EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB contribution to the European Commission's targeted consultation on the review of the crisis management and deposit insurance framework

General remarks

The European Central Bank (ECB) welcomes the Commission's targeted consultation on the review of the bank crisis management and deposit insurance framework. A well-functioning European crisis management and deposit insurance framework is essential to prevent and address the failure of banks of all sizes within and across Member States. The current framework introduced in the wake of the global financial crisis comprises the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD) and has been in place for some years now. This review is an important opportunity for revision in light of the lessons learned in the first years applying the framework. Experience has shown that improvements are needed to foster its effectiveness in preventing and managing the failure of banks of all sizes across Member States in a harmonised way.[1]

Improving the crisis management framework and completing the banking union are important objectives. Since they support each other, they need to be achieved in parallel. Differences in national legal regimes for dealing with bank failures stand in the way of a fully integrated market and do not allow a uniform level of protection for the same category of investors and depositors across participating Member States. As a result, the intrinsic value of a deposit in one Member State could differ from that in another, even within the banking union. Introducing harmonised procedures would pave the way for a European Deposit Insurance Scheme (EDIS). The introduction of EDIS would in turn strengthen the crisis management framework, as it would provide additional sources of funding to support asset transfers in resolution and liquidation. The introduction of EDIS should therefore be an essential element of this review.

Progress in facilitating cross-border banking within the EU should also remain a priority. Small-scale amendments to the current framework would encourage the use of existing legal options already in place, such as cross-border liquidity waivers, and allow incremental progress on cross-border integration. This would be

[1] See the crisis cases discussed in the ECB Annual Report on supervisory activities for the years 2017, 2018 and 2019.

particularly important within the banking union. Further legislative changes would support the effectiveness of intra-group support agreements.

In general, improvements to the crisis management framework should cover all the different stages of a bank's crisis. The tools and powers available to authorities must be adequate and effective for dealing with a crisis before a bank is deemed failing or likely to fail (FOLTF). These include early intervention, precautionary recapitalisation, preventive action by the deposit guarantee scheme (DGS), reducing the residual risk of "limbo" once FOLTF has been declared and ensuring failed banks not subject to resolution are dealt with consistently and effectively by introducing an EU administrative liquidation framework.

The early intervention framework should be clarified to make practical implementation easier. This includes removing early intervention measures (EIMs) already available in the Capital Requirements Directive (CRD) and the Single Supervisory Mechanism Regulation (SSMR) from the BRRD, and amending the SRMR to provide a direct legal basis for the ECB to act.[2] Aligning the conditions for making an early intervention with those for imposing supervisory measures would make it easier to apply the early intervention framework.

Automatic triggers for taking EIMs or determining FOLTF should not be introduced. The decision to apply EIMs and deem a bank FOLTF should remain a case-by-case assessment taken on the basis of a comprehensive assessment of the specific circumstances and considering all relevant information.

Precautionary recapitalisation provides an element of flexibility in the current crisis management framework and should be maintained. The limited use made of this tool in recent years shows that the current framework, including the strict conditions for its use, is adequate.

DGS preventive measures have proven to be a useful crisis management tool which should be kept and extended across the EU in a harmonised way. Pending the agreement on EDIS, but also in the preparation phase for EDIS, it would be desirable to harmonise and thus broaden the availability of this type of intervention.

The residual risk of "limbo" situations needs to be addressed. An institution which is declared FOLTF but not subject to resolution should enter a procedure involving the realisation of its assets, eventually leading to its exit from the banking market. The introduction of a harmonised administrative liquidation framework would allow this issue to be addressed as the power to initiate the administrative liquidation procedure would be assigned to the resolution authority. The definition of "winding-up" in the BRRD should be clarified accordingly.

Competent authorities should always be able to withdraw the banking licence of a bank declared FOLTF which is not subject to resolution. The EU legal framework does not explicitly regulate the interaction between the resolution

[2] See ECB Opinion of 8 November 2017 on revisions to the Union crisis management framework (CON/2017/47).

procedure and the withdrawal of the licence. The situation where a bank is FOLTF, there are no alternatives to prevent failure and no public interest in resolution should be added to the grounds for the withdrawal of the licence.

Broader application of the resolution framework would enhance the level playing field and access to best-practice resolution tools, but this does not remove the need to revisit the liquidation framework.[3] Widening its scope to smaller and mid-sized banks which are heavily reliant on deposits as a funding source can be challenging from a financial stability perspective. Even with broader application, resolution would still not be available for all banks. There is therefore a justified need to revisit the liquidation framework to ensure a level playing field.

