Options and national discretions under the Deposit Guarantee Scheme Directive and their treatment in the context of a European Deposit Insurance Scheme

EXECUTIVE SUMMARY

A study prepared by CEPS in collaboration with Milieu Consulting SPRL for the European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union

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Objective

Deposit insurance protects deposits and discourages depositors from bank runs. The strength of a deposit guarantee scheme (DGS) is primarily determined by the relative strength of its member institutions (mostly banks), the level of available financial means and the guarantor. It follows the principle that banks, participating in a DGS, and not taxpayers, should pay for bank failures.

In the European Union, **deposit insurance has been harmonised over the past two decades**. The current rules and procedures on depositor protection are set out in the Deposit Guarantee Schemes Directive (DGSD) adopted in 2014, which strengthened depositor protection by requiring faster pay-outs, more robust funding, including a minimum target level for *ex ante* risk-based contributions, and increased information disclosure. **Deposit insurance is therefore organised at national level and guaranteed by national governments**, which are required to contribute when the funds of national DGSs are insufficient.

In November 2015, the Commission proposed to set up a **European deposit insurance scheme (EDIS)** for bank deposits in the euro area as the third pillar of the Banking Union. Negotiations on the EDIS proposal are still ongoing.

The DGSD contains **about 22 national options and discretions (NODs),** which may be applied on the basis of national circumstances, and their relevance under EDIS was frequently addressed in the context of the negotiations on EDIS in the European Parliament and the Council.

In this context, the purpose of the study is to provide an overview of the current use of NODs in the Member States and contribute to the discussion regarding their treatment under EDIS, by formulating policy recommendations, including in view of the impact on EDIS in terms of financial exposure and administrative burden.

Methodology

The study assesses both the transposition of each NOD across the EU Member States and the experience in practice. It evaluates the impact of each of the NODs on the risk profile of the DGS, the level playing field, depositor confidence as well as its relevance in the respective Member State. Consequently, the following policy options are assessed in the context of EDIS, which, for the purposes of the study, takes the form of a full insurance scheme: retaining the NOD in its current form, eliminating the NOD, alternative options or full harmonisation. This assessment is performed against the criteria of effectiveness, efficiency, coherence and subsidiarity.

In view of generally unavailable public information, considered the major difficulty when carrying out the study, several data collection tools and surveys involving the DGSs and their member institutions were necessary in order to complement the desk research. In addition, simulation and estimation exercises were used in order to feed the policy analysis and draw policy recommendations.

Main findings

There are many differences between Member States in terms of the transposition of the NODs into national law and their use in practice. The mapping of the current use of NODs in the Member States, set out in the study, contributes to the discussion regarding the treatment of NODs under EDIS because it helps to identify the degree of current fragmentation and the possible scope for further convergence.

Several NODs are highly important for the protection of deposits in the Member States and would continue to be relevant in the context of EDIS as well.

For example, the coverage of temporary high balances (NOD 4) is currently largely divergent across Member States and has a clear potential to increase financial exposure to EDIS. However, there is a public interest in protecting the deposits linked to specific, often one-time, life events although such amounts exceed the regular coverage level. Moreover, the study shows that the calculation of the contributions differ somewhat across the EU (NOD 4, 17 and 19[1]) or that depositors of third-country branches may be subject to a different treatment in some countries (NOD 20). Therefore, further harmonisation would help improve the level playing field and ensure the same level of protection for the depositors (see below), while addressing their treatment under EDIS.

By way of another example, DGSs can currently have different objectives across the EU: protection of covered deposits only ('pay box' function), or also preventive measures (NOD 13) or alternative measures (NOD 14). These differences could make the build-up of EDIS to take the form of a full insurance scheme more complicated.

