Banking Union WG Meeting

European Forum of Deposit Insurers

"DGS alternative measures in banking crises under the new EU framework"

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1. Introductory remarks.

Good morning and thank you for inviting me to the EFDI Banking Union WG Meeting. I am very pleased to be here and to have a chance to talk about an issue which is of great interest at this time.

One of the key elements of effective banks' resolvability is the financing system, both before and during the resolution.

Two typologies of private crisis financing system could coexist under the new European Union crisis management framework to be used in different scenarios of resolution and early intervention.

According to the Bank Recovery and Resolution Directive and the Single Resolution Mechanism[1], the Single Resolution Fund and the Deposit Guarantee Schemes (DGSs), in some circumstances, will complement the primary role played by the bail-in of banks' shareholders and creditors for financing resolution schemes. At the same time, the DGS Directive seems to enlarge the role of DGSs in supporting and financing the early research of "market solutions" in broad terms that may avoid the failure of a bank.

More specifically, with the adoption of the DGS Directive, which harmonizes the DGS framework, the EU framework allows to preserve a key role for the DGS in the pre-resolution crisis management regime. This is in line with the Italian experience. As a consequence of the important functions that the DGSs play in crisis management, the new framework provides that the National Resolution Authorities will supervise DGSs on an ongoing basis.

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[1] See Directive 2014/59 and Regulation 806/2014.

2. The Italian Deposit Guarantee Systems.

The Italian Deposit Guarantee Systems have played an important role over the years, mainly in financing banking crises. As you know, there are two Deposit Guarantee Systems in Italy: the "**FITD"**[2], for all Italian banks except small cooperative banks, and the "**FGDCC"** for small cooperative banks. The **FITD** has managed 11 interventions since its establishment in 1987. The total amount of these interventions equaled 1.5 billion euros (about 0.3% of total covered deposits at year-end 2014); only 2 cases involved depositors' payout for very limited amounts. The **FGDCC** has managed 71 interventions since its establishment in 1997. The total amount of these interventions equaled 200 million euros (about 0.28% of total covered deposits at year-end 2013); only one case involved depositors' payout[3].

Until the implementation in Italy of Directive no. 2014/49 ("DGS Directive"), Deposit guarantee schemes are regulated under Directive 94/19/EC of 30 May 1994, amended by Directive 2009/14/EC of 11 March 2009 as regards the coverage level and the payout delay[4].

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[2] The Interbank Deposit Protection Fund, established in 1987 as a voluntary consortium, is now a private-law mandatory consortium, recognized by the Bank of Italy; the activities of which are regulated by the Statutes and By-laws (Directives 94/19/EC). All Italian banks (about 300) are members of the Fund, except for "mutual banks" ("Banche di Credito Cooperativo"), which are members of the Deposit Guarantee System of Mutual Banks ("Garanzia dei Depositanti del Credito Cooperativo").

[3] See C. BARBAGALLO speech at IADI, 31st Europe Regional Committee Meeting - Bank Crisis Management in Italy: Experiences and Perspectives. May 2015.

[4] The Italian legislator implemented the Directive 94/19/EC with the Legislative Decree n. 659 of 4 December 1996 and the Directive 2009/14/EC with the legislative decree n. 49 of 24 March 2011, effective from 7 May 2011. The legislative decree n. 49 of 24 March 2011 provides for the application of a maximum level of guarantee equal to 100,000 euro and a 20 working days payout limit, which may be extended by the Bank of Italy only in exceptional circumstances for further 10 days. The payout limit starts from the compulsory

Pursuant to the Banking Law, claims eligible for reimbursement are those relating to repayable funds acquired by clients, in Euros and in foreign currency, in the form of deposits or in other forms as well as banker's drafts and equivalent instruments.

Guarantee schemes shall succeed to the rights of depositors in respect of the bank's compulsory administrative liquidation within the limits of the payments made and, within such limits, shall have priority in receiving allotments from the liquidation with respect to depositors who have received such payments.

