Presidency non-paper on the Bridge the Gap

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1. Introduction

This non-paper covers the use of the DGS in resolution, the so-called 'Bridge the Gap', which the Commission proposes to include in the Articles 109 BRRD and 79 SRMR (and the associated recitals 42-46 BRRD and 40-41 SRMR).

In addition, the Presidency wishes to broaden the discussion by adding elements related to the division of resolution funding between the DGS and the resolution financing arrangement (RFA) included in Articles 44 and 108 BRRD, and Articles 27 and 76 SRMR.

These topics have been discussed under the preceding Presidency at the Council Working Parties of 7 July, 18 September, 31 October, and 21 November 2023. The non-paper provides an overview of the current framework and of the proposal of the Commission, a summary of the main concerns raised by Member States and a potential way forward to accommodate these concerns.

The Presidency proposes to structure the discussion sequentially and to address three questions in the following order :

(i) What is the **purpose** of the Bridge the Gap, i.e. in which cases could it be used?

(ii) How should the **burden** be **shared** between the internal sources of loss absorption (losses absorbed by the individual bail-in capacity of the institution), the DGS (mutualisation of the losses at national level) and the Resolution Financing Arrangement ('RFA') (mutualisation of the losses at national level outside the Banking Union and mutualisation of the losses at the level of the Banking Union otherwise) – and which **safeguards, checks and balances** are desirable?

(iii) Who decides on the intervention, i.e. how is the **governance** structured?

The Presidency acknowledges that given the underlying burden sharing is different if the Bridge the Gap is considered at national level in a non-participating Member State, or at the Banking Union level, the question of the checks and balances, safeguards and governance may deserve different answers in and outside the Banking Union. The Presidency invites both participating and non-participating Member States to reflect on this distinction and if need be to indicate which safeguards should only be present at the Banking Union level.

2. Current framework

<u>Intervention of the DGS</u> : Articles 109.1, 1st sub-paragraph of the BRRD provides that the DGS may support resolution actions and may be used when the bail-in tool is applied or when one or more resolution tools other than the bail-in tool is applied provided that the resolution action ensures that depositors continue to have access to their deposits. However, the third sub-paragraph specifies that the DGS shall not be required to make any contribution towards <u>the costs of recapitalising</u> the institution or bridge institution when the bail-in tool is applied. Finally, the current Article 109 does not make any explicit reference to article 44.3 BRRD.

<u>DGS liability</u> : Article 109.1, 1st subparagraph of the BRRD provides that, in resolution, the DGS is liable for the amount by which covered deposits would have been written down to absorb losses had they

been included within the scope of the bail-in tool or, if a transfer tool is applied, for the amount of losses that covered depositors would have suffered if they would have had to suffer losses in proportion to the creditors with the same priority level under normal insolvency proceedings. Article 109.1, 1st subparagraph BRRD thus establishes the liability of the DGS in resolution.

Cap on the DGS intervention : The 2nd subparagraph of Article 109.1 of the current BRRD limits the intervention of the DGS in resolution, making a link with the Least Cost Test ("LCT"). In particular, it states that the liability of the DGS should not be greater than the losses it would have had to bear had the institution been wound up under national insolvency proceedings. This is subject to a No-Creditor-Worse-Off assessment ("NCWO-assessment") (subparagraph 4). On top of that, Article 109.5, 2nd subparagraph of the BRRD provides an additional safeguard by capping the liability of the DGS to 50% of its target level.

Governance: Pursuant to Article 11.2 DGSD, the intervention of the DGS is determined by the resolution authority, after consultation of the DGS, within the boundaries set in Article 109. Within the Banking Union, article 79 SRMR provides that the Board determines the amount by which the DGS is liable after consultation of the designated authority.

3. Proposal of the Commission

The Commission's proposal amends Article 109 BRRD to clarify certain aspects and facilitate the use of the DGS in resolution with the objective to make its use possible in practice. According to the Explanatory Memorandum, the amendments aim '*to ensure a higher degree of proportionality, enhance the application of transfer tools in resolution for smaller or medium sized banks that will exit the market and facilitate DGS interventions in support of such tools where needed to prevent depositors from bearing losses*.'

