Note drafted by the Eurofi Secretariat

THE PROTECTION OF DEPOSITS IN THE EU: PROS AND CONS AND A POSSIBLE WAY FORWARD

This note presents the expected benefits of a European Deposit Insurance Scheme (EDIS), the arguments against it and two possible ways forward (EDRIS, EReIF).

1. The current protection of deposits

For the time being depositors are protected by Directive 2014/49/EU of 16 April 2014 (Deposit Guarantee Scheme Directive / DGSD). This Directive includes all credit institutions and all schemes, without distinction. By July 2024, the available financial means of a Deposit Guarantee Scheme (DGS) should at least reach a target level of 0,8 % of the amount of the covered deposits of its members.

These requirements will ensure that regardless of where the deposits are located in the Union, depositors will always have a claim against a scheme and that all schemes must be soundly financed. Depositors thus benefit from significantly improved access to DGSs, thanks to a broadened and clarified scope of coverage, faster repayment periods, improved information and robust funding requirements. At the same time, the common requirements laid down in this Directive ensure the same level of stability of DGSs and eliminate market distortions. The Directive therefore contributes to the completion of the internal market.

2. Weaknesses of the current system

Despite the many improvements made by DGSD, some weaknesses remain.

The most important ones concern the case of large local shocks. No national deposit guarantee scheme has sufficient resources to deal with such shocks, which could overburden a national DGS, taking into account that the DGSD provides only a vague voluntary borrowing facility between national DGSs. Under the regime of DGSD a national deposit fund, which is depleted in the case of a large pay-out, would typically get a loan from the relevant national government that would intervene as a national backstop.

This system will have negative impacts. It undermines the credibility of national DGSs in less wealthy Member States that have no financial means available to intervene as backstops. In addition, the financial disparity across backstops of national DGSs may create adverse incentives, contributing to market fragmentation and competitive distortion. Finally, it intensifies the loop between sovereign risk and banks.

Against this background, the EU Commission is aiming for the mutualisation of the national DGSs by establishing a European Deposit Insurance Scheme. In line with the Five Presidents' Report of 2015, the Commission tabled a legislative proposal on EDIS at the end of 2015 that would progressively evolve from a reinsurance scheme into a fully mutualized scheme over a number of years, replacing the existing national DGSs which are then entirely depleted. A joint Deposit Insurance Fund (DIF) would be created, managed under the auspices of the existing Single Resolution Board. EDIS would be mandatory for euro area Member States and open to non-euro area Member States willing to join the Banking Union.

Nevertheless discussions are on-going at the EU Parliament and the EU Council, particularly related to legacy risks (Non-Performing Loans / NPLs) and the fully-fledged mutualisation approach. In its Communication dated 11 October 2017, the Commission considered certain ideas in an attempt to address the diverging views and concerns that emerged during the negotiations and to influence the discussions in the European Parliament and the Council. In particular, EDIS could be introduced by the co-legislators more gradually: In the reinsurance phase, EDIS would provide national DGSs with liquidity in the case of a bank failure, which would have to be paid back by the national DGS. Liquidity support is the most essential element to ensure that depositors are paid out. In the coinsurance phase, EDIS would also cover losses, without recouping them from the national DGS. This would further reduce the link between banks and their Member States. However, moving to this second phase would be conditional on the progress achieved in reducing the level of NPLs and other legacy assets recognised in the course of an Asset Quality Review (AQR).

Further to the Franco-German declaration of Meseberg and a decision of the heads of government of last year a High Level Working Group has now been established at the Council in order to consider ways forward on the political level since it seems that all the technical details and options of a European deposit scheme have been laid out in the council discussions. The HLWG is supposed to present its report in June and has been given a broad mandate, acknowledging the fact that any European deposit guarantee scheme has to be embedded in a wider context, dealing with legacy issues, existence of any backstops and the general set-up of the Economic and Monetary Union.

3. The expected benefits of the European Deposit Insurance Scheme (EDIS)

3.1. Achieving a true single currency

Full monetary union and a single banking system cannot exist without "single money", which has to be fungible whatever form it takes, independent of its location within the euro area. Therefore the concept of "single money" requires deposits to inspire the same degree of confidence regardless of where the Member States of the Banking Union are located.

And EDIS would be an effective tool to promote a uniform level of depositor confidence and help ensure the true singleness of the euro. Moreover, to ensure that deposits are truly safe everywhere across the euro area, the likelihood that a bank might fail means it has to be independent of the jurisdiction in which it is established. And, when push comes to shove, depositors must be awarded similar protection wherever they are resident.