The ECB supports the creation of a European administrative liquidation framework supported by EDIS to harmonise and improve the effectiveness of the crisis management framework for banks where there is no public interest in resolution and which therefore go into liquidation. The Single Resolution Board (SRB) should be granted administrative liquidation powers for banks under its remit, giving it the ability to start and manage the liquidation of the assets of banks not subject to resolution, in a way that allows their exit from the banking market. The same powers and tools should be granted to national resolution authorities for banks under their remit. Once a fully-fledged EDIS is in place, the SRB's responsibility for the use of funds should be widened to cover all banks (including less significant institutions). The administrative liquidation framework should include the harmonised availability and the wider use of transfer strategies, which are considered an international best practice, as they have the potential to preserve significant economic value and ensure better continuity of access to banking services.

During the transition to EDIS, a two-step governance process could be considered for using national DGS funds by the SRB to support transfer tools in liquidation. The SRB should maintain the power to trigger the start of administrative liquidation and to decide on the transfer of a bank's assets and liabilities. However, national authorities or entities responsible for the funding could maintain the right to block the transaction.

The main tool for absorbing losses in bank failures should be bailing in shareholders and creditors; public support should only be available as a last resort. This principle limits moral hazard and costs for the taxpayer and is fully supported by the ECB.

The conditions for accessing resolution funds in resolution and liquidation aid in liquidation differ, creating an unlevel playing field. Some of these divergences reflect to some extent differences in crisis management strategies and banks' balance sheets. However, the current split into two groups depending on whether a bank is subject to resolution or liquidation may be suboptimal, as it creates equal-treatment issues for some banks and may not allow for appropriately taking into account the specificities of a crisis situation.

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[3] The reference to liquidation frameworks/tools across the text also encompasses winding-up frameworks/tools.

Work should be done to investigate whether conditions for accessing resolution funds and liquidation aid need to be revised, while still maintaining current options for addressing financial stability risks. The following principles could guide such investigation. Use of public funds should: (i) remain a last resort; (ii) allow an approach which safeguards financial stability, e.g. through a financial stability exemption to be used only in times of euro area-wide or country-wide crisis, as recommended by the International Monetary Fund (IMF); and (iii) be proportionate to the moral hazard implied by an intervention. If changes are pursued, it is important that neither framework – resolution nor liquidation – be amended in a way that reduces authorities' ability to mitigate financial stability risks in practice.

Broader use of DGS resources in liquidation and resolution would facilitate the use of transfer tools. To achieve this, the ability of DGSs to support "alternative" measures to depositor pay-out should be extended and harmonised across the banking union. The "least-cost" test for using alternative measures would need to be adjusted and harmonised. Moreover, removing the DGS super-preference should be considered.

Further harmonisation of national creditor hierarchies, such as by introducing a general depositor preference which is considered an international best practice, would support the level playing field and facilitate resolution. This would limit the need for the Single Resolution Fund (SRF) to cover no-creditor-worse-off (NCWO) claims in resolution when dealing with deposits and would be combined with amendments to the creditor hierarchy, facilitating use of DGS funds in asset transfers.

Putting in place an EDIS with full risk-sharing, including full coverage of both liquidity needs and losses, should remain a key priority. Keeping depositor protection at the national level maintains the link between a bank and its sovereign, which implies that one of the main objectives of banking union has not been achieved. A common scheme would strengthen the level playing field by creating uniform depositor protection regardless of banks' location and improve financial stability by breaking the bank-sovereign nexus. EDIS should therefore be designed to (i) minimise operational complexities so as to allow timely intervention in a crisis, both in its ultimate form and in any model in place for a transitional period, including the hybrid model that would offer liquidity support to national DGSs as a first step; (ii) facilitate a strong European component, with a large central fund to allow a rapid move to a fully-fledged EDIS; (iii) sever the link between banks and sovereigns by adding a fiscally neutral common backstop to an EDIS in addition to the SRF backstop; and (iv) achieve cost-efficiency, synergy effects and independent decision-making by making the SRB responsible for managing both the resolution fund and the Deposit Insurance Fund.

During the transition to a fully-fledged EDIS, existing DGSs should be further harmonised. Harmonisation of national DGS tools and measures will facilitate the transition to fully-fledged EDIS. It is therefore important to harmonise DGS options and national discretions, notably extending the availability of preventive and alternative measures to all national DGSs.

Specific remarks

1 Measures available before a bank’s failure

1.1 Early intervention measures (EIMs)

Experience in the first years of application of the early intervention framework has shown that improvements are needed. Currently, some measures[4] can be adopted either as supervisory measures, based on Article 16 of the SSMR, or as EIMs, based on national implementation of Article 27 of the BRRD. In its Opinion of 8 November 2017 on revisions to the Union crisis management framework, the ECB recommended removing from the BRRD those EIMs that are already available in the CRD and the SSMR and amending the SRMR to provide a legal basis in a regulation for the ECB's early intervention powers in order to facilitate their consistent application. Those recommendations are still valid.