As an alternative to the reimbursement to depositors, and provided that the cost to the Fund is presumed to be lower (i.e. "least cost" criterion), the FITD and the FGDCC may intervene in operations involving partial or total transfers of assets and liabilities of the institution involved. The Funds may also provide support to banks placed under special administration, provided that there are reasonable prospects for recovery and, again, under the "least cost" criterion. Support by the FITD may take the form of: a) financing; b) guarantees; c) temporary acquisition of equity interests; d) other technical forms.

It is important to notice that the FDGCC can intervene even when a procedure has not been formally initiated in order to support a turnaround plan or to facilitate M&A by a healthier institution.

The FDGCC supports mutual banks also by expressing binding opinions (i.e. "*gradimento*") on the new corporate bodies and managers in charge of restoring the soundness of the bank.

Finally, it is worth mentioning that another fund was incorporated ten years ago on a voluntary basis among mutual banks (the "*Fondo di Garanzia dei portatori di titoli obbligazionari del Credito Cooperativo*") with the purpose of providing, in case of default

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administrative liquidation of the bank in accordance with article 83 of the Italian Banking Law.

of the bank, the reimbursement of bonds issued by the same mutual bank up to a maximum of € 103.291 per bondholder.

FITD and FGDCC interventions are subject to the authorization of the Bank of Italy which verifies their lawfulness and coordinates them with the crisis management duties assigned to the Bank of Italy by law.

DGS's interventions that are alternative to depositors' payouts, and which are by far the large majority, have allowed to preserve financial stability and, in general, depositors' confidence in the banking system while ensuring that non-viable banks were liquidated.

3. The Resolution Fund.

The new European framework concerning bank recovery and resolution (BRRD) and the Single Resolution Mechanism will have a significant impact on the operational scenarios of DGSs. As it is well known, indeed, the "Single Resolution Board" – which is the governing body of the Single Resolution Mechanism – will be responsible for managing the "Single Resolution Fund", which will be established to ensure that funding support will be available while a credit institution is being resolved.

In particular, the new Single Resolution Fund will be funded by contributions from the banking sector in the Member States participating in the Banking Union. The financing will be raised at national level and should be pooled at Union level in accordance with the Intergovernmental Agreement on the transfer and progressive mutualisation of contributions, thus increasing financial stability and limiting the link between the perceived fiscal position of individual Member States and the funding costs of banks and undertakings

operating in those Member States [5].

The target funding level (see below) will be at least 1% of covered deposits of all credit institutions (at least € 55 billion on the basis of 2011 data). In particular, the target level of the fund will be reached as follows: by the end of an initial period of eight years from 1 January 2016, the available financial means of the Fund shall reach at least 1 % of the amount of covered deposits of all credit institutions authorized in all of the participating Member States[6].

The SRM Regulation empowered the Commission to adopt delegated acts to specify criteria for establishing the annual contributions. At the end of last year (24.11.2014) the Commission formally adopted a proposal for a Council implementing act to calculate the contributions of banks to the Single Resolution Fund; on 19 December 2014 the Council adopted the implementing regulation – EU 2015/81 – that specifies uniform conditions of application of SRM Regulation with regard to ex ante contributions to the Single Resolution Fund. The new framework provides that for each contribution period the Resolution Board

[5] The setup of the Single Resolution Fund is envisaged by Article 67 of the Single Resolution Mechanism Regulation (806/2014). Pursuant to whereas 19, Single resolution fund ('Fund') is an essential element without which the SRM could not work properly. If the funding of resolution were to remain national in the longer term, the link between sovereigns and the banking sector would not be fully broken, and investors would continue to establish borrowing conditions according to the place of establishment of the banks rather than to their creditworthiness.

[6] During the initial period, contributions to the Fund shall be spread out in time as evenly as possible until the target level is reached. The Board may extend the initial period for a maximum of four years in the event that the Fund has made cumulative disbursements in excess of 0.5 % of the total amount of covered deposits and where the criteria of a delegated act by the Commission are met. During the transitional period, the contributions will be allocated to different compartments corresponding to each participating Member State (national compartments). Those compartments will be subject to a progressive merger so that they will cease to exist at the end of the transitional period.