Intervention of the DGS in resolution : Article 109.1 as proposed by the Commission clarifies the purpose of the intervention of the DGS and provides that, where a resolution action ensures that depositors continue to have access to their deposits or prevents depositors from bearing losses, the DGS has to contribute :

- when the bail-in tool is used : the amount by which covered deposits would have been written down or converted had covered deposits been included in the scope of bail-in (Article 109.1, point (a)),
- when the sale-of business or bridge bank tool are applied independently or in combination with other tools : to cover the difference between the assets and the covered deposits transferred and where relevant to ensure capital neutrality of the recipient of the transfer (Article 109.1, 1st sub-paragraph point (b)).

Where, for those cases under point (b), the transfer to the recipient also includes deposits that are not covered or other bail-inable liabilities and the resolution authority assesses that the circumstances referred to in Article 44.3 BRRD are met for those deposits or liabilities, the DGS has to cover the difference between the value of the assets and of the transferred deposits (deposits, including deposits that are not covered and the liabilities with the same or higher priority ranking than deposits for which the conditions in Article 44.3 BRRD are met) and where relevant the amount needed to ensure capital neutrality.

The Commission's proposal thus only allows transferring (and thus avoiding allocating losses to) non-covered deposits or other bail-inable liabilities with the same or higher priority ranking than deposits with the support of the DGS where the circumstances referred to in Article 44.3 apply to those deposits or liabilities[1].

Bridge the Gap : Article 109.2b as proposed by the Commission clarifies that the contribution of the DGS can be counted for the 8% loss absorption threshold laid down in Article 44.5, point (a) or for the 20% risk weighted asset threshold established in Article 44.8, point (a) (referred to as the Bridge the Gap). However, it restricts this possibility to the cases referred to in Article 109.1, 1st subparagraph, point (b) of its proposal, i.e. the cases where the sale of business tool or the bridge institution tool is applied, independently or in combination with another resolution tool, the DGS intervenes to cover the difference between the assets and the liabilities transferred and where relevant to ensure capital neutrality of the recipient of the transfer, and the conditions referred to in Article 44.3 BRRD are met in relation to non-covered deposits or other bail-inable liabilities. Furthermore, only deposits and liabilities with the same or higher priority ranking than deposits for which the conditions in Article 44.3 BRRD are met can benefit from the contributions of industry funded safety nets under the Bridge the Gap. More junior liabilities may be part of a transfer, but their transfer must be self-financed. Recital 43 in the Commission proposal also seems to imply that the intervention of the DGS under point (b) should only be possible when there is a market exit, even though this is not entirely explicit in Article 109.

The Bridge the Gap is therefore not possible in an open bank bail-in. Article 109.2b, third sub-paragraph provides in addition that the Bridge the Gap is also not possible for institutions that have been identified as liquidation entities in the resolution plan.

DGS contribution : Article 109.1 as proposed by the Commission establishes that the DGS has to contribute either the amount by which covered deposits would have been written down or converted had covered deposits been included in the scope of bail-in (when a bail-in tool is used) or to cover the difference between the assets and the deposits and potentially excluded liabilities with the same or higher priority ranking than deposits transferred or to ensure capital neutrality of the recipient of the transfer (when the sale-of business or bridge bank tool is used). The proposed amendments to Article 109 should be interpreted considering the amendments to Article 108, which introduce a single tier general depositor preference, thereby removing the super preference of the DGS. The removal of the super preference contributes to increase the minimum and maximum intervention of the DGS in resolution.

