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From:	Presidency
To:	Working Party on Financial Services (AHWP BU)
Subject:	Draft Presidency progress report on strengthening the banking union

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Ad Hoc Working Party on the strengthening of the Banking Union (AHWP BU)

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Meeting XX May 2021

Draft Presidency progress report on strengthening the banking union

Summary

The Portuguese Presidency focused the discussions on the design of the European Deposit Insurance Scheme (EDIS) using a reference hybrid model and proceeded to address the scope of EDIS and the treatment of the Options and National Discretions (ONDs) provided for in the Deposit Guarantee Schemes Directive (DGSD), including the preventive and alternative measures. The articulation between EDIS and the crisis management framework and the risk-based contributions (RBC) were also analysed. Discussions took place under a set of guiding principles.

A ***hybrid model*** *that entails the access by national Deposit Guarantee Schemes (NDGS) to additional financial resources provided by a central Deposit Insurance Fund (DIF) and via mandatory lending from other NDGSs was confirmed as a potential compromise model for launching EDIS, starting with liquidity provision only. It exhibits flexibility to evolve into a model with a component of loss sharing up to a fully-fledged EDIS in the steady-state. Views were divergent, with some members advocating for a fully-fledged EDIS with loss sharing and others arguing that EDIS would not require different phases or loss coverage, given that the architecture of EDIS is contingent on a political agreement also involving preconditions. The need for a simple and efficient model fostering an alignment between liability and control was also broadly mentioned.*

Several dimensions of the hybrid model at its initial stage were explored. There was support for an ***EDIS design*** *where, in addition to the pooling of funds at the central level, the national funds available for mandatory lending would also be deposited in individual compartments next to the DIF, as it would be administratively less complex and more likely to ensure a timely support. The introduction of a cap at national level for mandatory lending gained significant support, while the introduction of a cap for the DIF was more contentious.*

According to several members, if a uniform protection of depositors is pursued, ***non-CRD/CRR entities*** *and* ***Institutional Protection Schemes (IPS) recognised as DGSs*** *should be included in the scope of EDIS. For non-CRD/CRR entities, such inclusion could be dependent on the use of proportionality provisions, by including these entities in the CRD/CRR, or on the implementation of a conformity test at the European level. On the IPSs recognised as DGSs, the majority of the members supported the inclusion of IPSs and their members in the scope of EDIS. One member supported their exclusion on the basis that such IPSs are different from other DGSs and their non-inclusion would be cost neutral. On* ***third country branches****, a harmonised equivalence test may be a way forward to ensure a level playing field although there was no consensus on their inclusion in EDIS. The inclusion of such entities in the scope of the CRD/CRR was also discussed.*

Apart from the scope of entities, the discussions on the harmonization of ***ONDs*** *and possible coverage by EDIS proved important to frame the discussion on the allocation of funds between the NDGSs and the DIF. In fact, the majority of members considered that ONDs should, whenever possible, be harmonised and covered, at least to a certain degree, by EDIS. An increase of EDIS coverage is expected to be accompanied by the gradual build-up of the DIF. Also in this regard, the importance of aligning the three pillars of the Banking Union and establishing a uniform level of depositor protection were broadly underlined.*

Several members argued in favour of harmonising substantive regimes on the use of ***preventive and alternative measures in EDIS****, in particular in what concerns the least cost test, with some also expressing concerns on the need to ensure that, in the overall framework revision, the tools created can effectively be used. As for the coverage of these measures by EDIS, members were divided between allowing coverage by EDIS and maintaining these measures at national level. Some members supported that the inclusion of these measures under EDIS would require a larger DIF. Members in favour of such tools being included noted the possible enhanced efficiency of providing for such measures.*

The discussion on the potential ***articulation between EDIS and the current review of the Crisis Management and Deposit Insurance (CMDI) framework*** *confirmed divergent views, both on the role of the DGSs in crisis management (with several members favouring an enlargement, while some argued that the primary function of a DGS is the protection of covered deposits through pay-out) and on the inclusion or not in EDIS of any enlargement of DGSs functions.*

In what concerns the ***build-up of the DIF****, there was support for a model involving up-front direct contributions from NDGSs, with the majority of members indicating their preference for contributions being benchmarked at the Banking Union level from the onset. Although the high political nature of the issue was acknowledged, there was openness to the idea of providing EDIS with an external funding capacity namely through the introduction of a common backstop.*

The possibility of adding ***indicators based on sovereign exposures*** *in the methodology for the calculation of* ***RBC*** *was considered by several members as a component of the political discussion on the regulatory treatment of sovereign exposures (RTSE). While the indicators based on concentration exposures had some support, the reliance on indicators based on credit risks raised concerns, in particular due to the potential adverse impacts on smaller markets and the fact that external ratings are prone to exacerbate pro-cyclicality and financial stability risks.*

