

Completing the Banking Union: Deposit Insurance

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Key Ideas and Policy Recommendations

It is generally agreed that a Banking Union should have common or 'single' institutions responsible for carrying out three basic functions: supervision, resolution and deposit insurance. So far, however, agreement has been reached in the EU on only the first two functions.

The Commission has now presented its proposal on how to complete the Banking Union with a European Deposit Insurance Scheme (EDIS).¹ It is an innovative and courageous proposal. It is courageous because it will clearly be very controversial in a number of member states (especially Germany) and it is innovative because it proposes a three-stage process, starting with re-insurance, then switching to co-insurance and finally to full direct insurance of deposits via a 'single' Deposit Insurance Fund (DIF). This final stage should be reached in 2024, which is also the date at which the Single Resolution Fund (SRF) will become the only source of financing for bank resolution. The Commission's proposal calls for integrating the decision-making for EDIS into the decision-making entity for the SRF, namely the existing Single Resolution Board (SRB). This makes sense if one views resolution and deposit insurance as two highly interlinked dimensions of dealing with banks in trouble. In this view the two dimensions should be bundled into one institution – and one suspects that over time the two funds (the SRF and the DIF) could be merged into one.

This Policy Brief argues that re-insurance should not be considered as a transitory phase, but could also provide a solution for the long run. 'Experience rating' could be used to ensure a proper pricing of risk and to protect the interests of the depositors in countries with safer banking systems. Moreover, EDIS should have a decision-making structure separate from and independent of the SRM, since it has mainly a macroeconomic function.

¹ See the Commission's proposal published 24 November 2015, at: http://ec.europa.eu/finance/general-policy/docs/banking-union/european-deposit-insurance-scheme/151124-proposal_en.pdf

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1. Introduction

It can be argued that deposit insurers should normally also be responsible for resolution and that the two functions should be combined into one institution (and have the same source of funding), as is the case in the US with the Federal Deposit Insurance Corporation (FDIC) (Gros & Schoenmaker, 2012). The basic rationale for this ‘unitary’ view is simple: when deciding whether or not to finance the resolution of a failing bank, the resolution authority should take into account the potential cost for the deposit insurer that might arise if the bank is allowed to fail. This can be achieved best if the two functions are housed under the same roof.

In reality, however, resolution and deposit insurance are of quite a different nature; and the rationale for fully centralising deposit insurance is much weaker than for resolution. The purpose of bank resolution is to avoid an insolvency with all the costs and contagion effects it might generate. Resolution thus aims to ensure continuity of those main functions of a bank that are deemed to be of systemic importance. Public funding is needed only to the extent that no private-sector solution can be organised on short notice. The purpose of a resolution fund is to finance investment in a new bank (to be carved out of the failing one) – not to give money away. A well-run resolution fund should thus be profitable. By contrast, a deposit insurance fund can only make losses, as it is used when a bank has failed and the losses are so large that depositors cannot get their money back. In short, a resolution fund invests in the future, whereas a deposit insurance fund pays for losses from the past.

Moreover, resolution is decided on a case-by-case basis, necessarily involving a considerable dose of discretion, as there can always be legitimate disagreement over the systemic importance of a bank and the financing needed to create a new one that could take over its essential functions. Deposit insurance, by contrast, applies to all banks in the same way and leaves no discretion: the pay-out is pre-determined (up to €100,000 per person) and has to be done within a few days.

Reserving discretion on which banks to resolve (and how to finance their resolution) at the national level would have endangered the level playing field of the internal market. And this is why a single resolution mechanism was needed. But this argument does not apply to deposit insurance where there is little room for such discretion.

Large banks active in several member states would represent a problem for any national resolution fund, but much less for national deposit insurance funds since any one of them would only have to pay out to make good on the losses suffered by resident depositors (provided the retail operations are organised via subsidiaries, rather than via branches). By contrast, resolution funding is needed for the entire group. This is another reason why a *single* resolution fund is needed for large, internationally active banks, but not necessarily a single deposit insurance fund.

