Position paper

on the European Commission's proposal for a reform of bank crisis management and deposit insurance framework (CMDI Review)

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The German Banking Industry Committee (GBIC) is of the opinion that an improvement in crisis management for credit institutions makes sense, but that the path proposed by the European Commission in the CMDI legislative package would have the opposite effect, as it would considerably impair the performance of the proven national deposit-based guarantee schemes and call into question the structure of the German banking market. In addition, the European Commission's proposal would create misplaced incentives that would lead to a far-reaching moral hazard problem. As a result, it would not improve crisis management for credit institutions, but jeopardize financial stability as a whole.

The German Banking Industry Committee embodies the diversity of the German banking market, which is reflected by different individual key areas of focus with regard to the effects of the proposed law. Nevertheless, the associations of the GBIC are united by the fact that they represent a large number of small and medium-sized credit institutions that would be affected to the same degree. The German Banking Industry Committee therefore rejects the legislative package in its entirety.

I. General Comments

On 18 April 2023, in the context – but not because of – the recent banking turmoil, the European Commission published a legislative package to revise the requirements for bank crisis management and deposit insurance ("CMDI Review"). The intention is that the requirements for the resolution of credit institutions and deposit guarantee schemes should undergo comprehensive changes, which would have serious consequences for the German and European banking industry as a whole. As part of the legislative package, amendments to the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD) are envisaged.

In addition to some technical changes to the DGSD, the intended changes focus essentially on the following four key points:

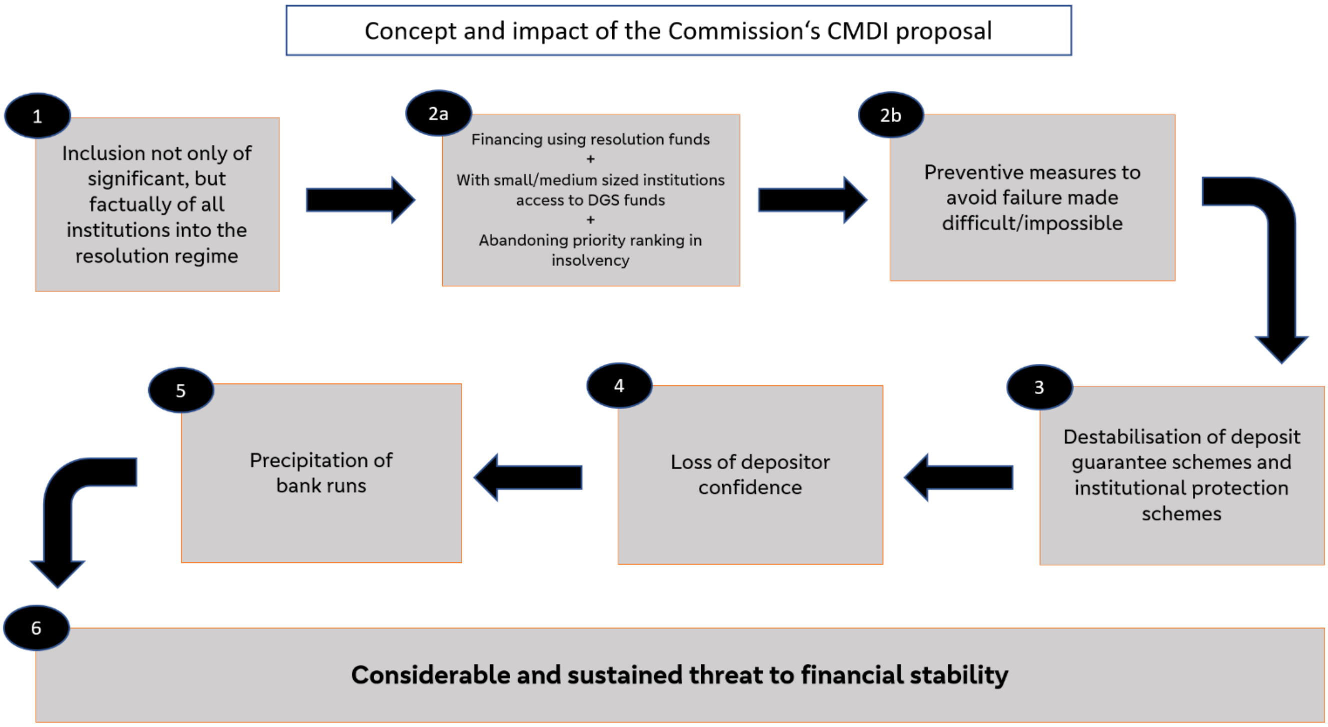
- Inclusion of medium-sized and smaller credit institutions in the resolution regime, in particular by broadening the definition of public interest in a resolution.