Through a single fund, EDIS would ensure equal, high quality protection for all depositors across the Banking Union in the case of bank failure. Europe would have more resources than national deposit guarantee funds to cope with large local shocks, which could otherwise overburden national DGSs.

EDIS would be used notably when smaller banks are put into liquidation. EDIS is a European DGS and a way to break the loop between sovereign risk and the banks when the state has to intervene and fund the DGS.

If we look across the Atlantic, we can see that the US has a Deposit Insurance Fund which is pre-funded and managed by the FDIC, which has adopted a 2% Designated Reserve Ratio each year since 2010. By comparison, in the EU we have two prefunded facilities to address bank failures: Deposit Guarantee Funds at the national level and the Single Resolution Fund. Implementation of EDIS could ultimately centralise the deposit guarantee funds and would therefore align the EU and US more in this regard (even though the EU would still retain two separate pre-funded facilities).

3.2. Increasing financial stability

The Banking Union must be completed without delay if we do not want the EU banking system to be still vulnerable in case of crises and for two reasons:

- The first is size, which is the same as the law of insurance: it works better when it pools more resources. By pooling resources at a central level we will significantly increase the resilience of the financial sector. No national DGS would have sufficient resources to do this.
- The second is that, even if you believe that national DGSs can deal with a systemic crisis by themselves, bank failures do not happen in isolation. Banks are so strongly interconnected that an instrument like EDIS is much better placed to deal with spill-over effects.

EDIS could create smoother, more credible and transparent insolvency procedures. There is a concern that national DGSs could trigger massive deposit outflows that could provoke the resolution or insolvency of a bank. The financial disparity across backstops of national DGSs may indeed create adverse incentives, contributing to market fragmentation and competitive distortion. In such a context EDIS should reinforce depositor confidence, reduce market fragmentation and the risks of bank runs and increase financial stability across the Banking Union.

People need to be convinced that there is one Europe and one euro, so that whichever country their bank is in, they can trust the entire system, not just one part of it. Such a system will support confidence in the market. To achieve this goal the Eurozone must put in place a process of gradual increase in risk-sharing, that must go hand in hand and in parallel with risk reduction in a reasonable timeframe.

3.3. Aligning liability and control

EDIS is a small part of a big mosaic serving two goals: the first is to ensure that accidents in the financial sector are less frequent, cost less and are less severe; the second is to provide the financial sector with a level playing field, as soon as possible.

EDIS is important for enhancing the sector's credibility especially within the European Union, but it also has a political dimension. If the responsibility for supervision is elevated to the EU level, the question can be asked as to whether accidents should be paid for at the national level.

There is currently a mismatch between European control and national liability. As supervision and resolution are European, their effectiveness will influence the "if and when" a DGS has to pay out to insured depositors or contribute to resolution.

The supervisory powers of the Banking Union are under the lead responsibility of the ECB, so we cannot argue that national DGSs should pick up the bill in any event of failure. Thus there is a mismatch between European control and national liability that can lead to extra costs and inefficiencies. An EDIS is therefore felt to be necessary to eliminate such asymmetry by elevating accountability for a trusted safety net for deposits to the European level.

3.4. Completing the Banking Union is necessary to reduce risks of systemic crises

Unfortunately, the European Union has a history of launching new projects and leaving them incomplete. Take the Schengen treaty. It opened up opportunities for people to travel, but Europe forgot to put police in its borders until later finding out that this had created risks. The monetary union has been left unfinished, because there is no de facto economic union. Now the Banking Union has been launched, and there are doubts about whether it will be completed.

The three pillars of the Banking Union were tabled for all the negotiations taking place at the European institutions. Everybody agreed to them then, but now people are having second thoughts. Consistent in the project is that a Banking Union can unleash more risks.

It thus needs instruments capable of managing such risks. Without being part of a Banking Union, all national DGSs might prove effective in dealing with a domestic crisis, but this is a globalised financial system with a globalised banking system. Europe is part of that process.

The objective of having a fully integrated banking and financial system must also include the instruments for managing this supranational system. Instead, some argue for a reliance on national schemes and procedures, backtracking on what had been agreed at the beginning. The reason EDIS is now needed is not just for the sake of the completion of the Banking Union; it is because the industry is not immune to the possibility of a major liquidity shock that may affect European or global banking systems. Europe needs to be prepared for such an emergency but it cannot do so using the domestic imbalances of individual countries. The crisis of 2007-08 came from difficulties in controlling capital flows, and the risk management strategies adopted to deal with them. We may continue to live without EDIS, but we will be running greater risks and have insufficient instruments to deal with future crises.

