Irrevocable Payment Commitments: A New Form of Servicing Banks´ Obligations towards the EU Sovereigns?

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Building on the previous work (Országhová – Mišková, 2015), this article zooms in on the specific topic of irrevocable payment commitments. These commitments have been introduced as an alternative to cash payments to both the resolution fund and the deposit guarantee fund. This novel instrument in the EU regulatory framework could thus facilitate the achievement of the future target level of ex-ante funding while limiting the impact of the new measures on the lending capacity of credit institutions in the post-crisis period. The article discusses the rationale of introducing irrevocable payment commitments into the framework of annual financial contributions and provides an overview of their main characteristics. Furthermore, it compares the EU-wide framework to similar approaches which have been applied in some EU Member States.

Rationale: A compromise between long-term objective and post-crisis reality

Since the global crisis, an exhaustive reform agenda in the financial sector has been undertaken both at global and European level. One of its prominent features is the introduction of risk-based financial contributions from the credit institutions to the resolution and deposit guarantee funds (referred to collectively as 'financing arrangements' throughout this article).[3] The decision to introduce risk-based financial contributions needs to be seen in a broader perspective of unprecedented government interventions into the financial sector during the recent financial turmoil.[4]

The financing arrangements were created to address several objectives, namely to lower the probability of occurrence of any banking crisis in the future by internalising its costs by the credit institutions themselves, to protect taxpayers from bearing any future costs of bank distress as well as to re-gain their confidence in the financial sector. In order to avoid any pro-cyclical effects which would arise if financing arrangements had to rely solely on ex-post contributions, it has been understood as indispensable that the available financial means of the resolution and deposit guarantee funds amount to at least a certain minimum target level. Within the EU, a consensus emerged that the resolution fund should reach at least 1% of the amount of covered deposits of all authorised institutions by end-2024 and the deposit guarantee fund should reach at least the target level of 0.8% of the amount of covered deposits of its members by 3 July 2024.

In order to reach the target level within these deadlines, annual risk-based ex-ante contributions will be imposed on the credit institutions over the coming ten years (until 2024).[5] Without prejudice to the benefits of a harmonised approach, which leads to higher consistency within the EU and thus to further reduction of the fragmentation of the financial sector, it must be noted that the ex-ante contributions to financial arrangements have been introduced in a very complex external environment. It is characterised, on one hand, by an ongoing adjustment of financial and non-financial sector balance sheets, given the post-crisis overhaul of bank regulation and supervision (including new rules on capital requirements) and on the other hand, by the efforts of national authorities to revive the bank lending channels and thus to boost economic growth (also via non-standard monetary policy measures). The new risk-based contributions to financial arrangements could further impair, at least in the short-term, both liquidity and (to a limited extent) capital of the credit institutions and as such also the capacity of banks to finance the real economy.

With this in mind, the European legislation provides that the available financial means to be taken into account in order to reach the required target level may include irrevocable payment commitments (referred also as 'IPC' throughout this article). IPC have, by definition, some pro-cyclical dimensions and entail a certain level of liquidity risk for the financing arrangements. As such, they could be seen as a derogation from the main principles for ex-ante financing. However, they were included in the EU legal framework with the intention to provide for some flexibility during the transition period until 2024. They could thus facilitate the achievement of the future target level

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2 The article should not be reported as representing the views of Národná banka Slovenska (NBS) or any other institutions the authors have been associated with. The views expressed and mistakes made remain of the authors.
3 Please note that we refer to both the national resolution funds as well as the Single Resolution Fund (SRF), which will become operational as of 2016.
4 As concerns the EU, since the beginning of the crisis around 110 European banks have received state aid, representing roughly 25% of total banking assets in the EU. Between 2008 and 2013, the national governments injected EUR 608 billion into banks in capital and assets relief measures, an equivalent of 5.2% of the average GDP of the EU over the same period. Furthermore, in the peak year of 2009, the outstanding amount of guarantees provided to banks reached EUR 835 billion (Almunia, 2014).
5 For further details about the risk-based contributions, please consult Országhová and Mišková (2015).

of ex-ante funding while limiting the impact for the new measures on credit institutions and on their lending capacity. This is particularly crucial for those EU Member States which are still facing ex-post liabilities after the financial crisis as well as for those which have not been operating deposit guarantee schemes on a pre-funded basis. The inclusion of collateralised commitment thus allows the financing arrangements to have immediate access to funding if needed, but without the requirement on the part of the credit institutions to cash funds entirely upfront.

