Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

ABBL position on the EU Commission Proposal of a Crisis Management and Deposit Insurance Framework

Author: Gilles Pierre

Date: August 2023

Executive summary

The ABBL welcomes the underlying objective of the Commission's proposal for a Crisis Management and Deposit Insurance framework (hereafter **CMDI**), which aims notably at:

- **Broadening** the application of resolution tools in crisis management at European and national level **including for smaller and medium-sized banks**;
- **Extending the use of privately funded safety nets (i.e. Deposit Guarantee Schemes' Funds and Resolution Funds)** to reinforce the crisis management toolbox, as a complement to banks' internal loss absorption capacity.

Notwithstanding this, the ABBL would like to draw the attention on the **consequences** of this proposal, which constitutes a paradigm shift compared to the existing framework. Indeed, **financing** is the pivotal issue of the CMDI proposal, because extending the use of resolution to a broader population of banks will put pressure on national Deposit Guarantee Funds and on the European Single Resolution Fund. Consequently, there is a real risk that banks' financial contributions **will significantly increase over time as these Funds will be depleted, putting at risk the competitive position of the banking sector and financial stability.** In this respect, **transparency** on the use of the Funds is crucial for contributors to appreciate their level of expected or future contributions.

With regard more specifically to **deposit insurance**, some amendments proposed by the Commission deserve further clarification, in particular **broadening eligible deposits to public authorities and to clients' funds deposits.**

Against this background, the ABBL would welcome **several adjustments** compatible with the Commission's objectives, along the following priorities:

- Adding **safeguards** for the use of Deposit Guarantee Schemes' (hereafter **DGSs**) funds in resolution;
- Ensuring a **level playing field** among banks by requiring **a minimum level of MREL** for banks subject to transfer strategies;
- Specifying early intervention rights and triggers by the Authorities **to prevent late intervention and excessive use of DGSs' resources;**
- Removing the proposed amendments on **the use of the Irrevocable Payment Commitments** (IPCs), which would cancel the P&L benefits of IPCs with retroactive effect, by forcing banks to recycle the existing stock through P&L;
- **Framing** the use of preventive measures financed by DGSs;
- **Clarifying** the definition of public authorities for the purpose of deposit insurance;
- As for **clients' funds deposits** eligible to the deposit insurance, **specifying** the practical conditions for identifying clients' funds deposits and considering some **unintended consequences** for deposit-taking banks.

Detailed Comments

1. Safeguards for the use of DGSs' Funds in resolution to preserve financial stability

1.1. Excluding other non-covered deposits from the general depositor preference

The **general depositor preference** introduced in art. 108.1 BRRD constitutes the **key measure** to increase DGSs' contribution to finance resolution strategies. Indeed, removing the current "super preference" of covered deposits and hence, that of DGSs, would reduce DGSs' recoveries in insolvency and would in turn **increase the cost of the payout for DGSs**. Given that the cost of payout is the limit imposed by the **Least Cost Test** for the DGS contribution in resolution, the latter would mechanically increase: **see simplified illustration in Annexes 1 and 2.**

We observe that the general depositor preference implies putting on the same ranking, in creditors' hierarchy, deposits that are very diverse by nature, i.e.:

- Covered deposits;
- Eligible deposits (> EUR 100 000) of natural persons and of Small and Medium-sized Enterprises (hereafter SMEs);
- Other non-covered deposits, i.e. corporate deposits > EUR 100 000 **and deposits excluded from the deposit guarantee.**

We believe that including other non-covered deposits in the general preference would be **unfair for natural persons and SMEs**. Moreover, the recent events have demonstrated that deposits of large corporates **are not sticky in times of turmoil**, making a preferential treatment in insolvency quite ineffective. In addition, the proposal would put undue pressure on the cost of banks' senior debt and would **hamper their funding capacity** in a period of monetary tightening.

Furthermore, we see no justification for granting a preferential ranking in insolvency to **deposits excluded from the deposit guarantee**.

Therefore, we suggest limiting the general depositor preference to covered deposits and to eligible deposits of natural persons and of SMEs.

1.2. Removing the proposal to make DGSs contribute to the requirement to bail-in 8% of Total Liabilities and Own Funds

The proposal specifies in art. 109.2b BRRD that DGSs' contributions to financing a transfer strategy could be used **to meet the requirement to bail-in 8% of the resolved bank's Total Liabilities and Own Funds (TLOF)**, which gives access to the financing of the Single Resolution Fund. We understand that this mechanism aims to solve the issue of smaller and medium-sized banks primarily funded by deposits, by ensuring their access to the Single Resolution Fund while avoiding to bail-in depositors. **We do not support this proposal** that would **depart from the general principle where shareholders and creditors must first bear losses,** via sufficient levels of TLAC or MREL, before using the solidarity of the Single Resolution Fund. Furthermore, it would lead to **inappropriate mutualization** of losses by mobilizing DGSs' financial resources: **see an overview of the overall increase of DGSs' contribution to resolution in Annex 3.**

