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Options for reforming deposit protection schemes in the EU

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The trust of EU citizens in the EU's single financial market was seriously undermined as a result of the financial crisis. Citizens suddenly realised that different levels and forms of depositor protection co-existed in the EU, whereas they had been told for almost 20 years that a single market was in place. Following the Northern Rock bank run in September 2007, it was clear that deposit protection systems in the EU did not function as they should. But it took European policy-makers another year to modify the 1994 Directive and drastically increase the level of deposit protection, in order to avoid a deep systemic crisis.

Current deposit insurance arrangements in Europe need to be changed, as they match neither market integration nor consumer expectations. But deposit insurance cannot be considered in isolation; it is part of the broader financial safety net and the crisis resolution tools for banks. Confronted with the question of what option should be taken to draw the right lessons from the crisis, practically the only option is an EU-wide fund, but policy-makers are still hesitant. Any intermediate solution will maintain too many distortions and imperfections and will not provide a coherent response to current challenges.

This policy brief starts with a review of current policy discussions on deposit insurance in the EU.[1] The second part looks at the role of deposit insurance as part of the (European) financial safety net. The following sections examine the Commission's recent proposal to amend the EU Directive on deposit guarantee schemes (DGS), and what is missing from it. The three options for a European deposit guarantee scheme and their implications are assessed in the fifth part. The final section presents conclusions and recommendations.

[1] Throughout the text, the terms "deposit guarantee" and "deposit insurance" are used interchangeably. While the EU directive refers to deposit guarantee schemes, we prefer the term "deposit insurance", as such schemes have typical insurance characteristics: in theory, the insured institution should pay regular contributions that serve to protect depositors in case of failure. Those contributions may be calculated on a risk basis and are typically not refunded at the end of the contract.

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1. Introduction

Deposit insurance generally has two main functions: to protect consumers and to enhance the stability of financial markets. These two objectives are also stated in the European Directive 94/19/EC on deposit guarantee schemes, which aims at "increasing the stability of the banking system and protection for savers" (Council, 1994). The consumer protection argument is straightforward. Banking stability is supported by DGS fostering depositors' trust in financial markets and giving them less of an incentive to relocate their savings.

Goodhart (2008) argues for a third rationale, namely that deposit insurance allows public authorities to shut down failed banks more easily: when social hardship is limited (because of consumer protection), the liquidation of an institution becomes politically more acceptable (see also Boyd et al., 2009). In support of this point is also the idea that the financial sector should bear the cost of collapsing banks, not the consumer or the taxpayer.

The Directive on deposit guarantee schemes was adopted by the EU in 1994, following the resolution to establish a single market within the EU. Back then, the idea was to enhance the integration of retail banking by providing minimum standards for deposit protection. Yet, the level of harmonisation was too low. A multiplicity of deposit insurance schemes was maintained, with wide variations in coverage level, deposit/depositor eligibility, legal statute (private or public), governance, payout procedures and funding mechanisms.

The wide variety of deposit guarantee schemes has not proven to be crisis-resilient. Large government interventions were necessary to deal with failing banks in order to restore depositors' trust and stop bank runs, such as the Northern Rock one in the UK (2007) or Landsbanki in Iceland (2008). Several European deposit insurers were not prepared to deal with such extreme crisis situations and even less with the cross-border dimensions of them.

Although the differences and flaws in European schemes were known and well-documented by the European Commission (see EC, 2006), no action was taken at EU level until the financial crisis hit. In July 2010, the Commission presented its proposal to recast the 1994 Directive, moving towards more targeted harmonisation. The proposal is a response to the problems that arose during the crisis, and to the recommendations by the experts in the de Larosière report for further harmonisation of DGS (EC, 2009a). The report argues that depositors should enjoy the same level of deposit protection in all member states, as the existing variety of DGS is considered unsustainable and unreliable in times of crisis.[2]

But how should an efficient, reliable and sustainable (pan-)European system of deposit insurance be designed? The harmonisation approach may range from limited to maximum, from a network of national DGS to the creation of one single deposit insurance fund that applies to all EU-licensed credit institutions. The mandate of deposit insurers may be limited to the simple 'pay box' function or going further towards an active role in the restructuring and/or liquidation of financial institutions. Other aspects that may differ, depending on the design of DGS envisaged, are the scope of coverage, funding mechanisms or organisational structures (see Box 1).

The Commission's recent proposal essentially extends the 1994 Directive, further harmonising numerous aspects of deposit insurance. The proposal does not represent a system change, as in some aspects it maintains the diversity in national systems. However, industry has already started to lobby to lower the harmonisation requirements and to water down the Commission's text. The three largest EU countries: the UK, France and Germany, have expressed their concerns about the legal basis of the proposal (interfering with national sovereignty) as well as about the content.

We believe that the Commission's proposal does not represent a sufficient response to the problems raised by the crisis. Aspects related to the governance of DGS, their role in financial stability and the cross-border dimension have not been sufficiently addressed, leaving scope for regulatory arbitrage, competitive distortions and moral hazard. Further harmonisation is desirable to sustain an integrated financial market.

[2] The report proposes: "Recommendation 14: Deposit Guarantee Schemes (DGS) in the EU should be harmonized and preferably be pre-funded by the private sector (in exceptional cases topped up by the State) and provide high, equal protection to all bank customers throughout the EU." (EC, 2009-02).

