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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITEE AND THE COMMITTEE OF THE REGIONS

on the review of the crisis management and deposit insurance framework contributing to completing the Banking Union

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Introduction

The creation of the Banking Union in 2014 was a powerful response to the global financial crisis and the ensuing euro-area sovereign debt crisis. By reforming the EU supervisory and resolution architecture for banks, the Banking Union has reinforced stability in the banking sector allowing it to support businesses and households even through the recent Covid crisis. The Banking Union also plays a key role in financing growth and investments, improving the EU's competitiveness[1] and reinforcing the Economic and Monetary Union, helping the EU to face major structural challenges, such as the green and digital transitions, as well as those challenges brought about by Russia's illegal and unjustified aggression against Ukraine.

Two pillars of the Banking Union - the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) - are now fully operational. The Commission has published its second report on the functioning of the Single Supervisory Mechanism[2], together with this Communication. The report finds that the SSM is functioning well overall and has matured as a supervisory authority delivering on the objectives set out when it was created. The Single Resolution Mechanism is also well-established. The Single Resolution Board, together with the national resolution authorities, have developed resolution plans for the major EU banks and the Single Resolution Fund is in place to support resolution should this become necessary. A backstop to the Single Resolution Fund to be provided by the European Stability Mechanism has been politically agreed. The SSM and the SRM, together with reinforced rules on banking supervision and resolution, have ensured that the EU banking sector has greatly increased its resilience to shocks and overall, is in good shape. The third pillar - a common deposit protection scheme - is also key in reinforcing the resilience of the banking sector, but political agreement among the EU co-legislators has not yet been achieved.

Work to complete the Banking Union continues. The December 2020 Euro Summit invited the Eurogroup to prepare 'a stepwise and time-bound workplan on all outstanding elements needed to complete the Banking Union'[3]. Subsequent discussions in the Eurogroup did not deliver on such a workplan, but it was agreed[4] that the common framework for bank crisis

[1] European Commission (2023), *Long-term competitiveness of the EU: looking beyond 2030*.
[2] Article 32 of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation).
[3] European Council (December 2020), *Euro Summit meeting Statement*.
[4] Eurogroup (June 2022), *Eurogroup statement on the future of the Banking Union*.

management and deposit insurance (CMDI)[5] should be strengthened as a next step[6]. The proposal to reform the CDMI framework, adopted by the Commission today, begins that process. The Eurogroup also committed to review the state of the Banking Union in the next legislative cycle and to identify in a consensual manner possible further measures to complete it. This commitment was restated by the Euro Summit on 24 March 2023[7]. In parallel, the European Parliament, in its latest annual report on the Banking Union[8], recalled the importance of completing the Banking Union, with the establishment of a common deposit protection scheme, as its third pillar.

The Commission proposes to reform the CMDI framework via legislative amendments to the Bank recovery and resolution directive, the Single resolution mechanism regulation and the Deposit guarantee scheme directive. The objective of the reform is to enhance the existing arrangements for managing failing banks in the EU. In particular, it is proposed to make the arrangements for managing the failure of smaller and medium-sized banks more effective in terms of their design and implementation. While the reform of the CMDI framework has been under discussion for several years and pre-dates the very recent U.S. and Swiss banking crises, these crises underline the importance of ensuring that EU arrangements for managing bank failures are as robust and effective as possible.

The proposed reform of the crisis management and deposit insurance (CMDI) framework

The key objectives of the CMDI framework are to preserve financial stability, depositor confidence and protect taxpayers in the context of bank failures[9]. To meet these objectives, the framework must ensure that any losses related to a bank failure can be met while minimising the risk of recourse to public funding. Since the global financial crisis, EU banks have accumulated a substantial capacity to absorb losses in the event of crises via increased holdings of capital and other loss-absorbing liabilities. In addition, industry-funded safety nets such as the Single Resolution Fund in the Banking Union, national resolution funds outside of the Banking Union and national deposit guarantee funds are now available to absorb losses. However, experience with implementing the CMDI framework has revealed difficulties in managing the failure of smaller/medium-sized banks, in particular, where there is an implied allocation of losses to depositors, which could affect depositors' confidence and financial stability. The result has been a reluctance to implement the CMDI framework as intended and often a recourse to public funding in managing failures in the banks concerned.

[5] Achieving a stronger framework for the management of failing banks in the EU was one of four workstreams that was discussed as part of a potential Banking Union completion workplan, in addition to a more robust common protection for depositors, a more integrated single market for banking services and increased diversification of banks' sovereign bond holdings in the EU. The Eurogroup also committed to reviewing the progress made on strengthening the Banking Union and resuming discussions on the other workstreams following the adoption of the CMDI legislative reform.

