



# Deposit guarantee reform in Europe: A systemic perspective

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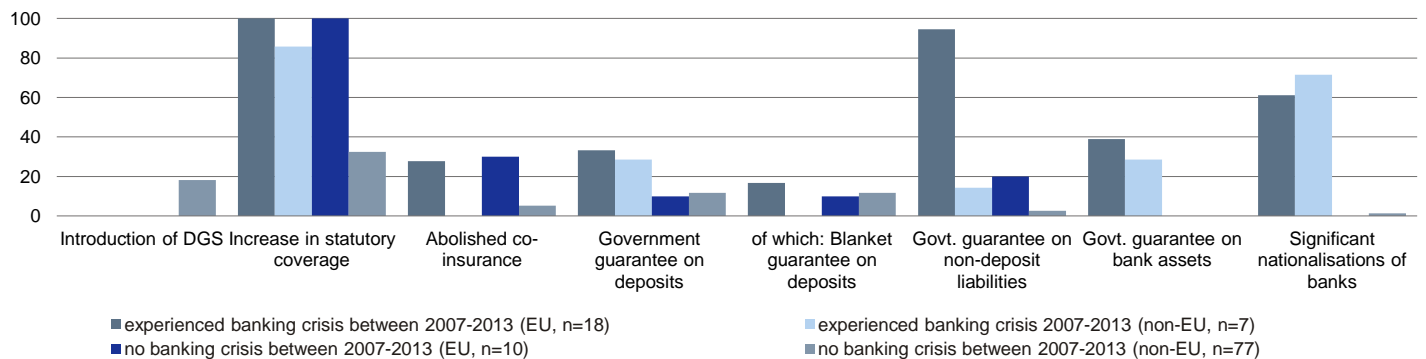
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- **Deposit guarantee schemes (DGSs) play a key role in consumer protection and financial stability.** Rules for DGSs serve three purposes: 1. define the position of DGSs as part of the financial safety net; 2. define their interaction with the other components of the safety net; and 3. ensure that they fulfil their role.
- **Crisis drives reforms:** The financial crisis has led to substantial reforms of the system of financial regulation and supervision in Europe – not limited to but including DGSs. In particular, rules for bank resolution now complement DGS arrangements.
- **Evolution, not revolution:** The new rules for DGSs further harmonise deposit insurance in Europe. Notably, structural issues such as the financing of DGSs are now “in scope” of common rules. At the same time, DGS reform follows a gradual approach, i.e. focuses on adapting existing national systems rather than replacing them.
- **Complexity is a key challenge:** Nevertheless, new rules for bank resolution and the emerging Banking Union are substantially changing the environment in which DGSs operate. The complexity of the new setup makes cooperation between the different players in the financial safety net – including DGSs – a sine qua non.

Increase in deposit protection since 2008: Financial crisis the main driver

Percentage share of countries (by group) taking respective measures



Sample based on countries with explicit DGS in 2013

Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research



## Introduction

Deposit guarantee schemes (DGSs) have two main functions that are closely intertwined: consumer protection and contributing to financial stability. They provide insurance to depositors and can thereby help to reduce the threat of bank runs. In addition, they can also facilitate bank resolution, shielding depositors from losses and in doing so making it easier to shut down banks.

Their design and function therefore play an important role both for individual market participants and the economy at large. DGSs form part of a comprehensive system to maintain and enhance financial stability and interact with the other components of the financial safety net.

### Deposit insurance: Basic rationale and trade-offs

1

Deposit insurance has become a widespread feature of countries' financial safety nets around the world. Theoretically, deposit insurance can be conducive to financial stability, helping to mitigate threats that arise from self-fulfilling depositor runs on banks. At the same time, deposit insurance can also give rise to moral hazard, weakening market discipline exercised by depositors because they are protected and inducing greater risk-taking by banks – with potential detrimental effects on stability.

The empirical literature investigating the effects of deposit insurance on financial stability stresses that the net effect depends on:

1. The institutional context in which DGSs operate – a strong institutional environment, including high-quality supervision and regulation, tends to reduce potential negative effects.
2. The specific design of DGSs, for instance their coverage, financing and organisation, which are important to determine the extent to which moral hazard issues arise and are balanced.

There remains substantial variation worldwide with respect to the design of financial safety nets including –but not limited to –deposit insurance. Historically, financial crises have often triggered the introduction of or changes to DGSs.

See for instance Folkerts-Landau/Lindgren (1998), Demirgüç-Kunt and Detragiache (2002), Demirgüç-Kunt and Huizinga (2004) and Demirgüç-Kunt, Kane, and Laeven (2008) and Demirgüç-Kunt et. al. (2014).

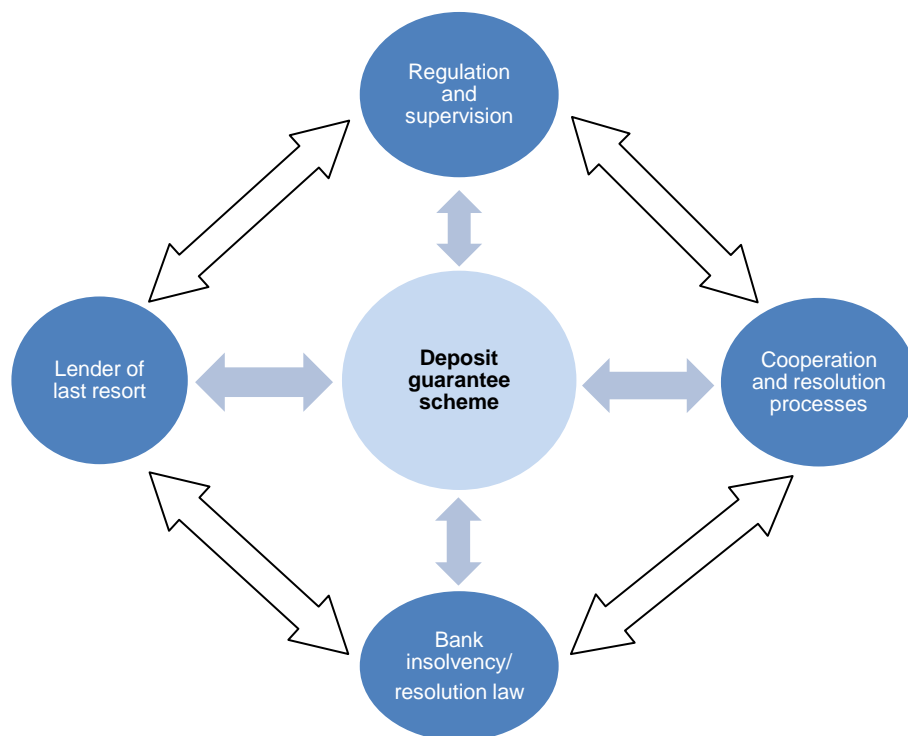
### Financial safety nets: Purpose and design

2a

Financial safety nets aim to reduce the occurrence of financial crises and limit their costs if they do occur. Typically, arrangements include strategies for bank regulation and supervision, procedures for investigating and resolving banks, lender-of-last-resort facilities, and deposit insurance systems. In addition, domestic arrangements can be complemented with provisions at the international level. See for instance Demirgüç-Kunt and Kane (2002) or Demirgüç-Kunt and Huizinga (2004).

### DGS as part of the financial safety net

2b



Source: Deutsche Bank Research building on Bernet and Walter (2009)

To that effect, rules for DGSs serve three purposes: 1. define the position of DGSs as part of the financial safety net; 2. define their interaction with the other components of the safety net; and 3. ensure that they fulfil their role. The recent reform of DGS rules in the EU is pertinent to each of these three elements.

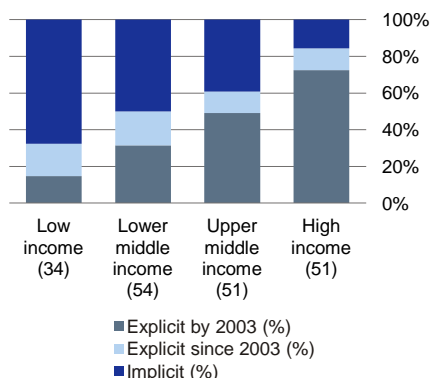


## Deposit guarantee reform in Europe

Most high-income countries have explicit schemes

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Percentage shares of explicit/implicit deposit insurance schemes by income group, 2013



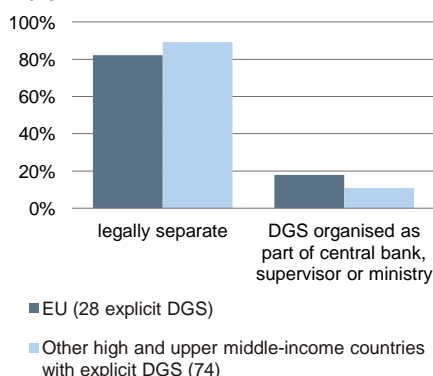
Figures in brackets refer to number of countries in each income category

Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research

Legally separate schemes most common organisation in the EU

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Shares by country group for organisation of DGS, 2013



Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research

New common provisions for DGSs were adopted in April 2014 by the European Parliament, finally published in June,<sup>1</sup> and now member states must transpose most of the new rules into national law by July 2015.<sup>2</sup>

This paper provides an assessment of the recent DGS reform in the EU. It explains key elements of the new rules for deposit insurance and analyses the changes from a systemic perspective. In doing so, it places changes to DGSs in the context of the larger set of financial market reforms in Europe, notably new rules for recovery and resolution and the emerging Banking Union, and looks at their interaction.

