Addendum to the Staff Working Paper Series #3 - The Commission proposal to reform the EU Bank Crisis Management Framework: A selected Analysis

Disclaimer

This staff working paper is for information purposes only and aims to foster debate on some technical aspects of the CMDI proposal. This paper describes research being undertaken by the author(s) on certain technical aspects. It should not be reported as representing the views of the SRB. The views and opinions expressed in this paper are those of the authors and do not necessarily reflect the position of the SRB. The SRB cannot be held liable for the content of this paper and this paper does not represent a statement of official SRB policy, methodology or position on matters addressed therein, nor can this paper be understood as anticipating or pre-empting same.

1. Executive Summary

This study assesses the potential impact of some of the proposed changes to the review of the Crisis Management and Deposit Insurances (CMDI) framework, particularly regarding the use of Deposit Guarantee Scheme (DGS) funds as a "bridge" to the Single Resolution Fund (SRF) for resolving medium-sized and smaller banks. The study also provides a practitioners' view by outlining the cases in which the "DGS bridge" could be useful (see Section 3) and an indicative mock-up resolution weekend process (see Section 6).

The study follows a previous SRB staff working paper[1]. Key assumptions and data are the following:

- Recognising that the financial position of a bank failing or likely to fail (FOLTF) can differ significantly depending on the nature of the crisis it faces, the study assumes the severe but realistic depletion of capital buffers (with remaining own funds equivalent to pillar 1 and pillar 2 requirements).
- Only a subset of conditions for the use of the "DGS bridge" are assessed in this study, that is, those conditions that can be credibly assessed ex-ante. Many conditions are not covered given their nature (e.g., qualitative, or FOLTF-dependent conditions). These additional conditions are likely to exclude further banks from the use of the "DGS bridge" and to raise challenges that are not assessed in this study.
- Contrary to the previous SRB working paper, this study does not assume any changes to the Public Interest Assessment (PIA); therefore, it assumes that the current PIA is maintained for the banks assessed.
- The study does not focus on other parts of the framework that are relevant for the funding of resolution, such as the calibration and eligibility of MREL and bail-inable instruments, that is, current BRRD2/SRMR2 provisions on MREL are assumed to remain unchanged for the purpose of this study.
- The study used end-2023 data covering 201 credit institutions domiciled in the Banking Union.

Based on the above assumptions, the assessment shows that:

- Certain banks currently earmarked for resolution (including both banks under SRB remit and LSIs) would require the bail-in of uninsured deposits in order to reach the 8% TLOF threshold.
- While the changes to the LCT have the potential to make the DGS bridge available for most of the banks concerned, the additional conditions proposed in the Council text limit the availability of the DGS bridge to a few.
- This impact is likely to be exacerbated by those conditions that cannot be assessed ex-ante, ultimately making the use of the DGS bridge unrealistic.

[1] Please see SRB Staff Working Paper #3 for the full analysis and main methodological assumptions.

2. Introduction

The EU bank Crisis Management and Deposit Insurance (CMDI) framework review consists of a comprehensive set of measures designed to strengthen the existing EU crisis management toolkit, which the Single Resolution Board (SRB) and Mechanism (SRM) implement for the Banking Union through their day-to-day work on resolution planning and crisis preparedness.

The CMDI review aims to improve the ability to resolve medium-sized and smaller banks[2], among other topics. More specifically, the Eurogroup statement on the future of the Banking Union of 16 June 2022 agreed that the review would underpin the CMDI framework by delivering these four components: "*(i) A clarified and harmonised public interest assessment (ii) a broader application of resolution tools in crisis management at European and national level, including for smaller and medium-sized banks, where the funding needed for effective use of resolution tools is available, notably through MREL and industry-funded safety nets (iii) Further harmonisation of the use of national deposit guarantee funds in crisis management, while ensuring appropriate flexibility for facilitating market exit of failing banks in a manner that preserves the value of the bank's assets. A harmonised Least-Cost Test (LCT), administered by national authorities, to govern the use of Deposit Guarantee Schemes (DGS) funds outside pay-out to covered depositors, to ensure consistent, credible and predictable outcomes (iv) Harmonisation of targeted features of national bank insolvency laws to ensure consistency with the principles of the European CMDI framework."*

In autumn 2023, the SRB assessed the impact of the CMDI proposals tabled by the European Commission. The results showed that the changes proposed by the Commission have the potential to make a difference for a number of smaller and medium-sized banks. At the same time, the impact on the Single Resolution Fund (SRF) and on national Deposit Guarantee Schemes (DGS), both in resolution and insolvency, appeared relatively minor compared to the available financial means.

The analysis presented in this note provides some updates to the said previous SRB study, also in response to some recent requests by stakeholders[3]. It does so by further explaining some of the assumptions of the 2023 study, and by **testing the impact of the main changes proposed by the co-legislators** (i.e., European Parliament and Council) particularly **in relation to the creditor hierarchy, LCT and conditions to use DGS funds** to support a resolution of smaller and medium-size banks. This note does not review the proposed changes related to the Public Interest Assessment (PIA) as done in the previous study, and it does not focus on other parts of the framework which are relevant for the funding of resolution, such as the calibration and eligibility of MREL and bail-inable instruments (i.e., current BRRD2/SRMR2 provisions dealing with these subjects are assumed to remain unchanged for the purpose of this study). *Therefore, this note assumes that the current PIA is kept for the banks analysed (and whether their preferred resolution strategy is resolution or liquidation).*

Structure

Section Three of the study outlines some of the alternative scenarios that may arise when handling the failure of smaller and medium-sized banks. Section Four provides an overview of the deposit books' breakdown of the credit institutions reviewed in the analysis. Section Five assesses the impact of the main changes by the

[2] When proposing the CMDI review, the European Commission notes that "*experience with implementing the CMDI framework has revealed difficulties in managing the failure of smaller/medium-sized banks, in particular, where there is an implied allocation of losses to depositors, which could affect depositors' confidence and financial stability. The result has been a reluctance to implement the CMDI framework as intended and often a recourse to public funding in managing failures in the banks concerned*".

