IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK FOR SMALL AND MEDIUM SIZED BANKS OF THE SSM AND THE SRB

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Having an effective and integrated framework for managing crises, is essential for preserving the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability.

The EU bank crisis management framework lays out the rules for handling bank failures. The framework was established in 2014 after the global financial crisis and in reaction to the EU sovereign debt crisis. It consists of three EU legislative texts that will be reviewed later this year: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD) that all contain review clauses.

The principle is that all banks under SRB remit must be resolvable, and the reason is simple: safeguard financial stability without taxpayers being expected to foot the bill. So far, there is limited experience on the application of this framework that aims at addressing the "too-big-to-fail" issues exposed by the great financial crisis. The management of crises involving small-and-medium-sized banks usually takes place under ordinary liquidation procedures at the national level as, in most cases, they do not raise concerns for financial stability.

However, the experience of these first years of the Banking Union was perceived as showing some flaws in the current framework. In the limited number of cases of the recent years, some national resolution authorities used specific clauses in the crisis framework which led to an impression that "bail out" solutions for failing banks with a negative Public Interest Assessment were used rather than minimizing taxpayer losses. By doing so, these authorities applied more favorable burden-sharing requirements than would have been requested in resolution. This decision has to be seen against the background of potential losses to retail investors and small firms, which seemed to put pressure on the national policy authorities.

Furthermore, the differences between the resolution framework and the State aid rules create incentives to apply the former instead of resolution, which is negative given that the resolution framework was precisely developed to avoid the involvement of taxpayers. Indeed, State aid rules (Banking Communication 2013) have not been updated since they were published and therefore risk clashing with the current BRRD, SRMR and DGSD which came into force at a later stage. This draws attention to misalignment and consistency issues between the various components of the crisis management framework.

In addition, there are significant differences in national legal regimes for the liquidation of banks that do not satisfy the Public Interest Assessment. This generates level playing field concerns that might impair banking market integration and they may stand in the way of a smooth exit from the market for the weakest players.[1] These differences also create additional drawbacks when the SRB carries out the Public Interest Assessment (as it may diverge for banks in a similar position but under different national insolvency proceedings) and when applying the no-creditor-worse-off (NCWO) principle. More generally, it is essential to address the structural issue of the overcapacity of the banking system and to achieve an efficient crisis management framework, which allows an orderly exit of the weakest players from the banking market, thus strengthening the overall capacity of the banking system to finance the recovery of the European economy.

Against this backdrop, a review of the EU crisis management framework is welcome. This note presents the main characteristics and weaknesses of the EU banking crisis regime and proposes a way forward for improving the EU crisis management framework for small and medium sized banks under the remit of the Single Supervisory Mechanism (SSM) and the the Single Resolution Board (SRB).

1. The EU crisis management framework: features & weaknesses

1.1 Main features of the current EU crisis management framework

The EU bank crisis management lays down the rules for handling bank failures. In the Banking Union, unlike in some other jurisdictions, there is a clear distinction between the resolution regime[2] and the insolvency regime. The former is a single EU framework, applying to all banks that are failing or likely to fail and meeting with public interest criteria. This framework and the ensuing extraordinary powers are justified by the overriding interest in preserving financial stability. The failing banks that do not meet these criteria are liquidated through the domestic insolvency regimes, which vary substantially across jurisdictions.

So far, in practice, the EU Resolution is for the few, not the many, if we consider all banks in the Banking Union. Most banks will continue to fall under normal national insolvency proceedings in the same manner as any other failing business is dealt with. However, for 'systemically important' banks - whose failure would have a ripple effect on the rest of the economy – the EU resolution framework

1. A. Enria, Crisis management for medium-sized banks: the case for a European approach, Keynote speech by Andrea Enria, Keynote speech at the Banca d 'Italia workshop on the crisis management framework for banks in the EU, 15 January 2021.

2. The idea of resolution is, put simply, to ensure that a bank that runs into trouble can be dealt with effectively, having the smallest possible impact on the taxpayer - in other words, no more bail-outs - and at the same time, causing the least amount of damage to the wider economy.

applies potentially to all banks irrespective of their size, business model, complexity or interconnectedness. But to date, its application is the exception not the rule. Nonetheless, most banks under the SRB direct remit (122[3] banks) are expected to meet the "Public Interest Assessment" and therefore go for resolution instead of liquidation.

