

**EUROPEAN COMMISSION**DIRECTORATE-GENERAL FOR FINANCIAL STABILITY, FINANCIAL SERVICES AND CAPITAL
MARKETS UNIONBank, insurance and financial crime
Resolution and deposit insurance

**Call for advice to the European Banking Authority (EBA)
regarding funding in resolution and insolvency as part of the review of the
crisis management and deposit insurance framework**

Context

The Commission included the review of the *bank crisis management and deposit insurance framework* in its work programme and aims to deliver a legislative proposal before the end of 2021. This review is an opportunity to improve the functioning of the second pillar of the Banking Union (single resolution mechanism (SRM)), to revisit its foundations and ensure it is fit for purpose, in particular as regards funding available in case of bank failures. It also aims to make progress on the common deposit insurance mechanism, the third pillar of the Banking Union.

By reviewing the framework, the Commission aims to increase its efficiency, proportionality and overall coherence to manage bank crises in the EU, irrespective of the banks' size and business model, as well as to enhance the level of depositor protection, including through the creation of a common depositor protection mechanism in the Banking Union.

The scope of the review covers three EU legislative texts which together with relevant national legislation represent the rulebook for handling bank failures: the Bank Recovery and Resolution Directive (BRRD – *Directive 2014/59/EU*), the Single Resolution Mechanism Regulation (SRMR – *Regulation (EU) 806/2014*), and the Deposit Guarantee Schemes Directive, DGSD – *Directive 2014/49/EU*). The possible revision of the resolution framework as well as a possible further harmonisation of insolvency law are also foreseen in the respective review clauses of the three legislative texts.

Experience with the application of the crisis management and deposit insurance framework¹ so far indicates the partial achievement of the objective of shielding public

¹ European Commission (30 April 2019), *Commission Report (2019) on the application and review of Directive 2014/59/EU (BRRD) and Regulation 806/2014 (SRMR)*.

money from the effects of bank failures. This would appear to be particularly the case for smaller and medium-size banks, which rely essentially on equity and deposits in their funding structure. Therefore, an important area of the evaluation of the current framework and possible subsequent adjustment focus on the toolbox available to manage the failure of these banks and the availability of the necessary funding of crisis management measures (preventive /resolution /liquidation measures).

The issue is twofold: (in-)sufficient internal loss absorption capacity and the conditions to access additional external funding when needed in case of resolution or insolvency. More specifically, the conditions for accessing the resolution fund under the BRRD are not aligned with the conditions (often less stringent) for accessing other forms of financial support (such as DGS or public funds) under existing EU State aid rules when national insolvency procedures are applied. There is therefore an incentive to avoid resolution and to recourse to public funding outside resolution.

In this context, the Commission services are seeking a targeted technical advice from the EBA to:

- i. assess the reported difficulty for some small and medium-sized banks to issue sufficient loss absorbing financial instruments (Minimum Requirement for Own Funds and Eligible Liabilities (MREL))
- ii. examine the current requirements to access available sources of funding in the current framework, including in view of the funding structure of the above mentioned banks;
- iii. assess the quantitative impacts of various possible policy options, as specified by the Commission services, in the area of funding in resolution and insolvency and their effectiveness in achieving the policy objectives.

Scope of the request to EBA

General considerations

The Commission services invite the EBA to provide all information considered relevant to inform the Commission's decision on the implementation of the revisions in the area of funding of resolution and insolvency actions.

In particular, the EBA is invited to assess the impact on institutions of introducing revisions in the EU crisis management and deposit insurance legislation (as set out in more detail in the specific sections below) as well as the combined impact of all those potential revisions. Those impacts should be assessed in comparison to the situation under the existing EU legislation (i.e. the general "baseline" for comparison, unless specified differently in the below sections). Where necessary and not otherwise specified, the EBA may complement quantitative analysis with qualitative analysis.

The EBA should strive to use the most recent (Q4 2019) available bank-level data at individual and consolidated resolution group levels to ensure a comprehensive response and in particular with the view of enabling the necessary considerations on resolution groups at their point of entry entities and entities, which are subsidiaries but not resolution entities. The impact analysis will consider the amounts of liabilities following the hierarchy of claims under national insolvency law.

In terms of sample coverage and scope, the EBA's work should ensure consistency as much as possible on all EU banks, while focusing in particular on less significant institutions (LSIs) in the Banking Union, which are not under the remit of the Single Resolution Board (SRB), and on institutions outside of the Banking Union.

While the detailed work should be carried out based on bank-level data, the impacts should be presented in an aggregate manner, by clusters with respect to the size, location and business model of the institutions. In collaboration with the Commission services, the EBA should determine the appropriate classification in accordance with criteria that the EBA would find relevant and should use that classification consistently across the report.

To illustrate the representativeness of the sample, the EBA is invited to provide, on a best effort basis a comparison between: i) the number of institutions per Member State included in the EBA sample used for this Call for advice and the total number of institutions in those Member States; and ii) the aggregated total assets amounts held by institutions included in the EBA sample used for this Call for advice and the aggregated total assets of all institutions in the EU.