### DGSs design features

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While DGSs share similar functions, they differ considerably in the way they fulfil them.

#### Implicit or explicit schemes

Without formal legislation that defines depositor coverage, DGSs remain implicit, i.e. there may be political pressure for governments to provide protection in case of bank insolvency but depositors' rights are not legally fixed. All EU member states have explicit DGS systems (and these have been required by EU rules since 1994).

#### Coverage

Refers to the *type* and *amount* of deposits that are protected by the respective schemes. The choice of coverage is important with respect to incentive effects. Coverage limits are one possibility to contain moral hazard effects. Coverage can be limited by setting a maximum amount of deposits that are protected, excluding specific types of deposits or depositors or requiring coinsurance.

#### Organisation

A DGS can operate as a separate legal entity or can be organised as part of a country's supervisory structure, e.g. operating under the jurisdiction of a ministry, the central bank or other supervisory authorities. Choices for organisation can matter for the interaction of DGSs with other parts of the safety net as well as their independence and efficiency.

#### Administration

DGSs can be administered privately (e.g. by banking associations), publicly or by a combination of the two. The administration form often reflects the genesis of a DGS.

#### Participation

They can be voluntary or compulsory. Rules on participation affect the size of the insurance pool. They can also affect competition, for instance between foreign and domestic banks. Voluntary participation might be associated with inducing strong peer monitoring (Beck 2000) but can give rise to adverse selection effects with a negative impact on stability.

#### Role & responsibilities

The most basic role of DGSs is acting as a "paybox", i.e. reimbursing depositors in case of bank failure. However, many DGSs also play a role beyond payout, for instance being involved in bank resolution and restructuring.

#### Single or multiple schemes

Some countries (incl. Germany) have multiple schemes that provide deposit protection. Multiple schemes often result from the structure of the banking system and country characteristics.

#### Statutory or voluntary

There is also a difference between statutory and voluntary arrangements for deposit insurance. EU rules for DGSs are mainly concerned with rules for statutory DGSs.

Another central dimension on which DGSs vary substantially is the *financing* of the systems. DGSs can be financed ex post or ex ante, i.e. a standing fund exists. Funds can come from public, private or both sources. Typically, privately financed funds are supposed to mitigate moral hazard. Financing provisions reflect, inter alia, countries' experience with financial crises and banking system characteristics. For further information on DGS financing see also box 16 and pp.13. For a recent overview and classification of DGSs worldwide see also FSB (2012) or Demirgüç-Kunt et al. (2014).

<sup>1</sup> See OJ L 173/149 (June 12, 2014), Directive 2014/49.

<sup>2</sup> See Art. 20 of the Directive. There is a limited possibility of derogations relating to the calculation of contributions (Art. 13) and access to funds in case of repayment (Art. 8(4)) and some requirements will be gradually phased in.

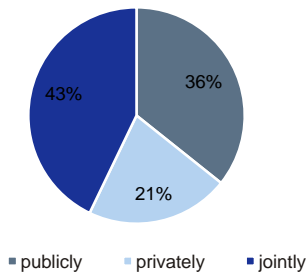


## This time *is* different: DGS reform in the EU

Administration of DGS: Mix across EU member states

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Percentage shares for administration of EU-DGS, 2013



Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research

### Minimum common requirements

Rules for DGSs in the EU aim to ensure core DGS functions, i.e. consumer protection and adding to financial stability, in the context of the single market. To this end, the directive on deposit guarantee schemes (DGSD) established a first set of common provisions for DGSs in 1994. The original DGSD contained only a basic set of common requirements, e.g. the need to establish DGSs in each member state, and defined a minimum coverage amount of EUR 20,000 (with a possibility to include coinsurance). Against this background DGSs have remained fairly heterogeneous across member states. Systems have differed for instance in organisation, administration, coverage and financing.<sup>3</sup> Also, their role in national financial safety nets has varied, sometimes being limited to payouts but partly also having a wider role, e.g. in bank resolution and contributing to monitoring within the respective system.

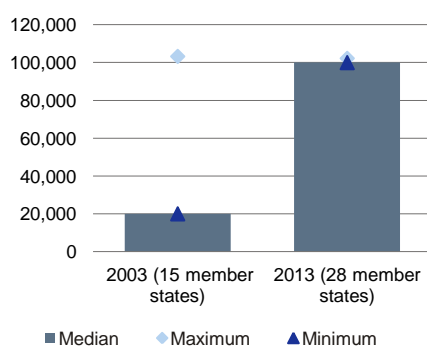
### Pressure for immediate measures

The financial crisis triggered two DGS reforms. Following increases in coverage or guarantees by several member states, and facing pressure for immediate action, the EU moved to raise coverage<sup>4</sup>, abolish coinsurance where it was in place, and cut payout periods in 2008/09. These measures aimed to instil confidence in the financial market and to prevent detrimental effects for the single market arising from differences in DGS coverage and credibility. As a result of these crisis-response measures, coverage for statutory schemes increased substantially in most member states.

Harmonised and extended coverage in the EU

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Statutory coverage limits in EUR



Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research

### Focus moves to structural reform

The second DGS reform (2010-14) differs with respect to its goals and context. Changes aim for a structural reform of DGSs and add a number of factors that were not part of common rules before – notably provisions on the financing of DGS schemes. At the same time, this reform reflects the insight that DGSs are but one component of the financial safety net and that some of the key problems exposed by the financial crisis – especially the inability to deal with systemic crises and cross-border bank failures in Europe – also require fundamental changes to the architecture of the safety net *beyond* DGSs. As a consequence, this led to the adoption of the Bank recovery and resolution directive (BRRD) and the establishment of the Banking Union.

The recent DGS reform needs to be assessed against this background – all the more since a key insight from the literature on DGSs is that their effects and effectiveness also depend on the broader institutional context.

<sup>3</sup> For recent overviews see for instance FSB (2012) or IMF (2013).

<sup>4</sup> The amount covered was raised in two steps, first to a minimum of EUR 50,000 by mid-2009 and then to EUR 100,000 by end-2010.



## Recent trends emphasise importance of well-functioning DGSs

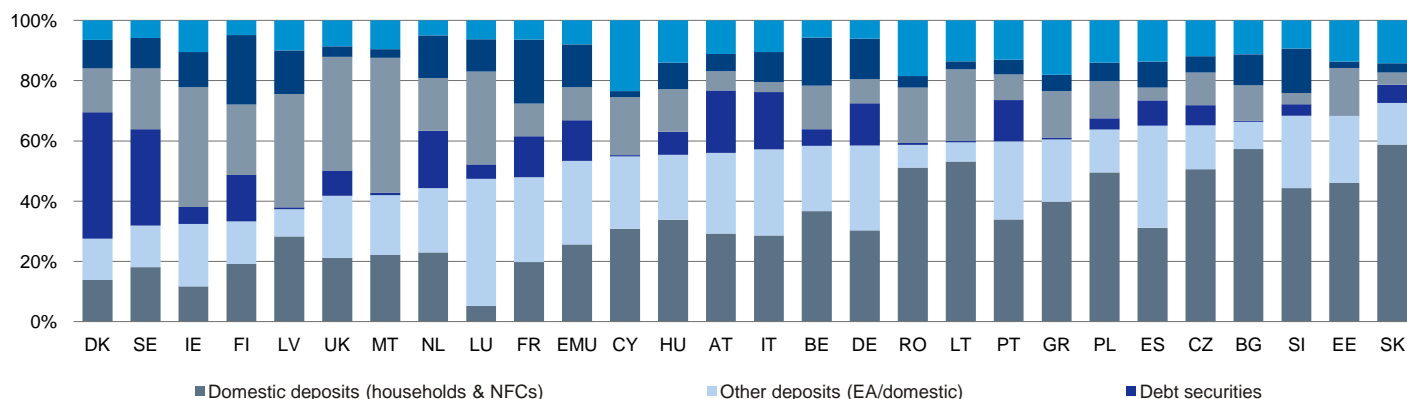
The experience of the financial crisis provides the current driver for financial market reforms including DGSs. However, empirical trends during recent years also reemphasise the importance of well-functioning DGSs.