- Considerably facilitated and more far-reaching financing of resolution measures by national Deposit Guarantee Schemes.

- Abandonment of the proven preference of national Deposit Guarantee Schemes in bank insolvency proceedings.

- Substantial restriction of the ability of Deposit Guarantee Schemes to prevent the failure of a credit institution through preventive measures or to implement alternative measures.

At a glance, the Commission’s proposal has the following approaches and implications:



II. Comments on the four key elements

In 2014, the European legislator reacted to the last financial crisis with the regulations on crisis management for credit institutions. As far as the regulations on the resolution of credit institutions are concerned, it was important for the lawmaker at the time to provide the resolution authorities with a reliable set of instruments to be able to intervene quickly in the event of an institution in distress. On the other hand, the rulebook should be applied in an appropriate and proportionate manner, taking sufficient account of, i.a., the nature of an institution's activities, its legal form, its risk profile, its size, the complexity of its activities and whether it is a member of an institutional protection/guarantee scheme. Proportionality in particular, for example with regard to property rights, is also an expression of the EU Charter of Fundamental Rights. Consequently, principally only systemically important institutions should be subject to the resolution regime and the less significant institutions should be routinely classified as suitable for insolvency. For distress situations among the latter, the requirements for deposit guarantee schemes were consequently strengthened and the possibility of setting up deposit guarantee schemes in the form of institutional protection schemes was created, too. Great store was set by deposit protection in the recitals of the Deposit Guarantee Scheme Directive: "*Deposit protection is an essential element in the completion of the internal market and … an indispensable complement to the system of supervision of credit institutions.*"

These considerations by the European legislator, which were made when the DGSD was introduced, would without compelling reasons be abandoned by the four key points in the European Commission's proposal. The German Banking Industry Committee is opposed to this paradigm shift, which for each of the individual points will be explained in more detail below.

1. Inclusion of medium-sized and smaller institutions in the resolution regime, in particular through enhanced requirements for the public interest assessment (PIA) of a resolution

The resolution of credit institutions is a special mechanism created primarily for systemically important institutions whose failure could jeopardise the stability of the financial system. In the event of distress, small and medium-sized institutions have not yet routinely been subject to resolution tools; rather, in their case, regular insolvency proceedings come into effect, which ensures sufficient customer protection and at the same time the achievement of the resolution objectives.

However, with regard to resolution arrangements, the European Commission's proposals now envisage that this mechanism should become a de facto standard procedure for medium-sized and even smaller credit institutions, too. This objective is achieved by modifying the PIA of the resolution of an institution to be carried out by the competent resolution authorities: For example, critical functions at *regional* level, too, rather than only at the previous level of a Member State or the Union should be sufficient to subject an institution to the resolution regime. It must furthermore be possible to achieve the resolution objectives *more effectively* through insolvency proceedings than through resolution (until now, it has sufficed for insolvency proceedings to be suitable to the *same* extent). The suitability of an institution for insolvency would also require that insolvency proceedings be more cost-effective than resolution.