Moreover, the direct benefits of insuring depositors are quite local as cross-border retail deposits remain a rarity. It thus makes sense to keep the cost local as well. All this implies that the argument for centralising deposit insurance is much weaker than for bank resolution.

The one public function that national deposit insurance funds are not well equipped to perform is that of maintaining the confidence of depositors when the entire banking system of a country is under stress. In a systemic banking crisis (systemic at the national level), the accumulated funds in the national deposit insurance scheme are likely to be insufficient. But the government of the country in question is likely to be under pressure as well, which implies that the national fiscal backstop is likely to be weak when it is needed most.

A national systemic crisis is actually much less likely to arise in future since the SRM will probably intervene if the failure of a bank (or a number of them) threatens to trigger a systemic crisis, especially given that most large banks are also internationally active. The SRM is actually directly responsible for only the 120-plus banks under direct ECB (or rather SSM) supervision,

and banks with significant cross-border business. There are thus 'only' about 140 banks that would come under the direct competence of the Single Resolution Board (SRB). This group of banks accounts for the bulk of banking activity in the euro area (about 80%, whether measured by assets or deposits). This implies that the SRM de facto represents a first line of defence against systemic crisis. But there remains a significant part of the banking system that is not covered by the SRM.

The main activity of national deposit (or guarantee) systems (DGSs) might thus become monitoring hundreds of smaller banks with little international business. There might of course be more failures among these 'national' banks since the SRM is much less likely (than national authorities) to intervene to resolve medium-sized banks that might be important at the national level, but would not represent a threat to systemic stability at the euro-area level.

It cannot be ruled out, however, that the SRM will not intervene in a crisis that is systemic at the national level, but does not endanger euro-area stability. In this (unlikely) case, the national DGS might be overwhelmed and its sovereign might not be able to provide a sufficient backstop. This is why some mechanism is needed to insure against this risk of a systemic shock. The appropriate mechanism to achieve this is re-insurance: i.e. to provide national DGSs with an insurance against large shocks. Gros (2013) provides a detailed proposal along these lines (see also the next section).

The purpose of deposit insurance - or Deposit Guarantee Systems (DGSs), as they are called in EU legislation - is to prevent a run on deposits. Such a run can arise for any single bank if the protection is not perceived as absolute, as shown in the case of Northern Rock in the UK. But this problem has been taken care of by the new, more stringent rules for protection and payout periods. A nation-wide deposit run, however, is unlikely to occur in the 'standard' setting of a country with its own national currency since it would require all depositors to switch out of deposits into cash. Within the euro area, however, the probability of a generalised bank run within any

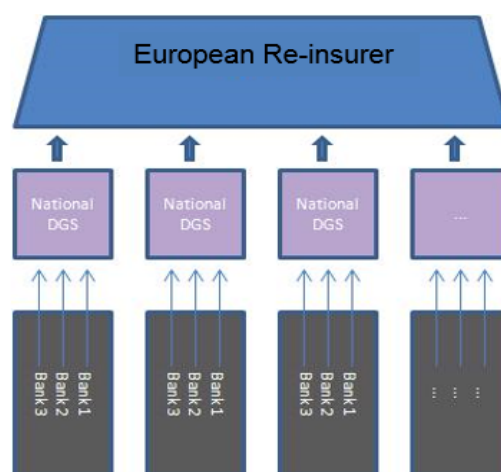
one member state is much greater, since depositors could just transfer their accounts abroad and continue to transact their banking in the same currency. This is why it is important to give savers the confidence that their deposits will be protected even if the entire nation is under stress.

2. The re-insurance approach: A schematic presentation

Under the pure re-insurance approach, national DGSs would continue to function as before, but each one would be forced to take out insurance coverage against large shocks. This (re-)insurance could be managed under the EDIS, as foreseen for the first three years under the Commission's proposal. The funding for the re-insurance could come from the DIF, which the Commission wants to set up.