1.3. Removing the proposal to make DGSs contribute to the capital neutrality of transfers

In the same vein, the proposal contemplates in art. 109.1(b) BRRD that DGSs contribute, where relevant, to ensure **the capital neutrality of transfers** for the recipient of the resolved bank's assets. We do not support this proposal, **which lacks objective rationale** and where the concept of capital neutrality is **ill-defined.**

2. Ensuring a level playing field among banks by requiring a minimum level of MREL for banks subject to transfer strategies

We welcome the addition in art. 45.ca BRRD of the principles guiding the calibration of the MREL Recapitalization Amount for resolution transfer strategies, which **complement the existing provisions art. 45c focused on bail-in strategies.**
While we acknowledge the necessity of some degree of flexibility to calibrate the level of MREL appropriate to the situation of a resolved bank, it is key to ensure **a level playing field among all types of banks,** whatever their size, business model or preferred resolution strategies may be. In this respect, **we call for setting out a quantitative floor for the level of MREL**, which is key to keep the credibility of the resolution framework. Such a floor should be carefully calibrated **and should fully recognize CET1 as an eligible liability**. It should be set **at a sufficiently high level** to ensure that the resolution strategy can be funded **by the bank's own shareholders and creditors** in almost all circumstances without requiring DGSs' intervention.

3. Specifying early intervention rights and triggers by the Authorities to prevent late intervention and excessive use of DGSs' resources

Authorities should be encouraged to intervene early enough to avoid deteriorated situations where there is no other solution but to request the intervention of the DGS. To do so, we suggest:

- Firstly, setting **objective criteria** according to which Authorities must necessarily position themselves on the implementation of the recovery plan;
- Secondly, defining **specific milestones** according to the planned recovery measures where a decision on the bank's resolution or liquidation must be taken.

4. Framing the use of preventive measures financed by DGSs

We welcome that the Commission proposal maintains the current framework unchanged, where the decision to empower national DGSs with preventive measures is as an **option left to Member States**. However, **to avoid unfair competition among national banking systems**, using DGSs to finance preventive measures **should be restricted to the following categories of banks**:

- Banks earmarked for resolution with a positive Public Interest Assessment and having built up a sufficient level of MREL;
- Banks having committed to a credible restructuring plan demonstrating their medium to long term viability.

5. Extension of eligible deposits

a. Clarifying the definition of public authorities

We note the extension of the deposit guarantee to the deposits of public authorities. Pending a clear definition of public authorities, which is missing in the Commission proposal, **we express some reservations about this extension.**

b. Clients' funds deposits: specifying the practical conditions for identifying clients' funds deposits

We welcome the clarification provided by the Commission proposal (new art. 8b DGSD) regarding the conditions under which clients of financial institutions (e.g. payment institutions, e-money institutions, investment firms) would be protected by the deposit guarantee. In this respect, the condition that those clients are **identified or identifiable** is **a matter of concern** for banks, **which are not necessarily the best placed** to collect such information from financial institutions. To ensure an efficient flow of information from an operational and legal standpoint, we believe that **the Directive should clearly specify that financial institutions bear the responsibility to communicate directly to the DGS the information related to clients**, e.g. client identity, deposit balance, etc. Due to its importance, this clarification **should be enshrined in art. 8b of the Directive** and **should not be delegated to the EBA** Regulatory Technical Standard proposed in paragraph 4 of art. 8b.

c. Clients' funds deposits: unintended consequences of the Commission proposal for deposit-taking banks

While it is necessary to offer protection for customer funds held by non-bank financial institutions with a credit institution against the insolvency of the latter, these funds may constitute **substantial balances,** which in turn have an impact on the calculation of the **leverage ratio** of the said credit institution, while being **solely dedicated to settlement of payment transactions** to the exclusion of any other purpose.

