



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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## Common Deposit Guarantee Schemes

Monetary Dialogue  
July 2013

COMPILATION OF NOTES





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

# **Banking Union: Common Deposit Guarantee Schemes**

**Monetary Dialogue 8 July 2013**

**COMPILATION OF NOTES**

## **Abstract**

A Common Deposit Guarantee Schemes was at the beginning of the discussion of the Banking Union conceived as one of the main pillars. The notes in this compilation examine options for a possible future design of a Common Deposit Guarantee Scheme in more detail.

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

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## **CONTENTS**

<b>INTRODUCTION</b>	<b>4</b>
<b>1. Principles for European Deposit Guarantee Schemes by Daniel GROS</b>	<b>5</b>
<b>2. Deposit Guarantee Schemes by Anne SIBERT</b>	<b>21</b>
<b>3. A European Deposit Guarantee Scheme? by Charles WYPLOSZ</b>	<b>33</b>
<b>4. Deposit Guarantee Schemes by Sylvester C. W. EIJJFINGER</b>	<b>43</b>

## INTRODUCTION

Deposit Guarantee Schemes (DGS) are commonly recognised as one major pillar of the Banking Union project. However, there is a debate about the nature and extent of the DGS, i.e. whether harmonised national schemes are sufficient or if a common European Deposit Guarantee Scheme is necessary.<sup>1</sup> The Commission has envisaged a '*common deposit insurance*' in its first outline of the Banking Union framework.<sup>2</sup> The Vice-President of the ECB outlined in January 2013 a gradual approach: '*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 [Single Resolution Mechanism] SRM. A **European deposit guarantee scheme is therefore not essential in the short term**.*<sup>3</sup> The **IMF** acknowledged in a technical note on Deposit Insurance, that '*[h]armonization of deposit guarantee schemes across the EU is important to support financial integration and the functioning of the internal market*' and further recommended that '*[i]n the context of the banking union, steps should be taken toward a common funding of deposit insurance*<sup>4</sup>.

In particular, the Cyprus crisis brought the topic of DGS back on the agenda. The crisis underlined the link between DGS and bank resolution, i.e. bail-in of creditors.<sup>5</sup> The discussion in this respect evolves around '*deposit preference*', meaning that deposits are usually last in the '*cascade*' of bail-in able debt instruments in case of resolution in Member States. More recently, the President of the Euro Group and Commissioner Mr Rehn underlined the need for common deposit guarantees in order to complete the Banking Union.<sup>6</sup>

Discuss the issue of DGS in the context of the Banking Union. Please consider also the following:

- Harmonised national DGS (taking into account the Commission proposal COM(2010)368) vs. a common European DGS
- Interactions to bank recovery and resolution proposals, e.g. bail-in requirements
- Possible role of Central Banks (either as supervisor or monetary policy authority) in deposit guarantee issues

<sup>1</sup> Whereas at the beginning of the banking union debate in relation to deposit guarantee schemes the word '*common*' was used, later reports preferred the word '*harmonised*'. For the first, see European Council, Towards A genuine Economic and monetary Union, EUCO 120/12, Brussels, 26 June 2012; [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/131201.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf); or Commission Communication, A Roadmap towards a Banking Union, COM(2012)510 final, Brussels, 12.9.2012; [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-510\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf). For the latter see: [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/134069.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf); or [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/11/pdf/blueprint\\_en.pdf](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf).

<sup>2</sup> [http://ec.europa.eu/commission\\_2010-2014/president/news/archives/2012/06/20120626\\_speeches\\_2\\_en.htm](http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/06/20120626_speeches_2_en.htm).

<sup>3</sup> Speech by Vítor 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>.

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

<sup>5</sup> Mr Asmussen stressed in its introductory statement to the exchange of views with the Economic and Monetary Affairs Committee on the financial assistance to Cyprus on 8 May 2013: '*[...] the new framework should place depositors at the top of the creditor hierarchy and ensure that the role of DGS in resolution is limited to insuring eligible depositors. This will contribute to reducing the risks to financial stability by providing legal certainty and predictability to resolution.*'

<sup>6</sup> Taken from Bloomberg, 7 May 2013; <http://www.bloomberg.com/news/2013-05-07/dijsselbloem-says-eu-needs-common-deposit-backstop-in-long-run.html>.



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

# **Principles for European Deposit Guarantee Schemes**

**Daniel GROS**

## **NOTE**

### **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.

## **CONTENTS**

<b>LIST OF ABBREVIATIONS</b>	<b>7</b>
<b>EXECUTIVE SUMMARY</b>	<b>8</b>
<b>INTRODUCTION</b>	<b>9</b>
<b>1. MICROECONOMIC ASPECTS: SOME BASICS</b>	<b>11</b>
<b>2. MACROECONOMIC OR SYSTEMIC ASPECTS: TRANQUIL VERSUS TURBULENT TIMES</b>	<b>14</b>
<b>3. A CONCRETE PROPOSAL</b>	<b>16</b>
<b>4. CONCLUSION</b>	<b>18</b>
<b>REFERENCES</b>	<b>19</b>

