



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Deposit Guarantee Schemes

NOTE

Abstract

A common Deposit Guarantee System is not likely to be implemented in the near future. However it is the natural endpoint in the formation of a European banking union. Implementing a common Deposit Guarantee System would constitute a political leap. To facilitate this decision, countries should go further in harmonising the national Deposit Guarantee Schemes (DGS), including dimensions which have been neglected so far. The protection of deposits should be absolute for all deposits up to an ex-ante set threshold (e.g. EUR 100,000). This should be firmly anchored within EU legislation and be clearly communicated in order to avoid the confusion as evidenced with the recent events in Cyprus. However, we do not favour additional, optional deposit insurance nor other optional elements which induce rather than eliminate differences between national DGS.

When in place, a common Deposit Guarantee System should be combined with a (at the moment not existing) European Resolution Authority and remain independent of the European Central Bank.

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DRAFT

EXECUTIVE SUMMARY

In this note we make recommendations for a common Deposit Guarantee System, a system in which the national Deposit Guarantee Schemes (DGS) are combined into one homogenous pan-European Deposit Guarantee System.

We realise that such a common Deposit Guarantee System is not feasible in the short-term. For this reason we suggest countries participating in the Banking Union should harmonise their national DGS further. This harmonisation should comprise all elements of DGS. Such a harmonisation paves the road for a common Deposit Guarantee System which is a political decision with far reaching consequences as it would imply, in our view, fiscal burden sharing.

Within the Banking Union, the common Deposit Guarantee System should then be combined with the Single Resolution Mechanism and remain formally independent of the prudential supervisor.

With respect to bail-in requirements, we strongly recommend that deposits below some appropriate threshold are fully protected. This idea is widespread yet recent events (which we discuss in this note) cast doubt on whether this protection is universal. This protection should be universal and this should be firmly anchored within legislation. However, we do not favour unlimited deposit protection. Deposit protection should be limited to small deposits where the notion of small is defined with respect to the richest participating country. This approach would also improve the stability of the DGSs as their claims would enjoy priority.

DRAFT

1. CONTEXT

A full-fledged Banking Union consists of a few important building blocks which are related to supervision, resolution and deposit guarantee.¹ So far most progress has been made with respect to the Single Supervisory Mechanism (SSM).² This term refers to the supervision in the European Banking Union for which the responsibility will be assigned to the European Central Bank (ECB). The ECB will however not be responsible for all credit institutions in the euro area but rather for a subset of large banks, including systemically important banks. The precise assignment of tasks within the SSM will be outlined in a Framework Regulation which the ECB will publish six months after the entry into force of the SSM regulation.

The second building block is labelled the Single Resolution Mechanism (SRM). With respect to SRM less progress has been made;³ but the European Commission has announced a proposal for the SRM to be adopted in summer 2013. Such a mechanism should be responsible for resolving insolvent institutions threatening financial stability and forms an important complement to the SSM.

The third building block concerns the deposit guarantees. Throughout this document we distinguish between the current situation with national Deposit Guarantee Schemes (DGS) and the common Deposit Guarantee System. The latter is not in place, but should be the final goal of a further harmonisation.

The harmonisation process started in 1994 with the EU directive on DGS.⁴ The financial crisis renewed the debate on DGS. The minimum levels of deposit coverage and maximum payout periods were harmonised⁵ and in 2010 the Commission proposed a reform.⁶ This proposal is a response to the crisis situation of the last years and to the expert recommendations from the de Larosière report.⁷ The proposal can be seen as an overhaul of the 1994 Directive by harmonising additional aspects. However, as noted by Gerhardt and Lannoo (2011) *'the proposal does not represent a system change, as in some aspects it maintain the diversity in national systems.'*