The Portuguese Presidency explored the concept of loss sharing and its interactions with several parameters of the hybrid model during the ***transition to the steady-state****. A design where the DIF and the NDGS would intervene in parallel and where the share of the DIF's intervention would be considered towards the absorption of potential losses gathered of support. Moreover, there was relatively broad support for a solution whereby, during the transitional phase, the proportion of funds allocated to the DIF would increase and the proportion of funds for mandatory lending and of funds allocated for national uses would decrease.*

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1. Introduction

Pursuant to the Council Conclusions on the roadmap to complete the Banking Union as adopted by the Council on 17 June 2016 (10460/16) and building upon the Progress Reports prepared by the Dutch Presidency (10036/16), the Slovak Presidency (14841/16), the Maltese Presidency (9484/17), the Estonian Presidency (14808/17), the Bulgarian Presidency (9819/18), the Austrian Presidency (14452/18), the Romanian Presidency (9729/19 ADD1), the Finnish Presidency (14354/19 REV1), the Croatian Presidency (8335/20 ADD1) and the German Presidency (13091/20), the Portuguese Presidency continued to work constructively on a technical level on the European Commission proposal for the establishment of EDIS.

The Portuguese Presidency organised five meetings of the Ad Hoc Working Party on the strengthening of the Banking Union (AHWP) – on 2 February, 23 February, 22 March, 27 April and XX May.

This progress report summarises the discussions held during the semester and was prepared taking into account the views of the AHWP members, but under the responsibility of the Portuguese Presidency.

The discussions were centred on the advancement and strengthening of the Banking Union. The main focus was placed on the technical elements of the design for a credible and effective EDIS, building upon the previous discussions and recent political guidance such as the letter of the President of the Eurogroup to the President of the European Council ahead of the December Euro Summit 2020.

The work pursued by the Portuguese Presidency aimed at clarifying the main issues at stake. Using a set of guiding principles as a backdrop, the Portuguese Presidency initially assessed the design of the hybrid model based on a liquidity-only EDIS that covers the mandatory functions of the DGSs set out in the DGSD (*i.e.* pay-out and the use of NDGSs in resolution).

Subsequently, following a block-by-block approach, several other building blocks were addressed, namely: (i) the treatment of different entities (non-CRD/CRR entities, third country branches, and IPSs and their members); (ii) the interaction between EDIS and the ONDs provided for in the DGSD; and (iii) the inclusion of preventive and alternative measures in the scope of EDIS. The latter was complemented by a debate on the possible articulation between EDIS and the revision of the CMDI framework. Finally, the risk-based contributions under EDIS were also discussed, including adding potential sovereign exposure indicators to their calculation methodology.

On this basis, Member States were invited to discuss the inclusion of additional elements of increasing complexity to the hybrid model and finally discuss the interaction between them in the transitional phase with possible loss coverage, while converging to a fully-fledged EDIS in the steady-state, depending on a political decision.

The Portuguese Presidency shares the view that the discussions during the semester may be framed in the wider context of the political discussions of the High-Level Working Group on EDIS (HLWG), in particular regarding three of the workstreams under the holistic approach (EDIS, crisis management and RTSE), as well as on the European Commission's CMDI Review expected by the end of 2021. Concerning the former, a regular debriefing of the discussions took place at the HLWG meetings.

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2. Guiding principles

In the first meeting the Portuguese Presidency proposed a number of **guiding principles** for the subsequent discussions on further strengthening the Banking Union, including EDIS, with one non-paper from the Portuguese Presidency as a background document.

These guiding principles were the following:

1. Ensuring financial stability at both Banking Union and national levels;
2. Ensuring a high and uniform level of depositor protection, regardless of the bank location;
3. Adequate balance between control and liability at the Banking Union level;
4. Alignment of incentives in a uniform and harmonised deposit guarantee framework;
5. Break the reliance on national backstops and on taxpayers' money;
6. Equal treatment for NDGSs with mitigation, in the transitional phase, of the first-mover advantage;
7. Develop a setup for EDIS as simple as possible.

The majority of members expressed their general agreement with the seven principles proposed by the Portuguese Presidency and on their usefulness to frame the discussions, while some considered that high-level principles should be discussed at the political level.

In particular, among the principles presented, some members emphasised the need to ensure depositors' protection and trust in the system. Moreover, some members expressed concerns about the need for interaction between the crisis management and EDIS frameworks and the principle on the alignment between control and liability. A few members also raised concerns regarding how these principles would address the treatment of national specificities, such as ONDs and IPSs. A few members also emphasized the importance of banks' risk when entering EDIS.

