cep

cepAdhoc

22/11/2016

EU Deposit Guarantee Scheme in the European Parliament: Some progress, need for improvement

In November 2015, the EU Commission proposed a European deposit guarantee scheme (EDIS) for the eurozone. It will replace national deposit guarantee schemes by 2024. The process of opinion forming is currently under way in the European Parliament. The basis for this is the draft report submitted at the beginning of November 2016. cep assesses the amendment proposals which it contains.

Author: Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-107 | www.cep.eu

1 EU Commission's EDIS proposal

On 24 November 2015, the EU Commission submitted a proposal for a regulation to establish a European Deposit Insurance Scheme (EDIS) [1] (see cep**PolicyBrief**). This proposes a gradual mutualisation of the existing funds in national deposit guarantee schemes (DGSs) of the eurozone by 2024. A European Deposit Insurance Fund (DIF) will be set up which the national DGSs will initially

– re-insure until 2019,
– co-insure from 2019 until 2024 and finally
– fully insure as from 2024 by ensuring that funds for the deposit guarantee scheme are provided by the DIF in full and amount to 0.8% of the covered deposits; as from 2024, the national DGSs would no longer have to provide funds.

2 Core components of the EP's draft report

At the start of November 2016, the Rapporteur for the Commission proposal in the European Parliament, the Dutch MEP Esther de Lange, submitted her draft report.

The core components are:

► **Continuation of the national deposit guarantee schemes**

The national DGSs remain in existence. As from 2017, they will provide half of the total funds in the European deposit guarantee scheme. Their financial means will rise continuously and reach the target funding level of 0.4% of covered deposits in 2024.

► **Establishment of a semi-European deposit guarantee scheme**

In addition to the national DGSs, an EU deposit insurance fund (DIF) will be set up to provide the other half of the funds for deposit insurance, i.e. likewise 0.4% of the covered deposits. This DIF consists of

– individual subfunds for each individual (sub)national DGS and
– a joint subfund in which the financial means of all DGSs are pooled.

The financial means in the joint subfund and the total amount of means in the individual subfunds are identical and each amount to 0.2% of the covered deposits. They will be built up gradually.

		2017	2018	2019	2020	2021	2022	2023	2024
National Level	National DGSs	0.05%	0.1%	0.15%	0.2%	0.25%	0.3%	0.35%	0.4%
EU Level (DIF)	Individual subfunds	0.025%	0.05%	0.075%	0.1%	0.125%	0.15%	0.175%	0.2%
	Joint subfund	0.025%	0.05%	0.075%	0.1%	0.125%	0.15%	0.175%	0.2%
	Total	**0.1%**	**0.2%**	**0.3%**	**0.4%**	**0.5%**	**0.6%**	**0.7%**	**0.8%**

[1] COM(2015) 586 of 24 November 2015.

- **Re-insurance phase 2019 – 2023: Liquidity assistance**

  As from 2019, the DIF will grant repayable liquidity assistance to a national DGS in the event of a compensation claim. Initially, the assistance will be a maximum of 20% of the liquidity shortfall[2]. The maximum amount of assistance increases over the four subsequent years by 20 percentage points in each case and will amount to 100% as from 2023. The co-insurance phase proposed by the Commission is omitted.

- **Insurance phase as from 2024 "at the earliest": Excess loss cover**

  As from 2024 "at the earliest", in addition to what will by then be 100% liquidity assistance, the DIF will also grant excess loss cover to a national DGS[3]. In the first year of the insurance phase, this will be 20% of the excess loss, increasing in each of the four subsequent years by 20 percentage points and amounting to 100% as from the fifth year. The excess loss cover does not have to be repaid.

- **Conditions for the start of the insurance phase**

  The EU Commission decides when the insurance phase will start by way of a delegated act. The draft report sets out four requirements for this. Mandatory legally binding provisions, yet to be laid down,

  – on Total Loss Absorbing Capacity (TLAC) for global, systemically important banks and on the minimum requirement for own funds and eligible liabilities (MREL) for other banks;
  – on an insolvency ranking for the subordinated debt of credit institutions;
  – on business insolvencies which enable the early restructuring of banks and regulate the handling of non-performing loans;
  – on a leverage ratio for banks including additional requirements for global systemically relevant banks.