The European resolution framework[4] introduces some constraints on the management of bank failures. Indeed, it not only substantially constrains any possibility of providing public funds for failing institutions, but also imposes a minimum amount of creditors' bail-in - 8% of total liabilities including own funds (TLOF) - as a precondition for the use of the Single Resolution Fund (SRF) for capital support. In addition, all entities that could possibly be subject to resolution must issue a sizeable amount of bail-in-able securities (minimum requirement for own funds and eligible liabilities (MREL)). Indeed, for banks intending for resolution, the MREL requirements are in principle doubling the capital requirements, as the MREL loss-absorption component is complemented by the recapitalisation amount.

Moreover, the state aid rules impose some less stringent restrictions on the use of precautionary recapitalizations. In addition, there is a growing uncertainty on whether preventive interventions by Deposit Guarantee Schemes (DGS), are subject to State Aid conditionality or escape from such conditionality. The Tercas decision actually relaxes the rules and adds additional complexity to the framework.

In the EU, the bail-in tool could be applied to any credit institutions[5] in order to avoid the use of public funds. For that purpose, the BRRD requires banks to comply with MREL requirements that are determined by resolution authorities on a bank-by-bank basis[6] and may include, for banks expected to be resolved and not liquidated, where appropriate, a subordination requirement. The banks that should go into liquidation are subject to an MREL level covering loss absorption. If those banks have losses, someone has to absorb them: the shareholders/ creditors (even uncovered depositors) or the national taxpayers (bail out).

In addition, the use of public funds is permitted under article 44 of BRRD in exceptional circumstances after the bail-in of 8% of total liabilities (in case the SRF funds are used for capital support – the 8% bail-in threshold does not apply to liquidity support) and the contribution of the Single Resolution Fund for 5% of the total liabilities. MREL is therefore a cornerstone of the EU resolution regime and the solvency support.

1.2 The weaknesses of the EU crisis management framework are well known

The key impediments are summarized at the beginning of the EC Consultation on the EU bank crisis management and deposit insurance framework (January 2021).

- One of the cornerstones of the current framework is the objective of shielding public money from the effects of bank failures. Nevertheless, this has only been partially achieved. This has to do with the fact that the current framework creates incentives for national authorities to deal with failing or likely to fail (FOLTF) banks through solutions that do not necessarily ensure an optimal outcome in terms of consistency and minimisation in the use of public funds. These incentives are partly generated by the misalignment between the conditions for accessing the resolution fund and certain (less stringent) conditions for accessing other forms of financial support (State, DGS) under existing EU State aid rules and DGSD, as well as the availability of tools in certain national insolvency proceedings (NIP), which are in practice similar to those available in resolution. Moreover, a reported difficulty for some small banks to issue certain financial instruments, that are relevant for the purpose of meeting their MREL requirements, may contribute to this misalignment of incentives.
- The procedures available in insolvency also differ widely across Member States, ranging from purely judicial procedures to administrative ones, which may entail tools and powers akin to those provided in BRRD/SRMR. These differences become relevant when solutions to manage failing banks are sought in insolvency, as they cannot ensure an overall consistent approach across Member States.
- The predictability of the current framework is impacted by various elements, such as divergence in the application of the Public Interest Assessment (PIA)[7] by the SRB compared to National Resolution Authorities (NRA) of the Banking Union. In addition, there are differences among national insolvency frameworks, with some providing tools similar to those available in resolution which has an impact when carrying out the PIA, thereby reducing the consistency of the overall framework. Finally, differences in the hierarchy of liabilities in insolvency across Member States complicate the handling of banking crises in a cross-border context.
- Additional complexity comes from the fact that similar sources of funding may qualify as State aid

3. https://srb.europa.eu/en/content/banks-under-srbs-remit 122 Banks in January 2021.
4. The choice of resolution tools depends on the specific circumstances of each case and builds on options laid out in the resolution plan prepared for the bank. The EU Regulation allows the application of four resolution tools They consist of powers to: (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders); (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits; (iii) separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities; and/or (iv) bail in creditors (mechanism to cancel or reduce the liabilities of a failing bank, or to convert debt to equity, as a means of restoring the institution's capital position).
5. The main aim of bail-in is to stabilise a failing bank so that its essential services can continue, without the need for bail-out by public funds. The tool enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity so that the bank can continue as a going concern.
6. For setting the MREL, the 8% is a benchmark, not a floor.
7. As also explained in detail later, the PIA is carried out by a resolution authority to decide whether a failing bank should be managed under resolution or insolvency according to national law.

or not and that this depends on the circumstances of the case. As a result, it may not be straightforward to predict ex ante if certain financial support is going to trigger a FOLTF determination or not. The recent Tercas ruling by the European Court of Justice, against the Commission 's decision, is a good example.