### 1. Deposits have become more important as a source of refinancing for banks

Funding trends for European banks suggest that deposits are growing in importance.<sup>5</sup> However, European banks' reliance on deposits as a source of funding continues to vary considerably, reflecting country and bank characteristics. Overall, the share of euro-area deposits in euro-area banks' total assets has been increasing – from 51.4% in 2007 to 54.7% in 2013 (the increase has been even greater for core customer deposits, excl. interbank deposits).

European banks' liabilities

Percentage shares, Q3 2014



External: For eurozone countries - creditors domiciled outside the euroarea; for non-eurozone countries: all non-residents

Sources: ECB, Deutsche Bank Research

This reflects a mix of market and regulatory trends. Other sources of funding have become less available and/or attractive. While funding situations have differed considerably across EU markets, regulatory changes such as the introduction of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) under Basel III also induce a preference for deposit funding.<sup>6</sup>

In particular, the importance of deposits from domestic households and non-financial corporations has been increasing in all but three EU countries since 2007.

<sup>5</sup> At the same time, recent research suggests that greater reliance on deposit funding may be associated with lower bank risk (e.g. Demirgüç-Kunt/Huizinga 2009).

<sup>6</sup> See also IMF (2013a).

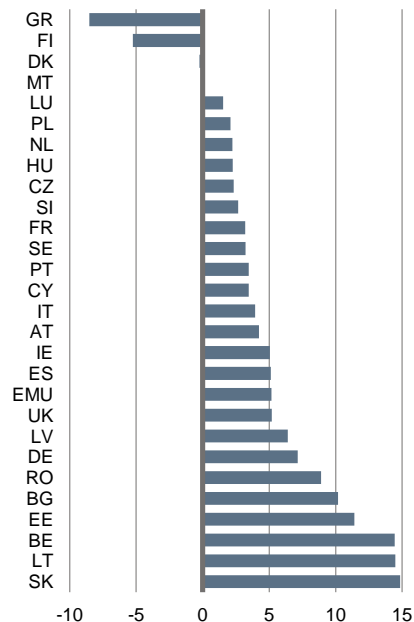


## Deposit guarantee reform in Europe

### Domestic deposits gain importance

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Change of domestic deposits (from households and NFCs) as % of banks' total assets. Q1 2007-Q1 2014, pp



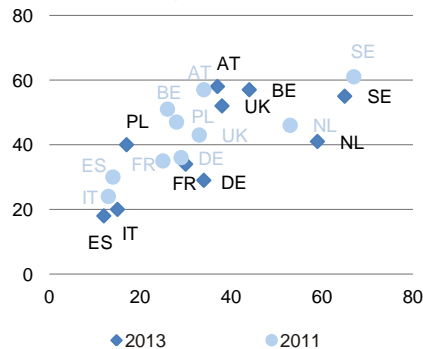
Values for Estonia refer to difference Q1 2008-Q1 2014

Sources: ECB, Deutsche Bank Research

### Trust in banks and sovereigns correlates

10a

X-axis: Trust in government; Y-axis: Trust in banks and insurance companies. Percentage of respondents stating that they "(mostly) trust"



Sources: GfK, Deutsche Bank Research

## 2. Household deposits in particular have provided stability benefits

Trends in deposit growth have been very heterogeneous during past years, reflecting a mix of different economic conditions in member states and "safe-haven" flows. Yet deposits by domestic households have remained a low-volatility liability category, emphasising their value as a stabiliser.

## 3. Households showing increased preference for sight deposits

As for deposit maturities for households, there has been a strong shift to sight deposits. The share of overnight deposits increased from almost 35% in 2008 to about 40% in Q1 2014.<sup>7</sup> To some extent this had been driven by high levels of uncertainty at the peak of the euro crisis. Moreover, it mirrors a lack of alternative investment strategies against the background of the low interest rate environment facing households as much as the other sectors of the economy.

The trends discussed reemphasise the importance of deposits as a source of refinancing for banks. They might be interpreted as moving closer to the model world of Diamond and Dybvig (1983), which make the theoretical case for the existence of deposit insurance.<sup>8</sup> In practice, household deposits are typically very stable but this is in turn also contingent on well-functioning DGSs. In addition, given market conditions in which banks are facing the challenge to regain trust and digital distribution continues to spread, the role of DGSs is arguably even more important – for banks, customers and the financial system at large.

### Trust in banks in the EU: A look across countries and recent trends

10b

Conceptually, trust in banks or financial institutions in general is not identical to trust in DGSs. At the same time, it is plausible to assume interaction between trust in banks, governments and DGSs which in turn can affect households' behaviour.

Theoretically, lower levels of trust could be associated with greater susceptibility to bank runs, particularly when combined with low levels of knowledge about and credibility of DGS arrangements.

With respect to developments in the EU, a number of patterns can be observed:

1. There is considerable heterogeneity across EU countries when it comes to trust levels, but this is not specific to banks, i.e. trust levels in different institutions and sectors typically vary, often influenced by idiosyncratic factors (e.g. historical experiences).
2. Trust in banks is correlated with other trust measures – correlation is highest for trust in banks and trust in government and the currency.
3. The past years indicate some changes at the margin of trust levels for banks. While some countries recorded small increases, the overall trend is a decline (average for 10 countries: -2.6 pp compared to 2011). Notably Spain, being severely affected by the financial crisis and euro crisis, records the largest decrease (-12 pp). Remarkably, though, the general category of big (international) corporations has seen a larger drop (-3.8 pp) for average values of trust than the category of banks and insurance companies.

<sup>7</sup> Values refer to euro area countries.

<sup>8</sup> Banks interact with households in the model and banks' liabilities are deposits. Stability risks result from the possibility of self-fulfilling depositor runs (i.e. a sudden collective withdrawal of deposits by households) and from maturity mismatches between banks' assets and liabilities.



## DGS reform assessment

DGS reform addresses both the consumer protection and financial stability functions. While the two are intertwined, a number of changes emphasise the first element. With respect to their role as part of the financial safety net, it has been redefined and complemented.

### Focus on consumer protection

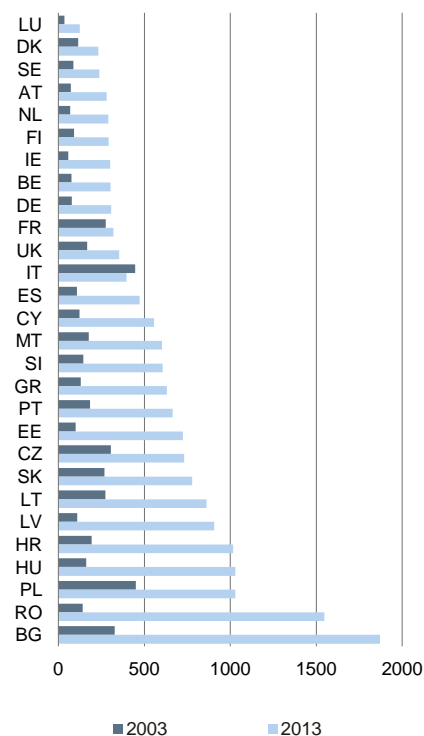
Key elements from a consumer protection perspective include:

- **Harmonisation of coverage:** The revised rules further harmonise coverage, i.e. stipulating who is entitled to deposit protection, the types of deposits covered and the amount. While the latter was already raised following concerted action in 2008, the eligibility of depositors and deposits for protection continued to differ somewhat in practice. The recast maintains the coverage limit at EUR 100,000 for statutory DGSs (fixed, per depositor, per bank); provides for higher coverage on special occasions,<sup>9</sup> and further clarifies details on scope. Both individuals and enterprises are protected by DGSs, public sector entities by contrast remain excluded but there is an option to include small local entities. Also, deposits in non-EU currencies will be covered under the new rules.

DGSs with considerable extension of coverage in Europe

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Coverage limit/GDP per capita, in %



Sources: Demirgüç-Kunt et. al (2014), Deutsche Bank Research

The coverage offered by DGSs must be designed carefully, balancing consumer protection, financial stability and market discipline. Theoretically, DGSs need to cover a sufficient number of depositors and deposits to prevent runs effectively, i.e. size and distribution of deposits in the economy should be taken into account when choosing levels of coverage.<sup>10</sup> On the one hand, for consumer protection purposes and to prevent runs, a sufficiently large number of households need to be protected. On the other, coverage should not be too wide in order to limit potential moral hazard issues.