Cap on the DGS intervention : The Commission proposes to delete the second sub-paragraph of paragraph 3 of Article 109, that caps the amounts of the DGS intervention to 50% of its target level. In the Commission proposal, the gross amount of the intervention of the DGS in transfer strategies and its costs are subject to caps :

- The cost of the DGS contribution to resolution should be smaller than the cost of repaying depositors as calculated by the DGS in accordance with Article 11e.1 DGSD and on the basis of a single tier general depositor preference;

[1] Recital 45 clarifies that « the DGS may only contribute to a transfer of liabilities other than covered deposits in the context of a resolution if the resolution authority concludes that deposits others than covered deposits cannot be bailed-in, nor left in the residual institution under resolution which will be wound up. In particular, the resolution authority should be allowed to avoid allocating losses to those deposits where the exclusion is strictly necessary and proportionate to preserve the continuity of critical functions and core business lines or where necessary to avoid widespread contagion and financial instability, which could cause a serious disturbance to the economy of the Union or of a Member State. The same reasons should apply to the inclusion in the transfer to a buyer or to a bridge institution of bail-inable liabilities with a priority ranking lower than that of deposits. In that case, the transfer of those bail-inable liabilities should not be supported by the contribution of the DGS. If any financial support to the transfer of those bail-inable liabilities is required, that support should be provided by the resolution financing arrangement. »

- The total amount of the DGS intervention should not exceed the amount of covered deposits of the institution (Article 11e.3 DGSD)[2];
- The DGS intervention should not exceed the amount necessary to reach the 8% threshold (and to "bridge the gap") (Article 109.2b BRRD).

Governance: Article 109.2 BRRD of the Commission's proposal provides that the resolution authority determines the amount of the DGS contribution in accordance with Article 109.1 BRRD. The determination can only take place after the resolution authority has consulted the DGS on the outcome of the Least Cost Test as provided for in Article 11e DGSD, fully carried out by the DGS, taking into account the valuation carried out pursuant to Article 36 BRRD. After having adopted its decision, the resolution authority notifies it to the DGS, which is required to implement the decision without delay. The precise perimeter of the transfer tool (the assets and liabilities to be transferred) is defined by the resolution authority. It is also the resolution authority that assesses whether non-covered deposits and other bail-inable liabilities with the same or higher priority ranking than deposits should be excluded from bail-in because the circumstances of Article 44(3) are met.

Finally, the Presidency would like to recall that the Commission proposal does not amend Article 7, paragraph 3, 2nd sub-paragraph SRMR, which provides that, within the Banking Union, it is the exclusive competence of the Board to adopt any resolution scheme which would require the use of the SRF.

4. Summary of the previous discussions

The Spanish Presidency concluded in its progress report that although a few Member States question the size and even the existence of a funding gap, considering that non-covered deposits can absorb losses (as discussed at the Council Working Party of 18 September 2023), a majority of Member States broadly agree with the existence of a possible funding gap. Various views have been expressed on the ways to close said funding gap ranging from setting higher MREL, adjusting the 8% threshold to access the SRF for smaller banks, to the authorisation of a direct use of the DGS. It should be recalled that many comments expressed so far on the functioning of the Bridge the Gap and the distribution of the burden between DGS and RFA were made in a context where a single tier depositor preference would be introduced.

Purpose of the Bridge the Gap : In this context, Member States broadly agree that an intervention by the DGS counting towards the threshold to unlock the RFA should be a measure of last resort and that the first and main line of defence should remain the MREL and the bail-inable liabilities of the institution. Even though some Member States suggest that the Bridge the Gap should not be limited to transfer strategies with market exit but could also be available for entities with a liquidation strategy or even open-bank bail-in strategy, most Member States consider that the Bridge the Gap should be of exceptional nature, and limited to support the transfer of deposits when it is less costly or when there are risks for financial stability; and while many Member States may support the idea that, in case the 8% TLOF cannot be met with MREL, the DGS may intervene to bridge this gap, they generally subject this intervention to predefined conditions, sufficient safeguards and adequate governance arrangements.

On the conditions to unlock the RFA through the Bridge the Gap, the Spanish Presidency proposed to introduce a restriction for entities whose preferred resolution strategy has recently changed from a liquidation under normal insolvency proceedings to resolution. Some Member States indicated their

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[2] Note that this cap may be less binding than the first one (as the first cap, i.e. the cost of repaying depositors, even including some limited operational and administrative costs, will deduct recoveries. The cost of repaying depositors can be approximated as follows : [Covered deposits x (1-recovery rate)] + additional costs for the DGS. This is lower than covered deposits if [Covered deposits x recovery rate] > additional costs for the DGS ; which is likely to be the case in many situations.

support for this restriction while others expressed their concern as to how the funding gap would be resolved in those cases.