- The rules and decision-making processes for supervision and resolution as well as the funding from the resolution fund, have been centralised in the Banking Union for a number of years. DGSs remain on the national level, with differences in their functioning and their ability to handle adverse situations. Furthermore, there are some practical difficulties (e.g., when a bank transfers its activities to another Member State and/or changes the affiliation to a DGS). The different transpositions of the DGSD among Member States, with 22 different options and national discretions (ONDs) including relevant aspects such as preventive (Article 11(3) DGSD) and alternative measures (Article 11(6) DGSD), create further unlevel playing and fragmentation concerns.
- Discrepancies in depositor protection across Member States in terms of the scope of protection, such as specific categories of depositors, and payout processes result in inconsistencies in access to financial safety nets for EU depositors[8].

1.3 Small banks under the remit of the SSM and the SRB raise specific resolution challenges in Europe

3 years ago, the Financial Stability Institute stressed that 70% of banks under direct supervision by the SSM were not listed, 60% had never issued convertible instruments and 20% had never issued subordinated debt. F. Restoy explained[9] that those banks are typically too large to be subject to straight liquidation, as they may generate adverse systemic effects, but they might be also too small and too traditional to issue large amounts of MREL-eligible liabilities that could facilitate the application of the bail-in tool in resolution. Thus, the large depositors of such banks might be inordinately called upon in the case of resolution, which could lead to difficult social consequences.

The SRB, in a recent "non paper" on the resolution of this type of bank, concludes that for all the 60 medium-sized banks under its responsibility (with total assets below €100bn at Dec. 2019), the reach of the 8%-bail-in requirement is highly contingent on the level of capital depletion in the run up to FOLTF declaration. Indeed, at the current capital levels, capital support by the SRF would be available for all the banks in sample, assuming that the current level of bailinable liabilities will be available at the resolution weekend, without applying bail-in to uncovered, but preferred, deposits.

However, it is not expected that a bank will be considered FOLTF with capital ratios well above minimum capital requirements, which raises challenges around the use of the SRF for capital support where such banks are reliant on equity financing only. Indeed, in such cases non-covered deposits would need to be bailed-in, which may reduce the franchise value of the bank when applying a transfer tools strategy and create financial stability concerns. Drawing conclusions from the conclusions should be done with caution, given the number of assumptions used. Also, one must bear in mind that we remain in a transitional period with MREL still being built up (with final targets binding in 2024 and intermediate targets in 2022) and the SRB carefully monitoring it. At the same time, the numbers suggest that most banks should be able to raise or maintain the needed MREL, given that de facto most of them comply (albeit with equity).

Similarly, an analysis of a Eurofi member based on public date (Bloomberg) of recent issues by banks with balance sheets of less than EUR 100 billion indicates that even quite small banks (balance sheets of around EUR 20 billion) have issued at very reasonable costs. Of course, apart from balance sheet size, other factors such as ratings and business models also influence the issuing capacity of these banks. In the AT1 and T2 debt category, medium-sized banks in the euro area issued 14.8 bn EUR (74 public issuances) in the last three years, of which 58% were Southern European banks. Over the same period, they issued 11.2 bn EUR of senior non-preferred debt (63 public issuances), which shows that they have indeed started to accumulate the resources needed to meet their MREL objectives

Mainly, only small banks that have a balance sheet size of less than €20bn may have difficulty to raise the needed MREL. An objective assessment of such difficulties would be needed. Therefore, solutions need to be found for the orderly exit of smaller deposit funded banks affected, to safeguard financial stability.

