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Proportionality in Bank Crises: the Case of Retail Banks

The financing of resolution and liquidation: the role of DGS

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Siena, 18 October 2024

Contents

Why do DGS exist?

Public policy objectives

1. Protect depositors
2. Contribute to financial stability

How are depositors protected?

- ❖ reimbursement up to a threshold (coverage level) – <u>exit perspective</u>

- ❖ access to deposits – <u>continuity perspective</u>

Mandates of DGS

Mandates can range from narrow "pay box" systems to those with extensive responsibilities, such as preventive action and loss or risk minimisation/management, with a variety of combinations.

Four categories:

a. "pay box" - DGS is only responsible for the reimbursement of insured deposits;
b. "pay box plus" - DGS has further responsibilities (e.g. certain resolution functions);
c. "loss minimiser" – DGS actively engages in a selection from a range of least-cost resolution strategies;
d. "risk minimiser" - DGS has comprehensive risk minimisation functions, including risk assessment/management, early intervention and resolution powers, and prudential oversight responsibilities.

Mandates and intervention

The width of DGS mandates defines the scope of intervention and their involvement in crisis management

Mandates ultimately impact proportionality of DGS's role in crisis management

✓ Crisis management also means crisis prevention

This presentation does not focus on crisis prevention

➢ preventive measures (Article 11(3) DGSD) are **not** discussed

Types of DGS

A. Public structure

B. Private structure

Italian case: a private consortium of banks, mandatory membership of all banks, funds are provided by banks, Banca d'Italia is an observer

Public dimension is mainly considered for EU state aid purposes (Tercas jurisprudence): Italian DGS preventive measures are <u>not</u> state aid

The Italian experience

Tradition of DGS involvement in crisis management

- Preventive measures to avoid a crisis
- Alternative measures to support transfer strategies in compulsory administrative liquidation

Italian framework for bank liquidation

- Administrative model with limited Court involvement
- Governance – central role of Banca d'Italia
- Enabling provision for sale of assets and liabilities in bulk (sale as a going concern)
- Flexibility

Single track vs dual track regimes

The structure of the legal framework for bank failure management matters

- A **single track** regime is a single framework dealing with any bank failure (e.g. USA)

- A **dual track** is a framework that distinguishes conceptually between resolution and liquidation/insolvency proceedings (e.g. EU Members States)

Dual track regimes are considered in this presentation.

DGS may have different roles – and they may raise different proportionality issues – depending on whether resolution or liquidation is at stake

Resolution

Why resolution?
Resolution allows to manage bank crises by restoring the viability of the business of a bank, in whole or in part

<u>Going concern perspective</u>

If only part of the business is preserved under resolution, the residual part is wound up

When does resolution apply?
Resolution applies when there are public objectives to achieve and liquidation is less effective than resolution

Resolution objectives

Resolution objectives to be weighted among each other are set out under the BRRD :

(a) to ensure the continuity of critical functions;

(b) **to avoid a significant adverse effect on the financial system, in particular by preventing contagion**, including to market infrastructures, and by maintaining market discipline;

(c) to protect public funds by minimising reliance on extraordinary public financial support;

(d) **to protect covered depositors and investors**;

(e) to protect client funds and client assets.

The cost of resolution

Cost to be financed: what is needed in order to make the bank's business viable again

This may include the cost for the banking system as a whole: critical functions, contagion (interconnectedness)

Different tools ⇨ **different costs**

Who mainly contributes to the financing of resolution?

- Shareholders and creditors (insolvency hierarchy, but bail-in exceptions)
- Resolution financing arrangements
- DGS

Liquidation

Why liquidation?

Liquidation manages market exit of banks whose viability may not be restored/is not worth restoring.

Gone concern perspective

When does liquidation apply?

Liquidation applies when there is no actual public objective to achieve - unlikely so – or there are public policy objectives at stake and liquidation is as effective as (or theoretically more effective than) resolution

Liquidation also applies in respect of non-resolved parts of the business (e.g. residual entity after use of a transfer-based resolution tool)

Liquidation

Is liquidation really residual to resolution?

- Yes in principle

but

- Under the BRRD (Art. 32(5)) if liquidation meets the resolution objectives **to the same extent** as resolution, liquidation (and not resolution) applies – is resolution in fact residual to liquidation?

