



Council of the European Union  
General Secretariat

**Brussels, 30 June 2023**

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**Interinstitutional files:  
2023/0115 (COD)**

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**WK 9012/2023 INIT**

**LIMITE**

**EF  
ECOFIN  
CODEC**

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## **WORKING DOCUMENT**

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From:	Commission services
To:	Working Party on Financial Services and the Banking Union (CMDI) Financial Services Attachés
N° Cion doc.:	ST 8483 2023 INIT
Subject:	CMDI Review: DGSD - Item 2 – Commission services non paper Use of alternative financing

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WK 9012/2023 INIT

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## Commission services' note on targeted explanation of selected changes related to Article 10 DGSD – the financing of DGS

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### **1. Introduction**

Article 10 of Directive 2014/49/EU on deposit guarantee schemes (DGSD) concerns the “Financing of Deposit Guarantee Schemes” (DGSs), that is the sources of DGS financial means. This note has the purpose to clarify some of the amendments introduced in this Article, in particular Articles 10(2) and 10(11).

The EBA opinion on *DGS funding and the use of DGS funds* (further referred to as the ‘EBA opinion’)<sup>1</sup> informed the preparatory work.

### **2. Brief introduction to the changes in funding related paragraphs in Article 10 DGSD**

The existing Article 10(2) states that available financial means should equal at least 0,8% of covered deposits of the affiliated credit institutions in 2024 (the ‘target level’). The proposed amendment clarifies which available financial means among those DGSs are expected to have qualify for the DGS’s compliance with the target level requirement<sup>2</sup>. Replenishment requirements in case the available financial means that qualify for the target level fall below the target level are also clarified.

The existing Article 10(9) of the DGSD states that countries should have alternative funding arrangements in place to enable them to obtain short term funding to meet claims against the DGS. Alternative funding arrangements as such are not defined by the DGSD. The amended provision in Article 10(11) clarifies the flexibility of the DGS on the sequencing of the use of funds deriving from different sources, and in particular the possibility for the DGS to use DGS funds derived from alternative funding arrangements before those collected through regular annual contributions from

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<sup>1</sup> EBA/OP/2020/02.

<sup>2</sup> Article 10(1) states that DGSs should have available financial means proportionate to their liabilities. They raise the available financial means by annual contributions of their members while not being prevented to raise additional financing from other sources. These available financial means are defined in Article 2(1) point 12 as financial means as cash, deposits and low risk assets. No changes to this paragraph is proposed.

affiliated credit institutions under Article 10(1)<sup>3</sup> and before collecting extraordinary contributions under Article 10(8).

### **3. Delineation of available financial means that count towards the target level (Article 10(2))**

Article 10(1) states that DGSs should have available financial means proportionate to their liabilities. They raise the available financial means by annual contributions of their members while not being prevented to raise additional financing from other sources. These available financial means are defined in Article 2(1) point (12) as cash, deposits and low risk assets.

According to the EBA opinion, DGSs interpret differently which available financial means should be counted for the target level. EBA notes that a majority of DGSs uses a source-based perspective. In this case it is the source that determines if particular assets of the DGS (cash, deposits, low-risk assets and payment commitments) should count towards the available financial means of that DGS. This is supported by Article 10(1) which states that available financial means shall be raised by contributions of affiliated banks. From this perspective, means obtained by loans would not qualify for the target level. A minority of DGSs uses an asset-based perspective. In this case only the existence of that asset of the DGS (cash, deposits, low-risk assets and payment commitments) determines that it should count towards the available financial means of that DGS. The underlying perception is that if an asset is available and complies with the definition in Article 2(1)(12) of the DGSD, it is part of available financial means<sup>4</sup>.

Given the importance of having a pre-funded target level, the EBA opinion advises to amend the DGSD unequivocally to state that funds or low-risk assets stemming from or being financed by borrowed resources should not be included in the calculation of the DGS target level. EBA also proposed to clarify this through an EBA legal instrument or Q&A until this is clarified in the DGSD. EBA has issued guidelines on the delineation of available financial means providing for this<sup>5</sup>.

The Commission proposes the same approach as in the EBA guidelines. Funds originating from loans are not counted for the DGS target level as Member States should **only** take into account available financial means directly contributed by, or recovered from the liquidation proceeds of members of the DGS, net of administrative fees and charges, as well as investment income.