Box 1. Characteristics of deposit insurance

The main aspects that vary in the set-up of deposit insurance schemes are the following:

Explicit or implicit schemes: In explicit schemes, protection is formally set, as opposed to implicit schemes, where this is – by definition – not formally specified. Explicit protection typically has the positive effect that the financial burden of failed banks does not have to be borne by the taxpayer (or only in exceptional circumstances). For implicit schemes, no rules are spelled out regarding the degree of coverage, the eligibility of bank liabilities or the funding of guarantees (Basel Committee and International Association of Deposit Insurers, 2009). In the case of a bank experiencing difficulties under implicit schemes, the state would have to step in to provide depositor protection, but it could let the bank fail as well. A downside of implicit protection is that it reduces the incentives for monitoring the behaviour of banks and their riskiness (Demirgüç-Kunt et al., 2006).

Legal form: Deposit insurance schemes may be created as public or private entities. Public or private organisation has further implications for responsibility and accountability – lying either with the government or the industry; typically, banking associations.

Voluntary or compulsory membership: Membership in DGS may be voluntary or compulsory. Deposit protection is only provided to banks participating in the scheme.

Funding of schemes: Deposit insurance schemes may be funded ex ante, ex post or with elements of both. Ex ante schemes rely on the collection of regular contributions, which build a fund that is drawn upon in case of a member's failure. Ex post financing implies that funds are pulled together by DGS participants in the event of a member's collapse. General advantages of ex ante funding are continuous contributions from all types of members (also poorly managed banks) and the immediate availability of funds. Yet, such financing creates a moral hazard problem, and entry and exit barriers, as contributions are typically not reimbursed when banks leave the system. Ex post funding schemes may set incentives for closer monitoring of credit institutions. However, a major drawback is its pro-cyclical dimension, as funds must be collected in times of economic/financial distress.

Risk-based contributions: Contributions to DGS can be calculated based on the riskiness of credit institutions' operations, measured, for instance, in relation to a bank's capital structure, exposures or income and profitability profile (for more information see European Commission, Joint Research Centre, 2008). The advantage of risk-based contributions is that they create incentives for sound management; however the development of such systems requires more resources and thorough analysis.

Coverage level: In the EU, the obligatory minimum level of protection was €20,000 just before the crisis (1994 directive), and was raised to €50,000 in October 2008, with a further increase to €100,000 by the end of 2010 (Council, 2009). Non-EU currency deposits were excluded under the 1994 Directive, but are covered under the Commission's 2010 proposal.

Eligible depositors: DGS generally cover retail customers (natural persons), but may also cover legal persons. Financial institutions are typically excluded from coverage.

Eligible deposits: Cover is generally provided for the current account, savings deposits and other transaction accounts. It does not include investments such as bonds or securities. Deposits are generally covered per depositor per financial institution.

Pay-out delays: The time lag before depositors are reimbursed generally depends on two events: (1) authorities' determination of deposits' unavailability and (2) the final payout of claims.

Co-insurance: Co-insurance makes the depositors partially responsible for protection. For example, if the coverage limit is set at €40,000 and co-insurance at 10%, the depositor receives a payout of maximum €36,000. Co-insurance was the rule in the UK before Northern Rock filed for bankruptcy, but it was not applied when the bank failed.

2. Deposit insurance as part of the (European) financial safety net

While the motivation for having deposit insurance tends to be the same across countries, DGS tasks, structures and their integration in the financial system are very different. Tasks may range from the basic ‘pay box’ function to supervisory duties, providing liquidity, preventing failures or crisis management.

The US Federal Deposit Insurance Corporation (FDIC) is one example of a deposit insurer that carries out tasks well beyond the pay box function. Its mission is not only to protect deposits, but also to “examine and supervise financial institutions for safety and soundness and consumer protection, and manage receiverships”.[3] The Federal Deposit Insurance Corporation (FDIC) therefore performs an active role in financial supervision and even bank resolution (Beck and Laeven, 2006).

There seems to be a trend towards attributing more responsibilities to deposit insurance schemes and giving them more powers as well. They need to be equipped with the right tools to be able to effectively support stability in financial markets, not only during normal times, but under crisis situations as well. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has indeed given the FDIC more responsibility in bank examination and resolution processes, for instance by transferring receivership authority over failing institutions to the FDIC. In Europe, DGS mostly have much less financial safety net functions.

It has been widely accepted that deposit insurance is a core component of the financial safety net, along with prudential regulation and supervision, lender of last resort and bank failure resolution mechanisms. A financial safety net aims at promoting and maintaining safety and stability in financial markets. In the best-case scenario, prudential regulation and supervision are sufficient for ensuring stable markets. However, in the event of mounting uncertainty or crisis, the other mechanisms of the safety net come into play as well.

Before the crisis, only a minimal part of the safety net was actually organised at EU level, namely the regulation of financial services providers. EU initiatives for regulating financial services are generally motivated by the objective of creating and enabling the single market. The other elements of the financial safety net (financial supervision, lender of last resort, resolution mechanisms and deposit insurance) remained largely national. This changed dramatically with the crisis: the lender of last resort function has partly been taken up by the European Central Bank; financial supervision has been integrated into a European System of Financial Supervisors; and a discussion has opened up on European resolution mechanisms. As is the case for the other elements of the financial safety net, deposit insurance arrangements call for a European approach as well.

DGS need to have an adequate supervisory role to allow efficient deposit protection. They should have access to supervisory information and be constantly informed about their members’ financial standing, as they are one of the first mechanisms to take action in the case of a failing bank. Academic research has shown that bank stability is better in countries where deposit insurers have supervisory powers and have the facility to intervene in failing banks (Beck and Laeven, 2006).

In addition to supervisory tasks, other roles may be attributed to DGS in crisis management, for instance the provision of single point-of-contact services between depositors and banks and the coordination of reimbursement procedures.[4] The coordinating function is an important value-added in the case of cross-border institutions, where several deposit insurance schemes and other stakeholders are involved.