## LIST OF ABBREVIATIONS

<b>BaFin</b>	Bundesanstalt fuer Finanzdienstleistungen
<b>DGS</b>	Deposit Guarantee Scheme
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>ELA</b>	Emergency Liquidity Assistance
<b>EReIF</b>	European Reinsurance Fund
<b>ESBG</b>	European Savings Banks Group
<b>ESM</b>	European Stability Mechanism
<b>FDIC</b>	(US) Federal Deposit Insurance Corporation
<b>FSA</b>	Financial Supervisory Authority
<b>GC</b>	Governing Council (of the ECB)
<b>GIIPS</b>	Greece, Ireland, Italy, Portugal and Spain
<b>GSE</b>	Government-sponsored enterprises
<b>MREL</b>	Minimum Requirements Eligible Liabilities
<b>NCB</b>	National Central Bank
<b>SB</b>	Supervisory Board
<b>SRM</b>	Single Resolution Mechanism
<b>SSM</b>	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]<sup>1</sup> 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<sup>2</sup>) 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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<sup>1</sup> COM(2010)368 final; <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0368:FIN:EN:PDF>.

<sup>2</sup> Council of the European Union, Council agrees position on bank resolution, 11228/13, PRESSE 270, 27 June 2013, Brussels; [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/137627.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/137627.pdf).

## 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<sup>3</sup> 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.<sup>4</sup> However, it remains to be seen whether Member States will actually impose sufficiently tough MREs 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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<sup>3</sup> 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.

<sup>4</sup> 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.'*<sup>5</sup>

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.

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<sup>5</sup> Speech by Vítor Constâncio, Vice-President of the ECB, on the Establishment of the Single Supervisory Mechanism; the first pillar of the Banking Union, 11th Annual European Financial Service Conference, Brussels, 31 January 2013 (<http://www.ecb.int/press/key/date/2013/html/sp130131.en.html>).

## 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<sup>6</sup>).

### ***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:

- **(C)**apital adequacy
- **(A)**ssets
- **(M)**anagement Capability
- **(E)**arnings
- **(L)**iquidity (also called asset liability management)
- **(S)**ensitivity (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.

<sup>6</sup> More on the CAMELS approach can be found on the FDIC webpage: <http://www.fdic.gov/deposit/insurance/assessments/risk.html>.

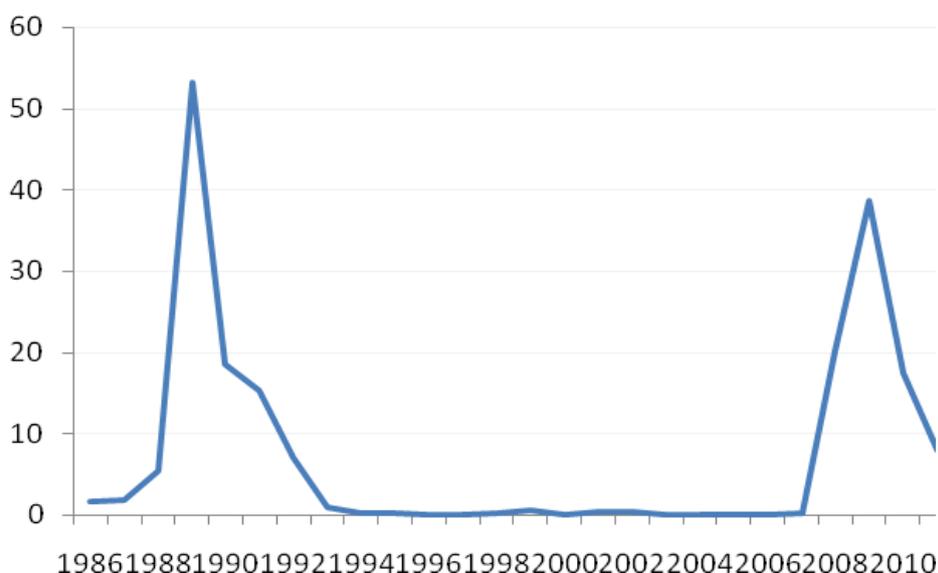
A first basic reform in the area of deposit guarantee that is needed in Europe is thus to just apply some simple basic principles. From an economic point of view, the key aspect of any EU-wide regulation of deposit insurance would thus be the proper supervision and even more importantly the proper pricing 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<sup>7</sup> 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 (USD billion)**



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

<sup>7</sup> 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?<sup>8</sup> 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 USD 40 billion, or about 30 % of the state's GDP. The losses for the FDIC in these rescue/restructuring operations amounted to about USD 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 USD 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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<sup>8</sup> 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'.<sup>9</sup> 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 stabilise 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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<sup>9</sup> 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 EUR 1,000 thousand billion, backed up by about EUR 7,000 billion in assets (equivalent to EUR 2,800 billion in terms of Risk-Weighted-Assets). As long as depositors are/remain 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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**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
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# **DEPOSIT GUARANTEE SCHEMES**