1.4 Lessons to be drawn from the US FDIC experience for improving the EU resolution and liquidation framework of small and medium sized banks under the remit of the SSM and the SRB

It would be appropriate to draw lessons from the FDIC experience as far as the legal and institutional framework relevant for the US can be compared to the situation in the European Union. The FDIC efficiency comes from:

- The fact that the FDIC is a national organization (not 21 Jurisdictions).
- The plurality of options: no hard-wired obligations (8% - 5% SRF thresholds) but a pragmatic, flexible, least cost principle base[10]. Thus, the FDIC takes on the risks of some losses in relation to transferred assets rather than requiring creditors to absorb minimum losses in relation to their claims.
- The FDIC has the capacity to select healthy banks in order to purchase some of the assets of the failing banks.
- The FDIC usually agrees to absorb a portion of future losses on assets because this method produces a better net recovery than an immediate liquidation.

8. While the protection of standard banking deposits by DGSs has been harmonised, exceptions excluding certain deposits (for instance those of public authorities) or extending the protection above the EUR 100 000-threshold are defined on a national basis.
9. F. Restoy, How to improve crisis management in the Banking Union: a European FDIC? Financial Stability Institute, 4 July 2018.
10. Liquidation of banks: Towards an FDIC for the Banking Union? In- depth analysis, European Parliament, February 2019.

- Operations of the FDIC are backed by the unlimited credit line from the Treasury which allows the FDIC to gain time and not be threatened by purchasers which are eager to buy the assets at the lowest possible price.

The experience of the FDIC shows that size is not the major criteria for resolution. What is important is to get the best solution/deal out of an ailing bank. This requires experience, intimate knowledge of the banking system, the capability of negotiating with other banks without being paralyzed by some mechanistic prescriptions.

In the US, the 15 systemic banks have the necessary capital requirements (including TLACs, stress tests, etc.…) and the other medium and smaller ones have, de facto, a level playing field which is shaped by the FDIC. FDIC is guided by common sense principles: it is free to choose the best solution, case by case.

However, in Europe there is not even agreement on public guarantees to refinance the backstop in case the SRF has not been able to pay back the ESM[11]. The banking sector would have to refinance the SRF if needed. It seems difficult to make the EU crisis management framework evolve towards the US FDIC model.

2. A way forward for improving the EU crisis management framework for small and medium sized banks under the remit of the SSM and the SRB

Defining the public interest criteria in a single way, identifying the banks under the remit of the SSM and the SRB, which are meeting those criteria and publishing the list of these banks would make more predictable the resolvability of failing banks.

Moreover, it is essential to achieve the right balance between the internalisation of losses and the use of deposit guarantee schemes to finance the transfer tools in order to address the gap for medium-sized and smaller banks which fall between the EU resolution framework and heterogeneous national insolvency frameworks.

2.1 Defining the public interest criteria in a single way would make more predictable the resolvability of failing banks

If a bank does not qualify for the precautionary recapitalization and is declared by the supervisory/ resolution authority to be failing or likely to fail, the choice is between liquidation or resolution. This decision is a prerogative of the SRB for the banks under its remit and it hinges on an assessment of the existence of public interest. In other words, European resolution decisions are strictly binary: the SRB acts only when banks satisfy a strict European public interest test. All other cases are invariably handled at the national level, enabling divergent courses of action to be pursued along national lines.

But resolution and liquidation differ substantially when it comes to the scope of legislation that is applicable to the use of public funds. While resolution is governed by the BRRD, liquidation is regulated by national insolvency laws and will be managed by national authorities.[12] While the use of public funds in resolution would be subject to both BRRD scope and State Aid scope – thus requiring a preliminary bail-in up to at least 8% of total liabilities (for capital support), the use of public funds in liquidation is only subject to State aid burden sharing requirements.

Consequently, since the scope of EU law regulating the use of public money in resolution and liquidation is different, a substantially similar operation conducted under these two different frameworks can lead for similar banks to very different outcomes. These affects (i) the acquiring bank; (ii) the banks' creditors and (iii) the taxpayers.

However, these criteria are vaguely defined in European law and there are currently two definitions of "public interest ": one at the SRB level, and one by national authorities. Indeed, the question of whether the resolution of a bank deemed failing or likely to fail is in the "public interest" or whether such a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at the national levels. Some ailing banks that have been turned down by the SRB were subsequently found to be of public interest by national authorities. Moreover, there is a difference between "public interest" in the sense of BRRD to choose between resolution and liquidation, and the justification of State aid to allow public support.