[3] Inter alia, EGOV briefing PE 764.172 (December 2024) page 8.

co-legislators on the availability of funding (from DGS) to facilitate resolution of smaller and medium-sized banks. Section Six lays down the indicative steps of a mock resolution weekend (with the use of the DGS bridge), assuming the co-legislators’ texts as a baseline, to illustrate the complexity of the processes involved to execute a successful resolution sale. Finally, section Seven draws some conclusions.

3. Options to handle the failure of medium-sized banks in the scope

In this section, we take a look at some of the different ways in which the SRB could handle, through a resolution sale, the failure of a mid-size or smaller bank and how that could be financed, so as to better understand the trade-offs that the CMDI review tries to address. For illustrative purposes, we outline four scenarios to show the different paths a resolution might take based on the bank's financial health and available resources at the point of resolution:

1. The bank has sufficient bail-inable liabilities for the resolution:

In this situation when the bank is deemed to be Failing or Likely to Fail (FOLTF), it carries enough own funds and bonds to absorb losses and achieve the necessary recapitalisation and/or support the sale to an acquirer. In this case, the resolution is executed by leveraging the bank's own financial buffers. This scenario does not trigger questions around the impact of the bail-in of uninsured deposits or use of industry-funded safety nets.

It should be noted that in resolution planning the SRB and NRAs do not assume the use of a DGS nor the SRF. Rather, plans for banks earmarked for resolution set an MREL target to support the resolution strategy, along with the other resolvability conditions (structural, operational, liquidity etc.).

2. The bank has adequate bail-inable liabilities other than uninsured deposits to access SRF (i.e., 8% TLOF):

For the SRF to provide solvency support, the bank's creditors have to absorb a high level of losses and recapitalisation: 8% of Total Liabilities and Own Funds (TLOF). In this scenario, the failing bank has sufficient bail-inable liabilities other than uninsured deposits to reach the 8% TLOF threshold. This enables the SRF to support the execution of a resolution sale of the ailing bank.

According to Article 12c (4) SRMR, Pillar 1 banks (namely resolution entities of G-SIIs, top tier banks and other banks selected by the resolution authorities) are required to hold an MREL subordination level equal to 8% TLOF, which may be increased or decreased by the resolution authority under certain conditions, subject to a cap and a floor. In addition, and for all banks, a requirement equal to 8% TLOF or more may be ensured through calibration rules to set the total MREL (including a non-subordinated part)[4]. This means that not all entities have an MREL requirement set at 8% TLOF, and such requirement can at any rate be met with equity (which could face significant depletion in the run-up to a FOLTF). Therefore, depending on the business model and funding composition[5], there may be entities that significantly rely on own funds to meet their MREL requirement and, in some exceptional cases, also on uninsured deposits[6], which are bail-inable (and this structural element is unchanged in either Commission, Council, or European Parliament texts). This takes us to the next scenario.

3. The bank sale requires the use of DGS funds (to a level lower than 8% TLOF) but not the DGS bridge to SRF:

Beyond the two scenarios above, there may be instances where the bail-inable liabilities of the bank are insufficient to support its resolution without a need to bail in some uninsured depositors. In some cases, the SRB may find that bailing in certain types of uninsured deposits is viable and does not trigger risks. However,

[4] According to Article 12d (3) resolution authorities can take into account the 8% TLOF requirement to set the total MREL- there is discretion.

[5] As found by a number of policy and empirical studies, a large number of smaller banks in Europe are listed on the markets, nor have they ever issued convertible instruments or financed themselves with subordinated debt. See for example: https://www.bis.org/speeches/sp210511.htm#:~:text=That%20might%20be%20achieved%20by,resolution%20plan%20based%20on%20SoB

[6] Non-covered non-preferred deposits may count towards MREL if they have a maturity of at least one year (and meet all other applicable MREL criteria)

in other ones, the SRB may conclude that imposing losses on these uninsured deposits may create significant contagion concerns and wider financial stability issues: in these instances, the legislation foresees that it may decide to exclude uninsured deposits from the bail-in tool.

As briefly explained above, this can occur for banks that have uninsured deposits as part of their bail-inable stack, due to their funding structure and limited capacity to tap capital markets. This can also occur, or be exacerbated, due to a strong depletion of the bank's equity in the run-up to FOLTF. That is, even banks with an MREL target above 8% TLOF, if they rely significantly on equity to meet the target, may have their equity depleted before FOLTF, and so uninsured deposits could end up in the stack that is counted to reach the 8% TLOF.

For such cases, where excluding uninsured deposits from bail-in is assessed to be necessary, the CMDI framework allows the use of DGS funds in lieu of the (excluded) deposits[7], to support the resolution sale. This can be done up to the amount necessary to finance the sale to an acquirer. If the total amount[8] were to be lower than 8% TLOF, the SRF would not be able to intervene, and is not needed in this case. Nevertheless, the feasibility of this solution would be subject to the availability of DGS funds, which depends on the outcome of the least cost test (LCT).

4. The sale of the bank requires the use of "DGS bridge" to the SRF:

A fourth scenario materialises when the resolution of a failing bank requires support above 8% TLOF to be successful, and therefore the use of the DGS funds as well as the use of the SRF: i.e., the "DGS bridge" and then the SRF. In these instances, the CMDI review allows authorities to use DGS funds in lieu of bailing in uninsured deposits or other bail-inable liabilities to reach this 8% TLOF threshold, thereby enabling the SRF solvency support. This is the so-called "DGS bridge".

This is a residual scenario, as it requires to have losses and recapitalisation needs higher than 8% TLOF, that the bank's easily bail-inable resources fall short of this, and that and the exclusion of the deposits[9] is assessed necessary. While residual, this scenario is possible given the various factors explained above: i.e., banks with uninsured deposits in the bail-inable stack, equity depletion before FOLTF in banks with a limited stock of debt instruments, threats to financial stability, etc. Section 4 of this note focuses on this scenario.

[7] And other liabilities with the same or higher priority.

[8] I.e., total write-down, conversion and DGS support.

[9] Bail-inable deposits and other liabilities, to be precise.

4. Credit institutions[10] assessed and their deposits

Our analysis starts from the sample banks used in the SRB Staff Working Paper of December 2023[11]. This brings into focus banks which might require the bail-in of uninsured deposits to reach the 8% TLOF threshold, assuming **a balance sheet at the point of failure where Pillar 2 Guidance (P2G) and capital buffers have been depleted**, with remaining own funds equivalent to the Pillar 1 Requirement (P1R) and Pillar 2 Requirement (P2R).

