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**Working Paper**

## Reform of the CMDI framework: Driving off with the breaks on

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Ioannis G. Asimakopoulos | Tobias H. Tröger

# Reform of the CMDI Framework – Driving Off With the Breaks On

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# Reform of the CMDI Framework - Driving Off With the Breaks On

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### **Abstract:**

The lack of a European Deposit Insurance Scheme (EDIS) – often referred to as the ‘third pillar’ of Banking Union – has been criticized since the inception of the EU Banking Union. The Crisis Management and Deposit Insurance (CMDI) framework needs to rely heavily on banks’ internal loss absorbing capacity and provides little flexibility in terms of industry resolution funding. This design has, among others, led to the rare application of the CMDI, particularly in the case of small and medium sized retail banks. This reluctance of resolution authorities weakens any positive impact the CMDI may have on market discipline and ultimately financial stability. After several national governments pushed back against the establishment of an EDIS, the Commission recently took a different approach and tried to reform the CMDI comprehensively, without seeking to erect a ‘third pillar’. The overarching rationale of the CMDI Proposal is to make resolution funding more flexible. To this end, the proposal seeks to facilitate contributions from (national) deposit guarantee schemes (DGS). At the same time, the CMDI Proposal tries to broaden the scope of resolution to include smaller and medium sized banks. This paper provides an assessment of the CMDI Proposal. It argues that the CMDI Proposal is a step in the right direction but cannot overcome fundamental deficiencies in the design of the Banking Union.

**Keywords:** bank resolution, CMDI, EDIS, bail-in, transfer strategies, MREL, Banking Union

**JEL Classification:** G01, G18, G21, G28, K22, K23

# Reform of the CMDI Framework - Driving Off With the Breaks On

Ioannis G. Asimakopoulos<sup>†</sup> and Tobias H. Tröger<sup>††\*</sup>

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## 1 Introduction and background

We revisit the efforts to reform the European Crisis Management and Deposit Insurance (“**CMDI**”) framework. We anchor our discussion on the reform proposal of the European Commission (the “**CMDI Proposal**”)<sup>1</sup> and consider the approach adopted by the Committee on Economic and Monetary Affairs of the European Parliament (the “**ECON Report**”).<sup>2</sup> The Parliament has adopted the ECON Report<sup>3</sup> and the Council is likely to also agree on its position in June 2024, allowing trilogue negotiations to start at the beginning of the next legislative term. Should the proposal fall victim to discontinuity, we expect the European co-legislators to retable it during the next one. To inform the impending legislative process, we highlight several shortcomings of the CMDI Proposal and recommend amendments to remedy them. Our analysis focuses on the proposal’s impact on the resolvability of small and medium-sized retail banks. The structure of the EU banking sector and its deposit-heavy funding structure makes providing viable resolution strategies for such retail banks one of the most critical challenges for the credibility of the CMDI framework.<sup>4</sup>

Unfortunately, the experiences under the European CMDI regime and the recent banking turmoil of 2023 indicate that the current framework cannot quell banking crises involving significant liquidity outflows at ailing institutions without extraordinary government interventions. This observation starkly contrasts the objectives of the reform agenda after the Global Financial Crisis (“**GFC**”). If the CMDI Proposal were in place in 2023, it would have marked an incremental improvement, yet it would not have fundamentally altered the picture. Future reform

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<sup>1</sup> The CMDI Proposal comprises the three European Commission proposals to amend the Bank Recovery and Resolution Directive (“**BRRD**”) (COM/2023/227 final), the Single Resolution Mechanism Regulation (“**SRMR**”) (COM2023/226 final) and the Deposit Guarantee Scheme Directive (“**DGSD**”) (COM/2023/228 final).

<sup>2</sup> The ECON Report comprises three ECON reports discussing the proposed amendments to the BRRD, the SRMR and the DGSD.

<sup>3</sup> However, the MEPs of the next economic and monetary affairs committee remain free to open negotiations based on the mandate adopted by the April 2024 plenary or to seek a new negotiating mandate.

<sup>4</sup> The “retail challenge” establishes as crucial impediment to the rigorous implementation of the CMDI. If vulnerable retail investors hold a significant amount of bail-inable liabilities, resolution authorities and politicians have incentives to refrain from rigid write-downs and conversions, see Ioannis Asimakopoulos, ‘The Resolution of Retail Banks: Balancing Proportionality and Standardisation’ (2022).; Irene Mecatti and Tobias H Tröger, ‘Who Should Hold Bail-Inable Debt and How Can Regulators Police Holding Restrictions Effectively?’ (2023) 33 Rivista Italiana di Diritto Pubblico Comunitario 91.; Tatiana Farina and others, ‘Is There a “retail Challenge” to Banks’ Resolvability? What Do We Know about the Holders of Bail-Inable Securities in the Banking Union?’ (SAFE 2022) <<http://publikationen.uni-frankfurt.de/frontdoor/index/index/docId/65186>>.

initiatives must take bolder steps, although European regulators could achieve significant enhancements without radical legislative interventions.

To make this point, we briefly recall the main objectives of the CMDI framework (infra 2). We then outline why resolution authorities' incentives to trigger resolution are currently limited, and the CMDI framework thus remains underutilized (infra 3). In the principal analysis (infra 4), we assess the CMDI Proposal and show how it would have improved realizing the policy objectives underpinning the CMDI framework and where it would have fallen short. We evaluate the reform proposals along two interrelated criteria: Do the reforms improve decision-makers' incentives to trigger resolution and deal with failing banks under the CMDI framework? Do the reforms improve resolution funding without conjuring up run risks? Our discussion also incorporates the lessons that the recent banking turmoil of 2023 teaches for future reform initiatives. Against this background, we sketch two desirable policy interventions that we consider attainable even under current and future political restrictions (infra 5). Finally, we conclude (infra 6).

## 2 Policy objectives of the CMDI framework and their implementation

A key feature of resolution is to compel bank creditors to share the burden of a failed bank's losses and recapitalization needs. Such Private Sector Involvement ("PSI") is the preferred policy alternative to loss-sharing arrangements for non-viable banks that rely on public funds, i.e., inject funds from the treasury or central banks ('bail-outs').<sup>5</sup> PSI can be either internal (i.e., banks individually internalize losses through 'bail-in') or external (i.e., the banking sector collectively internalizes losses through contributions to funds designated to finance the resolution of banks, such as resolution funds, deposit guarantee schemes ("DGS"), or institutional protection schemes ("IPS").

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<sup>5</sup> The first notice of intent occurred at the G20 summit in Pittsburgh 2009, see G20 Leaders Statement, *The Pittsburgh Summit* (2009), 9 <<https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf>> accessed 20 August 2017. For key policy documents see Financial Stability Board (FSB), *Reducing the moral hazard posed by systemically important financial institutions* (2010) 3-6 <[http://www.fsb.org/wp-content/uploads/r\\_101111a.pdf](http://www.fsb.org/wp-content/uploads/r_101111a.pdf)> accessed 20 August 2017; High-level Expert Group on reforming the structure of the EU banking sector, Final Report (2012) 81-83, 92-93 <[http://ec.europa.eu/finance/bank/docs/high-level\\_expert\\_group/report\\_en.pdf](http://ec.europa.eu/finance/bank/docs/high-level_expert_group/report_en.pdf)> accessed 20 August 2017; Paul Tucker, 'Resolution and the Future of Finance' (The Hague, 05 2013) <<http://www.bis.org/review/r130606a.pdf>>; see also Thomas F Huertas, 'The Case for Bail-Ins' in Patrick S Kenadjian and Andreas Dombret (eds), *The Bank Recovery and Resolution Directive: Europe's Solution for 'Too Big To Fail'?* (De Gruyter 2013) 4–20 <<https://doi.org/10.1515/9783110321401.167>> accessed 6 March 2024. (describing the negative growth implications of TBTF); for a review of the early academic literature see Philip E Strahan, 'Too Big to Fail: Causes, Consequences, and Policy Responses' (2013) 5 Annual Review of Financial Economics 43.