Amendments should aim to clarify the existing framework to make practical implementation easier. Application of EIMs across the EU has been limited so far.[5] A policy decision needs to be taken on whether to align the conditions for taking EIMs (which will be left in the BRRD) with those currently specified in Article 16 of the SSMR for taking supervisory measures. The latter include the ability to take measures based on a determination by the competent authority that the arrangements, strategies, processes and mechanisms implemented by the credit institution and its own funds and liquidity do not ensure a sound management and coverage of its risks.[6] The alignment of conditions would make it easier to apply the early intervention framework, while ECB decisions would still be subject to the proportionality principle. We also recommend replacing the reference to “in the near future” by “within the next 12 months” to enhance legal clarity and improve alignment with Article 16 of the SSMR also because the current reference to “in the near future” could be interpreted as referring to a period which is shorter than twelve months, restricting potential use of EIMs.

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[4] The overlapping measures are referred to in Article 27(1)(b), (d), (f), (g) of the BRRD, and Article 16(2)(c), (e), (m) of the SSMR. For example, requiring the institution to examine the situation and draw up an action plan (Article 27(1)(b) of the BRRD and Article 16(2)(c) of the SSMR) or requiring changes to the institutions business strategy (Article 27(1)(f) of the BRRD and Article 16(2)(e) of the SSMR).

[5] See EBA Discussion Paper (DP) on the application of early intervention measures in the European Union according to Articles 27-29 of the BRRD (EBA/DP/2020/02). According to the DP, EIMs have been used only in nine jurisdictions, whereas other competent authorities have decided to use other supervisory powers instead of the EIMs. Among the competent authorities that have used this tool, the total number of EIMs applied was also very small. According to the EBA DP, the main reasons for not applying EIMs are the following: (i) a broad array of supervisory measures available in some MS under the national law, (ii) overlap between EIMs and supervisory powers, as well as conditions for applying them, (iii) sequence that has to be followed in applying EIMs, (iv) the fact that Article 27 of the BRRD measures are unlikely to result in an immediate improvement in the capital / liquidity position of an institution, (v) procedural obstacles coming from national legislation / administrative law (e.g. the right to be heard), (vi) uncertainty regarding the disclosure requirements and reputation risks, (vii) specification of EI triggers.

[6] See Article 16(1)(c) of the SSMR.

Early exchange of information and cooperation between the competent authority and the resolution authority has been a good common practice over the past years and should be maintained. This good practice also reflects the Memorandum of Understanding (MoU) signed between the ECB and the SRB in 2015, which was revised and expanded in 2018 to reflect the experience of the ECB-SRB collaboration.

Any revision to the requirement for the ECB to notify the SRB should strike the right balance between ensuring the SRB is adequately involved in potential resolution cases and avoiding an unnecessary increase in the administrative burden. Ongoing involvement by the SRB irrespective of any formal notifications is also specified in the revised ECB-SRB MoU, which ensures a comprehensive exchange of information, especially regarding priority entities.[7]

Quantitative indicators are in general a useful reference for informing supervisory action, but should not be used to trigger supervisory decisions automatically. The ECB's internal escalation process – the Emergency Action Plan – already takes specific quantitative thresholds into account to inform supervisory actions, including EIMs taken with respect to banks showing first signs of deterioration and therefore subject to closer scrutiny. However, automatic thresholds should not be established for applying EIMs, as it would be too complex to define suitable indicators to correctly identify all relevant cases for specific measures. Such automatic thresholds could also limit the ability to deal with specific situations in the absence of a breach of indicators. The decision to apply EIMs should therefore remain a case-by-case assessment taken on the basis of a comprehensive assessment of the specific circumstances. In addition, the example of 1.5 percentage points above the institution's own funds requirement should be removed from Article 27 of the BRRD, since it can be misinterpreted as an additional condition.

1.2 Precautionary recapitalisation

Precautionary recapitalisation provides an element of flexibility in the current crisis management framework that should be maintained. It is among the very few exceptions to the general rule that the provision of extraordinary public financial support to a bank leads to it being FOLTF. Precautionary recapitalisation is subject to strict conditions, which have been deemed fulfilled in only a very small number of cases. Thus the current framework, including the conditions for not triggering FOLTF, can be considered adequate. There is also no need to further specify the conditions set down in BRRD/SRMR; some flexibility for the relevant authorities is necessary to take the specifics of each case fully into account. In particular, the existing flexibility on the tools that can be used to identify incurred losses should be preserved with a

[7] The MoU defines "priority entity" as (i) an entity in a distressed situation in respect of which the ECB has triggered its internal crisis management arrangements; or (ii) an entity with a Supervisory Review and Evaluation Process (SREP) score of 4 or a SREP score of 3 in combination with a sub-score of 4. The ECB triggering of "internal crisis management arrangements" (see (i)) refers to a bank being classified under stage 2 of the Emergency Action Plan. The SREP scores to be taken into account for (ii) are the latest ones available.

view to identifying the tool, within the supervisory toolkit, which is best suited to identify incurred losses.

