EUROPEAN PARLIAMENT

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

DEPOSIT GUARANTEE SCHEMES

NOTE

Abstract

This note examines the position of insured and uninsured bank deposit holders in Europe in light of the recent EFTA court ruling and events in Cyprus. It considers the merits of further harmonisation of existing national deposit guarantee schemes and the adoption of a single deposit guarantee scheme. Further progress toward a single resolution mechanism requires the specification how uninsured deposit holders are to be treated in the event of a bank failure. This note also considers the issues of whether uninsured depositors should be bailed in and, if so, where they should be in the pecking order and also how much flexibility national authorities should have in deciding their treatment.

IP/A/ECON/NT/2013-02 July 2013

Part of the compilation PE 507.468 for the Monetary Dialogue EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR

Anne SIBERT, Birkbeck, University of London and CEPR

RESPONSIBLE ADMINISTRATOR

Doris KOLASSA
Rudolf MAIER
Dario PATERNOSTER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to:
Poldep-Economy-Science@ep.europa.eu

Manuscript completed in July 2013

This document is available on the Internet at:
http://www.europarl.europa.eu/studies

DISCLAIMER

CONTENTS

EXECUTIVE SUMMARY AND INTRODUCTION

- The recent EFTA Court Ruling and events in Cyprus indicate that the legal obligation of sovereigns to provide depositor insurance is limited in the event of systemic crises. While governments are credible that they will go to great lengths to protect their insured depositors, their willingness to protect uninsured depositors may not be as great had been thought.
- The best way to make the passport system effective and to achieve the free movement of financial services within the EU is to have a single supervisory mechanism, a single resolution mechanism and a single common deposit insurance scheme. This is not necessary, however, for promoting financial stability. From the point of view of consumer protection, a single deposit insurance scheme is not a pressing need.
- It is not obvious whether uninsured depositors should rank ahead of other unsecured creditors or not in the event of a bank failure. But, this is an issue of second-order importance that does not merit holding up progress on the single supervisory mechanism and the single resolution regime. It is also more important that the rules be harmonised and clear in advance than it is whether one or the other option is chosen.

EU Member States are required to provide a deposit guarantee scheme funded by resident banks that covers most bank deposits up to EUR 100,000. Recent events have raised the question of what happens if a country sets up such a scheme and the scale of a banking crisis is such that there is insufficient money in the scheme to repay depositors. That depositors might not be protected calls into question the adequacy of the current system. Would it be better to replace this current system with a more harmonised system of national deposit guarantee schemes? Or, does an integrated market for financial services call for a single deposit guarantee scheme?

It is increasingly accepted that financial stability in the euro area or the EU requires a single resolution mechanism. A stumbling block in progress toward this goal has been the treatment of uninsured depositors. Can they be bailed in, along with other unsecured bank creditors? And, if so, where should they rank in the pecking order?

Section 2 of this note examines how the recent EFTA court ruling and events in Cyprus have clarified the positions of both insured and uninsured depositors in the event of a banking crisis and discusses the adequacy of the current deposit guarantee schemes and the benefits of reform. Section 3 considers the problem of how to treat uninsured bank depositors in the event of the failure of a financial institution.

1. DEPOSIT GUARANTEE SCHEMES IN THE EU

The recent EFTA Court Ruling indicates that the legal obligation of sovereigns to provide depositor insurance in the event of systemic crises is limited. Reactions to the proposals and policies of the Cypriot government indicate that while governments are credible that they will go to great lengths to ensure protection of their insured depositors, their willingness to protect uninsured depositors may not be as great as had been previously thought.

1.1. Deposit Guarantee Schemes after the EFTA Court Ruling

The provision of deposit insurance in the EU (and also in the three EFTA states that along with the EU nations make up the EEA) is governed by Directive 94/19/EC as amended by 2009/14/EC of the European Parliament and of the Council of 11 March 2009.[1] Directives are legislative acts that specify a result that Member States must achieve, leaving the form and method up to the Member States. This directive requires that Member States are to have and monitor a deposit guarantee scheme that protects most depositors up to EUR 100,000. Member States are allowed to choose among different types of schemes and the idea is that these schemes are to be funded by charging resident banks. Until recently policy makers and market participants might have interpreted the directive the way that the EFTA Surveillance Authority (ESA) did: that it imposes an obligation of result on Member States to ensure that a deposit guarantee scheme is to be set up that protects depositors in all circumstances.[2]