An update of the underlying data, which takes into account end-2023 data, finds that within the 201 reviewed credit institutions there would a subset of **34 banks that, due to their funding and balance sheet structure, would need the bail-in of uninsured deposits to reach 8% TLOF**[12], after assuming the depletion of capital buffers in the run-up to FOLTF, as mentioned above. These are the **22 LSIs + 12 SRB banks earmarked for resolution**, "RES", in Table 1, across 16 Member States. This group of banks does not include entities for which the preferred strategy in case of failure is, presently, liquidation under Normal Insolvency Proceedings (NIPs).

Table 1. Credit institutions in the scope of sample of the study[13]

Type of credit institution	LSI		SRB		Total banks	Ofw: total resolution banks
	LIQ	RES	LIQ	RES		
Number of entities in the sample	58	**52**	8	**83**	**201**	**135**
Ofw: may need funding without bailing in uninsured deposits	24	22	2	12	**60**	**34**

Table 2 provides the composition of deposits by type of holder for all the credit institutions which may need funding without bailing in uninsured deposits. These banks rely significantly on deposits for their funding (77% of TLOF on average), and in particular on non-covered retail deposits (these "preferred deposits" are held by households and SMEs but are the part over the 100,000 EUR amount covered by the DGS).

Table 2. Share of total deposits by holder[14]

Type of credit institution	LSI		SRB		Total
	LIQ	RES	LIQ	RES	
Number of entities in the sample which may need funding without bailing in uninsured deposits	24	**22**	2	**12**	**60**
% Total deposits/ TLOF	79%	**74%**	77%	**77%**	**77%**
% Of covered deposits/Total deposits (non-bail-inable)[15]	48%	**58%**	49%	**66%**	**55%**
% Of preferred deposits held by HH and SMEs /Total deposits [16]	27%	**17%**	28%	**24%**	**22%**
% Of other deposits (non-covered non preferred) / Total deposits [17]	25%	**25%**	23%	**10%**	**22%**

Regarding the status of deposits under CMDI, the use of DGS comes into play where resolution authorities find it necessary to exclude deposits from the bail-in tool "*to avoid a wide-spread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium enterprise (SMEs*)"[18].

As elaborated in detail in Annex 8 of the European Commission's impact assessment[19] (I.A.) accompanying the CMDI proposal, the liability structure of banks shows substantial differences across the European banking sector. In this regard, the Commission I.A. notes that recent experiences with bailing in certain liabilities such as uncovered deposits could entail a risk of depositor runs, thereby putting overall financial stability at risk, even where depositor protection is in place. The I.A. mentions that during and after the global financial crisis, Cyprus, Greece and Iceland adopted several types of administrative measures to stop financial instability and contagion, and in Italy precautionary measures were required to maintain depositor confidence. Conversely, the I.A. reports on the resolution of a small Danish bank in 2016 in which uncovered depositors were bailed in, which apparently did not influence depositor confidence. Likewise, in certain recent cases in the US, the FDIC has shielded all deposits from losses to protect financial stability. The solution provided by the CMDI proposal for cases where resolution authorities find it necessary to exclude deposits from bail-in is to use the DGS to finance the sale of the ailing bank, up to a level set by the national designated authority calculating the LCT and only up to 8% TLOF (after which the SRF can step in)[20].

[10] In this note, the terms "credit institution" and "banks" are used interchangeably.

[11] https://www.srb.europa.eu/system/files/media/document/2023-12-15_Working-paper-series-3-CMDI_December-2023_0.pdf. For more information on this and other working assumptions, please refer to the methodological chapter and sample chapter (chapters number 3 and number 4) in this publication.

[12] In order to carry out the analysis and reach this number, a number of assumptions are applied: (i) Reduction of capital to minimum capital requirements (capital buffers depleted), (ii) For later parts of the study an 85% recovery rate for assets is considered (same as in the EBA study and Commission Impact Assessment); (iii) General depositor preference, i.e. all deposits rank above senior preferred liabilities in insolvency; (iv) All deposits are excluded from bail-in , in order to assess the maximum funding gap; (v) reference date for the balance sheet information as 31/12/2023 (vi) all banks in the sample reviewed are considered, irrespective of their preferred resolution strategy.

[13] Deposit data are identified based on resolution reporting, namely based on Liability Data Reporting (LDR), with deposit reported in fields T01.00. As the identification of deposits is based on resolution reporting, this implies that not all deposits (in particular deposits that are currently subordinated to ordinary unsecured liabilities) as defined by DGSD are included.

[14] Deposit data are identified based on resolution reporting, namely based on Liability Data Reporting (LDR), with deposit reported in fields T01.00. As the identification of deposits is based on resolution reporting, this implies that not all deposits (in particular deposits that are currently subordinated to ordinary unsecured liabilities) as defined by DGSD are included.

[15] I.e., Those deposits that are eligible for protection by a DGS, namely deposits held by Households, Micro & SMEs and corporates < €100k based on the LDR template. For more information on the template taxonomy, please refer to https://www.srb.europa.eu/en/content/2019-ldr-excel-template-update.

[16] Deposits of > €100k held by Households and Micro & SMEs.

[17] Deposits of corporates > €100k, deposits of public authorities and non DGS-eligible deposits (deposits by 'credit institutions' and 'other financial corporations' as per LDR).

[18] I.e., in situation where "the exclusion is strictly necessary to avoid a wide-spread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium enterprise (SMEs)".

[19] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52023SC0225

[20] To note, the success of such a transfer strategy ultimately depends on the ability to attract a suitable buyer. This in turn is affected by the state of the balance sheet of the bank under resolution and its franchise value. In that sense, bailing-in (a part of) the bank's deposits' book could erode the banks' core franchise value, and might have negative effects on the assets side of the bank in instances where depositors are, at the same time, debtors of the ailing bank.

5. Impact of European Parliament and Council CMDI texts on the availability of DGS funds in resolution[21]

This Section explores the impact of some of the EP and the Council changes to the creditor hierarchy and LCT criteria on the 34 banks in the sample that meet certain conditions: small/medium banks, with positive PIA, for which the bail-in of certain deposits would be required to reach 8% TLOF, assuming the prior depletion of P2G and buffers as explained in previous sections. The purpose is to analyse if the changes allow the positive LCT to be met in order to enable the use of the "DGS bridge".