¹ The European Commission outlined as the three major parts of the Banking Union: the SSM, the SRM and a common deposit guarantee scheme. Some observers distinguish more than three building blocks and add for example the existence of a financial backstop as a separate building block. See by the speech by Vitor Constâncio, Vice-President of the ECB, 11th Annual European Financial Services Conference, Brussels, 31 January 2013; <http://www.ecb.int/press/key/date/2013/html/sp130131.en.html>. Our choice for three main blocks follows Coëré, B. (2013) The Single resolution Mechanism: Why it is needed. *Speech at the ICMA Annual General Meeting Conference 2013*, organised by the International Capital Market Association, Copenhagen, 23 May 2013; <http://www.ecb.int/press/key/date/2013/html/sp130523.en.html>; these building blocks have also been described in some detail by Schoenmaker, D. and D. Gross (2012), A European Deposit Insurance and Resolution Fund – An update. *DSF Policy Paper*, no.26.

² Our views on supervision are outlined in an earlier note, see Eijffinger, S. (2012), Monetary Policy and Banking Supervision, European Parliament, Brussels, December 2012.

³ In a previous note we set out our views on the key elements of a well functioning Single Resolution Mechanism; see Eijffinger (2013), Single Resolution Mechanism, European Parliament, Brussels, February 2013.

⁴ Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>; as subsequently amended in 2009: http://ec.europa.eu/internal_market/bank/docs/guarantee/200914_en.pdf.

⁵ IMF Country Report No. 13/66, European Union: Publication of Financial Sector Assessment Program Documentation – Technical Note on Deposit Insurance, March 2013 p.4; <http://www.imf.org/external/pubs/ft/scr/2013/cr1366.pdf>.

⁶ European Commission (2010), Proposal for a Directive .../.../EU of the European Parliament and of the Council [recast], COM(2010)368 final, Brussels; <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0368:FIN:EN:PDF>.

⁷ European Commission (2009), Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Brussels, http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

In this note we envision a common Deposit Guarantee System as final goal in the continuous construction of a genuine Banking Union. However, for various (mostly political) reasons a common European Deposit Guarantee Scheme is not feasible in the near future. This view is shared by many observers and for this reason some feel that it is not worthwhile to pursue this for the moment.⁸

For this reason we propose a gradual approach where the European Union strives relentlessly for further harmonisation beyond the current proposal.⁹ The idea is that national differences should be eliminated as much as possible to make the transition to a common Deposit Guarantee System easier. A highly harmonised system of Deposit Guarantee Schemes (DGS) provides a fertile ground for a *leap* to a common European Deposit Guarantee System.

In this note we further discuss the following issues: First, we comment on the ongoing harmonisation process. We stress that continuing harmonisation eventually should lead to a common Deposit Guarantee System. When the EU would accept a common Deposit Guarantee System, then this function should be combined with a European Resolution Authority (ERA)¹⁰ which would then (likely) already be established and active.¹¹

We stress that this institution should be independent of the supervisor, the ECB. Then we discuss the relationship between bail-in requirements and depositors. In particular we emphasise that deposit protection below a threshold should be firmly anchored. At the other hand we do not favour limitless deposit protection nor do we favour optional deposit guarantees above a commonly agreed threshold. Optional deposit protection creates additional differences between countries and hampers the convergence in national DGS as a preparation for a common Deposit Guarantee System.

⁸ See for example Schoenmaker, D. and D. Gross (2012), or see Gerhardt, M. and Lannoo, K. (2011) Options for reforming deposit protection schemes in the EU. *ECRI policy brief* No.4.

⁹ COM(2010)368 final.

¹⁰ European Resolution Authority refers to a separate and independent (from the SSM) entity responsible for resolution as we have outlined in our note on SRM (Eijffinger February 2013). We do not reiterate the entire argument but the essence is that combining resolution and supervision is incentive-incompatible.

¹¹ Linking deposit guarantee and bank resolution is a recurring theme in policy papers on this topic. See for example Schoenmaker, D. and D. Gross (2012), or Gerhardt, M. and Lannoo, K. (2011).

2. THE ONGOING HARMONISATION AND THE ROLE OF THE ECB

The current harmonisation process should go further. While some steps have been taken in harmonising national DGS, there still exist substantial differences across countries, as evidenced by the Commission proposal and the corresponding impact assessment.