**Anne SIBERT**

## **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.

## **CONTENTS**

<b>EXECUTIVE SUMMARY AND INTRODUCTION</b>	<b>23</b>
<b>1. DEPOSIT GUARANTEE SCHEMES IN THE EU</b>	<b>24</b>
1.1. Deposit Guarantee Schemes after the EFTA Court Ruling	24
1.2. Depositor Protection after Cyprus	25
<b>2. DOES IT MATTER THAT DEPOSIT GUARANTEE SCHEMES ARE NOT HARMONISED?</b>	<b>26</b>
2.1. Deposit guarantee schemes and economic integration	26
2.2. Deposit guarantee schemes and financial stability	27
2.3. Deposit guarantee schemes and consumer protection	27
2.4. Harmonisation might deter beggar-thy-neighbour policies	28
<b>3. THE PROBLEM OF UNSECURED DEPOSITORS</b>	<b>29</b>
<b>REFERENCES</b>	<b>31</b>

## 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.<sup>1</sup> 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.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> Finally, the Court ruled that it was permissible for Iceland to treat depositors at home differently than depositors in foreign branches.<sup>8</sup>

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

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<sup>1</sup> 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.

<sup>2</sup> EFTA Court (2013), paragraph 76.

<sup>3</sup> 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.

<sup>4</sup> EFTA Court (2013), paragraph 126.

<sup>5</sup> EFTA Court (2013), paragraph 158.

<sup>6</sup> EFTA Court (2013), paragraph 164.

<sup>7</sup> EFTA Court (2013), paragraphs 150 – 151.

<sup>8</sup> EFTA Court (2013), paragraphs 218-227.

same question to be put to the EFTA and EU courts with different outcomes.<sup>9</sup> 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.<sup>10</sup> 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.*'<sup>11</sup> 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.<sup>12</sup>

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.<sup>13</sup> Moreover, there was a widespread suspicion that the Russian investment in Cyprus was driven by corruption-linked money laundering.<sup>14</sup> 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.

<sup>9</sup> See Pirker (2013).

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

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

<sup>12</sup> 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).

<sup>13</sup> Reported in Young (2013).

<sup>14</sup> See Ledyeva 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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> 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.<sup>18</sup> 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.

<sup>15</sup> IMF (2013).

<sup>16</sup> Calculated using 2012 per capita GDP from the IMF World Economic Outlook database.

<sup>17</sup> 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.

<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup> 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.

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<sup>19</sup> 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).

<sup>20</sup> 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.<sup>21</sup>

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.

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<sup>21</sup> 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 Groups 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.<sup>22</sup>

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

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**NOTES**



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

# **A European Deposit Guarantee Scheme?**

**Charles WYPLOSZ**

## **NOTE**

### **Abstract**

Deposit Guarantee Schemes are an inherent necessity for modern banking systems, because banks cannot survive a run, when all customers simultaneously attempt to withdraw their deposits. Such schemes work because they credibly reassure depositors. This requires immediate access to potentially considerable resources, which only a central bank can provide at crisis times. In the euro area, this means that the ECB must lie at the heart of deposit guarantees. This in turn creates the need to adopt clear rules of engagement, including sharing rules to meet potential residual costs or profits. On the other hand, there is no need for a common fund.

## **CONTENTS**

<b>EXECUTIVE SUMMARY</b>	<b>35</b>
<b>INTRODUCTION</b>	<b>36</b>
<b>1. WHY DO WE NEED BANK DEPOSIT GUARANTEES?</b>	<b>37</b>
<b>2. WHAT IS SPECIAL IN THE EURO AREA?</b>	<b>38</b>
2.1. The ECB must have real time and complete information	38
2.2. The ECB must be protected	38
2.3. The ECB must be reassured	39
<b>3. THE FUNDING ISSUE</b>	<b>40</b>
<b>4. CONCLUSION: COMMON OR HARMONISED?</b>	<b>42</b>

## EXECUTIVE SUMMARY

Banks are inherently fragile. Because they operate maturity transformation – borrowing very short in the form of freely withdrawal deposits by their customers – they never have enough cash to pay back all deposits simultaneously. They are open to the '*multiple equilibria*' phenomenon. When trusted by their customers, they only need very little cash at hand. However, if customers wrongly fear for their deposits, they collapse as they cannot satisfy massive withdrawals. The purpose of a Deposit Guarantee Scheme (DGS) is to make massive panic withdrawals pointless. Credible DGSs in effect eliminate the bad equilibrium.

DGSs exist in a very large number of countries. To be credible, they must have immediate access to resources large enough to rapidly reimburse all depositors who want to withdraw their monies. What are those resources? In some countries, some funds have been established but they are always too small to match all guaranteed deposits. In the event of a full-fledged banking crisis, the government must instantly mobilise massive amounts that can reach 50 % to 100 % of GDP in the worst cases. This is why the ultimate guarantor can only be the central bank, which has the possibility of creating unlimited amounts of money on behalf of the government.

In the euro area, it is the ECB that can act as lender of last resort. In order to be able to fulfil this function, the ECB needs a number of guarantees. First, it must have real-time and accurate information of the situation of all banks, hence the need for a single supervisor. Second, it must be reassured that the resources that it provides will be used wisely, protecting depositors and not banks with a view of shielding taxpayers. This calls for an independent resolution authority. Third, because its interventions can be costly, an arrangement must work out to cover possible losses.