Table 3. Impact of LCT and other EP and Council amendments on a sample of SRB banks earmarked for resolution

	Type of credit institution	LSIs	SIs	Total
A.	Number of entities in the sample	52	83	**135**
B.	ofw: theoretically need funding without bailing in deposits	22	12	**34**
C.	ofw: positive LCT with a single tier deposit system as proposed by EC	17	12	**29**
D.	ofw: positive LCT with a two-tier deposit system as proposed by the EP, including indirect costs, assuming hypothetical losses to non-covered deposits in the LCT[22]	19	12	**31**
E.	ofw: positive LCT with a four-tier deposit system, inclusion of indirect costs and 85% LCT scalar as in the Council's approach (without considering conditions for DGS bridge access)	21	12	**33**
F.	Ofw: positive LCT with a four-tier deposit system, inclusion of indirect costs and 85% LCT scalar as in from the Council's approach AND meeting cumulatively some conditions for DGS bridge to SRF (cf. next section and table 4) for banks > 30 bn EUR	**N/A**[23]	**3**	**N/A**
G.	Ofw: positive LCT with a four-tier deposit system and 85% LCT scalar as proposed by the Council AND meeting cumulatively some conditions for DGS bridge to SRF (cf. next section and table 4) for banks < 30 bn EUR	**13**	**1**	**14**

Methodological note: *estimates performed assuming that the LCT are carried out taking into account the criteria set out in the amendments put forward in DGSD Art.11e. The credit institutions with a "positive LCT" are those that would be able to use the DGS as a bridge to the SRF based on the outcome of the LCT. Cfr. more details in Annex 1 regarding the assumptions used for the calculations.*

[21] Based on the legislative packages proposed by the European Commission in April 2023, the position agreed by the European Parliament in April 2024 and by the Council of the EU in June 2024. These steps pave the way to interinstitutional negotiations in view of reaching an agreement on the final shape of the legislation. Once an agreement is reached, the revised CMDI framework would have to be formally adopted before becoming law.

[22] As a proxy for indirect costs, in both the scenarios under EP and Council, the LCT has been modified by adding indirect costs corresponding to the amount of non-covered deposits which would be excluded from bearing losses under the two-tier scenario. Annex I for more details.

[23] These results are not applicable (N/A) given that the conditions applied jointly, as per some rows in Table 4 row 6 are applicable only for SIs. Cfr. more details in Table 4 and the related explanatory paragraphs.

Table 3 shows the availability of the "DGS bridge" in resolution depending on the combination of two main criteria: the number and thickness of the deposit layers in the creditor hierarchy and the criteria applicable to the LCT. Based on the EC proposal, 29 out of the 34 banks would have a positive LCT, potentially enabling the use of DGS funds in lieu of bailing in deposits (where duly justified) to reach the 8% TLOF threshold to access the SRF. Without incorporating indirect costs, as co-legislators split deposits in more tiers, this reduces the number of banks for which the LCT is positive and the DGS can be used.

However, if the LCT modification by the EP were to be interpreted, for instance, with LCT indirect costs corresponding to the amount of non-covered deposits, the DGS bridge could be available for up to 31 banks. Such an LCT modification remains subject to the specification of the calculation of the LCT through an EBA RTS, with the calculation to be performed by DGSs; therefore, it is clear that this figure is purely indicative of one of the potential outcomes of the negotiations.

Turning to the Council text, the **high number of banks with positive LCT (33 banks) is led by the inclusion of indirect costs, as well as to changes to LCT related to the 85% multiplier for recovery rates** ("scalar").

However, the Council text then introduces a number of conditions to be met for using the DGS as a bridge to the SRF, which reduce the number of banks for which it could be used. For instance, **assessing cumulatively four Council conditions applicable to banks above € 30 bn leads to a reduction of the DGS bridge significantly** (cfr. Table 3.F and Table 5 for more details). Before turning to the quantitative assessment of some conditions, hereafter is an overview of all the conditions introduced by the Council which could exclude banks from the use of the DGS bridge.

Box 1. List of conditions introduced by the Council for the use of the DGS bridge to the SRF (Articles 79 and 18 SRMR and 109 BRRD)

DGS bridge available only in the following conditions:

- Prior bail-in of MREL (with maximum share of 2.5% discretionary exclusions) (Art 109(2b)(a) BRRD)
- Winding up of the residual institution and termination of bridge bank's operations as soon as possible (Art 109(2b)(b) BRRD)
- No MREL breach during the eight to 36 months preceding the FOLTF declaration (Art 79 1a.b. ii SRMR)
- DGS cannot contribute for more than 62.5% of their target level; the cap can be lifted by the DGS designated authority -after consulting the macro-prudential authority in systemic crisis or to allow DGS to contribute after 5% (Art 79.2 SRMR)
- No DGS bridge to SRF for liquidation entities earmarked as such in the two years preceding FOLTF (Article 109(2b), 3rd subparagraph, (i) BRRD)
- No DGS bridge to SRF for entities under transitional MREL period, can be lifted in very extraordinary situation of systemic crisis (Article 109(2b), 3rd subparagraph, (ii) BRRD)

- Compulsory reimbursement claim on variable remuneration or discretionary pension paid to managers in last 2 years in case of DGS or RF (bail-in) intervention (Article 109(3) BRRD) [24]

For banks below EUR 30bn, the following restrictions apply:

- 2.5% TLOF cap on DGS contributions (Art 79 1a.a SRMR)
- 6.5% TLOF minimum contribution of shareholders and creditors in the year preceding FOLTF (Art 79. 1a.b.i SRMR)

For banks above EUR 30bn DGS bridge not possible except only where all of the following conditions are met:

- In exceptional circumstances and only for 10 years (i.e., sunset clause with COM review possible) (Art 79.1b SRMR)
- If needed to preserve financial stability and avoid significant adverse effects on the financial system (Art 79.1b SRMR)
- Bank is below EUR 80 bn assets (Art 79.1b. 1st subpara SRMR)
- Bank has deposits exceeding 65% TLOF (Art 79.1b. 2nd subpara SRMR)
- MREL capacity of at least 8% TLOF the year preceding FOLTF (Art 79.1b.3rd subpara SRMR)
- 1.25% TLOF cap on DGS contributions (Art 79.1b.a SRMR)
- 8% TLOF minimum contributions of shareholders and creditors in the year preceding FOLF – (Art 79.1b.b.i SRMR)
- Five out of six full-time Board members to approve (Art 79.1b SRMR)
- NRA and SRB to report to Commission and Council on the reasons for the use of DGS bridge (and why it could not be avoided with planning) within three months (Art 79.1b SRMR)
- Council approval of scheme with DGS bridge (Art. 18.7.3rd subpara SRMR)
- DGS bridge not available if SRF contribution over a three-year period exceeds 17,5% of its target level; COM to review application of the DGS bridge for banks between EUR 30 bn-80 bn and its further use (Art 79.3a SRMR)

Among the conditions listed in Box 1, this study reviews those that can be assessed ex ante, due to their quantitative nature and more static reference to the banks' balance sheet. Table 4 below shows the individual impact of each of the five conditions that have been reviewed (cf. points 1 to 5) as well as their cumulative impact for the conditions applicable to banks above € 30bn (cf. point 6) and for banks below € 30bn (cf. point 7). Among the ones assessed, the most impactful criteria appear to be the caps on DGS contribution to 2.5%, which applies to smaller banks.

[24] NB: this condition applies to all uses of the DGS in resolution and not only to the "DGS bridge".

Table 4. Assessment of impact of some of the Council conditions for DGS bridge (follow-up from previous table)

Type of resolution entity	LSIs	SIs	Total
Number of credit institutions with positive LCT with a four-tier deposit system, indirect costs, and 85% LCT scalar as proxied from the Council's approach, without further restrictions to use of DGS	**21**	**12**	**33**
Number of credit institutions potentially still eligible for the use of DGS as a bridge due to the following conditions*:*			
1. **Banks < 30 bn TA**: Gap to 8 % < 2.5 % TLOF	13/21[25]	3/3	16/24
2. **Banks >30 bn:** Gap to 8 % < 1.25 % TLOF	NA	6/9	6/9
3. Banks >30 bn: > 65% deposits/TLOF	NA	9/9	9/9
4. Banks >30 bn: < 80 bn TA	NA	5/12	5/33
5. For all banks: DGS contribution capped at 62.5% of DGS AFM	20/21	8/12	28/33
6. Banks >30 bn: Conditions 2,3,4,5 applied jointly	NA	3/9	NA
7. Banks <30 bn: Conditions 1,5 applied jointly	13/21	1/3	14/24

Methodological note: *each condition is tested individually in rows 1 to 5; while SRMR Article 79 of the Council text requires all conditions to be met in order to enable the counting of DGS towards 8% (hence row 6 and row 7 are added).*

As noted previously, Table 4 summarises only the impact of those restrictions to the use of the DGS bridge that may be measured *ex ante*. Yet in reality **this impact may be significantly more pronounced owing to the rest of the Council's text conditions which are all to be met simultaneously to enable the use of the DGS bridge**.

As examples to illustrate this, this study cannot assess the two conditions that require 6.5% TLOF burden-sharing (for banks below € 30bn) and 8% TLOF (for banks above €30bn and below €80bn) after accounting for losses in the previous 12 months. Another condition that cannot be assessed ex-ante, and yet increases the uncertainty on whether the DGS bridge can be used or not, is the need to seek Council approval. As further examples, there are also restrictions for banks under MREL transitional periods and for banks above €30bn that did not have an MREL capacity of at least 8% TLOF the year preceding FOLTF. The latter is a condition that cannot be assessed ex-ante (as it takes FOLTF as reference point) and, as explained in Section 3 scenario 2, holding MREL capacity of 8% TLOF is not a statutory requirement for Banking Union banks.

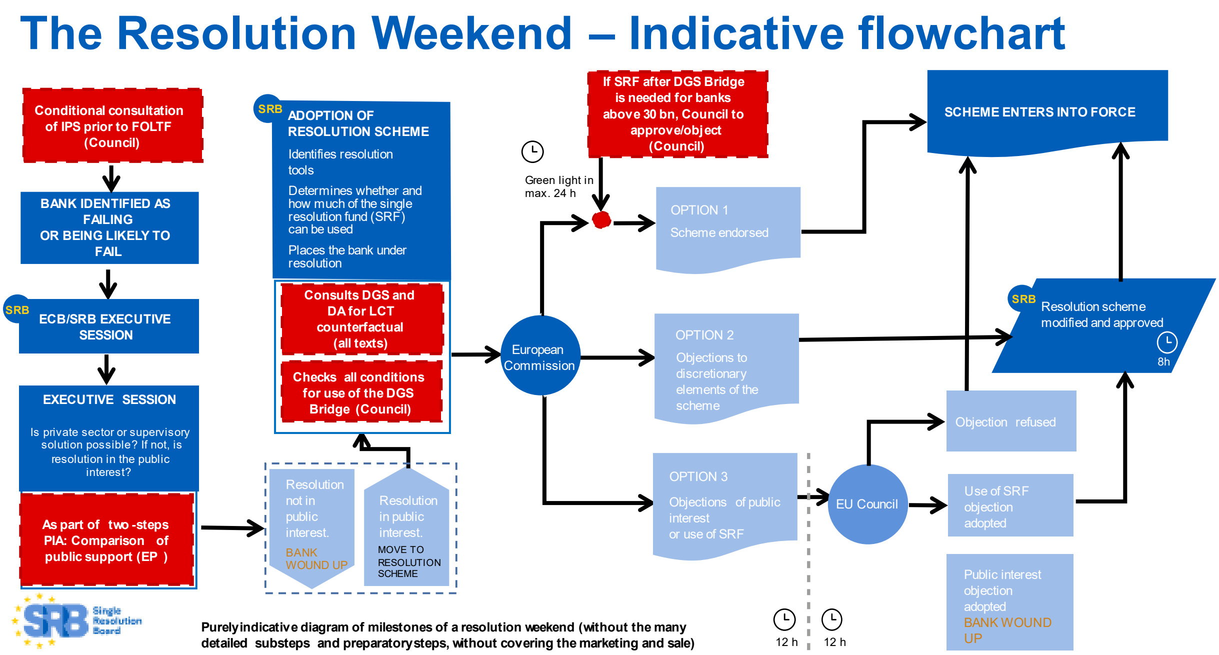
[25] Explainer: 13/21 referred to here means that, in this instance, 13 out of the 21 LSIs that have a balance sheet size below 30bn EUR remain eligible for the bridge after the condition of 2.5% TLOF maximum DGS contribution has been factored in.

