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From:	Presidency
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés
Subject:	CMDI 25 March 2024 Item 6: Presidency non-paper on extraordinary public financial support

Presidency non-paper on extraordinary public financial support

CWP CMDI 25-03-2024

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1. Introductory comments

This non-paper outlines the content of the newly introduced Articles 32c BRRD and 18a SRMR (and the accompanying recitals) in the CMDI proposal, defining a new framework for extraordinary public financial support (EPFS). These Articles have already been discussed under the Spanish Presidency, at the Council Working Party of 7 July 2023 (WK 9018/2023) and of 20 July 2023 (WK 9952/2023). This non-paper provides an overview of the Member States' principal observations as well as some options and questions for Member States.

2. Commission's proposal

Current Article 32(4)(d) BRRD is amended to specify that an institution is failing or likely to fail (FOLTF) if EPFS is required, except where it is granted in one of the forms and under the conditions laid down in Article 32c BRRD.

The Commission's proposal on Article 32c BRRD provides a list of EPFS forms which by exception do not trigger a FOLTF under article 32(4)d, namely (a) EPFS granted to remedy a serious disturbance in the economy of a Member State *or* to preserve financial stability (in the form of a State guarantee to back liquidity facilities provided by central banks, or a State guarantee of newly issued liabilities or an acquisition of own funds instruments/impaired assets measures), (b) preventive and (c) alternative measures financed by the DGS and (d) State aid within the meaning of Article 107(1) TFEU granted in the context of the winding up of the institution.

As from the second paragraph, the Article specifies conditions and rules solely applicable to EPFS measures targeted under (a).

3. Summary of the previous discussions and options

The discussions in the Council Working Parties have mostly focused on the precautionary recapitalisation measure. Apart from that, some Member States indicated that they do not support the qualification of a DGS intervention as EPFS and, one Member State indicated being concerned that the introduction of *all* the EPFS measures would create moral hazard and therefore proposed that Member States should not obliged to have all the EPFS measures available.

3.1 Solvency and incurred or likely losses

On the *definition of solvency*, some Member States advocated that the definition is too restrictive making the use of the measures practically impossible. Two Member States supported a point-in time assessment. According to the Commission, the forward-looking dimension in the solvency definition is important to avoid situations of "false positive" where a bank is deemed to be solvent based on a point-in time assessment and fails shortly after, which are harmful to the credibility of the resolution regime.

The Commission's proposal *prohibits the use of precautionary measures* "*to offset losses that the institution or entity has incurred or is likely to incur in the near future*"[1]. Two Member States opposed this prohibition as they think it is too restrictive. Two other Member States were of the opinion that the notion of "near future" should be specified further and proposed introducing 12 months, in line with the solvency criterion. The open concept of "near future", however, allows the competent authority to perform a case-by-case assessment, which may result in a justifiable period longer or shorter than 12 months.

Related to the *identification and quantification* of incurred or likely losses[2], some Member States advocated to formulate the text more strictly: only if asset quality reviews (AQR) are not possible, targeted on-site inspections could be an option. One Member State raised the concern that public funds should not be used to cover existing losses and suggested therefore that the fair market value should be used. That Member State also expressed its willingness to examine a clawback mechanism to adjust the aid amount in case of an initial miscalibration of the aid. Accommodating the Member States' request to introduce AQR as the first recourse would increase monitoring and independent third-party involvement on the issue that has proven to be a pressure point. AQR and on-site inspections are, however, very resource-consuming for authorities and may be impracticable to conduct within the short deadlines imposed by a situation of tensions. Therefore, the Presidency would propose that this should not be compulsory in all situations.

3.2 2% cap and use of CET1

The derogation to use CET1 instruments was also discussed. Several Member States called for a more flexible system by questioning the exceptional nature of the use of CET1, the exclusion of CET1 in the first paragraph of Article 32c point (a) (iii), as well as the rationale behind the 2% TREA cap.

In its non-paper[3], the Commission explained its preference for instruments, other than CET1, that qualify as own funds instruments since the latter typically have a maturity date and thus their divestment is automatic after a certain period without any actions taken by the authorities. This design facilitates an effortless compliance with the requirement of temporariness. To accommodate requests for a more flexible system, the Presidency could show openness towards changing "*exceptionally*" in a more neutral wording, such as "only" and deleting the words "*other than CET1"* in the first paragraph point (a) (iii) while retaining the conditions that apply in case CET1 is used (Article 32c(2), subparagraph 5).

The Commission introduced the 2% cap to avoid support to entities experiencing more serious challenges and that should not be candidates for precautionary recapitalisation. This cap, however, may be too rigid in some situations and not enough tailored to individual specificities or difficulties experienced by some banks. Additionally, as with any hard threshold, there will be a degree of arbitrariness, or at least difficulty in making it evidence-based.

