IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK FOR SMALL AND MEDIUM SIZED BANKS AND D-SIBs[1]

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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 the financial system, 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 experience of these first years of the Banking Union was perceived to show some flaws in the current framework. Although the number of bank failures remained limited in recent years, in many of them 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 or liquidation. Such decisions are often related to potential losses for retail investors and small firms resulting from insufficient or inappropriate loss absorbing capacity, which put political pressure on the national authorities.

Furthermore, differences between the resolution framework and the State aid rules create incentives to apply the latter 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 are not well aligned 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 insolvency regimes applicable to banks that do not satisfy the Public Interest Assessment. This generates level playing field concerns that hinder banking market integration and they stand in the way of a smooth exit from the market for the weakest players[2]. These differences also create additional drawbacks in the Public Interest Assessment (as banks in a similar position but under different national insolvency proceedings may have a very different fate) and when applying the no-creditor-worse-off (NCWO) principle. Although, it is essential to address the structural issue of overcapacity of the banking system. An efficient crisis management framework, which allows for an orderly exit of the weakest players from the banking market, can support this and thus strengthen the overall capacity of the banking system to finance the recovery and transformation of the European economy as well as reliability from the investors' point of view.

Against this backdrop, a targeted review of the EU crisis management framework would be 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 Single Resolution Board (SRB), but also for domestic systemically important banks (D-SIBs).

115 banks are currently under the remit of the SSM and the SRB and around 110 banks have been classified in the euro area as systemically important for the domestic market by national authorities (DSIBs), representing 68% of total assets for the entire banking sector[3].

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[4] and the insolvency regime. The former is a single EU framework, applying to all banks that are failing or likely to fail and meeting public interest criteria. This framework and the ensuing extraordinary powers are justified by the overriding interest of the public in preserving financial stability

1. This note is focusing on the specific issues of small and medium sized banks under the remit of the SSM and the SRB and domestically systemically important banks (DSIBs), which are directly supervised by their National Competent Authority.

2. 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.

3. 20 D-SIBs are not under the remit of the SSM and are directly supervised by their National Competent Authority.

4. 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.

everywhere in the European Union. Failing banks that do not meet these criteria should be liquidated through domestic insolvency regimes.

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. However, for ‘systemically important’ banks — whose failure would have a ripple effect on the rest of the economy — the EU resolution framework applies potentially and irrespective of their size, business model, complexity or interconnectedness. In particular, this regards most banks under the direct remit of the SRB (122[5] banks) and D-SIBs that are expected to meet the “Public Interest Assessment”.

But to date, the application of the European resolution framework is limited[6], also, due to 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 shareholders’ and 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. Accordingly, 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)) almost doubling the capital requirements.

By contrast, state aid rules impose somewhat less stringent restrictions on 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 by the European Court of Justice actually relaxes the rules and adds additional complexity to the framework.

In the EU, the bail-in tool could be applied to any credit institution[7] 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[8] and generally includes, for banks expected to be resolved and not liquidated, a subordination requirement. The banks that should go into liquidation are subject to an MREL level covering loss absorption only, usually equal to capital requirements. If those banks incur important losses, someone has to absorb them: the shareholders and junior creditors (up to uncovered depositors) and not national taxpayers (bail out) in a standard case.

In addition, the use of public funds is permitted under article 37.10 of the BRRD in exceptional circumstances of a systemic crisis after the bail-in of 8% of TLOF only (and subject to State Aid rules). 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 Single Resolution Fund (SRF) and certain (less stringent) conditions for accessing other forms of financial support (State, DGS) under existing EU State aid rules and the DGSD, as well as the availability of tools in certain national insolvency proceedings (NIP), which are in practice similar to those available in resolution.

- 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 the BRRD/SRMR. These differences become relevant when solutions to manage failing banks are sought in insolvency, as they prevent 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)[9] by the SRB compared to National Resolution Authorities (NRA) within the Banking Union. In addition, 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 or not and that this depends on the circumstances of

5. https://srb.europa.eu/en/content/banks-under-srbs-remit 122 Banks in January 2021.
6. 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).
7. 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.
8. For setting the MREL, the 8% is a benchmark, not a floor.
9. 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.

the case. As a result, it may not be straightforward to entirely predict ex ante, if certain financial support is going to trigger a FOLTF determination or not. The 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 SRF, have now been centralised in the Banking Union for a number of years, although in both areas the centralized functions cannot act in sole discretion or without the support and interaction with their relevant national counterparts, due to the legal environment which is different in each member state.