On 28 January 2013 the EFTA court rendered its interpretation of the directive in its ruling on an action dated 15 December 2011 against Iceland by the ESA.[3] It made clear that, in its view, the intent of the directive was to eliminate restrictions on the establishment and provision of financial services within the EEA while supporting the stability of the area's banking system and providing insurance for its savers. Specifically, the directive was intended to prevent EEA Member States from impeding the activities of credit institutions licensed in other Member States by invoking depositor protection.[4] The directive was not intended to protect depositors in all instances. The court noted that forcing the banking system to provide the funding necessary to cover depositors in a systemic crisis would undermine the objective of promoting the stability of the banking system.[5] It further pointed out that if the state were required to provide the funding that the banking system could not that this would have a negative effect on competition.[6] It also interpreted the wording of the directive to suggest that it was meant only to cover the failure of individual banks and not the failure of a large part of the banking system that would occur in a systemic crisis.[7] Finally, the Court ruled that it was permissible for Iceland to treat depositors at home differently than depositors in foreign branches.[8]

It is possible that if the question of the intent of the Directive were put to the Court of Justice of the EU that this court would reach a different conclusion: it is possible for the

1 Directive 94/19/EC, OJ L 135 of 31 May 1994, p. 5; Directive 2009/14/EC, OJ L 68 of 13 March 2009, p. 3.

2 EFTA Court (2013), paragraph 76.

3 Iceland was bound by an earlier version of the Directive, Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 that required depositors to be protected up to EUR 20,000.

4 EFTA Court (2013), paragraph 126.

5 EFTA Court (2013), paragraph 158.

6 EFTA Court (2013), paragraph 164.

7 EFTA Court (2013), paragraphs 150 – 151.

8 EFTA Court (2013), paragraphs 218-227.

same question to be put to the EFTA and EU courts with different outcomes.[9] However, for now the legal interpretation of the EFTA Court has been made clear: the directive is meant to cover the failure of individual banks, not a systemic crisis. In the event of a sufficiently large banking crisis, depositors may ultimately be protected only up to the ability and willingness of the sovereign to step in with the necessary funds.

1.2. Depositor Protection after Cyprus

On 15 March 2013 President Nicos Anastasiades of Cyprus, was directed to come up with EUR 5.8 billion, without increasing his country's indebtedness, as Cyprus's contribution to a European Stability Mechanism package to stave off the collapse of the Cypriot banking system. In desperation he proposed a one-off levy on all bank deposits in Cyprus, with deposits up to EUR 100,000 to be taxed at 6.75 percent.[10] The initial proposal was later replaced with one that spared small depositors, but at the time it was announced this proposal had the approval of Eurogroup, ECB and IMF policy makers. For a while it appeared that small deposit holders might bear some of the burden of bank. The adoption of the second proposal makes it clear that if there ever was an implicit government promise to protect all deposit holders, it no longer exists. Large deposit holders can be treated as just another type of senior unsecured creditor.

Does the experience of Cyprus shake the view that insured deposits are sacrosanct? German Finance Minister Wolfgang Schäuble recently stated that, '*[deposits] are safe, though only on the proviso the states are solvent.*'[11] However, with respect to insured deposits this seems excessively pessimistic. The situation of Cyprus was highly unusual. The government was desperate to come up with domestic funds quickly to satisfy the ESM and avert economic catastrophe. It looked to the only obvious source of readily available funds: the deposits of its over-sized banking system.[12]

The Cypriot bank deposits had the highly enticing feature (from the Cypriot point of view) that non-EU residents owned a large fraction of them, perhaps a third or even a half. The rating agency Moody's estimates that there were about USD 31 billion (EUR 24 billion) of Russian money in Cypriot bank accounts.[13] Moreover, there was a widespread suspicion that the Russian investment in Cyprus was driven by corruption-linked money laundering.[14] The initial proposal to tax small as well as large deposits may have been in part a result of a belief that much of the Russian money in Cyprus had been broken up and put into small, insured deposits. Thus, the only way to access it was to tax both small and large accounts. However, ultimately even Cyprus in its dire circumstances spared its insured depositors.

9 See Pirker (2013).

10 http://www.bbc.co.uk/news/world-europe-21819990.

11 Reported in Vaughan, Liam and Elisa Marinuzzi, 'Cyprus Bank Tax Threatens European Deposit Guarantees Plan,' Bloomburg, 19 Mar 2013, http://www.bloomberg.com/news/2013-03-19/cyprus-bank-levy-threatens-european-plan-for-deposit-guarantees.html.