The funding for the DIF in turn would come from the national DGSs, which would have to transmit part of the fees they are levying on individual banks to the European level (the DIF). Schematically there would thus be two tiers of deposit insurance: by the national DGSs in relationship to 'their' banks and by the European re-insurer in relationship to the national DGSs.

Figure 1. The two-tier approach to deposit insurance: Re-insurance



This two-tier system would react differently to the failure of a small bank than to a systemic problem at the national level. This is illustrated in Figures 2 and 3.

Figure 2. The case of a single bank failure

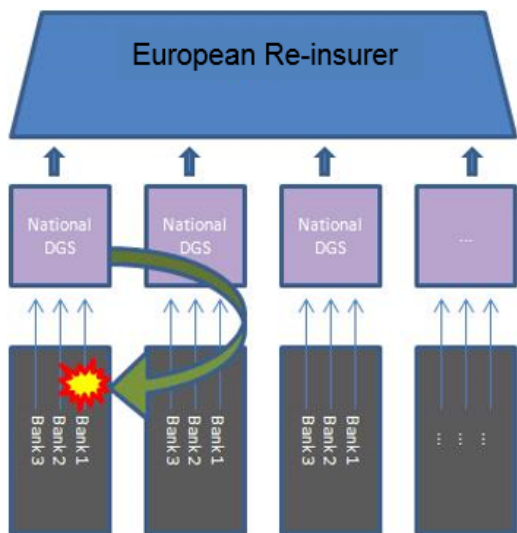
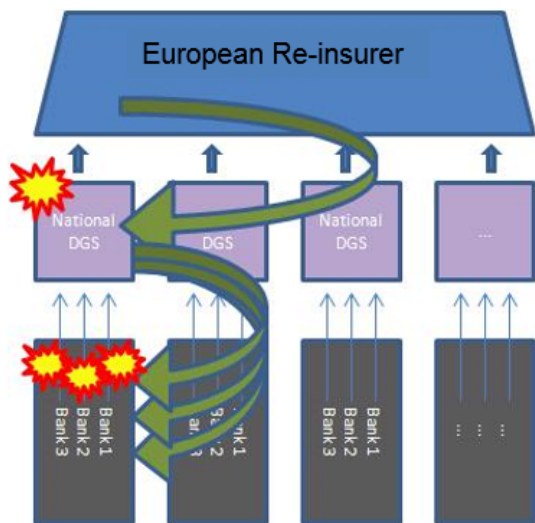


