale capital markets and relying exclusively on the CET1 capital or retained earnings is not feasible, because it is a type of capital: “going concern”, not “gone concern capital”. As a result, a large part of this class of capital will be significantly deteriorated at the stage of implementing repair options and the weakening of the bank. In Poland, this class of capital (in each case) was depleted the fastest, even before resolution was initiated. This problem was noticed by the EC and addressed in the CMDI package. In such a situation resolution funding by DGS may be the only alternative to bank’s insolvency. Resolution goals will still have to be met and, at least, the least cost test will ensure that DGS systems do not incur higher costs than in the event of bankruptcy and the need to payout covered deposits.

Bankruptcy and DGS payout also have other consequences that may not be visible at first glance. Based on Polish experiences, whether in the case of PBS or other resolutions, or simulation of the implications if we had not conducted these resolutions action, we are able to indicate the following. First of all, for a market with Polish parameters, **even in case of the bankruptcy of a medium-sized bank the consequences of its bankruptcy are significant, in particular for financial stability**, e.g. as a result of burdening the banking sector additional contributions to reimburse DGS resources (the example of Idea Bank given above and the need for the sector to replenish DGS funds to minimum levels within a short period of time after most resources have been exhausted), this results in increased costs and affects capital requirements, lower profitability and as a result the ability to generate new credit. **Even in the case of resolution of cooperative banks, we observed an outflow of deposits to larger entities (which has a significantly negative impact on local banking and access to banking for older people - less proficient in forms of digital and online banking). In the event of bankruptcy, this effect would become stronger** since the discontinuation of access to deposits for longer time (DGS pays out deposits in 7 days, resolution aims to sustain constant access to the deposit) initiates depositors’ panic. Bankruptcy also means consequences for depositors with savings above the guaranteed limit. Such depositors are also business entities (micro, small and medium-sized enterprises), their loss of uncovered funds upsets their current liquidity, or even poses the risk of bankruptcy layoffs of employees or restrictions on investments. Such events, especially in smaller urban centers will cause serious negative social consequences. It may significantly affect the unemployment rate in this area and result in the so-called second round effect for the local community. Similarly, there will be consequences for local government units that will not be able to fully: pay out social assistance benefits due to the poorest and most needy residents, or provide various educational and family benefits; allocate appropriate funds for the maintenance of social welfare homes, orphanages, or funds to support hospitals; ensure the maintenance of kindergartens, schools and the payment of utility bills in school and kindergarten buildings; provide residents with heat, electricity and gas energy; continue the implementation of started investments, pay invoices for services provided, or repay debt obligations on time.

As depositor payout only compensates covered depositors, the expectation of losses may lead to destabilising outflows of uncovered deposits ahead of a bank's failure. When, during crisis, depositors start to expect that their uncovered deposits may have to bear losses, they quickly reallocate their deposits among banks to stay below the coverage limit. As this reallocation has empirically been observed to be asymmetric, e.g. from smaller to bigger banks or from banks that are perceived to be 'weaker' to those who are perceived to be 'stronger', this can lead to destabilising net outflows endangering the liquidity buffers and eventually the viability of those banks that are perceived as being weaker. Looking at overall deposits by retail and other non-financial customers, uncovered deposits make up 48% of the total for significant institutions and 36% for less significant institutions. Uncovered deposits thus make up a notable share of overall deposits and if they start being moved during a crisis, this can have systemic consequences[7].

	Resolution	**Bankruptcy**
Level of harmonization in the EU	Procedure harmonized at EU level under the BRRD framework with clear triggers.	Non-harmonized procedure; different in each Member State.
Primary goal	Protection of the public interest (and financial stability); protection of public funds, protection of DGS funds	Protection of creditors interests.
Conditions of initiation	The bank is failing or likely to fail (FOLTF); alternative measures cannot be used or are ineffective; the public interest condition is met.	Formal (balance sheet) insolvency or lack of liquidity.
Maintaining critical functions	Yes.	No (in most cases).
Social costs and costs for the banking sector	Minimized.	Maximized.

Transfers supported by DGSs are frequently used in some major non-EU jurisdictions that have drawn lessons from previous systemic banking crises in which DGSs were required to play a major role, such as the US and Japan. The US Federal Deposit Insurance Corporation (FDIC) estimates that between 2008 and 2013, the use of the most common type of transfer supported by the DGS saved $42 billion, or 43%, compared with the estimated cost of payouts[8].

