Principles for European Deposit Guarantee Schemes

Abstract

There are two key problems with the current state of Deposit Guarantee Schemes (DGSs) in Europe:

- ‘Microeconomic’: The guarantee they provide is not properly priced as in most countries all banks contribute at the same rate.
- ‘Macroeconomic’: A national DGS can provide a credible protection only when any single bank, or a small group of banks, fails; but not when the entire national banking system is under stress. Moreover, the credibility of any national DGS depends on the strength of the national public finances.

The proposed Directive on DGSs is promising on the first aspect, but inadequate under the second aspect.

Lending among national DGSs (as proposed in the Draft Directive on DGSs) is a non starter as the strong DGSs will be reluctant to lend to the DGS of a country that is experiencing a systemic banking crisis. What is needed is common funding against systemic shocks, which should be properly priced, by using the excessive imbalances procedure and borrowing principles from the re-insurance industry.
This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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Original: EN

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Manuscript completed in July 2013
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This document is available on the internet at: http://www.europarl.europa.eu/studies

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CONTENTS

LIST OF ABBREVIATIONS 4
EXECUTIVE SUMMARY 5
INTRODUCTION 6
1. MICROECONOMIC ASPECTS: SOME BASICS 8
2. MACROECONOMIC OR SYSTEMIC ASPECTS: TRANQUIL VERSUS TURBULENT TIMES 11
3. A CONCRETE PROPOSAL 13
4. CONCLUSION 15
REFERENCES 16
LIST OF ABBREVIATIONS

BaFin  Bundesanstalt fuer Finanzdienstleistungen
DGS   Deposit Guarantee Scheme
EBA   European Banking Authority
ECB   European Central Bank
ELA   Emergency Liquidity Assistance
EReiF European Reinsurance Fund
ESBG  European Savings Banks Group
ESM   European Stability Mechanism
FDIC  (US) Federal Deposit Insurance Corporation
FSA   Financial Supervisory Authority
GC    Governing Council (of the ECB)
GIIPS Greece, Ireland, Italy, Portugal and Spain
GSE   Government-sponsored enterprises
MREL  Minimum Requirements Eligible Liabilities
NCB   National Central Bank
SB    Supervisory Board
SRM   Single Resolution Mechanism
SSM   Single Supervisory Mechanism
EXECUTIVE SUMMARY

There are two key problems with the current state of DGSs in Europe:

- The guarantee they provide is not properly priced as most existing schemes do not ask banks for ex-ante contributions and where they exist they are not linked to banks’ specific risk factors.

- A national DGS can provide a credible protection only when any single bank, or a contained group of banks fails, but not when the entire national banking system is under stress. Moreover, the credibility of any national DGS depends on the strength of the national public finances.

The second aspect concerns really the question of banking union. There is wide agreement that a true banking union is based not only on a single supervisor, but also a common institution responsible for bank restructuring and deposit guarantee. The latter two are obviously linked as any bank restructuring has to take into account the special status of deposits. Losses that are not absorbed by the equity holder, creditors or the bank restructuring fund must fall on the DGS. The recent crisis in Cyprus has provided a strong reminder of this aspect.

The Commission Proposal for a Directive on Deposit Guarantee Schemes [recast] provides for the harmonisation of certain aspects of national DGSs. But this is of secondary importance relative to the provisions on differentiated risk premia. The main weakness of the Directive is that it does not foresee any insurance mechanism in the case of systemic shocks.

Lending among national DGSs, as proposed by the Commission (and reiterated for the case of national bank resolution funds at the ECOFIN Meeting of June 26/27 2013) is a non-starter as the strong DGS will not ‘voluntarily’ lend to the DGS of a country that is experiencing a systemic banking crisis. What is needed is common funding against systemic shock. This reinsurance could be properly priced using the analysis coming from the excessive imbalances procedure and by borrowing principles from the re-insurance industry.

