The European Deposit Insurance Scheme

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I. **ADDED-VALUE OF DEPOSIT GUARANTEE SCHEMES**

Deposit guarantee schemes protect depositors’ wealth (in the EU: up to € 100,000) from bank failures. At their core, they are a trust building mechanism that

- increases savers’ willingness to deposit money at a bank at all and
- dissuades depositors from massively withdrawing deposits in uncertain times (bank run).

Given that deposits are an important source for financing bank lending, deposit guarantee schemes contribute to bank lending and hence to economic growth. Transformation of maturity, risk and lot size by banks is only possible where there is a critical amount of constant deposits.

Deposit guarantee schemes also contribute to financial stability: No bank is able to cope with a large number of depositors “running the bank”, i.e. suddenly withdrawing liquidity. Given maturity transformation, only a small amount of depositors’ savings is immediately available. Deposit guarantee schemes therefore provide an important psychological element: in uncertain times, they aim to dissuade any depositor from trying to achieve a “first mover advantage” by being the first to withdraw deposits while the bank is still liquid.

II. **ADDED-VALUE, RISKS AND NON-ADDED-VALUE OF EDIS**

1. **Added-Value**

Institution-specific defaults are rare events causing high costs to the DGS (and hence to the participating banks). Insurance theory suggests that pooling such risks amongst a high number of insurance takers may lower the costs of insurance (i.e. in sum, not necessarily for all participants) and may increase the resilience (and hence credibility) of the insurance system. This may increase financial stability.

2. **Risks**

Each and every insurance involves a mutualisation of risks. For EDIS as such insurance to produce an added-value, the following abstract preconditions must be met:

- **Price risk correctly**: The risk that each and every member of an insurance poses to the community of insurees must be correctly identified and priced. Not doing so redistributes income amongst insurees (here: distorts competition amongst banks) and jeopardises the financial stability (and hence credibility) of the insurance.

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- Contain moral-hazard: Once a member of the insurance, insurance takers may have incentives to externalise the consequences of their acting on the insurance and may act suboptimally risky. This as well may jeopardise the financial stability and hence the credibility of the insurance.

Given that EDIS would be a central corner stone of depositor confidence in the Eurozone and any malfunctioning of EDIS would negatively affect general confidence in the EU, it is extremely important to shape EDIS in a way that limits these risks.

3. Non-Added-Value

Despite these advantages, EDIS cannot be expected to notably improve the functioning of the internal market.

- EDIS clearly divides the EU internal market: For the Euro-Zone, EDIS would apply whereas non-Eurozone-States would continue to work with national Deposit Guarantee Schemes. This must distort competition. Hence Art. 114 TFEU does not seem to be a convincing legal basis for EDIS.

- The country bias does not seem very relevant and EDIS is not necessary to eliminate this. The EU commission argues that the existing system of national deposit guarantee schemes causes a country bias among the Member States which distorts competition.² If some Member States are economically stronger than others, the credibility of the national deposit guarantee schemes will differ. Hence, banks based in the stronger Member States are in a better position to acquire deposits than banks in the weaker Member States. The Commission argues that EDIS is necessary to eliminate this problem.

It is debatable whether this is a relevant problem in practice. The fact that only 3% of EU-citizens have an account abroad³ indicates that, in any given Member State, competition for private deposits mostly takes place between domestic banks and domestic branches of international banks. Both types of banks are members of the same national deposit guarantee scheme. At national level, there is no distortion of competition in this respect which needs to be eliminated by a Eurozone DGS.

Moreover, the European Stability Mechanism (ESM) should be able to alleviate the country bias. With ESM-assistance, member states can recapitalise ailing banks or support ailing deposit guarantee schemes.

III. Five Preconditions for EDIS to Make Sense

1. What is the purpose and does EDIS fit it?

Despite their general added-value, it is important to stress the limits of any deposit guarantee scheme. In the EU, with a targeted financial endowment of 0.8% of deposits by 2024 (Art. 10 para. 2, Directive 2014/49/EU), deposit guarantee schemes are absolutely incapable of dealing with large scale systemic crises. If at all, they can (and should) only be expected to cope with isolated, institution-specific default.⁴

Given consensus on this point, EDIS is not necessary to deal with isolated institution-specific defaults and is not able to deal with large scale systemic crises.

³ SWD(2013) 164, p. 11.
Beyond EDIS, there is at least three alternative policy measures which may also lead to cheaper and more resilient deposit guaranteeing in the Eurozone.
- Different targets for the financial endowment of national DGS
- Mutual borrowing between national DGS
- ESM-Assistance.