Coverage limits in terms of GDP per capita continue to differ considerably – both worldwide and across the EU. As of end-2013, average coverage limits stood at 5.3 times per capita income for high-income and 6.3 for middle-income countries.<sup>11</sup> While the EU average is rather similar, heterogeneity across countries is pronounced. Coverage for some member states with relatively low levels of income and financial market development may appear rather high.<sup>12</sup> Also, it is worth bearing in mind that comparisons based on most recent values across countries already include prior extensions throughout past years. These were partly crisis-driven but also reflect the fact that a number of countries joined the EU and have brought their DGSs in line with common provisions since 2003.

From a financial stability perspective, both levels and changes of coverage (and potential effects thereof) matter. Recent extensions reflect the belief that depositor sensitivity might have increased as a result of the financial crisis and that households might not be best placed to exercise market discipline – after all, they have relatively high information costs for monitoring. Hence, there is a relatively high threshold covering most retail

<sup>9</sup> This concerns exemptions for specific transactions, such as buying a house, or certain lifetime events for which (temporarily) higher coverage is permitted. See Art.6.2 DGSD.

<sup>10</sup> Other factors such as historical experiences may also play a role for setting coverage as they can affect households' behaviour and susceptibility to withdrawing deposits.

<sup>11</sup> Demirgüç-Kunt et. al (2014).

<sup>12</sup> See also IMF (2013).



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deposits of ordinary households and even wider coverage for special life situations.

For consumers, a coverage level of EUR 100,000 implies that a substantial share of deposits by number of depositors is (continues to be) covered.<sup>13</sup> In addition, by now this amount marks a symbolic threshold and a reduction may have been counterproductive for households' trust in the EU financial system.<sup>14</sup> The uniform level and greater harmonisation of coverage partly reflects the idea of EU citizens having equal rights to consumer protection. However, it also reflects crisis experiences and the insight that differences in coverage can be detrimental to the single market.

To the extent that the reform has a reassuring effect on households, emphasis on the protection of EUR 100,000 across the EU might also influence consumer perceptions of placing savings with non-domestic providers – i.e., make households more confident that their deposits are also safe with banks from other EU countries – and therefore increase deposit mobility in the medium term.<sup>15</sup>

What the coverage extensions of past years do imply, though, is a stronger emphasis on measures to mitigate moral hazard via other channels. These include elements of DGS design (rules for financing!) as well as other measures such as strengthening banks' corporate governance, financial supervision, and establishing bail-in (which stresses bondholders' role in market discipline).

- **Faster payout:** The maximum repayment period will be cut from 20 to 7 working days with the reduction following a stepwise schedule.<sup>16</sup> Once deposits have been determined unavailable by the competent authority<sup>17</sup>, reimbursement shall take no longer than 15 working days as from Jan 2019, then 10 as of Jan 2021 until it reaches 7 days from Jan 2024. Also, during the transition period, DGSs shall at least pay out sufficient funds to cover costs of living if they cannot make the full amount of covered deposits available within 7 working days.

Quick access to funds is obviously valuable for households but can also help to avoid spreading uncertainty if a bank becomes insolvent. The stepwise reduction of payout time is a compromise to provide time for adapting processes, DGS infrastructure and funds to ensure that stricter timeframes can be met (after all, failure to deliver on payout could just as easily have a detrimental impact on confidence). Currently, repayment periods (and processes) continue to vary across member states. Reducing them involves both legal and practical steps. To some extent payout processes also reflect differences in insolvency regimes (IMF 2013). Greater convergence with respect to the ranking of creditors' claims and the introduction of depositor preference by the BRRD could therefore also help to facilitate faster payout. In practice, depositor payout needs an infrastructure to support reimbursement, in particular ready availability of information about customer deposits. In addition, observed past DGS

<sup>13</sup> According to Joint Research Center (JRC) estimates (2010), at a coverage level of EUR 100,000 about 95% of deposits in the EU would be fully covered (percentage share when calculating covered/eligible deposits by number). Higher thresholds would add only marginally. The share calculated by amount is typically lower because the distribution of deposits tends to be skewed, i.e. a small number of depositors often hold large amounts.

<sup>14</sup> See for instance European Commission (2010).

<sup>15</sup> This trend can be supported by technological developments facilitating deposit placement in other EU countries. See for instance Wall Street Journal Europe (Sept. 17, 2014).

<sup>16</sup> The repayment period starts after it has been determined by the competent authority that deposits are unavailable.

<sup>17</sup> The choice of authority to determine unavailability of deposits remains up to the member states, whose practices on this issue diverge.





## Deposit guarantee reform in Europe

DGSs in Germany: A case of multiple schemes

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Although Germany is not the only country with multiple DGSs in the EU (other examples are Austria and Italy), its arrangements are unique. This reflects the three-pillar structure of the German banking system. DGSs in Germany basically consist of:

- Two statutory compensation schemes: one for private commercial banks and one for public banks. They are privately run but publicly supervised (by BaFin). They provide protection for deposits up to EUR 100,000.
- Two institutional protection schemes (IPSS): one operated by savings banks and one for cooperative banks. IPSSs aim to protect the viability of their member institutions (e.g. by providing guarantees), thereby also guaranteeing deposits, but do not have arrangements for depositor reimbursement.
- Two voluntary protection funds for private commercial banks and public-sector banks. There is no coverage limit for the voluntary scheme of public-sector banks. The voluntary scheme for private banks currently offers protection (this includes sight, time and savings deposits) for each creditor up to 30% of the relevant liable capital of each bank. The ceiling will be reduced over the next ten years (until Dec. 31, 2014: 30%, until Dec 31, 2019: 20%, until Dec 31, 2024: 15%, as of Jan 1 2025: 8.75%). The adjusted ceilings will apply to deposits set up or renewed after Dec. 31, 2011.

The basic three-pillar DGS structure is likely to be retained with the new DGSD but adapted in some respects. With the new DGSD all credit institutions that take deposits must be part of a statutory/officially recognised DGS. Until now, IPS members were exempt from the obligation to join a statutory scheme. IPSs can be recognised provided that requirements of the DGSD are met, which include granting legal right to compensation, providing for payout and accumulating sufficient funds. The BaFin will have enhanced authority to comprehensively supervise all recognised schemes.

payout performance provides an incomplete picture of payout readiness – mainly because some schemes have been activated very rarely or have never actually administered any payouts.<sup>18</sup> With DGS payouts tending to be “rare events”, stricter requirements on payout also imply an increasingly important role for contingency planning.

- **Single point of contact:** Previously, subsidiaries participated in host schemes while branches were covered by home schemes. Under new DGS rules, local schemes will act as a “single point of contact”. For consumers, this means that they do not have to interact with a foreign deposit scheme when they have placed a deposit in a local branch of a bank from another EU member state. For DGSs, it implies that they must manage payouts on behalf of the home DGSs.

For consumers, switching to a single point of contact makes it easier as they probably do not distinguish between placing deposits in a branch or a subsidiary. For DGSs, it points to the importance of cooperation and information sharing among schemes to ensure smooth functioning of safety nets across member states.

- **Enhanced information requirements:** The new DGSD requires that banks provide customers with more information about deposit insurance. This includes information on customers’ account statement about the DGS protection of their deposits and mandatory DGS information sheets in a standardised format that must be countersigned by consumers when placing deposits and regularly updated.<sup>19</sup>

While evidence regarding the link between information about and trust in DGSs remains scarce, several studies have found that knowledge about DGSs is rather limited.<sup>20</sup> Promoting information on DGSs seems worthwhile against this background. However, a regular assessment of the effectiveness of information provision should be part of best practices, and recent international comparisons suggest that gaps remain in this respect.<sup>21</sup>

Providing comprehensive and competitively neutral information remains a particular issue in places where multiple DGSs operate. From a theoretical perspective, information should be clear on the benefits and limits of DGSs. This can help to shift customers’ focus towards entitlements and away from more implicit provisions.

Altogether, the revised DGSD includes a number of points to strengthen consumer protection, including reinforced commitment to coverage levels, faster payout, easier handling from a consumer perspective (e.g. single point of contact) and better information regarding DGSs. For DGSs, however, the new rules also imply enhanced obligations and raise performance requirements.

## DGS role in future crisis management: More limited and complemented

How did the financial crisis affect DGSs from a systemic perspective? First, it emphasised the need to look beyond DGSs to promote financial stability. To some extent, this follows from the origins of the crisis, which had exposed problems with (unsecured) wholesale funding. Arguably, the root causes of

<sup>18</sup> This is for instance the case for institutional protection schemes (IPSSs) in Germany.