Deposit insurance schemes could also be mandated to act preventively, for instance by providing liquidity to credit institutions in certain circumstances. In times of crisis, banks are confronted with illiquidity on the asset (market drain) and liability side (withdrawal of deposits) (Furceri and Mourougane, 2009), which is why governments have increasingly decided to implement a broader safety net (Garcia, 1999). DGS can intervene before the extreme case of a bank’s failure and maintain a bank’s activities. Such assignments are, however, risky and require strong monitoring. It would need to be assured that the DGS primarily continues to serve its main purpose: that of paying out depositors. In this context, the crucial difference between deposit insurance and other bank rescue measures is that DGS serve mainly depositors' interests, while general crisis management measures serve all creditors' and other stakeholders' interests.

A financial safety net should form a coherent and efficient network, yet it is difficult to design, as the inclusion of different safeguard components may lead to conflicts of interest within the net. Supervisory authorities and policy-makers may be keen to keep a failing bank alive as long as possible for political reasons and in order to maintain financial stability. Deposit insurers on the other hand are likely to be in

[3] For more information, visit the FDIC’s website: http://www.fdic.gov.

[4] Those two tasks were proposed in the Commission’s recast of the DGS Directive in July 2010.

favour of a rapid closure of failing institutions before the situation worsens and losses increase.

Such conflicting interests are inherent in financial safety nets and are difficult to resolve. A close cooperation between the different net components is therefore very important. To alleviate the problem, the responsibilities and powers of all participating entities need to be clearly defined. Beck (2003) suggests that a stronger inclusion of the industry in the financial safety net could minimise the dilemma, because "embedding the financial safety net and its different components in the banking community can reduce principal-agent problems by making banks the managers and owners of the safety net." (Beck, 2003, p. 24).

3. The Commission's July 2010 proposal

The consensus to review the 1994 Directive emerged during the financial crisis, although the many flaws of this measure were well recognised before then. The EU initially increased the level of protection in the midst of the crisis, announcing that it would come forward with a more far-reaching proposal at a later stage. This section reviews the different aspects of the Commission's proposal, as proposed in July 2010.

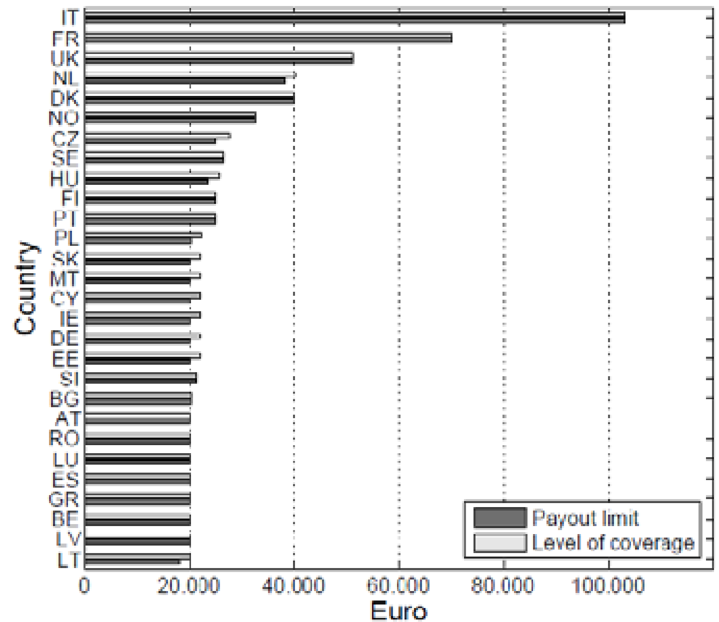
Compulsory membership

Compulsory membership in deposit insurance implies that all depositors of credit institutions are protected and any bank failure will be covered by a scheme. The latter point is important in order to ensure that the cost of collapsing credit institutions is borne by the industry that contributes to the fund. Under the 1994 Directive, participation in deposit insurance was not absolutely obligatory for credit institutions, as certain banks were allowed to be exempted if they were part of an alternative protection system. The Commission now proposes to eliminate any exception and to make membership fully compulsory. Such obligation is surely desirable as it establishes consistent coverage across credit institutions.

Scope of coverage

In past years, the coverage levels of national deposit insurance have varied widely within the EU (see Figure 1). The 1994 directive fixed the minimum coverage at €20,000 with the possibility of unlimited coverage, which maintained differences in coverage levels, for instance ranging from €14,481 in Latvia to €103,291 in Italy in 2005 (EC, 2006). These differences in protection were well known, and were raised in a public consultation in 2006 (EC, 2006). But the Commission's reaction at that time was somewhat elliptical. It only stated that amendments to coverage level would be considered in the longer term, and that no immediate action was necessary. This attitude changed dramatically under crisis circumstances, when two years later, in October 2008, the coverage was increased with immediate effect by the EU Council (without awaiting a Commission proposal) to €50,000. It was later formally increased to €100,000 from end 2010 onwards (EC, 2008).

Figure 1. Payout limits and level of coverage in EU member states and Norway (2008)



Note: Amounts as of 01.01.2008. 'Payout limits' may differ from the level of coverage for those countries where DGS apply co-insurance (see Box 1).

Source: European Commission's Joint Research Centre (JRC, 2008)

The 2010 proposal confirms the coverage of €100,000, but this time as a maximum amount. The word 'at least' is dropped in the re-cast proposal (Art. 5), which means that on this element, the draft follows the maximum harmonisation approach. The deposit guarantee needs to be high for psychological and political reasons, to calm depositors and to show commitment. With a coverage of €100,000, approximately 90% of EU deposits are expected to be protected. But, by limiting the coverage to 100,000, the draft limits distortions related to the so-called 'unlimited coverage' DGS.