1.3 DGS preventive measures (Article 11(3) of the DGSD)

Recent experience has shown that DGS preventive interventions can be a useful crisis management tool. Preventive measures under Article 11(3) of the DGSD refer to interventions aiming to prevent the failure of an institution, subject to certain conditions. They can represent a suitable way to mitigate the financial deterioration of a bank while ensuring the costs are borne by the banking system. At the moment, the ability of DGSs to intervene is an option specified in the DGSD. However only nine Member States[8] have implemented it, and therefore the tool is not available in the other 18. Pending agreement on and preparation for EDIS, it would be desirable to harmonise this type of intervention and make it available more widely to ensure a level playing field for banks located in different Member States (see also Section 4 below).

The role of the competent authority in the assessment under Article 11(4) of the DGSD should be clarified. Article 11(4) of the DGSD stipulates that preventive measures by a DGS are not to be applied where the competent authority, after consulting the resolution authority, considers the "conditions for resolution action under Article 27(1)" of the BRRD to be met.[9] We note that under Article 32(1) of the BRRD the competent authority is responsible for assessing the first condition for resolution under Article 32(1)(a) of the BRRD (i.e. that a bank is FOLTF), while the resolution authority is in charge of assessing the two remaining conditions under Article 32(1)(b) and (c) of the BRRD. This allocation of responsibilities reflects the different roles played by the competent authority and the resolution authority in the resolution process and could be mirrored better in the wording of Article 11(4) of the DGSD. We therefore recommend clarifying in the DGSD that, for the specific purposes of Article 11(4) thereof, the competent authority only needs to confirm the bank is not FOLTF under Article 32(1)(a) of the BRRD.

2 FOLTF, winding-up and withdrawal of the banking licence

We do not see a need to amend the principles regarding the regulatory framework for declaring a bank to be FOLTF. This determination should be made on the basis of a comprehensive assessment of both qualitative and quantitative objective elements, taking into account all other circumstances and information relevant to the institution.[10] The ECB considers all these elements carefully and exercises its supervisory judgement to ensure banks are declared FOLTF in a timely manner. We consider that the current SRMR framework strikes the right balance

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8 Austria, Croatia, France, Germany, Ireland, Italy, Malta, Poland and Spain.

9 There appears to be a typo in the DGSD, as the intention seems to be to refer to FOLTF under Article 32(1) BRRD.

10 See EBA Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU (EBA/GL/2015/07).

between preserving flexibility on the one hand and preventing inappropriate supervisory forbearance on the other, with the SRB able to declare a bank FOLTF if the ECB does not do so.

Quantitative triggers that automatically result in a bank being declared FOLTF are undesirable. While quantitative information is key to enabling supervisors to take informed decisions, the ability to exercise supervisory judgement inherent in the current framework is crucial to ensuring that FOLTF declarations are based on all the relevant circumstances of a case. Apart from the risk of false signals, quantitative triggers can cause unnecessary concerns and lead to market over-reactions when they draw near, possibly exacerbating a banking crisis.

The residual risk of "limbo" situations should be addressed. This relates to institutions for which the resolution authority considers that the conditions in points (a) and (b) of Article 32(1) of the BRRD are met, but that a resolution action would not be in the public interest (hereinafter "a bank declared FOLTF which is not subject to resolution"). Article 32b has been introduced with the BRRD II to address the risk of limbo situations arising from the fact that the circumstances specified in Article 32(1)(a) and (b) of the BRRD are not always sufficient to trigger exit from the banking market as, for example, these circumstances will not always be sufficient to meet the triggers for national insolvency proceedings. According to Article 32b, a failing institution which is not subject to resolution "shall be wound-up in an orderly manner in accordance with the applicable national law". However, a residual risk of limbo situations may still exist if the applicable national law implementing this provision does not explicitly require the commencement of a winding-up procedure for a failing bank where there are no alternatives to prevent the failure and the bank is also not subject to resolution, or in cases where the procedure under national law does not allow the timely exit of the bank from the market.

An institution which is not subject to resolution should enter a procedure involving the realisation of its assets, eventually leading to its exit from the banking market. Market exit after being declared FOLTF with no resolution should not be left at the discretion of the institution itself. It is important to avoid situations where an institution refuses to initiate private or voluntary liquidation, but national authorities lack the power to initiate compulsory winding-up, for example, if an institution is not (yet) technically insolvent. The introduction of a European administrative liquidation regime (as proposed in Section 3.1) would address this issue as the power to initiate the administrative liquidation procedure should be assigned to the resolution authority in all cases where the bank has been assessed as FOLTF but the outcome of the public interest assessment is negative. The definition of winding-up provided in Article 2(1)(54) of the BRRD should be amended accordingly.