Finally, some Member States are in favour of a systemic risk exception for accessing DGS funds without conditionality, under certain circumstances.

Burden Sharing : In addition, several Member States have expressed doubts on the division of labour (between the DGS and the RFA) as laid down in the Commission's proposal. Some Member States state that the DGS will carry an undue burden for its mandate, diluting the role of resolution financing of the RFA. Several Member States propose to cap the DGS intervention to prevent its full depletion. Vice-versa, another Member State indicates that the mutualised funds of the SRF could be unlocked with a small DGS contribution, which would imply that the RFA would bear the costs related to the protection of covered depositors while it should be the DGS.

In the view of some Member States, the use of Deposit Guarantee Schemes to bridge the possible funding gap could be considered a deviation from the 8% TLOF rule and thus not be in line with the permanence of the legal framework clauses in the Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund and the European Stability Mechanism amendment.

Governance : During previous discussions, some Member States expressed the view that, within the Banking Union, MREL, the first and main line of defence, is determined by the Single Resolution Board ('SRB') while, under the Commission's proposal, the consequences of not being able to reach the threshold laid down in Article 44(5), point (a) BRRD would have to be borne at the national level, by DGS funds.

5. Purpose of the DGS intervention in the context of the Bridge the Gap

The Presidency lists, in this and the following sections, **a menu of options** to further frame the Bridge the Gap, i.e. the intervention of the DGS to unlock the RFA, in light of Member States concerns. Most of these options exclusively concern the Bridge the Gap mechanism and not the intervention of the DGS in resolution outside the Bridge the Gap. **The necessity to include these options and the choice of these options will eventually need to be assessed together with the other parts of the framework.** The most obvious link between the safeguards and the rest of the package is the link with Article 45ca as a higher level of MREL would constitute the strongest safeguard for industry-funded safety nets. Finally, while most of the options are compatible, some of them may nevertheless be mutually exclusive.

The first set of options aims at ensuring that the Bridge the Gap is effectively used in line with the initial intention of the Commission; the second set of options aims at ensuring a fair burden sharing and a sufficient protection of both DGSs and RFAs ; and the third set of options addresses the question of the governance of the framework.

With regard to the first set of options, the Presidency wishes to acknowledge the initial intention[3] of the Commission, i.e. to facilitate the use of the DGS and of the RFA in transfer strategies leading to a market exit, and where the DGS/RFA intervention can be used to support the transfer of deposits (the DGS contribution cannot cover other liabilities than deposits, and non-covered deposits protection should be justified) when the 8% TLOF threshold cannot be reached by internal loss absorption.

The Presidency proposes to better reflect these conditions in Article 109 BRRD.

[3] See slide 5 of the Commission presentation of 15 September 2023 (WK 11566/2023).

5.1 Market exit

While the intention of the Commission is to restrict the Bridge the Gap to situations leading to a market exit, this intention is referred to in Recital (43) but not explicitly mentioned in its proposed Article 109 BRRD. The Presidency could envisage to reinforce this condition by

- Clarifying in Article 109.2b that the contribution of the DGS can count for the Bridge the Gap only when the resolution leads to a market exit (**Option 1**).

- While the market exit is clear when the sale of business tool is used, this may be less certain when the bridge bank tool is used, especially as Article 41.6 BRRD offers the possibility to extend the life period of the bridge bank beyond two years, for one or more additional one-year periods. While the rationale behind Article 41.6 BRRD is not questioned, and should generally be maintained, one option could be to disapply Article 41.6 BRRD when the Bridge the Gap is used so as to ensure an effective market exit and not a protracted resolution with an uncertain exit strategy (**Option 2**).