As in the EBA guidelines on the delineation of available financial means, in the proposal loans between DGS are excluded from available financial means qualifying for the target level. As stated in the EBA's report on the public consultation of the guidelines, to avoid double counting available

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<sup>3</sup> Article 10(1) states that DGSs should have available financial means proportionate to their liabilities. They raise the available financial means by annual contributions of their members while not being prevented to raise additional financing from other sources. These available financial means are defined in Article 2(1) point 12 as financial means as cash, deposits and low risk assets. No changes to this paragraph are proposed.

<sup>4</sup> See also pages 38-42 of the EBA opinion

<sup>5</sup> EBA/GL/2021/17 17 December 2021 Final Report Guidelines on the delineation and reporting of available financial means (AFM) of Deposit Guarantee Schemes (DGS)

financial means, which could occur if the lent amount were to be counted as available financial means both by the lending and the borrowing DGSs, the guidelines should specify that a loan that a DGS provides to another DGS should not count towards the lending DGS's available financial means and hence also not to its available financial means qualifying for the target level or other available financial means. Furthermore, funds that a DGS borrows from another DGS cannot count towards the borrowing DGS' available financial means qualifying for the target level, but they should be counted as other available financial means. However, expected repayment for loans provided by a DGS to another DGS (according to the agreed repayment plan) can be taken into account by the lending DGS when setting contributions to reach the target level again.

While the guidelines on the delineation of funds already exist, to ascertain full consistency in calculations of the relevant financial means that qualify for the target level, a mandate for a regulatory standard is added as it would provide additional certainty and contribute to equal depositor protection in all Member States.

#### **4. Replenishment requirements for the DGS (Article 10(2))**

The present DGSD Article 10(2), third subparagraph provides that, if after the target level has been reached for the first time and the available financial have been reduced to less than two-third of the target level, the regular contribution shall be set at a level to allow reaching the target level again within six years.

As became apparent during TFDGS meetings on the EBA review of the guideline on risk-based contributions, the rule to replenish the DGS to its target level in 6 years has been transposed differently across Member States. Some Member States consider any change in the DGS target level could trigger the six-year period while at least one Member State has transposed in such a way that only a reduction caused by an actual DGS intervention on the basis of its mandate can be reason to replenish in 6 years to the target level.

The amended provisions clarify that the six-year period is only applicable in case the reduction is caused by a DGS intervention. The aim of the provision is to ensure that the servicing of a liability does not lead to an artificial extension of the deadline to meet the target level. This could occur if foreseeable loan repayments of a DGS were structured in such a way that the DGS first exceeded and then breached the two-thirds threshold again. The modification follows a similar clarification in the revised guidelines on contributions methods for calculating contributions to deposit guarantee schemes.<sup>6</sup>

Article 10(2) second subparagraph also states that where the financing capacity falls short of the target level, payment of contributions by affiliated credit institutions shall resume until the target level is reached. In light of this paragraph EBA considered the case in which the relevant available financial means are reduced but remain higher than 2/3rd of the target level and concluded that,

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<sup>6</sup> EBA/GL/2023/02 21/02/2023 - Final Report on Guidelines (revised) on methods for calculating contributions to deposit guarantee schemes under Directive 2014/49/EU repealing and replacing Guidelines EBA/GL/2015/10

even though there is a lack of clarity in such circumstances, there would be limited value in being more precise in cases in which the fall in DGS funds is less significant.

Based on the EBA advice the Commission has therefore not proposed a specific timeframe for replenishments in case the relevant financial means are reduced but still higher than 2/3rd of the target level. The Commission has however proposed a mandate for the EBA to develop regulatory technical standards that include details of the process to reach the target level after the DGS has used available financial means in accordance with Article 11 (which regulates uses of DGS means). This provides for a possibility to agree a timeline also for reductions smaller than 2/3th of the target level.

## **5. Sequencing of the use of alternative funding arrangements (paragraph 10, new paragraph 11)**

The present DGSD does not contain rules on the sequencing of the use of alternative funding arrangements in relation to DGS financial means from other sources.

Article 10(8) states that, in case the available financial means are insufficient to repay depositors, credit institutions can be asked to provide extraordinary financial contributions not exceeding 0,5% of covered deposits per calendar year. However, various DGSs consider that extraordinary contributions cannot be raised within the few days available for a pay-out or would not be appropriate to raise due to procyclicality risk. Some Member States allow the use of funding arrangements ahead of available financial means and extraordinary contributions. In this context EBA considered the option of allowing full flexibility on the sequencing of the use of alternative funding arrangements, as well as the option of requiring a clear sequence.<sup>7</sup>

In order to harmonise the application of Article 10(9), EBA advises to clarify whether or not there is a hierarchy or sequence in using the alternative funding arrangements as the current provisions are interpreted differently across the EU. EBA does not recommend one of the two options.