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INTRODUCTION

Deposit guarantee has been a non-issue in Europe for a long time. Banking was considered a territory under the control of national authorities, and, during the boom years, bank failures, and thus the need for the protection of depositors, did not seem to constitute a problem. However, when the financial crisis broke, the fundamental flaws in this area became apparent. The first stage of the crisis (2008), which affected most of the banking sector in a similar way, showed the importance of all the fundamental issues about deposit insurance.

The euro crisis which started later uncovered another, macroeconomic, problem, which is specific to the euro area: when the entire banking system of a country is under stress, the national sovereign is no longer able to provide a credible guarantee for the deposits with local banks.

The public discussion about bank failures and their consequences for small savers is strongly influenced by a fundamental misconception. Political leaders and consumer advocates maintain that a bank account just represents a ‘deposit’ and that therefore the consumer should have a 100% guarantee that he/she can always get the money back which had been merely ‘deposited’ with the bank. The economic reality is, however, that a bank ‘deposit’ constitutes a credit, which can never be 100% certain unless the bank makes only totally safe investments (see the proposal by Mayer, (2013). The political reality is that small depositors must be fully protected because they cannot be expected to monitor the financial situation of the bank they are entrusting their savings to.

Banks do much more than collecting deposits and lending to enterprises. This is especially the case in Europe with its universal banking system where (non-bank) deposits account for only about one third\(^3\) of total liabilities and where lending to the non-financial sector also accounts for a small share of overall assets. In principle, one could argue that the likelihood that depositors (or the DGS) suffer a loss is much lower the smaller the share of deposits in the total liabilities of a bank. Since depositors enjoy super senior status the losses would have to be very large (as a % of total assets) before depositors are threatened. However, reality is more complicated, as many banks have ‘encumbered’ a large part of their balance sheets by using it for collateral for ECB lending, or covered bonds and similar instruments. The call to ensure a minimum loss-absorbing capacity by setting ‘minimum requirements for own funds and eligible liabilities (MREL) for each institution, based on its size, risk and business mode’ is entirely justified.\(^4\) However, it remains to seen whether Member States will actually impose sufficiently tough MRELs on their home banks.

The argument that a single European DGS is not necessary seems to rely implicitly on the hypothesis that retail deposits are not mobile and that if all sovereigns in Europe were equally strong (and if there were no national systemic shocks) there would be no need to pool the risk inherent in providing a guarantee for retail deposits. But the arguments against a common European DGS are often more political.

Looking in more detail at the official pronouncements why a common DGS is not necessary reveals that the main argument seems to be ‘not needed immediately’, e.g. as outlined by the Vice-President of the ECB in a speech in January 2013:

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\(^3\) For the euro area the consolidated balance sheet of MFIs shows liabilities of about 27 thousand billion euro, of which about 9 thousand billion are deposits from households and non financial enterprises.

\(^4\) See the Communiqué from the last ECOFIN meeting.
Finally, the fourth element of the Banking Union is the establishment of a common system of deposit protection. A first step in this direction will be the adoption of the legislative proposal on deposit guarantee schemes, providing a harmonised framework. This framework should ensure depositor confidence and the national deposit guarantee schemes, built on common EU standards, could interact with the SRM. A European deposit guarantee scheme is therefore not essential in the short term.\(^5\)

This statement is interesting because it reiterates the concept that a DGS is a part of a fully fledged Banking Union. But the Vice President then argues that the national DGSs interact with the SRM, which underlines the point that one should not consider DGSs separately from resolution.

When the Directive for DGSs was first put together, Banking Union was not on the agenda. However, times have changed and there is a need to have a more coherent approach which recognises the link between supervision (SSM), resolution (SRM) and deposit insurance. The proposed Draft Directive contains many useful elements, especially on risk pricing, but it fails to address the need for coherence under the nascent Banking Union.