Policymakers introduced PSI to establish market discipline in the financial sector.<sup>6</sup> PSI should replace government-funded bail-outs and force private sector investors in bank capital and debt to internalize the failed bank's losses and contribute to its recapitalization needs. It should undo implicit government guarantees, thereby instilling risk sensitive pricing of bank capital and debt.<sup>7</sup> However, this disciplining effect is only as powerful as the credibility of PSI. Suppose markets anticipate a weak and time-inconsistent enforcement of PSI and expect resolution authorities and politicians to revert to bail-outs in banking crises. In that case, market discipline in the financial sector will remain suboptimal and moral hazard will be reinforced.

Amid the public outcry that followed the bail-out of banks during the GFC and the euro area sovereign debt crisis, EU policy aspired to demote bail-outs to the solution of last resort, accessible only after achieving an ambitious level of PSI.<sup>8</sup> So far, PSI occurs primarily at the individual bank level. Industry funding is only accessible subject to a predetermined minimum bail-in requirement (8% of a bank's total liabilities and own funds ("TLOF"))<sup>9</sup> and is limited either by specific caps (e.g., caps for the use of the Single Resolution Fund ("SRF"))<sup>10</sup> or by design (e.g., national DGSs, in some jurisdictions, are available to fund resolution strategies insofar as

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<sup>6</sup> Tobias H Tröger, 'Regulatory Influence on Market Conditions in the Banking Union: The Cases of Macro-Prudential Instruments and the Bail-in Tool' (2015) 16 *European Business Organization Law Review* 575, 588 figure 3.; Tobias H Tröger, 'Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime' (2018) 4 *Journal of Financial Regulation* 35.; see also John C. Coffee, Jr., 'Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk', (2010) *Columbia Law and Economics Working Paper No. 380*, 35 <<http://ssrn.com/abstract=1675015>> accessed 20 August 2017; Virginia Skidmore Rutledge and others, 'From Bail-out to Bail-in : Mandatory Debt Restructuring of Systemic Financial Institutions' (International Monetary Fund, 24 April 2012) 5, 20 <<https://www.imf.org/external/pubs/ft/sdn/2012/sdn1203.pdf>>; Huertas (n 7).; see also Rutledge and others 7.; Jeffrey N Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' (2015) 115 *Columbia Law Review* 1297, 1355–1356.

<sup>7</sup> External PSI that partly relies on mutualization of burdens in the banking sector potentially attenuates the incentive effect and introduces moral hazard if individual institutions' contributions do not reflect these banks' risk structure adequately.

<sup>8</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council 2014. [2014] OJ L 173/190, art. 37(10)(a) prescribes that at least 8% of an institution's total liabilities and own funds must be bailed-in before any government support in the form of a capital contribution or even the nationalization of the bank can be extended under BRRD arts. 57, 58.

<sup>9</sup> *ibid.* BRRD art. 44(5)(a) and Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L 225/1, art 27(7)(a). require a minimum bail-in of at least 8% of an institution's total liabilities and own funds before national resolution financing arrangements or the Single Resolution Fund can take any losses.

<sup>10</sup> BRRD art. 44(5)(b); SRMR art. 27(2)(b).



these strategies would impact covered deposits, thereby restricting DGSs' contributions to depositors' hypothetical losses). In addition, the respective funds' financial capacity limits their momentum quasi-naturally. Therefore, the success of any resolution strategy in the EU hinges primarily on the internal loss-bearing and recapitalization capacity from bail-in. In turn, to ensure the pivotal enforceability of bail-in, the CMDI framework requires banks that are designated to be resolved instead of liquidated when reaching their point of non-viability ("PONV"). In this case, banks have to comply with a minimum requirement of own funds and eligible liabilities ("MREL") that predetermines the composition of institutions' balance sheets, in addition to the minimum capital requirements.<sup>11</sup> Banks have to hold a specified layer of capital and/or high-quality, non-runable debt instruments that increases the chances of an effective bail-in should the bank reach the PONV. Ultimately, the prospect and credibility of resolution of failing banks, including small and medium-sized retail banks, depends critically on these institutions' MREL buffers. Reform initiatives that unlock more sources of external PSI reduce this dependence without sacrificing the overarching policy objective of minimizing the need for taxpayer-funded bail-outs.

### 3 CMDI as an underutilized asset

Evidence suggests that since 2015, most failing retail banks were managed outside resolution and under national regimes, often involving government funding. Authorities dealt with 60% of failing retail banks in the EU outside of resolution; this percentage exceeds 70% for banks within the SRM.<sup>12</sup> This paper focuses on structural deficiencies in resolution financing that impeded the broad application of the CMDI framework. These deficiencies disincentivized resolution authorities to trigger resolution. The prospect of touching on bank deposits undermines

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<sup>11</sup> For banks where the resolution plan provides that they are wound up under normal insolvency proceedings or other equivalent national procedure, MREL does typically not include a recapitalization amount and the loss absorption amount is equal to the own funds requirements, including pillar 2 add-ons, cf. BRRD art. 45c(2) subpara. 2 and (3)(a)(i).

<sup>12</sup> European Commission, Commission Staff Working Document Impact Assessment Report Accompanying the Proposals for a Directive of the European Parliament and Council amending Directive 2014/59/EU as regards early intervention measures, conditions for resolution and financing of resolution action Regulation of the European Parliament and Council amending Regulation (EU) 806/2014 as regards early intervention measures, conditions for resolution and financing of resolution action Directive of the European Parliament and Council amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency 2023 [SWD(2023) 225 final] 23.; for case studies see also Tobias H Tröger and Anastasia Kotovskaia, 'National Interests and Supranational Resolution in the European Banking Union' [2023] European Business Law Review 781, 796–798.

orderly resolution efforts and creates *ex post*-inefficiencies.<sup>13</sup> Therefore, the looming fragility stimulates an *ex ante* appetite to deal with failing banks outside of resolution if such regulatory side-tracking minimizes disruptions. The banking turmoil of March 2023 highlighted not only the fragility of deposit-centered funding models in banking but also documented central banks' and governments' propensity to resort to *ad hoc* interventions if systemic disruptions loom.<sup>14</sup> The interrelation of insufficient resolution financing through PSI and decision-makers' preference for handling banking stress outside of resolution explains the underutilization of the European CMDI framework.

Banks are resolvable when they can absorb losses and, if needed, recapitalize themselves while preserving at least their critical functions.<sup>15</sup> Three components contribute critically to this end by providing the necessary loss-absorbing and recapitalizing capacity: (i) the MREL instruments and the additional (non-MREL eligible) bail-inable liabilities which are written-off or converted in case of failure, (ii) resolution financing arrangements which provide capital (and liquidity) in resolution when bail-in is not sufficient, and (iii) deposit insurance which funds resolution when covered deposits would have been bailed-in in resolution<sup>16</sup> or reimburses covered depositors when they are haircut in liquidation. If one of these components is unavailable

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<sup>13</sup> Florian Heider and others, 'European Lessons from Silicon Valley Bank Resolution: A Plea for a Comprehensive Demand Deposit Protection Scheme (CDDPS)' (SAFE 2023) <<http://publikationen.ub.uni-frankfurt.de/frontdoor/index/index/docId/64058>>; Enrico Perotti and Edoardo D Martino, 'Containing Runs on Solvent Banks: Prioritising Recovery over Resolution' (02 2024) <<https://cepr.org/publications/policy-insight-127-containing-runs-solvent-banks-prioritising-recovery-over-resolution>>.

<sup>14</sup> In the US, in the wake of the Silicon Valley Bank failure, the Federal Reserve and the Treasury quelled contagion risk outside the designated crisis management framework, by providing an unlimited guarantee of uninsured deposits (invoking the systemic risk exception), liquidity to U.S. banks in the FDIC system at par in the Bank Term Funding Program, and internationally coordinated swap-lines, see James Lee and David Wessel, 'What Did the Fed Do after Silicon Valley Bank and Signature Bank Failed?' [2024] The Hutchins Center on Fiscal and Monetary Policy <<https://www.brookings.edu/articles/what-did-the-fed-do-after-silicon-valley-bank-and-signature-bank-failed/>>.. In Switzerland, the demise of Credit Suisse prompted the Swiss Federal Council to enact new legislation that allowed the Swiss National Bank to provide additional emergency liquidity ("ELA+") up to CHF 100bn to Credit Suisse and UBS, to inject an additional CHF 100bn in liquidity to Credit Suisse secured by a public guarantee issued by the Swiss Confederation; in addition the Swiss Confederation provided a public guarantee to UBS for CHF 9bn on losses impending on Credit Suisse most toxic assets, see Basel Committee on Banking Supervision, *Report on the 2023 Banking Turmoil* (BCBS 2023) 14 <<https://www.bis.org/bcbs/publ/d555.pdf>>..