Therefore, while the impact of all conditions in Box 1 cannot be assessed ex-ante, as other conditions than those assessed in this study can exclude ailing banks from the use of the bridge in certain scenarios. Moreover, even if the SRB were able to assess compliance with all conditions during the resolution weekend, such an extensive conditionality would make the resolution decision more exposed and vulnerable to litigation risk, particularly for those conditions that cannot be assessed ex-ante.

6. Mock-up resolution weekend timeline

In residual cases where a bank could still be sold during resolution with support from DGS financing instead of bailing in deposits, this process would ideally take place when markets are closed, such as over the weekend, or overnight during the week as in the resolution of Banco Popular Español. Therefore, the speed of procedures during the resolution weekend or at the point of FOLF is critical. Table 5 presents a schematic flowchart illustrating a resolution week-end, incorporating additions introduced by the co-legislators' texts (highlighted in red boxes), while the remaining elements represent the current framework.

Table 5. Schematic flowchart of a resolution week-end (with co-legislators' additional steps in red)



The diagram outlines only the milestones in the decision-making, without reflecting all the preparatory steps, the coordination among various teams and authorities – particularly crucial when the bank operates in multiple countries - and the process required for a sale. During this 48-hour period (which may be shorter if it occurs mid-week, or longer if a moratorium is applied) resolution authorities will work intensively to secure the sale of the ailing bank to a purchaser; with the terms of the sale shaped also by inputs of third parties, such as the valuer and the DGS for the LCT counterfactual and, most importantly, the bids received during the marketing process.

To provide an indicative overview of some of the procedural steps required over the weekend, the following will be necessary, among others:

- FOLFT assessment;
- PIA assessment;
- Valuation 1, to determine whether conditions for resolution or write-down or conversion of capital instruments are met;

- Valuation 2, to inform the choice of resolution action to be adopted, and the commercial terms in a sale of business;
- the DGS calculation of LCT counterfactual, to establish a cap on the potential DGS contribution;
- considerations and exchanges on the possible use of the SRF;
- verification of requirements for deploying the DGS bridge;
- execution of the competitive bidding process.

All these steps must be completed before the resolution scheme is adopted. Following adoption, additional processes will take place such as Commission endorsement, potential Council consultation (newly introduced), and actions outlined in the flowchart. These processes involve multiple organisations, including the SRB and relevant NRA(s), the ECB and/or NCA(s) (as supervisors), possibly the external valuer, bidding banks, the DGS and its designated authority, and the European Commission.

Clearly, while some of these processes can run in parallel (and indeed they certainly do at the working level), the formal decision-making process (e.g., by the SRB Executive Session) follows a sequence. This sequence requires the completion of certain steps before subsequent ones can proceed, as illustrated in the flowchart.

In this context, the new steps introduced by co-legislators naturally add additional processes (and related time requirements) and, in some case, uncertainty to existing resolution weekend procedures. For example:

- While conditional, the requirement for IPS consultation before FOLTF formalises interactions that would already occur with the concerned credit institution. This would require more time and potentially increases the confidentiality risk inherent in more formal consultations;
- The requirement (maintained in the EP text) for the SRB to compare, as part of the PIA, extraordinary public support that could be granted to the institution in resolution versus insolvency necessitates time and a non-trivial consideration by the SRB on a domain (i.e., requests of extraordinary public support) that falls outside its mandate;
- The consultation of the DGS/Designated Authority (existing in all Commission/EP/Council texts) on the LCT counterfactual (which caps the DGS contribution), depends on a finalised Valuation 2. While DGS/Designated Authorities are requested to reply "without delay, the feasibility of a swift response is uncertain. This introduces significant uncertainty into the ongoing marketing process, as the availability and extent of DGS support would remain conditional on this consultation.
- The number of conditions introduced by Council[26] adds additional operational challenges for resolution authorities as well as all the other authorities (e.g., DGS, designated authorities, competent authorities, Commission, Council etc.) to execute a resolution sale in the "weekend". While some of the conditions can be easily checked in advance or at FOLTF (e.g., the ones relating to the absolute size in terms of assets or percentage of deposits), others require real-time evaluations at the point of FOLTF (e.g., the ones on historical losses, the caps to DGS contribution) or retroactive assessments on information that is not available based on existing MREL and reporting requirement (e.g., whether or not MREL stood at 8% TLOF the year before FOLTF). Moreover, some conditions – such as the Council consultation - introduce a particular degree of uncertainty, complicating the marketing and bidding process for all parties involved.

[26] The EP introduces one restriction to banks that have breached their intermediate or final MREL target in 4 non-consecutive quarters within 4 years ending 6 months prior to the FOLF determination (excluding the two consecutive quarters immediately preceding FOLF). This condition can be checked by the Resolution Authority in a relatively fast manner given there is a requirement to notify RAs of MREL breaches.

7. Conclusions

This paper provides an assessment of the expected impact of the application of some core elements from the EP and Council proposed texts on the CMDI review, in particular the issue of DGS funding for resolution. A previous study, released by the SRB in 2023, focused on the Commission's initial proposal to broaden the scope of the PIA. Elements related to other components of the resolution framework (e.g., MREL) are not in the scope of this assessment (current BRRD2 provisions are assumed to remain unchanged).

The study first outlines the different ways in which resolution authorities could handle the resolution sale of mid-sized and smaller banks and how that could be financed. The study recalls that the SRB resolution plans do not count on any external support (from DGS/SRF). Therefore, **the scenario of the use of DGS as a bridge to the SRF is residual for tail cases, i.e., where losses exceed 8% TLOF, own funds and eligible liabilities fall short (due to the funding structure for those banks that do not have 8% TLOF at FOLTF, and/or due to equity depletion effects). Yet, despite being residual, this is a possible case.**

The analysis then tests the impact of the main changes proposed by the co-legislators on the creditor hierarchy, LCT, and conditions to use DGS funds as "bridge" to the SRF. The study finds that both Council's and Parliament's changes to the Commission proposal would reduce the number of banks for which the use of DGS would be a realistic option.

