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WORKING DOCUMENT

From:	Presidency
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés
Subject:	CMDI Political Compromise - Areas for Continued Dialogue

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CMDI Political Compromise
Areas for Continued Dialogue

This paper has been prepared by the Presidency to support discussions at the Council meeting on May 14th on potential directions for a political compromise on CMDI. It outlines a selected set of key political elements of the package that remain particularly contentious between the co-legislators, including:

1. Public interest assessment (PIA);
2. Creditor hierarchy (CH) and resolution objectives (ROs);
3. Least cost test (LCT);
4. Bridge the Gap (BtG);
5. Alternative measures (AM);
6. Preventive measures (PM);
7. SRB governance;
8. MREL calibration.

This paper does not cover the topic of Extraordinary Public Financial Support (EPFS), since during the political trilogue in April 28th it was agreed to delegate work on this issue to the technical level. Any discussion on this topic at the political level may only resume following technical level deliberations and depending on their outcomes.

Ad. 1. Public interest assessment (PIA)

The EP has signalled broad acceptance of the PIA design proposed by the Presidency. In this context it was agreed that the aim of the CMDI review is to moderately expand the application of resolution framework, keeping insolvency procedure as the default option. It was further accepted that the basis for further technical works is the Council's proposal introducing two-stage approach (i.e. starting with the assessment whether any resolution objectives are at risk during within the normal insolvency procedure). Also, work on the PIA presumption (line 217b BRRD) and the comparison with other forms of EPFS (line 218 BRRD) has been delegated to the technical level. As regards PIA presumption, Council's arguments in favour of its deletion will be further examined with a view to duly reflecting them in the final drafting.

The remaining issue to be discussed is the EBA's role in enforcing the application of PIA (with possibility to issue RTS in this regard), as proposed by the EP (lines 218b-218d BRRD). The Council strongly opposes such a solution, and the Commission also expressed skepticism in this regard during the 4th political trilogue held on March 12th.

Arguments of the Council: (i) PIA requires taking into account the specificities of each crisis, national markets, and the bank concerned; (ii) the resolution authorities (RAs) must retain flexibility to perform their duties effectively; (iii) the EP's proposal may unduly limit this discretion, which is crucial for resolution; (iv) report and level 2/3 regulation may increase the legal risk (by obliging RAs to some actions, which may be inappropriate in a given case).

Arguments of the EP: (i) proposal includes two-step approach (i.e. EBA would be asked first to produce a report and, based on it, the EBA may develop an RTS if deemed appropriate); (ii) the EP does not regard the proposal on this issue as overly imposing or prescriptive; (iii) the goal is to harmonise practices, not procedures, and insisted that it is essential to have a level playing field here (and thus limiting litigation risk).

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Presidency's strategic directions for advancing discussions on landing zones:

a) Limiting the legal risks connected to PIA;
b) Keeping the initial position on the EBA mandate (lines 218b-218d) and insist on deleting the provisions proposed by the EP;
c) Questioning the need for any EBA mandate in this area — particularly in the form of RTSs or Guidelines — as potentially overcomplicating NRA practices and misaligned with CMDI objectives;
d) In a spirit compromise – showing the openness to accept, as suggested by the COM, the preparation of a mere report on PIA practices.

Ad. 2. Creditor hierarchy (CH) and resolution objectives (ROs)

An overview of the co-legislators approaches in the area of creditor hierarchy and resolution objectives is presented in the table below. One critical area were the views of the Council and the EP are divergent is the DGS super-preference.