Some members proposed to take into account other principles, such as: the promotion of cost-effectiveness, the need to ensure cost neutrality for the banking sector, the avoidance of systematic cross-subsidisation, and an improvement of risk reduction. Some members also underlined the need to align the three pillars of the Banking Union, to break the sovereign-bank nexus, to ensure equivalent treatment across all Member States participating regardless of whether they use the euro currency and to improve the level playing field and to preserve the integrity of the internal market. The importance of a swift progress towards the end goal of EDIS and the need for a fully-fledged EDIS as an end goal was also referred by some members.

The Portuguese Presidency concluded that most of the suggestions proposed by the members were already inherent in the seven principles presented.

3. The hybrid model

Members of the AHWP discussed the **operationalisation of the hybrid model** in the meetings of 2 and 23 February, on the basis of two non-papers from the Portuguese Presidency.

The Portuguese Presidency focused the debate on the main elements of the hybrid model: (i) the allocation of funds and size of the DIF; (ii) the mandatory lending mechanism; (iii) the caps on the DIF and on mandatory lending; (iv) the build-up and financing of the DIF; (v) the access to external funding; (vi) the concept of liquidity shortfall; (vii) the repayment of the liquidity support (including the interest rates and maturities of the loans); and (viii) governance.

For purposes of the above elements, the Portuguese Presidency envisaged a simple setup, a so-called "reference model". This reference model was characterised by liquidity provision encompassing only the pay-out of covered deposits and the contribution to resolution financing in the amount of losses that would be borne by covered deposits.

On the **allocation of funds**, the majority of members supported a small or medium-sized DIF. Some argued that the reference model has a limited scope to its interventions. The enlargement of the scope could, however, require a larger DIF. Many members were also open to increase the DIF's size over time.

For the **mandatory lending** mechanism, two options were presented: one where funds that can be mobilized for mandatory lending are maintained next to the NDGSs and another one where these funds are deposited in individual compartments next to the DIF (one compartment per each Member State). The latter option was supported by many members who noted that it is administratively less complex and more likely to ensure a timely support from the DIF. Some members expressed their preference for the former option emphasising the importance of the funds being under direct national control. A few members proposed an alternative option where the central fund would be entirely composed of individual compartments, departing from the hybrid model.

Concerning the **cap** on the DIF, many members preferred the cap to be defined as a percentage of the DIF's target level, while others opposed the existence of a cap. Some argued against the need for the cap on the grounds that adequate external financing arrangements are in place and because of the importance of the overall firepower of the system. Only a few members preferred a cap that would vary with the financial means available in the DIF at the moment of the request. Furthermore, a few members proposed that the cap should take into consideration the size of the national banking system as it impacts the repayment capacity of the NDGS in need.

The cap applicable to mandatory lending gathered broad support, although members had differing opinions on its implementation. Many members preferred the cap to be defined as the share of national funds exclusively available for national uses (calculated as a percentage of NDGS's target level), while some members preferred a cap defined as a percentage of the available financial means placed next to the NDGS at the moment of the request.

The proposal of the Portuguese Presidency to **build-up the DIF** through up-front direct contributions by NDGSs was supported by several members. In addition, a few members preferred risk-based contributions to be benchmarked at national level during the liquidity phase, while the majority of members argued that the Banking Union benchmark should be used from the onset of EDIS. Some members asked for a quantitative analysis by the European Commission.

Many members were open to the idea of providing EDIS with an **external funding capacity** to increase firepower, and reduce the reliance on national backstops, while others highlighted the political sensitiveness of this topic and the need for political guidance.

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Under this discussion, different positions were raised. The introduction of a common backstop to EDIS, similarly to the Single Resolution Fund (SRF) gathered some support. However, others rejected any external funding that involves public money. The remaining options presented by the Portuguese Presidency, namely the setting up of voluntary financing among NDGS and lending from the industry were also favoured. It was recalled that these options exist for the SRF, so there are no reasons for not doing the same for EDIS, given the parallelism and similarities between them. A few members further mentioned the possibility of the SRF lending to EDIS, taking advantage of synergies between them. Further analysis on the potential funding needs to better assess the policy options on the hybrid model was also proposed.

Under the hybrid model, the NDGS is firstly required to exhaust its available financial means (up to the target level), then, if any shortfall remains, the DIF may lend up to that amount. In this context, the **concept of liquidity shortfall** and the role of extraordinary contributions were discussed, namely whether these contributions should be raised before NDGS having access to the DIF (thus reducing the shortfall amount). The majority of the members agreed that the concept of the liquidity shortfall to be financed by EDIS should not entail extraordinary contributions.

