Deutsche Bank
Research

Research Briefing
Global financial markets

August 19, 2015

# Deposit insurance in the Banking Union: Options for the third pillar

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— The latest reform of deposit guarantee schemes (DGS) in the EU, which had to be transposed by July 2015, followed a gradual approach. It further harmonised deposit insurance and for the first time established common requirements on financing: schemes should be ex-ante funded with a common target level to be reached by 2024. National DGS funds remain separate, though. To that extent, DGS reform contrasts with resolution and supervision, which have seen further-reaching reform.

— Recently, the debate about the future of DGS has been revived. The five presidents' report on the future of EMU identified deposit insurance as one of the main areas of the Banking Union still pending completion and proposed ideas to launch a European deposit insurance scheme. It also put DGS reform back into the larger debate about the state of the eurozone and its future development.

— While joint deposit insurance may still seem a rather long-term option, several short- and medium-term suggestions to complement DGS have been made. They put an emphasis on adapting the current setup with a view to increase back-up financing capacity of individual DGS. Ideas include i) strengthening the network of DGS and possibilities for bilateral lending, ii) establishing a reinsurance scheme for DGS, iii) giving DGS access to a common fiscal backstop.

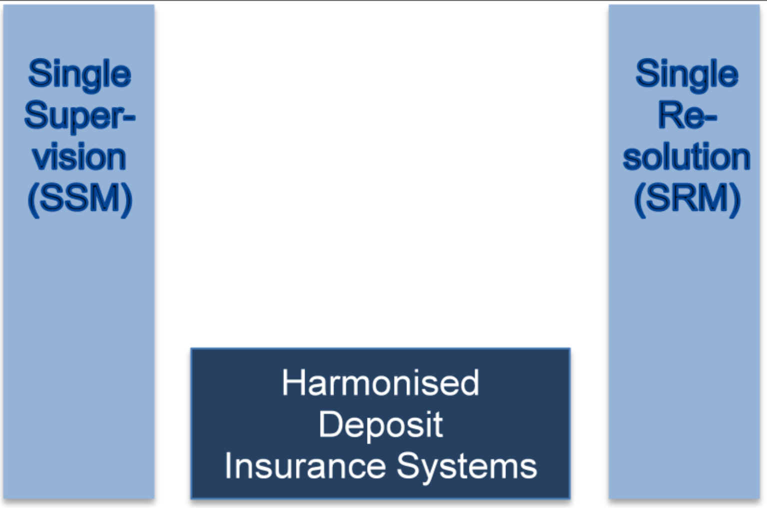
Up until now, deposit insurance has been the neglected pillar of the Banking Union. Yet, being part of the larger debate about the state of the eurozone and its future development, discussions about deposit insurance have been revived lately. Notably, the recent five presidents' report on the future of the EMU identified deposit insurance as one of the main areas of the Banking Union still pending completion. It also proposed ideas to launch a European deposit insurance scheme.[1]

Recall the current situation: common banking supervision under the aegis of the ECB has been up and running since November 2014. A Single Resolution Mechanism to resolve failing banks has been established with the Single Resolution Board (SRB) fully operational from 2016 and the Single Resolution Fund (SRF) financed by banks' contributions to be gradually filled up over the next few years. Both are significant steps towards an integrated and more resilient banking market in Europe. Both have involved the transfer of competencies to the European level and a joint fund is going to be established in the form of the SRF.

[1] See Jean-Claude Juncker et al. (2015) and IMF (2015).

Changes to deposit guarantee schemes (DGS) have followed a more gradual route.[2] The recent reform of the DGS directive to be transposed by early July this year further harmonised rules for DGS. It put an emphasis on consumer protection, for instance strengthening requirements regarding depositor information about DGS and requiring faster payout. The biggest change, though, is that the new rules now also include common requirements on financing of DGS for the first time, requiring ex ante financed funds to reach a common target level by 2024. While provisions have been harmonised, funds remain separate.

Two pillars and one building block 1




Source: Deutsche Bank Research

Critics have pointed out that the current setup would give rise to liquidity ring-fencing and market fragmentation in times of stress. Also, large-scale but locally concentrated shocks would be a challenge for decentralised deposit insurance. Such a scenario would put concentrated pressure on individual DGS and bring links between banks and sovereigns back in the spotlight – which is precisely what the Banking Union aims to mitigate.