- CMDI Proposal

The EC proposes to amend Article 109 to clarify certain aspects of the use of DGS in resolution. It clarifies that the DGS can be used to support transfer transactions that include covered deposits, and, under certain conditions, also eligible deposits beyond the coverage level and deposits excluded

[7] Source: ECB, Q4 2020.
[8] ECB Occasional Paper Series No 308 / October 2022 – Non-technical summary

from the DGS guarantee. The amount of the DGS contribution may not exceed any shortfall in the value of the assets of the institution under resolution transferred to the buyer or the bridge institution in comparison to the value of the transferred deposits and liabilities with the same or a higher priority ranking in insolvency than those deposits. To ensure access to resolution financing arrangements where necessary for the implementation of a transfer strategy, paragraph 2b of Article 109 provides that the DGS contributions in resolution should count towards the 8% total liabilities and own funds (TLOF) requirement for accessing the resolution financing arrangement. And last, to facilitate the use of the DGS in resolution where this is necessary to maintain financial stability and protect depositors, Article 108(1) is amended to introduce a general depositor preference with a single-tiered ranking, which would be achieved thanks to two modifications. First, the legal preference in the insolvency laws of Member States required by BRRD relative to ordinary unsecured claims is extended to include all deposits. Second, the relative ranking between the different categories of deposits is replaced by a single-tier depositor preference, where the super-preference of the DGS/covered deposits is removed, and where all deposits rank *pari passu* and above ordinary unsecured claims.

<u>The amount needed to bridge to 8% TLOF is not high and is in any case lower than the payout.</u> 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. So, the role of the LCT in the CMDI reform is the harmonization of the LCT as a prerequisite to fulfil the CMDI overarching goal to facilitate recourse to resolution for smaller and mid-sized banks <u>when this is the most cost-efficient solution. Nevertheless as to the LCT harmonization, we believe that (i) indirect costs should also include additional costs for the financial system (such as, higher funding costs and impact on weaker banks) and that (ii) that some flexibility should be retained at national level, for instance to apply to most appropriate recovery rate in the counterfactual scenario. We also believe that, in light of the above, the best way to harmonize the LCT is through EBA guidelines and not through an RTS.</u>

The pronounced differences between Member States in terms of DGS powers and functions weaken the level playing field.

In its explanations, the EC pointed out that the divergences among Member States in their approach to LCT completion justify the harmonization of its underlying methodology for all uses of DGS funds. In combination with the new fundamental design of the hierarchy of creditors, this harmonization 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 recognized as DGSs vs. IPSs not recognized as DGSs).

<u>Nevertheless, depositor payouts will still be an option for the DGSs, and the least cost test, which has to be passed before alternative measures can be taken, rules out the use of alternative measures whenever these would result in costs higher than a payout. Indeed, the main reason that justify the introduction of a general depositor preference single-tier is to unlock the access to the DGS fund so that it is able to perform alternative measures in a wider number of cases. Moreover lifting all deposits into a higher tier it also helps mitigate NCWO (no creditor worse off) risks for those cases where today deposits may rank pari passu with certain types of (bail-inable) debt.</u>

V. <u>Final remarks</u>

DGSs are essential to mitigate the risk of bank runs and are thus a key policy feature for ensuring financial stability. In the EU, the role played by DGSs in managing bank failures has only been harmonized to a limited extent. The ability to compensate covered deposits through payouts to depositors after bank failures is a feature of all EU DGSs.

To make other measures usable in practice in the EU, the DGS or other authority must be able to implement the transfer and the least cost methodology in all EU countries. Furthermore, to make the use of DGS possible outside payout for measures that are more cost-effective and preserve the access of depositors to their deposits, it is necessary to remove the DGS super-preference. However we are open to hear other solutions that would have an effect of unlocking DGS funds for the support of transfer strategies in resolution or in insolvency **(provided [these alternatives] offer sufficient room to address the shortcomings of the current framework by allowing safety nets i.e. DGS and resolution funds to be used effectively where necessary to preserve financial stability), because we realize that general preference may not be suitable for all Member States, where some DGS did not obtain full recovery rate even with current priority, so this also gives a space for the use of DGS bridge.**

A liquidation process combined with a depositor payout is typically lengthy and expensive. **If a bank is liquidated, valuable customer relationships, which would have generated revenue in the future, are lost as depositors and borrowers move to other banks.** The multi-year nature of liquidation procedures and the associated administrative costs also reduce the recovery rate. In such cases, liquidation destroys value that could otherwise have benefited creditors. The depositor payout accompanying the liquidation typically requires the DGS to compensate fully all covered deposits within seven working days of the bank's failure. The funds provided by the DGS are then (often only partially) recovered after several years. As covered deposits often make up a sizeable part of a failed bank's liabilities, this can impose a substantial burden on the available financial means of the relevant DGS. **When the DGS is depleted, the other DGS member banks have to step in with extraordinary contributions with an adverse impact on their profitability and ability to absorb shocks.**

Moreover depositor payouts are also not the best possible tool in a bank failure for the purpose of ensuring depositors' access to their deposits, which is increasingly critical as cashless payment instruments become more prevalent. In payouts depositors' access to their accounts is typically interrupted for several days before their deposits are paid out. **This could be problematic for depositor confidence, and disruptive, especially for depositors who increasingly use digital means of payment.**

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From:	Polish Delegation
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