On the policy options presented by the Presidency on this regard, the majority of members agreed to provide full flexibility to the NDGS to decide on whether to raise extraordinary contributions after the provision of a liquidity support. On the contrary, some preferred a minimum amount to be collected within a pre-defined timeframe, with a few stressing the importance of extraordinary contributions raised after receiving liquidity support as a timely way to repay loans. Some members also recalled the importance of preserving the level playing field between the members and non-members of the Banking Union.

Regarding the **repayment of the liquidity support**, several members concurred on the need for flexibility in establishing the repayment plan, mainly to avoid pro-cyclicality and to limit the negative impact on the banking system, although with some support for guiding provisions in the law to ensure predictability, transparency and quickness of negotiations between the NDGS and the central authority. Other members preferred a stricter and less flexible approach arguing on the need to ensure a level playing field, as well as clarity and certainty, also for the beneficiary NDGSs.

In general, members were supportive of charging interest on the loans granted by EDIS, advocating for a simple and pragmatic methodology. They also supported that such interest rates would result from the combination of the opportunity cost of the funding sources. Indeed, many members agreed with aligning the interest rate applicable to funds coming both from the DIF and from mandatory lending, arguing that it reflects the likely equal opportunity cost of these sources, mitigates first-mover advantage and it is simple and straightforward. A few members favoured non-zero and different interest rates reflecting different opportunity costs. Lastly, several members were open to explore using the European Central Bank (ECB) deposit facility rate as a benchmark.

On the maturity of the loan granted to the NDGS in need, several members underlined the need for sufficient time to repay such loan to avoid excessive burden on the banking system and pro-cyclicality while ensuring an adequate pace of replenishment. The Presidency's proposal to introduce a maturity mismatch between loans granted and loans raised did not gain support, in particular given concerns around the challenges of funding such a mismatch.

On **governance-related issues**, some members underlined the importance of the alignment of liability and control. A few members asked for a role for NDGS in the decision-making process, while others mentioned that access to the individual compartment by NDGSs must not depend on the central authority's authorization. There was no opposition to the SRB as EDIS central authority and some members referred

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that the governance arrangements depend on the design of EDIS and broader discussions on crisis management. One member emphasized that regarding governance the hybrid model should not be overly complex, in order to be operational through clear and effective decision making. The need for governance not to be overly complex was also emphasized.

To support the discussions on the hybrid model in the liquidity phase, the European Commission's Joint Research Centre presented the preliminary results of its ongoing quantitative analysis on **the effectiveness and the pooling effect of EDIS** according to which the hybrid model and a full liquidity pooling model would be more effective and efficient in preventing liquidity shortfalls in crisis situations, when compared to the current status-quo. The findings also highlighted the synergies created by the pooling of resources in terms of the firepower of the model.

4. Non-CRD/CRR entities

The discussion around the EDIS scope started in the meeting of 23 February with the potential inclusion in EDIS of the **non-CRD/CRR entities**, which was based in the Portuguese Presidency's non-paper on the treatment of the non-CRD/CRR entities under EDIS.

Upon invitation of the Portuguese Presidency, members where non-CRD/CRR entities are a material part of their banking system presented a short description on the quantitative and social importance at national/regional level of the non-CRD/CRR entities in their jurisdiction. Despite the limited size of these entities at the Banking Union level, those members demonstrated the importance of such entities in their banking system and shed some light on the relative risk presented by those entities.

On this topic, several members expressed their preference for the alignment of the three pillars of the Banking Union by including non-CRD/CRR entities in the scope of EDIS and in the CRD/CRR framework, taking into account the proportionality provisions already envisaged. Nevertheless, other members stressed that the current proportionality provisions may not be suitable for all non-CRD/CRR entities. The implementation of a conformity test, at the European level, on the regulation and supervision of these entities as a condition for their inclusion into the scope of EDIS was supported by other members.

The non-inclusion of non-CRD/CRR entities in the scope of EDIS was supported by a few members, while one member suggested an alignment with the treatment of third country branches where inclusion into the scope of EDIS could be attained through an adjustment of risked-based contributions.

5. Third country branches

The inclusion of **third country branches** in the scope of EDIS was another element discussed during the 23 February meeting, which was based on the Portuguese Presidency's non-paper on the treatment of third country branches under EDIS.

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The EBA shared its work on the third country branches carried out in the context of the EBA Opinions on the implementation of the DGSD, which showed that the majority of the third country branches in the European Union are members of a NDGS, as their national schemes were not considered equivalent.

Considering that the equivalence tests are not harmonised under the current framework, the majority of members agreed on the implementation of a harmonised equivalence test as a way to ensure a level playing field.