With the uniform coverage of €100,000, topping-up arrangements that were possible under the 1994 Directive are no longer necessary. The 1994 Directive allowed for branches to 'top up' their deposit protection in case they operated in a host country where the DGS provided for higher protection than under the home scheme. The idea was to exclude competitive disadvantages related to differing deposit protection coverage levels. At the same time, the non-export provision of the 1994 Directive forbidding countries with higher protection countries to export their coverage levels could be dropped as well.

Another point omitted from the 1994 Directive is co-insurance, under which the depositors could be held partially responsible for protection (see Box 1).

Supervision

The Commission proposes to establish supervision of DGS and to carry out regular stress tests on their ability to handle claims. While this is a step in the right direction, the point is not elaborated sufficiently. The details of such supervision as well as the data on which stress tests should be based are left to the member states; no European approach or standard is being proposed. It is questionable to what extent the strength of those tests or supervisory information may be comparable or are actually meaningful.

According to the Commission text, member states shall ensure that deposit insurers receive sufficient information from member banks to prepare reimbursement of depositors. Any details on how such communication between banks and DGS should take place are not specified in the proposal. For the sake of simplicity, especially in the context of cross-border DGS cooperation, it would be advisable to have guidelines for this type of communication. After all, credit institutions' motivation to voluntarily communicate financial difficulties to deposit insurers may be limited – information about a bank failure is typically not passed on until the very last moment. As argued above, deposit insurers absolutely need to have access to adequate (supervisory) information to maintain their schemes and enable fast payout.

Table 1. Comparing the 1994 Directive with the 2010 Commission proposal

	1994 Directive	**2010 Commission's proposal**
Participation in DGS	Possibility to exempt an institution if it is part of an alternative deposit protection system	Compulsory for all deposit-taking institutions, without exception
Coverage level	Minimum €20,000; possibility of unlimited coverage	Maximum €100,000; unlimited coverage not possible
Topping up	Possible	No; coverage should be the same
Co-insurance	Allowed up to 10% of the covered amount	No
Eligibility: depositors	Exclusion of deposits by insurance undertakings, financial institutions, authorities, collective investment undertakings, pension funds, etc.	All private individuals and non-financial enterprises, excluding authorities and financial institutions
Eligibility: deposits	Only EU-currencies	All currencies; only fully repayable instruments, no certificates or bonds
Payout delays	21 days for the authorities' determination of unavailability of deposits; 3 months for payout, possible extension to 9 months	5 days for the authorities' determination of unavailability of deposits; one week for payout
Financing	*(not addressed)*	75% ex ante fund and 25% ex post collection
Contributions	*(not addressed)*	Risk-based contributions
Fund size	*(not addressed)*	Target level of 1.5% of eligible deposits
Depositor information	Presentation of information	Countersignature of "Depositor information template" required
Borrowing arrangements	*(not addressed)*	Access to funds from other DGS (also across borders)
Home/host country schemes	Subsidiaries participate in host scheme, branches in home scheme with possibility to top up	Subsidiaries participate in host scheme, branches in home scheme; topping up not necessary with standardised scope of coverage. Further cooperation between DGS fostered. Local DGS serve as single point-of-contact to depositors, providing direct reimbursement
Reporting and inquiries	*(not addressed)*	Reporting to EBA on a monthly basis
Procedural stages for payout	*(not addressed)*	*(not addressed)*
Precise definition of triggering event	*(not addressed)*	*(not addressed)*
Governance/ management	*(not addressed)*	*(not addressed)*

Eligibility criteria and payout

The Commission proposes to further harmonise eligibility criteria, basically extending coverage to all individuals and non-financial companies, and excluding authorities and financial institutions of any kind. Compared to the 1994 Directive, the coverage is extended to deposits in all currencies, EU as well as non-EU currencies.

In order to ensure that depositors are reimbursed quickly, the Commission proposes to reduce the time delay for payout to one week. The 1994 Directive envisaged a reimbursement period of three months with a possible extension to nine, which had already been amended to 20 working days in 2009. This reduction is important as shorter delays reduce corrosion depositors' trust. Several representatives of DGS have argued that the payout delay of seven days would be very difficult to meet, as the procedural steps needed more time. By comparison, in the US, reimbursement is possible even faster: in one day. However, as mentioned above, the US deposit insurer is much more integrated into the financial safety net and has access to more information.

One element of the proposal that appears to be rather difficult to implement – especially for cross-border claims – is the reimbursement of depositors without a previous request. Such a procedure implies that depositors are being paid out without having to submit an application. In the case of branches operating in foreign countries, the host scheme would directly start the reimbursement, even though the home country would actually be responsible. Hence, the host scheme would pay out without depositors' previous request, but at the same time probably only having limited access to information on the failing institution, as most data are held by the home scheme.

DGS financing provisions

The financing mechanism of DGS is of high significance in assuring the adequate funding and credibility of the scheme. Under the 1994 Directive, the funding of EU DGS is not harmonised and may either be ex ante, ex post or a combination of both. Past research has shown that national deposit guarantee schemes are not equally able to bear similar bank failures (EC, 2008). The Commission's Joint Research Centre (JRC) collected data from all DGS in the EU to examine the ability to handle payouts (JRC, 2008). It revealed that the coverage ratio[5] in most countries is not even sufficient to protect 1% of eligible deposits (see Table 2).