In many Member States, NODs have been transposed in law but not (yet) used in practice. Only about 20 % of the NODs transposed have so far been used in practice. In some cases (mostly regarding the NODs 1 to 10 related to the coverage level and pay-out procedure), this may be explained by the lack of pay-out events. In other cases, the study shows that some of the NODs are not easy to use in practice (NOD 11, 12 or 16) or the national DGS has chosen not to use the NOD.

The lack of practical use of some NODs calls into question whether they should continue to be part of the framework. Indeed, NOD 16 on lower contributions for low-risk sectors is not used in practice because the definition of a low-risk sector is considered too complex. NOD 12 dealing with contributions into existing mandatory schemes is only specific to one Member State[2] and would not be relevant any longer. The relevance of transitional NODs (NODs 21 and 22) is naturally diminishing, as they are designed to expire at some point in time.

A small number of NODs address national specificities and circumstances. For example, the exclusion of deposits to pay off a loan on private immovable property (NOD 3) and deposits fulfilling a social purpose (NOD 8) address each circumstance specific to one Member State. They could be retained under EDIS, as they are neither increasing the risk for EDIS nor for the depositors.

With few exceptions, the relevance of NODs in terms of impact on covered deposits in a Member State is generally low.

The study shows that the majority of NODs, including that for temporary high balances, would only have a low impact of up to 10 % on the covered deposits in a Member State and thus form a limited risk to the DGS. There are several exceptions. Among NODs addressing special national circumstances that relate to substantial amounts of deposits, NODs 3 and 8 would have no impact for the risk profile of the DGS. By contrast, old-age provision products and pensions (NOD 5) could increase the risk profile of the DGS, though this could be mitigated with risk-based contributions in the context of EDIS. In addition, there are other NODs regarding risk adjustments in the calculation of contributions (e.g. NOD 18 involving 80 % of deposits covered by the national DGSs[3]).

[1] NODs 17 and 19 deal with lower contributions for the members of IPS and the minimum contribution to the DGS.

[2] NOD 12 is applicable in the UK.

[3] NOD 18, related to the use of uniform risk-weights for banks affiliated to a central body, is particularly important in Finland. Three central body networks collectively account for approximately 80 % of national covered deposits.

Policy recommendations

The treatment of NODs under EDIS should account for (i) the use of NODs in practice, (ii) the existence of national specificities, (iii) the potential risks for EDIS and (iv) the impact on depositor confidence.

In defining the recommendations regarding the treatment of NODs, the effectiveness, efficiency, coherence and subsidiarity of potential policy options are assessed. In practice, this means that the recommended option aims to ensure an effective depositor protection, without requiring support from taxpayers, incurs limited operational costs, safeguards the level playing field, fits in the broader context of finance policies such as bank capital, supervision and resolution, and is in line with the principle of subsidiarity, addressing national specificities. The main policy recommendations are as follows.

1) <u>EDIS should maintain a high level of coverage for depositors.</u>

In order to preserve depositor confidence, EDIS cannot provide a lower coverage level than current national DGSs. Therefore, it is recommended to retain those NODs providing additional coverage.

Member States use a number of NODs which increase the coverage level. This is primarily the case of temporary high balances (NOD 4) and deposits in the pension schemes (NOD 1 and 5). In view of their importance for depositor protection, it is recommended to retain these NODs. For example, for temporary high balances, the study recommends harmonising the coverage level to protect depositors up to the limit of EUR 500 000 and for a period of up to 6 months[4]. The main benefit of this approach would be a significantly reduced fragmentation across Member States in the current relative amounts of temporary high balances.

However, some covered deposits related to these NODs would have to be included in the calculation of the contributions.

The study points out that, currently, the deposits under NODs 1, 4 and 5 are not consistently reflected in the contributions. Therefore, it is proposed that all these deposits should be included in the calculation of the risk-based contributions in order to mitigate the impact on the financial exposure to EDIS. With respect to temporary high balances, the study acknowledges the difficulties in identifying such temporary amounts in advance and proposes that the latter could be accounted for in the calculation of the contributions based on estimations. According to this study, if the temporary high balances were included in the calculation of the contributions, the total amount of covered deposits would increase by 4.6 % on average in the EU.