  In addition, the draft report sets out four additional requirements. In particular, international standards for the prudential treatment of sovereign debt held by credit institutions must be given "proper consideration".

- **Requesting pay-out from the DIF**

  A national DGS must first have fully exhausted its own national financial means outside the DIF and then also the means in its own individual subfund in the DIF. Only then will financial means be taken from the joint subfund of DIF and - "if necessary", i.e. subordinately - from the individual subfunds of other DGSs in the DIF.

- **DIF borrowing**

  After every liquidity assistance or coverage of excess loss, the DIF will borrow on the capital market. The aim is that the DIF will have the target funding level available at all times. The loans will replace the extraordinary ex-post contributions of the banks currently used to replenish deposit guarantee schemes after a claim for compensation. The draft report criticises the procyclical nature of this system.

---

[2] A liquidity shortfall is deemed to be the compensation payable less the financial means which the DGS must have at its disposal.

[3] Excess loss is deemed to be the compensation payable less the total from the financial means that the DGS must have at its disposal and from the financial means which the DGS was able to regain from resolution of the bank.

Author: Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-107 | www.cep.eu

3 Assessment of the EP's draft report

The assessment criteria for evaluating the draft report are the six requirements applicable to a European deposit guarantee scheme which cep formulated prior to the Commission's proposal.[4]

1. The specific national risks of bank failures must be accurately priced.

Without risk-adjusted pricing of country-specific risks, there is a risk of a distortion of competition to the detriment of healthy banking systems which, as a result, would take greater risks. The EU Commission's proposal does not provide for any consideration of country-specific risks post-2024 because the national DGSs lose their function.

The draft report eases this problem. Varying risks at country level are now indirectly taken into account by

- the continuation of the national deposit guarantee schemes,
- the individual subfunds in the DIF and
- the fact that funds first have to be taken from the national deposit guarantee scheme before they can be claimed from the joint DIF subfund or individual subfunds of other DGSs.

This issue still plays an important role in relation to the proposed joint subfund within the DIF however. It is important for the contributions from the respective national DGSs to the joint subfund, to be priced according to the risk. The draft report provides for the EU Single Resolution Board (SRB) to set the contributions of each individual DGS and to take account, not only of the extent of covered deposits but also the national risk which exists in each case. This approach is correct. It not only allows bank-specific risks but also additional country-specific risks to be taken into account.

The precise method of calculating the contributions will be crucial in this regard. According to the EU Commission's draft report it will be established in a delegated act. Although the European Parliament and the Council can raise an objection to this act, the barriers to this are high. The draft report avoids this problem by listing very specific criteria in the basic legislative act which the EU Commission must take into account for the method of calculation - as must the SRB when identifying the risks. Of major importance is, in particular, the fact that the level of sovereign debt in the respective banking sector must be taken into account. The draft report goes too far, however, with the requirement that the SRB must allocate at least one DGS to each of the seven risk classes.

2. Distortions of competition must be avoided.

In view of the substantial differences in the funds available in the existing national deposit guarantee schemes, the European deposit guarantee scheme must not be allowed to distort competition.

The individual subfunds proposed in the draft report and the order of priority for claiming DIF funds only theoretically alleviate this problem because the draft report only restricts the liquidity assistance and the excess loss cover in relative terms (as a % of the liquidity shortfall or excess loss) and not in absolute terms. At the same time, after every compensation payment, the DIF will borrow on the capital market so that it always has the target funding level.

The combination of both factors may lead to an unlimited level of liquidity assistance and loss cover which would have to be borne by the other DGSs (and thus by the other banks). The consequence will be a distortion of competition between the European banks that belong to the various national DGSs.