In our view, Member States should harmonise (via corresponding directives to be proposed and adopted) up to the point that they have *de facto* similar DGSs in all relevant dimensions. Important dimensions are: coverage (type of deposit/depositor covered and up to which amount), funding standards (and in particular the relationship between *ex ante* and *ex post* funding), a target *ex ante* fund size, payout periods, delineation of responsibilities, etc. At that point, when the national DGSs have converged up to a point that they are similar, the EU Member States need to take a political leap and opt for a common Deposit Guarantee System. Such a system would imply burden sharing. There would be no difference in deposit protection within the Banking Union. Deposit holders would be equally protected regardless of the country where they hold their deposits (within the EU). The common Deposit Guarantee System would be truly a monolithic system with no room for regulatory arbitrage within the Banking Union. In such a system competitive distortions are minimised (level playing field) and disturbing cross-border differences in consumer protection do not exist.¹² Differences in national DGSs allow for arbitrage by the financial institutions who may take advantage of regulatory differences and by the depositors who may locate their funds in countries with a higher deposit protection.¹³

This leap is not feasible at this moment or the near future. In order to facilitate the political leap, differences between systems need to be reduced and countries need to work with similar systems, exactly what the harmonisation process is referring to. A common Deposit Guarantee System is the desired endpoint of an ongoing harmonisation. Also, as Schoenmaker and Gross (2012) stress, it aligns well with the 'single' resolution of financial institutions.¹⁴

Resolution and deposit protection are separate things and we have drawn them as such in Figure 1. However, in practice these functions are often combined. In the United States the Dodd-Frank Act assigns resolution powers for large banks to the Federal Deposit Insurance Corporation (FDIC),¹⁵ in Japan the Deposit Insurance Corporation (DIC) has resolution power as well. There, combining the resolution and deposit insurance seems natural as it allows for swift decision making and crisis management.¹⁶ If one entity is responsible for both, then the least-cost principle can internally be applied in each case. Proposals along these lines have been made by Gerhardt and Lannoo (2011), Schoenmaker and Gross (2012).

In a previous briefing paper we suggested that the ERA should be a separate, SSM-independent identity. This implies that the common DGS, when combined with the ERA, would also be independent of the ECB. This is desirable in our view. The academic literature suggests that deposit insurance should be independent and certainly separated from the

¹² See Gerhardt, M. and Lannoo, K. (2011).

¹³ See Gerhardt, M. and Lannoo, K. (2011).

¹⁴ In the previous briefing paper (Eijffinger February 2013), we argued for an SRM with a strong and independent European Resolution Authority.