<sup>15</sup> We acknowledge that satisfying a failing institutions' liquidity needs is also a critical dimension of 'resolution funding', see Maria Demertzis and others, 'How to Provide Liquidity to Banks after Resolution in Europe's Banking Union' (Bruegel Policy Contribution, 2018) 4–5 <[https://www.bruegel.org/sites/default/files/wp-content/uploads/2018/11/PC-21\\_2018.pdf](https://www.bruegel.org/sites/default/files/wp-content/uploads/2018/11/PC-21_2018.pdf)>.. However, due to the Commission's restricted mandate, the CMDI Proposal does not address this unresolved issue. Instead of working through the wish list of all desirable additions to the CMDI framework, we align our discussion with the proposal's narrow scope.

<sup>16</sup> Cf. BRRD art. 109(1). Covered deposits are exempt from bail-in (BRRD, art. 44(2)(a)) and thus rank *pari passu* with secured liabilities (BRRD, art. 44(2)(b)). However, covered deposits can be written off in liquidation under national insolvency proceedings.

or underperforms, the pressure for adequate financing falls upon the others. Ultimately, the success of the crisis management efforts can be at risk.

Commentators have voiced concerns that resolution financing in the EU is currently inadequate.<sup>17</sup> We share this view,<sup>18</sup> mainly because the current CMDI framework does not ensure sufficient financing in resolution.

Member states' resolution financing arrangements and the SRF, which mutualized national resolution funds in the euro area, are primarily designed as a recapitalization tool for European banks only once the 8% bail-in of the failing bank's TLOF has been applied. Moreover, resolution funds can contribute only up to 5% of the failing bank's TLOF.<sup>19</sup>

DGSs can also provide resolution financing.<sup>20</sup> These schemes can contribute to resolution up to the amount they would have to reimburse if covered depositors were subject to internal PSI at the failed institution. In particular, if resolution schemes foresee the application of the bail-in tool, the DGSs are liable for the amount covered deposits would have been written down to absorb losses (not: to recapitalize the bank) were they not exempt from internal PSI.<sup>21</sup> When other resolution transfer tools are applied, the DGS is liable for the losses covered depositors would have suffered had they been treated like creditors ranking equally under ordinary insolvency proceedings.<sup>22</sup> DGSs' contributions reflect the protection covered depositors enjoy in case of liquidation and thus avoid violating the 'no creditor worse-off' principle ("NCWO"),<sup>23</sup> also for *pari passu* creditors.

Moreover, the DGS' liability should not be greater than the amount equal to 50% of its target level unless member states increase the maximum contribution.<sup>24</sup> This contribution is further

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<sup>17</sup> Several contributions have exposed various shortcomings of the current CMDI framework, see, e.g. Ioannis Asimakopoulos and David Howarth, 'Stillborn Banking Union: Explaining Ineffective European Union Bank Resolution Rules†.' (2022) 60 *Journal of Common Market Studies* 264; Jens-Hinrich Binder, 'Failing Banks within the Banking Union at the Crossroads: Taking Stock and Next Steps' <<https://papers.ssrn.com/abstract=4036699>> accessed 26 February 2024; Jens-Hinrich Binder, 'Inter-Agency Cooperation Within the SRM: Legal and Operational Challenges for the Cooperation Between Banking Supervision and Resolution Authorities in the EU and With Third-Country Authorities.' (2022) 19 *European Company & Financial Law Review* 900; Thomas F Huertas, 'Reset Required: The Euro Area Crisis Management and Deposit Insurance Framework' [2021] SAFE White Paper; Phedon Nicolaides, 'State Aid after the Banking Union: Serious Disturbance and Public Interest.' (2022) 23 *Journal of Banking Regulation* 79; Irene Mecatti, 'The Crisis Management of Smaller Banks: Perspectives of Reform.' (2023) 20 *660*; Martin Hellwig, 'Twelve Years after the Financial Crisis—Too-Big-to-Fail Is Still with Us.' (2021) 7 *Journal of Financial Regulation* 175; Tröger and Kotovskaia (n 14).

<sup>18</sup> For a broad discussion see Tröger and Kotovskaia (n 14).

<sup>19</sup> See *supra* n 9.

<sup>20</sup> See *above* n 16.

<sup>21</sup> BRRD art. 109(1) subpara 1(a) and subpara 3.

<sup>22</sup> BRRD art. 109(1) subpara 1(b).

<sup>23</sup> BRRD art. 109(1) subpara 2. For the general principle see BRRD art. 34(1)(g).

<sup>24</sup> BRRD art. 109(5) subpara 2.

limited by potential recoveries on reimbursed deposits.<sup>25</sup> First and foremost, however, the super-priority provided to insured deposits makes using DGS financing in resolution very unlikely because the essential hypothetical loss can only occur after all other (lower ranking) liabilities, including uninsured deposits, would have been bailed-in.<sup>26</sup>

The current CMDI framework may create a scarcity of resolution financing. Figures 1a – 1c and 2a – 2c illustrate the resolution funding gap that may occur under the waterfall for internal PSI under the current CMDI framework. It distinguishes between those member states that rank ineligible deposits, i.e., non-SME corporate deposits, *pari passu* with other unsecured liabilities on the one hand (Figures 1a – 1c) and those member states that rank these deposits higher than other unsecured liabilities on the other (Figures 2a – 2c). They show that the balance sheet composition of the failing institution is crucial for effective internal PSI that avoids impairing runnable deposits. Therefore, resolution strategies relying on internal PSI are only credible if the bank has sufficient liabilities that can be bailed-in to meet the 8% TLOF minimum without destroying value beyond their nominal value,<sup>27</sup> and, most importantly, without triggering a run.

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<sup>25</sup> BRRD art. 109(5) subpara 3.

<sup>26</sup> BRRD art. 108(b); for a discussion see Mecatti (n 19) 685.

<sup>27</sup> Critical client relations appear on the liability side of the failed bank's balance sheet. Therefore, their treatment in ordinary insolvency law would destroy value beyond the nominal value of the claim. For instance, the automatic stay impairs the liquidity providing function of deposits and the loss participation of riskshifting derivatives destroys hedges, see Joseph H Sommer, 'Why Bail-in? And How!' (2014) 20 *Economic Policy Review* 207, 209–213. (highlighting the specific characteristics of 'financial liabilities' whose social value exceeds their nominal one and may have a firm-specific element). Hence, the cost-minimizing social optimum can only be achieved if these liabilities receive a special (preferred) treatment in insolvency; Emiliios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-Ins' (2015) 1 *Journal of Financial Regulation* 3, 12. (same, with diverging terminology).