The Veneto banks[13] cases have made it clear that, depending on national insolvency law, resolution tools may be used at the national level outside the BRRD framework, despite the absence of a 'public interest' determined at the EU level by the SRB. Such actions remain subject to the EU State Aid framework while avoiding more restrictive conditions under the BRRD. This is what Andrea Enria, previous chair of the European Banking Authority (EBA) called "two different definitions of "public interest" […] one at the EU level and another one by national authorities".

While the definition of critical functions seems clear as regards the SRB's assessment of the existence of public interest, it is not equally clear what role it plays in the EU discipline on liquidation aid, as the 2013 Banking Communication does not include guidelines on how the local effect of liquidation should be evaluated. In the absence of clarity on what constitutes a serious impact

11. If the credit line provided by the European Stability Mechanism (ESM) to the Single Resolution Fund (SRF) is used, it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended by up to another two years. Consequently, it will be fiscally neutral over the medium term.

12. In the US, the FDIC will be the managing authority in charge of the insolvency process.

13. The Veneto banks - which did not pass the SRB's 'public interest test' that is required for a bank to be 'resolved' at the EU-level - have been liquidated through a special insolvency procedure under Italian law. That special insolvency procedure involved resolution tools and state aid. Albeit the SRB concluded that the resolution was not warranted in the 'public interest', the Commission indicated that EU state aid rules foresee the possibility to grant State aid to mitigate any economic disturbance at the regional level. Consequently, BRRD bail-in rules were not enforced, the Italian government made available 17 billion euros, and creditors were "in fine" better off than in a resolution which would have entailed a more stringent bail-in of creditors than this liquidation.

on the regional economy, the rules on liquidation State Aid leave room for governments to effectively re-instate at the regional/local level the public interest that the SRB had refused at the national/European level.

One way to overcome this problem, which undermines the credibility of the Europe's resolution framework, could be to ask the SRB to provide an explicit assessment of the impact of failure at the regional/local level, to ensure the assessment is homogeneous.

In any case, the identification and the publication by the Single Resolution Board of the list of significant banks of public interest would make more predictable the resolvability of failing banks.

2.2 Achieving the right balance between the internalisation of losses and the use of deposit guarantee schemes to finance the transfer tools for addressing the gap for small-and-medium-sized banks that fall between the EU resolution framework and heterogeneous national insolvency frameworks

The toolbox for handling failed banks under the SRB direct remit that do not pass the Public Interest Assessment (PIA) should be expanded and rendered more flexible by allocating the SRB administrative liquidation powers including the power to transfer assets and liabilities supported by national DGS. If this mechanism is clearly established and enforced in a clear and stringent way, it could allow smaller banks under the direct remit of the SRB to be submitted to a lower standard level of MREL.

Such an EU flexible approach has the potential to reduce the costs compared to atomistic liquidation, would promote more consistent treatment of banks and should be more feasible in the short-medium term than the complete harmonisation of insolvency regimes. This could be created by amending the BRRD, SRMR and DGSD.

2.2.1 A limited level of MREL for smaller banks that do not pass the PIA for ensuring a smooth exit from the market

Allowing small and medium sized banks under the remit of the SRB not to have MREL above minimum capital requirements raises level playing field issues for failing banks between Significant Banks and hinders wind-ups across the banking union. Losses need to be allocated; there is no cost-free solution.

Whereas MREL and bail-in requirements form a cornerstone of the common EU resolution regime for larger and medium-sized banks (see1.3), the 8% bail-in hurdle within the BRRD is claimed by some to be excessive for smaller banks whose business model relies on retail and SME client deposits. According to some public decision makers, high MREL levels could be very expensive to achieve for many of these institutions.

At the same time, if creditors and depositors of small banks are totally exempted from the consequences of resolution, this contradicts the principles of BRRD and would mean that uncovered depositors in small banks have more rights than taxpayers («bail-out») or stakeholders of the whole banking system (intervention of the DGS). Taxpayers and the DGS would be subsidizing banks that do not issue sufficient MREL. Therefore, it would be desirable to avoid the moral hazard issue of "free-riders" sailing between the two positions, claiming not to have the means to raise MREL, but claiming to be too important locally/nationally to go into insolvency.

Furthermore, it could be argued that the small banks affect the profitability of the entire EU banking system: not only can they sell their financial products and services at a lower price because they do not currently have to charge for the cost of MREL, but they can also force other banks to contribute more to the SRF or DGS to pay for their potential failure. These banks must exit from the market in an orderly fashion in the event of failure. It is in everybody's interest.