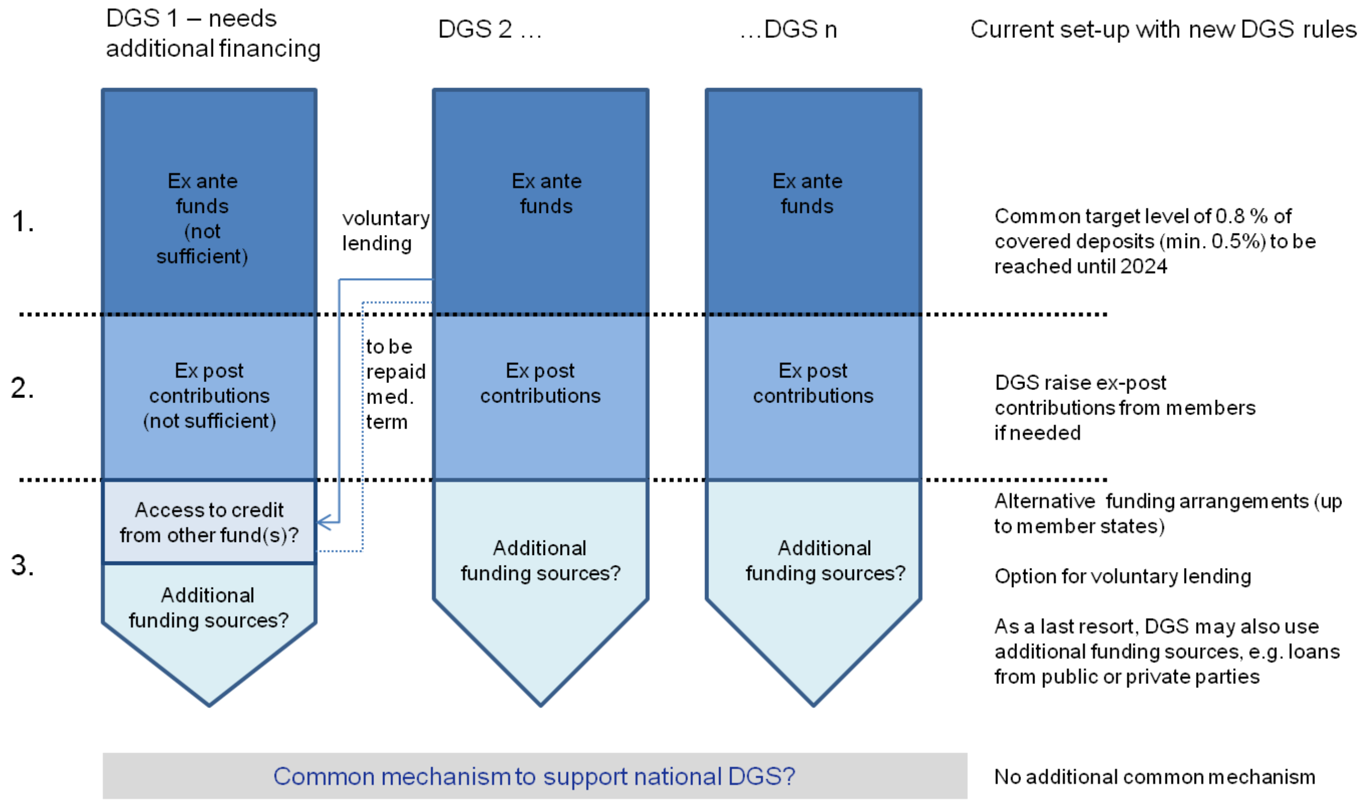
## Different options to back up DGS

What are the potential options for tackling this problem? Setting up a common scheme remains controversial – proponents emphasise the greater resilience and efficiency of a joint scheme while opponents stress subsidiarity, arguing that national DGS can add to monitoring capacity in financial systems and warn about mutualisation of risks. At the moment, a joint scheme may still seem a distant prospect given the heterogeneity of existing DGS and banking systems across member states. But what about the short- to medium-term suggestions that have been put forward recently?

Ideas for the short- to medium-term put an emphasis on adapting the current setup, i.e. national schemes operating under new DGS rules, with a view to increasing back-up financing capacity of individual DGS (i.e. stage 3 in the second chart), increasing systemic resilience and mitigating the link between banks and sovereigns. Theoretically, there are several options which include lending between individual DGS or setting up a common mechanism to provide support.

2 For further discussion of the recent reform of the deposit guarantee schemes directive see Wruuck (2014).

Thematic illustration of DGS financing options in the EU 2




Sources: European Commission, EBA, Deutsche Bank Research

## A network of DGS

The first option, i.e. encouraging lending between DGS, promotes the idea of a 'network of DGS'. The revised DGS directive already provides for this option on a voluntary basis. It also specifies the conditions under which borrowing can take place – for instance ensuring that accumulated and ex-post funds are used first, that credit may not exceed a maximum amount and has to be repaid within five years.