Figure 1a-1c – Funding gap with three tier depositor preference (NSMS)

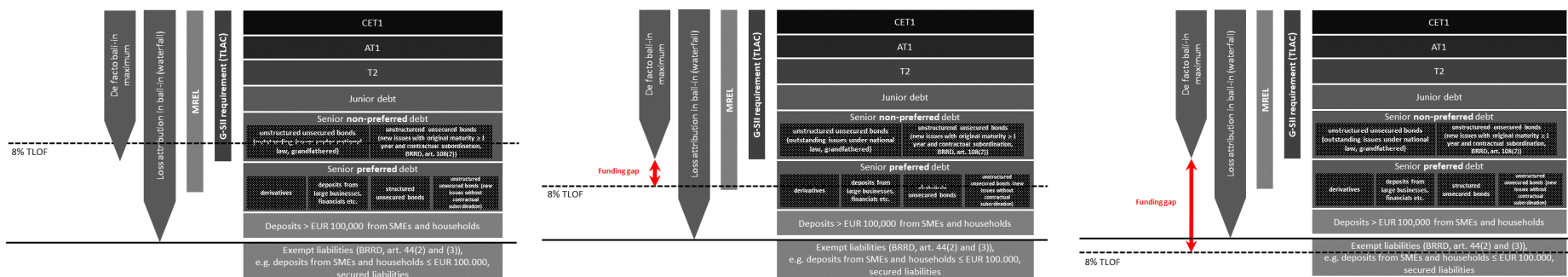
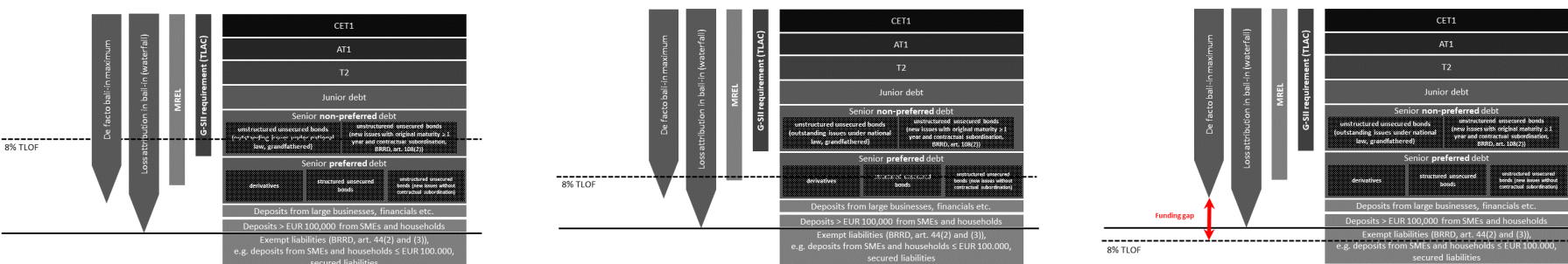


Figure 2a-2c – Funding gap with three tier depositor preference (SMS)



The looming funding gap effectively compels resolution authorities to ensure the resolvability of banks through the MREL calibration if they intend to resolve banking crises under the CMDI framework without touching runnable deposits.<sup>28</sup> At the outset, EU law allows for such an MREL calibration. The CMDI framework requires all banks, regardless of size and business model, to meet demanding MREL prescriptions<sup>29</sup> and, therefore, compels banks to build up buffers of subordinated liabilities<sup>30</sup> that exceed their prudential own funds requirements if the resolution plan foresees resolving the bank under the CMDI framework (instead of liquidating it in bankruptcy). However, many retail banks, regardless of the soundness of their business models and financing strategies, face severe obstacles in accessing public capital markets at sustainable costs.<sup>31</sup>

According to empirical evidence provided by the European Commission<sup>32</sup>, in a sample of 187 banks that would go into resolution if they failed as of Q4 2019, deposits in 44 banks in 18 member states would have to bear losses for an aggregate amount of EUR 14.16 bn under the baseline scenario (status quo) to reach 8% TLOF and be able to access the national resolution financing arrangements/the SRF. Retail and SME deposits are the predominant source of funding in smaller and medium-sized banks across the EU. Exactly these institutions find it challenging to place MREL instruments on capital markets, with their alternative funding strategies as prototypical deposit-taking credit institutions not being objectionable per se.

Predictable funding gaps may explain the reluctance of many resolution authorities to utilize the CMDI framework, which would compel them to impose losses on depositors. Decision makers may thus make sub-optimal crisis management choices outside resolution,<sup>33</sup> financed

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<sup>28</sup> In principle, all uncovered deposits are bail-inable, BRRD art. 44(1)-(3); SRMR art. 27(3)-(5).

<sup>29</sup> BRRD art. 45(1).

<sup>30</sup> While the liabilities eligible for fulfilling institutions' total loss absorbing capacity (TLAC) requirements must generally be subordinate to ineligible liabilities, Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 of the European Parliament and Council of 26 June 2012, art. 72b(2)(d), MREL eligible liabilities *de iure* are not subject to such a strict subordination requirement; instead they can rank *pari passu* with ineligible liabilities, cf. BRRD, art. 45b(1) which deliberately does not refer to CRR, art. 72b(2)(d). However, to avoid running afoul of the no creditor worse off-principle, the liability class favoured by regulators to meet MREL targets is the newly created senior non-preferred debt which also ranks below other unsecured claims, cf. BRRD, art. 108(2). Moreover, BRRD, art. 45b(3) empowers resolution authorities to require individual institutions to meet their MREL targets with subordinated liabilities.

<sup>31</sup> European Banking Authority, Final Report on MREL: Report on the implementation and design of the MREL framework, 14 December 2016.

<sup>32</sup> European Commission Commission Staff Working Document Impact Assessment Report Accompanying the Proposals for a Directive of the European Parliament and Council amending Directive 2014/59/EU as regards early intervention measures, conditions for resolution and financing of resolution action Regulation of the European Parliament and Council amending Regulation (EU) 806/2014 as regards early intervention measures, conditions for resolution and financing of resolution action Directive of the European Parliament and Council amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency (n 14) 30.

<sup>33</sup> See also Tröger and Kotovskaia (n 14) 790–792. (explaining the political economy of bureaucrats' and politicians' choices).



from public budgets and following widely varying national regimes.<sup>34</sup> The structure of the EU banking sector, characterized by many small and medium-sized institutions with, at best, limited access to capital markets, makes relying on MREL calibration alone a dubious policy choice (see also below 4.2.2). The incentives to manage banking crises outside of the CMDI framework may persist beyond a transition phase, and resolution authorities can accommodate such preferences by already scheduling liquidation strategies in the capital market remote institutions' resolution plans. If resolution authorities instead impose demanding MREL targets on these institutions, they might trigger an ambiguous concentration in banking. Sound banking policy may thus promulgate legislative amendments that allow tapping other sources of resolution funding, notably if they ensure external PSI.

## 4 The CMDI Proposal

### 4.1 Background: member states' reluctance to fully centralize resolution and deposit insurance

The CMDI Proposal was an attempt to optimize under constraints. Since its inception, the Banking Union was conceived as a three-pillar construct, with the third pillar being a common mechanism for deposit insurance.<sup>35</sup> However, even though the Commission adopted a legislative proposal already in 2015,<sup>36</sup> a fully mutualized European Deposit Insurance Scheme (“EDIS”) remained a no-go for several member states over the years.<sup>37</sup> Retaining national idiosyncrasies like institutional protection schemes allowed them to shield politically well-networked parts of domestic banking systems from the arguably more demanding requirements of the CMDI framework.<sup>38</sup> Against this background, the Commission initiated the review of the CMDI

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<sup>34</sup> Jens-Hinrich Binder, ‘Towards Harmonised Frameworks for the Liquidation of Non-Systemically Relevant Credit Institutions in the EU?: A Discussion of Policy Choices and Potential Impediments.’ (2021) 18 *European Company & Financial Law Review* 555, 558–565; Michael Schillig, ‘EU Bank Insolvency Law Harmonisation: What Next?’ (2021) 30 *International Insolvency Review* 239; Anna Gelpert and Nicolas Véron, ‘European Banking Reform Should Embrace a Unitary Approach to Failed Banks.’ (2021) 22 *CESifo Forum* 37.

<sup>35</sup> European Commission, Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union 2012 [COM(2012) 510 final].

<sup>36</sup> European Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme 2015 [COM(2015) 586 final].

<sup>37</sup> The European Parliament adopted its position on the EDIS Regulation in April 2024. However, in light of the Council's negative stance, we do not expect material progress any time soon. Therefore, we align our analysis with the narrow mandate for the CMDI review and do not consider the EDIS proposal in this paper, see also below 5.

<sup>38</sup> For an in-depth analysis of the merits and shortcomings of the German IPS in the savings and loans-sector see Rainer Haselmann and others, *Institutional Protection Schemes: What Are Their Differences, Strengths, Weaknesses, and Track Records?: In Depth Analysis*. (Publications Office 2022) <<https://data.europa.eu/doi/10.2861/479118>> accessed 14 March 2024.

framework in 2019 with limited scope, signaled in its report on the application and review of the BRRD and the SRMR.<sup>39</sup>

The political constraints that militate against a full-fledged reform implementing a first-best approach to completing the banking union<sup>40</sup> will likely persist or become even more pronounced in the near future as the opposition to further centralization grows in many member states. Therefore, a critical assessment of the 2023 reform proposal remains worthwhile because it can improve real-world policy choices once the co-legislators carry the CMDI reform project forward during the next legislative term.