- DGSs remain at national level, with differences in their functioning and ability to handle adverse situations. Notwithstanding the fact that harmonization has been advancing, there are some practical complexities (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 concerns with regard to a potential unlevel playing field and fragmentation.

- 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[10].

2. KEY PRINCIPLES AND PRIORITY AREAS OF IMPROVEMENT FOR ONE EU CRISIS MANAGEMENT SYSTEM ACROSS EUROPE

Any reform of the EU bank crisis management framework must ensure that there is always an alignment between preserving financial stability and ensuring that taxpayers' money is not at risk. An EU crisis management with a continuum of solutions is needed, irrespective the size, business model and situation of the bank.

2.1 Key principles

- The principle that **the SRF or public money can be accessed only in resolution and only after a bail-in of at least 8% of the bank's total liabilities and own funds remains essential to reduce moral hazard and achieve a level playing field.**

  Access to public or mutualized funds should always remain subordinated to this key condition: the burden sharing by shareholders and subordinated creditors first, and by other creditors if necessary, only. To reduce the burden on other banks, minimize moral hazard and avoid competition distortions, burden sharing must be imposed on any failing banks' shareholders and creditors, whenever an authority or a DGS deploys preventive or alternative measures. Accordingly access to Single Resolution Fund for any IPS member should be subject to the bail-in of 8% of total liabilities and own funds (TLOF).

  This key principle of burden sharing must also apply to Failing or likely to fail (FOLF) depositor-funded banks whatever their size. Equity and debt holders of such banks must be clearly informed about the risks attached to their investments, in line with MiFID, and protection rules for depositors should be reinforced as appropriate.

  Similarly, there should be no discrimination between IPS and DGS. Preventive or alternative measures are allowed under the EU legislative framework and IPSs should not be prevented from using them. Though recourse by an IPS protected bank to external funds outside its IPS must be subject to the same rules as any other bank.

- **To be resolvable, banks must build-up the necessary MREL levels** to support the implementation of the resolution strategy. The same principle should apply to all DSIBs.

- **Nearly all the banks under the remit of the SSM/ SRB and D-SIBs should be resolvable**. The reason is simple: safeguard financial stability without taxpayers being expected to foot the bill.

- **FOLTF banks with a negative Public Interest Assessment should exit from the market in an orderly manner**, noting that non-covered deposits may suffer losses if more junior liability levels are insufficient to absorb losses. This should be explicitly stated in the EU legislative framework.

- **A crisis management with a continuum of solutions is needed in Europe, allowing to address all banks under the SRB and D-SIBs** irrespective of the size, business model and situation of the bank. **A double system**, with an expensive system for large banks and a system at a discount for smaller banks **should be avoided**.

- The diversity of the business models of banks must be preserved since it fosters the resilience of the banking system in Europe. In this perspective for instance, well-functioning systems like institutional protection schemes (IPS) as in Germany or Austria, are protecting the credit institutions as such and are ensuring the liquidity and solvency of their members. They should be maintained[11]. Since they are subject to the EU state aid framework and the DGSD — and

10. 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.

11. Such systems guarantee a different level of protection for depositors in comparison to the protection provided by a standard DGS. If, due to the support of an IPS, a bank does not fail and its services continue to be provided, which is a big advantage from the perspective of the clients, it is not necessary to reimburse depositors. About 50% of credit institutions in the euro area are members of an IPS, representing around 10% of the total assets of the euro area banking system. The two main sectors covered by IPSs in the three relevant euro area countries (Germany, Austria and Spain) are cooperative and savings banks.

- notably to the need to fulfill the same funding requirements as DGS — they should not harm the level playing field.

2.2 Area of improvements

- **Defining the public interest criteria in a single way** is an area for improvement. Indeed, this would help to achieve a better predictability of the outcome of a resolution process especially for those banks that are "mid-sized" in terms of their balance sheet and therefore do not seem to have many alternatives to re-enter profitability by altering their business model once they have lost confidence of investors or lenders.