5.2 Business model and size

The CMDI reform was proposed to facilitate the resolution of small and mid-sized institutions. The Bridge the Gap mechanism should be interpreted in that context, as an instrument facilitating the resolution of small or mid-sized banks. Considering this rationale, the Presidency could envisage the introduction of a restriction based on the size of the institution (**Option 3**). A natural benchmark could be to reserve the Bridge the Gap (i.e. the unlocking of the RFA by an intervention of the DGS) to banks with assets below EUR [30] bn (which corresponds to the threshold to be considered as an LSI in the SSMR).

5.3 Purpose of the transfer

The Commission clarified in its presentation of 18 September 2023 that “Other liabilities ranking below deposits may be included in the scope of the transfer, but the DGS can only be used to support the transfer of deposits (i.e. DGS contribution cannot cover other liabilities)”. At the same time, other forms of transfers should not be restricted and should remain possible if they do not affect the recovery position of the DGS/RFA. In this context, and in order to facilitate all other transfers which could benefit the resolution, the Presidency could consider including an additional condition to the use of the Bridge the Gap, namely that the assets of the resolved institution should be in priority reserved for and affected to the transfer of deposits and other liabilities for which the intervention of the DGS/RFA is required (**Option 4**).

5.4 Transition period

In order to avoid any last-minute change in the resolution strategy and to ensure that the Bridge the Gap is reserved for institutions which have already reached a certain level of resolvability, including the constitution of a minimal loss absorbing capacity, the Presidency is ready to explore an additional condition for the recourse to the Bridge the Gap mechanism. Namely the Bridge the Gap mechanism could only be accessible to institutions which (i) have already fully complied with their final MREL target once and which (ii) had a positive PIA decision during at least the [two] yearly cycles preceding the resolution (**option 5**). These conditions should be interpreted in line with the restriction arising from Article 109.2b, third sub-paragraph (i.e. no Bridge the Gap for liquidation entities) and, as regards the PIA, to avoid any last minutes circumvention of the proposed framework.

Q1 : Do Member States support the options described above to better reflect the purpose of the Bridge the Gap function?

Q2 : Do Member States see a need for any additional conditions? If yes, which ones?

6. Burden sharing, safeguards, checks and balances.

The Presidency wishes to acknowledge the different concerns raised in relation to the proposed Bridge the Gap role entrusted to the DGS and, more generally, the use of industry-funded safety nets in resolution and other measures. The potential options discussed below aim at maintaining the Bridge the Gap function of the DGS, enabling an access to industry-funded safety nets in resolution but also at introducing sufficient safeguards to ensure a consistent burden sharing between internal sources of funding and industry-funded safety nets.

The discussions held on the creditor hierarchy showed that many Member States support a stronger protection of the national DGS to ensure its capacity to discharge its primary role, i.e. the payout function. In parallel, it is also important to maintain the firepower of the RFA and its capacity to intervene in resolution, especially in the Banking Union where the SRF is mutualised.

The following sections therefore outline solutions to (i) ensure a sufficient loss absorption by shareholders and creditors; (ii) enhance the protection of DGS; and (iii) enhance the protection of RFA.

6.1 Ensuring a sufficient loss absorption by shareholders and creditors

Considering that all Member States agree that the first line of defence should remain the MREL, the Presidency proposes that the Bridge the Gap function should only be available once all instruments effectively recognised by the resolution authority as counting towards the MREL requirement have fully been bailed-in. This would ensure that the first line of defence effectively plays its role by ensuring a minimal level of loss absorption and thus constitutes a protection for the DGS and the RFA (**Option 6**), as well as an incentive for resolution authorities to be strict and consistent when assessing the MREL eligibility criteria.

6.2 Enhancing the protection of the DGS

The Presidency invites Member States to reflect on the following safeguards (**Option 7**) to preserve the payout function of DGSs.

i. Reaffirm the limit of the LCT as a cap to the cost of the DGS intervention in resolution, in a context where the LCT would need to be broadened if the super preference of the DGS is reintroduced. For instance, a broader LCT could be achieved through a combination of a scaling factor on the recovery rate of the DGS and through the recognition of some indirect costs proxied by non-covered deposits (see discussions in the previous Council Working Parties under Belgian Presidency).

ii. Capping the DGS intervention in resolution to [75%] of its target level, to safeguard the DGS's main mandate and avoid a full depletion of the fund for one intervention in resolution.

iii. Remove the cap in terms of covered deposits, given its ineffectiveness and potential overlap with the other limitations introduced above. Indeed, with the assumption that the target level corresponds to 0,8% of the covered deposits of the sector, the cap of 75% of the available financial means would be reached as soon as an institution has a market share of 0,6% of covered deposits.