If the available financial means diminish below the target level specified in that paragraph, the regular contributions shall be raised until the target level is reached. After the target level has been reached for the first time and where the available financial means have subsequently been reduced to less than two-thirds of the target level, those contributions shall be set at a level allowing to reach the target level within six years. The regular contribution shall take due account of the phase of the business cycle and of the impact pro-cyclical contributions may have when setting annual contributions in the context of this paragraph.

shall calculate the annual contribution due by each institution, on the basis of the annual target level of the Fund, after consulting the ECB or the national competent authorities and in close cooperation with the national resolution authorities.

The individual contribution of each institution shall be raised at least annually and shall be calculated pro-rata to the amount of its liabilities (excluding own funds) less covered deposits, with respect to the aggregate liabilities (excluding own funds) less covered deposits, of all of the institutions authorized in the territories of all of the participating Member States.

For Member States participating in the Banking Union, the national resolution funds set up under the BRRD as of 1 January 2015 will be replaced by the Single Resolution Fund as of 1 January 2016.

The Resolution Fund may be used by the Resolution Board within a resolution scheme, only to the extent necessary to ensure the effective application of the resolution tools for the following purposes:

(a) to guarantee the assets or the liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;

(b) to make loans to the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;

(c) to purchase assets of the institution under resolution;

(d) to make contributions to a bridge institution and an asset management vehicle;

(e) to pay compensation to shareholders or creditors if, following an evaluation, they have incurred greater losses that they would have incurred in a winding up under normal insolvency proceedings;

(f) to make a contribution to the institution under resolution in lieu of the write-down or

conversion of liabilities of certain creditors, when the bail-in tool is applied and the decision is made to exclude certain creditors from the scope of bail-in.

It must be noted that the possibility to use the Fund to absorb losses in the place of creditors is subject to strict limits and conditions under the BBRD. The Resolution Fund intervention is subject to the fact that a contribution to loss absorption and recapitalization equal to an amount not less than 8 % of total liabilities has been made by the shareholders and other creditors.

The DGS will directly contribute to funding the resolution process by absorbing losses in lieu of covered deposits - that are excluded from bail-in - to the extent of the net losses that covered deposit would have suffered if they were subject to the bail-in powers.

However, this should only take place when the bail-in of all unsecured creditors is not sufficient to absorb losses, i.e. when losses are exceptionally high or when the bank is mainly financed by covered deposits.

4. Financing banking crises in the "traditional" regime and in the new resolution regime.

In light of the above, except for the depositor payout function – that will remain an exclusive task of the DGS – the funds for financing banking crises will come from the DGS, the Resolution funds, and the bail-in.

While the bail-in will provide funds to absorb losses and recapitalize the firm under resolution, the resolution fund will supply the liquidity that is necessary to support the application of the resolution tools and, in exceptional circumstances, may complement the loss absorbing capacity coming from shareholders and creditors.

The upcoming implementation of the Resolution Fund will not undermine the DGS functions in banking crisis management. Indeed, there is still room for voluntary DGS interventions in the new European framework given the fact that the Resolution Fund can only be used in resolution, i.e. when the bank is failing or likely to fail and there are not alternative solutions.

Art. 11, paragraph 3 of the DGS Directive, in which DGS alternative interventions have been regulated as a national discretion of the Member States, allows the DGS to use the available financial means for alternative measures in order to prevent the failure of a credit institution provided that "the resolution authority has not taken any resolution action under Article 32 of Directive 2014/59/EU".

Having said that, we can assume that for banking crises that are at an initial stage, when the triggers of resolution are not met yet, there could be a role for the DGS, as provided by the mentioned Article 11 of the DGS Directive, whereas, when the triggers for resolution are met, banking crises will be managed through resolution and financed by the resolution fund, and of course the bail-in of creditors.

This means that, in the future, two different and alternative models of financing banking crises could coexist under the European and national framework: the Resolution Fund, which properly operates in resolution, and the DGS, which may operate outside resolution, in the early intervention phase. As clearly stated in whereas no. 16 of the Deposit Guarantee Schemes Directive (no. 2014/49), it will be possible for a DGS to go beyond a pure reimbursement function and to use the available financial means in order to prevent the failure of a credit institution with a view to avoiding the costs of reimbursing depositors and other adverse impacts[7].