2) <u>In the perspective of EDIS, one of the main challenges seems to relate to preventive and alternative measures.</u>

The role of preventive measures (NOD 13) in the crisis management framework would benefit from further policy reflection.

The preventive measures are particularly crucial for institutional protection schemes (IPSs) recognised as DGSs which rely on this NOD to achieve their main goal, i.e. to prevent the failure of member institutions. Some DGSs also seem interested in using such measures to lower the costs of intervention as compared to a pay-out.

If this NOD is retained, the following targeted improvements would be required. First, the DGSD has not clearly defined the least-cost test[5] and the latter is applied

[4] Based on the median implementation, assuming a coverage of EUR 500 000 in the UK with about 87 % of the deposits covered, the recommended coverage level would cover basically all the deposits related to primary residential property transactions in the majority of Member States.

[5] The cost of the preventive measures may not exceed the costs of fulfilling the statutory or contractual mandate of the DGS.

differently across Member States. Besides, State aid rules should be clarified because the NOD seems available for use mainly to private DGSs, which are more likely than public DGSs to fall outside State aid rules. Therefore, other DGSs seem to have limited room for the use of the NOD in practice, which potentially gives rise to level playing field issues.

The study also contemplates that, under a full insurance scheme, IPSs could finance preventive measures with separate (existing) voluntary funds. Under this option, the definition of the least-cost test would not be necessary but State aid rules may still need to be clarified. For the members of IPSs recognised as DGSs, the contributions could be split between the DGSs and IPSs and lowered to compensate for the IPS membership (NOD 17). Admittedly, the costs for these institutions could, however, be higher than in the current framework.

The alternative measures (NOD 14) have demonstrated a high potential to preserve access to deposits and reduce the destruction of economic value resulting from an insolvency proceeding and should be maintained.

However, some targeted modifications to address the fragmentation in the national transpositions affecting the level playing field across the EU and the protection of depositors are needed. In particular, these modifications would ensure (i) an open competitive procedure to find a potential acquirer interested in taking over either assets and liabilities or just the deposit book at a higher price than the latter would have otherwise been materialised in insolvency (i.e. lesser destructive value), (ii) that such a transaction constitutes the least cost[6], possibly in line with the Valuation 3 used in the BRRD, and (iii) does not put the financial stability of the acquirer at risk. This modification could also entail possible changes in creditor hierarchy, by levelling the covered and uninsured deposits[7]. With EDIS in place, alternative measures could be financed by EDIS under the full insurance scheme or, alternatively, depending on the form EDIS takes, also by national DGSs.

3) <u>Some harmonisation is needed in order to strengthen the level playing field.</u>

In view of the differences among Member States, some further harmonisation would be necessary to level the playing field, and to ensure a same level of protection for depositors. For instance, the treatment of third-country branches and some NODs related to contributions could be harmonised further.

Currently, with few exceptions, most third-country branches participate in the national DGSs in the vast majority of Member States, but the approaches as to the equivalence testing and calculation of contributions are diverse. In order to ensure equal treatment of third-country branches across Member States, including the protection of depositors in the EU, the treatment of these branches (NOD 20) should be harmonised. Therefore, the study recommends requiring all third-country branches to participate in the DGSs and defining common criteria for the equivalence test[8] and the calculation of contributions. Besides, as third-country branches would increase the risk profile of EDIS, these common criteria would mitigate the risk to EDIS. In addition, third-country branches could be subject to a maximum threshold of EUR 500 million on covered deposits to mitigate the risk to financial stability.

By way of another example, the lower contributions for members of IPSs not recognised as a DGS (NOD 17) should be maintained, because this NOD takes into

[6] The costs of these measures may not exceed the net amount of compensating covered depositors of the failing member institution but there are no detailed rules how to apply as such the least-cost test.