The EBA is invited to explain, on a best effort basis, the main identified drivers behind at least the most significant individual and cumulative impacts of the reforms. The EBA may complement the quantitative analysis requested as part of this Call for Advice with qualitative analysis, where necessary.

Specific considerations

1. Loss simulation and allocation of losses

The objective of this analysis is to assess, with the help of a statistical model (e.g. Symbol model), the allocation of simulated losses to various categories of instruments in the institutions' balance sheet, respecting the hierarchy of claims in order to show which class of instruments would be impacted. The possibility of using external sources of funding (resolution fund/ DGS funding) subject to the conditions set out by the law should also be assessed as part of this exercise.

In particular, for subsidiaries which are part of a single point of entry (SPE) resolution group and which are not resolution entities themselves, two scenarios should be considered when performing the allocation of losses in cases where the losses exceed the internal MREL capacity: (1) SPE strategy holds and the losses of a subsidiary exceeding its pre-positioned internal MREL capacity, if any, are shifted to the resolution entity and (2) SPE strategy breaks down and the allocation of losses continues beyond the internal MREL capacity to other bail-inable liabilities of the subsidiary following its hierarchy of claims.

The Commission services will assist the EBA in running these analyses.

2. Assessing the possibility for DGS intervention under various scenarios of depositor preference

Article 109 BRRD sets out the conditions for DGS intervention in resolution. The BRRD governs the access to DGS funds in resolution and requires, besides other conditions, that

such contribution be inferior to losses that the DGS would incur under an insolvency counterfactual scenario.

The EBA should analyse to what extent the DGS funds could intervene in resolution, under four scenarios of depositor preference:

- **Baseline (Scenario 1):** considering the current hierarchy of claims (i.e. for most Member States, covered deposits are super-preferred and rank above preferred deposits (natural persons and SMEs above EUR 100,000) which in turn rank above other deposits, the latter ranking *pari passu* with ordinary unsecured claims. However, in some Member States, there is a three-tier depositor preference (i.e. covered deposits rank above preferred deposits which rank above non-preferred deposits, the latter also ranking above ordinary unsecured claims);
- **Scenario 2:** considering changing the hierarchy of claims and implementing a general depositor preference for all Member States – i.e. all types of deposits rank *pari passu* among themselves but rank immediately above ordinary unsecured claims
- **Scenario 3:** considering changing the hierarchy of claims and implementing a 3-tier deposits preference for all Member States (i.e. covered deposits rank above preferred deposits which rank above non-preferred deposits, the latter also ranking immediately above ordinary unsecured claims)
- **Scenario 4:** considering changing the hierarchy of claims and implementing a 2-tier depositor preference in all Member States (i.e. covered deposits rank above all other non-covered deposits, including those are currently preferred and those that are non-preferred, both ranking immediately above ordinary unsecured claims).

The above analysis on possible interventions of DGS in resolution will require assumptions or estimates as regards aggregate losses in insolvency for all bank creditors.

In addition to the above analyses, the EBA should also assess whether any changes in the “least-cost test” (LCT), in particular the potential inclusion of certain quantifiable indirect costs would impact the outcome related to the possibility of accessing DGS funding in resolution.

The presentation of the outcome of this analysis should be done both on aggregate level (minimum, maximum, mean for all banks) as well as by clusters of banks, taking into account the preponderance of deposits in total balance sheet.

3. Assessing the capacity of institutions to access resolution financing arrangements

This analysis should focus on the capacity of institutions to comply with the minimum bail-in rule of 8% of total liabilities and own funds (TLOF) and 5% TLOF condition to access the resolution fund for loss absorption or recapitalisation purposes. More specifically, the results of this analysis should conclude on the incidence of 8% TLOF by assessing whether such requirement can be met solely through the use of available MREL resources (including those exceeding the total MREL requirement where relevant) and, if not, which additional class(es) of liabilities would need to be bailed-in to meet the requirement. Special attention should be given when deposits need to be bailed-in in order to gain access to the fund. This analysis should take account of various scenarios of depletion of core equity tier 1 capital.

A comparison between the aggregate level of 8% TLOF and bail-inable liabilities including and excluding deposits as well as the aggregate level of MREL requirement should be made to conclude on the gap or distance to 8% TLOF and enable the analysis of possible alternatives.

Final considerations

The inclusion in the final report by the EBA of considerations on any other issues or inconsistencies with regard to funding of preventive, resolution or insolvency measures, which may have already been identified by EU resolution authorities is encouraged and would be appreciated by the Commission services.

The Commission is aware that time and resource constraints may restrict the range of methodologies that the EBA may use to analyse certain aspects of the Call for advice. Should this be the case, the EBA should highlight these limitations in its final report.

It is recalled that the analysis provided will not prejudice the Commission's final decision with regard to the policy options in its legislative proposal. Moreover, in accordance with the established practices of the Commission Expert Group on Banking, Payments and Insurance, the Commission will continue, where appropriate, to consult the experts appointed by the Member States in the preparation of its proposal. Responses to the public consultation launched in January 2020 will also be carefully assessed in taking the final policy decisions.

The EBA should deliver the report to the Commission services by 14 June 2021.