We reject this paradigm shift. It is not justified on the merits of the case and would impose a disproportionate administrative and financial burden on the institutions concerned. Ultimately, this will also jeopardise the existence of small and medium-sized institutions with traditional business models in the medium term.

Specific reasons against this approach:

- In the case of regionally active credit institutions, negative effects on financial stability are generally not to be expected in the event of a distress situation. This is also underlined by the annual risk analysis carried out by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*) and the German Central Bank *Deutsche Bundesbank* for small and medium-sized credit institutions (Less Significant Institutions – LSI) regulated directly by BaFin. According to the study, the potential impact of a solvency or liquidity crisis is relevant for only 1.4% of LSIs. Furthermore, in the event of distress of a credit institution, any critical functions of medium-sized and smaller institutions can easily be substituted at regional level - in contrast to those of more systemically important or significant institutions.

- The introduction of the indefinite legal concept of regionality in the PIA does not reduce the discretion of the resolution authority in the PIA, which is criticised in the Commission's proposal.

- On the basis of the preferred resolution strategy, the resolution authority determines the institution-specific minimum requirement for Own Funds and Eligible Liabilities (MREL). If, in the future, the preferred resolution strategy is no longer insolvency proceedings but resolution, it is likely to be a major challenge for medium-sized and especially smaller institutions, which are rarely capital market-oriented, to issue the eligible liabilities required to meet MREL. The set-up is further complicated by the minimum denomination for the sale of subordinated eligible liabilities to retail investors (Art. 44a BRRD) set by the legislator in the last revision of the BRRD. Also, the newly created regulation on the determination of MREL when applying transfer strategies (Art. 45ca BRRD proposal) does not set any reliable limits either. Ultimately, in the medium term, this will also jeopardize the existence of small and medium-sized institutions with a classic business model, which can meet the requirements only through size.

- Additional unnecessary burdens would also be created for smaller and medium-sized institutions by extensive obligations in resolution planning, excessive resolution reporting and new disclosure obligations. Regarding proportionality, these would be precisely contrary to the efforts of the European legislator in the CRR to relieve small, non-complex credit institutions (SNCIs) from such obligations. It should be noted also that the simplifications for SNCIs in the CRR apply only if the credit institution is not subject to any or at most simplified resolution planning requirements (Art. 4 para. 1 no. 145 (c) CRR). These simplifications in the CRR could no longer be used in the future, as the credit institutions could lose their status as SNCIs if they were classified as "resolution institutions". Furthermore, there is a risk that the facilitations of the CRR will be undermined by irrelevant requirements of the BRRD.

In addition to breaking down critical functions to the regional level, the European Commission is proposing further changes to the resolution objectives to be taken into account as part of the PIA. If insolvency is more costly than resolution, the latter should be preferred. The same should apply if the resolution objectives are not better achieved by means of insolvency proceedings than by means of resolution. According to current legislation, it is sufficient for the insolvency rules to apply if the objectives are achieved to the same extent. Especially for the latter policy change, there is neither a factual nor a legal necessity. It is incomprehensible why insolvency proceedings should not be applied if the objectives pursued by them are achieved to the same extent as with the application of a resolution procedure. Forcing as many medium-sized and smaller institutions as possible into the more complex resolution should not be an unjustified end in itself.

The European Commission's proposals to widen the resolution regime to almost all credit institutions, regardless of their size, are all the more incomprehensible because in the past, for the smaller and medium-sized institutions that are the focus of the reform, insolvency with depositor reimbursement has in the vast majority of cases been the appropriate instrument for successful crisis management. This is underpinned by the high level of confidence among depositors in national deposit guarantee schemes, not least in Germany. However, it is precisely this depositor confidence that is a valuable – but fleeting – asset, as the recent crises of confidence in banks in the US and Europe have shown. The requirements for crisis management are therefore not suitable as a field for experimentation.