[6] In addition to updating the Basel single rule book (the Capital Requirements Regulation and Directive - CRR/CRD).

[7] European Council (24 March 2023), *Statement of the Euro Summit, meeting in inclusive format*. In its Euro Summit meeting statement of 24 March 2023, the European Council called for continued efforts to complete the Banking Union in line with the Eurogroup statement of 16 June 2022.

[8] European Parliament (July 2022,), *Report on the Banking Union – annual report 2021* (2021/2184(INI)).

[9] The Commission stands ready to provide support to Member States through the Technical Support Instrument (COM(2020) 409 final) in further enhancing their crisis management preparedness and operationalisation.

Under the current CMDI framework, rules for accessing funding differ across the various crisis management tools. This makes the use of these tools less homogenous across Member States and often less effective by constraining access to industry-based funding without imposing losses on depositors. This feature of the existing framework is compounded by a broad discretion of resolution authorities in determining whether the public interest requires that a bank failure should be managed under EU harmonised resolution rules or liquidated under national insolvency proceedings. As a result, there is a risk of market fragmentation and suboptimal outcomes in managing bank failures, particularly in respect of the smaller and medium-sized banks that may be 'too big to liquidate' under national insolvency regimes.

The reform now proposed by the Commission seeks to address these limitations in the existing CMDI framework. Based on extensive consultation and preparation[10], the proposed reform of the framework covers a range of key policy aspects and constitutes a coherent response to the identified problems. The main elements of the proposed reform are:

- A clarification of the public interest assessment in managing bank crises to ensure that a full range of crisis management tools, such as transfer tools[11], can also be applied to failing smaller and medium-sized banks, if this can more effectively achieve the objectives of safeguarding financial stability, depositor confidence and protecting taxpayers' money.
- Facilitating the use of deposit guarantee scheme (DGS) funds in the financing of crisis management tools as an alternative to the basic pay-out function. Such use of the DGS would be enabled by amending the hierarchy of claims in insolvency but must only be a complement to the banks' internal loss absorption capacity, which remains the first line of defence. Alternative use of deposit guarantee scheme funds in funding crisis management tools must also be subject to a harmonised least cost test.
- Use of deposit guarantee scheme funds, when applied to smaller/medium sized banks in resolution, including to access the Single Resolution Fund, should be possible only (a) when the resolution authority(ies) deem(s) it necessary to safeguard financial stability and protect taxpayers while facilitating the exit from the market; (b) when it avoids imposing losses on depositors, and (c) when it is subject to adequate conditions and safeguards, notably in the case of accessing the Single Resolution Fund where the bank concerned must have been previously planned to be resolved.

These elements of the proposed reform are highly inter-linked and must be considered holistically if the reform is to achieve the desired objectives. The proposed reform also includes other elements, which are intended to make the framework more predictable and efficient (e.g. removing overlaps between early intervention and supervisory measures, facilitating an earlier triggering of resolution) and improve depositor protection (e.g. targeted improvements of provisions in the Deposit guarantee schemes directive on the scope of

[10] The proposal drew on a broad range of information sources, detailed in the accompanying impact assessment.
[11] Transfer tools include the sale of the failing bank or parts of it to a viable buyer, the transfer to a bridge bank or the use of the asset management vehicle.

protection and cross-border cooperation, harmonisation of national options, improvement of transparency on financial robustness of DGSs).

By improving the interaction with national insolvency proceedings, the proposed reform aims to make the CMDI framework function even more effectively for all EU banks, irrespective of their size, business model and liability structure. In the absence of this reform, there is a risk that failing small/medium-sized banks will continue to be managed outside of the CMDI framework, under heterogeneous national regimes, often resulting in unnecessarily costly and disruptive insolvencies that involve public funds. Such outcomes distort the level playing field in the single market, reduce the efficiency of crisis management and can result in unnecessary costs for taxpayers.

The role of a common deposit insurance scheme in the crisis management and deposit insurance (CMDI) framework

The impact assessment, which accompanies the legislative package adopted today, shows that the proposed reform of the CMDI framework would be even more effective if combined with a common deposit insurance scheme. Such a scheme would expand the safety net available to protect depositors by reducing the vulnerability of national deposit guarantee funds to very large local shocks. It would ensure a level playing field across the Banking Union and avoid market fragmentation due to divergences between national deposit guarantee schemes. The pooling of deposit guarantee scheme funds would also create efficiency gains, making it possible to reduce the target level for all contributing deposit guarantee schemes, reducing costs for banks while preserving the same level of protection for depositors[12]. It would also enhance the consistency of the decision-making process with a strengthened central governance within the Banking Union. Clearly, a common deposit insurance scheme is an essential complement to the CMDI framework.