- "same extent" depends on the national regime of normal insolvency for banks (ordinary business insolvency or special rules)

Liquidation objectives

Under the Unidroit draft legislative guide for bank liquidation (consultation ended on 11 October 2024):

1) Value preservation and maximisation

2) Depositor protection

3) Financial stability

4) Avoiding use of public funds and loss to taxpayers

5) Certainty and predictability

Such objectives are subject to balance

The cost of liquidation

Cost to be financed: what is needed in order to ensure that the bank is liquidated in an orderly manner. Broad notion of "creditor satisfaction" (it also includes value preservation for their benefit and in their interest)

Cost for the banking system as a whole: general perception of an efficient functioning of the banking system (especially in terms of depositor protection), including when banks exit the market
- contagion and interconnectedness angle matters both in liquidation <u>and</u> in resolution
- Any market exit may matter for financial stability (2013 Banking communication, p. 65)

Who contributes to the financing of liquidation?

- Shareholders and creditors (insolvency hierarchy)
- DGS
- Liquidation aid under the 2013 Banking Communication

The costs of crisis management

A unified perspective

Let aside the difference in crisis management procedures (*i.e.* resolution vs. liquidation), the costs of crisis management depend from:

- The strategy to be applied
- The tools to be used (*e.g.* transfer and/or bail-in/burden sharing)

The costs of crisis managements are different, for example, in the Banco Popular, Veneto banks and Sberbank cases.

DGS role in resolution

Under Art. 109 BRRD and 11 DGSD, DGS may contribute subject to conditions and limits:

- In order to ensure that depositors continue to have access to their deposits
- Always in cash
- Not to recapitalise the bank or a bridge bank
- Up to the amount of covered deposits at the bank
- Up to 50% of the target level of DGS funds
- NCWO (hypothetical disbursement in liquidation)
- The resolution authority consults with the DGS and determines the amount

DGS role in liquidation

Article 11(6) DGSD

- DGS may finance measures to **preserve the access of depositors to covered deposits**
  - this includes the transfer of assets and liabilities and deposit book transfer
- the costs borne by the DGS may **not exceed** the **net amount of compensating covered depositors** at the bank

- **Least cost test**
- DGS not worse off than in liquidation where covered depositors are paid out (Unidroit draft legislative guide refers to piecemeal liquidation)

Depositor protection in bank crises

(I) Covered depositors ("fixed" protection)

"*Covered deposits are fully protected*"
(a general principle of the resolution framework under Article 34 BRRD)

A. Not bail-inable in resolution

B. Paid out in liquidation

Depositor protection in bank crises

(II) Transfer strategies ("dynamic" protection)

- How to protect the depositor base?

A. DGS + RFA (**resolution**)
→ DGS up to the amount of covered deposits (NCWO implies least cost test)
→ RFA subject to 8% TLOF (what if deposits must contribute to 8% TLOF?)

B. DGS only (**liquidation**)
→ subject to least cost test

DGS and proportionality

- DGS reflect a **“proportionality” rationale**

  - No matter the crisis and the way to solve it (*i.e.* resolution or liquidation), covered deposits must be protected

    - Acceptable sacrifice for depositors by reference to predetermined standardized legal protection

  - Public interest is attached to depositor protection :

    - Pay-out
    - Continuity of access to deposits

  - Least cost for DGS implies some form of (not only individual but also) systemic proportionality assessment

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DGS and proportionality

- Proportionality should take into account that DGS funds are <u>industry funds</u> (<u>private funds</u>)
  → use of DGS funds other than pay-out is <u>discretional</u>
  → should the decision (*i.e.* if, how and how much?) be primarily left to DGS members?

- Proportionality of the least cost test also takes into account the <u>fragmentation of bank liquidation rules</u> in EU Member States. Are outcomes less predictable than in a scenario where uniform/harmonised bank liquidation rules?

- Proportionality and <u>insurance logic</u> within DGS – risk of bank failures (e.g. oversight responsibilities of DGS)

- BU 3rd pillar (<u>EDIS</u>): proportionality under a centralized deposit guarantee perspective.