Main characteristics of irrevocable payment commitments

Irrevocable payment commitments (IPC) can be defined as an obligation on the part of credit institutions to pay their contributions in the future. This obligation is duly formalised in a contract[6] signed between the financial arrangement and an institution that opts for the IPC instead of paying its contribution in cash. This is a perpetual and irrevocable obligation, as it will not cease nor decrease until such an obligation is eventually fulfilled.

The right of the financial arrangement is guaranteed by a formal pledge of securities, which is transferred directly to the financial arrangement or registered in a central securities depository in favour of the financial arrangement. The financial arrangements can only accept **low-risk assets as collateral** to secure the IPC. Furthermore, the collateral cannot be encumbered by any third-party rights and it should be at the free disposal of and earmarked for exclusive use by the receiving authority. Furthermore, the authorities need to determine criteria on the eligibility of the collateral, including with respect to concentration and currency risks, as well as to apply a haircut to its value. This implies that the market value of the asset is always reduced by a certain percentage (haircut). The EBA advises the use of the criteria and haircut schedules as applied by central banks in their monetary operations. Furthermore, the credit institution is, at the request of the financial arrangement, obliged to replace the IPC with a cash payment within a certain time limit – the EBA proposes 2 working days.[7] If the credit institution does not meet its obligations, the financial arrangement has the right to realise the collateral.

The underlying idea of the strict criteria on the IPC is on one hand to secure that they could be realised if needed and on the other hand that they are not incentivised in any way over cash contributions. The incentive for the credit institutions to use the IPC instead of cash however lies in their accounting treatment. Contrary to cash contributions, which are reflected in the profit and loss statement (P&L) upon their payment, the IPC are, in most cases, considered as contingent liability. As commented on by several respondents in the consultation phase of the EBA guidelines, this treatment is possible under conditions where the events triggering their call are determined and their likelihood of occurrence can be assessed. In other words, the IPC may be treated as contingent liabilities as they can only be paid out in the event of a particular set of circumstances arising.

Legal framework: A harmonised approach or a puzzle?

The legal basis for the use of IPC is provided for in European secondary legislation, namely Article 103(3) of the BRRD, Article 70(3) of the SRM and Articles 10(3) and 2(1) of the DGSD.[8] They state, broadly in similar terms, that IPC may be used to account towards the target level; however their share shall not exceed 30% of the total amount of contributions. Furthermore, basic requirements, such as their full backing by low-risk assets, are also specified in these legislative acts.

However, when it comes to further details, a different approach has been chosen for the two financing arrangements. In the case of the resolution fund, the IPC are further defined in non-legislative acts,[9] which are directly applicable in the EU/euro area-wide context as of early-2015. In the case of the deposit guarantee fund, there are no further legal acts at present. Instead, the European Banking Authority (EBA) has been mandated to issue guidelines on IPC in order to ensure their consistent application within the European deposit guarantee schemes (DGS). Although the EBA guidelines provide for a great amount of detail, they are not legally binding. However, the national authorities are obliged to inform the EBA of their compliance with the guidelines or to explain the reasons for any non-compliance. The final guidelines on IPC were published on 28 May 2015, following an extensive consultation process at end-2014.[10] The national authorities are requested to confirm their compliance status with the guidelines within two months after their publication and to implement them into their national practices by end-2015.

With the objective of creating an internal EU market for banking services and thus preventing any regulatory arbitrage, the set of provisions on IPC are to be interpreted as providing for a coherent and consistent application of IPC across the different financial arrangements as well as across the whole EU. However, in our view, the different legal acts appear somewhat conflicting on a few issues. This is due to the fact that the different legal acts provide for different levels of detail and the respective provisions are not universally applicable across all financial arrangements and across all countries. As an example, both SRM and DGSD allow other means of contributions than cash or IPC to count towards the target level, namely deposits and low-risk assets; however the legislation remains silent about this option for national resolution funds.[11] In other words, the authorities outside the Single Resolution Mechanism (SRM) as well as in all EU countries in 2015 (given the fact that the Single Resolution Fund (SRF) only becomes operational as of 2016) do not have an implicit right to accept deposits or low-risk assets

6 *Please note the EBA guidelines envisage two legal instruments, namely an agreement on payment commitment which provides for the right of the financial arrangement to claim the amount, and another agreement on financial collateral, which ensures that the right of the financial arrangement is guaranteed by a low-risk asset. For further details, please consult the EBA guidelines (EBA/GL/2015/09).*