## 4.2 What would the CMDI Proposal have achieved, and what would the remaining shortcomings be?

### 4.2.1 Enhanced industry resolution funding

The CMDI Proposal aims to increase available resolution funding by introducing two changes to the existing CMDI rules – (i) it amends the creditor hierarchy by canceling the super-priority of covered deposits and treating covered deposits *pari passu* to uncovered deposit (Article 108(1) BRRD3); (ii) it allows the use of DGS funding as a replacement to eligible deposits that would otherwise have to be bailed-in in a transfer-based resolution strategy (Article 109 BRRD3). The ECON Report takes a similar position but proposes a two-tier depositor hierarchy separating retail and SME deposits from large enterprise and central and regional government deposits.

#### 4.2.1.1 Depositor preference

Article 108(1) BRRD3 abolishes the distinction between covered and uncovered deposits in the creditor hierarchy. Instead, it treats all deposits (covered and uncovered as well as eligible deposits of corporates and excluded deposits) as one creditor class that sits above all ordinary unsecured claims and ranks *pari passu* to the DGS. This amendment, all things being equal, would already permit the use of the DGSs' funds earlier because loss absorption through internal PSI would not have to burn up uncovered deposits to trigger DGS contributions (see above 3). Therefore, DGS funding becomes more accessible, and the looming funding gap occurs less frequently. Figures 3a-3c illustrate this effect.

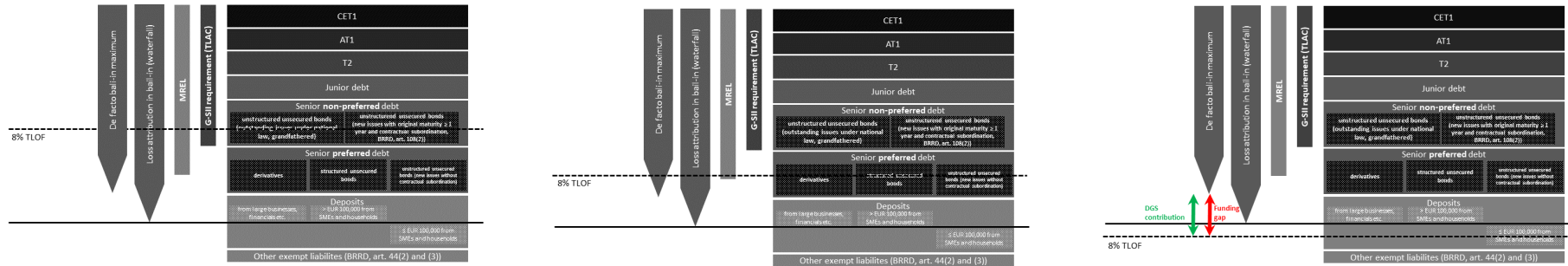
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<sup>39</sup> European Commission, Report from the Commission to the European Parliament and the Council on the application and review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation) 2019 [COM(2019) 213 final].

<sup>40</sup> Jeromin Zettelmeyer and others, 'How to Get the European Banking Union Unstuck' (Bruegel 2022) <[https://EconPapers.repec.org/RePEc:bre:polbrf:node\\_8580](https://EconPapers.repec.org/RePEc:bre:polbrf:node_8580)>.



Figure 3a-3c – Funding gap and DGS contribution with single depositor preference under the CMDI Proposal



This amendment is also consistent with the literature on deposit insurance, which argues that the co-existence of deposit insurance and covered deposits' super-priority minimizes the useability of deposit guarantee schemes.<sup>41</sup> The policy decision of the EU legislator to protect covered deposits in bank crisis management remains intact since covered deposits still benefit from an exclusion from bail-in and would, in any case, be reimbursed by the DGS within a short period (Recital 39 and 43 BRRD3). From a financial stability perspective, DGSs' capacity to step in in a resolution scenario and cover deposits without incurring tail effects for the financial system should be further investigated – especially considering the funding model of DGSs, which relies heavily on *ex post* contributions.

The ECON Report confirms the abolition of the distinction between covered and uncovered deposits. However, it proposes a two-tier depositor hierarchy where retail and SME deposits rank *pari passu* to covered deposits and higher than deposits of large enterprises and central and regional governments. This proposal enhances the protection of retail and SME deposits. It also conforms with existing MREL rules that consider some deposits to be MREL eligible. Yet, compared to the CMDI Proposal, the amendment would also increase the run risks because it requires the bail-in of large enterprises' and central and regional governments' deposits before DGS funding can be activated. As a result, the use of DGS funding in resolution would remain unrealistic at banks with significant wholesale and sovereign deposits on their balance sheets (see section 4.2.1.2 below).

#### **4.2.1.2 Use of DGS funding in resolution**

Consistent with creating a simpler depositor hierarchy (either single or two-tier depending on the outcome of the legislative negotiations) (see above 4.2.1.1), DGS contributions can substitute for a more comprehensive set of losses predicated on resolution actions. BRRD3 art. 109 specifies the use of additional sources of funding that become available due to dropping covered deposits' super-priority (*supra* 4.2.1.1).

The leeway for DGS funding in resolution is not materially increased in an open-bank resolution strategy with or without the use of the asset separation tool. The DGS contribution remains limited to the hypothetical losses covered deposits would have suffered in a bail-in, although DGSs can also contribute to the failed banks' recapitalization.<sup>42</sup> Hence, the reforms cannot bridge resolution funding gaps at banks that rely heavily on uninsured deposits and, therefore, have no bearing on run risks similar to those that materialized in spring 2023 at the faltering US regional banks. (Recital 45 BRRD3).

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<sup>41</sup> Rosaria Cerrone, 'Deposit Guarantee Reform in Europe: Does European Deposit Insurance Scheme Increase Banking Stability?' (2018) 21 Journal of Economic Policy Reform 224.

<sup>42</sup> BRRD, art. 109(1) subpara 1 (a).

DGS contributions are available beyond covered deposits' hypothetical losses if resolution authorities pursue transfer strategies (sale of business and bridge institution). Article 109(1) subpara 1 (b) BRRD3 specifies that DGS contributions to transfer strategies shall consist of (i) the amount necessary to cover the difference between the value of the covered deposits and of the liabilities with the same or higher priority ranking than deposits and the value of the assets of the institution under resolution which are to be transferred to a recipient,<sup>43</sup> and (ii) where relevant, an amount necessary to ensure the capital neutrality of the recipient following the transfer. Although the exact scope for the use of DGS contributions in transfer strategies remains questionable,<sup>44</sup> the essential feature of the proposed rule is straightforward: DGS contributions can cover losses and satisfy recapitalization needs that would, absent DGS interventions, create a burden for uncovered depositors (and other *pari passu* creditors).<sup>45</sup> At the outset, the reform could thus effectively quell detrimental run incentives.

Moreover, DGS funding in resolution can bridge a gap between the failed entity's MREL capital resources and the 8% TLOF requirement to access national resolution financing arrangements or the SRF (see above 2 and 3).<sup>46</sup> The proposed amendment would open two tiers of resolution funding with external PSI once a failing bank's internal loss-absorbing capacity beyond deposits is exhausted. It would, in principle, close the funding gap in resolution many retail banks face and, as a consequence, also mitigate the retail challenge that many banks and, as a consequence, resolution authorities and political decision makers currently struggle with. Under the ECON Report, the DGS funding options are broadened because a DGS can also contribute when funding from resolution financing arrangements has reached the 5% cap (see above 3) and no other liabilities than deposits could be bailed-in.

However, the ECON Report's proposal for a two-tier depositor preference model (above 4.2.1.1) may hinder the availability of DGS funding in resolution. The demise of the US re-

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<sup>43</sup> The contribution can be made regardless of whether resolution authorities decide to exempt uncovered deposits and *pari passu* ranking liabilities from bail-in, BRRD3 art. 109(1) subpara 2.