However, lending between schemes raises a number of issues: if assistance were to be requested "ad hoc", i.e. once funds in one deposit guarantee scheme had turned out to be insufficient, other DGS might be reluctant to lend, for fear of shocks not being completely uncorrelated in practice. Yet setting up assistance arrangements in advance would require extended information sharing between DGS, about capacities, contributions and assistance policies in order to adequately assess risks when offering support. Also, a cooperation forum or broker might be needed to negotiate such arrangements and play a coordinator role.[3] DGS differ in capacity and hence their ability to lend (and borrow). There might be little appetite to act as a lender while funds still have to be accumulated to meet target level requirements. Some countries for instance have only recently started to set up ex-ante financed DGS.

[3] Both the European Forum of Deposit Insurers (EFDI) and EBA have stepped up efforts recently to facilitate cooperation between DGS. See for instance EBA (2015).

## Establishing joint capacity

The second option would be to set up a joint capacity that could serve as additional backup. Here, different ideas have been raised, such as a reinsurance scheme (5 presidents' report) or a common fiscal backstop for national DGS (IMF). These differ conceptionally.

With the reinsurance model, there would be an entity that assumes part of the risks and potentially the losses.[4] The conditions under which the reinsurer steps in would be agreed in advance between the reinsurer and the individual deposit guarantee scheme, with the latter paying a premium for the coverage provided, i.e. this is envisaged as a privately financed system.

National DGS would still take the first loss tranche and the reinsurance scheme would only pay out under the specified conditions. This would preserve monitoring incentives for national DGS. In fact, a reinsurer might even add "systemic" monitoring capacity, helping to improve risk management and resilience also because it can collect and combine information about a number of insured parties. Contracts could be written with differentiated premia for national DGS reflecting differences in risks. However, contracting and adequately pricing reinsurance risks would be a crucial task to make the system work effectively and add to financial stability. Also, a reinsurance scheme would need access to sufficient funds in order to be credible. This would pose challenges if a system were to be set up in the short term because funds would then need to be readily available rather than collected over time. In the latter case, a reinsurer could only gradually become a complement.

**DGS reform in Austria** 3

The new DGS directive has triggered DGS reform in Austria. The system has operated with a mix of private and public funds, which used to be funded ex post, with banks and the Austrian state each guaranteeing EUR 50,000 per depositor per bank.

Up until now, there have been five DGS schemes to cover i) private commercial banks, ii) rural cooperative banks, iii) private savings banks, iv) industrial cooperative banks, v) privatised provincial mortgage banks.

A new draft law to implement the DGS directive would substantially change DGS organisation. The proposal envisages DGS to be ex ante financed, as stipulated in the DGSD. Several funds would continue to exist in parallel until 2018 and would be obliged to support each other. A unified system would start to operate from 2019 onwards. Institutional protection schemes could be officially recognised as DGS.

Sources: Austrian Finance Ministry, JRC, Deutsche Bank Research

An alternative could be to give DGS access to a common fiscal backstop for instance through the ESM.[5] This would have advantages in terms of availability, simplicity and credibility – hence potentially trust in the short term – but would lack the additional monitoring component. Instead, it would raise the issue of how to deal with legacies in banks' balance sheets and their potential mutualisation (again). While access to a common fiscal backstop would weaken the sovereign-bank nexus at member state level, it implies joint public liability for ESM members.

Helping to safeguard the financial stability of the euro area as a whole and of its member states is part of the ESM's purpose.[6] However, acting as a backstop to DGS raises the question of how the conditionality principle would be implemented and whether it is a good idea to use the instrument for multiple purposes. Also, backstopping via the ESM might raise practical questions, such as potential consideration by national parliaments that could lead to politicisation and delays.

These different ideas are not mutually exclusive and arrangements could also change over time. Clearly, each of the options currently discussed comes with advantages and drawbacks and involves trade-offs. Nevertheless, it is worth keeping the big picture in mind: if the sovereign-bank nexus is mitigated via a robust back-up for DGS, this could considerably strengthen Banking Union and help develop an integrated banking market.

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[4] The reinsurance idea has been discussed previously by Gros (2013).
[5] See IMF (2015).
[6] See Art. 3 ESM treaty.

## Outlook

The discussion about the future of DGS is likely to continue for the next few years. In the near term, the Commission has announced further consultation on complementing DGS within the existing legislative framework. As for the medium term, a report on the implementation of new DGS rules is scheduled for 2019, which may be accompanied by a legislative proposal setting out how DGS may cooperate through a European scheme. This might also be a point at which coherence with resolution rules and Banking Union architecture might be reassessed.

Deposit insurance systems have grown and evolved with their national banking systems. Arguably, reforming structures that have already been in place – i.e. DGS – is more difficult than creating entirely new ones (in contrast for instance to resolution, where few countries had set up dedicated funds until recently). Yet, DGS are operating as part of the Banking Union now. This means that the functioning of individual DGS matters for the system at large and therefore warrants particular attention. To the extent that robust financing arrangements can contribute to systemic resilience and help to support the Banking Union at large, they deserve an open discussion.

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Internet/E-mail: ISSN 2193-5963