Another option could be that the 2% TREA cap is retained with an escape clause involving sufficient safeguards to ensure control from authorities. For instance, a derogation from the cap could be allowed based on a justified request from the institution and approved by the relevant authority. Depending on the Member States' appetite to leave discretion to the authorities, it may need to be accompanied with some additional criteria. The escape clause bears the risk of reducing the effectiveness of the proposal in preventing circumvention if those criteria are too discretionary, or of creating inflexibility and administrative burden if the additional criteria are too tightly framed. Overall, this option would increase the complexity of the system.

[1] Article 32c (2) (d) BRRD.
[2] Article 32c (2), subparagraph 3 BRRD.
[3] Presented during the Council Working Party of 20 July 2023.

The deletion of any cap for CET1 constitutes a third option. On the one hand, this would make the system as flexible as possible to meet unpredictable needs. On the other hand, this could increase the risk to support banks experiencing more serious challenges and should be compensated by adequate safeguards.

3.3 Failing of exit strategy

Some Member States expressed their disagreement on an automatic FOLTF declaration if the exit strategy terms are not respected. Two Member States proposed including the option to prolong the timelines to redeem or repay the support under the exit strategy if the initial terms are not respected. While this would make the system more proportionate, it should be ensured that the number of prolongations is limited to mitigate the risk of endless prolongations.

Several Member States were in favour of an assessment of whether the FOLTF condition is met instead of an automatic FOLTF declaration. One Member State proposed replacing the automatic FOLTF declaration by a FOLTF assessment in case the exit strategy is not complied with, and only declaring the institution as FOLTF if the conditions are met at that point.

Another Member State suggested to introduce an escalation mechanism. More specifically and similarly to preventive measures, the suggestion entails submitting a remediation plan after the first non-compliance with the exit strategy. This proposal would take into account situations where non-compliance is not due to the failure to act by the institution, but, for instance, when the State is not active enough in searching a buyer or prefers to remain a shareholder to cash in dividends and recoup its injections. While it also may remove cliff-edge issues to a certain extent, it does not appear to eliminate the cliff-edge issues spotted by *inter alia* the ECB (pressure and weak situation of the bank to carry out market operations before the deadline) but just moves them further into the future.

To accommodate the Member States' concerns as well as to ensure that the support can be qualified as temporary, the Presidency suggests introducing a one-time possible extension accompanied by a remediation plan and a FOLTF assessment in case the support measures have not been terminated by the end of said plan.

3.4 Financial stability exemption

Some Member States mentioned that the conditions are very restrictive, making it difficult to use the precautionary recapitalisation measures. One suggestion referred to the introduction of a financial stability exemption where in extraordinary circumstances the conditions could be relaxed. This could be the case for example when in exceptional circumstances, such as in the event of a systemic crisis, the losses that the institution or entity has incurred or is likely to incur in the near future, resulting from those events, would be disregarded from the quantification established in Article 32c (2) subparagraph 2. To prevent that the exemption would be systematically invoked in practice, it should be accompanied with adequate conditions, a sound governance, and safeguards.

3.5 Revision of the Banking Communication on the State aid framework

Some Member States mentioned the dependencies with the revision of the Banking Communication on the State Aid framework announced by the Commission, urging the Commission to provide more details on the review and to align its timing with the CMDI review. To accommodate this concern the Presidency proposes to introduce a recital confirming that the EPFS is linked to and should be aligned with the revision of the Banking Communication.

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4. Questions for Member States

To allow the Presidency to move forward to drafting suggestions, could you indicate for:

Item 3.1 - solvency and incurred or likely losses:

Q1: Your views on the positions as summarised in the non-paper (the timing of the solvency assessment the need to clarify the concept of near future and the identification and quantification of the losses)?

Item 3.2 - the 2% cap and use of CET1:

Q3: Do you agree with the 2% cap on CET1 as proposed by the Commission to avoid support to entities experiencing more serious challenges? If not, please indicate which of the following options you favour.

a) Another form of caping the use of CET1 (other amount and/or basis). Please specify which one and the rationale for the suggestion.
b) Retaining the cap with a possibility to overrule it under some circumstances. Please specify which circumstances and which governance setup (e.g., approval by the competent authority) you think should be considered.
c) The outright deletion of the cap.

Item 3.3 - the failing of exit strategy

Q4: Your views on the proposed way forward to accommodate the concerns raised by Member States?

Item 3.4 - the financial stability exemption

Q5: Whether the Presidency needs to assess the introduction of a financial stability exemption and, if positive, which conditions and safeguards should be considered?

Item 3.5 - the revision of the banking communication on the state aid framework

Q6: Whether you could agree with the proposed way forward or see any other option to address the concerns?

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