<sup>19</sup> The DGSD requires banks to provide the standardised sheet to depositors at least once a year. See DGSD Art.16.3.

<sup>20</sup> See for instance Sträter et. al. 2008 for Germany, or Bartiloro 2011 for Italy, IADI 2012.

<sup>21</sup> See IADI 2012, FSB 2012.



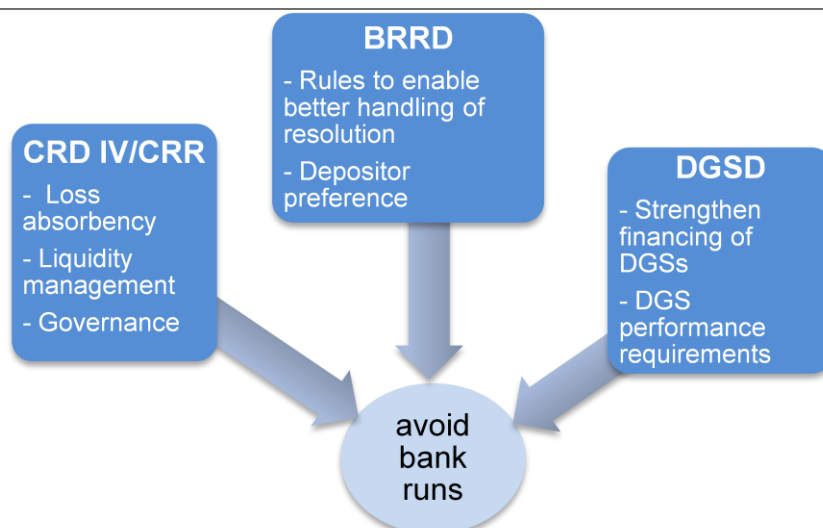
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some bank-run instances mainly had to do with banks' overly extensive reliance on wholesale funding (Northern Rock) or were also related to political uncertainty (Cyprus, and to some extent also the drain of deposits from Greece reflecting fears about the country's potential exit from the eurozone). For Europe in particular, this implied that rather than reforming DGSs on a "standalone basis", changes were considered as part of a more comprehensive agenda for financial markets reform with an emphasis on strengthening resolution regimes to address "too big to fail" and improve the cross-border resolvability of banks. As a consequence, the context DGSs operate in has been undergoing substantial changes.

Second, while the financial crisis triggered a substantial extension of DGS coverage, both via government guarantees and formal measures as an immediate "crisis response", this also led to a more comprehensive approach to DGS reform in the second step.<sup>22</sup> As a consequence, the focus shifted towards the design of DGSs as well as their role as part of reformed financial safety net architecture.

Multiple measures can help to increase financial stability and avoid bank runs

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Source: Deutsche Bank Research graph, based on European Commission (2014)

### Core function can be supported by additional measures

DGSs play an important role in reducing the threat of "classic" bank runs, but as a standalone measure they remain limited at best in their effectiveness. Changes to other components of the financial safety net can therefore support their core function.

Several recent reforms that aim to increase the resilience of financial institutions and improve the quality of supervision can help to reduce the likelihood that DGSs need to be called upon.

<sup>22</sup> Coverage increases, particularly in the wake of the financial crisis, also mark the global trend during recent years. See Demirgüç-Kunt et. al (2014) and chart on page 1.



## Acknowledging limits implies need for additional measures

The financial crisis demonstrated that DGSs as a standalone measure are inadequate to deal with systemic failures. Therefore, a key change compared to the situation prior to 2007 is the establishment of dedicated arrangements to deal with systemic crises across the EU and cross-border aspects of bank failure in particular. Strengthening the architecture to deal with system-wide shocks thus addresses a gap that DGSs were not capable of plugging but also not really meant to cover. At member state level, DGSs have varied with respect to their function, ranging from paybox arrangements to schemes with wider competences.<sup>23</sup> As for resolution arrangements, the financial crisis clearly highlighted the need to enhance existing regimes, prompting unilateral reform in some member states (e.g. the UK or Germany, see also FSB 2013 for an overview). The BRRD now provides for a common framework for bank resolution across the EU. It requires member states to adjust/add to their insolvency proceedings to deal with bank failures outside of formal bankruptcy processes, strengthen contingency planning, and ensure private-sector contributions to resolution via bail-in and the building up of resolution funds.

### Bail-in sequence under BRRD

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Bank resolution aims to ensure continuity of key banking operations, protect depositors, client assets and public funds. It tries to avoid “unnecessary destruction of value” and to safeguard financial stability.

Creditor bail-in is one possible tool that can be used by resolution authorities to ensure these goals. It aims to stabilise a failing institution, and ensure that key functions can continue – without having to resort to public money. It is creditors that make a contribution to restore the failing bank’s capital position through write-down of their claims or the conversion of debt into equity.

The bail-in sequence is set out as follows:

- Equity Tier 1 & Tier 2
- Other subordinated debt
- Non-preferred senior unsecured debt & non-preferred deposits
- Preferred deposits, i.e. all individual and SME deposits
- Contribution by deposit guarantee schemes

Notably, strengthening resolution rules including the establishment of dedicated instruments and funds has two effects for DGSs: 1. it reduces pressure on them because there are additional arrangements to deal with larger-scale banking crises, and 2. it helps to circumscribe the tasks of DGSs and their position in the financial safety net more clearly – both via the BRRD and the DGSD.

The revised setup reflects a “division of labour” approach for DGSs and resolution arrangements but also stresses that the two are complementary. For DGSs, there is an emphasis on payout and their “paybox” function.<sup>24</sup> Also, for the first time, there are Union-wide rules on “use of funds” for DGSs, i.e. what purposes other than payout DGS funds can be used for. This concerns the use of DGSs for early intervention (e.g. recapitalisation, liquidity assistance or guarantees) and their financial contribution to resolution. This can strengthen the role of DGSs where it used to be limited to pure payout. At the same time, having common rules on what DGS money can be used for and introducing certain conditions can help to shore up a level playing field.

The use of funds for early intervention is possible – but such use is supposed to be limited and subject to conditions.<sup>25</sup> It can only take place prior to resolution action and any support needs to come with certain obligations for the credit institution receiving funds.<sup>26</sup> Taking early intervention action also comes with requirements for DGSs themselves, such as having adequate procedures in place for selecting and implementing them, monitoring their risks and consulting with competent authorities on appropriateness and design. As an additional condition, member banks must provide DGSs with the means for early intervention if depositors must be reimbursed and DGS funds amount to less than two-thirds of the target level or if they fall below 25%.<sup>27</sup> Essentially, this adds a further safeguard to preserve DGSs’ main responsibility, i.e. to repay depositors, and circumscribes the use of funds for early intervention purposes.

<sup>23</sup> For an introduction to resolution arrangements and the role of DGSs see Schich/Kim (2010).

<sup>24</sup> See DGSD Rec.14 and Art.11.

<sup>25</sup> DGSD Art.11.3 leaves member states the option to allow DGS the use of funds for alternative measures (other than payout and contributing to resolution). If the option exists and DGSs want to make use of it, the DGSD requires the respective resolution and competent authorities to be consulted on measures and conditions.

<sup>26</sup> This includes more stringent risk monitoring and verification rights to DGS and conditions support on commitments of the credit institution receiving support “with a view” to securing clients’ access to covered deposits (Art. 11.3 d, e).

<sup>27</sup> DGSD Art.11.5.



## Deposit guarantee reform in Europe

As for resolution, the contribution of DGSs is further clarified via the BRRD.<sup>28</sup> In particular, the BRRD redefines creditors' claims in resolution and introduces depositor preference, which also affects DGSs.

The bail-in tool created by the BRRD aims to ensure that shareholders and creditors take losses first (contributing at least 8% of total liabilities including own funds<sup>29</sup> before the resolution fund may step in) if a bank is resolved and defines a hierarchy in which they must contribute. It also requires banks to hold a minimum amount of bail-in-able debt.

As depositors are also creditors, they can potentially be bailed in and contribute to burden-sharing. However, the BRRD introduces depositor preference for deposits held by SMEs and natural persons, thereby strengthening their position in the hierarchy of claims. Covered deposits (< EUR 100,000) are protected from losses because DGSs would step in on their behalf and DGSs would be last in line to contribute. From a consumer perspective, this anchors deposit protection up to EUR 100,000, provides insurance for both insolvency and resolution at the same level and removes remaining uncertainty about treatment under bail-in.