In our opinion, the claim that the resolution of smaller and medium-sized institutions is more cost-effective than insolvency has, at the end of the day, no empirical basis.

2. Extension of the co-financing of resolutions by Deposit Guarantee Schemes.

In the current legal framework of the BRRD, Deposit Guarantee Schemes can already be involved in the financing of resolution measures. Such involvement, however, is provided for only in narrowly defined exceptional cases. The amount to be paid by the Deposit Guarantee Scheme may not exceed the loss which it would have had to bear if insolvency proceedings had been opened and conducted against the assets of the credit institution. In particular, it is limited in absolute terms to half of the target level of funds under the Deposit Guarantee Schemes Directive, which amounts to 0.8% of the aggregate of covered deposits of the members of a Deposit Guarantee Scheme.

Now, this co-financing of resolution measures by Deposit Guarantee Schemes is to be extended. On the one hand, this extension would involve the complete abandonment of the previous absolute limitation of the amount of liability, so that, in a worst-case scenario, all the accumulated funds of the Deposit Guarantee Scheme would have to be used to finance the resolution of an institution and would have to be built up again within six years at the latest. On the other hand, the circumstances in which a resolution measure has to be co-financed by the Deposit Guarantee Scheme will also be considerably broadened. In particular, the funds of the Deposit Guarantee Scheme can in future be used to finance the transfer of covered deposits – and, under certain conditions, also of uncovered or unprotected deposits – as part of transfer strategies for smaller and medium-sized credit institutions. This is complicated by the fact that it leads to problems in raising funds on the one hand and has an impact on the earnings situation of the institutions on the other. Ultimately, if the available financial resources were not sufficient for further cases, unscheduled special contributions would have to be levied on the institutions, which in turn would reduce earnings.

In the event of a failure of a resolution measure, Deposit Guarantee Schemes would be doubly burdened because they would ultimately still have to finance depositors' payouts. Together with the loss of the preferential position in the insolvency proceedings mentioned under Section 3 below, the credibility of the performance of the deposit guarantee would no longer hold true.

The outlined extension of co-financing through deposit guarantee funds is to be rejected. Particularly in conjunction with the proposed extension of depositor protection to unprotected deposits - which is contrary to the mandate - this can have serious effects on financing requirements and lead to a financial depletion of Deposit Guarantee Schemes.

The extension is a subsequent fault in the European Commission's erroneous rationale for widening resolution rules to credit institutions of all sizes, which, contrary to the European Commission's view, could at worst lead to a financial "drain" of Deposit Guarantee Schemes. In the legislative text, the last remaining limitation of co-financing by the Deposit Guarantee Schemes amounts to a claim for compensation against the Single Resolution Fund in the event that the contribution of the Deposit Guarantee Scheme to the resolution was greater than the net losses it would have suffered had the institution been wound up under normal insolvency proceedings. This is not sufficient, however. Rather, the existing absolute maximum limit alone ensures that Deposit Guarantee Schemes and the affiliated contributory institutions are not overburdened and can continue to credibly carry out depositor compensation at any time in the future. Any threat to existing confidence in the functioning and performance of the Deposit Guarantee Scheme, in particular its guarantee for the payment of EUR 100,000 within a few days, is counterproductive to financial stability; on the contrary, it fuels depositor fears and is likely to accelerate crises of confidence in European credit institutions and deposit security.

3. Abandonment of the proven preference of Deposit Guarantee Schemes in the insolvency proceedings of credit institutions

A key factor in the system proposed by the Commission is the change in the position of Deposit Guarantee Schemes in the creditor hierarchy. In 2014, the BRRD introduced a preferential ranking for the claims of Deposit Guarantee Schemes, which in the event of insolvency assumes the rights and obligations of covered depositors or compensated the depositors (so-called "super-preference"/"super-priority"). The aim is to minimise the losses of Deposit Guarantee Schemes in the event of payout and thus ensure their sustainable financing.