Table 2. Coverage ratio of EU DGS ranked by decreasing coverage ratio

EU-15	Coverage ratio (%)	New Member States	Coverage ratio (%)
SE	1.44	**LT**	2.30
PT	0.99	**BG**	1.58
ES	0.82	**EE**	1.54
GR	0.58	**RO**	1.19
FI	0.47	**HU**	0.62
DK	(*)0.37	**LV**	0.58
BE	0.33	**PL**	0.38
IE	(*)0.19	**CZ**	0.31
FR	0.14	**MT**	0.05
UK[20]	0.001	**CY**	(*)0.02
		SK	-0.72
NO	1.63		

Source: European Commission's Joint Research Centre (JRC, 2008). The report is based on own survey data.

Notes taken from the report:
(*) Data on eligible deposits estimated from the dataset.
(20) Though classified as an ex post scheme, the UK has a residual fund, a legacy from the previous system.

Coverage ratios in the new member states tend to be higher, as those countries had to increase coverage to the EU €20,000 minimum standard when joining the EU. Since the average size of savings tends to be lower, the coverage ratio is comparatively high in the new member states: the average coverage ratio is 0.86%, which compares to 0.53% in the EU-15 countries (0.59% when the UK is excluded).[6]

In the same report, the JRC carried out a 'stress-testing' exercise, which confirmed the weaknesses of EU DGS to handle payouts. Three different scenarios were tested, taking into account the availability of funding (ex ante, ex post and borrowing of funds):

- *Small-impact scenario*: €100 million average financial burden
- *Medium-impact scenario*: €2.18 billion average financial burden
- *High-impact scenarios:* €8.69 billion average financial burden

Results showed that all EU DGS could cover a small-impact bank failure. A medium-sized failure could be borne by seven EU countries with the highest coverage ratios using only ex ante funds. Six member states would not be able to reimburse depositor claims in the medium-impact case, even if they used all available funding, including ex post funds and additional borrowing. No member state was well-equipped to cope with a large failure using only ex ante funds.

[5] Coverage ratio = fund size (2005) / total amount of eligible deposits (2005).

[6] Several countries have not been included in part of the calculations because of a lack of or insufficient data being provided; Germany, for instance.

At first glance, the amounts used above for the third scenario seem to be large. However, they are very realistic when considering the sums of deposits that were suddenly at risk during the financial crisis. When the relatively small UK bank Northern Rock applied for emergency funding in 2007, depositors withdrew more than £2 billion (ca. €3 billion) in under a week (BBC, 2007a). The total of customer deposits at Northern Rock amounted to around £24 billion (BBC, 2007b), therefore exceeding the 'high-impact scenario' by far. The consequence of the bank run was that the UK government decided to step in and provide a full guarantee to Northern Bank depositors.

The Commission's proposal introduces harmonised financing mechanisms of national DGS and a target level of 1.5% of eligible deposits ex ante. In case ex ante funds are insufficient to reimburse depositors in the event of bank failure, banks are obliged to contribute up to 0.5% of eligible deposits to finance the DGS. The Commission's proposal therefore envisages a combination of ex ante and ex post financing, which is desirable as it keeps the advantageous aspects of both: ex ante funding is considered more credible, flexible and not pro-cyclical, while ex post contributions provide for monitoring incentives amongst financial market participants.

To reach a fund size of 1.5% of eligible deposits, the Commission suggests a transition period of ten years, until the end of 2020. This transition period is long, but should be considered in combination with other regulatory changes. Attention needs to be dedicated to the compound impact of new regulations, such as minimum liquidity requirements in Basel III, contributions to a bank resolution fund, and new deposit insurance arrangements have on banks.

In the event that the first two funding mechanisms (ex ante and ex post funding) are not sufficient for a payout, the Commission proposes to establish a mutual borrowing facility. Such facility allows national DGS to borrow from all other deposit insurance schemes in the EU under certain conditions. As a fourth financing mechanism of DGS, the Commission requires deposit insurers to have in place 'alternative funding arrangements'. But further information on such arrangements is not given, neither are details on what form they could possibly take.

Risk-based contributions and the use of funds

The Commission proposes contributions that include non-risk and risk-based elements. The non-risk part is calculated on the level of deposits eligible for insurance. The risk-based element depends on the risk profile of credit institutions, such as their risk exposure, capital structure and income profile.

Risk-based contributions are recommended as they create incentives for sound management and discourage risky engagements. A further argument for risk-based contributions is that they introduce some component of fairness to financing structures, because riskier businesses have to pay higher contributions. It is therefore of utmost importance to have well-designed contribution mechanisms, as deficient calculations would result in the opposite, namely unfair financing structures. The risk-based calculation therefore has to fully take account of different business models of banks to be efficient and provide the right incentives.

According to the Commission's proposal, the DGS funds shall mainly be used to pay out depositors' claims. Member states may allow deposit insurers to dedicate established funds to other measures to avoid bank failures. That may be permitted only when funds are sufficiently large, 1% of eligible deposits has to remain on the DGS after the intervention. The precise regulation regarding the use of funds is left to member states' judgement. It can be argued that it might be in depositors' interests to use part of the funds for pre-emptive actions in order to avoid bank failure. However, if this is done it should always be ensured that the use of the funds does not imply any reduction in depositor protection.

Another aspect regarding the fund size is how funds should be used once the balance exceeds the 1.5% target level. The Commission does not address this point in its proposal. In the US, the FDIC provides dividends to its contributing institutions in case the fund level is above the target. For Europe, this point is again left to member states.

Cross-border activities of banks and DGS

The appropriate coverage of subsidiaries as compared to branches emerged as a major issue in the crisis, but the Commission's proposal does not address this problem at all. Instead, it holds on to the current branch/subsidiary and home/host country distinction.