The draft Directive on DGSs contains an explicit exemption for savings banks and mutual with their own support systems (Articles 1.3 and 1.4). But if one allows the regional public banks to retain their own DGSs without or with much less explicit funding, one should consider a specialised European Supervisor for the regional public banking system (European Sparkassenaufsicht). The public banks are already organised in the ESBG (European Savings Bank Group), but this is just a grouping that defends their interests. A dedicated European supervisor/regulator would be better positioned to understand the specificities of this sector, but sufficiently removed to be less politically dependent than the current national bodies. Such a European supervisor of regional public banks should have the mandate to review and correct business models to prevent a repetition of the excesses observed in Spain for example. The remainder of this contribution does not deal further with the specific issues raised by public regional banks and concentrates on the general issues for DGSs which are most relevant in the European context.

Section 1 deals with an often-neglected basic aspect, namely the need to properly price the insurance provided by a DGS. This is not being done in most Member States today and the Commission has put interesting elements on the table, which need to be strengthened. This is particularly important given that the lack of a proper pricing of risk (or the fear thereof) dominates much of the opposition to a common DGS system, which would provide some insurance against systemic shocks.

Section 2 then deals with the issue of national systemic shocks. It shows that the US banking union provides several shock absorbers which are lacking in Europe. Section 3 then presents a simple two-tier proposal to provide reinsurance against this type of systemic shocks. Section 4 concludes.

1. MICROECONOMIC ASPECTS: SOME BASICS

The archetypical business model of a bank is ‘maturity transformation’, collecting short-term deposits and lending medium to long term to enterprises to finance real investment. This exposes the bank to a ‘run’ when it loses the confidence of its depositors. When all customers suddenly demand their funds back, the bank will not be able to dispose of its investments without large losses (Diamond and Dybwig (1983)). The purpose of Deposit Guarantee Schemes (DGSs) is to make such bank runs less likely by providing depositors, especially those who cannot be expected to monitor the financial strength of the bank, with the guarantee that their funds are safe.

As a counterpart to this guarantee, the authority behind the DGSs should have the right to limit the risk taken by the bank and to charge an appropriate risk premium. Unfortunately, these elementary principles are not implemented in most Member States because in many Member States the national DGS is a mere pay box and in even fewer does the national DGS charge appropriate differentiated risk premia (see European Commission, 2010a). This implies that until now the risk inherent in bank deposits have not been properly priced in Europe. This is not the case in the US where the Federal Deposit Insurance Corporation (FDIC) calculates the contribution from individual banks premia based on its own risk assessment (the CAMELS system).

Risk-rating of contributions to the FDIC

In the US the risk rating of deposit insurance was introduced and reinforced after major financial crisis. The first step came after the savings and loans crisis of the early 1990s, which led to stronger risk pricing, but initially with a small spread (the lowest risk assessment at 23 and the highest at 29 basis points) (see Cornet et al., 1998).

The CAMELS system, which constitutes the basis for risk-rating by the FDIC, has the following components:

- Capital adequacy
- Assets
- Management Capability
- Earnings
- Liquidity (also called asset liability management)
- Sensitivity (sensitivity to market risk, especially interest rate risk)

Ratings are assigned from 1 (best) to 5 (worse) in each of the above categories. The draft Directive contains a similar system with its first two elements identical.

Risk scoring formula for large banks

The FDIC also takes ratings into account. Large institutions that have long-term debt issuer ratings (e.g. debt ratings from Moody's, Standard & Poor's or Fitch) will have their scoring based on the weighted average of CAMELS component ratings (weighted the same as small banks) and the debt ratings. The debt ratings and the CAMELS weighted average will each be weighted at 50% of the total rating (ICBA, 2013).

This would not make sense in Europe, since the ratings of bank debt depend to a large extent on the rating of the sovereign of the home country. Only the ratings without support, which exist in some cases, would make sense in Europe.