Table 1. Comparison of the Council's and EP's approaches to creditor hierarchy

Comparison's criteria	Council GA	EP approach
Main elements of the proposal	- Implementing general depositor preference with 4-tier approach - Retaining DGS super-preference - Higher protection for households' and SMEs' deposits (as most sensitive) in comparison to the rest of depositors - Addressing the issue of MREL-eligible deposits (technical concerns and potential solutions were raised by COM in its paper) - No change to the formal list of resolution objectives	- Implementing general depositor preference with 2-tier approach - Sharing of DGS super-preference with deposits of SMEs and households above coverage - No consideration of MREL-eligible deposits - Including in the resolution objectives the obligation to protect, apart from covered deposits also eligible deposits of households and SMEs
Main objectives	- Seek to ensure the safety of deposits where necessary and as far as possible - Strengthen the efficiency of all potential crisis management tools - Preserve the effectiveness of the deposit guarantee system and maintain public confidence in its reliability	- Ensure higher protection of retail and SMEs deposits (also above coverage) in the liquidation

Presidency's strategic directions for advancing discussions on landing zones:

a) Maintaining efficiency and legal reliability of all kinds of crisis management tools (including insolvency, resolution, alternative and preventive measures);
b) Emphasising the need to maintain DGS super-preference as a prerequisite for advancing the negotiations, as it is considered by the Council the only workable solution to ensure economic stability at national level (line 428-429b BRRD);
c) Ensuring higher protection for selected groups of eligible depositors (openness to define the group) by higher seniority than other depositors (lines 429c-431c BRRD);
d) Addressing the separate treatment of MREL-eligible deposits, with openness to technical refinements suggested by COM in its paper, provided that the separation of such deposits is preserved (lines 431d-431e BRRD);
e) Expressing openness to address the issue of subordinated deposits (though line 428 BRRD should materially retain the Council approach);
f) Keeping the list of resolution objectives unchanged (line 202 BRRD).

Ad 3. Least Cost Test (LCT)

Both the Council and the EP aim to significantly increase the use of DGS funds through an appropriate LCT framework. However, they differ on specific elements to be included in the LCT calculation, i.e.:

- Usage of BRRD valuation as a basis for the estimation of DGS recoveries;
- Application of 85% scaling factor on DGS recoveries in the case of the use of DGS funds outside payout;
- Inclusion of indirect costs (losses of selected depositors other than covered depositors as a proxy for in the Council text and financial stability, contagion and similar notions in the EP);
- Inclusion of a cap on the overall DGS contribution in the amount of covered deposits.

Presidency's strategic directions for advancing discussions on landing zones:

a) Facilitation of DGS funds' usage outside the deposit payout;
b) Using BRRD valuations (Art. 36(1) BRRD) only in the context of DGS contribution in resolution to limit the risk of the necessity for conducting costly valuations (line 244b DGSD);
c) Pursuing a clear and operational design of the Least Cost Test (LCT) for potential application during the resolution weekend, including in relation to indirect costs (if net losses are maintained as a basis for the calculation of the LCT) (lines 244-247a DGSD);
d) Taking into account specificities of IPS-DGS;
e) Reflecting the uncertainty connected to the estimates of recoveries to the extent possible (if scalar is maintained as a part of the calculation of the LCT) (line 244 DGSD);
f) Allowing for EBA RTS adjusted to the final design of the LCT (lines 248-254 DGSD).

Exploring the potential compromise should be based on the elements that are common in both Council and EP approaches.

Ad. 4. Bridge the Gap (BtG)

CMDI introduces the mechanism for Bridge the Gap, where DGS contribution can be used, under specific conditions and only in extraordinary circumstances, to fill 8% burden sharing requirement instead of the bail-in of the deposits where the conditions for the exclusion from bail-in are met. However, the provisions should prevent the creation of a tendency to replace a bank's internal contribution to burden sharing with the DGS funds. Therefore, credible and effective safeguards must be included in the framework to ensure that it is exceptional, yet working solution. The main difference between the Council and the EP concerns the extent and effectiveness of safeguards. Some elements appear to be shared across both mandates:

- Use of DGS funds as BtG only within the limits of LCT (line 446 BRRD);
- Clear sequence of using DGS and resolution funds (line 454 BRRD);
- No breach of MREL in the defined period (although periods and time of acceptable breach are not convergent) (lines 453c, 455b BRRD);
- No BtG for liquidation entities (line 455a BRRD)[1].