The 1994 Directive stipulated that in the case of cross-border activities through branches, the competent DGS is the one in which the head office is located. Therefore, subsidiaries – being separate legal entities – participate in the deposit insurance schemes of the country of incorporation, while branches – which are not separately incorporated – are covered by the home-country deposit insurance scheme. The approach of subsidiary/branch participation in host/home country DGS is in general consistent with the supervisory responsibility of financial authorities, however it leaves shortcomings in practice. While branches should be covered by their home country DGS, the crisis has shown that in several cases host countries had to step in as the home deposit insurer was not in a position to honour its obligations (see

Box 2). If branches (i.e. the parent company) face financial difficulties, the host country has reason to intervene in order to protect consumers and avoid any spill-over effects from the bank failure. Such intervention represents a de facto shift of responsibility from the home- to the host-country, the latter actually not having supervisory responsibility.

The EU DGS regulation for branches/subsidiaries was criticized several years before the crisis by Eisenbeis (2004), who stated that the current approach "bifurcates the responsibilities for controlling banking risk between the micro-risk associated with the operation of single institutions from the macro-risk associated with contagion risk or risk that spreads from one institution to another regardless of where the institutions are headquartered". He strongly argued in favour of a harmonised system of deposit insurance within the EU, and warned that the decentralised DGS would not be robust enough to face a financial crisis, because it would be exposed to several conflicts of interest and regulatory competition (see also Garcia, 1999).

The home-host responsibility represents a serious challenge to the integration of the single market, concerning supervision as well as deposit insurance. With larger shares of savings being deposited abroad, as well as more foreign branch activity, the incentive for domestic supervisors or national deposit insurers to intervene decreases. Where there are emerging financial difficulties, this problem rapidly turns into a supra-national challenge that needs a supra-national response.

Further cross-border challenges are raised in the Commission proposal as it calls for enhanced cooperation between deposit insurers. It foresees, for instance, the establishment of a system of single point of contact for customers. This implies that if a bank with cross-border operations fails, branch customers from abroad (who are covered by the bank's home country scheme) do not have to contact several DGS, but simply their national deposit insurer. That insurer serves as the sole point of reference and should directly reimburse the depositors on behalf of the DGS that is actually responsible (in the home country). The home scheme will then refund the host country insurer at a later stage.

Box 2. The case of Iceland

The meltdown of the Icelandic banking system is a good illustration of the weaknesses of the current EU DGS Directive. Shortly before the crisis, the Central Bank of Iceland set the interest rates above 15%, which led to strong capital inflows from abroad and encouraged Icelanders to borrow in other currencies. These trends, combined with exchange rate appreciation, resulted in a bubble that burst in late 2008.

At the beginning of October 2008, the three largest Icelandic banks (Landsbanki, Glitnir and Kaupthing) collapsed within one week and the government had to step in to take control. Many foreign depositors with savings in accounts of Icelandic branches abroad saw their deposits frozen. Following the collapse, the UK decided to intervene and use the British anti-terrorism act to seize the assets of Landsbanki in Britain. This move outraged the Icelandic government, as it felt that it was suddenly classed as a 'terrorist' state.

The branch structure of Icelandic banks' activities in mainland Europe implied that the home-country DGS was responsible, as stated in deposit contracts; in this case the Icelandic Depositors' and Investors' Guarantee Fund (DIGF). The DIGF is a private foundation and therefore not necessarily bailed out by its government. Yet, political pressures from abroad were such that the Icelandic government promised to repay the UK and the Netherlands (June 2009) – both countries had fully compensated depositors with accounts at Landsbanki, with the aim to recover the amounts from Iceland at a later stage. However, the compensation was turned down by the Icelandic population in a national referendum in March 2010. Almost a year later, in February 2011, the Icelandic Parliament finally approved a new agreement to repay €4bn to the UK and the Netherlands. However, this deal is not yet sealed, as there are chances that the repayment might be blocked once more as another referendum is scheduled for April 2011.

The case of Iceland illustrates numerous weaknesses of the 1994 Directive. Since Iceland is a member of the European Economic Area (EEA), it must comply with the requirements laid down in the DGS Directive. Icelandic banks were maintaining branch and subsidiary structures in continental Europe providing financial services, where the branch structures were not adequately backed up by the DIGF. The Kaupthing bank for instance maintained subsidiaries in Finland and Luxemburg, which then again served other countries. In 2008/09, those subsidiaries had to ask for state aid from Finland and Luxemburg in order to reimburse depositors in Finland and Belgium (from Luxemburg) (EC, 2009d and EC, 2009e). The number of supervisors in charge evidently complicated the task.

The legal framework stipulates that the Icelandic DGS should have covered the branch activity in other EEA member states. Yet, the collapse of the Icelandic banking system shifted the responsibility de facto from the home to the host country. The UK and the Netherlands were under political pressure to act and calm depositors' worries. This situation is not sufficiently addressed in the new Commission proposal.

Note: This section is based on information from the Central Bank of Iceland, Reuters, (www.iceland.org) and the Turner Review (FSA, 2009).

This cross-border cooperation should not be difficult to impose in theory; several challenges remain in practice, however. If host schemes advance the reimbursement, they evidently run the risk of not being reimbursed by the home country DGS. This may appear unlikely in a network of cooperating deposit insurers, yet this is exactly what happened in the case of Iceland, where UK and Dutch depositors were paid out by national schemes in 2008. The UK and the Netherlands are still waiting for reimbursement two years later, although a settlement is in the making (see Box 2 above).

Moreover, is it questionable whether the exchange of information between different European schemes will make for successful collaboration. The Commission proposes that member states shall ensure that deposit insurers exchange information, but no details have been given on how this should take place. If home schemes pay out depositors on behalf of the home scheme, they need to have access to all information relevant for reimbursement. The information evidently needs to be accessible to DGS rapidly in order to stay within the one-week payout period. If the exchange of information remains non-standardised across Europe, important obstacles to cross-border cooperation remain. Guidelines on standardised information exchange and procedures would be helpful.