<sup>44</sup> BRRD3 art. 109(1) subpara 1 (b)(i) targets partial transfer strategies; BRRD3 art. 109(1) subpara 1 (b)(ii) has a broader scope and, in principle, captures both partial and whole bank transfers. Supporting whole bank transfers could also be squared with the objective of BRRD3 to provide additional DGS funding in resolution if the entity in resolution exits the market (cf. BRRD3 recital 45). Such a market exit is the *de iure* result of a sale of business-resolution, although the failing bank's franchise survives at the absorbing entity. Moreover, although, in theory, legacy risks could be reflected in price reductions, resolution practice also suggests that external loss absorbing capacity that shields the acquirer from successor liabilities increases the chances of a transfer in resolution. DGS contributions can indeed serve this function, thereby supporting transfer strategies in resolution.

<sup>45</sup> Kai Gereon Spitzer and Marcel Magnus, *CMDI Reform: What Are the Implications for Depositors?* (Economic Governance and EMU Scrutiny Unit 2023) 6 <[https://www.europarl.europa.eu/Reg-Data/etudes/BRIE/2023/741522/IPOL\\_BRI\(2023\)741522\\_EN.pdf](https://www.europarl.europa.eu/Reg-Data/etudes/BRIE/2023/741522/IPOL_BRI(2023)741522_EN.pdf)>.

<sup>46</sup> BRRD3, art. 109(2b).

gional banks in early 2023 illustrated that the bail-in of large enterprise and government deposits might generate financial stability risks (depending on the type of bank and jurisdiction in consideration). Therefore, the ECON Report's proposal places resolution authorities between a rock and a hard bed. They can either avoid stability risks by refraining from a bail-in of the respective liabilities, thereby constraining their access to DGS for resolution funding. Alternatively, they could accept the impending perils and impose losses on wholesale and sovereign deposits, thereby gaining access to DGS resolution funding. Although the latter may not always be the dominant strategy for a considerate resolution authority,<sup>47</sup> the increased possibility of suffering losses on their deposits amplifies large enterprises' and government bodies' incentives to run under the ECON report approach, leading *ceteris paribus* to a more fragile financial sector.

However, even the CMDI Proposal would not provide a comprehensive solution. DGS funding has to satisfy the 'least cost test' ("LCT"), according to which any DGS contribution to resolution shall not be greater than the cost of repaying depositors.<sup>48</sup> Hence, at banks that have a high proportion of uninsured deposits<sup>49</sup> – and are thus particularly prone to runs – the available DGS funding in resolution may not always suffice to fully bridge the gap between an entity's available loss-absorbing capacity and the 8% TLOF requirement to access the SRF. Consider an institution that has no access to public capital markets and thus refinances itself with equity and deposits, satisfying MREL exclusively with CET1-instruments. If a buyer in a sale of business transaction required a 15% markdown on the bank's total assets and the remaining equity valued at 4% of total assets, deposits would have to be written down by 11% to meet the buyer's demand. If 80% of these deposits were uncovered, the DGS contribution would be capped at 2.2% of total assets (assuming that the assets could also be sold for 85% of their book value in insolvency). Hence, writing down equity and receiving a DGS contribution would not meet the 8% TLOF requirement.<sup>50</sup> To meet this requirement, uncovered deposits would have to be cut, a prospect which would typically precipitate a run.

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<sup>47</sup> See Franklin Allen and Douglas Gale, 'Optimal Financial Crises' (1998) 53 *The Journal of Finance* 1245. (discussing desirable policies to prevent socially costly runs while maintaining market discipline).

<sup>48</sup> BRRD3 art. 109(1) subpara 3. The methodology and process for calculating the LCT is complex and involves some inter-agency intricacies. While the DGS calculates the (hypothetical) costs of repaying depositors, it does not seem to ultimately determine the cap for the use of DGS funding, because resolution authorities/the SRB decide on the DGS contribution after consulting with the DGS, BRRD3 art. 109(2), SRMR3 art 79(2). This suggests that the SRB is not bound by the DGSs' cost calculations and can substitute it with their own determination. In any case, on resolution weekend all stakeholders would have to cooperate. Moreover, the predictability of outcomes and ultimately market discipline hinges on developing a consistent methodology across different member states.

<sup>49</sup> Only insofar as covered depositors are impaired in a (hypothetical) insolvency, repayment obligations arise for the DGS, see BRRD3 art 109(1).

<sup>50</sup> For another numeric example see also Spitzer and Magnus (n 48) 8.

Despite some changes in the wording,<sup>51</sup> the TLOF requirement remains intact. Therefore, the CMDI Proposal remains stuck halfway in implementing the legislative intention of making resolution under the CMDI framework a more attractive choice. The funding gap persists if DGS contributions are insufficient to reach the 8% TLOF requirement once an institution's MREL resources have been exploited. This result may accord with the political intention to push resolution authorities and banks to achieve high MREL targets. However, it is heedless of the challenges such a policy approach creates for small and medium-sized banks.

#### 4.2.2 Lower MREL for transfer strategies

The rationale for unlocking the use of DGS funding in resolution more generously acknowledges that not all tumbling banks can rely on MREL up to the 8% TLOF threshold before accessing the SRF. This is not to say that MREL would not remain a pivotal component of the CMDI framework under the reform proposal. In fact, the ECON Report introduces a requirement that DGS funding in resolution is subject to the failed entity has been MREL-compliant for a certain period before its financial distress event. Yet, the CMDI Proposal introduces further distinctions for MREL calibration. Resolution authorities or the SRB can set MREL lower for entities with transfer strategies than for entities with open-bank bail-in strategies in their resolution plans. BRRD3 article 45ca and SRMR3 article 12da consider the availability of a private sector backstop in transfer strategies and, therefore, set out the variables that the resolution authority may consider when calibrating the institution-specific recapitalization amount of MREL for entities with transfer strategies.<sup>52</sup> At first sight, the amendments would not alter outcomes significantly because the SRB's MREL policy for transfer strategies arguably factors in most of these enumerated components.<sup>53</sup> However, BRRD3 would introduce an explicit basis in primary legislation, which resolution authorities could rely upon.

The unspecific reference to the 'depth of the market' as a consideration for setting MREL targets has the potential to materially change MREL calibration. BRRD3 article 45ca(1)(a) / SRMR3 article 12da (1)(a) SRMR3 may refer to either the depth of the market for failed banks (availability of potential buyers in a resolution scenario) or to the depth of the market for MREL instruments. If legislators had the M&A market in mind, MREL levels for banks would be lower at banks that are sought-after acquisition targets. In contrast, slow sellers would face more ambitious requirements because the lower probability of getting an M&A deal through on a resolution weekend would increase the likelihood of having to resort to a bridge institution or

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<sup>51</sup> The specific prescription that a failed banks TLOF should be determined "at the time of resolution action" (BRRD art. 44(5)(a)) would have been dropped in BRRD3 art. 44(5). Yet, this should not be read as allowing a sweeping consideration of historical losses during the banks' going concern, because such a reading would debase the requirement comprehensively.

<sup>52</sup> Determinants to be considered are: size, business model, risk profile, transferability analysis, marketability, use of share/asset deal and use of an asset management vehicle for assets which cannot be transferred as well as the depth of the market in which the resolution entity operates.

<sup>53</sup> MREL Policy 2023 2023.

an open-bank bail-in (if at all feasible) which requires more internal loss-absorbing capacity. If, instead, the criterion referred to an entity's capacity to place MREL instruments on capital markets, it could lead, in principle, to lower MREL targets if the requirements were calibrated with a view to what banks can achieve realistically. Yet, the latter interpretation is rather far-fetched because it would widen the DGS-SRF funding gap without offering a viable way to bridge it.

The ECON Report introduces additional conditions to minimize the risk of banks operating with no MREL or an MREL shortfall for an extended period while benefiting from DGS funding. Although the proposed amendments move in the right direction, they are unlikely to change the CMDI framework materially. They merely mirror the current SRB practice.