Allowing a failed entity to reorganise/restructure as part of the winding-up process can create delays and uncertainty about its exit from the banking market. In cases where this is allowed – with the sole purpose of increasing the sale proceeds for creditors – it should be evident that it cannot be open-ended and should always ultimately result in the failed entity exiting the banking market.

It should always be possible to withdraw the licence of a bank which has been declared FOLTF and is not subject to resolution. The EU legal framework does not explicitly regulate the interplay between the resolution procedure and withdrawal of a licence.[11] The grounds for withdrawal are provided in the CRD and complemented by additional references in national legal frameworks. In some Member States, for example, authorisation cannot be withdrawn even where a bank has been declared FOLTF, because the grounds for withdrawal pursuant to Article 18 of the CRD (e.g. letter (d)) as implemented in national law are not met. This is particularly the case where the FOLTF assessment is made on the grounds of likely infringement, likely over-indebtedness, likely illiquidity or State-aid. Nor is this issue sufficiently addressed when a failing bank with a negative public interest assessment enters a liquidation procedure under national law immediately, as even then withdrawal of the licence may not be possible. A declaration that a bank is FOLTF and that there is also no public interest in resolution should therefore be added to the grounds for withdrawal of a licence provided in Article 18 of the CRD.

Nevertheless, supervisory discretion to withdraw a licence should be retained. The proposed amendment should not introduce an automatic link between the assessment of the conditions for resolution and withdrawal of the licence. This would not allow the specific circumstances of each case to be taken into account, as in some cases transactions requiring a banking licence could be necessary to ensure a smooth liquidation process, protecting the interests of stakeholders. It would also imply mechanistic use of the ECB’s sole competence over access to and exit from the banking market (in the case of less significant institutions, for example, conditions for resolution are generally assessed by national authorities[12]). For the same reasons, setting a specific maximum timeline for withdrawal of a licence could be problematic, in particular if there are tools available which could be used to protect depositors against a possible disruption of services. Hard-wiring withdrawal of the licence into the assessment of the conditions for resolution could also have a negative effect on due process.

3 An EU framework for managing the failure of all banks

Banks declared failing or likely to fail and not subject to resolution are wound up under national law, leading to different results across banks located in different Member States. This affects the level playing field for bank creditors and the availability of banking services. The resolution framework offers a wide range of harmonised tools for dealing with banking crises. However, by setting a high bar to the use of resolution funds, it relies on banks having substantial loss-absorption capacity. The current resolution framework may not be suitable for banks which are heavily reliant on deposits as a source of funding, since it implies that uncovered depositors are likely to bear losses. This raises concerns about depositor confidence and possible spillovers to the real economy. National insolvency and

[11] A negative public interest assessment by the SRB implies that the bank will not undergo resolution but will (usually) be wound up under national insolvency procedures.

[12] In addition, the SRB is responsible for the resolution of some less significant institutions under the SRMR.

liquidation frameworks, on the other hand, differ markedly in how well they are prepared for dealing with bank failures. In some Member States, winding up banks under national law entails inefficient procedures that limit the recovery of value for creditors and the availability of banking services.

The EU resolution framework and national procedures for failing banks should be revisited, with a view to enhancing the effectiveness of both in dealing with all types of bank failures. Key objectives of such a review could be:

- the availability of harmonised best-practice tools and procedures, such as asset transfer tools, in all Member States for all failing banks, whether they are in resolution or liquidation;
- an adequate mix of funding sources in resolution and liquidation which minimises recourse to public support while ensuring resilience in a systemic crisis;
- increased consistency between the treatment of banks in resolution and liquidation when there is no objective reason for differences.

Various elements of the crisis management framework may need to be enhanced to achieve these objectives, while keeping a holistic perspective as suggested by the Commission's review. The key elements to consider are: introduction of a European administrative liquidation framework; definition of the scope of the public interest assessment (PIA); use of best-practice transfer tools both in liquidation and resolution with funding from deposit guarantee schemes; and the conditions for accessing resolution funds.

Broader application of the resolution framework would enhance the level playing field and improve access to best-practice resolution tools. The ECB therefore welcomes the SRB's ongoing work to broaden the scope of the PIA; this could improve the crisis management framework without requiring legislative changes.

Widening the scope of the resolution framework does not remove the need to revisit the liquidation framework. Widening the scope of resolution to include smaller banks, which are often heavily dependent on deposits, could be challenging, as they would be required to meet higher minimum requirements for own funds and eligible liabilities (MREL). Banks may have to change their business model to meet such MREL requirements. However, from a system-wide perspective, having a diverse set of business models in the EU is a form of risk diversification that increases the ability to absorb shocks. For banks with limited access to capital markets, MREL would likely be met mostly with equity, which can be heavily depleted at the point of failure, requiring a bail-in of uncovered deposits. For these banks it should be possible to design alternative transfer strategies which allow their orderly exit from the banking market while ensuring the protection of depositors. Finally, we note that, even with a broader PIA, resolution would still not be available to all banks. This again emphasises the need to revisit the liquidation framework too.