In such a context, small Institutions (under the remit of the SSM and the SRM) without public interest, could benefit from lower standards in terms of levels of MREL due to their funding specificities. But they would have to be submitted to a minimum level of MREL in order to absorb possible losses. It is up to the SRB to define this level for each bank concerned notably on the basis of the resolution plan. For instance, in the case of the sale of business tool, the level of MREL should take into account the fact that the buyer will probably have to recapitalize the bank and provide the liquidity the bank may need when opening after resolution. The MREL requirement should cover the loss absorption but it also seems reasonable that the coverage of the recapitalization amount is partially fulfilled by the buyer.

A minimum level should be fixed in the EU legislation (e,g. not less than 6% of total liabilities including own funds) on the basis of appropriate criteria taking into account that these banks are predominantly financed by deposits However, access to the Single Resolution Fund, if needed, would remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF).

Such a proposal would reduce potential implicit subsidies enjoyed by these banks, avoid imposing losses on individual households and small firms (since MREL should be subscribed by non-retail investors), facilitate the implementation of the centralized administration liquidation tool financed by the use of national DGS (see below) by reducing these financing needs. It would indeed contribute to address the concerns raised by the absence of EDIS and the misalignments in incentives between decision-making powers at the EU level and financing tools at the national level.

2.2.2 Introducing a centralised administrative liquidation tool

The toolkit available to the SRB could be expanded and equipped with the administrative power to liquidate a bank under its remit when no public interest is identified, including by transferring some of its assets and liabilities to another bank within the Banking Union with the support of deposit guarantee systems to finance such transfer.

The allocation of these powers to a centralised European Authority (the SRB) would ensure consistency in the treatment of banks, could lead to efficient gains and enable the transfer of assets and liabilities to interested bidders in several Member States. Where there is no immediate buyer, assets and liabilities may be transferred to a temporary entity, i.e. a bridge bank.

For these banks to exit the market the focus might need to be on so called "transfer strategies", in particular sale-of-business.

Referring to this tool, E. König stressed that "as a first step, the SRB's toolbox could be enriched with a "pre-liquidation tool", allowing the application of resolution tools to save the good part of a bank without entering into liquidation, or without requiring a specific liquidation regime at the European level"[14].

2.2.3 Conditions to get access to the DGS funds to support early intervention

If the value of the transferred assets is less than the value of transferred liabilities - a scenario very likely in insolvency scenarios -, financial means are required and DGS funds could finance the transaction. One solution could be to grant the SRB powers to expand the use of DGS funds. In other words, the deposit guarantee scheme would become responsible for ensuring the financing of an orderly exit from the market of small and medium sized banks that do not pass the PIA.

This supposes that DGS have reached the target of 0.8% of covered deposits[15] and that the amount available for use in such circumstances be capped at a certain level (e.g. 0,4% of covered deposits) to ensure that public confidence is not lost. It would also imply limits on the amounts raised from other banks to reconstitute the fund, so that such usage would not become a transfer mechanism from healthy banks to failing banks, which would ultimately weaken the entire system.

If these DGS resources are insufficient to address a small or a medium sized bank likely to fail, the SRB should liquidate it and the DGS should borrow the necessary liquidity funding from other DGS or from commercial banks.

In such a solution, according to A. Enria, Chair of the Supervisory Board of the ECB[16], "specific governance arrangements should be designed in order to ensure the adequate involvement of the national resolution authority (NRA) and the national DGS in the SRB decision making process".

DGS funding can already be used for alternative measures under the current framework as an option given to Member States. The amount of DGS resources available for alternative measures under Article 11(6) DGSD is subject to a financial cap based on the least-cost-principle: The cost of the intervention must not exceed "the net amount of compensating covered depositors at the credit institution concerned".

Increasing the capacity of DGS to fund alternative tools must not come at the cost of deteriorating DGS's general position. This is why such an approach must strictly respect the 'least-cost' principle through a method that combines the methods of cash flow analysis with the ultimate loss while taking into account indirect costs up to a certain cap. Indeed, according to many experts, it would not be acceptable that DGS intervene to protect other creditors than protected ones, up to the protected amount. That would be equivalent to upgrading all creditors to the rank of protected deposits.

The least cost test (LCT) should be harmonised at the EU level in order to achieve a level playing field across the Banking Union.