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6 More on the CAMELS approach can be found on the FDIC webpage: http://www.fdic.gov/deposit/insurance/assessments/risk.html.
A first basic reform in the area of deposit guarantee that is needed in Europe is thus to just apply some simple basic principles. From an economic point of view, the key aspect of any EU-wide regulation of deposit insurance would thus be the proper supervision and even more importantly the proper pricing of the insurance provided. With the SSM the ECB will become the supervisor of about 120 large banks. Given that the ECB is much less likely to favour ‘national champions’ and much more remote from national or regional political pressure this should lead to a more objective supervision. The draft Directive on DGSs should also improve the situation.

The proposed EU Directive on DGSs focuses contains a number of provisions for to harmonise secondary aspects, such as the amount covered, speed of payment, etc. This was done partially under the shadow of the last major bank run in Europe, the case of Northern Rock in the UK, which seemed to prove that insufficient protection of depositors in one country could lead to contagion in other countries. However, the circumstances of 2008 were probably unique as there was a state of generalised near panic in financial markets.

The real innovation of the draft Directive on DGSs lies in the risk weighting it proposes, which national DGSs would have to apply. The criteria mentioned in Annex II are quite similar to the US CAMELS: “The following core indicators shall be used…These indicators include: capital adequacy, asset quality and profitability liquidity.”

The contribution of this author to the February 2013 Monetary Dialogue provided an illustration of the nature of the tasks facing a DGS: long periods of calm, which are interspersed with periods of acute stress. The risk premia levied during the calm periods help to build up a buffer for intervention during crisis times (this is why it is important to build up funds ex ante) and help to provide market-based incentives against too much risk-taking (this is why the risk rating applied in the US and that now hopefully will be adopted in the EU is important).

**Figure 1: Financial crises are rare, but costly: FDIC estimated losses ($ billion)**

![Financial crises are rare, but costly: FDIC estimated losses](image)

*Source: Beck, Gros and Schoenmaker (2013).*

Figure 1 above, taken from Beck, Gros and Schoenmaker (2013), illustrates this tendency of financial crises to be rare, but very costly when they do materialise. This applies also to individual Member States. It follows that individual Member States are subject to a similar
risk as the US. But within the euro area, individual Member States no longer have access to central bank financing, which implies that they can get into a serious liquidity or even solvency problem if the domestic banking system experiences a systemic crisis. This leads to the second aspect that has been brought to the fore by the cases of Spain and Ireland.
2. MACROECONOMIC OR SYSTEMIC ASPECTS: TRANQUIL VERSUS TURBULENT TIMES

Europe, and in particular the euro area faces also an additional problem, namely the question what happens when the entire banking sector of a Member States is stressed. The cases of Ireland and Spain have shown that a national boom-bust cycle in local real estate can lead to losses which are so large that the capacity of the national sovereign to provide a backstop of the national DGS is called into question.

A DGS funded at the EU or euro area level can in this case make a material difference. Gros (2012) provides an illustration of the quantitative importance of this aspect by comparing Ireland to Nevada. These two countries/states share several important characteristics. They both have similar populations as well as GDP, and they both experienced an exceptionally strong housing boom. However, when the boom turned to bust, the local financial crisis did not collapse and the finances of the state government were not stressed by the need to bail out local banks.

The key difference between Nevada and Ireland is that in the US banking problems are managed at the federal level, whereas in the euro area, responsibility for banking losses remains national (today and this would remain so under the Commission’s proposals). In other words, the US is an effective banking union – but the EU (or the euro area) is not, and will not become one unless resolution and DGSs are financed at the federal level.

What happened after the financial crisis of 2008? Most banks in Nevada experienced large losses and many of them became insolvent. But this did not lead to any disruption of the local banking system as the failing banks were seized by the Federal Deposit Insurance Corporation (FDIC), which covered the losses and transferred the operations to other, stronger banks. Over the two year period 2008-09, the FDIC thus closed 11 banks headquartered in the state, with assets of over $40 billion, or about 30% of the state’s GDP. The losses for the FDIC in these rescue/restructuring operations amounted to about $4 billion (3% of the ‘Gross State Product’ of Nevada). If a similar system had existed in Europe, there might not have been the vicious circle between banking debt and sovereign debt as in the cases of Ireland and Spain.