This super-priority, which has been tried and tested in practice, is now to be discontinued in favour of a general deposit preference. This new single-tier general deposit preference in insolvency is to include:

- deposits,
- deposits made through branches located outside the Union of institutions established within the Union,
- Deposit Guarantee Schemes to which the rights and obligations of covered depositors in insolvency are transferred after payouts.

The abandonment of the proven preference of Deposit Guarantee Schemes in insolvency jeopardises the financing of the deposit guarantee principle and thus the confidence of depositors in the Deposit Guarantee Schemes.

The main effect of the change in the position in the creditor hierarchy is that Deposit Guarantee Schemes receive significantly lower recoveries in insolvency proceedings, which leads to proportionately higher losses in the event of a payout. As a result of the least cost test, e.g., in the context of a resolution, alternative measures will consequently appear more cost-effective and it will be more likely that Deposit Guarantee Scheme funds will be used for this purpose.

The planned reduction / elimination of the – hitherto rapid and regularly complete – recoveries will ultimately also significantly increase the regular contributions to the Deposit Guarantee Schemes. This, in turn, will have a negative impact on the earnings and competitiveness of the institutions.

First of all, the criticism already voiced in the context of the extension of the co-financing of resolutions by Deposit Guarantee Schemes applies accordingly. The disadvantaged position vis à vis the status quo can lead to a financial depletion of Deposit Guarantee Schemes and undermine confidence in their performance and functioning. According to the DGSD, depositor compensation/payouts will continue to be assigned to Deposit Guarantee Schemes as the main task in the future (cf. recital (24) of the DGSD draft: *"While the primary role of DGSs is the repayment of covered deposits..."*). However, if this remains the central task of a Deposit Guarantee Scheme in the future, everything that leads to unnecessary losses for the Deposit Guarantee Scheme – such as the expansion of the group of preferential deposits – must be avoided. It should also be borne in mind that functioning Deposit Guarantee Schemes represent key resolution objectives, such as the avoidance of serious negative impacts on financial stability, the protection of public funds and the protection of depositors.

In addition, the single-tier general deposit preference in the insolvency of credit institutions poses further threats to financial stability, emanating from both ordinary unsecured creditors and credit institutions. The proposed general deposit preference will worsen the ranking of the claims of ordinary unsecured creditors, as now all, rather than just certain, depositors will rank in preference to them. In the event of a (looming) institution failure, "run"-like behaviour can therefore occur at this creditor level. Particularly from the point of view of the institutions, the issuance of such products is also becoming more expensive, as has already been seen with the differentiated introduction of senior preferred and non-preferred instruments. It is possible that, from an economic standpoint, institutions would no longer be able to issue such instruments, but would make greater use of previously unknown instruments, e.g., securitisations, and create risks in this market segment.

Ultimately, there is no need for single-tier equal treatment of all depositors, since particularly vulnerable depositors, namely natural persons and micro-enterprises as well as small and medium-sized enterprises which hold eligible deposits in excess of covered deposits already have a higher ranking than do the claims of ordinary non-covered and non-preferential creditors. In addition, other depositors, such as large companies or, in the future, government bodies, do not require any protection that would be granted to them with the general depositor preference. On the contrary, the single-tier treatment is likely to create moral hazard on the depositor side.

4. Making alternative private and preventive measures based on the BRRD and the DGSD more difficult

The European Commission's proposals link alternative private measures to avert a (looming) default in the BRRD as well as preventive measures in the DGSD with additional, in part detailed requirements, which may make the application of such measures at any rate more difficult or impossible.