- **Transfer strategies seem to be an appropriate tool for the resolution of medium sized banks, but access to public or mutualized (DGS or SRF) funds to support resolution should remain subject to clear and consistent conditions** (*see 4.*). Under this approach, viable parts of an insolvent bank are matched with a thriving acquirer, ideally located in another member state, thereby allowing medium sized banks to reap the benefits of the EU internal market. However, economies of scale across borders are only possible with a true Banking Union where capital and liquidity move freely and where market practices as well as products are comparable.

  DGS — subject a least cost test due to be harmonized as far as possible at the EU level for those banks for which resolution is the intended strategy — could support the resolution of such failed banks' assets, ensuring that the failure of medium sized banks (including DSIBs) is handled in an orderly and effective manner that guarantees a smooth market exit and only a small impact on local financial stability.

- Framework(s) for the provision of **liquidity in resolution** remains nevertheless an important challenge to increase the credibility of the EU resolution framework. To address this issue is crucial since lack of liquidity can jeopardise any resolution strategy and lead to an uncontrollable situation within only a few days.

- One area for improvement concerns **the point at which a bank is considered to be "failing or likely to fail" (FOLF)**. This decision involves a difficult trade off: if the decision to declare a bank FOLF is taken too late, the available loss-absorbing and recapitalization capacity might not be sufficient anymore. However, taking the decision prematurely may prevent a successful recovery. The availability of collateral to obtain funding could serve as a formal criterion[12].

In the remainder of this note, we propose to focus on ways to define the public interest criteria in a single way to make the crisis management framework more predictable and make proposals to enhance the funding options available in resolution.

3. DEFINING THE PUBLIC INTEREST CRITERIA IN A SINGLE WAY WOULD MAKE THE RESOLVABILITY OF FAILING BANKS UNDER THE REMIT OF THE SSM/SRB OR DSIBS[13] MORE PREDICTABLE

If a bank does not qualify for the precautionary recapitalization and is declared failing or likely to fail by the supervisory/resolution authority, 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 or mutualized funds. While resolution is governed by the BRRD, liquidation is regulated by national insolvency laws and will be managed by national authorities[14]. 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. This affects (i) the acquiring bank if a transfer strategy is implemented, (ii) the banks' creditors and (iii) taxpayers.

Unfortunately, public interest criteria are only vaguely defined in European law and there are currently two definitions of "public interest ": one at the SRB level, and several by national authorities. Indeed, the question of whether the resolution of a bank deemed failing or likely to fail is of "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 whose resolution did not seem to trigger a public interest on the European level were subsequently found to be of public interest by national authorities, albeit on a smaller scale, i.e. on the level of the member state or a region of the member state. 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.

12. C. Buch, "Bank resolution: delivering for financial stability", SRB Annual conference, 2021.

13. When this note refers to D-SIBs, it refers to those who are not subject to the direct supervision of the SSM but to their national competent authority.

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

The Veneto banks[15] cases have made it clear that, depending on national insolvency law, resolution tools may be used at the national level using specific provisions of 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 when applying the public interest provisions. 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 on the regional economy, the rules on liquidation State Aid leave room for governments to effectively re-instate at the regional or local level the public interest that the SRB had denied at the national or European level.

To overcome these issues, taking into account that the harmonisation of national insolvency proceedings (NIPs) remains a political challenge in the short and medium term, we suggest the following:

- All these banks under the remit of the SSM and D-SIBs — with a minimum balance size, e.g. €15 billion would be deemed susceptible of a positive public interest assessment a priori. They should be subject to MREL requirements, including a recapitalization amount, and would have access to the SRF at the same conditions (i.e. prior bail-in equivalent to at least 8% of TLOF).

- For smaller banks below the threshold (under the remit of the SSM and D-SIBs), a way to foster consistency would be to give the SRB a final say in the PIA.

- Ailing banks under the remit of the SSM and SRB or D-SIBs with negative PIA (with no specific financial stability impact on national or regional economic systems) should exit the market without necessarily going directly into liquidation (*see 4*).

- It is the task of the National Resolution Authorities (NRA) and the SRB to define a common interpretation of the existing PIA definition and implement it in a consistent way in all member states.