On the other hand, a common DGS does not require a common fund. The reason is that a fund of adequate size would reach more, possibly significantly more than 50 % of GDP. Anything less would be insufficient in the face of a generalised banking crisis. It is not necessary either once the way is cleared for the ECB to be able to act as lender in last resort.

A common DGS would involve a formal commitment by the ECB to honour the guarantee in the event of a bank failure. This, in and by itself, is enough to stem bank runs. The more complex question is how to deal with a bank failure, an event bound to occasionally occur. As lender of last resort, the ECB will be necessarily involved, through the DSG and possibly the resolution of the bank. This is why DSG and bank resolution are intimately related. While a well-managed resolution does not have to ultimately involve costs, and can even be profitable, the issue of who will bear the losses, or share in the profits, must be dealt with *ex ante*.

## INTRODUCTION

A '*banking union*' is essential to the stability – and possibly the survival – of the euro area but there is much confusion about what it entails. Most academics agree that the following elements are necessary:

- common regulation of banks
- a single supervision authority for all banks
- a single resolution authority

There is some debate about the need for a common resolution fund.

While we are a long way from all these elements to be agreed upon and implemented, it is natural to ask whether bank deposit guarantee schemes should also be harmonised and commonly funded. The experience during the months that followed the collapse of Lehman Brothers has shown the need for *some* harmonisation. Indeed when Ireland faced the premises of its banking crisis, the authorities promptly moved to guarantee all deposits. The measure soon led to a migration of deposits, which prompted some other countries to adopt explicit or implicit full deposit guarantees. The message is clear: the scope for regulatory arbitrage is potentially strong in the area of deposit insurance. This has led the Commission to propose in 2010 that deposits guarantee be fully harmonised, a step that has been only partially taken so far. Within the existing regulatory regime, the EU countries have agreed that bank deposits up to EUR 100,000 shall be guaranteed.

In addition, at present, the guarantee is a national undertaking, which could imply that it is backed nationally by each government. This is perfectly consistent with the fact that, so far, national authorities have carried out bank supervision and resolution. Indeed, the potential costs of deposit guarantee payouts can only be charged to the entities that set and enforce the scheme. When and if a single supervisory authority emerges, national authorities should not be liable to costs that result from actions (bank supervision) that they no longer undertake.

Thus the euro area will have to move to some a common Deposit Guarantee Scheme (DGS). Yet, a number of misconceptions must be cleared and the links with the needed resolution authority clarified. This note starts by recalling the purpose of deposit guarantees. It then argues that the need for more harmonisation in the euro area is mostly predicated upon the much under-discussed role of the ECB as lender of last resort. This observation naturally leads to the poorly understood question of funding.

## 1. WHY DO WE NEED BANK DEPOSIT GUARANTEES?

DGSs fulfil an essential objective: they reduce the odds of bank runs when depositors rightly or wrongly worry about the health of their bank. Panic runs have been ubiquitous in banking history. When they occur, banks invariably fail because fractional reserve banking implies that a bank never has enough cash - or cashable assets - to match deposits. In fact, the economic function of banks is to operate maturity transformation - borrowing very short in the form of freely withdrawable deposits by their customers - while offering loans of variable maturities, some of them extending to 20 years or more. A bank is a bank if it never has access to enough cash to pay back all deposits simultaneously. This is why banks are inherently fragile.

Banks fragility is extreme because banks are subject to the '*multiple equilibria*' phenomenon. Consider a perfectly healthy bank. As long as its customers rightly believe that their deposits can be paid back, they will not withdraw more than customary cash, which the bank is set to routinely pay back through the holding of reserves, i.e. deposits at the central bank that can be instantly transformed in cash. This is the good equilibrium. The bad equilibrium occurs when customers wrongly fear for their deposits. As the rumour spreads, they all proceed to claim their deposits, which the bank cannot meet. The bank fails and deposits are indeed lost to a self-fulfilling prophecy.

If deposits are fully guaranteed by some authority, depositors have no reason to worry since they know that they will be paid back if the bank fails. As a result, they have no reason to run on their banks and the bad equilibrium does not occur. Even if the bank goes bankrupt for other reasons, depositors need not withdraw their deposits if they have faith in the DGS. Preventing bank runs is the *raison d'être* of DGSs.

In practice, however, DGSs do not offer a blanket guarantee. The reason is moral hazard. If depositors are completely reassured, they have no reason to monitor their banks and banks are then tempted to take excessive risks in search for higher profits. They can even attract more depositors by using high profits to offer attractive conditions. High profits and generous conditions are justified by the risks being taken, which is acceptable as long as depositors are correctly informed that they may suffer losses, possibly very large losses. Most depositors are unable to monitor their banks, because they are not technically equipped to do so, or they have no access to the relevant information, or they are not able to dedicate the time required to analyse the information. Obviously, most small depositors are in this situation.