For DGSs, the new rules define their position in the hierarchy of claims, which means that their potential contribution to resolution measures also becomes somewhat clearer. Both their "superpreferential treatment" (i.e. their position at the bottom of the bail-in sequence, even after preferred depositors) and depositor preference for bail-in, which can help to increase deposit stability, work to reduce their potential costs.<sup>30</sup> The BRRD stipulates that DGSs shall only contribute to resolution up to what they would have had to pay under normal insolvency proceedings. They do not have to make a contribution to the costs of recapitalising the institution or to the bridge bank, and their liability is capped at a maximum 50% of their respective target level.<sup>31</sup> However, if called upon, they must provide a contribution to resolution in cash.

Altogether, the establishment of a dedicated resolution framework that includes resolution funds and the new bail-in hierarchy can all work to take some pressure off DGSs (compared to the pre-crisis situation). Also, the rules for DGS involvement in resolution include "safeguards", which potentially limit their losses. At the same time, the fact that a DGS contribution for bail-ins is envisaged also implies a potential liability for them – albeit one hard to quantify precisely a priori.

Redefining and complementing the role of DGSs also have implications for their financing. The DGSD envisages resolution and deposit insurance as separately funded. This contrasts with a joint approach that exists for instance in the US where the Federal Deposit Insurance Corporation (FDIC) is tasked with both resolution and deposit insurance.

Ultimately, DGS funding arrangements must be tailored to their tasks. Also, "context matters" in the sense that the environment in which they operate can influence, for example, the likelihood of DGSs being called upon or the viability and practicality of funding arrangements.

At the same time, financing rules are a key element of the institutional design and – if drafted properly – can help to reduce moral hazard problems.<sup>32</sup>

### Depositor preference

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Anchoring depositor preference as part of the bail-in hierarchy improves depositors' position vis à vis other unsecured creditors when a bank goes insolvent or enters resolution. It means that they receive compensation first (or conversely take losses later). New EU rules introduce depositor preference for SMEs and natural persons. DGS claims are even further prioritised.

Many countries already have explicit depositor preference (e.g. the US) or provide implicit preference to depositors in times of (systemic) crisis – but there were no uniform rules in the EU previously. Changing the order of claims, however, can have strong distributional effects as it shields some creditors but concentrates eventual losses on others.

See IMF (2013a) and European Commission (2014).

<sup>28</sup> See Art. 11.2 DGSD and Art.109 BRRD.

<sup>29</sup> Or alternatively 20% of risk-weighted assets in specific situations.

<sup>30</sup> See also European Commission (2014) and IMF (2013a, Ch.3).

<sup>31</sup> See BRRD Art. 109. Note, however, that member states may set a percentage share higher than 50%.

<sup>32</sup> See Demirgüç-Kunt et. al. (2008).



## It's all about the money: New financing provisions for DGSs

Principles of DGS financing

16

### *Ex-ante vs ex-post*

DGSs can be financed by collecting funds ex ante or ex post. Ex-ante financed systems build up funds over time from banks' contributions. Ex-post funds are collected "ad hoc" in the event of a bank failure. Advantages of ex-ante funding include availability of funds, which can improve confidence in DGSs. Distribution is also considered more "just" as ex-post funds rely on a "survivor pays" approach. Ex-post funds, on the other hand, can induce peer monitoring and be cheaper to administer but may have a pro-cyclical impact.

### *Flat-rate vs. risk-based contributions*

DGSs can require flat-rate or risk-adjusted premia. Risk-adjusted premia are preferable because they help to promote market discipline, but are more complex to administer.

### *Back-up funding arrangements*

DGSs are typically supported by explicit back-up funding arrangements to enhance their credibility. These include additional ex-post levies and access to other financial resources, e.g. support by central banks or the ministry of finance, or borrowing from markets.

### *Target levels*

Optimal fund size is a function of coverage, dedicated use of DGSs and their likelihood of being called upon, which again reflects interaction of DGSs with both resolution and supervision. From a theoretical perspective, optimal fund size involves making assumptions about probabilities of failure and their likely impact, which can be challenging to determine exactly in practice.

Setting common financing requirements is a key element of DGS reform. Adequate financing is a prerequisite for DGSs to fulfil their consumer protection function. It also matters with respect to their role in financial stability because from a systemic perspective the design of financing provisions can help to mitigate moral hazard problems associated with deposit insurance, for instance by taking into account bank risk via contributions. Finally, financing provisions must be tailored to the role that DGSs play in the financial system, the respective institutional and market environment.<sup>33</sup>

In a nutshell, the new provisions require ex-ante financed DGSs with a target level of funds set at 0.8% of covered deposits as a general rule. The volume must be reached within 10 years. Up to 30% of the funds provided may consist of irrevocable payment commitments. Banks' contributions shall be risk-based. There is a possibility to raise ex-post contributions in case resources are insufficient. If additional funds are needed, the directive also foresees access to alternative funding arrangements including the possibility of voluntary borrowing between different DGSs across borders.

Currently, the way DGSs are financed and the funds they have at their disposal differ across the EU. This reflects, inter alia, different experiences with bank failures, financial system characteristics and the role that DGSs play within the respective financial systems. Agreement on financing principles therefore involves a double challenge: 1. agree on the role of DGSs, particularly in resolution, and set funding accordingly, and 2. fix common principles to ensure financial soundness of DGSs against divergent existing practices.

## Common principles to ensure sound financing

Establishing common standards for sound financing of DGSs in a single market makes sense. The reason is simply that malfunctioning DGSs in one country can spread insecurity to others. (Sound) Common rules are a way to limit negative spillovers. In addition, strengthening privately financed funds can help to reduce the role of public backstops for deposit insurance (at least to some extent). Hence, from a financial stability perspective, improving financial soundness of DGS via common financing rules is sensible to reduce threats of contagion and market distortions. In addition, harmonised requirements for DGS financing make sense given increasing convergence of resolution and supervision.

Strengthening ex-ante financing is also in line with empirical trends of the past several years and reflects best practices.<sup>34</sup> Most EU member states have ex-ante funds in place (ex-post: Italy, Luxembourg, Austria, the UK and Slovenia)<sup>35</sup>, with the Netherlands currently transitioning to an ex-ante system. Not all DGSs in the EU operate with fixed target levels though (FSB 2012), and the basis for assessing contributions differs (using for instance total liabilities or eligible deposits rather than covered deposits<sup>36</sup>) and funds are filled to a different extent. That the target level of 0.8% of covered deposits is lower than originally

<sup>33</sup> For an introduction to deposit insurance pricing see also Laeven Ch.3 in Demirgüç-Kunt/Kane/Laeven (2008).

<sup>34</sup> See IADI (2012), IMF (2013).

<sup>35</sup> IMF (2013).

<sup>36</sup> "Eligible deposits" refers to deposits repayable by the guarantee scheme under national law before the coverage level is applied. "Covered deposits" are a subgroup with the respective coverage limit being applied. See also JRC (2007) Annex IV.



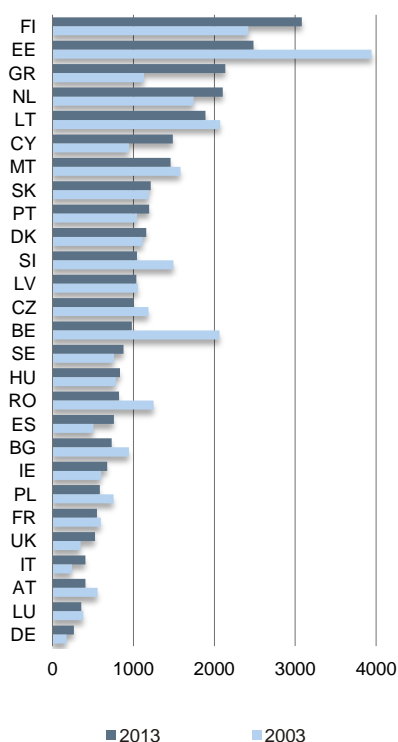
## Deposit guarantee reform in Europe

proposed also needs to be seen against the background of developments on resolution and the buildup of funds dedicated to this purpose.<sup>37</sup> In practice, the new financing requirements can make it necessary to 1. change the assessment base to covered deposits, 2. introduce or adapt methodologies for calculating (risk-based) contributions, and 3. step up funding efforts to ensure that target volumes will be reached in time. Currently, the focus is on ensuring that the new target level requirements are met across the EU. However, it is less clear what will happen once the funds have reached their designated level.

### Banking system concentration (I): Measurement and dynamics matter

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Herfindahl index by EU member state. Higher values typically indicate greater concentration



Values for Bulgaria refer to 2004 and 2013.