4. TRANSFER STRATEGIES SEEM TO BE THE BEST TOOL FOR SMALLER BANKS UNDER THE REMIT OF THE SSM AND SRB, BUT STRICT ACCESS CONDITIONS SHOULD BE DEFINED TO GET ACCESS TO DGS FUNDS TO SUPPORT RESOLUTION.

Allowing mid-sized banks under the remit of the SRB not to have MREL above minimum capital requirements would raise level playing field issues and hinder wind-ups across the Banking Union. Losses need to be allocated; there is no cost-free solution.

If creditors and depositors of banks under the remit of the SRB with a negative PIA are totally exempted from the consequences of resolution, this would contradict the principles of BRRD. Taxpayers and the DGS (i.e. essentially healthy and relatively large banks within the sector) might be subsidizing ailing banks that do not issue sufficient MREL. Therefore, it appears mandatory to avoid the moral hazard issue caused by "free-riders" sailing between the two positions, claiming not to have the means to raise MREL, but claiming to be too important locally or nationally to go into insolvency.

Furthermore, it can be argued that such "free-riders", sometimes smaller banks or banks with one sided business models attracting depositors with off-market deposit interest rates, 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 the market in an orderly fashion in the event of failure. It is in everybody's interest.

In such a context, we propose that **MREL requirements must be specified for smaller banks under the remit of the SRB (and small DSIBs as the case may be) even with a credible sale of business as preferred resolution strategy.**

Currently, the MREL market — also due to the low interest rate environment that fuels a search for yield — is wide open for small medium sized banks. In such a context, we propose that:

- **MREL requirements must be specified for smaller banks under the remit of the SRB (and DSIBs as the case may be) even with a credible sale of business as preferred resolution strategy**. There might not be a real need to set MREL at a level that allows the full recapitalization of the bank. MREL requirements could be lower, based on the likelihood of transfer strategies being reliably implementable but in any case they should be higher than the mere capital requirements.

- Access to the Single Resolution Fund would also remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF): taxpayers and DGSs should not subsidize banks that do not have sufficient MREL, and the moral hazard issue caused by "free riders" must be avoided.

In addition, the toolkit available to the SRB could be expanded with a centralized liquidation tool:

- The SRB would be equipped with the administrative

15. 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.

power to wind up a bank in particular by transferring some of its assets and liabilities to another bank within the Banking Union.

- The allocation of these powers to a centralized 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 of other Member States. Where there is no immediate buyer, assets and liabilities may be transferred to a temporary entity, i.e. a bridge bank. The SRB's toolbox should foresee a possibility to acquire funding in resolution and thus allowing the application of resolution tools over a longer period of time to save the good part of a bank without entering into forced liquidation at depressed asset prices, or without requiring a specific liquidation regime at the European level"[16].

DGS funds could support early or alternative intervention but within strict pre-established safeguards in order to limit moral hazard:

- DGSs have reached the target of 0.8% (or 0.5% in concentrated markets) of covered deposits and that the amount available for use in such circumstances be capped at a certain level (e.g. 0.2% of covered deposits)

- If these DGS resources are insufficient to address a small ailing bank under the remit of the SRB, the SRB should liquidate this bank and the DGS should borrow the necessary liquidity funding from other DGS.

- Increasing the capacity of DGS to fund alternative tools must not come at the cost of deteriorating a DGS's general position. This is why such an approach must strictly respect the 'least-cost' principle.

- This least cost test (LCT) should be harmonised at the EU level to allow for consistent application to banks under the remit of the SRB (or the SSM for early intervention measures) and ideally across the whole banking union.

- The LCT should be subject to 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 alternative measures.

  2. The hypothetical loss resulting from the alternative measures (cost of alternative measures, including indirect costs, 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. As reminder, alternative measures should anyway lead to market exit.

  3. The indirect cost assumed in case of a pay-out does not exceed a cap determined in terms of the covered deposits.

In addition, any early intervention that aim at preventing failure and at keeping a bank alive should also be subject to SSM (or SRB) approval, which should only be granted to banks with a credible and sustainable business plan.

A recent work conducted by the Financial Stability Institute (FSI) suggests that "replacing the existing super-preference of covered deposits by a general depositor preference — or, more specifically, to replace the seniority of covered over uncovered deposits by a general depositor preference rule — would have a material impact on available funding. In particular, for banks holding large amounts of non-covered deposits, removing the super-preference would substantially amplify the support that the DGS could provide, thereby making the transfer transactions much more feasible under either resolution or insolvency"[17].