As a preliminary potential compromise to bridge the co-legislators' approaches, there appears to be an option for a BtG target design guided by the following common general objectives:

1) DGS bridge should not replace nor discourage banks' own loss-absorption capacity and should explicitly not compensate for insufficient MREL requirements;
2) DGS bridge should remain exceptional and limited after full exhaustion of a bank's loss-absorption capacity;
3) Ensure prudent use of safety nets (DGS and resolution funds) by clear limitations for their use;
4) Scope of banks for which the DGS bridge can be used should be well-framed and justified.

While the Council considers that additional or more thoroughly assessed objectives should be taken into account before deploying this exceptional tool - such as adherence to the principle of burden-sharing by shareholders and creditors, and the avoidance of moral hazard and potential loopholes - the EP continues to advocate for a simplistic approach, potentially at the expense of prudence, caution, and regulatory rigour.

<u>Presidency's strategic directions for advancing discussions on landing zones:</u>

a) Respecting the shared objectives enlisted above;
b) Keeping the safeguards that are common in the EP and Council approach;
c) Taking a firm stance on the need to introduce quantitative safeguards on the use of DGS funds for BtG, alongside adequate MREL requirements and full bail-in of all MREL-eligible liabilities;
d) Ensure that the use of BtG is primarily dedicated to banks with a balance sheet below EUR 30 billion, while allowing its application to banks with balance sheets up to EUR 80 billion only under stricter conditions;
e) In light of the assumptions above – offering the EP the possibility of reconsidering or recalibration of, in particular, clawback mechanism in lines 456-456a BRRD and/or emergency brake in 412a-412b SRMR. While these safeguards are still deemed justified in light of the BtG objectives, they could be re-evaluated in the final design of

[1] In the Council text, an entity must not have been a liquidation entity for at least two years. In addition, only the Council text ensures market exit (line 453b BRRD).

the CMDI package, contingent upon the level of flexibility shown by the EP in other areas of the package.

Ad. 5. Alternative measures (AM)

The positions of the EP and the Council differ as regards the design of the alternative measures. The divergencies are summarized in the Table 2. The Council wants to keep the flexible and working character of the alternative measures, as tools devoted to manage the failures of usually smaller banks (with negative PIA, where the application of the whole resolution framework might not be appropriate) in more cost-effective manner. However, the EP strives to harmonize the tool irrespective of the national set-ups of financial safety net and insolvency systems.

Table 2. Comparison between the Council's and EP's positions on AM

Criterion	EP approach	Council approach
Optional or compulsory tool (line 230 DGSD)	Compulsory	Optional
Perimeter of asset and liabilities whose transfer could be financed by the DGS (lines 235a-235c DGSD)	Limited to covered deposits and eligible deposits of individuals and SMEs*	No limits
Cap to the DGS contribution (line 246 DGSD)	Caps the DGS contribution to the amount of covered deposits	No cap to the DGS contribution
Replenishment of DGS financial means (lines 197-199 DGSD)	When the need for pay-out and resolution arises, and available financial means of the DGS fall below 2/3 of the target level.	No replenishments

* There seem to be inconsistencies in the terminology used in the EP text in lines 200c and 200g when defining the transfer perimeter and what could be financed by the DGS: 200c refers to deposits of natural persons and SME's above EUR 100.000, while 235b refers to liabilities in rank equal to covered deposits (which would essentially be those deposits of natural persons and SME's above EUR 100.000).

<u>Presidency's strategic directions for advancing discussions on landing zones:</u>

a) Keeping the alternative measures as optional tool, adjusted to the national specificity of the banking sector (line 230 DGSD);
b) As a concession to the EP, contingent on its openness regarding other elements of the package, the possibility of refining certain conditions for the application of alternative measures (lines 235a-235c, 246 DGSD) could be considered, provided they do not undermine the effective application of alternative or preventive measures (including by IPS-DGS) in crisis situation;
c) Keeping the rules for the framework of the DGS funds' replenishments well-balanced (preserve status quo in lines 197-199 DGSD).