3.1 The adequacy of the tools available in resolution and insolvency

A European administrative liquidation framework supported by EDIS should be introduced to harmonise the crisis management toolkit for banks where there is no public interest in starting resolution. The SRB should be granted administrative powers for the banks under its remit not subject to resolution, allowing it to start and manage the liquidation of their assets, in a way that allows their exit from the banking market. The SRB should have access to best practice liquidation tools used in the United States by the Federal Deposit Insurance Corporation (FDIC) and also applied successfully in some Member States. Among these is the transfer tool which allows some of the assets and liabilities of a failing bank to be sold, with potential support from EDIS funds, or from national DGS funds during the transition to EDIS. This would provide the SRB with the necessary tools to deal with the failure of all banks under its remit.

For banks currently outside the SRB's remit, and therefore under national liquidation frameworks, these administrative liquidation powers should be harmonised and granted to the respective national resolution authorities. The failure of all banks with a negative PIA would then be managed in a harmonised way to the benefit of the level playing field for bank creditors. Adding the transfer tool to the EU liquidation toolkit is important because wider use of such strategies has the potential to preserve significant economic value and can ensure better continuity of access to banking services compared with piecemeal liquidation. These administrative liquidation powers and tools could be integrated into the BRRD/SRMR to build on the legal framework already in place. As administrative liquidation powers and tools are currently not consistently available outside of resolution, their introduction would not represent a duplication of existing powers and could be introduced without significantly modifying national insolvency frameworks. Once a fully-fledged EDIS is in place, the SRB's responsibilities for the use of EDIS funds should be widened to all banks, including less significant institutions.

A two-step governance process could be considered for use of national DGS funds during the transition to EDIS which would enable adequate funding to support use of the SRB's transfer tools in liquidation. During the transitional phase before EDIS, appropriate arrangements need to be put in place when national DGS resources are needed by the SRB to fund the assets transfer in liquidation of a bank under its remit. One option would be to establish a "two-keys" process: the SRB would retain the power to trigger administrative liquidation and decide on the transfer of a bank's assets and liabilities, but the national authorities or entities responsible for the funding would maintain a right to block the transaction before the final decision is taken. This governance arrangement for use of national DGS funds would be superior to a national-only process since the SRB can ensure a European-wide market for liquidation of assets and liabilities, which could eventually generate better prices. As a result, the cost to a national DGS is likely to be lower than it would be with the national solution. An additional benefit for the banking union as a whole is that a two-step governance process is likely to facilitate cross-border acquisitions, thereby enhancing integration within the banking sector.

3.2 Sources of funding for managing bank failures

The conditions for accessing safety nets currently depend on whether a bank is in resolution or liquidation. The principle that losses after a bank failure should first and foremost fall on shareholders and creditors is a cornerstone of the crisis management framework. This limits moral hazard and costs for the taxpayer and the ECB fully supports it. With resolution funds and deposit guarantee schemes funded by industry contributions, the crisis management framework also establishes safety nets to protect financial stability and covered depositors while limiting the cost for the taxpayer. As a last resort, government support is possible under strict conditions. However, the conditions for accessing resolution funds while in resolution and liquidation aid in liquidation are not the same. In resolution, a contribution from the resolution fund in lieu of bail-in is only possible once 8% of total liabilities and own funds have already been bailed in; in liquidation, State-aid rules require only the burden-sharing of shareholders and subordinated creditors.

The different conditions for access to funding in resolution and liquidation reflect to some extent differences in crisis management strategies and balance sheets, but the current split into two groups may be suboptimal. Access to resolution funds in resolution and liquidation aid in liquidation should be most difficult where risks to financial stability are limited and moral hazard most pronounced. Imposing the most stringent requirements in cases where a bank with ample bail-inable liabilities enters open bank resolution therefore seems justified. On the other hand, in some instances it may be in the public interest to facilitate market exit for a deposit-funded bank with lower levels of bail-inable liabilities if financial stability is at risk. There may also be less moral hazard, given the extensive coverage of liabilities by (national) deposit insurance. To some extent, these considerations are reflected in the different availability of funding support in resolution and liquidation. However, in some instances there may currently be incentives to manage bank failures under the national liquidation framework. For example, where transfer strategies are possible under national liquidation frameworks, the acquiring bank may be offered more attractive terms in liquidation than in resolution if liquidation aid is provided to support the transaction. Allowing DGSs or EDIS to support asset transfers in liquidation would effectively reduce the need for liquidation aid, enhancing the level playing field across banks and ensuring the regulatory framework provides the right incentives.