The assessment confirms that **the number of banks with positive LCT is impacted negatively by the introduction of two or more tiers in the depositors' layer of the creditor hierarchy. This impact is then counterbalanced by the LCT modifications** introduced by the Council - through the so-called 85% scalar and inclusion of indirect costs - and depending on the future implementation, also by the LCT modifications introduced by the EP with the consideration for indirect costs.

The study then shows the impact of some of the conditions introduced by the Council for the use of the DGS bridge to the SRF (selected as the ones that can be credibly assessed ex-ante). Using end-2023 data, all the **conditions tested in the study lead to a reduction of the number of banks for which the DGS bridge would be available**, with some of them having a particularly acute impact. Those conditions are only a portion of the roughly 20 conditions introduced by the Council. **The other conditions, while not tested in this study, have the potential to exclude the ailing bank from the use of the DGS bridge**. And even in cases where the authorities were able to check compliance with all the conditions, such conditionality is expected to make the resolution scheme more exposed and vulnerable to litigation, particularly for those conditions that cannot be assessed "easily" or ex-ante, that rely on data currently not provided to the SRB, or that rely on external consultations. **It follows that these changes reduce the number of options available to fund the sale of a bank in resolution. For such cases, authorities could be tilted towards the use of DGS to finance a sale outside resolution, through national preventive/alternative measures and through liquidation, potentially involving State aid in liquidation** (i.e., to finance the sale for the gap left by the DGS bridge) and a lower contribution by creditors than in resolution, increasing the scope for moral hazard.

Finally, the study displays how the new different steps introduced by legislators add further complex process and, in some cases, uncertainty to the steps that are due to be performed during the "resolution weekend" in order to execute a successful resolution sale.

Annex

Annex 1. Working assumptions for creditors hierarchy (CH) and least cost test (LCT) calculations

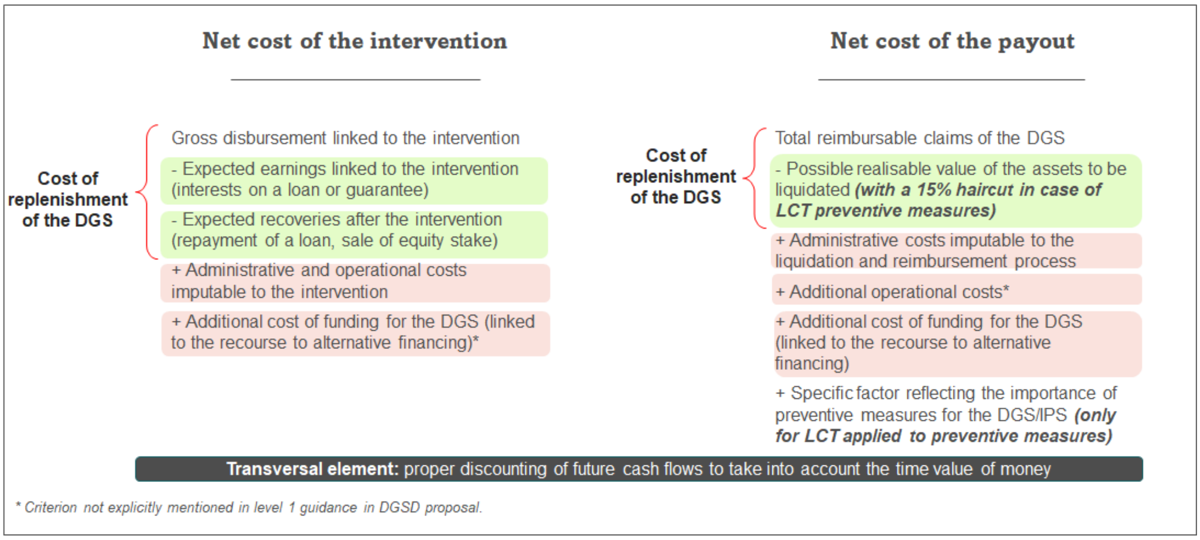
Commission CMDI proposal LCT and creditors' hierarchy (CH)

Creditors' hierarchy (CH): Under the Commission CMDI review proposal the CH provides for a **'single-tier'** for the ranking of deposits**:**

- **Single deposit tier:** all deposits eligible and non-eligible under DGSD (covered deposits, DGS claims, preferred non-covered deposits, non-preferred non-covered deposits irrespective of eligibility for coverage).
- **Other unsecured claims** (general depositor preference) absorbing losses towards 8% TLOF for the purpose of our study.
- All deposits in the single tier are excluded from losses for the purpose of our study.

LCT: Under the Commission CMDI review proposal, the LCT equation is foreseen as follows:

Figure A.1. LCT equation as per Commission proposal



- Left side - DGS net cost of intervention in resolution/preventive/alternative measures in insolvency. It is calculated starting from:
  - the gross disbursement from the DGS for the intervention
  - minus/netted off by expected recoveries after the intervention and expected earnings such as interest (assumed zero for our simulations);

- plus other admin, operational and cost of funding costs are to be added (assumed zero in our simulations).

- Right side - DGS net cost of payout in an insolvency counterfactual. Calculated as:
  - total gross amount of payout by DGS in insolvency
  - minus/ netted off by recoveries in insolvency pertaining to the DGS as per its rank in the hierarchy of claims (assume 85% recovery rate on all assets). For preventive measures only, an 85% scaling factor introduced (multiply recoveries by 85%), not relevant for the simulations which are focused on DGS intervention in resolution (not preventive).
  - plus other admin, operational and cost of funding costs (assumed zero in our simulations)

CH and LCT modifications by EP and Council and our working assumptions

The EP and Council modify the creditors' hierarchy (CH) and LCT as follows:

Table A.1. EP and Council modifications to the CH

Topic	EP compromise text	Council compromise text
CH	A 2-tier ranking of deposits is provided as follows: • **Top deposits tier:** covered deposits, DGS claims, and eligible non-covered deposits that are not in the lower tier (households, SMEs, and possibly public authorities that are not central and regional governments). • **Junior deposits tier:** non-DGS eligible deposits, eligible non-covered deposits from large corporates, and eligible non-covered deposits of central and regional governments. • Other unsecured claims (general depositor preference)	A 4-tier ranking of deposits is provided as follows: • **First deposits tier**: Covered deposits + DGS; • **Second deposits tier:** the part of eligible deposits from natural persons and micro, SMEs which exceeds the coverage level • **Third deposits tier:** the part of eligible deposits not mentioned in the second tier which exceeds the coverage level provided for in Article 6 DGSD and with an original maturity of less than one year + non-DGS eligible deposits with an original maturity of less than one year • **Fourth deposits tier:** the part of eligible deposits not mentioned in the second tier which exceeds the coverage level provided for in Article 6 DGSD and with an original maturity of one year or more + non-DGS eligible deposits with an original maturity of one year or more.