This is why monitoring banks is primarily the task of supervisors. When they detect excessive risks, supervisors issue warnings but this action may fail to elicit adequate corrective action from a bank. Closing down the bank, or withdrawing its licence, is an extreme action that supervisors only take if they are sure that the bank is unsafe, but full certainty is rarely reachable. This is why it is a good idea to combine supervision with incentives for large depositors to be constantly careful. A warning by the supervisor will lead large depositors to withdraw part of their monies and thus exercise adequate pressure on a bank reluctant to heed the supervisor's suggestions. The small depositors, whose deposits are fully guaranteed, need not be concerned, nor even aware of the situation. Partial DGS, e.g. the EUR 100,000 guarantee agreed upon in the EU, thus represents an acceptable trade-off between stabilising banks and providing them with incentives to act prudently.

## 2. WHAT IS SPECIAL IN THE EURO AREA?

In order to be credible, a DGS must have access to sufficient resources to effectively pay back all guaranteed deposits, and to do it fast. Indeed, the scheme loses its effectiveness if depositors are not fully convinced that they will be able to cash in whatever they wish without delay. In many EU countries, bank deposits amount to about 100 % of GDP and covered deposits range from 50 % to 100 % of GDP.<sup>1</sup> Full credibility is achieved if depositors are reassured that all of their guaranteed deposits are effectively protected. Banking crises erupt abruptly and are often contagious. They are abrupt because it is inherent to bank runs; they are contagious because of the self-fulfilling prophecy nature of bank runs. This means that, to be credible and therefore effective, a DGS must have immediate access to amounts of this order of magnitude. How can this be achieved?

One solution is for the DGS to accumulate adequate reserves (ex-ante funding). Obviously, a fund of 50 % of GDP, or more, is beyond reach (this is of the same order of magnitude as current public debts). Smaller funds can handle occasional failures of small banks or isolated shortages of large banks. More serious events, however, will never be dealt with pre-accumulated funds. This is why a credible DGS, of the kind required to **deal with a systemic banking crisis**, must have access to emergency central bank financing. Indeed a central bank is the only source of large emergency funding. This is the meaning of lending of last resort, a function of any central bank.

The fact that the central bank is an essential component of a DGS immediately alerts us to the fact that the euro area is special. The fundamental need for a DGS means that the ECB is the lender of last resort for each and every euro area Member State. This simple observation carries far-reaching implications.

### 2.1. The ECB must have real time and complete information

In order to commit potentially large resources, the ECB must be able to evaluate the situation of the bank(s) in crisis. In particular, it needs to assess the viability of the bank and the amounts that need to be injected and in what form. Obviously, banks are complex undertakings and such judgements require intimate knowledge of the banks in question. On the other side, bank crises need to be dealt within a matter of days, possibly even hours (e.g. before the end of the next weekend). This can only be done if the parties involved, including the ECB, have already analysed the situation of every single bank. In effect, a bank crisis should never catch the central bank by surprise. This is the key reason why the ECB must be the single supervisor, and the supervisor of all banks in contrast with the currently agreed-upon arrangement.<sup>2</sup>

### 2.2. The ECB must be protected

Emergency injection of resources does not necessarily imply that there will be losses, but losses are a possibility. Such losses are properly understood as a transfer from taxpayers to either the banks or their creditors, including the depositors. In a democracy, such transfers can only be decided and arranged by elected officials who are accountable to their taxpayers. This means that the eventual losses must not be borne by the ECB, nor should

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<sup>1</sup> See IMF Country Report No.13/66, Deposit Insurance, Technical Note, March 2013, <http://www.imf.org/external/pubs/ft/scr/2013/cr1366.pdf>.

<sup>2</sup> This point was made clear during the crisis of Northern Rock in the UK. Even though the Bank of England and the Financial Services Authority were supposed to share information, the Bank of England was caught off guard and its initial reaction not to intervene was a clear mistake. One can argue that a well-informed Bank of England would have reacted differently. The lesson has been learned and the Bank is now the key supervisor.

the decision on how to structure the emergency assistance be left to the ECB alone. The ECB must be protected from the unavoidable political fallout of its actions.

The central bank is the arm that provides resources but it is understood – and often formally agreed – that any loss will be borne by the Treasury. Within the euro area, the Treaties also stipulate that any cost of a bank rescue will be borne by the country of origin of the bank. The situation is doubly complicated.

First, the issue of who is responsible for the bank failure immediately emerges. Obviously, the supervisor's responsibility cannot be ignored. The fact that the ECB will be the single supervisor, fully justified as argued above, creates a serious difficulty. The bank's home Member State, which will always be able to claim that the crisis is a failure of the supranational ECB, will naturally object to bearing the costs. Unless it is fully reassured that it is protected from such a situation, the ECB will be reluctant to undertake the lender in last resort function and the DGS will lose all credibility. Bank runs will not be eliminated.

Second, overtime the situation will become more complicated as more banks operate in many countries. Although a bank is incorporated in one country, its losses may emerge in a subsidiary or a branch located in another country. This will create further ambiguity and it stands to undermine the DGS.

In the end, any residual cost must be borne not by the ECB but by some political authority. How to structure the corresponding payments, and how to apportion possible profits, is a complicated issue. It must rest on commonly agreed sharing rules based on transparent criteria. It can be a common undertaking of all euro area Member States or it can be devolved to specially created bank resolution authority or to a dedicated fund.