The Commission proposal for a European deposit insurance scheme (EDIS) was adopted in 2015[13] and envisages the establishment of a fully-fledged EDIS in three consecutive stages: a reinsurance scheme for participating national deposit guarantee schemes in a first period of three years, a co-insurance scheme for participating national deposit guarantee schemes in a second period of four years, and full insurance for participating national deposit guarantee schemes beyond these periods, i.e. the final and definitive design of EDIS. In all three stages, EDIS would cover ultimate losses incurred by the participating national deposit guarantee schemes. Several intermediate or alternative options such as a 'hybrid' model for EDIS have also been explored. Unlike the EDIS proposal of 2015 and in line with the ideas put forward by the Commission in a 2017 Communication[14], such a hybrid model would make it possible to pool a portion of the funds financed by the banking industry in the Banking Union in a Deposit Insurance Fund to coexist with funds remaining within the national deposit guarantee schemes[15]. During an initial phase, the Deposit Insurance Fund would provide liquidity

[12] Calibrations included in the CMDI impact assessment suggest that a rather ambitious pooling of DGSs resources at European level (75 % of the target level) would deliver significant synergies and subsequently allow a potential reduction of the target level from 0.8 % to 0.6 % of covered deposits for all contributing DGSs.
[13] COM/2015/0586 final.
[14] European Commission (October 2017), *Communication on completing the Banking Union (COM(2017) 592 final)*.
[15] Further details on the hybrid model are provided in Annex 10 of the impact assessment to the CMDI package.

support to a beneficiary deposit guarantee scheme when the latter has exhausted its funds. If the Deposit Insurance Fund was depleted, it would be able to borrow from the other national deposit guarantee schemes through a mandatory lending mechanism. The final risk would remain at national level as the liquidity support received from the Deposit Insurance Fund would be reimbursed by the beneficiary national deposit guarantee scheme.

Political negotiations on EDIS have stalled and the legislative process has now extended over almost eight years. Despite substantial technical work in the Council working groups[16], no tangible progress has been made towards an agreement in Council. Meanwhile, the Parliament has also not adopted its report. In its latest annual report on the Banking Union[17], the European Parliament has stated its willingness to revive negotiations on the introduction of EDIS and, on 5 December 2022, the Chair of the ECON Committee, and the coordinators of six political groups issued a political statement urging the Council and the Commission to work towards the establishment of a realistic, credible and solid EDIS. Given the complementarity between EDIS and the proposed reform of the CMDI framework, a renewed effort to reach a political agreement on EDIS should be a priority.

Conclusion

The completion of the Banking Union remains a policy priority of the European Union. Significant progress has been made with the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism, which are now fully operational. While political agreement on a workplan for completing the Banking Union remains elusive, the proposal to reform the CMDI framework adopted by the Commission today is an important step forward. The proposed reform will enhance existing arrangements for managing bank failures in a manner that safeguards financial stability and protects depositors and taxpayers, allowing the Banking Union to offer an even higher level of financial system resilience and competitiveness.

In parallel, the Commission is carrying out an evaluation of its State aid framework for banks, which is expected to be completed in the first quarter of 2024. The outcome of this evaluation will inform a subsequent potential review of the State aid framework for banks. Given the interlinkages between the CMDI framework and the State aid framework for banks, such potential review would aim at ensuring consistency between the two frameworks, taking into account the regulatory scenarios that will be set out in the renewed CMDI framework. Within this context and depending on the results of the evaluation, the Commission could assess whether a more progressive approach could be adopted with different criteria for assessing the compatibility of State aid in the form of preventive measures, resolution measures or liquidation aid outside resolution. In particular, the Commission could assess whether a more effective use of resolution, including its financing with a facilitated access to industry-funded safety nets, in line with today's CMDI proposal, would allow further consistency of requirements.

[16] European Council (June 2021), Portuguese Council *Presidency Progress Report on strengthening the Banking Union* and European Council (November 2021), *Strengthening of the Banking Union – Slovenian Presidency Progress Report*.
[17] European Parliament (July 2022), *2021 Annual report on the Banking Union* (2021/2184(INI)).

It is essential that the effort to complete the Banking Union, including a common deposit insurance scheme, should continue and the Commission remains fully committed to this task. Accordingly, the Commission invites the European Parliament and the Member States to reach agreement on the proposed reform of the CMDI framework before the next elections of the European Parliament in 2024.