12 In 2011, assets of commercial banks in Cyprus with Cypriot parents were about five times as large as Cyprus's (annual) GDP. Including subsidiaries of foreign banks domiciled in Cyprus (and covered by Cyprus's deposit insurance) the ratio is about seven. Moreover, a sizable fraction of the deposits of the Cypriot banks were foreign owned. In 2011 non-resident deposits in Cypriot banks (excluding foreign affiliates) was EUR 25 billion, or 125 percent of GDP. See IMF (2011).

13 Reported in Young (2013).

14 See Ledyaeva et al (2013) for a study of this.

2. DOES IT MATTER THAT DEPOSIT GUARANTEE SCHEMES ARE NOT HARMONISED?

Does it matter that countries currently provide their own imperfectly harmonised deposit schemes and that these schemes do not cover all eventualities? This section considers this issue from the views of promoting European economic integration, the provision of financial stability and the protection of consumers. The conclusion is that a single deposit guarantee scheme would help promote European economic integration, but is not needed to for banking stability and is of relatively low importance for consumer protection.

2.1. Deposit guarantee schemes and economic integration

The EU strives to achieve an integrated market for financial services. Policies are aimed at ensuring mutual recognition through the *single passport*. This is a system that allows a legitimate provider of financial services in one Member State to establish itself and to provide services in another Member State without hindrance from that state's government.

The difficulty that the passport system faces is the existence of banks' foreign branches. The foreign subsidiaries of banks are incorporated under the laws of the host country. The host country supervises them and requires membership in the national deposit insurance. The foreign branches of banks, on the other hand, are supervised by the country in which their home office is located and it is this country that provides the deposit insurance. This leads to two related hurdles that must be overcome for the passport system to operate properly.

First, it should not be possible for an EU Member State to protect its own banking system from competition by forbidding another EU Member State's banks from opening branches within its borders on the pretence of consumer protection. Second, if the banks of an EU Member State open branches in another EU Member State, it should not be genuinely detrimental to the host state's consumers.

The EFTA case makes it clear that further harmonisation of the system of individual EU deposit insurance schemes is not enough to overcome these two hurdles. Countries cannot be expected to protect all depositors in the event of a systemic bank failure and apparently some may be able to discriminate against deposits located in foreign branches. No system of national deposit insurance schemes can guarantee that allowing foreign branches to operate within a nation's borders does not put a country's residents at risk. Since assessing the extent of the risk is subjective, the host country will have an incentive to overstate the risk if this allows it to hinder or forbid the establishment or operation of a branch and thus promotes the welfare of its own banks. This makes it difficult to achieve an integrated market for financial services. The best way to make the passport system effective and to achieve the free movement of financial services within the EU is to have a single common supervisor and a single common deposit insurance scheme.

2.2. Deposit guarantee schemes and financial stability

In the canonical story of depositor runs each depositor believes that all other depositors will run and, thus, the bank will fail. Thus it is optimal for each depositor to run and a bank that would otherwise be solvent can fail solely as a result of self-fulfilling expectations. This financial fragility argument has been used to justify deposit insurance. If it is known that deposits are safe and that consumers will always have access to their money, then no depositor has an incentive to run.

The problem with using deposit insurance to avert bank runs, however, is that deposit insurance also promotes moral hazard. If depositors have no incentive to monitor the activities of banks, then banks will engage in riskier behavior. Thus, as an empirical matter, it is not clear whether deposit insurance promotes financial stability. There are fewer runs but the quality of bank assets is likely to deteriorate. Demergüç-Kunt and Detragiache (2002) use data from a large panel of countries from 1980 – 1997 and find evidence that offering explicit deposit insurance is detrimental to bank stability.

In addition to possibly increasing the instability of the banking system, deposit insurance is not necessary to prevent bank runs. For countries in the euro area, the Eurosystem can act as lender of last resort in the event of a depositor run. In other EU countries as long as banks' deposits are not allowed to become too large, the central bank can act as the lender of last resort. If it is fully credible that the central bank will always loan to illiquid, but fundamentally solvent, banks then depositor runs based solely on self-fulfilling expectations should not occur.

2.3. Deposit guarantee schemes and consumer protection

The main argument for the existence of deposit insurance is consumer protection. As even most official supervisors appear to sometimes have difficulty judging the health of financial institutions, it is unreasonable to expect small retail depositors to evaluate the soundness of their bank. Moreover, it is inefficient to have thousands of individual depositors carrying out the same assessment. Therefore, it is sensible for small customers to be protected if their bank fails.