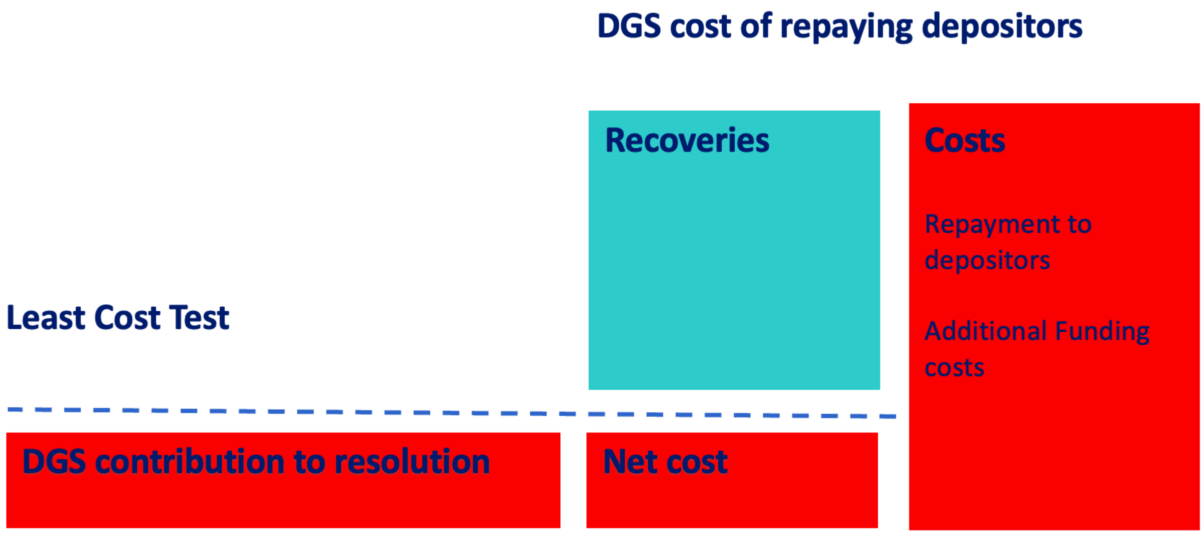
Instead of extending the DGSD to deposits made by non-bank financial institutions in the pursuit of their regulated activities with the challenges laid down above, **another possibility** could be to anchor in applicable regulation such as the CRR or the revised PSD3/EMD3, or other applicable regulation, a mechanism whereby any funds that represent customer funds deposited by non-bank financial institutions in the pursuit of their regulated activities with a credit institution, for the fulfilment of their regulatory safeguarding obligations, **would be held off balance sheet by the credit institution, provided they are deposited in a segregated account dedicated to the holding of such funds with its national central bank**. By ring fencing the funds by law, they would be protected in case of the insolvency of the credit institution and the objective pursued by the EU Commission will be equally met.

The off-balance sheet treatment afforded to such funds would **release the pressure on the leverage ratio of the credit institution**. It would also **simplify the indemnification process** at the level of the national Deposit Guarantee Scheme since, in case of insolvency of the credit institution, balances will simply be returned to the non-bank financial institutions without the need to identify any beneficiaries of the funds before indemnification.

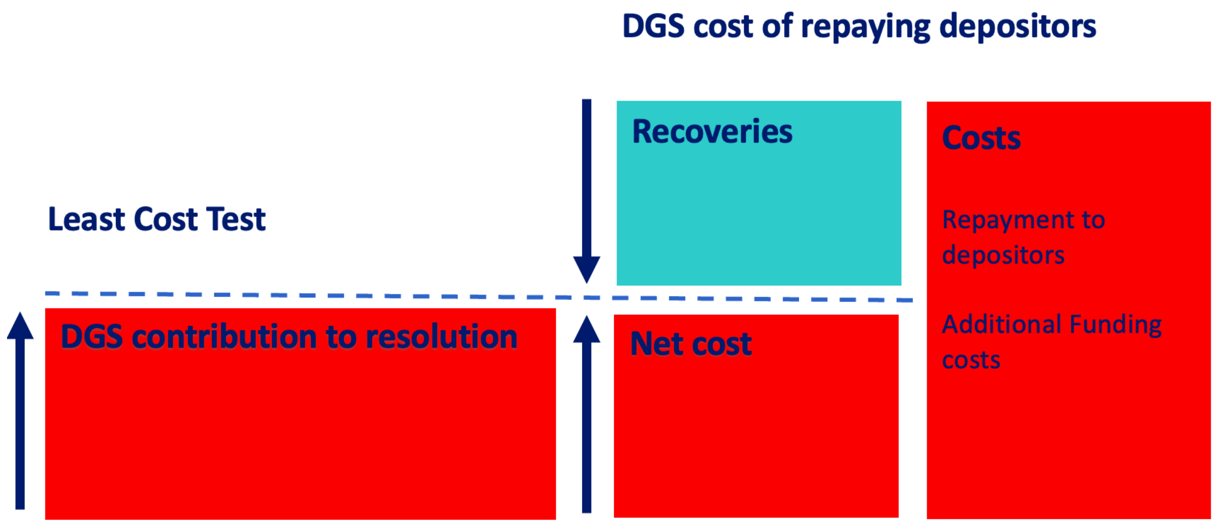
Alternatively to the above, while the DGSD is being modified, an **amendment of article 429a CRR** should also be contemplated to assign a risk weight of 0% to any funds constituting deposits accounting for under the DGSD so they are equally excluded from the total exposure measure under article 429a CRR.

Finally we would like to add that, with the current approach of the EU Commission, certain EU Member States such as Luxembourg will see the size of their Deposit Guarantee Funds **increase substantially** and ultimately cover mostly non-resident deposits, due to the offering of the banks in the market servicing EU payment institution out of Luxembourg, whose deposits will be protected by the Luxembourg DGS.

Annex 1: DGS contribution to resolution, current framework



Annex 2: DGS contribution to resolution, proposed framework with general depositor preference



Annex 3: Overall increase of DGS contribution to resolution under the proposed framework