In sum, the proposed amendment of MREL calibration methodologies, at best, would lead to fine-tuning adjustments without tackling the fundamental challenges of insufficient resolution funding that may occur at small and medium-sized retail banks. Therefore, the 2023 CMDI reform proposal would not fundamentally improve the CMDI framework's attractiveness for dealing with such banks' failures.

#### 4.2.3 Public interest test

The purpose of the CMDI Proposal has been to widen the scope of the framework's application and include particularly retail banks that currently may not be resolvable. Improving resolution funding for these banks goes hand in hand with broadening the public interest assessment (PIA), which has served as the divide allowing the SRB to hand bank crisis management over to national authorities when the available internal and accessible external PSI would not smoothly support the preferred resolution strategy.<sup>54</sup>

The PIA requires comparing the effects of resolution under the CMDI framework on the one hand and liquidation under national law on the other against the resolution objectives set out in the BRRD. Therefore, adapting the geographical scope of the assessment broadens the scope for a positive PIA because, at smaller banks, the CMDI framework may facilitate achieving the resolution objectives better on the regional or national level but not on a European one. It thus matters that article 2(1)(35) of BRRD3 amends the definition of 'critical functions' to include explicitly functions that may disrupt financial stability "at national or regional level". The SRB may now arrive at a positive PIA for the resolution of smaller banks if their failure imperils the smooth and reliable functioning of the financial system in a specific member state or even a region, but not in the euro area or the EU. This amendment sought to incorporate a lesson learnt

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<sup>54</sup> Tröger and Kotovskaia (n 14) 792–799. Decision makers found the CMDI framework also unattractive when vulnerable retail investors held significant proportions of bail-inable securities, Mecatti and Tröger (n 6) 101–106. (describing the Italian efforts to avoid involving retail investors in internal PSI).

from the case of the Veneto banks in 2017. The SRB denied a public interest in the banks' resolution,<sup>55</sup> although the European Commission approved a state aid package from the Italian government to ensure the orderly liquidation of the two failed banks to preserve financial stability on the regional level.<sup>56</sup>

In line with the attempt to involve DGS more in resolution funding (above 4.2.1.1 and 4.2.1.2), the CMDI Proposal intends to expand the scope of resolution objectives to include the protection not only of covered depositors but also of all other depositors and, at the same time, minimize losses for DGSs.<sup>57</sup> Such a depositor protection objective would allow arriving at a positive PIA if the DGS would incur higher losses in liquidation than in resolution.

Article 32(5) of the BRRD3 and article 18(5) of the SRMR3 would broaden the scope for positive PIA even more by making resolution under the CMDI framework the default and allowing liquidation under national law only if it met the resolution objectives more effectively than resolution. In contrast, under the current CMDI framework, normal insolvency would apply even if it met resolution objectives only to the same extent as resolution. The legislator intends to bend the burden of proof for the PIA toward resolution. Yet, the practical effect of this exercise may be limited: forecasting the impact of resolution and winding up under national law does not come with scientific precision, and the discretionary choices the forecasting agency has to make allow arriving at the desired result, regardless of how the burden of proof is allocated.

With a potentially countervailing effect, the PIA shall also consider any public financial support available in resolution or liquidation under national law.<sup>58</sup> The proposed amendments codify the experience in the Veneto bank cases where regular insolvency proceedings were combined with state aid support from the Italian government. However, it also tilts the balance against resolution, because the ambitious 8% TLOF requirement does not apply outside the CMDI framework,<sup>59</sup> leaving more room for achieving the resolution objectives with a government hand outside of resolution.

This assessment holds even if we consider that under the CMDI Proposal, DGS funding can also be utilized as a recovery tool before resolution. Article 32c(1)(b) of BRRD3 allows DGS

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<sup>55</sup> *Decision of the Single Resolution Board of 23 June 2017* [2017] Single Resolution Board SRB/EES/2017/11; *Decision of the Single Resolution Board of 23 June 2017* [2017] Single Resolution Board SRB/ EES/2017/12.

<sup>56</sup> *Orderly liquidation of Banca Popolare di Vicenza and Veneto Banca - Liquidation aid* [2017] European Commission SA.45664.

<sup>57</sup> BRRD, art. 31(2)(d).

<sup>58</sup> BRRD, art. 32(5) subpara. 2; SRMR, art. 18(5) subpara. 2.

<sup>59</sup> The only limit is set by the 2013 Banking communication, which is less rigid than the 8% TLOF minimum, see. Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ( 'Banking Communication' ) 2013.



to intervene to preserve the viability of an entity without triggering a FOLTF determination (assuming that all other FOLTF conditions under Article 32(4) BRRD3 are not met). Yet, at the same time, the calculation of the LCT in the case of preventive measures restricts the latitude for such interventions. Specifically, the DGS, when comparing the payout costs to the costs of the preventive measures, needs to offset potential recoveries (up to a cap of 85% of the repayment of deposits) from the payout costs, which means the cap for the use of DGS funding is significantly reduced, DGSD, Article 11e(2) and 11(3).

#### **4.2.4 Assessment of the CMDI Proposal**

In our view, the proposed amendments are not ambitious enough because the Commission was operating within the boundaries of the possible, i.e., what was accepted by the member states. The attempts to optimize under constraints will arguably not yield the first best outcomes. Though addressed to a certain extent, the funding gap will persist. The PIA will become broader in scope but as such, it does not alter authorities' incentives to shy away from resolution with its ambitious PSI requirements. Moreover, under the CMDI Proposal, the assessment can also consider any government-assisted alternatives outside resolution, potentially skewing incentives further toward liquidation outside the CMDI framework. Strengthening the DGS's contribution at the recovery stage does not fundamentally change the expected outcomes under the CMDI Proposal. Therefore, despite moving broadly in the right direction, the reformed CMDI framework will likely remain an underutilized asset that does not deliver on its core objective of making banks "safe to fail" without government involvement.

## **5 More is more: additional steps towards effective crisis management**

In the following section, we sketch two incremental changes in the CMDI framework that accept the political constraints that European co-legislators face. However, they would still make a difference and thus represent a valuable addition to future reform efforts.

### **5.1 Early write-down and conversion (the CoCo alternative)**

The banking turmoil of March 2023 teaches a critical lesson for the CMDI review. The causes of banking stress may differ.<sup>60</sup> While the US regional banks were suffering from poorly managed interest rate and concentration risks, backfiring regulatory arbitrage (held-to-maturity sovereign bonds in the banking book), and highly fragile funding structures (overreliance on uninsured deposits) without decent liquidity risk management, Credit Suisse was suffering from serious and continued weaknesses in governance, risk control, and risk management. In addition, particularly in the US, but also in Switzerland, various supervisory shortcomings amplified the problems. However, one overarching question in all these idiosyncratic bank failures was whether the liability side of banks' balance sheets allowed for sufficient loss absorption and

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<sup>60</sup> Basel Committee on Banking Supervision (n 16).



effective recapitalization when the fragilities materialized. While the AT1 damm of preferred shares did not stem the tide at Silicon Valley Bank, Signature Bank of New York, and First Republic Bank, the contingent convertible bonds at Credit Suisse provided a sufficiently thick cushion to absorb the bank's losses. However, significant hiccups had to be remedied with unconventional legislative interventions<sup>61</sup> that prompted leading scholars in the field to ask for, among other things,<sup>62</sup> improvements in the design of CoCo-bonds.<sup>63</sup> We concur with the objective of providing for sufficient recapitalization capacity that authorities can activate to stabilize a wobbly bank without triggering resolution. However, we do not think prudential regulators should continue the thus far unsuccessful CoCo experiment. Requiring a layer of going concern loss absorbing capacity that the regulator can write down at an early stage of an ensuing crisis can be achieved consistently with minor tweaks of the current European regulatory framework. BRRD art. 59(1) allows the writing down not only of own funds but also eligible liabilities, as defined in BRRD art. 2(71a), once an institution reaches the point of non-viability (PONV). Therefore, in principle, MREL instruments and resolution authorities' write-down-and-conversion-powers provide precisely the loss absorption capacity in a going concern scenario that Perotti and Martino seek to establish with CoCos that empower the regulator to trigger the recovery. The only adjustment required in the regulatory framework is an adaptation of the PONV take-up criterion in BRRD art. 59(1). Instead of requiring a failing or likely to fail determination,<sup>64</sup> the WDCCI tool could become available once indicators, suggested in the literature, provide growing evidence that the bank is in severe trouble.<sup>65</sup> A future CMDI reform could implement such an incremental change without much effort and stay on the European resolution trajectory that puts MREL at center stage.