7 *For comparison, the DGS is obliged to repay the depositors within seven working days (for details, please consult Directive 2014/49/EU). Furthermore, in Denmark the institutions are obliged to honour their guarantee within eight days and in Portugal within 3 days upon the request by the respective fund. For more details about the two countries, see one of the sections below.*

8 *The BRRD refers to Directive 2014/59/E U, the SRM to Regulation (EU) No 806/2014 and the DGSD to Directive 2014/49/EU.*

9 *For further details, please refer to Article 13(3) of Commission Delegated Regulation (EU) 2015/63 (further referred to as 'DR' or 'delegated regulation') and Articles 7 and 8 of the Council Implementing Regulation (EU) 2015/81 as well as points 6 and 16 of the respective recital (further referred to as 'IR' or 'implementing regulation').*

10 *For further details, please consult EBA/GL/2015/09.*

11 *For further reference, see the definition of available financial means, namely Article 3(1) of the SRM and Article 2(1) of the DGSD.*

as available financial means to count towards the target level. In this respect, please see also our discussion below about the use of alternative means of contributions in the past in some of the EU Member States. Similarly, it is for the authority of the national resolution fund to decide on the mix of annual contributions for 2015, including the share of IPC, however at the same time the recital of the related implementing regulation[12] states that the Single Resolution Board will ensure that the same share of IPC will be transferred by each SRM Member State to the SRF.

Who has the right to exercise irrevocable payment commitments?

The legislation provides that the maximum share of IPC cannot exceed 30% of the total amount of available financial means. There is however no automatic right for credit institutions (or investment firms) to provide their contributions in the form of IPC. Such an interpretation would probably result in the systematic use of IPC, which would be inconsistent with the overall objective of the ex-ante financing. This provision is rather to be read as a discretionary power of the authorities to exercise the option (or not) to accept IPC of up to 30% of the available financial means.[13] This right gives the authorities the possibility to duly assess the application of IPC against the overall situation in the country, in particular against the main objective of preserving financial stability. At the same time, this right is somewhat limited in the case of the SRB, which shall allow the use of IPC under normal circumstances. Furthermore, it shall allocate no less than 15% of the payment obligation of an institution in the form of IPC if that institution requested their use.[14]

Furthermore, a question arises whether the 30% limit is set on an annual or cumulative basis. In the consultation phase of the EBA guidelines, the respondents supported a flexible approach where the authorities have the right both to overshoot and to undercut the 30% limit during the build-up phase as long as the 30% limit is met in 2024. As discussed above, the authorities have the right to undercut the 30% limit and to accept a lower share of IPC (or none) in a given year. It appears therefore meaningful that the authorities will also have the right to compensate the lower level of IPC of that year in the coming years, thus overshooting the 30% limit in a given year. This argument should also be seen in light of the consistent treatment of financial institutions across the EU internal market, namely the institutions which will build up the target following the new EU-wide harmonised rules and those institutions which were subject to ex-ante contributions in the past. Financial resources of the latter group, which are provided mostly in cash (as the IPC were often not an option), now count towards the target level. This is particularly the case for several national DGS. In light of a coherent treatment it could be envisaged to overshoot the annual limit for the remainder of the financial contributions until the target is met.

Let us however reiterate that we understand this flexibility without any prejudice to the overall limit, defined as a 30% share of the total (cumulative) amount of financial means already available in the financial arrangement.[15] The overall limit should be met not only in 2024 and it should not be jeopardised in any given year. In this respect, any frontloading of payment commitments and delaying of cash payments between years shall be avoided. This interpretation is, in our view, in line with the overall objective of ex-ante contributions, namely the intention to achieve a critical mass of resources and to avoid any pro-cyclicality by relying on ex-post funding.

It should be noted however that our arguments could be at odds with the rules of the SRM, which state that in any given year the sum of "those" IPC shall not exceed 30% of the total annual contributions.[16] If the total annual contributions are to be interpreted as referring to the total amount of contributions to be raised during the contribution period (thus in that given year), this would imply that in each individual year the limit of 30% of IPC is to be applied. In other words, in a given year, the SRB will have the right to set a lower, but not a higher limit, calculated as a 30% share of the total contributions to be raised in that specific year.

