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Reform of the CMDI Framework: Driving off with the breaks on

Tobias Tröger and Ioannis Asimakopoulos: The proposals to strengthen European bank resolution procedures need further improvements

Evidence suggests that the existing European Crisis Management and Deposit Insurance (CMDI) framework for failing banks is still an underutilized asset. The lack of credible funding inevitably narrows the scope of the special resolution regime. Therefore, authorities have often handled bank failures (particularly of retail banks) outside the designated resolution framework, where government funding was an option. The European Commission's proposal for a CMDI reform (CMDI Proposal) is an ambitious attempt to improve the situation. The crucial trilogue negotiation phase is imminent and the European Parliament, the Council of the European Union, and the European Commission will be working to finalize and agree on the ultimate changes of the CMDI framework.

In our recent paper, we argue, however, that the CMDI Proposal – let alone the retracting position of the European Parliament for the trilogue negotiations – represents an attempt to optimize under political constraints. Even if we accept political realities, we recommend additional amendments to the CMDI that co-legislators could implement in the trilogue.

The need for reforms

Policymakers conceived the European Banking Union to rest on three pillars: supranational supervision, resolution, and deposit insurance. Yet, until today, the institutional architecture has operated without the third pillar, common deposit insurance. Due to anticipated insurmountable resistance in pivotal member states, discussions around a European Deposit Insurance Scheme (EDIS) have been carved out from the CMDI Proposal. Therefore, the CMDI review will not accomplish a full-fledged banking union and can, at best, bring about incremental improvement.

Against this background, the CMDI Proposal aims to make resolution funding more accessible to banks, especially retail banks, thereby removing a de facto disincentive to use the resolution framework.

Gaps in the current framework

Existing CMDI rules make access to resolution funding (through the Single Resolution Fund (SRF)) subject to a prior write-down of a bank's liabilities (bail-in) that amounts to at least 8 percent of the bank's total liabilities and own funds (TLOF). To ensure that all banks have sufficient loss absorbing capacity during financial distress, banks need to build up sufficient equity and/or debt buffers of a certain quality and quantity, the so-called Minimum Requirement for Own Funds and Eligible Liabilities (MREL).

Evidence suggests that, in a resolution scenario, many retail banks would fail to achieve an 8 percent TLOF bail-in without imposing losses on uncovered deposits, which could impact financial stability, as recently illustrated during the US banking turmoil in March 2023. National deposit guarantee schemes (DGSs) are effectively unavailable to support a resolution strategy (except by paying out deposits), because they can only contribute funds if, and to the extent that, covered deposits would be impacted. As covered deposits sit at the top of the creditor hierarchy, DGS funding becomes available only after extensive bail-in, which would have damaged most of the bank's client relationships and precipitated a bank run.

Proposed reforms

Thus, the CMDI Proposal aims to make more DGS funding available earlier to unlock the SRF resources. Specifically:

- The CMDI Proposal allows banks to access the SRF without meeting the 8 percent TLOF bail-in requirement. DGSs contributions to resolution funding count toward the minimum bail-in requirement so that the bank and the DGS can jointly achieve the 8 percent target.
- Covered deposits would no longer benefit from a super-priority status and would, therefore, absorb losses along with other senior bank creditors. Consequently, DGS support, which substitutes for depositor loss absorbance, would become more accessible.
- However, DGS funding would be subject to the 'least cost test' (LCT), meaning that DGS could provide support only to the extent that resolution action would hit covered deposits. This interpretation of the LCT limits the availability of DGS funding when banks have a high proportion of uninsured deposits.
- There is no change to national DGSs' (limited) financial capacity.
- Transfer strategies ('purchase and assumption'), preferred in small and medium bank resolutions, benefit from the acquirer's loss absorption and rely less on bail-in. Therefore, the CMDI Proposal also envisages lower MREL targets if an institution's resolution plan sets out a (partial) transfer as the preferred strategy.
- Complementary to making resolution funding more accessible, the CMDI proposal also seeks to broaden the scope of resolution by relaxing the requirements for 'public interest' in applying the special regime, potentially enlarging the CMDI framework's remit relative to regular insolvency proceedings.

The attempts to optimize under constraints will arguably not yield the first best outcomes. The CMDI Proposal reduces the funding gap many banks face before accessing resolution funding. It acknowledges that loss absorption can happen not only through bail-in but also through collective industry funding. However, though DGS funding becomes more accessible, and the scope of resolution becomes broader, the DGS resources remain unaltered (and national). While this arguably highlights the need for EDIS again, the lack of common deposit insurance (together with the lack of established and reliable liquidity support in resolution) will continue to undermine the credibility of the CMDI framework.

Additional steps to consider

Within the boundaries of the politically possible, we recommend the following additional steps:

- *Early write-down and conversion*: The March 2023 banking turmoil suggests that sufficient recapitalization capacity that authorities can activate to stabilize an ailing bank without triggering resolution is paramount. Instead of relying on contingent convertible capital instruments (CoCos), we argue that the objective of CoCos, particularly in the European regulatory ecosystem, can be more effectively achieved by allowing authorities to trigger a write-down or conversion already in the recovery phase (before entering resolution). This would require only minor adjustments to the CMDI framework.
- *Pre-structuring auctions in transfer strategies*: Economic theory favors using auctions rather than bilateral negotiations when authorities want to sell a failed bank to a healthy one. To realize the prospective efficiency gains, banking supervisors and resolution authorities need to prepare adequately for a bank resolution that may come unexpectedly and suddenly due to a bank run. Resolution authorities have undertaken such preparatory work but should still improve on making critical data available to potential buyers promptly, ideally before a rushed M&A transaction in resolution. As the scope of resolution expands, resolution authorities will need to enhance their contingency planning and procedures, especially for smaller banks where transfers are likely to be the preferred resolution strategy.

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