It is interesting to note that there is another aspect of the US system that provides a shock absorber, namely the federal housing financing system under which two entities ‘sponsored’ by the federal government securitise the most secure mortgages. The two government-sponsored enterprises (GSEs) (Fannie Mae and Freddy Mac) buy from local banks ‘conforming’ mortgages (which have to fulfil strict standards in terms of loan to value ratios, documentation, etc.) and package them into securities which are then sold to investors throughout the US. This implies that local banks no longer bear the full risk of a local real estate bust. In practice this meant that when residents of Nevada defaulted in large numbers on their home mortgages, the losses were borne by the Fannie Mae and Freddy Mac, and thus the US taxpayer in general. Data on mortgage losses by state which have recently become available show that these two US federal institutions lost about $8 billion on mortgages originating in Nevada. This second aspect of the US banking union provided thus an additional important shock absorber.

In assessing this aspect of the US system, one has to keep in mind that ex post Nevada benefited from the insurance provided by the FDIC and mortgage securitisation through

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8 The following is based on Gros (2012).
Fannie Mae and Freddy Mac. But during the long periods of tranquil times, and especially the boom which preceded the crisis, the local banks paid an explicit insurance premium to the FDIC. Local banks also paid an implicit risk premium to Fannie Mae and Freddy Mac, given that default rates on mortgages in Nevada had been lower than the national average during the boom. The insurance provided by the FDIC thus did not come for free. With hindsight, the pricing might have been imperfect, but it certainly limited the moral hazard problems which many opponents of a banking union for Europe fear today.
3. A CONCRETE PROPOSAL

As already illustrated in the Introduction, there is great resistance to the idea that a banking union also implies a common deposit guarantee. Part of the objection is that deposit guarantee is deemed politically too ‘sensitive’. Another objection is that it would invite moral hazard because it would induce national authorities to become less prudent. This latter argument is difficult to understand at least for the banks which are under the supervision of the ECB because the ECB would surely recognise and prevent excessive risk-taking by the banks under its responsibility. Finally, it is sometimes argued that the ESM can provide financial assistance in case of national shocks. However, this argument is misleading since the ESM does not share in any risk. It can only provide financing to the sovereign (which has to be repaid). In future the ESM might also, within tight limits, recapitalise banks. But it would do so only in extreme cases and with a substantial guarantee by the national sovereign.

Ex-post emergency financing by the ESM thus does not deal with the solvency problems that a national shock can create as it is designed by its statutes to deal only with liquidity problems. The ESM can lend only if a debt sustainability analysis shows that the country is solvent. ESM financing just delays the day of reckoning as the endless discussion about legacy assets shows. The ESM does not constitute a mechanism to mitigate the fall-out from national systemic shocks.

Gros (2013) provides a way to deal with systemic shocks, while respecting the political sensitivity of the issue. His proposal is based on the principles of subsidiarity and re-insurance applied to DGS. Under the proposal existing national DGSs would not need to be dissolved. In fact they could continue to operate much as before (with only minimal standards set by an EU Directive). However, they would be required to re-insure against risk too large to be covered by them. The reinsurance has to be mandatory because otherwise the countries that represent the biggest risks would not participate.

A European Reinsurance Fund (EReIF) would provide this reinsurance. The EReIF would be financed by premia paid by the national DGSs. Reinsurance in the private sector works under the same principle. The reinsurance contract would provide for a large deductible, which means that the European Fund would pay out only in case of large losses. This ‘deductible’ would provide the national authorities with the proper incentives to avoid taking measures which lead to excessive risk taking (to the extent that this is still possible under the SSM), but the reinsurance cover would stabilize depositor confidence even in the case of large shocks. The payout from the EReIF in case a large national shock arises would not be a loan (like ESM financing) but just like any payout from an insurance company.