Sources: ECB, Deutsche Bank Research

### Ensure level playing field for implementation

Some uncertainties remain with respect to the application of the new financing rules and the target level requirements at member state level.<sup>38</sup> This concerns, inter alia, the possibility of lowering the target level for “concentrated” banking systems to 0.5% (minimum) of covered deposits.<sup>39</sup> This seems a questionable option for several theoretical and practical reasons. First, higher concentration levels are not necessarily better from a financial stability perspective, making it questionable to grant deductions on these grounds.<sup>40</sup> Second, operationalisation is unclear. Standard measurement criteria (CR-3 or CR-5 concentration ratios, Herfindahl index<sup>41</sup>) are sensitive to reporting and other specification issues and often yield different results.<sup>42</sup> They can, for instance, be affected by:

- accounting standards: IFRS and US GAAP partly result in significantly differing values for total assets
- the consolidation level: group vs separate legal entities
- the treatment of international exposures

In addition to their geographic dimension, concentration measures also have a product dimension, i.e. the relevant “suppliers” in the respective market must be defined.

Hence, measurement and methodological choices can substantially affect bank concentration levels and countries’ relative positions. For example, Cyprus ranks 6<sup>th</sup> across the EU when measuring concentration based on Herfindahl but 13<sup>th</sup> when using the CR-5 ratio as the benchmark.<sup>43</sup> Third, while these measures may provide useful information to compare countries or analyse trends over time, they do not indicate “optimal” levels of concentration for individual markets. Fourth, it is unclear how dynamics would be dealt with, e.g., if concentration levels in a banking system changed over time. This might prove challenging if for instance bank consolidation were to gain pace again. The application of the concentration exception would be discretionary, possibly impractical and seemingly questionable within a single market.

<sup>37</sup> DGSs and resolution funds are separately funded but they can be administered jointly.

<sup>38</sup> The UK for example has traditionally relied on ex-post financed DGSs and has a different setup for resolution financing. Both the BRRD and the DGSD contain provisions that would basically allow maintaining the current arrangements (i.e. banks must pay a levy to the state budget rather than contributions to separate funds).

<sup>39</sup> Art. 10.6 of the revised DGSD contains the possibility to set a lower target level and defines the relevant conditions.

<sup>40</sup> See Calomiris/Haber (2014).

<sup>41</sup> The Herfindahl (or Herfindahl-Hirschman) index is a common measure to assess market concentration. It is calculated by squaring the market shares of all firms competing in a market and summing them.

<sup>42</sup> For an introduction to concentration measures see for instance Bikker/Haaf (2002).

<sup>43</sup> Based on the latest ECB figures for 2013, sorted by rank (27 countries in total). Ranks for Herfindahl and CR-5 ratios are identical for only 10 of 27 member states, and some countries such as Cyprus but also Belgium, Slovenia and Finland show large differences in ranks depending on the indicator being used.

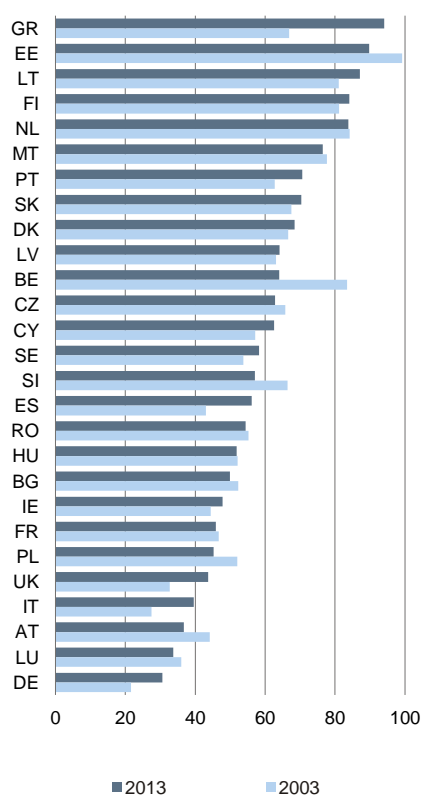


## Deposit guarantee reform in Europe

### Banking system concentration (II): Measurement and dynamics matter

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CR-5 ratios (market share of the five largest credit institutions)



Values for Bulgaria refer to 2004 and 2013

Sources: ECB, Deutsche Bank Research

Maintaining a level playing field is also important in light of the risk-based nature of contributions. The basic decision to use risk-based schemes seems sensible for financial stability reasons – risk-based schemes should help to limit moral hazard – and to ensure distributional fairness among members. Given the increases in coverage during recent years, their design and pricing has become even more relevant (see also Demirgüç-Kunt et al. 2014).

For implementation of the new rules, both internal and cross-country effects should be considered. Some DGSs already rely on risk-based contribution schedules and developed methodologies in the context of their respective banking systems. At the same time, some consistency is needed to ensure comparability of approaches and a Europe-wide level playing field for banks. The compromise reached tries to account for that by allowing DGSs to use their own risk-based methods for calculating contributions but requiring approval by competent authorities and information to the EBA. It also emphasises the EBA's role: to ensure consistent approaches by issuing guidelines on risk-based contributions and detailed rules for payment commitments. The directive allows member states to provide for lower contributions of (presumably) low-risk sectors governed by national law and for members of IPSs. Nevertheless, as a general rule, methods for calculating contributions should be based on a comprehensive set of objective criteria and be competitively neutral with respect to their treatment of business models. With regard to exemptions it is also worthwhile considering, for instance, the correlation of risks within banking groups which can have repercussions on the rest of the banking system, too.

### Beyond collection of funds

Strengthening ex-ante funding is an important component, but collected funds do not fully reflect DGS financing capacity. The DGSD also includes the possibility of additional ex-post levies and an option for voluntary credit between DGSs.

Government-backed funding has traditionally been the last resort for DGSs, providing credibility and allowing intertemporal smoothing. Revised funding arrangements still imply a role for governments as a possible financing backstop and provider of emergency liquidity if necessary. Arguably this role is somewhat less in the forefront given that ex-ante financing is to be strengthened, additional arrangements for ex-post measures are being added and the role of the DGS itself is being adjusted.

## DGSs in the Banking Union

Nonetheless, the approach taken for DGSs here clearly contrasts with the new resolution structure in the Banking Union. For Banking Union members there will be a single fund to support resolution measures.<sup>44</sup> For DGSs there are harmonised financing provisions but funds remain separate. Whether DGS reform is considered a step or a leap therefore also depends on perspectives: On the one hand, this reform can be considered quite substantial. It implies further harmonisation in many respects, especially bringing areas such as financing of DGSs in scope. On the other, it reflects a gradual approach pursuing harmonisation of national financing provisions rather than establishing a single European fund. In addition, a number of factors remain that reform is unlikely to substantially alter, including the organisational and institutional setting, the number of DGSs per member state or voluntary arrangements for

<sup>44</sup> For an introduction and further discussion of the Banking Union see also Speyer (2013).



## Deposit guarantee reform in Europe

### SRB and resolution decision-making

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The Single Resolution Board will be the main authority to decide on bank resolution in the Banking Union. It can convene in plenary or executive session (executive=chair, vice chair, four independent full-time members, two observers appointed by the European Commission and the ECB; plenary format in addition includes one member per member state representing national resolution authorities). When deciding on resolution, the executive session will also include the representative of the member state directly concerned.

Resolution decisions will be prepared and adopted in executive session. However, if resolution involves the use of SRF funds above EUR 5 bn, plenary members may request to move decision-making to the plenary.

deposit protection.<sup>45</sup> To that effect, DGS reform is certainly more gradual and preserving than the new rules for resolution.

At the same time, Banking Union shapes the context in which (most) EU DGSs will operate. This means that the safety architecture they are one component of will be partly European, partly national.

### Supervision will be unified:

Supervisory structures will build on the central role of the ECB as the main prudential supervisory authority for banks in the euro area and those countries joining the single supervisory mechanism (SSM). While only the 120 largest banks are now being supervised directly (which, however, account for about 85% of the system's total assets<sup>46</sup>) and national supervisors continue to play an important role particularly for the supervision of less significant banks, the ECB certainly has a strong role. It can for instance instruct national supervisors or ultimately assume direct supervisory competencies if considered necessary.