### **2.3. The ECB must be reassured**

As noted above, an emergency intervention may result in losses. This does not need to be the case. Much experience has been gained in recent years on how to structure these interventions in a way that protects the taxpayers. For example, in both the US and Switzerland, the interventions have turned to be profitable. The principle is to inflict the first losses on the bank, meaning its shareholders and unsecured creditors but excluding insured deposits, and to make sure that the first profits accrue to the taxpayers. The outcome will depend on how the bank recovers, which is the reason why the DGS authority and the central bank must have real-time, complete and accurate knowledge of the bank situation. In some cases, it will turn out that the bank is irremediably insolvent and it will have to be closed down, or resolved as it is called. Here again, there are many ways of resolving a failed bank, some of which may entail large losses to the taxpayer while others may protect the taxpayer. As before, there are deep issues of income redistribution, with serious political implications.

This is why the central bank must be reassured that resolution will be conducted in a way that does not tilt the stakes in favour of bank shareholders and/or unsecured depositors. The experience is that the political authorities are occasionally partial to the bank interests. This is one reason why the euro area needs a single resolution authority independent of the ECB and of unquestioned integrity, which means an arm's length relationship with national (and other European) authorities.

### 3. THE FUNDING ISSUE

Currently, some countries have already established an **ex-ante** funding scheme, others have not.<sup>3</sup> Schemes are funded by a levy of all banks, in some case weighting individual bank assessed riskiness.

The Commission Proposal for a Directive on Deposit Guarantee Schemes (COM(2010)368 final), which is currently in the legislative procedure, foresees the gradually built up of a fund from bank contributions which should reach a pre-funding of 1.5 % of guaranteed deposits within 10 years. This means that the fund would not have an ex-ante significant size for years to come and that, after 10 years, it could only deal with **occasional individual bank runs**. Meanwhile and for systemic banks crises, the funding problem would remain unsolved. Implicitly, therefore, the ECB would have to be involved in many plausible situations. Because this role remains implicit, the proposed DGS will lack credibility and the ECB will not have any of the guarantees listed in Section 2.

There are discussions about establishing a European fund that would be used for financing a common DGS. The reasoning is that the fund would solve several of the requirements listed above:

- It would match the collective nature of the SSM and a contemplated common DGS.
- It would avoid the delicate issue of assigning eventual costs according to the nationality of the rescued bank.
- It would create an access to a larger fund than is available through national funds.
- Charging the banks for insurance premia would reduce moral hazard (which national funds can also achieve).

Unfortunately, the essential requirement, that the DGS has access to resources sufficient to match any contingency would also not be met.

One answer could be larger capital requirements, as stipulated in the Basel III agreement. A higher loss absorbing capacity, so goes the argument, would allow a bank to face significant losses and thus remain solvent. The argument misses the fact that the main purpose of a DGS is *not* to protect a bank from insolvency but to make bank runs impossible, even in the case the bank is solvent. Repeating the point made in Section 1 above, a bank run destroys a bank independently of whether it is solvent or not. A bank run does not relate to bank solvency but to fears that may well be unjustified. There is no amount of capital large enough to stem a bank run.

It follows that the euro area does not need a common fund to establish a common DGS. A fund stands to make matters worse by not foreseeing the crucial role of the ECB in the event of a **generalised bank crisis**. A fitting example is the Irish crisis that saw the government injecting more than 30 % of its GDP. This intervention – certainly badly designed, largely under pressure from other countries – pushed Ireland into a public debt crisis even though its governments had been remarkably fiscally disciplined before the crisis. Adding this amount and the EUR 40 billion support to Spanish banks, the total amount reaches 1.2 % of euro area GDP. Further adding EUR 80 billion injected in 2008 by Germany and EUR 10 billion by France, the amount mobilised during the crisis reaches 2.1 % of GDP. In none of these cases a bank run occurred because national DGSs were in place, some of which offered a blanket guarantee. Somehow, national DGSs were credible

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<sup>3</sup> For an overview see Table 1. EU: Characteristics of EU Deposit Guarantee Schemes, 2012, in IMF Country Report No.13/66, Deposit Insurance, Technical Note, March 2013, <http://www.imf.org/external/pubs/ft/scr/2013/cr1366.pdf>.

and, yet, there was no commensurate fund available. Had a run happened, it is unclear whether the governments would have had the means to disburse the promised funds.<sup>4</sup>

Finally, one argument against the setting up of a fund must be dispelled. It is sometimes claimed that a bank-financed fund would harm the industry's competitiveness if some countries refuse to join and do not build up their own fund. This is either a misunderstanding of the role of insurance or an admission that the fund is useless. For those who believe that the fund is needed to provide an effective guarantee, its cost should be seen as an insurance premium. One way or another, these costs are bound to be borne by bank depositors, hence the fear of a loss of competitiveness. But depositors benefit from the guarantee. Some may prefer unguaranteed deposits and migrate their banking business to other countries. This is not a loss of competitiveness, it is the provision of a particular service. Of course, if the fund is useless, the service is not worth the cost, but the argument is not competitiveness. Finally, if the costs are supported by all taxpayers, as is currently the case in some countries, we face a case of state aid.