Reaching an agreement on the deposit insurance mechanism would also show inter alia that political commitments taken in 2012 are fulfilled.

4. Arguments against implementing EDIS

The on-going debate on EDIS since 2015 has shown many concerns expressed by various stakeholders (Member States, the European Parliament, industry, consumers) they range from legal ones (EDIS cannot be implemented without a treaty change; infringement of the principles of subsidiarity and proportionality), a missing comprehensive impact assessment, the lack of a necessary and suitable mutualized system up to fears of moral hazard effects and risk sharing as an entry into the transfer union through the back door (in case a European backstop has to intervene as a last resort), which would be in contradiction to the EU treaty.

Apart from the above mentioned legal problems and risk sharing issues the main concerns involving these stakeholders are:

4.1. Moral hazard

EDIS could have negative impacts on banking markets, the most important one being moral hazard. Experience shows, depositors will invest in high risk assets in risk friendly banks. By mitigating the risks of overburdening national DGS, a mutualised Deposit Guarantee Scheme would create incentives to direct flows to Member States whose banking sector as a whole has a relatively high risk affinity (including with regard to investments in government bonds) and spread precisely these risks across the entire euro area with negative impacts on financial stability. In this way relatively 'healthy' banking sectors in Member States with a low level of risk and a high level of debt sustainability would support their competitors in other Member States. EDIS thus leads to cross-subsidization on a massive scale.

It is agreed that in the context of EDIS banks with higher risk-taking will have to contribute proportionately more to the DIF. But the existing DGSD also provides for risk-based contributions. And recent examples in some Member States show, that higher contributions to the national DGS because of excessive risk-taking have absolutely not deterred banks from continuing to do so. And even enhanced supervision based on now available supervisory tools under SSM has not prevented that behaviour. General experience in insurance teaches that the larger the insurance funds the lower the risk of having to bear losses and the more careless the investor becomes. Therefore, concerns are serious that EDIS would loosen the close link between risk and responsibility.

4.2. EDIS prevents the use of alternative measures and Institutional Protection Schemes (IPSs)

Alternative measures are an important issue concerning the use of funds. Alternative measures would apply to credit institutions that are in difficulty. In some Member States (e.g. Italy) DGSs have played an important role over the years in handling banking crises, mostly by applying alternative measures. Therefore, the DGSD explicitly encourages all kinds of DGSs to use their funds for alternative measures in certain cases.

In contrast to this, the EDIS legislation does not include the use of alternative measures. This restriction does not only affect DGSs as in Italy but in particular institutional protection schemes (IPSs) as in Germany or Austria, which are protecting the credit institutions as such and are ensuring the liquidity and solvency of their members. Such systems guarantee a different level of protection for depositors in comparison to the protection provided by a standard DGS. If, due to the support of an IPS, a bank does not fail and its services continue to be provided, which is a big advantage from the perspective of the clients, it is not necessary to reimburse depositors.

According to the DGSD an IPS may be officially recognized as a DGS if it complies with DGSD criteria. Under a fully mutualised EDIS such an IPS will see all its funds transferred to the DIF. Its functioning as an IPS will no longer be possible due to the lack of funds. The argument of the Commission that risk based contributions to the DIF of banks belonging to an IPS will be much lower compared to normal banks does not apply to an IPS that is recognized as a DGS. Once its funds are transferred to the DIF, the IPS would have to abandon its activities. Without an active IPS, the banks belonging to it have no claim to reduced contributions to the DIF. This result would force the IPS member banks to completely refinance the IPS which would financially overburden them given that a potential reduction in the contributions will never cover additional costs in view of the fact that contributions to an IPS would always come on top of the contributions to the DGS. Consequently, this results in a contradiction to the key principle of EDIS: No increase of costs for the banking sector, as compared to current obligations under the DGSD.