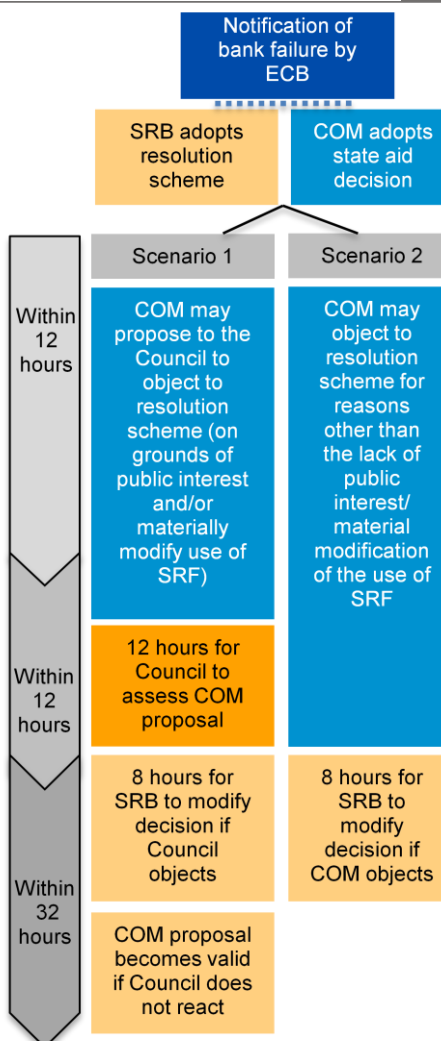
### Resolution will be subject to a unified procedure and a common fund will be built up:

Decision-making on resolution will involve several players, i.e. typically the ECB for determination of bank failure, the Single Resolution Board (SRB), the Commission and the Council for decision-making on resolution measures and national authorities for their implementation. The Single Resolution Fund will be built up over a period of 8 years, reaching a target volume of 1% of covered deposits of all banks in member states participating in the Banking Union and financed by banks' contributions. The fund will consist of national compartments that are to be pooled gradually with mutualisation being front-loaded (1<sup>st</sup> year: 40% pooled; 2<sup>nd</sup> year: 20%; and the remaining 40% following in linear steps). While some reservations about the practicability of decision-making processes and the lack of a full-fledged common backstop remain<sup>47</sup>, basic agreement on single resolution is still a major step.

Against this background, DGSs remain the least integrated element.

### Stylised resolution procedure

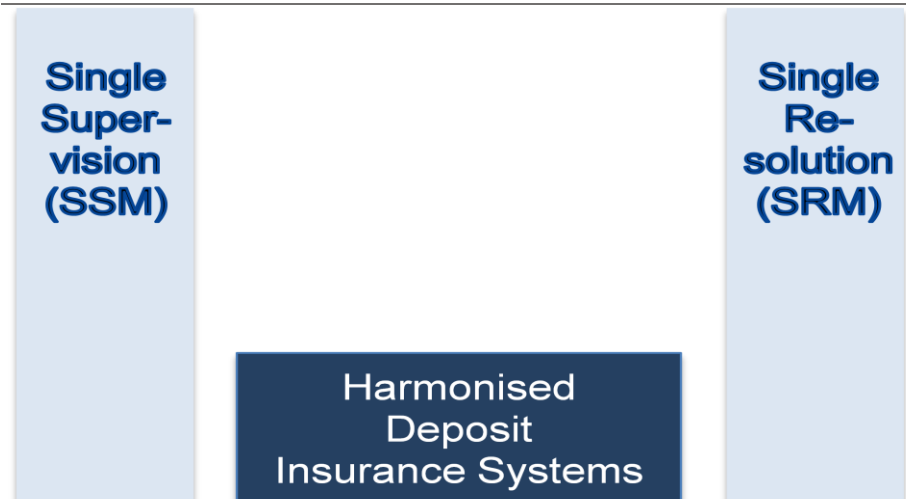
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Sources: European Commission, Deutsche Bank Research

### Two pillars of a building block: DGS in the Banking Union

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Source: Deutsche Bank Research

<sup>45</sup> The DGSD regulates statutory schemes. Only a limited set of provisions (for instance on advertising) also apply to voluntary arrangements.

<sup>46</sup> For the final list of credit institutions directly supervised by the ECB see <http://www.ecb.europa.eu/ssm/list/html/index.en.html> (Sept. 2014).

<sup>47</sup> IMF (2014).





## Deposit guarantee reform in Europe

US approach: Linkages between DGS, resolution and supervision

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The US exemplifies an integrated approach to supervision, resolution and deposit insurance. The Federal Deposit Insurance Corporation (FDIC) has traditionally been in charge of deposit protection for member banks since 1933. In addition to ensuring deposits, the FDIC also supervises many of the country's banks and operates and administers receivership of failed insured depository institutions. The resolution powers of the FDIC were significantly extended with the Dodd-Frank Act (2010) to also cover systemically important financial institutions (SIFIs). Essentially, the FDIC has quite far-reaching resolution powers for both insured depository institutions and bank holding companies.

In terms of funding, the FDIC can draw on the privately financed Deposit Insurance Fund (DIF) to handle depositor payout and resolution for all insured depository institutions. The fund currently has a designated target size of 1.35% of insured deposits. Deposit protection (up to USD 250,000 per depositor, per insured bank) is backed "by the full faith and credit of the United States government", and the FDIC also has the possibility to borrow from the Treasury department (USD 100 bn credit line) and additional sources if need be.

The Dodd-Frank Act also introduced a framework to enhance coordination between authorities to improve the early warning of threats to the financial system and counteract them (Financial Oversight Council). Overall, the US system assigns a central role to the FDIC, which considers DGSs and resolution "jointly" for insured depository institutions and can rely on additional tools for SIFIs with back-up funding arrangements.

Sources: FSB (2013), IADI (2012) and FDIC

Whether and to what extent DGS need (further) harmonisation has been subject to controversial debate. However, given that the SSM, SRM/SRF and the revised DGSD, as recently agreed, now together define the framework and conditions for a DGS to operate for the foreseeable future, what does it take for this setup to work from a systemic perspective?

Complexity poses a major challenge to the emerging Banking Union architecture, and a more harmonised but decentralised and still somewhat heterogeneous layer of DGS only adds to that.

### Complexity enhances need for cooperation and coordination

What follows from greater complexity is an extended need for cooperation and coordination. First, this applies to interaction between DGSs to ensure, for instance, that the single-point-of-contact principle and payouts work well in practice. Strengthening exchanges among DGSs, e.g. via European or international bodies that foster cooperation, can also help to spread and strengthen best practices. Second, it also applies to interaction between DGSs and other participants of the financial safety net. This particularly concerns day-to-day cooperation between national DGSs and the new and more integrated supervisory structures, which must work well together.

Greater need for cooperation is also reflected in the revised DGSD, which calls for written cooperation agreements between DGSs and improved information sharing between DGSs and other financial safety net participants.<sup>48</sup> Regular and timely exchange of information will be vital as it can help to improve supervision and facilitate resolution actions. For DGSs, cooperation with supervisory authorities can help to make potential involvement in resolution more predictable.

### Conclusion

In the near term, the focus is on national implementation of the new DGS rules both for DGSs as well as other market participants. However, it is also important to look at the reform from a systemic perspective to understand the effects on the EU financial market and the interaction with other regulatory changes taking place in parallel.

The financial crisis demonstrated the need for DGS reform in Europe. The second DGS reform pursues a more comprehensive approach – compared to the previous EU framework – adding a number of elements that were not part of the common rules before. The new rules notably emphasise the role of DGSs for consumer protection. Also, they belong to a more comprehensive set of changes to the architecture of the financial safety net in Europe and redefine the role of DGSs as part of it.

The new structure envisages a more limited role for DGSs and complements it, notably by new rules for resolution. However, complementary measures do not imply that DGSs are becoming insignificant. It remains important that they perform their functions well – with respect to both consumer protection and financial stability.

The extension of DGS coverage that took place through the course of the financial crisis via various channels, including changes to statutory coverage and via public guarantees, triggered questions with respect to the appropriate-

<sup>48</sup> See Art. 14 DGSD.



## Deposit guarantee reform in Europe

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ness of DGS design and future market discipline. The new set of rules provides a high level of protection to households, aiming to shield them from losses to a large extent – both under insolvency and resolution. Given that information costs for the average household are typically high, this seems justifiable. However, it also emphasises the importance of DGS financing (particularly the risk-based nature of contributions) and credible bail-in as counterbalancing mechanisms to mitigate moral hazard and strengthen market discipline in the future.

The new rules further harmonise DGSs but do not establish a unified European scheme. Nevertheless, national DGSs are linked to the European level in various ways. First, well-functioning DGSs can contribute to financial market stability in Europe. Second, responsibilities for financial stability are now placed to a greater extent at the European level – via common supervision and resolution in the Banking Union – and thereby also affect DGSs. What is emerging as a result may be seen as a “multi-layer” safety net. This approach entails a high degree of complexity. Hence, cooperation between the different players – and layers – is crucial.

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