Another aspect is the possibility of differential treatment of individual banks. As a general principle, the authorities are bound to apply their rights (including the right to exercise the IPC) in an objective and non-discriminatory manner and to treat the credit institutions as consistently as possible across the internal market. As such, the same limit of IPC should apply to each institution's ex-ante contributions.[17]

It shall be also noted that it remains the right of a credit institution to service its financial obligation in the form of IPC, but within the limit allowed by the financial arrangements. As such, the IPC are not compulsory. A general envisaged approach is that the financial arrangement announces the share of IPC which is accepted in a given year and the credit institution may exercise this option up to the statutory amount. A slightly different approach is foreseen within the SRM, where the process is initiated by a request from credit institutions and subsequently, the SRB allocates the use of IPC evenly among those institutions that requested it.[18]

Are payment commitments new?

IPC represent a novelty in the EU regulatory framework. Moreover, they are also new to most of the EU Member States. However, some EU countries have experiences with applying alternative instruments to financial contributions in cash. In what follows we will present the approaches which exist in France, Denmark and Portugal.

In **France**, as of 1999 the member institutions may be exempt from paying (part of) their contribution to the deposit guarantee scheme and

12 For further details, see point 6 of the recital of the IR.

13 In this respect, see e.g. the decision of the Slovak Resolution Council of 21 May 2015 not to exercise this option in 2015 (for further details, consult its website www.rezolucna-rada.sk).

14 For further details, please consult Article 8 of the IR.

15 In other words, if the authorities do not allow any IPC in the first year, they should have the right to set the limit of IPC in the next year of up to 60% of the annual contributions in that particular year, while respecting the 30% overall limit set at the level of total available financial means (thus the sum of contributions from the previous and this year).

16 Please refer to Article 8 of the IR.

17 On this aspect, please refer to point 8 of Title II, Part 1 of the EBA guidelines which state that "[…] DGS should not accept more than 30% of a given member's ex-ante contributions to be made in the form of payment commitments." or Article 8 of the IR which states "The Board shall allocate the use of irrevocable payment commitments evenly […]."

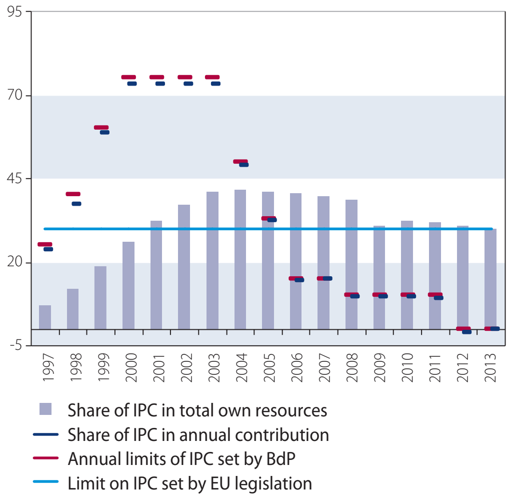
18 For further details, please see Article 8 of the IR.

to the resolution fund of the FGDR[19] provided that the institution agrees to make such payment upon request. The credit institution has the option to replace its contribution with a **guarantee commitment**, which remains valid for five years. Moreover, the institution is required to pay a guarantee deposit (*dépôts de garanties*) in the same amount instead. This surety deposit, which is recorded at the FGDR for an amount equal to the portion of the unpaid contribution, is frozen for five years (it can however bear interest during this period). Guarantee deposits are returned after that period if they have not been used to finance an intervention and they are partially or fully converted into cash contributions. As of 2007, 100% of the annual contribution may be provided in the form of a deposit guarantee.[20] Over the past several years, all contributions were paid in the form of five-year guarantee deposits, with the exception of those paid by new members and special contributions collected to replenish funds following an intervention (these are paid definitively).[21]

A similar approach for the deposit guarantee scheme of the GFDI[22] existed in **Denmark** until 2012, where credit institutions paid their contributions either in cash or in guarantees, however there was no condition as in France for a five-year rotation of the guarantees. With the proposed EU directive on deposit guarantee scheme, a complete redesign of the system was introduced in 2012. As part of the reform, liquidity requirements on the deposit guarantee scheme were introduced, e.g. minimum level of assets as well as minimum share of cash and cash equivalents in total assets.[23] As a consequence of the new funding model, the guarantees issued by the banks for the deposit guarantee scheme were fully replaced with liquid assets in 2012.