The LCT should set out three conditions that must be fulfilled for the DGS to provide funding for alternative measures:

1. The gross cost of alternative measures does not exceed the gross cost of payout for covered deposits. As for the cash flow analysis, it disregards reimbursements and recoveries and limits the gross amount used for P&A measures.
2. The hypothetical loss resulting from the alternative measures (cost of alternative measures net of funds that would be subsequently recovered, i.e. reimbursement of loans, reimbursement or sale of an equity stake in a bridge bank) does not exceed the hypothetical ultimate loss borne by the DGS in case of pay-out after deducting funds recovered in the insolvency proceeding and adding indirect costs.
3. The indirect cost assumed in case of a pay-out does not exceed a cap determined in terms of the covered deposits.

Last but not least, a review of the use of DGS should not come at the expense of the integration and level playing field within the Banking Union. Indeed, without progress in completing the Banking Union, this could lead to banking sectors becoming "ever more national" rather than integrating across the Banking Union. Moreover, relying only on national DGS to manage banking crisis may amplify the bank-sovereign nexus, and some Member States may be disadvantaged (e.g. because of smaller banking sectors and DGS, lack of bidders etc.).

This is the reason why if such transactions would be monitored by the SRB through an "enhanced" (partial) sale of business tool, there would be the possibility to attract bidders from other countries, potentially attaining better bids (thereby minimising destruction of value and the use of funds).

Of course, this funding mutualisation would warrant an increased SRB role to ensure a level playing field and must be accompanied by measures ensuring that contributions to the DGS reflect everywhere adequately the risks, and in particular take into account the other levels of protection that can be mobilised (preventive mechanisms where there exist, adequate levels of MREL, etc.)

14. E. König, Europe and the Covid-19 crisis, EBI Conference, 5 November 2020.

15. The DGSD requires Member States to raise funds into their DGSs equivalent to at least 0.8% (or in certain cases down to 0.5%) of covered deposits in that Member State. The DGSD, which was enacted in 2014, gives Member States until 3 July 2024 to raise this target level amount.

16. A. Enria, Crisis management for medium-sized banks: the case for a European approach, Keynote speech by Andrea Enria, Keynote speech at the Banca d 'Italia workshop on the crisis management framework for banks in the EU, 15 January 2021.

These issues related to the crisis management framework are part of the wider agenda on deepening the Banking Union. The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock:

- The European Deposit Insurance Scheme (EDIS), third pillar of the Banking Union, is still missing. EDIS would be an effective tool to promote a uniform level of depositor confidence. Through a relatively simple mechanism of liquidity support of national DGS when needed, EDIS could already ensure equal, high quality protection for all depositors across the Banking Union in the case of bank failure, while ensuring some discipline and supporting the development of an BU-wide level playing field. Europe would have more resources than national deposit guarantee funds to cope with large local shocks, which could otherwise overburden national DGSs.

Europe should progress towards EDIS. But we should not believe that the subject is purely technical and can be only resolved by technical measures. EDIS will not miraculously eliminate the following remaining fragmentation issues within the Banking Union that need to be addressed:

- For banks, the Single Market is still fragmented along national lines. There is little progress in cross border lending, especially in retail markets, i.e. lending to households and firms;
- Discrepancies in the regulatory framework reduce the economies of scale for banks operating across borders;
- The “sovereign-bank doom loop” has not disappeared and in certain countries and it has increased in certain EU Countries following the Covid crisis;
- Ring-fencing policies (capital, liquidity, bail-in instruments…) by host supervisors, applied to subsidiaries of transnational banking groups located in their countries, are still persistent; they discourage large EU banks to reinforce and increase the number of their subsidiaries in the EU;
- Such ring-fencing practices prevent cross-border integration and synergies. This is obviously hindering prospects of cross-border mergers and consolidation of the banking sector at European level, called among other by EU authorities, required to reduce EU dependence on third country banks and necessary for reducing the overcapacity in the system;
- The Covid crisis could increase banking risks differently across member states;
- One of the objectives of a true Banking Union should also be to ensure the development of a resilient and profitable banking sector where diverse business models co-exist, diversification participating to overall resilience;
- Finally, the banking union area is suffering from a lack of economic and fiscal convergence and the Covid crisis is increasing economic discrepancies across member states.

It is essential that these well-known fragilities be addressed by EU and national decision makers, which would be required for reaching a balanced agreement on EDIS.