It is not completely obvious to what extent they should be protected. The IMF says that in practice [explicit] insurance averages about twice per capita GDP.[15] From this point of view, EUR 100,000 is excessive, providing 3.3 times per capita GDP protection for Germans, 5.9 times per capita GDP for Cypriots and a whopping 10.6 times per capita GDP protection for Estonians.[16] In thinking about what is a sensible threshold for the EU it should be noted that the households and small businesses with more than EUR 100,000 in bank savings can spread their savings out across different bank groups to avoid having uninsured deposits.

In practice, small deposit holders around the world have been well protected.[17] In the United States, the Federal Deposit Insurance Corporation (FDIC) was established in 1933 and no one has ever lost a cent in an FDIC-insured deposit since then.[18] Not a single small deposit holder in an advanced economy has lost their money since the financial crisis arose. Perhaps the most recent example of a sovereign of what is now a euro area state not fully protecting its deposit holders is the Italian government's levying a paltry 0.6 percent tax on bank accounts as part of its attempt to stave off the collapse of the lira in July 1992.

---

[15] IMF (2013).

[16] Calculated using 2012 per capita GDP from the IMF World Economic Outlook database.

[17] Over 110 countries have deposit insurance schemes and new ones are regularly being added. The Palestine Monetary Authority has just announced one and China is apparently on the verge of commencing one.

[18] The FDIC website, http://www.fdic.gov/deposit/deposits/dis/.

In the event of a systemic collapse, there is no explicit protection for small deposit holders in the EU or even the United States.[19] Nevertheless, protecting small deposit holders is clearly a high priority. Despite their temporary lapse (followed by hasty back pedaling) in the case of Cyprus, euro area policy makers are credibly committed to seeing that insured depositors are protected. Even with the current deposit guarantee system, insured deposit holders in most of the euro area can feel safe. After a single supervisory mechanism and a single resolution mechanism are in place, a single deposit insurance scheme could further increase the risk sharing.

The only way that there is a significant chance of a depositor in the euro area losing money in the near future is if a country leaves the euro area. Suppose, as an example that Greece were to leave the euro area. Suppose further that it issues its new currency, the new drachma, with one new drachma worth one euro. However, in expectation that the government will need to promptly print money to keep its banking system from collapsing, the value of the drachma plummets. Hypothetically, suppose that two drachmas become worth one euro. Then, every depositor – large and small – loses half the value of their bank account. And, there is no deposit insurance against this redenomination risk.

2.4. Harmonisation might deter beggar-thy-neighbour policies

On 20 September 2008 the Irish government raised its depositor protection from a then conventional EUR 20,000 to EUR 100,000 per account.[20] Unsatisfied with the lavishness of this act, on 30 September the Irish government announced a scheme to comprehensively protect the creditors of the Irish banks. On 7 Oct 2008 – the same day that saw the purveyor of the Icesave accounts put into receivership – the British government raised its deposit insurance threshold from GBP 35,000 to GBP 50,000. Both of these actions were far too after-the-fact to be viewed as insurance and transferring money from taxpayers to those who have EUR 100,000 or even GBP 50,000 in the bank goes way beyond the protection of widows and orphans. Instead, the Irish action appears to have been a blatant beggar-thy-neighbour policy, designed to give its banks a competitive edge at the expense of other countries, particularly the United Kingdom. The British government appears to have recognised this and responded, tit for tat.

It is an unfortunate feature of global economic downturns that individual countries sometimes seek to gain at the expense of other countries, worsening the downturns. The tariff wars of the 1930s, for example, exacerbated the severity of the Great Depression. Harmonising the *upper* bound on both explicit and implicit deposit insurance – as is suggested in the Commission proposal of 2010 – would insure that the deposit insurance threshold cannot be used as a way for one Member State to gain at another's expense. It might also protect the taxpayers of countries such as Ireland from the impulsivity of their governments.

[19] It appears that the U.S. Congress has never enacted a provision in a law explicitly guaranteeing the government backing of deposits. See Pollack (2013).

[20] At the time most EU states had guarantee thresholds of EUR 20,000. Only the Netherlands, Denmark, the United Kingdom and Italy offered more than EUR 35,000.

3. THE PROBLEM OF UNSECURED DEPOSITORS

The establishment of a single supervisory mechanism and a single bank resolution mechanism are vital for European financial stability and integration. However progress towards these goals has been stalled over disagreement over the extent to which unsecured creditors should be protected from bail-ins and how much flexibility governments should have in deciding who is bailed in and to what degree.