Depositor information

The 1994 Directive simply required the presentation of information on the protecting DGS to customers. The Commission now proposes to make it compulsory to have depositors countersign the "Depositor information template" to ensure that customers are fully aware of the existence of deposit protection. It is important that customers entirely understand deposit insurance, as this knowledge may avoid bank runs, because depositors know their savings are protected. It is also necessary to increase general public awareness of deposit insurance and the existence of such schemes that protect depositors in order to prevent bank runs.

The new supervisory architecture

Deposit insurance is an essential element of the financial safety net, along with prudential regulation, ongoing supervision and other mechanisms. It is therefore highly important to include DGS in the ongoing process of redesign of the financial supervisory architecture in Europe. In the Commission's proposal, this is only done to a very limited extent, basically including the newly created European Banking Authority (EBA) in a few processes.

The Commission proposes the following tasks for the EBA with respect to deposit insurance: to collect statistical data on eligible/covered deposits and available financial means, to conduct peer reviews, to confirm borrowing arrangements between DGS and settle any disagreements that may arise between deposit insurers. A further elaboration of coordination between supervisory authorities and deposit insurance is missing.

In order to have a coherent approach to financial stability, deposit insurance schemes need to be included in the ongoing restructuring process of financial supervision in the EU. DGS should be attributed a clear role in the stability framework; reporting requirements to the EBA are not sufficient. Potential roles of deposit insurance in financial supervision or crisis prevention and management need to be considered.

4. Not considered in the Commission's proposal

Several key aspects and challenges of European deposit insurance have not been appropriately dealt with in the Commission's proposal. An important point is surely the problem of branch/subsidiary structure and the related liabilities, as mentioned above. A continuation of the existing home/host country division of responsibilities simply does not solve the problem. Other open issues are the legal structure and governance, payout procedures and the triggering event. A separate section is dedicated to the key question on a pan-European structure.

Legal structure and governance

The legal structure and governance of DGS differ throughout member states, being created and administered either as a public or private entity. This has important implications for the liabilities of the fund, in case it needed to be called upon or extra funding was necessary. In theory, governments should only be held responsible for reimbursement in case of a public fund scheme and the private sector should be liable for the private DGS. However, if the private sector cannot honour its obligations, governments face strong pressures to rescue and protect (part of) those that hold stakes in failed banks, especially private individuals (Demirgüç-Kunt et al., 2006). As has been seen in the past, it is unavoidable that governments are required to take action to protect depositors.[7] This government role persists, no matter whether the fund is public or private, or whether the responsibility is explicit or implicit.

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[7] The practice of governments issuing blanket guarantees to limit depositors' fears is not a new one; this approach has been taken in the past, for instance during the Swedish crisis in 1992, before Sweden adopted an explicit DGS in 1996 (Demirgüç-Kunt et al, 2006).

Based on past experience, the question of DGS governance and legal structure (public or private) needs attention and discussion. Is it advisable to have schemes in private or private hands? It appears that a private organisation is not necessarily efficient, as the ultimate responsibility is always likely to fall back on governments.

Payout procedures and triggering events

When it comes to reimbursement procedures, the Commission simply proposes the reduction in the number of days before payout. The variety in payout procedures of European schemes is not addressed, even though they tend to be very different. Research has shown that payout procedures at European deposit insurers can consist of up to 21 stages involving numerous different entities (JRC, 2008). The variety of procedures and competencies hampers the communication between deposit insurers across borders, even more so as different types of entity may be involved during these phases.

The 'triggering event' that leads to initialising the reimbursement procedure has not been clearly defined in the past, neither does the Commission propose a specification now. The JRC report (2008), illustrates that the triggering event falls within the responsibility of up to eight different types of entities, with no harmonisation across European countries. This is evidently not conducive to handling cross-border cases. It would be advisable to define clear criteria for when and how payout processes should be initialised. Beck and Laeven (2006) argue that it would be desirable to involve the owners of the fund or banking authorities in the decision of unavailability of funds as they are likely to be more efficient than courts, because they "better understand bank risk-taking incentives and how to remedy them".

Both issues – differences in payout procedures and triggering events – should be more harmonised to allow for close cooperation between national DGS and to avoid panic.

5. What pan-European structure for deposit insurance?

For the time being, deposit insurance in the EU is organised at the national level, which is also the reason for the great variety in schemes. The Commission's proposal does not change much of this organisation; it only introduces the idea of a strengthened network of national DGS. Given the EU's major objective of integrating markets for financial services in order to achieve the single market, the question arises whether the maintenance of national structures is the adequate response to credit institutions that are increasingly operating across borders, certainly for those working through branches.

In addition to the proposed network model of European deposit insurers, two further structures are conceivable, namely a 28th regime and the creation of a single fund. The three options basically range from the cooperation/network approach to full harmonisation (a single fund). They could potentially be introduced successively, gradually moving towards complete integration. A gradual upgrading would however lead to high administrative costs. If the goal is to introduce full integration, it would be more reasonable to aim directly for the single European DGS instead of establishing a 28th regime.

The first option (the network) could be implemented rapidly, if the political will is there. The network approach requires enhanced information-sharing among members and possibly the creation of inter-fund reimbursement and lending facilities. The disadvantage is that it does not fully address the challenges the internal market is facing at the moment. With cross-border banks maintaining structures of branches and subsidiaries abroad, responsibility for coverage and reimbursement may be confusing. A variety of national deposit insurance schemes with complex banking structures renders reimbursement formalities extremely difficult.