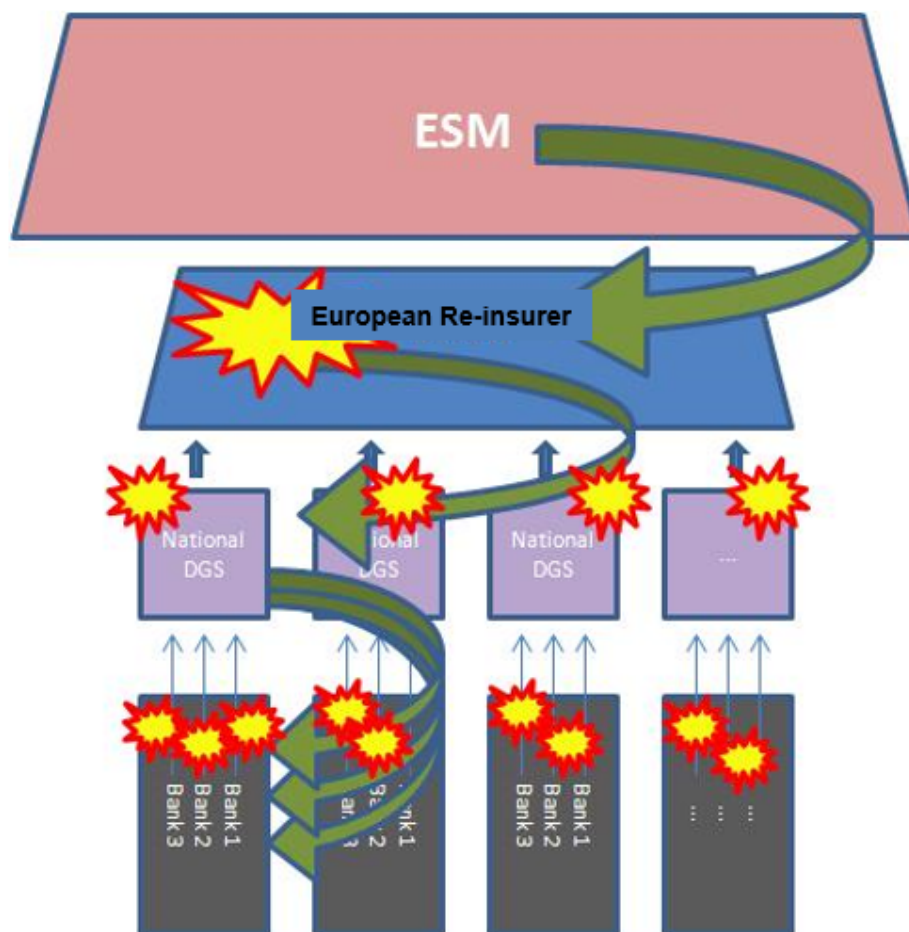
Figure 3. Systemic crisis at the national level



The European re-insurer (i.e. EDIS with its fund, the DIF) would thus intervene only in the event that so many banks fail in any given country that the national DGS would be overwhelmed.

It is often argued that the re-insurance concept cannot take care of the ‘fiscal backstop’ problem. It is clear that the resources of any normal deposit insurance will always be insufficient in the event of a systemic crisis. This also applies for the euro area as whole. If there is a systemic crisis at the euro-area level (as opposed to a national crisis), any European insurance scheme would need a fiscal backstop. This applies to the re-insurance approach as well as the case in which there would be one single European deposit insurer. Figure 4 depicts schematically the case of a euro area-wide crisis, assuming that the ESM would constitute the fiscal backstop.

Figure 4. The case of a euro area-wide systemic crisis and the need for a fiscal backstop



3. Pricing risk: Micro vs macro

One key aspect of the reinsurance approach is that it is a macroeconomic function. Its main concern will not be the risk parameters of each individual bank in the each country, but rather the systemic risk that arises from developments at the macroeconomic level (e.g. rising house prices, increasing leverage in the corporate sector, etc.). In principle, this expertise is already available in the ESRB. It would thus be important to find an institutional solution in which this expertise can be used. Moreover, procedures to prevent systemic problems already exist, such as the Macroeconomic Imbalances Procedure (MIP) and the Stability and Growth Pact (SGP). The macroeconomic aspect will remain a predominantly national responsibility for a long time, driven by national fiscal policy, wage

developments, the fiscal treatment of housing, etc.

Looking at the risk parameters of individual banks cannot capture these macroeconomic factors. During the boom years, for example, Spanish banks appeared to be among the strongest and most profitable in the EU. The normal risk metrics would have assigned them a very low risk level. By contrast, a macroeconomic approach, based for example on the indicators of the MIP, would have signalled a high level of risk. Increasing the price for re-insurance when the macroeconomic, or macro-prudential indicators signal higher risk would be appropriate, and possible under the re-insurance approach. This is another advantage of the re-insurance approach: it allows one to gradually price macroeconomic risk.

Pricing macroeconomic risk will always remain imperfect. One could thus consider an element of ‘experience rating’. This would imply that the DGS of a country that has experienced a large shock would be required to pay higher premia until a certain proportion of the funds it had drawn from the European re-insurer (say the DIF of EDIS) had been repaid.