To provide for sufficient flexibility in times of crisis, the Presidency could consider the possibility for the designated authority to lift the cap defined under (ii) in times of extraordinary situations.

Q3.1 : Do Member States support the options (6 & 7) described above to enhance the protection of the DGS in the Bridge the Gap context?

Q3.2 : If yes, what would be the optimal cap to the DGS intervention in resolution, expressed as a % of its target level?

Q4 : Do Member States see a need for any additional safeguards? If yes, which ones?

6.3 Enhanced protection of the RFA and alignment of incentives

The Presidency identifies the options below to enhance the protection of the RFA and align incentives to build-up sufficient external loss absorbing capacity.

a) Re-establishing a minimum for the DGS intervention

A first option to re-establish a burden-sharing closer to the current burden-sharing between the DGS and the SRF could be to reintroduce a minimal intervention of the DGS, linked to the net direct costs it would have to bear in national insolvency proceedings (i.e., strictly limited to the net cost of payout arising from the indemnification of covered deposits, i.e. without indirect costs) (**Option 8**). To provide some leeway and diminish the quantitative exposure of the DGS, this minimum could be multiplied by a scaling factor, e.g., [75%].

This minimum intervention would only be applicable in resolution cases where the DGS contribution counts towards the thresholds needed to unlock the RFA, and as stated above would be based on the net cost of payout, in a context where the super preference of the DGS would be potentially reintroduced (see Council Working Party of 26/02/2024). In resolution cases where no intervention of the DGS would be necessary (for instance, because the internal loss-absorbing capacity would be sufficient) or in resolution cases where the Bridge the Gap would not be activated, this minimum liability would not be applicable.

This option has the merit of coming closer to a burden sharing as specified in the current BRRD and of ensuring that the costs associated to the protection of covered depositors are effectively borne by DGSs.

b) Incentivising strong MREL buffers by increasing and/or capping the DGS intervention

A second option aims at penalising an excessive recourse to the DGS when it is used in order to unlock the RFA through the activation of the Bridge the Gap (**Option 9a**). This would be done through the introduction of a system of weights applied to the DGS intervention, as counted for the determination of the threshold set in article 44(5).

In that proposal, the following weights could be introduced:

Intervention of the DGS	Weight
First % of TLOF	100%
Second % of TLOF	[40% - 60%]
Third % of TLOF	[20% - 40%]
Any additional % of TLOF	[0% - 20%]

This would imply that if a prior bail-in of 7% TLOF has been executed, a 1% TLOF contribution by the DGS would be sufficient to unlock the RFA. However, if a bail of only 6.75% TLOF has been done, the DGS would need to contribute for a higher amount than 1.25% TLOF to unlock the RFA. Assuming a 50% weight, the intervention of the DGS necessary to unlock the RFA would amount to 1.5% TLOF.

Within the Banking Union, this option would have the merit of realigning incentives in using national resources to unlock mutualised funding, by increasing the risk taken when a potential loss-absorbing capacity decreases below 7% TLOF. This option would also allow to define a minimum loss absorption level if some TLOF tranches are weighted at 0%.