In the BRRD, for example, alternative measures to avert a (looming) bank failure in the "early warning period" are to be subject to a supervisory assessment with regard to their effects and timing of implementation (Art. 30a BRRD daft), and their actual implementation is tied not only to the already existing time constraints but also to an effective implementation of the resolution strategy for the institution (Art. 32 para. 1 (b)) BRRD draft). If the assessment of the alternative private measures submitted to the resolution authority constitutes an upstream barrier to the effective implementation of such measures, this would be tantamount to authorising such private measures, which in the worst case could lead to the measures being subject to state-aid law. It is likewise unclear how the prevention of the (looming) failure of an institution by private measures should take into account the effective implementation of the resolution strategy (e.g., bail-in). Rather, this new requirement could even stand in the way of averting the (looming) failure.

The current drafts for the revision of the BRRD and DGSD severely limit the actual possibility of implementing preventive measures through national guarantee/insurance systems. The trust placed in Deposit Guarantee Schemes and Institutional Protection Schemes and their proven benefits for financial stability are negated by the proposals. Against this background, in observing the principles of transparency and equal treatment, i.e., also considering other supervisory approval procedures that have been completed, in particular those in accordance with Art. 113(7) CRR, the GBIC advocates regulations that allow the use of preventive measures by Deposit Guarantee Schemes and do not restrict Institutional Protection Schemes in the exercise of their mandate.

Both the Institutional Protection Schemes and the voluntary guarantee schemes of private banks have tried-and-tested functional mechanisms for dealing with distress in small and medium-sized credit institutions. The functionality of these systems must not be impaired.

5. Technical changes in the DGSD

In addition to the four key elements outlined above, the Commission's proposal also contains extensive, rather technical amendments regarding the Deposit Guarantee Schemes Directive[1]. The proposed changes are based essentially on three opinions[2] of the European Banking Authority (EBA) which it published in 2019 and 2020, and with which it carried out its task of assisting the European Commission with its presentation to the European Parliament and Council of a report on the progress of the implementation of the DGSD.

The German Banking Industry Committee welcomes the fact that, with its present proposal, based on the practical experiences of the national Deposit Guarantee Schemes, the European Commission now wants to provide **clarification, flexibilization, operational simplifications** and other **meaningful harmonisation** in a number of places in the DGSD draft. In this context, the following should be mentioned as examples: modified regulations for determining the amount of compensation, the implementation of payouts - including cross-border payouts –s (Art. 7, 8, 14 DGSD draft) as well as a uniform level for the so-called "temporary high balances" (THB).

However, the German Banking Industry Committee still sees a **need for concretisation** about some proposals. For example, the practice of Deposit Guarantee Schemes has shown that there are ambiguities in connection with THB, including with regard to the disposition of the amount of THB money credited to an account in real estate transactions, whether the use of the real estate in question includes renting out in addition to personal use. Also, the period during which deposits for the purchase of real estate are to be protected should be specified.

In our opinion, Article 4 DGSD draft ("Official Recognition, Membership and Supervision") contains some unclear wording. The German Banking Industry Committee is in favour of streamlining the wording in such a way that the **status quo is maintained**. This concerns, in particular, rules on the powers of the

[1] Only these proposed amendments are the subject of the following comments. Article 11 and Articles 11a to 11e DGSD draft are not included here and have been commented on in the previous remarks.
[2] "Opinion of the European Banking Authority on the eligibility of deposits, coverage level and cooperation between deposit guarantee schemes" (8. August 2019) / "Opinion of the European Banking Authority on deposit guarantee scheme payouts" (30. October 2019) / "Opinion of the European Banking Authority on deposit guarantee scheme funding and uses of deposit guarantee scheme funds" (23. January 2020)

guarantee schemes with regard to breaches of obligations by an institution, as well as clarification that continues to guarantee the guarantee schemes at least the right to participate in a decision to exclude a credit institution from the respective scheme.

The planned inclusion of **public bodies** in the scope of protection of the DGSD draft must be critically assessed – contrary to the relevant "EBA opinion". Since it can generally be assumed that such bodies are in a position to deal with possible deposit risks, the German Banking Industry Committee does not for the most part see any need for protection here.