---

[4] See cep**Input** 21|2015, A Deposit Guarantee Scheme for the Eurozone: Six Prerequisites.

This first becomes a problem during the re-insurance phase, even though the liquidity assistance in this phase must be repaid. This is firstly because the proposed four risk-reduction measures, which form the condition for starting the insurance phase, will not yet have been fulfilled and, secondly, a heavy burden on other DGSs is more probable because the required funding level of the DGSs in this phase is still low. In the first year of this phase, the funding level may even be below the level proposed by the Commission.[5]

The EU Commission had planned for an absolute upper limit in the re-insurance phase of 20% of the DIF funds or 8% of the covered deposits. This is appropriate and should therefore be included in the EP report. However, the question arises as to the added value of a European deposit guarantee scheme: Liquidity assistance with an absolute limit - which in view of the aforementioned facts has a lot going for it - can also be achieved by way of lines of credit between the national DGSs.

Secondly, this problem is even more relevant for the insurance phase in which the loss cover does not have to be repaid. It is not made clear how the DIF will be able to afford the repayment of capital market loans which are the consequence of covering the excess loss of a DGS. Repayments by the affected DGSs are not planned, particularly in this case. The theoretically unlimited coverage of losses by the DIF results however in high risks for the other DGSs. It would be worth considering a cap for this DIF assistance as well. In the case of an additional need for funding, the affected Member State should provide its own DGS with financial means via national credit lines. A similar "backstop" solution was also found in the case of the Bank Resolution Fund SRF.[6]

The four "hard" conditions for the insurance phase are likely to delay its activation. They increase the probability that existing risks in the banking sector are reduced before the European deposit guarantee scheme is fully activated, but the question of whether and when the conditions are actually met will be open to interpretation. In the event of a premature activation, there will be a threat of further distortions of competition. In view of the fact that the level of possible loss cover by the DIF in the insurance phase is unlimited, the activation of the insurance phase should take place in a separate legislative act which has to be approved by the Council and the European Parliament - and not by way of a delegated act of the EU Commission.

3. Affected Member States must contribute financially to compensation for depositors.

Member States are still able to use national legislation to influence the size and risks of their domestic banking sector. There is a risk of moral hazard where Member States are simply able to claim funds from other DGSs having to contribute to the compensation of depositors.

On one hand, the draft report eases the problem: before DIF funds can be claimed, national funds must first be fully deployed (both outside and inside the DIF). This was not provided for in the EU Commission proposal. The proposal in the draft report will, in the event of a compensation claim, result in substantial costs for the banks in the affected Member State. Since this would have a negative effect, for example on the tax revenue or on employment in the respective Member State,

---

[5] According to the Commission proposal, every DGS must have funding of 0.28% of the covered deposits in 2019. In the EP draft report, the total funds of each DGS at national level and at the level of the individual subfund only amount to 0.225% of the covered deposits. Only after 2020 does the EP draft report provide for more DGS funds than the Commission requires.

[6] Cf. the Statement of the EU Finance Ministers of 8 December 2015 on national credit lines as a financial backstop for the SRF (available at: http://www.consilium.europa.eu/de/press/press-releases/2015/12/08-statement-by-28-ministers-on-banking-union-and-bridge-financing-arrangements-to-srf/). The EU Bank Resolution Fund SRF is made up of national resolution compartments. If the total funds of the SRF are exhausted, credit lines from the Member State, in which the bank under resolution is located, in favour of its national compartment, will ensure the SRF's capacity to act.

the respective national governments have an incentive to restrict the risks in the national banking sector.

On the other hand, the draft report exacerbates the said problem in that it dispenses with extraordinary contributions from the DGSs and introduces a DIF borrowing obligation instead: Whilst the level of extraordinary contributions in the Commission proposal[7] is limited, the draft report does not provide for an upper limit on DIF borrowings. This favours moral hazard. A cap on liquidity assistance and excess loss cover from the DIF is therefore necessary, supplemented by a financial backstop for the DGSs by the affected Member State. As set out above, national credit lines from the affected Member State in favour of the national DGS would be appropriate for this.