4.3. No respect of diversity and subsidiarity by eradicating ONDs

It is widely accepted, that the diversity of banks fosters the resilience of the banking system in Europe. The specificities of the banking structures in the Member States are mirrored by the national options and discretions within the DGSD. This is especially true for the possibility of Member States to allow the use of alternative measures or a reduced target level in Member States with a highly concentrated banking market. Under the Commission proposal, EDIS would eradicate those national options and discretions. This clearly affects the diversity and resilience of the banking system on the one hand, making it more uniform but at the same time also making it more inflexible. On the other hand, these negative impacts are directly linked to legal concerns emphasizing that EDIS does not respect the principle of subsidiarity and proportionality

5. Proposed alternative approaches

The debate on EDIS is stuck since 2015. Therefore, the political pressure on all sides to come to a decision is increasing. Taking the above mentioned weaknesses of the current system into account, the need for support between the national DGSs in the case of distress of one of them is widely accepted. It is agreed, that depositor confidence in all the Member States should be fostered independently of the geographical location of a bank in the EU.

The overview of the concerns with regard to EDIS and the proposed alternatives shows that, in principle, there is a willingness from most stakeholders to establish a support system between the national DGSs in case a national DGS is in distress. On the other hand, the rejection of a fully mutualized European system remains important in some Member States and not the least with a view to the issue of how to deal with legacy problems. Obviously, it is important to some stakeholders to retain national DGSs, so that they can maintain their important functions in the framework of the DGSD.

Therefore, most of the proposed models are based on the principle that the any DGS remains anchored at the national level while also including a "European" element. The models discussed range from a simple mandatory lending concept (favoured by some Member states) to hybrids that are based on national DGSs and complemented by European components (e.g. EP rapporteur, Council Presidency).

Given these persisting differences, one of the following models, both based on a genuine reinsurance approach, should be a possible way forward:

5.1. A way forward: European Deposit Re-Insurance Scheme (EDRIS)

Proposed by the French Banking Federation, EDRIS would be an instrument of last resort: only where the national DGS is depleted following an intervention, should the European re-insurance scheme kick in to help pay out depositors or fund resolution measures. More concretely, in cases where the national DGS has insufficient resources to finance its intervention, it would turn to the European Deposit Re-Insurance Fund (EDRIF) which would intervene as re-insurer for the DGS.

EDRIS would be funded ex-post by the national DGSs. It would call on the other national DGSs to provide funding, taken from the fees collected ex-ante at a national level. The national DGSs' respective contributions would be proportionate to the covered deposits of each participating country, weighted according to risk parameters/scoring which reflect the level of stability of the respective national banking systems.

National DGSs' ex post contributions to EDRIS would be capped so that after intervention for re-insurance purposes the available financial means of the DGS shall not decrease below a certain percentage of the target level.

<u>Pros</u>

- The existing model of national DGSs with all the options and discretions of DGSD would be maintained, including alternative measures and IPSs;
- Possible moral hazard effects would be reduced (pay back);
- Consistent methodology for contributions.

<u>Cons</u>

- Liquidity support only;
- EDRIS would impose significant organizational challenges due to ex-post contributions;
- Recovery depending on national insolvency law.

5.2. Another way forward: European Reinsurance Fund (EReIF) with fiscal backstop

CEPS proposed in 2013[1] a two-level framework in which deposit insurance would remain a national responsibility, only subject to the standards set by the EU directive, but the national DGSs would be required to take out reinsurance against systemic shocks. A new institution - the European Reinsurance Fund (EReIF) - would have to be created. This institution would collect premiums from all national DGSs and would pay out if losses at the national level exceed a certain threshold.

The responsibility for losses by individual institutions would thus remain at the national level. But the existence of the European Reinsurance scheme would stabilize the system even if a large, idiosyncratic shock destabilizes the local economy and puts the national guarantee in doubt.

Schematically there would be two tiers of deposit insurance: one by the national DGSs in relationship to 'their' banks and the other by the European re-insurer in relationship to the national DGSs.

The European re-insurer would intervene only in the event that so many banks fail in any given country that the national DGS would be overburdened. The ex-ante funding for the EReiF in turn would come from the national DGSs. National DGSs would thus continue to function as before, but each one would be forced to take out insurance coverage against large shocks to be financed from existing contributions.

Furthermore, CEPS recognizes that systemic shocks to a large country could not be handled by the two tiers of deposit insurance alone. For this reason CEPS advocates that in such a case an effective common fiscal backstop at the European level should be in place as a last resort.

<u>Pros</u>

- The existing model of national DGSs with all the options and discretions of DGSD would be maintained, including alternative measures and IPS;
- Possible moral hazard effects would be reduced (pay back);
- A central body is created and facilitates the implementation;
- Common fiscal backstop is available in case of systemic shocks, which even overburden the two tier system.

<u>Cons</u>

- Liquidity support only. ■

[1] See D. Gros, « Principles of a Two-Tier European Deposit (Re-) Insurance System, CEPS, 17 April 2013.