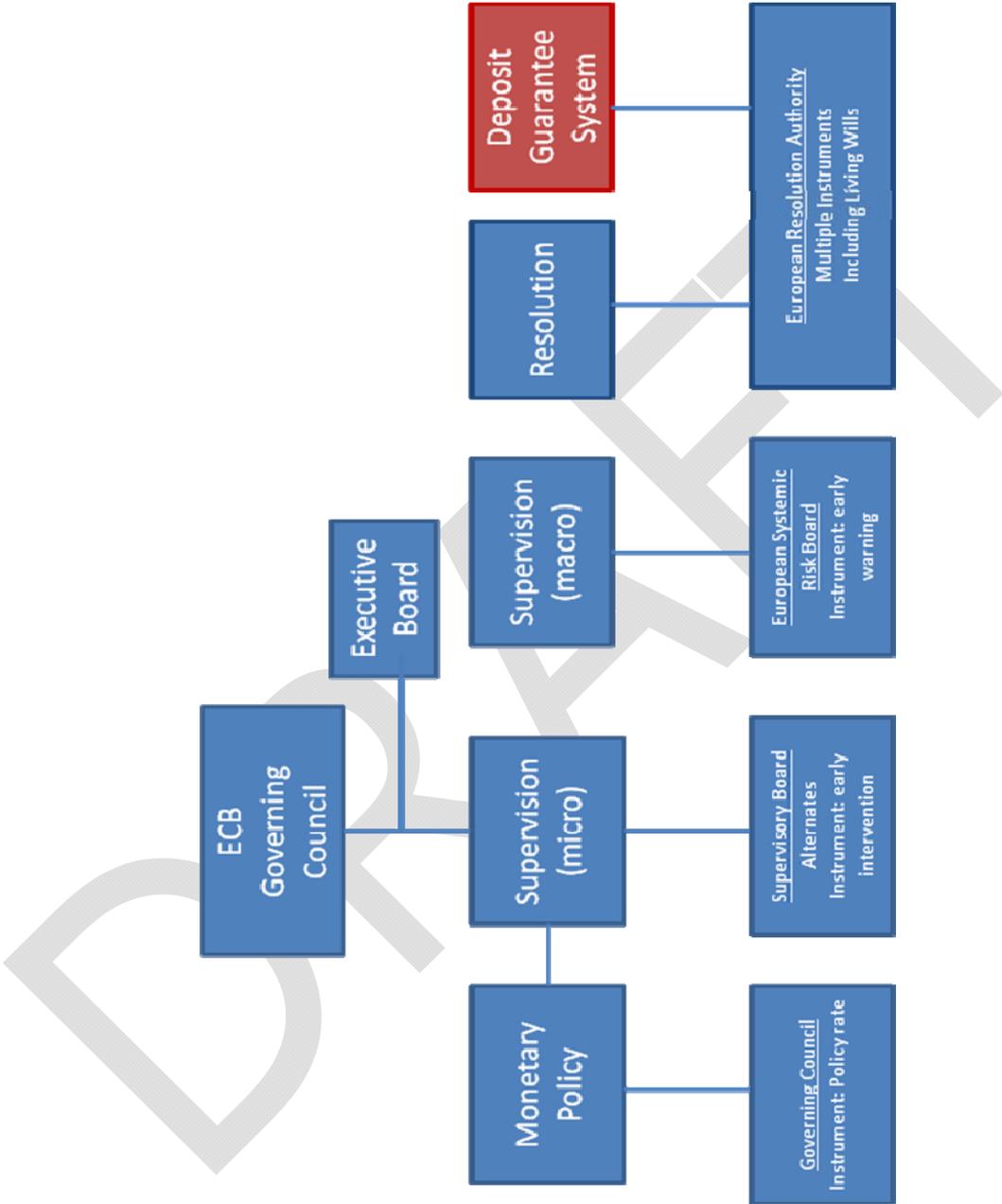
¹⁵ For smaller banks resolution powers were already assigned to the FDIC, see also Schoenmaker and Gross (2012).

¹⁶ However, the FDIC has also supervisory tasks and powers.

lender of last resort function.¹⁷ The ECB, as the (micro-prudential) supervisor, would then share information with the ERA but the two institutions would remain independent.¹⁸

This distribution of tasks is summarised in Figure 1.

Figure 1: Future Distribution of Tasks – An update



Source: Author's elaboration

¹⁷ See Repullo, R. (2000) Who should act as a lender of last resort? An incomplete contracts model. *Journal of Money, Credit and Banking* 32 or Beck, T., Todorov, R. And Wagner, W. (2012) Bank Supervision going global? A cost-benefit analysis. *EBC discussion paper no.2011-033*, European Banking Center, Tilburg, or Schoenmaker, D. and D. Gross (2012).