Informed by the EBA opinion, the Commission proposal clarifies in the new paragraph 11 of Article 11 that there is full flexibility in using alternative funding arrangements in order to avoid fire sales of the DGS assets and in order to limit possible negative pro-cyclical effects for the banking industry caused by the collection of extraordinary contributions.

The Commission considers that allowing for flexibility would not undermine the collection of contributions by affiliated banks because the available financial means that qualify for the target level will be clarified in Article 10(2) and the replenishment towards the target level is subject to separate rules that would require the target level to be met in any case within the relevant time

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<sup>7</sup> Arguments considered by EBA in favour of full flexibility are the possibility to not raise extraordinary contributions when that would endanger financial stability, manage its funds in the most efficient way, prevent a fire-sale of its assets and optimising the repayment schedule. Arguments considered by EBA in favour of strict sequencing are to increase the probability that a failing institution itself has participated financially, to avoid the reliance of public funding ahead of industry contributions and not to undermine incentives to collect financial means in the form of contributions. For a comprehensive overview of arguments see points 136 and 137 of the EBA opinion and table 2 on page 144

constraints under Article 10(2) (see the comments on replenishment requirements), independently of the maturity of a loan obtained through an alternative funding arrangement.

#### **6. Alternative funding arrangements in the form of public funds (Article 10, new paragraph 11)**

Most Member States have alternative funding arrangements in place.<sup>8</sup> As part of the written comments some Member States asked clarification on the text in the proposed provision that alternative funding arrangements financed by public means can only be used as a last resort.

Credit institutions should bear the cost and responsibility for financing DGSs. If means collected through contributions, including extraordinary contributions, from the industry are not immediately available and the DGS cannot attract alternative funding from private sources, the provisions in the new para 10(11) allow DGSs to attract alternative funding stemming from public funds as a last resort.

However, existing alternative funding arrangements show that in many cases the use of temporary public funding is an important way to ascertain sufficient funding would be available for a payout. Some DGS have a commercial credit line, and others have a credit line from the State. A credit line from the central bank, loans from other DGSs (under signed cooperation agreements), bond issuance programmes and obligations for affiliated banks to lend to the DGS when needed are used by different DGS as alternative funding arrangements. Some DGSs use a mix of different alternative financing arrangements.<sup>9</sup> The DGSs that indicated they used alternative funding for a payout refinanced an initial public loan with loans from International Financial Institutions and used a private repo agreement with a private bank.

The freedom of Member States to choose their own most suitable alternative funding arrangements is not changed. While referring to last resort, the proposal does not preclude the use of publicly funded alternative financing but requires DGSs to consider potential other sources of funds such as available financing means from regular contributions, extraordinary contributions under Article 10(8) and privately funded alternative financing arrangements are considered first.

#### **7. The use of alternative funding arrangements for different purposes (Article 10, new paragraph 11)**

Member States asked whether alternative funding arrangements can be used for all purposes.

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<sup>8</sup> The EBA opinion indicates that 21 DGSs from 19 Member States had actual financing arrangements in place in 2019, while 13 DGSs from 10 Member States had not for reasons of the DGS creditworthiness, the costs of establishing such arrangements or the reluctance of authorities such as central banks or governments to provide arrangements.

<sup>9</sup> See point 122 of the EBA opinion for an extensive overview.

The current DGSD does not contain explicit provisions on the use of alternative funding arrangements for different purposes. The EBA opinion does not consider different uses of alternative funding arrangements.

The proposed provision in Article 10(11) clarifies that full flexibility in the sequence of the use of funds, including the possibility to use financing from alternative sources before the available financial means and extraordinary contributions, is relevant for all DGS interventions [*pay-out under 11(1), resolution under 11(2), preventive measures under 11(3), alternative measures in insolvency under 11(5) (the previous 11(6))*]. While the pay-out is the type of use of DGS means that is most likely to require alternative funding arrangements due to the relatively large sudden disbursements in comparison with the other uses, it should be possible to use alternative funding arrangements for all types of DGS interventions in order to provide a full available continuum of tools to handle failing banks and align incentives when choosing between different tools. Safeguards for the use of funds under 11(2), 11(3) and 11(5) would be applicable in the same way.