Work should be done to investigate whether conditions for accessing resolution funds and liquidation aid need to be revised while maintaining current options for addressing financial stability risks. The following principles could guide this investigation. Use of public funds should: (i) remain a last resort; (ii) allow an approach which safeguards financial stability; and (iii) be proportionate to the moral hazard implied by an intervention. On this basis, consideration could be given to lowering the requirements for accessing resolution funds based on objective criteria in cases where this is in the public interest, e.g. in a systemic crisis or where the bail-in of uncovered depositors threatens to seriously undermine financial stability. The ECB therefore supports a financial stability exemption, as recommended by the IMF in its euro area Financial Sector Assessment

Programme[13], to be used only in times of euro area-wide or country-wide crisis. Similarly, where a failed bank exits the market (e.g. through the use of the sale of business tool, with a reduction of the banking over-capacity and withdrawal of the authorisation of the residual entity), the conditions for access could be less burdensome than for an open bank resolution. Strong discontinuities in the framework which distort incentives should be avoided. Following the same logic, interventions aimed at providing liquidity should, as currently foreseen by the resolution framework and State-aid rules, be subject to less intrusive requirements than interventions which absorb losses. If changes are pursued, it is important that neither framework – resolution nor liquidation – be amended in a way that reduces authorities' ability to mitigate financial stability risks in practice.

Allowing broader use of DGS resources in liquidation and resolution could facilitate the use of transfer tools. The DGSD allows DGS funds to be applied for certain "alternative" uses other than their primary role of compensating depositors; this includes the use of transfer tools, subject to a least-cost test. Alternative measures are only available in six Member States in the banking union. Transforming this option into a common tool available to all national resolution authorities within a regulatory framework would ensure more effective treatment of failing banks across the banking union and provide funding options to facilitate the use of asset transfers in liquidation. Currently, the super-priority DGSs enjoy in the creditor hierarchy after intervention limits their exposure to losses and their ability to support transfer strategies. It may be necessary to allow broader use of DGS resources to unlock the advantages of transfer strategies under a harmonised administrative liquidation framework in the context of alternative interventions or in resolution. Key ways to achieve a broader use of DGS include clarifying and harmonising the least-cost test while taking into account a broader concept of the costs of a pay-out scenario, or removing the DGS super-preference, in acknowledgment that protecting banks' contributions to the DGS over non-covered depositors might not be fully justified. While the least-cost test is likely to prevent the DGS from being used to benefit subordinated creditors or shareholders in most cases, this could be ruled out in general for clarification. Any requirements going beyond the bail-in of subordinated creditors could, however, limit the effectiveness of DGS funds in avoiding value destruction.

Further harmonisation in the creditor hierarchy across the EU would support the level playing field and facilitate resolution. Bank creditor hierarchies are not fully aligned across the EU, leading to a lack of transparency regarding the riskiness of asset classes for investors in different Member States. Since national creditor hierarchies are a reference point for resolution due to the no-creditor-worse-off (NCWO) principle, different national solutions can result in NCWO claims being covered by resolution funds. To limit such risks, the ECB supports further harmonisation of national creditor hierarchies, such as introducing a general depositor preference. Closer alignment of national creditor hierarchies to the order of loss absorption under resolution would be desirable. This could be combined with a pari-passu ranking for all deposits, which would also allow broader use of DGS

[13] IMF Financial Sector Assessment Program – Technical Note-Bank Resolution and Crisis Management

resources both in resolution and in liquidation by easing the least-cost test while maintaining protection of covered deposits under DGS insurance.

4 The importance of introducing the missing pillar in the banking union

Deposit insurance is still arranged at the national level and there has been a lack of consensus to change this, which is problematic. The banking union can only be considered complete if confidence in the safety of bank deposits is equally high across all participating Member States. Keeping depositor protection at the national level maintains the link between a bank and its sovereign, which implies that one of the main objectives of banking union has not been achieved.

Introduction of a common EDIS is therefore a key priority for the ECB. This would not only ensure uniform depositor protection regardless of location, it would also bring benefits in risk diversification and the ability to withstand shocks. Risks would be spread more widely across a larger pool of financial institutions, and individual pay-outs would be less likely to overwhelm the scheme. Putting deposit insurance at the level of the banking union would ensure liability and control are fully aligned, to the benefit of the level playing field and financial stability.

4.1 The design of EDIS

Member States are currently discussing a hybrid model as a compromise for the transition to a fully-fledged EDIS. The fully-fledged model would cover both liquidity needs and losses. The hybrid model would be an option offering only liquidity support to national deposit guarantee schemes as a first step; with this arrangement, the central fund and mandatory lending among national DGSs would complement each other. The ECB believes a fully-fledged model should remain the ultimate goal. A hybrid model could be a compromise for the transitional period and could be supported, but it must be designed to ensure a smooth transition to a fully-fledged EDIS.