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<sup>4</sup> Still, the question of why national DGS were credible remains. Was it belief that the ECB was ready to act as lender in last resort? Was it the lack of experience with bank crises?

## 4. CONCLUSION: COMMON OR HARMONISED?

The adoption of a euro area-wide **common DGS** is the logical implication of the single supervision mechanism agreed upon (but this mechanism must be applied to all banks). Along with a single resolution authority, it is a **mandatory component of a banking union**.

In the wake of the 2008-2009 crisis, the EU countries have agreed to adopt the same guarantee level, EUR 100,000 per deposit. In principle, this form of harmonisation should be adequate. Unfortunately, a DGS cannot operate without central bank acting as lender of last resort. This means that the euro area must adopt a common DGS. Given that the ultimate provision of the guarantee is collective, the guarantee must be the same and run by a euro area wide agency.

This greatly complicates the matter, of course. The lender of last resort, which alone can provide credibility to the DGS, must be protected against a number of risks inherent to any insurance scheme. The ECB must have real-time and accurate information of the situation of all banks: the SSM is a necessary bedfellow of the common DGS. The ECB must be protected against bad uses of its resources, which makes a common resolution authority necessary as well. While the execution of the guarantee and the occasional resolution of failed banks must be structured in a way such that taxpayers face no residual costs, losses are bound to occur now and then. In that case, the DGS needs a sharing rule that would apply to both residual losses and residual profits.

On the other hand, a common DGS does **not require a common fund**. The reason is not that it would unduly undermine euro area bank competitiveness, but that it is not useful. The power of a DGS is that it is credible: depositors must be reassured that under no circumstance they will lose access to their guaranteed deposits for more than a very short period of time, to be measured in days.<sup>5</sup> A fund of adequate size could be in excess of 50 % of GDP, or more. Anything less is useless. It is not necessary either once the way is cleared for the ECB to be able to act as lender in last resort.

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<sup>5</sup> This is why the first rescue plan of Cypriot banks, which included haircuts on guaranteed deposits, was a massive mistake. It is essential that the DGS provides iron-clad reassurance that there will never be any such haircut.



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

# **Deposit Guarantee Schemes**

**Sylvester C.W. EIJFFINGER**

## **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.

## **CONTENT**

<b>EXECUTIVE SUMMARY</b>	<b>45</b>
<b>1. CONTEXT</b>	<b>46</b>
<b>2. THE ONGOING HARMONISATION AND THE ROLE OF THE ECB</b>	<b>48</b>
<b>3. BAIL-IN AND DEPOSITORS</b>	<b>50</b>
<b>4. CONCLUSION</b>	<b>52</b>
<b>REFERENCES</b>	<b>53</b>

## **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.

## 1. CONTEXT

A full-fledged Banking Union consists of a few important building blocks which are related to supervision, resolution and deposit guarantee.<sup>1</sup> So far most progress has been made with respect to the Single Supervisory Mechanism (SSM).<sup>2</sup> 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;<sup>3</sup> 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.<sup>4</sup> The financial crisis renewed the debate on DGS. The minimum levels of deposit coverage and maximum payout periods were harmonised<sup>5</sup> and in 2010 the Commission proposed a reform.<sup>6</sup> This proposal is a response to the crisis situation of the last years and to the expert recommendations from the de Larosière report.<sup>7</sup> 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.'*

<sup>1</sup> 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 Coeuré, 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.

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

<sup>3</sup> 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.

<sup>4</sup> 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/quarantee/200914\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/quarantee/200914_en.pdf).

<sup>5</sup> 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>.

<sup>6</sup> 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>.

<sup>7</sup> 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](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.<sup>8</sup>

For this reason we propose a gradual approach where the European Union strives relentlessly for further harmonisation beyond the current proposal.<sup>9</sup> 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)<sup>10</sup> which would then (likely) already be established and active.<sup>11</sup>

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.

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<sup>8</sup> 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.

<sup>9</sup> COM(2010)368 final.

<sup>10</sup> 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.

<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>

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),<sup>15</sup> 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.<sup>16</sup> 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

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<sup>12</sup> See Gerhardt, M. and Lannoo, K. (2011).

<sup>13</sup> See Gerhardt, M. and Lannoo, K. (2011).