In this context, an impact assessment by the EU Commission examining the pros and cons of these alternative policy measures would have been necessary and would well fit to the EU’s better regulation agenda. I am not aware of such an impact assessment.

2. **Back sovereign bonds with own funds**

Preventing the economic problems of banks from jeopardizing the creditworthiness of Member States (and vice versa) has been one of the main drivers for establishing the Banking Union. However, as of today, many banks hold large portfolios of sovereign bonds of their respective Member State. The current European prudential rules do not entail an obligation for banks to cover these sovereign risks with own funds.

If EDIS were to increase depositor’s trust in the safety of deposits, banks in Member States with a low-credibility DGS will face more deposits. They will have an incentive to increase sovereign exposure as this exposure yields high returns without absorbing scarce own funds. This runs counter to the very idea of the Banking Union as it intensifies the link between banks and states.

EDIS would force all Eurozone banks to finance reimbursement costs caused by sovereign defaults.

3. **Harmonise Insolvency Law**

Differences in national insolvency law make it more or less feasible to clean up banks’ balance sheet from non-performing loans. This directly affects the likelihood of having to take recourse to EDIS means. Also the recovery rates following insolveny proceedings may vary widely, which directly influences the amount of EDIS assistance.

4. **Harmonise national discretions in DGSD**

Under EDIS, the current DGSD would distortion competition between banks in the Euro-Zone. Member States have used discretions in the DGSD (e.g. for temporarily increasing the level of protection) to different extents. This differences should be eliminated before EDIS can be activated.

5. **Harmonise/Eliminate NODs for indirectly supervised banks**

The quality of bank supervision within the Eurozone should not differ substantially given that all banks would be member of EDIS. Whereas the ECB has initiated a process to close some these NODs for banks it directly supervises; this process has not yet started for other banks.

IV. **Questions to be considered when designing EDIS**

1. **Moral hazard and national responsibility**

Even upon meeting the preconditions for establishing EDIS, the risk of moral hazard will also remain present. In the EDIS-context, moral hazard is especially relevant considering the behaviour of banks and member states. Economic and fiscal policy measures may undeniably have a
considerable impact on the size and/or probability of failure of any national banking sector. The SSM helps in limiting some of these risks but a European harmonisation of such discretions seems totally unrealistic.

Hence, there are good arguments for leaving some of the financial responsibility of compensating depositors on the national level. As such, DGS should remain in place with a financial target well above zero. Only once national DGS have fully used financial means on a national level, EDIS means should be made available. Alternatively, EDIS support may be capped at a certain level and DGS may be force to take out an excess of loss insurance.5

2. Room for alternative measures

Alternative measures may be a cheaper and more efficient way to protect depositors. It is not clear at all how such alternative measures may be feasible under EDIS without causing serious additional costs to banks/DGS applying them or without causing serious moral hazard problems (when EDIS finances such measures).

3. Risk-adequate DIF-contributions starting 2017

The Commission’s proposal stipulates that DIF contributions reflect banks’ individual Euro-wide risk profile only in the co-insurance phase. The Euro-wide risk profile should be relevant for DIF contributions already from the very start of EDIS. Not doing so leads to a wrong-pricing of risk.

4. Make sure DIF adequately financed

In our interpretation, the EDIS-proposal sets out a clear financial target level for national DGS, which falls from 2021 to reach zero in 2024. It is of utmost importance that this lowering is offset by a continued increase in financial means of DIF. The pace of bank contributions to DIF will be decided upon be the Commission in a delegated act (Art. 74b para. 5). It might be worth considering whether this should not rather be dealt with on Level 1.

5. Clear the role of payment commitments

The DGSD allows institutions to finance up to 30% of their ex-ante contributions through payment commitments. The EDIS-Proposal remains silent on this.

V. CONCLUSION

In my view, EDIS is not necessary to deal with isolated institution-specific defaults and is not able to deal with large scale systemic crises. Also, it is not necessary to eliminate a country bias, whose relevance I question. Nevertheless, EDIS may lower costs of deposit insurance and may increase financial stability. For this to be the case, five preconditions must be met, the most challenging one being banks having to back sovereign debt with own funds. Given the ever-present risk of moral hazard, I suggest leaving some of the financial responsibility of compensating depositors on the

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5 For a discussion of such insurances as means of financing guarantee schemes, see „Alternatives to Investor Compensation Schemes and their Impact“, Study for the ECON-Committee by Baran, Bigus, Eckhardt and Van Roosebeke.
national level. Inevitably, EDIS will distort competition between Euro and Non-Eurozone Member States. Hence, Art. 114 TFEU cannot be a legal basis for EDIS.