Another option could consist in introducing a limit expressed in % of TLOF on a possible intervention of the DGS under the Bridge the Gap (**Option 9b**). This limit would actually set a minimum level of losses that would need to be absorbed by the shareholders and creditors of an institution before an intervention of the DGS under the Bridge the Gap could be envisaged. Establishing such a limit would contribute to protect the DGS as its intervention would be capped. For instance, such a limit could be set at a level of [1.5%] TLOF, implying a minimum internal loss absorption by shareholders and creditors of [6.5%] TLOF. The level of this limit would need to be determined and thus would also depend on the result of the discussions on the LCT and on the governance of the pecking order.

c) Pecking order and burden sharing between the RFA, the DGS and alternative funding sources when there is a gap to fill

The burden sharing sequence can be decomposed in three phases: (i) below the 8% TLOF loss absorption threshold; (ii) between the 8% TLOF and the 13% TLOF loss absorption; and (iii) beyond the 13% TLOF loss absorption. The general rule, under the current framework and under the framework proposed by the Commission, is that the internal loss absorbing capacity of the institution should be fully mobilised independently of these thresholds. However, this may not be possible under certain crisis circumstances and that is why it is necessary to define a clear burden sharing throughout the sequence. This said, the Presidency would like to note that the probability of occurrence of each of these phases is decreasing, and the third phase is likely to remain very remote, especially in a context where the intervention of the DGS or RFA is limited to amounts necessary to cover the difference between the assets and the liabilities transferred or to ensure capital neutrality of the recipient of the transfer.

Under the current framework, Article 44.5 BRRD provides that the RFA may make a contribution under Article 44.4 BRRD after a contribution to loss absorption and recapitalisation equal to an amount not less than 8% TLOF has been made by the shareholders and creditors through write down, conversion or otherwise. The contribution of the RFA is limited to 5% TLOF. Once the 5% TLOF threshold is reached, if there is still a gap to fill, Article 44.7 BRRD provides that, in extraordinary circumstances, the RFA may seek further funding from alternative financing sources[4] or, as an alternative or in addition to it, use its own resources provided that all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full.

[4] i.e. governement stabilisation tools (see article 37.10 BRRD), or alternative funding means as described in Article 105 BRRD.

Article 44.7 BRRD is modified under the COM proposal to clarify that the RFA may fill the gap beyond the 5% threshold and make a contribution once the threshold is exceeded provided that all liabilities ranking lower than deposits and not excluded from bail-in pursuant to Article 44.2 or 44.3 BRRD have been written down or converted in full. It then establishes that, in extraordinary circumstances, the resolution authority may seek further funding from alternative funding sources as an alternative or in addition to the contribution from the RFA. Consequently, the intervention of the RFA beyond the 5% threshold can take place outside extraordinary circumstances and alternative funding sources are considered as a second option. Finally, while the Commission proposal establishes a clear role for the DGS to bridge the gap below the 8% TLOF threshold, it caps the intervention of the DGS at the amount necessary to reach the 8% TLOF and does not foresee any role for the DGS to fill the gap once the 5% TLOF threshold is reached.

Considering this sequence, the Presidency sees a need to clarify and potentially amend the pecking order and burden sharing between the DGS, the RFA and alternative funding sources when there is a gap to fill beyond the 5% TLOF threshold. Addressing the question of the fill the gap may also require assessing the burden sharing in the earlier phases.

The Presidency would like to consider two possible options when the Bridge the Gap is mobilised (i.e. when the DGS is used to unlock the RFA).

Under **option 10a**, the three steps of the sequences would unfold as follows:

- Below the 8% TLOF threshold : the DGS would be used to Bridge the Gap, possibly taking into account some of the options listed above (in terms of caps and minimum intervention);
- Between 8% and 13% TOLF: the means of the RFA would be used.
- Beyond 13% TLOF: the DGS could intervene, possibly taking into account some of the options listed above (in terms of caps) to fill the gap; or in extraordinary situation the RFA or alternative funding sources could be mobilised.

Under **option 10b**, the burden sharing would be different :

- Below the 8% TLOF threshold: the DGS would be used to Bridge the Gap, possibly taking into account some of the options listed above (in terms of caps and minimum intervention);
- Above the 8% TLOF threshold: the contribution of the DGS and of the RFA would be determined pro rata the share of covered / uncovered deposits transferred, the DGS absorbing losses due to covered deposits transferred (though recognising the contribution made to Bridge the Gap) and the RFA absorbing losses arising from the necessity to transfer uncovered deposits. The contribution of the RFA would be limited to 5% TLOF. The parallel intervention of the RFA and the DGS would imply that a level higher than 13% TLOF may be reached.
- If the parallel intervention of the DGS and the RFA is not sufficient to fill the gap : the RFA or alternative funding sources could be mobilised in extraordinary situations, as it is already provided under the current framework under Article 44.7 BRRD.