The discussion has not resulted in a consensus on a preferred option as to the treatment under EDIS of third country branches whose protection scheme is not equivalent. Some members preferred to adjust the contributions of these branches to EDIS by a specific extra risk factor, while other members preferred the inclusion of such entities in the scope of the CRD/CRR. A few members preferred the coverage of these branches by NDGSs, while others alerted that, although third country branches currently represent a small proportion of covered deposits in the European Union, this might change in the post-Brexit context.

6. Institutional Protection Schemes

An IPS is defined in the Capital Requirements Regulation (CRR) as a contractual or statutory liability arrangement of a network of credit institutions which protects its members and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary. Some IPS are officially recognised as DGSs under the DGSD.

Given the significant proportion of the covered deposits of the members of IPS recognised as DGSs in the Banking Union (20.8% in 2019, according to the EBA database), the discussions on IPSs are crucial for a clear definition of the scope of EDIS. To support these discussions, that took place on 22 March and 27 April, the Portuguese Presidency:

1. Invited two representatives of IPSs, one from Germany and another from Austria, to present their activity;
2. Invited the European Commission to present an overview of IPSs in the European Union;
3. Invited the ECB to present its monitoring of IPSs;
4. Prepared as a background document a non-paper on the treatment of IPSs and their members in the context of the EDIS.

To clarify the functioning of these schemes, the **National Association of German Cooperative Banks** and the **Austrian Savings Banks** presented the organisation and functioning of their IPSs.

The **European Commission** summarised the applicable legal framework and the key factual information concerning the IPSs, focusing on IPSs recognised as DGSs and on the impact of IPS (not recognised as DGSs) membership on the risk-based contributions in some Member States. In this context, a few members requested further clarifications regarding (i) the predictability of the support provided by IPSs to their members, (ii) the assessment of a risk mitigation factor on EDIS, (iii) the IPS eligibility under the CRR, (iv) the segregation of funds for preventive purposes and (v) the supervision of IPSs.

The presentation on the **IPSs monitoring by the ECB** addressed the regulatory and supervisory context of IPSs as well as IPSs related capital benefits and the economic support capacity of hybrid IPSs whose monitoring is conducted jointly by the ECB and the National Competent Authorities. In particular, the ECB explained that the differences of the capital benefits and waivers across IPSs are related to differences in the IPS's structure and organisation, mirroring the extent to which there are intragroup relations in terms of funding or capital holdings. It also clarified that some IPSs recognised as DGSs are required to support its members, while others have no mandatory commitment. In addition, the ECB highlighted some best practices for the functioning of IPSs, in particular: (i) robust rules that ensure a swift decision-making process, with clear escalation ladders in the multiple-bodies of the IPSs; (ii) stricter segregation of IPS's funds from those used for DGS's functions, and (iii) efficient processes to ensure appropriate monitoring at central level and the timely application of measures. The ECB also noted the role that IPSs can have in ensuring improved risk management practices, better monitoring and further consolidation of less-significant institutions. However, some members pointed out the absence of a legal obligation for financial support within certain IPSs as a shortcoming to the credibility and alleged lower risk of such schemes.

To enhance the debate on the policy options under the EDIS hybrid model for the treatment of: (i) the IPSs that are recognised as a DGS and (ii) the OND on lower contributions for members of IPSs that are not recognised as a DGS, the Portuguese Presidency prepared the non-paper on the **treatment of IPSs and their members in the context of the EDIS**.

Regarding the treatment of the IPSs recognised as DGSs in the context of EDIS, the majority of the members preferred including the IPSs and their members in the scope of EDIS, under the same terms as other DGSs, including for preventive measures. These members considered such option as consistent with the goal of alignment of the three pillars of the Banking Union and with a harmonised depositor protection. They also argued that excluding IPSs from the scope of EDIS would diminish EDIS' firepower, given that IPSs represent a large share of covered deposits in the Banking Union. It was also argued that this option promoted a more consistent treatment on the inclusion of preventive measures in EDIS, increasing the level playing field.

Moreover, a few members supported the inclusion of IPS and their members in the scope of EDIS with preventive measures being fully financed at the national level, either with additional funds above the target level or combined with a specific treatment for IPSs in what concerns the transfer of a lower portion of funds to the central fund when compared to other DGSs, stating that it reflects the features of IPSs recognised as DGSs. One member supported the exclusion of IPSs from the scope of EDIS on the basis that IPSs are different from other DGSs and their non-inclusion would be cost neutral.

Regarding the OND on lower contributions for members of IPSs not recognised as DGSs, the majority of the members expressed their preference for the full harmonisation of this OND possibly combined with the payment of harmonised risk-based contributions to the DIF, reflecting the risk-profile of the IPS' members.