Ad. 6. Preventive measures (PM)

In a few Member States, the use of preventive measures has traditionally proven effective in managing financial tensions under specific conditions, thereby preventing institutional failures and mitigating the costs of crises for the broader financial system. The final framework for applying preventive measures should therefore preserve the effectiveness and efficiency of this tool. At the same time, national financial safety net structures must be respected to avoid legal and strategic risks. Imposing a mandatory transposition of preventive measures, as proposed by the European Parliament for harmonisation purposes, may risk being counterproductive. Moreover, while the EP's proposal to significantly expand the list of conditions for their use aims to ensure that, ideally, resources are not allocated to failing institutions, in practice, these conditions could undermine the effectiveness and operational swiftness of preventive measures, potentially limiting the ability to assist institutions in need.

Presidency's strategic directions for advancing discussions on landing zones:

a) Keeping the preventive measures as optional tool, adjusted to the national specificity of the banking sector (line 193 DGSD);
b) Application of preventive measures as long as resolution or liquidation is not initiated (line 194 DGSD);
c) While largely consistent with the Council proposal, offering openness to refining some conditions for the application of preventive measures (e.g. line 217a within lines 202-227 DGSD), provided they do not undermine the effective application of these measures;
d) Keeping the rules for the framework of the DGS funds' replenishments well-balanced (preserve status quo in lines 197-199 DGSD);
e) Ensuring the full preservation of the ability of IPSs recognized as DGSs to take preventive measures using their available financial resources and to meet the requirements associated with their mandate and the CRR.

Ad. 7. SRB governance

The EP and the Council approach differ as regards the level of refinements of the current SRB operational functioning, especially as regards the involvement of plenary session (NRAs) in decision making process. While aiming for a unified and inclusive approach within the SRM and broader consensus and cooperation among Member States with the SRB by further involving the SRB plenary in the decision-making process (as postulated by the Council), any potential solution should not adversely impact the SRB's credibility and the ability to act effectively (as emphasized by the EP).

Presidency's strategic directions for advancing discussions on landing zones:

a) Emphasising the need for enhanced and inclusive involvement of national resolution authorities;
b) Avoiding legal risks and supporting the smooth functioning of the SRB and resolution processes;
c) Possibility of acknowledging the EP's role in approving the renewal of board members' mandates for a second term (lines 374–380 SRMR).

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Ad. 8. MREL calibration

A) MREL for transfer strategies

The EP would like to address the transfer strategies in the MREL calibration framework, arguing that the current one is more adjusted to the calculation of MREL requirement for bail-in strategies. Also, the EP would like to harmonize the calculation of MREL for transfer strategies, regardless of the fact the MREL is Pillar 2 requirement (i.e. it is bank-specific and always set by the resolution authority individually to reflect the specificity of the bank).

The Presidency conducted an additional analysis based on the contributions from Member States as regards their MREL policies for transfer strategies and the amounts (average, maximum, minimum) of MREL requirements for different resolution strategies. This analysis confirmed that the MREL requirements diverge to high extent, depending on the banks' characteristics and scenarios for resolution strategies. Consequently, the Presidency does not see a room for a harmonization of MREL requirements, especially in a way that the EP proposes.

Presidency's strategic direction for advancing discussions on landing zones:

Deleting Art. 45ca (lines: 323-338 BRRD) and Art. 12da (lines: 115-130 SRMR)

B) Transitional period for MREL (lines: 347a-347g; 349a-b BRRD; 142-146 SRMR)

A compromise solution between the Council and the European Parliament appears viable, based on the proposal shared by the Presidency with Member States and discussed at the Council meeting on March 18th.

Would Member States be able to agree on the above-mentioned strategic directions for advancing the discussions on landing zones?

Are there any additional comments or suggestions?