How do we assume the CH for the EP? As it is not possible to split the public authorities' sector in different categories, for the simulation, we consider all public entity deposits as eligible non-preferred non-covered deposits. As a result, we are testing a two-tier scenario accordingly as a '2-tier classic' depositor preference (as tested in the Commission CMDI Impact Assessment) – a two-tier system where:

- **Top deposit tier:** covered deposits, DGS claims, preferred non-covered deposits
- **Junior deposit tier:** all non-covered deposits
- Other unsecured claims (general depositor preference)
- It is assumed all deposits are excluded from losses for the purpose of our study. Other unsecured claims are assumed to bear losses.

How do we assume the CH for Council? With the present liability data reports (LDR) template, deposits cannot be split exactly in the same 4 tier ranking. In particular, the split of non-DGS eligible deposits between the third and the fourth tier cannot be done at this stage due to data on original maturity not being collected. Therefore, the following 3-tier system is tested. As a reminder, this should not impact the conclusions since the LCT will look at the first tier of deposits.

- **First deposit tier:** covered deposits, DGS claims
- **Second deposit tier:** preferred non-covered deposits
- **Third tier:** non-preferred non-covered deposits, (eligible and non-eligible)
- Other unsecured claims (general depositor preference)
- It is assumed all deposits are excluded from losses for the purpose of our study. Other unsecured claims are assumed to bear losses.

LCT modifications by EP and Council and our working assumptions

Table A.2. EP and Council modifications to the LCT

Topic	EP compromise text	Council compromise text
LCT	The methodology for estimating the cost of repaying depositors is amended to include "*the possible cost for DGS arising from potential economic and financial instability, **including the need to use additional funds, within the DGS mandate, to protect depositors**, financial stability and to prevent contagion*" (**Article 11e.2.letter c**) The EBA RTS specifying the methodology for estimating the cost of repaying depositors shall take into account "*contagion effects, economic and financial risks and any reputational damages for the banking system, including, where relevant, the protection of the joint trademark*".	DGSs to consider the estimated cost for the DGS to perform the pay-out and the estimated losses that deposits in the second and third tier included in the transfer would have suffered in liquidation (art. 11e (1) lett.b and art. 11e(2) lett. b1) taking into account: • Expected ratio of recoveries, **multiplied by an 85% scalar** [art. 11e lett. b1(a)] • The cost for the replenishment of the DGS that is to be borne by credit institutions that are members of the DGS (art. 11e lett. b1(a)) • The potential additional cost of funding and operational expenses for the DGS (art. 11e lett. b1(a) • When estimating the losses for deposits in the second and third tier, the DGS shall take into account the expected ratio and timeline of recoveries (art. 11e lett. b1(b) • In the case of transfer strategies, assessment of credit institution's assets and liabilities to be made according to Valuation 1 (art. 11e (2) lett. c) • EBA to develop draft RTS on the methodology to calculate the cost of different DGS interventions taking into due account the national specificities, including with reference to the recovery rate (art. 11e(5)

For the EP, we assume 2-tiers CH and a modified LCT whereby the costs to be considered would <u>include in the counterfactual</u> the points under figure 1 and the explanation of the LCT as per Commission proposal with <u>the addition of the amount of non-covered deposits that would be excluded from bearing losses</u>, as a broad potential interpretation of the amendment to DGSD Article 11e.2.c in the EP text. This would change the right-hand side of the LCT equation as follows:

1. **Right side - DGS net cost of payout in an insolvency counterfactual.** Calculated as:

2. o total gross amount of payout by DGS in insolvency
3. o plus total value of non-covered deposits that would be excluded from bearing losses and transferred to a buyer.
4. o minus/netted off by recoveries in insolvency pertaining to the DGS as per its rank in the hierarchy of claims (assuming 85% recovery rate).
5. o minus/netted off by recoveries in insolvency pertaining to non-covered deposits that were excluded from losses and transferred to a buyer as indicated under each sub-scenario (assuming 85% recovery rate on all assets).
6. o plus other administrative, operational and cost of funding costs (assumed zero in our simulations).

For the Council, **we run one simulation** to factor in the above said 3-tiers CH and a modified LCT with the 85% scalar and addition of indirect costs. Therefore, the left side of the LCT equation remains unchanged while the right side (insolvency counterfactual) sees the addition of the 85% scalar as follows (cf. underlined):

- Right side - DGS net cost of payout in an insolvency counterfactual. Calculated as:
  - total gross amount of payout by DGS in insolvency
  - plus, total value of non-covered deposits that would be excluded from bearing losses and transferred to a buyer.
  - minus/ netted off by recoveries in insolvency pertaining to the DGS as per its rank in the hierarchy of claims (assume 85% recovery rate on all assets). <u>An 85% scaling factor is introduced (multiply recoveries by 85%).</u>
  - minus/netted off by recoveries in insolvency pertaining to non-covered deposits that were excluded from losses and transferred to a buyer as indicated under each sub-scenario (assuming 85% recovery rate on all assets). <u>An 85% scaling factor is introduced (multiply recoveries by 85%).</u>
  - plus, other administrative, operational and cost of funding costs (assumed zero in our simulations)

Council conditions for access to the DGS “bridge” assessed in the study

The study tests the following thresholds for banks with positive LCT (given the information on the gap to 8%):

- **For all banks:** DGS contribution capped at 62.5% of DGS available financial means (AFM).
- **For banks below EUR 30bn:** 2.5% TLOF cap on DGS contributions.
- For banks above EUR 30bn and below EUR 80 bn (on solo basis) and with deposits exceeding 65% TLOF, 1.25% TLOF cap on DGS.