This reform did not have an impact on the other financial contributions of the GFDI, namely financial contributions for winding-up or resolution of credit institutions, which were introduced in Denmark in 2010. The capital for the winding-up process continues to be provided solely through guarantees (also referred to as commitments) from credit institutions, amounting to a minimum of DKK 3.2 billion. For the purposes of restructuring, a combination of guarantees (commitments) and cash contributions is envisaged, amounting to a minimum of DKK 1 billion. According to the annual report of the GFDI for 2014, all funds so far were provided in the form of guarantees.

Chart 1 Share of irrevocable payment commitments and statutory limits for FGD in Portugal (in percent of total/annual financial contribution)



Sources: Banco de Portugal (BdP), Portuguese Deposit Guarantee Fund (FGD) and authors´ calculations.

The system available for the deposit guarantee scheme (FGD)[24] in **Portugal** appears to be the closest to the EBA proposal on IPC. The IPC is based on a signed contract, guaranteed by a permanent pledge of securities and deposited at a central securities depository. Furthermore, only securities of high quality, low risk and high liquidity are accepted and following a conservative approach, a haircut of 10% is applied on their market value. Contrary to France and Denmark, IPC have only been used to replace cash contributions to the Portuguese deposit guarantee scheme.

The maximum amount of IPC (defined as a share in the total annual contribution) is decided annually by the central bank; however it may only be set within the legal limit of 75%. Whereas in early 2000s it was defined at the upper limit, the share of payment commitments in the annual contribution has since then gradually been reduced (see Chart 1). Moreover, as of 2012, the limit has been set at 0%, meaning that for the last 4 years credit institutions have not been authorised to use the IPC. This decision is, among other things, related to the efforts to harmonise the Portuguese approach with the latest EU initiative regarding the deposit guarantee schemes.[25] As a consequence, the overall level of IPC in the FGD's total own resources decreased in 2013 below the limit of 30% set by the DGSD. This implies that all IPC in Portugal may be included in the available financial means for the calculation of the target level of 1% of covered deposits in the country, which is to be reached by mid-2024.

In this respect, it is also worth noting the behaviour of the credit institutions. They seem to fully utilise this alternative means of servicing their payment obligations. Over the whole period, the share of the IPC in the total annual contributions largely mirrored the limits set by the Portuguese authorities for each particular year (see Chart 1).

Conclusions

Irrevocable payment commitments represent a novel instrument in the EU regulatory framework as well as in the legal systems of most EU Member States. Defined as an obligation on the part of credit institutions to pay their financial contributions in the future, the use of IPC does not have an immediate impact on the balance sheets of banks and thus on their capacity to finance the real economy. As such, they facilitate the achievement of the target level of ex-ante

19 Fonds de Garantie des Dépôts et de Résolution (FGDR) represents a single institution in France that collects and manages funds of the deposit guarantee scheme, investment guarantee as well as of the national resolution fund.

20 When introduced in 1999, half of the annual contribution could have been replaced by a guarantee fund. This amount has increased to 70% as of 2003 and to 100% as of 2007.

21 See e.g. p. 41 of the Annual Report 2013 of the FGDR. The annual breakdown of guarantee deposits broadly mirrors the annual contributions to the deposit guarantee scheme for the period 2009-2013, announced in the ministry orders (so called 'arrêtés' in French).

22 Similarly to France, a single institution in Denmark - the Guarantee Fund for Depositors and Investors (GFDI), collects contributions for the deposit guarantee scheme, the investment guarantee scheme as well as the national resolution fund. The financial contributions related to the deposit guarantee scheme are recorded in the "Banking Department" of the GDFI, whereas the financial contributions related to resolution are recorded in the "Winding-up and Restructuring Department" of the same institution.

23 It is worth noticing that the deposit guarantee scheme in Denmark used ex-post financing until 2011 and the ex-ante funding arrangements were only introduced in 2012.

24 FGD refers to Fundo de Garantia de Depósitos, the Portuguese Deposit Guarantee Fund.

25 Namely, the adoption of DGSD (Directive 2014/49/EU).

funding for both the resolution fund and the deposit guarantee fund in a rather challenging post-crisis environment.

There is strong conditionality related to the use of IPC, including strict eligibility criteria and haircut schedules on the low-risk highly liquid assets used as collateral. Given the whole set of legal, administrative and operational requirements, it might be rather challenging to set up the whole framework for their use. However, the extensive utilisation of the irrevocable payment commitments as well as of similar instruments in a few EU countries in the past indicates that they could provide flexible alternative to cash payments as well as address immediate liquidity concerns on the part of credit institutions.

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