Gros (2013) argues that the national DGSs would be ideally responsible also for resolution. In general, banking systems tend to be more stable, in which the authority responsible for deposit guarantees is also responsible for bank resolution. The here recommended approach could therefore also be used to design the ‘Single Resolution Mechanism’ (SRM).

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9 It seems that in Germany the popular objection to a common DGS system is that “German taxpayers would underwrite thousands of billions of GIIPS’ deposits which are backed up only by doubtful assets” (see Sinn et al., 2012 and Sinn, 2012). Reality seems to be different: The covered deposits in all GIIPS countries together amount, according to CEPS data, ‘only’ to about €1,000 thousand billion, backed up by about €7,000 billion in assets (equivalent to €2,8000 billion in terms of Risk-Weighted-Assets). As long as depositors are/super senior and the GIIPS’ economies do not collapse totally, the danger that a DGS system has to pay out large amounts remains small, even if one considers that part of the assets might be encumbered.
The build-up of such a reinsurance fund will take time, but this applies also to the national funds which now need to be built up. This reinsurance approach therefore can't solve the legacy problems of the current crisis.

A key element of the reinsurance approach is of course that the systemic risk is properly priced. However, this should be possible. The EReiF would not have to have a detailed knowledge of all the individual banks under the national DGS. It would only have to judge the quality of national supervision and the macroeconomic environment. Booms and busts are never recognised in the country where they take place (see Ireland and Spain). But the EReiF, which would be independent from national policy-makers, would be much better placed to recognise national imbalances (maybe with input from the macroeconomic imbalances procedure undertaken anyway by the Commission) and levy corresponding risk premia.

This aspect constitutes another key difference between ESM financing and the reinsurance principle: the ESM cannot levy risk premia ex ante and thus cannot provide market signals for prudent behaviour.
4. CONCLUSION

Creating a banking union deserving of the name will be a long process. There are two key elements: a proper pricing of risk and some insurance against systemic shocks. The first is now on the table in the context of the draft Directive on DGSs. But the second is absent both in the discussions on the Single Resolution Mechanism and in the existing proposals on DGSs. The SRM in particular does not deserve the attribute ‘single’. It seems to stand for the determination of Member States to maintain ‘Separate Resolution Mechanisms’.

It is surprising that the official deliberations do not take proper account of the fundamental distinction between the problems posed by the failure of any individual bank and those posed by a nation-wide shock. The cases of Ireland, Spain and Cyprus should have provided an illustration of the latter problem. The implicit assumption that one can maintain national DGSs and bank resolution funds because the ESM can provide a backstop in case of a systemic shock at the national level is flawed because ESM financing is not designed to provide any risk-sharing. The ESM can only provide financing, first to the national government, and, even in the case of bank recapitalisation, with a substantial guarantee by the national government. By contrast, a common European DGS would provide at least some risk-sharing as this institution would then absorb at least part of the losses should a national systemic shock hit any Member State. Moreover, a common DGS would provide the occasion to price national, systemic, risk, which the ESM cannot do.

It should go without saying that the ECB should not be involved in any way in the set-up and the management of any European DGS. The task of a central bank is to maintain price and financial stability, not to protect retail clients from losses when a bank fails. On the contrary, the ECB has to feel free to close any bank it does not deem viable without having to think about potential losses for taxpayers.

The objection against any type of risk-sharing via a true banking union is that many of the aspects that foster national boom-bust cycles remain under national control, given that laws and regulations concerning housing finance, labour markets, social security systems, etc., all remain at the national level. However, this argument fails to take into account that a proper pricing of risk can deal with this moral hazard problem.

Moreover, as shown in Gros (2012), there is no need to create European institutions to supervise and control every bank, including the smaller ones in great detail. The key is to create a system that provides a (properly priced) reinsurance against large shocks. A DGS is fundamentally just an insurance company. All prudent insurance companies take out reinsurance against large risks. The same principle should be applied to national DGSs in Europe.
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