Overall, some members were open to discuss a harmonised methodology for the calculation of contributions, preceded by an assessment of the risk profile of the members of IPSs to ensure the level playing field.

7. Options and national discretions

The Portuguese Presidency further discussed the treatment of the ONDs in the context of EDIS other than those addressed in other sections of this document (third country branches, lower contributions for

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members of IPSs that are not recognised as a DGS and preventive and alternative measures), in the meeting of 23 February.

In this context, the EBA presented its policy recommendations from the **EBA Opinions on the implementation of the DGSD**. The latter aimed at reducing the divergences in favour of a more harmonised system. In this regard, some members highlighted the importance of creating a system as simple and harmonised as possible in order to preserve the level playing field across Member States. Others emphasised the need for flexibility at national level to preserve national specificities and discretions and to ensure depositors' protection and trust in the system. In this context, some members recalled their position regarding the final design of EDIS by outlining the importance of developing a setup that works in the steady state based on a fully-fledged EDIS with mutualisation of losses, while few members stated that the hybrid model, with no loss sharing, appears to be a suitable design for the treatment of ONDs.

To frame the discussion, the Portuguese Presidency presented a non-paper on **the treatment of ONDs in the context of the EDIS**, which addressed different policy options under the reference model mentioned above. It also presented an overview of a possible way forward for each OND in the context of EDIS, by focusing on the impact of the ONDs on EDIS and on the relevance of the ONDs for the Member States.

Regarding the policy options presented by the Presidency, the majority of members considered that ONDs should, whenever possible, be harmonised and covered at least to a certain degree by EDIS. Among these members, some also supported the partial harmonisation of the ONDs to be partially or fully covered by EDIS or by NDGSs with additional funds in excess of the NDGSs target levels, in particular during the transitional phase. Others considered that the ONDs could remain optional, where harmonisation cannot be achieved, while being covered by EDIS or by the NDGSs, possibly with additional funds in excess of their target levels. A few members considered that ONDs should always remain in their current form and be covered by NDGSs only, possibly with additional funds. Finally, a few members were willing to consider the elimination of ONDs.

Moreover, several members have expressed interest in exploring how to reflect the amount of covered deposits or the risks associated to ONDs in the methodology for the calculation of contributions to EDIS. However, a few members were sceptical about the concrete parameters that may be used to achieve this goal.

8. Preventive and alternative measures

The treatment of ONDs on preventive and alternative measures in the context of EDIS is also of key importance for the scope of EDIS. In addition to the two mandatory functions of DGS, i.e. payout and contribution in resolution, the DGSD provides that Member States may also allow DGSs to finance (i) measures aiming to prevent the failure of a credit institution (the so-called preventive measures) and (ii) measures in insolvency to preserve the access of depositors to covered deposits (the so-called alternative measures).

In this context, in the meeting of 22 March, the European Commission presented the key highlights of the recent **decision by the Court of Justice on the Tercas case** and provided a brief **assessment of the impact of this ruling for DGS interventions** and of the interactions between DGSD and BRRD concerning the

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application of preventive measures and its financing by the DGSs (and eventually possibly EDIS) which could merit clarification in the ongoing CMDI review.

To support the discussions, the Portuguese Presidency presented a non-paper on the treatment of preventive and alternative measures in the context of EDIS and promoted a discussion on different policy options for the treatment of this measures in the context of EDIS as well as on their impact in the hybrid model design, in particular in the liquidity phase of EDIS.

With respect to policy options for the treatment of these measures in the context of the liquidity phase of EDIS, members' views were split. Some preferred a harmonised regime for both measures and their coverage by EDIS. Others supported a regime in which measures would remain at national level, to be financed by funds either counting towards the target level or above the target level. In general, members who supported the coverage of both measures by EDIS, highlighted its perceived advantages of efficient protection of depositor confidence and of the use of funds; the coherence with the overall regime for intervening in distress or failing banks; predictability; or level-playing field among Member States. Among these members, some agreed with the need to harmonise substantive regimes on the use of such measures (notably concerning least cost test). The members who were in favour of maintaining these measures at national level raised the following concerns: moral hazard; the interaction with the ongoing review of the CMDI framework, which may impact the discussions on the treatment of these measures in EDIS; and the fact that the failure of the institutions should be dealt within the resolution framework and not primarily through these measures. Few members preferred to retain such measures as a national option, notably for alternative measures, and to cover them by EDIS.

Some members also raised the impacts of the various policy options on the features of the hybrid model design, notably regarding the allocation of funds (with some members indicating that the inclusion of these measures could require a larger DIF) and on contributions to the DIF (in general, members which mentioned this aspect did not favour any change in the contributions to be paid by members of the DGS which use such measures).