4. Banks must be obliged to back sovereign credit risks with own funds.

Where, as a consequence of setting up a European deposit guarantee scheme, confidence in failing banks increases with the result that they gain new deposits, these banks will, due to the sparsity of own funds, have an incentive to invest the additional deposits in government bonds. The reason being that they do not have to be backed by own funds. This increases the link between sovereign and banking solvency. Where a country's credit rating falls, this also leads to problems for banks, which contradicts the very idea of the Banking Union.

It is therefore essential to back sovereign exposure with own funds. The Commission's proposal does not provide for this however. Although the EP draft report provides for "proper consideration" of the prudential treatment of sovereign debt, this only applies to the insurance phase, which is an improvement but still insufficient. What is required is, firstly, not just consideration but for sovereign credit risks to be actually backed up by own funds and secondly, for this to be introduced at the re-insurance phase. The difficulty of agreeing rules at international level - such as with the USA and Japan - does not change this fact.

5. Risks for the stability of the financial market must be limited.

By comparison with existing national systems, a European deposit guarantee scheme can significantly increase the risk of contagion because depositors in unaffected Member States could lose confidence in the credibility of the deposit guarantee scheme if its funds are used to compensate depositors in other Member States.

The individual subfunds proposed in the draft report and the order of priority for claiming DIF funds alleviate this problem, unlike the EU Commission proposal which ignores it.

On the other hand, the draft report exacerbates the said problem in that it dispenses with extraordinary contributions from the DGS and introduces a DIF borrowing obligation instead: Whilst the level of extraordinary contributions in the Commission proposal[8] is limited, the draft report does not provide for an upper limit on DIF borrowings. The associated costs could place a significant burden on all national DGSs which may jeopardise the credibility of the deposit guarantee scheme itself. A cap on liquidity assistance and excess loss cover from the DIF is therefore necessary, supplemented by a financial backstop for the DGS by the affected Member State. As set out above, national credit lines from the affected Member State in favour of the national DGS would be appropriate for this.

---

[7] The Commission had proposed being able to determine the maximum proportion of covered deposits that can be made up of such extraordinary contributions, by way of a delegated act.

[8] The Commission had proposed being able to determine the maximum proportion of covered deposits that can be made up of such extraordinary contributions, by way of a delegated act.

Author: Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-107 | www.cep.eu

6. Moral hazard on the part of banks must be limited.

By comparison with existing national systems, every European deposit guarantee scheme provides large incentives for banks to take risks because they can then externalise the costs incurred via other members of the European deposit guarantee scheme.

The individual subfunds proposed in the draft report and the order of priority for claiming DIF funds alleviate this problem, unlike the EU Commission proposal which ignores it.

4 Conclusions

In some respects, the EP draft report represents an improvement on the Commission's proposal. The main point is the continuance of national deposit guarantee schemes which always have to bear the initial compensation costs. Thus, greater consideration is given to the moral hazard problems, which, however, continue to exist.

There is still need for improvement and clarification:

(1) The SRB should not be forced to allocate at least one DGS to each of the seven planned risk classes.
(2) The DIF's borrowing obligation on assumption of excess losses must be clarified. It is unclear how the DIF will be able to pay off these loans to a DGS.
(3) Upper limits on DIF assistance must be brought in because dispensing with extraordinary contributions by banks to the DGSs in favour of the DIF taking up capital market loans may give rise to very high costs for the banks - and thus to risks to financial market stability.
(4) In the case of an additional need for funding, the affected Member State should provide its own DGS with financial means.
(5) An obligation must be brought in for banks to back sovereign debt with own funds.
(6) In the insurance phase, loss cover by the DIF is unlimited. This phase should therefore be activated by way of a legislative act which has to be approved by the Council and the European Parliament - and not by way of a delegated act of the EU Commission.

Author: Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
cep | Kaiser-Joseph-Strasse 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-107 | www.cep.eu