Under the second alternative – the 28th regime – national schemes are kept and a pan-European deposit insurance is created as a complement. Such a scheme could take the form of a common fund, complementing national schemes and providing part of the deposit insurance or a system of re-insurance for cross-border banks. As is the case for option (1), this second option keeps current DGS structures and does not provide a single solution to current challenges. The problems with cross-border banks, as well as competitive concerns, remain.

With the third option a newly-created single pan-European fund would replace existing DGS, insuring deposits of all credit institutions established in the internal market. Such a single fund could deliver the solution to many challenges that the networks structure or 28th regime cannot handle adequately. First of all, the important risk and responsibility issue for cross-border institutions would be solved, as all banks would adhere and contribute to the same DGS. That implies that the branch/subsidiary question would simply disappear. Furthermore, competitive distortions would be minimised as a single fund would create a level playing field for all deposit-taking institutions. Any remaining differences in protection would be eliminated. Consumer protection would be harmonised and no disturbing cross-border differences would persist. In addition, the centralisation of deposit protection would imply

considerably lower administrative costs than running separate national systems. Last but not least, a centrally located fund could easily take on additional tasks, such as observing/supervising risk-taking in the market, which would be of considerable value-added in the case of cross-border credit institutions.

In addition to the risk/responsibility issue in European deposit protection, the three pan-European structures have different implications regarding regulatory arbitrage and competition. In general, the more fragmented structure with a network of national DGS may lead to higher levels of regulatory arbitrage. With varying deposit insurance schemes, banks have an incentive to take advantage of regulatory differences, for instance by operating in countries where participating in DGS comes with a lower financial burden. On the other hand, depositors have reason to benefit from arbitrage by locating their funds in countries with higher deposit insurance. These issues could be solved by one single DGS for all credit institutions in the EU.

Moral hazard arises with any type of guarantee or insurance, but with the creation of a single pan-European deposit insurance fund, that problem may be stronger as national supervisors may be less attentive to risk. They may feel less need to monitor their banks, as there would be a large fund accessible to bail them out. At the other end, credit institutions may be more prone to risk-taking for the same reason, meaning that the existence of a bulky fund to offer support in case of business failure would lead to banks adopting more risk-taking behaviour. The moral hazard concerns that are stronger with full integration would need to be addressed with clear control/supervisory arrangements, possibly with bolstered responsibilities and powers of deposit insurers regarding the monitoring of and inquiring about the health of credit institutions, and clear triggers.

6. Conclusion and recommendations

Sixteen years after the first EU legislation, the challenge to harmonise deposit protection schemes remains. During the crisis, a number of DGS proved unreliable and serious cross-border tensions emerged in handling payouts. As a result, increasing the efficiency of deposit protection schemes emerged as a policy priority. But to what extent should schemes be harmonised in the EU and what roles should they have?

The Commission's 2010 proposal is a first step forward, covering a number of aspects of DGS, such as the harmonisation of scope of coverage and deposit/depositor eligibility. This will increase consumer protection in many countries and limit incentives to locate savings in markets with higher coverage levels, as the same amounts and types of deposits will be insured throughout the EU.

The proposed financing requirements and targeted fund size of deposit insurance are necessary, because past experience has demonstrated that the fund availability was not sufficient to handle consumers' claims following bank failures. The target level of 1.5% of eligible deposits appears reasonable, as experiences have been positive in the US with the FDIC target level at 1.15-1.5% of insured deposits. But it implies that several DGS have to change from ex post to ex ante funding and have to create considerable reserves. This comes at a high cost for credit institutions, in addition to the new standards for capital and liquidity requirements stemming from Basel III, and possibly other rules.

While the Commission's proposal certainly has its merits, a number of issues are left open, for example what further roles deposit insurers should take on. As argued above, there are strong reasons to equip deposit insurers with a mandate beyond the simple pay box function, and including them in the wider financial safety net. If that role was extended to intervention measures, European DGS would need to be equipped with adequate powers and tools. Such mandate would only make sense if banks' resolution procedures were clearly aligned as well. DGS should be assigned a clear role in the European stability framework; limited reporting requirements to the EBA is not sufficient. And their role should be reconsidered now, as the regulatory response to the crisis should embrace the entire safety net in order to avoid any inconsistencies.

An important omission in the Commission's proposal is governance structures and the ultimate liability of private and public DGS. Would it be better to have a pan-European scheme administered by the public or private sector? For the time being, both governance structures exist at the national level. Yet, no matter how well a DGS is designed, there always remains an implicit responsibility on governments to step in as the lender of last resort, as was largely the case during the crisis. This ultimate liability of the public sector is a strong argument in favour of publicly administered pre-funded deposit insurance.

Out of the three possible pan-European schemes discussed above, the only efficient, reliable and sustainable solution is full harmonisation, meaning the creation of a single European deposit insurance scheme. The network structure always leaves regulatory gaps, as does a 28th regime. With full harmonisation, many challenges posed by the existing variety in national deposit insurance schemes would disappear, for instance related to the scope of coverage, payout procedures and – most important – the branch vs subsidiary treatment of foreign banks.

For the time being, however, full harmonisation is difficult to enforce, as some member states and national interest groups are already manifesting their dissent over the Commission proposal.

Pleas by national governments and interest groups that stronger harmonisation of deposit insurance is not in line with the subsidiarity principle can be disregarded, as DGS of a different nature cannot co-exist in a single market and European action to address deposit insurance challenges is more effective than action taken at national or local level. The problems that have arisen to protect and reimburse depositors across borders call for more harmonisation, since a network approach is clearly insufficient.

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