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<sup>61</sup> -The Swiss Federal Council had to clarify that the emergency assistance provided to Credit Suisse constituted a viability event that warranted the write down of AT1 CoCo-bonds, *ibid* 14–15.

<sup>62</sup> The second prong of their proposal argues for haircuts on early deposit withdrawals to disincentivize runs. For the theoretical underpinning of this policy proposal see Rafael Matta and Enrico C Perotti, 'Pay, Stay or Delay ? How to Settle a Run' [2019] SSRN Electronic Journal <<https://www.ssrn.com/abstract=3487535>> accessed 22 March 2024. For an alternative see Heider and others (n 15).

<sup>63</sup> Perotti and Martino (n 15).

<sup>64</sup> BRRD art. 59(1) requires that the conditions of BRRD, art. 32 are met. Therefore, the application of the write down and conversion of capital instruments (WDCCI) tool is conditional on a FOLTF determination, cf. BRRD, art. 32(1)(a).

<sup>65</sup> Perotti and Martino (n 15) 10–14. (arguing for a CoCo trigger once the bank is severely undercapitalized and discussing a set of relevant indicators).

## 5.2 Effective auctions in transfer strategies

The second additional element future CMDI reforms should consider is the careful pre-structuring of auctions in transfer strategies. Research shows that ad hoc fire sales of failed institutions in resolution may lead to windfall profits for acquirers and their shareholders because resolution authorities leave money on the table to the detriment of all other stakeholders.<sup>66</sup>

Generally speaking, economic theory favors using auctions instead of negotiations when authorities want to sell a failed bank to a healthy one. The basic intuition is that when bidders have private information about the value of the object on sale, as is likely the case when acquiring a failed bank, using an auction compels bidders to reveal some of this information; even simply leaving an English auction, in which the price rises until one of the bidders drops out, reveals some of the private information. Such an information revelation leads to more efficient outcomes because acquirers earn a lower information rent – akin to a monopoly rent – in an auction.<sup>67</sup> The information revelation benefits the uninformed seller (e.g., the resolution authority acting on behalf of the failed banks’ equity holders, unsecured creditors, and taxpayers) and prevents purely redistributive transactions.

However, to reap the potential welfare gains from an auction, banking supervisors and resolution authorities need to adequately prepare for a bank resolution that may come unexpectedly and suddenly due to a bank run. Assets that are carved out because of valuation uncertainties need to be identified. Due diligence materials and information for potential bidders must be prepared early – long before the auction starts and even before the decision to sell the bank in an auction is ultimately taken. Resolution planning should enable the authorities to initiate a professionally managed sale process and due diligence. Resolution authorities also need to prepare the “Best Alternative to a Negotiated Agreement” (BATNA) carefully to avoid hold-up scenarios. The essential preparatory work needs to be a part of resolution planning, a core task of resolution authorities, including the SRB.

Quite importantly, resolution authorities also need to prepare for transfers of non-significant banks. For example, SVB was not designated as a global systemically important (G-SII) or other systemically important institution (O-SII) by the relevant authorities in 2022. SVB was large but not considered to be complex enough and interconnected enough to warrant significant institution status. If a similar bank were to fail in Europe, the national laws would apply because

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<sup>66</sup> JOÃO GRANJA, ‘The Relation Between Bank Resolutions and Information Environment: Evidence from the Auctions for Failed Banks’ (2013) 51 *Journal of Accounting Research* 1031; João Granja, Gregor Matvos and Amit Seru, ‘Selling Failed Banks’ (2017) 72 *The Journal of Finance* 1723. Florian Heider and others, *Do ‘White Knights’ Make Excessive Profits in Bank Resolution?* (European Parliament 2023) <[https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/747875/IPOL\\_IDA\(2023\)747875\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/747875/IPOL_IDA(2023)747875_EN.pdf)>.

<sup>67</sup> Jeremy Bulow and Paul Klemperer, ‘Auctions Versus Negotiations’ (1996) 86 *American Economic Review* 180. (showing that the benefit of having one more bidder in an auction outweighs the benefit of any extra bargaining power for the seller in a bi-lateral negotiation).

the SRB de facto only assumes jurisdiction over significant institutions due to the PIA (see above 4.2.3). There is little doubt that regular bankruptcy would have created massive uncertainty and systemic risk and triggered the need for a full-blown government bail-out. This observation provides another argument for widening the scope of the CMDI framework and making it fit for purpose, particularly for dealing with smaller banks in sale of business and other transfer strategies.

## 6 Conclusion

Overall, the CMDI Proposal would mark a (small) step in the right direction but would not overcome fundamental deficiencies in implementing the Banking Union.

Moving towards a single-tier depositor preference would make DGS funding more accessible and reduce bank-run risks because uncovered deposits would not have to be bailed-in before DGS funding becomes available. Suggestions by the European Parliament to retain a two-tier system for uncovered deposits of large enterprises and central and regional governments on the one hand and retail and SME deposits on the other would forfeit much of the efficiency gains. Such a system would reduce the risk for retail and SME deposits to suffer losses in a bank failure. Yet, the price for this risk reduction would be increased fragility, because DGS funding would again become accessible only after large enterprise and government deposits were bailed-in. This would increase the run risk for such deposits and may make DGS funding a less viable option in practice.

In principle, however, allowing DGS funding to count towards the 8% TLOF requirement for accessing the SRF, should also help better utilize the SRF's resources. However, the LCT attached to the use of DGSs would mean, in practice, that for banks with a high proportion of uninsured deposits, available DGS funding may not always suffice to fully bridge the gap between the entity's available loss-absorbing capacity and the 8% TLOF requirement to access the SRF. Since the 8% TLOF requirement remains in place, the funding gap persists if DGS contributions are insufficient to reach the 8% TLOF requirement once an institution's MREL resources have been exploited.

Sticking to the 8% TLOF requirement minimizes moral hazard and pressures banks to achieve high MREL targets. The CMDI Proposal's amendment to recognize the 'depth of the market' when resolution authorities calibrate MREL targets suggests that small and medium-sized banks with a transfer approach as the preferred resolution strategy may enjoy lower MREL targets. However, this alleviation risks widening the DGS-SRF funding gap without offering a viable way to bridge it.

More credible resolution funding, in principle, allows for enlarging the overall scope of bank resolution. In this context, broadening the scope of the PIA is a welcome development. It would permit considering the impact of a bank failure at a regional level and raise the bar for solutions under national insolvency laws: Resolution authorities could only handle banking crises under such national laws if these allowed them to achieve resolution objectives not only equally well (as is the case now) but better than in resolution. However, regardless of how the law on the books allocates the burden of proof, the SRB can still interpret the specific facts of individual cases to arrive at the desired PIA and avoid resolution with its ambitious PSI requirement. This appraisal is all the more true because the CMDI Proposal would permit resolution authorities to consider any public financial support available in resolution or liquidation under national law. Such considerations may open a wide back door to government-assisted solutions outside resolution where the 8% TLOF bail-in requirement does not apply.

The review of the CMDI framework follows a year of significant resolution experience in the US (SVB and other peripheral banks) and Switzerland (Credit Suisse). Hence, the prospective delay in the legislative process that the upcoming election of the European Parliament and the appointment of a new Commission will cause provides a welcome opportunity also to consider additional changes to the CMDI framework. We believe the political constraints that prevented bolder advances will remain and, therefore, propose only two incremental amendments in this context. First, regulators should be empowered to trigger write-offs and conversions at an early stage so that they can be used as an effective recovery tool. Therefore, MREL instruments should be available for that purpose earlier and without having to enter resolution. Second, future CMDI reforms should mandate a careful pre-structuring of auctions in transfer strategies to minimize the risk of fire sales in resolution. This preparatory work should supplement the resolution authorities' efforts at an operational level to enhance crisis preparedness by improving banks' resolution plans and making bridge institution strategies more credible.

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