However, reviewing the deposits or the DGS positioning in creditor hierarchies present significant drawbacks: bank liquidity issues, increased of volatility of bank deposit financing, potentially weakened depositors' confidence and this would inevitably introduce moral hazard. Raising all deposits to the same level in creditor hierarchies would de facto reduce the bail-in-able instrument base. This would force healthy banks to "bail out", i.e. replenish, DGSs much more often. Corporate behaviour would change to the detriment of bond assets and to the benefit of bank deposits. Such an approach would relieve corporate treasurers of their risk analysis duties who would seek then the best possible return for their deposits, which is often offered by the weakest banks (which need these deposits).

For DSIBs, in the case that some would remain under the direct supervision and resolution of national authorities:

- It is the task of the National Resolution Authorities (NRA) and the SRB to define a common interpretation of the existing PIA definition and implement it in a consistent way in all Member States. A way to foster consistency would be to precisely define the PIA in the EU legislative framework.

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

17. See F. Restoy, "How to improve funding of bank resolution in the Banking Union: the role of deposit insurance", BIS, 11 May 2021.

These issues related to the crisis management framework are part of the wider agenda on enhancing the Banking Union. The Banking Union (BU) remains fragmented, which weakens the global competitiveness of European banks, hamper the financial sovereignty of Europe 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 is expected to promote a more uniform level of depositor confidence, although a widely harmonised legal framework in the form of the DGSD already exists.

Creating a new system or institution such as EDIS may not be the right way to progress since there still exist many obvious differences with regard to the legal framework and the quality of balance sheet of banks in different member states, potentially aggravated after the ending of the support measures necessary in view of the pandemic. As first steps, a harmonization of insolvency practices across the BU would be necessary. As mentioned above, existing rules and principles are not applied consistently, among other because the crisis management framework is more in the form of Directives than Regulations.

- Applying the Public Interest Assessment (PIA) in the same way would help to avoid such discrepancies.

- DGS preventive or alternative interventions should also be harmonized. To that, effect the Least Cost Test (LCT) should be applied consistently throughout the Banking Union at a minimum for all the banks under the remit of the SRB and all the D-SIBs.

One way to advance on this way is to define the PIA clearly and precisely in the level 1 texts. Further, as much as possible, a harmonization of the type of interventions that DGSs are allowed to make, would be welcome too. Without such type of effective harmonisation, no further step towards a European Deposit Guarantee scheme can be realistically expected. Only then could the second step, i.e. mutual liquidity support between DGSs, be put in place, possibly combined with an hybrid EDIS that would provide liquidity in the systems. A fine balance has to be struck though between full harmonisation of the legal framework and the risks of moral hazard. While a uniform crisis management and deposit insurance framework could increase the predictability of the outcomes of measures it must be avoided that banks with riskier business models collect deposits at off-market rates for clients with the argument that large funds at the European level will help to cover depositors in case of bank failure.

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 and the ever-increasing regulations are cumbersome, especially for smaller banks.

- The "sovereign-bank doom loop" has not disappeared and it will increase in certain EU Countries following the Covid crisis.

- Ring-fencing policies (capital, liquidity, bail-in instruments…) by host authorities, applied to subsidiaries of transnational banking groups located in their countries, are still persistent; they discourage and make it even impossible for 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, although the legal framework for applying capital and liquidity waivers is already there and only needs to be used. This is obviously hindering prospects of cross-border mergers and consolidation of the banking sector at European level, called for among others by EU authorities, required to reduce EU dependence on third country banks and necessary for reducing the overcapacity in the system as well as the increase of profitability of large banking groups.

- Generalised gold-plating at EU level further reinforced by most host member states further prevent cross-border consolidation and hamper international competitiveness of EU banks.

- 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, since risk diversification adds to overall resilience in the sector.

- 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. This will make the paradigm of risk reduction before risk sharing even more important in the coming years.

- This deprives Europe from a well-needed banking autonomy and sovereignty that is necessary to meet the huge financing requirements of the climate and digital transition of its whole economy… making a large part if it dependent on third country banks.

It is essential that these well-known fragilities be addressed by EU and national decision makers independently from EDIS.