[7] Pursuant to the DGS Directive, those measures should, however, be carried out within a clearly defined framework and should in any event comply with State aid rules. DGSs should, inter alia,

For example, I believe that during the early intervention phase, the DGS could intervene by assisting banks in the implementation of the recovery plan and, if needed, by facilitating and supporting them to carry out private sector solutions. Non-financial support by the DGS, such as the provision of consultancy and audit functions could also be important: the DGS's non-financial support has often been successfully used over the last ten years especially by the DGSs of Italian cooperative banks . DGS non-financial support is now expressly requested by the DGS Directive which states that the implementation of every DGS alternative measure "*should be subject to the imposition of conditions on the credit institution involving at least more stringent risk-monitoring and greater verification rights for the DGSs*"[8].

In addition, we must consider that one of the triggers to start resolution is that there are no private sector solutions that can avoid a bank failure. I think that one question here is if the alternative intervention of the "*DGS in order to prevent the failure of a credit institution"* can be considered - and *de facto* is - able to act as or facilitate a "market solution" that can avoid the start of the resolution. It has to be noted that IPS measures are expressly mentioned by the BRRD as a kind of measure that, if available, will avoid resolution.

I think that preventive interventions by the DGS should also be considered in this context, since these interventions have exactly the same aim of those of an IPS, which is to avoid a failure.

have appropriate systems and procedures in place for selecting and implementing such measures and monitoring affiliated risks. Implementing such measures should be subject to the imposition of conditions on the credit institution involving at least more stringent risk-monitoring and greater verification rights for the DGSs. The costs of the measures taken to prevent the failure of a credit institution should not exceed the costs of fulfilling the statutory or contractual mandates of the respective DGS with regard to protecting covered deposits at the credit institution or the institution itself.

[8] See recital no. 16 of the DGS Directive.

This role of DGSs in preventing the failure has to be further exploited and analyzed in its prerequisites and conditions. Moreover, the DGS role in pre-resolution must take into account the constraints that could derive from the introduction of depositor preference coupled with the least cost criterion, and obviously – where relevant – State aid rules.

Other possibilities of interventions for the DGS are linked to the systemic relevance of banks, and particularly the size of banks. When a bank is failing or likely to fail, one of the conditions to start resolution is the occurrence of the public interest that could not always be met for small sized banks. In the new framework we can assume that, while the crises of major banks will be financed by the resolution fund, the crises of small sized non-systemic banks could continue to be financed by the DGS.

In this regard, the DGS directive provides that it will be possible to make recourse to the DGS not only to reimburse depositors but also to finance a transfer of assets and liabilities to another institution. Article 11, paragraph 6 of the DGS directive provides that the DGS may be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities, in the context of normal insolvency proceedings, that is to say, any time the public interest test is not met and the bank is liquidated.

5. Conclusions

The insurance function is the mandatory task of the DGS but not the only one: in fact, at the conditions highlighted above, and in particular, if the DGS considers that early interventions will be beneficial for the system as a whole, the DGS can continue to play an important role in banking crises.

More specifically, the DGS could decide to play a role in the pre-resolution phase,

when a bank is experiencing difficulties but is still viable and the authorities have several tools at their disposal to manage the situation. At this stage, competent authorities, resolution authorities and the DGS should cooperate to manage effectively the situation and prevent difficulties from worsening, thus avoiding an irreversible crisis.

In this perspective, the Resolution Fund, as a new tool provided by the Single Resolution Mechanism, will strengthen the whole crisis management mechanism, added together with the early intervention crisis management regime that may be supported by the DGS.

Over the years, DGS alternative interventions in Italy, especially with regard to the FGDCC, have proved the utility and the crucial role in supporting distressed banks in restoring their soundness. Our experience welcomes the possibility envisaged by the new EU framework that allows the DGS to continue to play a more active role in crisis management.