Experience rating is used in many areas of insurance: it implies that premia typically increase after an insured event has occurred. It seems normal to apply its principles also in the case of deposit insurance.² Experience rating is used in the United States in the area of unemployment insurance to distribute the cost more fairly among individual enterprises. Enterprises that fire employees more often pay a higher premium. Experience rating thus represents an attempt to link risk premia to risk that has actually materialised. But experience rating is also used to equalise, *ex post*, across states. States that experienced very large pay-outs to unemployed are later required to adjust their premia (or their coverage ratios) until they have repaid their debt to a Federal fund. In this case, experience rating is equivalent to a claw-back provision.

Something similar could be applied in the re-insurance model as well. The higher rates that a national DGS would be subject to after it has received a pay-out from the DIF should of course apply only in the very long run, since the purpose of the re-insurance model is to provide funding in case of a (national) systemic crisis. Claw back should start only once the crisis is over. Moreover, there should be no presumption that experience rating leads to a full claw back of any pay-out via higher premium payments. But a partial claw back (i.e. a recovery of the pay-outs) seems appropriate, given that, in reality, a country-wide crisis can only rarely be attributed to errors of supervision (which has been centralised), but also only rarely can it be attributed to macroeconomic mismanagement at

the national level. The reality of the EU, with its shared sovereignty in economic matters, implies that the cost of dealing with a systemic crisis of a single Member State should also be shared.

Experience rating with individual banks is not possible since the depositors need a pay-out only after the bank in question is bankrupt. This is another advantage of the re-insurance approach.

The one risk that cannot be properly priced and prevented is that of re-denomination, or rather exit from the euro. It is clear that no common deposit insurance could be asked to fully pay out €100,000 to each depositor in a country where the government has decided to re-introduce a national currency. The ‘Grexit’ problem cannot be solved either by fully centralised deposit insurance or via the re-insurance approach. The only solution one can imagine is that any country that leaves the euro will have to rely on its national DGS, which could claim from EDIS and the DIF only the amount of premia it had paid in previously.

Conclusions

The case for moving deposit insurance to the European (in reality euro-area) level seems simple and powerful: banking supervision is now performed at the European level. Any bank that fails represents an error made by a European institution, namely the European Central Bank, or to be more precise, the Single Supervisory Mechanism (SSM). Hence it is appropriate that a European fund also pays for the consequences of any mistakes in supervision.

However, this syllogism is less powerful than appears at first sight.

First of all, the purpose of supervision is not to ensure that no bank ever fails. The purpose of the Banking Union is not to prevent all bank failures, but rather to provide a workable framework in which failure is possible.

further costs for the insurer. From the perspective of the individual, this is perceived as unfair, but the logic could also apply to the likelihood of suffering a macroeconomic shock.

² Experience rating is used widely in health insurance as the occurrence of an insurable event usually indicates that the individual in question is of overall bad health and thus poses a higher likelihood of

Secondly, in reality bank failures are not evenly distributed over member countries. They tend to be bunched together at times of macroeconomic stress. This implies that widespread or systemic banking crises tend to be national, which suggests that widespread bank failures usually also have a national, macroeconomic background. This fact of banking life can be managed with the re-insurance approach, but not when resolution and deposit insurance are both totally centralised at the European level.

The Commission has already proposed to use the re-insurance approach, but only for a limited period. But there is no need to limit the re-insurance period. It should be maintained at least until 2024, when the SRR and all the national DGSs should have reached their funding levels. It would be sufficient to have a review clause so that a decision whether or not to proceed to further integration could be taken at that point.

This contribution has not addressed the issue of the large holdings of banks of the debt of their own government. It should be clear that any mutualisation of the protection of depositors makes sense only if the sovereign risk on bank balance sheets is also 'mutualised', or rather distributed. There is no need to restrict the holdings of sovereign debt by banks, but it would be necessary to impose strict diversification limits so that the insolvency of the sovereign does not immediately lead to the insolvency of all the banks of the country in question.

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