Seeing proportionality in pratice

1. Least cost test
2. Conditions for DGS's support to resolution
3. State aid

Least cost test

DGS as a **<u>systemic protection tool</u>**

- ❖ Least cost test – elements to be considered
    - Virtual costs of liquidation for the DGS, absent DGS intervention
    - Virtual recoveries for the DGS, absent DGS intervention
    - Insolvency ranking of the DGS subrogating to covered depositors after pay-out
    - **coverage level is a <u>legally pre-determined amount</u> that is taken as a <u>protection benchmark</u>**
        - **The cost of a disorderly winding up might be higher for the system as a whole**
        - **Liquidation of a bank is not just the unbundling of assets and liabilities for realisation and distribution to creditors.**

Least cost test

- The cost of the intervention must not **exceed** the cost of pay-out
  - Hypothetical counterfactual scenario (Unidroit guide)
    - Virtual piecemeal liquidation that is instantly completed

      (similar to NCWO mechanism when a bank is placed under resolution, mutatis mutandis*)*
  - If theoretically the cost of pay-out is exactly the same as the cost of alternative intervention, the latter is greenlighted
    - Does it signal a favour for alternative intervention compared to pay-out, at least in such a case?

Conditions for DGS support to resolution

DGS as a **resolution facilitating tool**

- DGS may support resolution, but
  - up to the amount of the losses that covered deposits would suffer/absorb

- RFA may support – *e.g.* when non-covered (bail-inable) deposits are discretionarily excluded from bail-in – but
  - only after 8% TLOF contribute
  - depending on the MREL base, 8% TLOF might need to include non-covered deposits
  - To bail deposits in might be sensitive for financial stability

- Now DGS may not contribute to satisfy (part of) the 8% TLOF requirement

DGS as industry funds

DGS and the **"public sphere"**

- 2013 Banking communication provides that:
  - Reimbursement of covered depositors is **not** State aid
  - Other interventions are to be assessed on a case-by-case basis:
    - Funds are within the control of the State or not
    - Decision to contribute is imputable to the State or not
- Tercas jurisprudence on the Italian framework
  - not State aid

CMDI reform – where we stand

1. EU Commission's proposal (April 2023)
https://finance.ec.europa.eu/publications/reform-bank-crisis-management-and-deposit-insurance-framework_en

2. EU Parliament's changes (May 2024)
https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2023)749798

3. EU Council's changes (June 2024)
https://www.consilium.europa.eu/en/press/press-releases/2024/06/19/bank-crisis-management-and-deposit-insurance-framework-council-agrees-on-its-position/

CMDI reform - DGS contribution

Holistic approach under Commission's proposal

- Least cost test would be better defined
- DGS to bridge 8% TLOF in resolution (transfer of non-covered deposits + exit strategy + RA decision + subject to NCWO)
- General depositor preference (single tier, in lieu of multiple-tier *i.e.* covered > other eligible deposits > ordinary unsecured)
- DGS intervention does not trigger FOLTF (to the extent amenable to be considered as EPFS, see Tercas)
- If resolution and liquidation are equal, resolution would apply

CMDI reform - DGS alternative measures

BRRD, SRMR and DGSD changes:

1) Alternative measures aim at supporting market exit or termination of banking activities when PIA is negative

2) Conditions:

   i. LCT (to be confirmed by DGS)

      → EBA to develop RTS for calculation

   ii. Marketing requirements (*e.g.* open, transparent, non-discriminatory, price maximization)

CMDI reform - DGS alternative measures

- Flexibility

- Conditions and requirements should not turn out to determine excessively burdensome / disproportionate

- Recital 29 of DGSD: "*it is necessary to avoid excessively stringent conditions that would effectively disable the use of DGS funds for other interventions than payout*"

- Alternative measures are not considered as EPFS triggering FOLTF (to the extent DGS intervention may actually qualify as State aid)

CMDI reform - LCT

- Least cost test elements would be spelled out:
  - Expected earnings related to alternative intervention
  - operational expenses related to alternative intervention
  - potential losses related to alternative intervention
  - expected ratio of recoveries
  - cost for the replenishment of the DGS to be borne by other banks
  - potential additional cost of funding for the DGS
- Acknowledgment of the need to also make reference to **system-wide proportionality**