In addition, a few members shared their views on the inclusion of these measures in EDIS in the transitional phase and in the steady state, having raised governance-related issues (namely a possible concurrent strengthening of the role of the central authority as the stepping stone for a steady-state EDIS). They also mentioned that when a fully-fledged EDIS is reached, it is important to ensure harmonisation and application of the same conditions to all. Until then, in their opinion, harmonisation should be calibrated differently between the various phases.

9. Crisis management and EDIS

Considering that some of the potential changes discussed in the context of the review of the CMDI framework foresee enhanced DGS intervention in crisis management scenarios, on the meeting of 27 April the Portuguese Presidency promoted a discussion on the role of EDIS in that regard. The Presidency non-paper on **CMDI revision and its articulation with EDIS** framed an exploratory discussion on the potential role EDIS might take following changes to the crisis management framework and try to shed some light on to what extent the CMDI revision is contingent on the setup of EDIS and vice-versa. The discussion confirmed the divergent views of members.

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As for the changes to be provided for under the CMDI revision, some members favoured an option in which resolution and an "orderly liquidation tool" (OLT) coexist. Some others voiced their preference for a broader scope for resolution, arguing that if an institution is not resolved, no alternative measures should exist and normal insolvency proceedings should apply, with a payout reimbursing covered deposits. A third current of thought, while supporting broader resolution, did not oppose to alternative measures being maintained when normal insolvency proceedings with depositor payout are not adequate or are less efficient.

Moreover, as for the role that DGSs, in abstract, could undertake in such revision, members were also divided on the role DGS should play in crisis management, with several members favouring such enlargement while some arguing that the primary function of DGS is the protection of covered deposits through pay-out, and any enlargement could endanger that purpose as well as depositor confidence. Some members also voiced their opposition to the elimination of the super-priority of covered deposits and DGSs. While recognising that a combination of funding mechanisms can be envisaged, few members expressed their concerns on the need to carefully look into the primary role of each mechanism.

Finally, in what concerns the articulation with EDIS, members' views differed on whether changes in DGS intervention should be included in the EDIS scope. Some members argued that such inclusion is needed to ensure a coherent system in light of the three pillars of the Banking Union, as well as to ensure consistent responses to banking crises. Conversely, some members took the view that any new potential DGS intervention in crisis management should remain at a national level, i.e. not centralised in EDIS whose role should be limited to pay-outs.

10. Risk-based contributions

Considering that risk-based contributions are a key element of EDIS, during the meeting of 27 April, the European Commission updated the AHWP members about the ongoing developments on the design of the methodology for calculating **risk-based contributions under EDIS**. The analysis of the Joint Research Centre showed the impact of applying the risk-based contributions at Banking Union level on the amount of contributions in comparison with non-risk-based contributions and also comprised the possible sovereign exposures indicators, contributing to the discussions of the RTSE.

The majority of the members favoured the use of risk-based contribution in EDIS, with several members advocating the benefits of a simple and transparent methodology.

Regarding the possibility of adding potential indicators based on concentration and/or credit risk of sovereign exposures in the calculation of risk-based contributions, members expressed divergent views, with several members considering this topic as a component of the **RTSE discussion**. Specifically, some members were in favour of using both type of indicators, while a few members opposed both indicators, arguing that the significant impact on contributions would have financial stability implications. Some members only agreed in including indicators based on concentration exposures and expressed concerns regarding the reliance on indicators based on credit risks, taking into account the potential adverse impacts on smaller markets, and on external ratings prone to exacerbating pro-cyclicality and financial stability risks. Some of these members also suggested that an indicator based on concentration exposures should only be introduced in the transitional phase.

In addition, some members called for further technical analysis as the scope of EDIS becomes clearer. Others identified other indicators that could be part of the analysis, possibly as an alternative to using indicators based on concentration and/or credit risk of sovereign exposures. The European Commission clarified that other indicators may be added, as long as there is data available, but underlined that the addition of indicators implies a rebalancing of the weights of the core indicators (reducing their relative importance in the whole equation).

Under this discussion, it was also recalled the recent EU General Court's ruling on the contributions to the SRF set by the SRB and the importance of balancing the benefits of introducing additional indicators against the risks of increasing the complexity and non-transparency of the methodology. It was also noted that complex calculation methods may not have a material impact on the incentives of banks.

11. Transition to the steady-state

In line with the approach set by the Portuguese Presidency for the semester, during the meeting of 27 April the Portuguese Presidency discussed the transitional period **from the hybrid model to the steady-state**, taking into account the positions of AHWP members in earlier discussions.