These options may not necessarily be compatible with certain of the options listed above, such as for instance option 8.

d) Preferential treatment for the RFA

The CMDI proposal, in its Article 108.9 BRRD, gives a higher priority ranking in insolvency to the claims of the RFA than to the claims of the DGS. This provision was, however, introduced together with the changes in Article 44.7 BRRD and the introduction of a single tier depositor preference.

This provision is especially relevant in the Banking Union where the RFA is mutualised while the DGS remains national. This implies that any compensation arising from the liquidation of the bankruptcy estate would first benefit the Banking Union mutualised industry-funded safety net, while the national one would be compensated thereafter. This option (**option 11**) offers an additional protection which should contribute to reassure all the contributors of the mutualised industry-funded safety net.

Q5 : Do Member States support the options (Option 8 & 9) described above to enhance the protection of the RFA in the Bridge the Gap context?

Q6 : Do Member States see a need to clarify the pecking order ? If yes, which option should be preferred?

Q7 : Do Member States see a need for any additional safeguards? If yes, which ones?

7. Governance

The proposed governance around the Bridge the Gap is clear and takes account of the respective responsibilities of each of the authorities involved. The Presidency sees a potential need for three additional options / clarifications.

7.1 Extent to which the resolution authority is constrained by the LCT as estimated by the DGS

Article 109.2 as proposed by the Commission provides that (i) the resolution authority determines the amount of the contribution of the DGS after having consulted the DGS on the LCT conducted on the basis of the valuation carried out pursuant to Article 36, and that (ii) the resolution authority shall notify its decision to the DGS which shall implement the decision without delay. It is however uncertain whether the resolution authority is bound by the counterfactual established by the DGS. The Presidency proposes to clarify that the cost of the contribution of the DGS shall not be greater than the counterfactual it has established under the LCT (**Option 12**).

7.2 Emergency brake clause

Given the uncertainty on the potential use of the mechanism, it may be necessary to introduce an emergency brake clause which could be activated in case the reserves of the RFA are threatened by a too important recourse to the Bridge the Gap mechanism. For instance, the Bridge the Gap could be frozen if 20% of the target level of the RFA has been used in the context of the Bridge the Gap mechanism cumulatively over a period of 3 years (**option 13**). This pause would be followed by a thorough assessment of the mechanism to be carried out by the Commission and the break could be lifted through a legislative change that would require a prior Commission proposal and an expedited adoption procedure, provided that the co-legislators agree to it.

7.3 Moral hazard

Another concern expressed by some Member States in the discussions is that introducing a mechanism of Bridge the Gap would contribute to substitute costly private sources of loss-absorbing capacity by an intervention by the DGS which would not be compensated by the institution which benefit from it (i.e. the institution would benefit from lower financing costs, at the expense of the DGS). One option to alleviate these concerns could be to amend Article 13 DGSD and require DGSs to factor in additional risks arising from a potential intervention under the Bridge the Gap when determining the contributions due by their members (**option 14**). This would constitute an additional risk factor to be integrated in the methodology to determine risk-based contributions. Institutions with a higher risk of having of recourse to the Bridge the Gap would have to pay higher contributions (and vice-versa, institutions with no risk of Bridge the Gap, for instance because they would be excluded from the mechanism, would see their contribution to the DGS decrease). The methodology to determine the risk-based contributions should thus take account of the regime of safeguards and exclusions underlying the Bridge the Gap mechanism as defined in the Level 1 legislation. In order to do so, the current mandate of the EBA in paragraph 3 can be modified to request a review of its guidelines following the CMDI publication.

Q8 : Do Member States support the options described above in relation to the governance in the Bridge the Gap context?

Q9 : Do Member States see a need for any additional safeguards? If yes, which ones?

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From:	Presidency
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés
Subject:	Item 2: Presidency non-paper on “Bridge the gap”