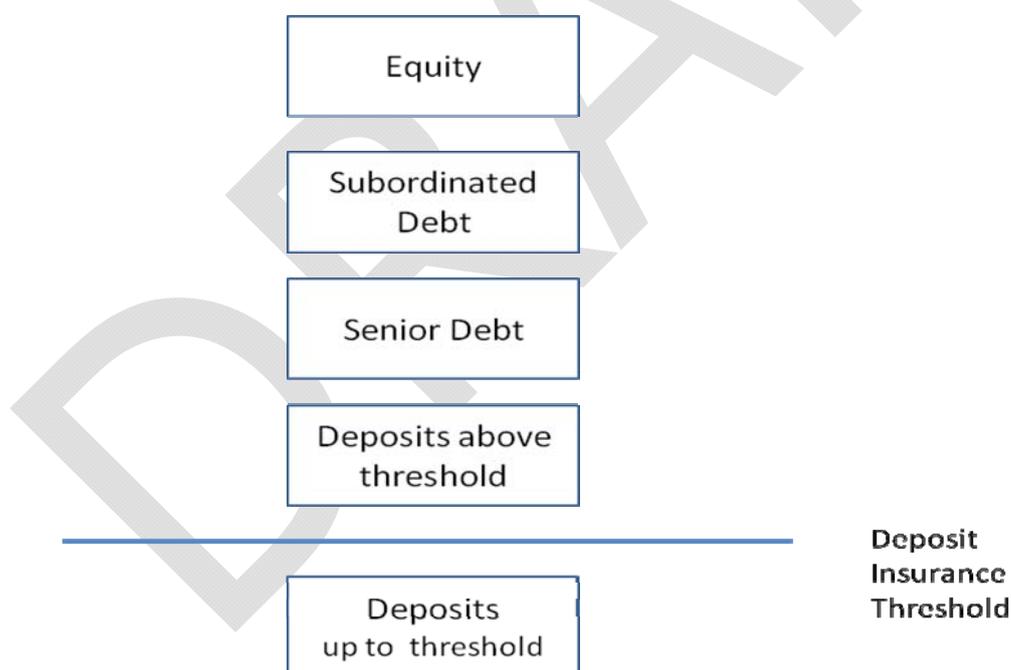
¹⁸ Some discussion on the separation of the European Resolution Authority from the ECB can be found in Eijffinger (February 2013).

3. BAIL-IN AND DEPOSITORS

A question which arises when discussing DGSs is how these relate to bail-in requirements. To understand this it may be useful to reiterate the hierarchy of responsibilities. This hierarchy refers to the pecking order of creditors. Our preferred hierarchy is shown in Figure 2. On top we have the equity holders. If a bank is in trouble, the equity holders are the first to pay for this. Then the debt holders are approached and depending on the structure of the debt a difference can be made between senior and subordinated debt. In our model, a third layer comprises deposits above a certain threshold. This hierarchy does not reflect a strict legal delineation of assets. It only serves to illustrate that the equity holders are the first to be approached and subsequently the debt holders. Among debt holders a distinction can be made between different categories depending on the specific debt structure of the bank under consideration. In the example in Figure 3, we only present two broad debt categories subordinated and senior debt. Most deposits are considered to be subordinated debt. In our view deposits (above the threshold) should come after senior debt.

We do not favour unlimited deposit protection. Deposit protection should serve to protect the 'small depositors'. Of course if the threshold, demarcating small from large, is harmonised then small in one country could mean medium or large in another. The threshold below which deposits are protected should be set such that also in the richest country a reasonable amount of deposits are protected. The widows and orphans argument counts for citizens of these countries too.

Figure 2: Bail-in order



Source: Author's elaboration.

So far this story sounds familiar but recent events in Cyprus and Iceland have shown that the idea that deposits are only to be touched above the pre-determined threshold is not sufficiently anchored. In Cyprus, President Anastasiades initially proposed a levy on *all* deposits. This proposal seemed to have the approval of various policy makers including the

Eurogroup.¹⁹ As Sibert (2013) noticed,²⁰ this is not the first time deposit security came in doubt: 'When the Icelandic bank Icesave went down, the relevant court ruled that the Icelandic government was not legally obligated to repay UK and Dutch depositors in a timely fashion (EFTA Court 2013).' And 'The court accepted Iceland's argument that the EU directive was never meant to deal with the collapse of an entire banking system.' These two cases cast doubt on deposit insurance in case of large or systemic crises.