It is generally accepted that shareholders should take losses in the event of a bank failure. Insured depositors should be protected, perhaps even at the expense of taxpayers. However, there is dispute over the fate of (the other) unsecured creditors, including uninsured deposit holders.[21]

It seems clear that no unsecured creditor should be rescued at the expense of taxpayers. As with depositor runs, the possibility of unsecured creditor runs based solely on self-fulfilling expectations can be dealt with by having the central bank act as the lender of last resort. There is no argument for protecting unsecured creditors on financial fragility grounds. Moreover protecting the large institutional investors who tend to be the unsecured creditors creates an unacceptable amount of moral hazard. If unsecured creditors are protected against losses then they have little incentive to ascertain and monitor the creditworthiness of the banks. As the official supervisors have proven themselves imperfect judges of banks' financial health, it is useful for the large institutional investors to have some stake in the banks that they make loans to or provide with deposits.

There is however a question of whether uninsured depositors should rank ahead of other unsecured creditors in the event of a bank failure. The answer to this question is not obvious. Whether this would lower bank funding costs is unclear: the cost of raising funds from deposits would fall while the cost of raising funds from debt would rise. It is also not apparent whether monitoring would go up or down: depositors would have an incentive to monitor less; other unsecured creditors would have an incentive to monitor more. It is also not clear whether there is a social argument to be made. Uninsured depositors can be households or small businesses. Or, they can be criminals.

However, two things seem clear. First, this is an issue of second-order importance that does not merit holding up progress on the single supervisory mechanism and the single resolution regime. Second, it is more important that the rules be harmonised and made clear in advance than it is whether one or the other option is chosen.

In addition to squabbling over the pecking order of claimants on failed banks, governments are arguing over the amount of flexibility that Member States should have in dealing with failed banks. If the EU had previously mandated treating all unsecured creditors equally it is true that they would have regretted that the Cypriot pension funds who had purchased Cypriot bank bonds would have to be treated no better than the presumed Russian money launderers who held uninsured Cypriot bank accounts. However, failing to spell out the rules in advance creates unnecessary uncertainty for investors and it leads to acrimony, of which the primary beneficiaries are lawyers. Allowing different countries to treat uninsured depositors differently is bad for competition.

[21] Not surprisingly, banks have been creative in getting around deposit insurance thresholds. In the United States, banks can use sweep accounts and services that break up large deposits and distribute them among other cooperating banks so as to retain insurance coverage. One such service, the Promontory Financial Croups is said to be able to spread USD 50 million over a network of 2,500 banks. This is more difficult in EU countries such as the United Kingdom that do not have a large number of independent banks.

In an important step toward a single bank resolution regime, on 27 June the Council announced an agreement on the pecking order for bailing in the creditors of failed financial institutions. The deposits of natural persons and of micro and small and medium-sized enterprises are to have preference over the claims of ordinary unsecured, non-preferred creditors and large corporate depositors. National authorities are to retain some flexibility.[22]

[22] European Council Conclusions EUCO 104/2/13 (2013) http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/137634.pdf.

REFERENCES

- Council of the European Union, "Council agrees position on bank resolution," Brussels, 27 June 2013, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf
- Demergüç-Kunt, Asli and Enrica Detragiache, "Does Deposit Insurance Increase Banking Stability? An Empirical Investigation," *Journal of Monetary Economics* 49, 2002, 1373-1406.
- EFTA Court, E-16/11 EFTA Surveillance Authority v Iceland, Luxembourg, 8 April 2013. http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf.
- International Monetary Fund, Cyprus: 2011 Article IV Consultation – Staff Report, Washington, DC, IMF, November 2011.
- International Monetary Fund, "Deposit Insurance", Technical Note, March 2013, http://www.imf.org/external/pubs/ft/scr/2013/cr1366.pdf.
- Ledyaeva, Svetlana, Päivi Karhunen and John Whalley, "Cyprus, corruption, money laundering and Russian round-trip investment," www.voxeu.org, 17 Jun 2013.
- Pirker, Benedict (2013), "Case E-16/11 ESA/Iceland: It might be called a life jacket but it doesn't mean it's built for emergencies", European Law Blog, 30 January 2013.
- Pollack, Alex J., "Deposits Guaranteed up to $250,000 – Maybe," *Wall Street Journal*, 28 May 2013.
- Young, Emily, "Russian money in Cyprus: Why is there so much," BBC, 18 Mar 2013, http://www.bbc.co.uk/news/business-21831943