CMDI reform - DGS new role in resolution

DGS would be allowed to contribute to 8% TLOF in order to unlock the RFA intervention when non-covered deposits are excluded from bail-in and are transferred

DGS would be used for the purpose of "counterbalancing" the deployment of RFA funds (**burden allocation logic**)

- 8% TLOF has to include non-covered deposits in certain cases
- Conditions:
  - LCT based on resolution valuations (and on the new general depositor preference)
  - For the amount required to cover the transfer unbalance
  - The exclusion of non-covered deposits from bail-in is necessary and proportionate (risk of contagion, critical functions)
  - The residual entity exits the market

CMDI reform – takeaways on DGS

- Single tier for all deposits in the insolvency hierarchy would be optimal to favour DGS support to transfer tools, as it would make such support less costly than mere pay out and consequent subrogation in liquidation.

- Clarifications on the least cost test are welcome, but they should not end up being «*excessively stringent*» (*e.g.* EBA methodology):

  - the least cost test would more expressly factor also indirect costs in (*e.g.* losses for non-covered deposits, systemic risks, etc.)
  - Expected recoveries in piecemeal liquidation for the DGS would be automatically reduced by 15% (scaling factor) as a measures of caution (virtual nature of counterfactual piecemeal liquidation)

- The CMDI reform will not necessarily entail more resolution for medium and small banks.

- Liquidation – with DGS involvement as per the Italian experience – might:

  - Ensure continuity of access to deposits
  - Limit disruption
  - accomodate DGS financing where efficient and less costly than (or equally costly as) pay-out

The case of medium and small banks

- Retail banks or medium and small banks? Size or type of business?

- As per the Commission proposal, the CMDI review tries to better reflect the specifics of medium and small banks.

- As far as DGS financing is concerned, the CMDI review seems to mainly focus on DGS intervention in resolution

- The CMDI review proposal refers to proportionality shortcomings. Typically, the three elements of proportionality are:

  - **suitability** to achieve the desired objective
  - **necessity** to achieve the desired objective
  - Imposition of a **burden** that is **not excessive** in relation to the desired objective

Conclusive remarks

- Proportionality is flexibility
- Flexibility may accommodate any specifics due to the size of the banks
  - Depositor protections is important in the case of medium and small banks
- The CDMI reform tries - *inter alia -* to:
  - facilitate resolution and the use of DGS for transfer strategies in it
  - clarify some elements of the least cost test

- The least cost test is spelled out by reference to a variety of elements that could better reflect the overall cost of bank failures for the system

- Transfer strategies are encouraged by the reform:
  - If the RP contemplates resolution transfer tools, MREL to be calibrated accordingly
  - DGS to bridge the 8% TLOF in resolution transfer strategies

- To assess proportionality is important in the Italian experience of bank liquidation, also as far as DGS alternative measures are concerned.

Documents and comments

Hereinbelow is a selection of preparatory works and comments on DGS and CMDI.

- Opinion of the European Banking Authority on deposit guarantee scheme funding and uses of deposit guarantee scheme funds (EBA/OP/2020/02)

- SRB Chair speech on 5 September 2024 at the Association of German banks

- SRB report of 12 September 2024 on small and medium sized banks

- MECATTI, I., *Deposit guarantee schemes and bank crisis management: legal challenges arising from the actual EU legal framework*, 2020 in *https://www.srb.europa.eu/system/files/media/document/6._dgs_and_crisis_managment_2020_-_irene_mecatti.pdf*

- BRESCIA MORRA, C., POZZOLO, A. F. , VARDI, N., *Completing the Banking Union, The case of crisis management of small- and medium-sized banks*" in *https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/741514/IPOL_IDA(2023)741514_EN.pdf*

- RAMOS-MUÑOZ, D., LAMANDINI, M., THIJSSEN, M., *A reform of the CMDI framework that supports completion of the Banking Union. Transfers, funding, ranking and groups* in *https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/741513/IPOL_IDA(2023)741513_EN.pdf*

- C. GORTSOS, V., *A reform of the CMDI framework that supports completion of the Banking Union* in *https://www.europarl.europa.eu/RegData/etudes/STUD/2023/741493/IPOL_STU(2023)741493_EN.pdf*

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