The notion that deposits below the threshold are protected at all times and under all circumstances should be formalised and *legally anchored* in such a way that it sends a strong signal to deposit holders that the protection is real. A bank resolution may require more than the bail-in of equity and part of the debt holders. In such a case it is of the utmost importance that the small deposits (below the threshold) are insured.

Here the burden sharing aspect kicks in as this could require a fund on a European level. The funding should to a large extent be based on *ex ante* funding and the premiums paid should be adequately set. *Ex ante* funding avoids excessive reliance on taxpayers money. Additionally, well chosen premiums may ensure that (or at least alleviate) moral hazard associated with insurance is discouraged. A description of such a premium is given by Acharya, Santos and Yorulmazer.²¹ The authors prescribe a premium which has three major characteristics:

- (1) It is sensitive to systemic risk and individual risk posed by the bank.
- (2) Large banks pay a proportionally large premium.
- (3) The premium charged is more than the actuarially fair premium to discourage moral hazard.

The hierarchy of responsibilities as outlined in this section is transparent. It should be backed by solid laws ensuring that the protection of deposits below the threshold can never be doubted as to avoid the confusion as in the case of Cyprus.²²

¹⁹ Sibert, A. (2013) Deposit Insurance after Iceland and Cyprus. *VOXEU column*. April 2 2013 <http://www.voxeu.org/article/deposit-insurance-after-iceland-and-cyprus>.

²⁰ Sibert, A. (2013) Deposit Insurance after Iceland and Cyprus. *VOXEU column*. April 2 2013 <http://www.voxeu.org/article/deposit-insurance-after-iceland-and-cyprus>.

²¹ Acharya, V., Santos, J. and Yorulmazer, S. (2010) Systemic Risk and Deposit Insurance Premiums, *Federal Reserve Bank of New York Economic Policy Review*, Special Issue on Central Bank Liquidity Tools and Perspectives on Regulatory Reform, 2010, 16 (1), 89-99.

²² Sibert, A. (2013) Deposit Insurance after Iceland and Cyprus. *VOXEU column*. April 2 2013 <http://www.voxeu.org/article/deposit-insurance-after-iceland-and-cyprus>.

4. CONCLUSION

In the short term, a common Deposit Guarantee System as outlined above does not seem feasible. The Vice-President of the ECB, Vitor Constâncio,²³ recently underlined in a speech the notion of a gradual approach and mentioned that '*A European Deposit Guarantee scheme is therefore not essential in the short term.*' This note stresses that a common Deposit Guarantee System should be the goal and outlines our view on how the common Deposit Guarantee System should look like. Meanwhile further efforts to harmonise national DGSs, as explained above, are essential to make the transition to a common system feasible.

When a common Deposit Guarantee System would become a real possibility, we suggest combining this with a (future) ERA. Such a combination follows partly the example of the U.S. (FDIC) and Japan (DIC). However, this entity should remain independent of the prudential supervisor (ECB) although cooperation related to information sharing is indispensable.

The recent events in Cyprus have put DGSs back on the agenda. While it is commonly understood that some deposit protection should be in place, we wish to underline that great efforts should be taken to anchor this in legislation and communicate it. The threshold for deposit protection should be set at a level which is acceptable for the all Member States and in particular also in view of the richest country as the widow and orphans argument also applies to citizens of that country. However, at the same time we do not endorse an unlimited deposit protection and deposits above the threshold should not be protected by the DGS (in line with the recast proposal).²⁴

Funding the deposit guarantee should be done as much as possible by *ex ante* premiums which are set up in such a way that moral hazard due to the protection is minimised.

²³ Constâncio, V. (2013), Establishment of the Single Supervisory Mechanism; the first pillar of the Banking Union. 11th Annual European Financial Services Conference, Brussels, 31 January 2013; <http://www.ecb.int/press/key/date/2013/html/sp130131.en.html>.

²⁴ European Commission, COM(2010)368 final.

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