The design of EDIS should ensure that it can intervene in a crisis in a timely manner. While the ECB supports the hybrid model during the transition to fully-fledged EDIS, this adds several layers of complexity to implementation and activating the transfer of funds, such as the hierarchy of repayments when funds from the national scheme, the central fund and/or mandatory lending are used. A solution must be found in advance that minimises operational complexities so as to prevent lengthy discussions in a crisis, when it is time to act. This design principle should apply both to the scheme as ultimately envisaged and to any scheme introduced for the transitional period.

The design of the hybrid EDIS should facilitate a strong European component. To mark a bold initial step towards EDIS, the hybrid model should be composed of a large central fund complemented by national compartments. This central fund will

represent a strong European component that will facilitate timely transition to a fully-fledged EDIS. Empirical analysis has shown that there would be no unwarranted systematic cross-subsidisation within EDIS in the sense of some banking systems systematically contributing less than they would benefit from the Deposit Insurance Fund.[14]

EDIS should be supported by a fiscally neutral common public backstop, which would help break the link between banks and sovereigns in individual Member States. A common public backstop would contribute to removing any differences in the level of protection due to the fiscal position of a Member State. Any backstop should respect the principle of fiscal neutrality and be in addition to the resources available via the common backstop to the SRF. This would underpin the credibility and effectiveness of both backstops.

EDIS should be administered by the SRB. It is important and most efficient that EDIS is centrally administered, and that this is done by an independent Union body which is shielded from political influence and will ensure access to the Deposit Insurance Fund on equal terms in the banking union.

4.2 Next steps on deposit insurance

During the transition to fully-fledged EDIS, existing DGSs should be further harmonised. The DGSD leaves several issues as options or discretions for Member States, notably the preventive and alternative measures mentioned above and, for instance, coverage of temporary high deposit balances. These options and discretions (ONDs) could be maintained during a transitional phase in which EDIS provides liquidity support only. However, further harmonisation of the framework is required to ensure a smooth transition to a fully-fledged EDIS. The ECB therefore supports harmonisation of these ONDs at an early stage, with a focus on the most material of them.

Use of irrevocable payment commitments (IPC) to fund safety nets should be reconsidered. Several DGSs, similar to the SRF, offer the option of IPCs, which have to be collateralised. The prudential benefits of these remain very limited, as such funds cannot be used to cover losses on an ongoing basis at the contributing bank and so their only effect, if any, is declaratory. Recognising the contribution as an asset in the bank effectively equates to an ex-post funding scheme, opening new contagion channels. European legislative solutions should therefore not offer such a scheme for deposit insurance and resolution funds.

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[14] See Carmassi J, Dobkowitz S, Evrard J, Parisi L, Silva AF, Wedow M (2018), Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation? *Occasional Paper Series*, No 208, ECB

5 Cross-border market integration

Progress on facilitating cross-border banking within the EU should remain a priority. Ever since the start of the banking union, the ECB has advocated closer financial integration to reap the benefits of a more integrated European banking sector. It has also supported various policy measures to increase and improve the cross-border integration of banking groups and the free flow of capital and liquidity within the banking union. This would help large cross-border banking groups manage their capital and liquidity more efficiently, as they would only need to satisfy regulatory and supervisory requirements at the group level and improve their competitive position against global rivals.

Small-scale amendments to the current framework could encourage use of existing legal possibilities and allow for incremental progress on cross-border integration. Cross-border liquidity waivers are legally possible at present (under Article 8 of the CRR) but not used in practice. One of the main obstacles could be linked to concerns about intra-group use of resources in times of stress. A way of addressing this would be to incentivise banking groups to have governance and/or contractual mechanisms in place that prescribe the circumstances in which group resources would be channelled from the parent to a subsidiary in a timely fashion and well ahead of any potential decision on resolution. These contractual agreements would be under existing national corporate law and law of contract and could be included as options in the banking groups' recovery plans, in a way that would link the provision of support to liquidity recovery indicators. The contractual validity of these arrangements would have to be confirmed by legal opinions. A similar approach should be considered to enable also cross-border capital waivers.

Legislative changes could support the effectiveness of intra-group support agreements. The validity of such agreements and the enforceability of associated guarantees in the whole EU should be secured through amendments to European law. These changes should also protect bank directors from liability under national company law for potential breach of fiduciary duties to shareholders if they authorise financial support to another bank within their group. Finally, modification of the BRRD should be considered to clearly establish that supervisors can enforce support obligations included in a recovery plan by imposing early intervention measures or supervisory measures on the parent to activate support in line with the agreed terms.[15]

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[15] See Enria, A. and Fernandez-Bollo, E (2020) Fostering cross-border integration in the banking union, *The Supervision Blog*, 9 October, ECB.

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