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

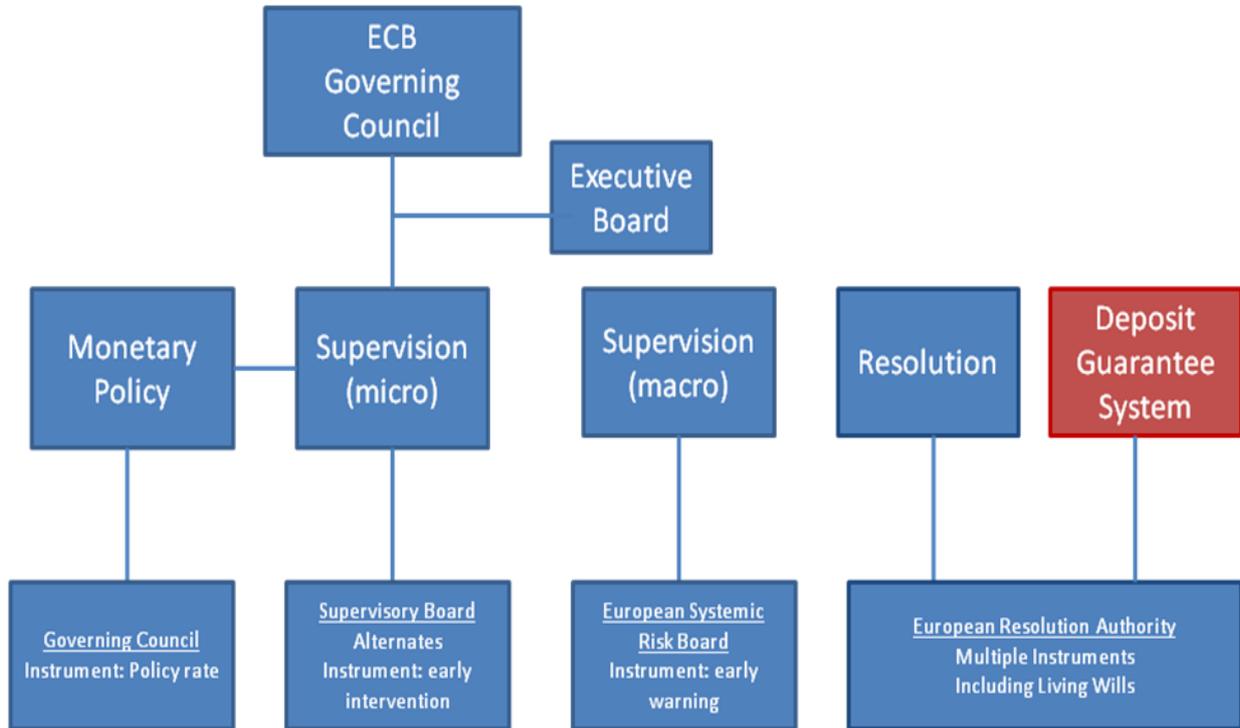
<sup>15</sup> For smaller banks resolution powers were already assigned to the FDIC, see also Schoenmaker and Gross (2012).

<sup>16</sup> However, the FDIC has also supervisory tasks and powers.

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

This distribution of tasks is summarised in Figure 1.

**Figure 1: Future Distribution of Tasks – An update**



**Source:** Author's elaboration

<sup>17</sup> 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).

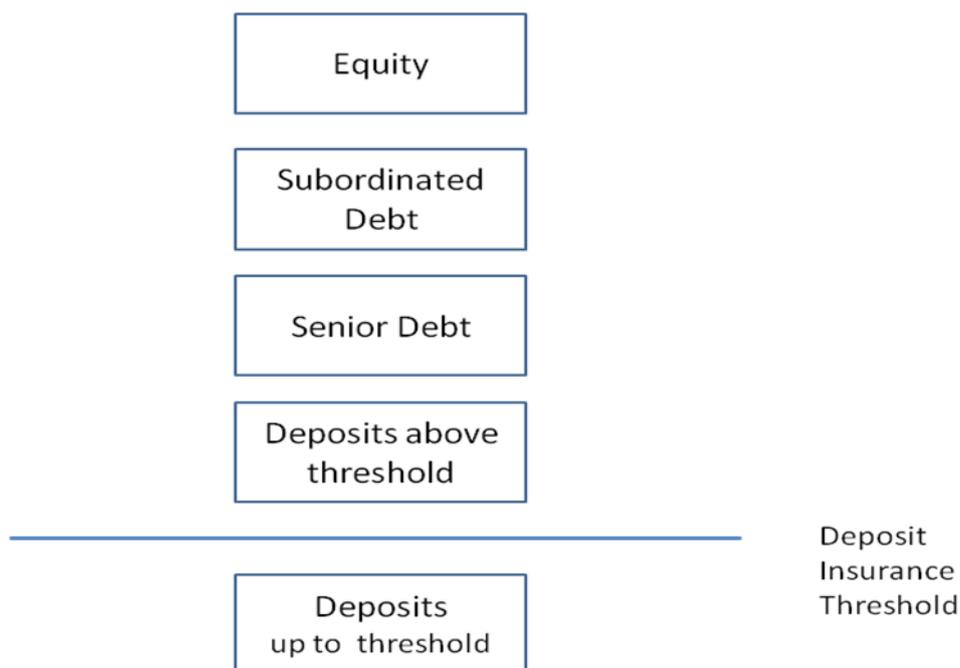
<sup>18</sup> Some discussion on the separation of the European Resolution Authority from the ECB can be found in Eijffinger (February 2013).

### 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.<sup>19</sup> As Sibert (2013) noticed,<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup>

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<sup>19</sup> 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>.

<sup>20</sup> 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>.

<sup>21</sup> 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.

<sup>22</sup> 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,<sup>23</sup> 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).<sup>24</sup>

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.

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

<sup>24</sup> European Commission, COM(2010)368 final.

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**NOTES**



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