The Portuguese Presidency recognises that EDIS is the necessary third pillar to complete the Banking Union, together with the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The establishment of EDIS, with the creation of a DIF at the European level, promotes the alignment between control and liability in deposit insurance. Consistency in its design involves the pooling of both governance and risks/liabilities from the national level to the central level in a balanced way, until full centralisation is achieved in a fully-fledged EDIS, to be agreed upon at the political level. A misalignment created by pooling risks/liabilities without pooling governance may result in unwanted incentives to raise risks at national level and in operational challenges in the wake of a crisis. Conversely, a misalignment created by pooling governance without pooling risks/liabilities may lead to the ultimate fiscal backstop of EDIS being the national treasuries. EDIS would be key to align incentives and would contribute to achieve a uniform level of depositor protection for all depositors, regardless of the geographical location of the bank, to foster financial stability as well as to limit the bank-sovereign nexus, including the use of taxpayers' money, which were the core milestones underlying the Banking Union project.

Building on the work of previous Presidencies, EDIS would start with a liquidity phase, while building trust and preparing the ground for a fully-fledged system in the steady-state, with liquidity and losses coverages. The flexibility of the hybrid model allows for a gradual introduction of mutualisation and loss sharing. Therefore, during the transitional phase, the DIF's support would include a loss coverage component that would evolve according to a gradually increasing extent.

In this context, the Portuguese Presidency explored the concept of loss sharing as well as how the introduction of this concept could interact with the following parameters of the hybrid model: (i) the allocation of funds and the size of the DIF; (ii) the build-up, financing and replenishment of the DIF; and (iv) the EDIS' governance.

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During the discussions, several members referred to the importance of a transitional phase that builds-up towards of a fully-fledged EDIS, as an end goal. Others stressed that EDIS would not need to be implemented in different phases and that a fully-fledged EDIS is contingent on a political agreement also including on preconditions.

On the concept of loss sharing, several members favoured the DIF and the NDGS intervening in parallel and the share of the DIF's intervention being counted towards the absorption of potential losses, while one member preferred a loss sharing component in the form of a percentage of the shortfall amount. A few members expressed a middle-of-the-road position, finding both options acceptable provided a gradual level of loss sharing is introduced. Some Members supported having a clear timeline for moving towards loss sharing.

Regarding the allocation of funds, some members supported that, during the transitional phase, the proportion of funds allocated to the DIF would increase and the proportion of funds for mandatory lending and of funds allocated for national uses would decrease. The alternative where the proportion of funds allocated for national uses is kept constant and the proportion of funds for mandatory lending decreases gathered less support. Few members highlighted that both options may be adequate, depending on circumstances, namely on the scope of EDIS.

The majority of the members reiterated their preference for the DIF being funded through contributions benchmarked at the Banking Union level from the start of the liquidity phase. A few members expressed their preference for the DIF being funded through contributions benchmarked at national level at the starting point, with the Banking Union benchmark being introduced in the beginning of the transitional phase. One member expressed preference for the introduction of the Banking Union benchmark in correlation with the rhythm of mutualisation of the DIF.

One member supported the possibility of introducing a safeguard to replenish the DIF when its available financial means fall below a pre-defined minimum threshold. Another member stressed the importance of a deferral period to mitigate excessive pressure on the national banking system that may trigger pro-cyclicality and hamper financial stability.

In what concerns the governance of EDIS, a few members have mentioned the need for a simple and efficient model, though more specific references were also made to the importance of fostering an alignment between liability and control, as well as to the need of having a model that takes in due consideration the role of a strong central authority but is also flexible to accommodate specific Member State concerns.

When designing a possible way forward, the Portuguese Presidency also briefly addressed the treatment of other building blocks of EDIS mainly related to: (i) the entities that could be covered by EDIS; and (ii) the possible use of EDIS to finance preventive and alternative measures, as well as the ONDs. In this regard, a few members favoured the gradual inclusion of the building blocks in EDIS in different points in time (in the set-up of EDIS, during the transitional phase or in the steady-state), depending on the progress with the implementation of the conditions identified to allow for such inclusion. Conversely, some members preferred their inclusion/exclusion from the beginning. One member stressed the importance of aligning the three pillars of the Banking Union and of reducing fragmentation.

Since the inclusion of the above mentioned building-blocks in EDIS may impact the coverage level, the collection and use of the available financial means and the calculation of contributions, during discussions, members were open to account for these facts in the calculation of the risk-based contributions via a harmonised methodology.

12. Final Remarks

The Portuguese Presidency invites the Council to take note of this Report, with a view to progressing work further. The Slovenian Presidency is also invited to build on the progress made and continue to work towards strengthening the Banking Union.

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