The German Banking Industry Committee is likewise critical of the contents of Article 8b DGSD draft. According to this, deposits held by financial institutions, including **investment/securities firms, e-money institutions or payment companies**, in the name and for the account of customers will now be covered by the Deposit Guarantee Schemes, provided that certain conditions are met. However, the proposed regulations leave many questions unanswered. For example, it is not clear which client funds from which specific companies in which type of account are subject to protection within the meaning of the Article. We see a **need for improvement** here. Furthermore, the protection of all so-called customer funds is likely to lead to high additional deposit volumes to be protected, so that the guarantee schemes will have to levy commensurate contributions for their funds in order to have sufficient money at their disposal in the event of a payout. In this respect, from the point of view of the German Banking Industry Committee, it is likewise imperative to word the provisions of Article 8b in such a way that sufficient, timely and absolutely certain collection of contributions is possible also for this purpose. Along with this, the depositors concerned must be clearly known at all times in order to ensure depositor payouts within seven working days.

From the point of view of the German Banking Industry Committee, the planned extended provisions of Article 8c on compensation (repayment) in the event of **suspected money laundering or terrorist financing** are not practical and leave questions unanswered. Apparently, the moment an institution has failed or is facing failure, customer due diligence is to be conducted under the supervision of the competent authority. The point of these measures is not clear, since the failing institution has already regularly carried out customer due diligence; any omissions can hardly be detected in such a situation, which is subject to considerable time pressure, and in view of the client's obligations to cooperate cannot be remedied either. The measures can moreover lead to the entire payout process being considerably delayed and not being able to be carried out within the prescribed deadline.

In addition, a depositor or any person should not be compensated (repaid) under Article 8c para.2 DGSD draft if they have been charged with or in connection with money laundering or terrorist financing. At any rate, in Germany, however, this regulation is ineffective, since the judiciary does not disclose an indictment to either the credit institution or the Deposit Guarantee Scheme or the regulator/supervisory authority (a possible disclosure obligation of the judiciary, moreover, is unlikely to come about in the foreseeable future). Also, the submission by the FIU of a suspicious activity report to the law enforcement authority is in most cases not communicated to the institutions. Therefore, it would be more appropriate to focus exclusively on other circumstances, such as transactional or account-related dispositions by public prosecutors or other authorities, which are already known to the distressed institution. In addition, a practical regulation should be introduced for those cases in which a failing institution has put a transaction on hold or blocked an account in connection with the submission of a money laundering suspicious activity report, but where there has not yet been a response from the authorities. In this context, however, it is essential that in this regard the Deposit Guarantee Scheme should not have any obligations to investigate and that a failing institution is expressly entitled to pass on the necessary information.

Art. 16 DGSD draft regulates the information for depositors about the statutory Deposit Guarantee Schemes. The **annual obligation to provide information** has already led to considerable costs for the affiliated credit institutions and in many cases also to confusion among clients, as this information is provided without a specific reason. In this regard, the German Banking Industry Committee is sceptical about the new regulations proposed at this point, which do not lead to simplification. In addition, it is incomprehensible that depositors should henceforth also confirm the annual receipt of depositor information. Such confirmation was previously limited to the time of the commencement of the business relationship and was sufficient.

The present draft DGSD mandates **EBA** for a variety of topics for the development of guidelines or technical standards. However, the German Banking Industry Committee considers a **mandate** of this scope to be excessive. Rather, it should be carefully examined where necessary regulations already make sense in the Level 1 text, and, taking into account economic aspects and bureaucracy avoidance, where the involvement of the EBA is completely dispensable.

In addition, the proposed Directive provides for a considerable extension of the **reporting content** to be issued by the DGSs to the EBA (Article 16a (3)(4)). The German Banking Industry Committee rejects such an extension. In particular, in our view, the publication of specific data of the relevant credit institution (Article 16a (5)) is by no means acceptable. The status quo must be maintained at this point.

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