[7] This is because the recent changes to the creditor hierarchy regarding the preferential ranking of covered deposits are likely to reduce the possibility of applying alternative measures.

[8] The equivalence test examines whether the third-country DGS offers protection equivalent to that of the DGS in which the third-country branch wants to operate.

account the lesser risk of a potential pay-out for members of IPSs, combined with a common method of reflecting IPS membership in the calculation of contributions.

A small number of Member States use the NOD on the minimum contribution for member institutions irrespective of their covered deposits (NOD 19) in different ways. In order to reduce the current fragmentation, the design of the minimum contribution could be revised by aligning it with that of the Single Resolution Fund, i.e. creating a tiered harmonised system of flat contributions for a number of categories of small institutions based on their size. This NOD could also be used to require any new institution to pay an entry fee when joining the DGS.

The summary table below provides an overview of the NODs that have been assessed in the context of this study, the number of Member States that have transposed and used NODs in practice so far, an indication of their importance expressed as the maximum % of covered deposits, the relevance of each NOD, and recommendations how the NODs could be best treated in the context of an EDIS that takes the form of a full insurance scheme.

Summary table - main findings and recommendations

NOD	**Title [Article in DGSD]**	**Transposed (Practical experience) - *Number of Member States***	**Importance - *Max % covered deposits***	**Relevance of NOD**	**Recommended policy option**
	Coverage level and pay-out procedure				
1	Coverage of pension schemes [Article 5(2)a]	5 (2)	1.4%	Important to maintain depositor confidence in few Member States	Alternative (retain NOD with fixed coverage and inclusion in calculation of risk-based contribution)
2	Deposits held by small local authorities [Article 5(2)b]	7 (1)	0.1%	Limited to no importance for nearly all Member States (limited or no repayments in past pay-out events)	Eliminating
3	Exclusion of deposits to pay off a loan on private immovable property [Article 5(3)]	3 (1)	22%	Important in the Netherlands; excluded deposits have *de facto* no impact on the risk profile of the DGS	Alternative (retain NOD with gradual phasing out)
4	Temporary high balances relating to certain transactions [Article 6(2)]	28 (2)	10%	Highly important for depositor confidence across Member States, but amount of deposits covered uncertain and varying across DGSs	Alternative (harmonisation of coverage and inclusion in calculation of risk-based contribution based on comprehensive model)
5	Old-age provision products and pensions [Article 6(3)]	2 (2)	22%	Important to maintain depositor confidence in two Member States, it can have impact on DGS risk profile	Retain in current form
6	Treated as single depositor [Article 7(2)]	14 (0)	9%	Reduces exposure to the DGS but also depositor confidence	Alternative (harmonisation, but only

NOD	Title [Article in DGSD]	Transposed (Practical experience) - *Number of Member States*	Importance - *Max % covered deposits*	Relevance of NOD	Recommended policy option
				Varying implementation across Member States	apply to for profit businesses)
7	Set-off of depositor liabilities [Article 7(5)]	17 (2)	5.9%	Low impact and limited importance for depositor confidence, DGS risk profile and operationally complex	Eliminating
8	Exclusion of deposits fulfilling a social purpose [Article 7(8)]	1 (1)	25%	Important for depositor confidence in France, limited impact on DGS risk profile	Retain in current form
9	Longer repayment period for certain deposits [Article 8(3)]	22 (3)	2%	Enhanced legal certainty for DGS, with limited negative impact on depositor confidence	Full harmonisation
10	Deadline on validity of repayment claims [Article 9(3)]	20 (2)	0.2%	Enhanced legal certainty, with limited impact on depositor confidence. Large differences in the implementation across Member States	Alternative (harmonisation of the deadline to 3 years)
	Contributions and available financial means				
11	Payment commitments [Article 10(3)]	24 (5)	0.6%	Limited impact on DGS effectiveness, but distorts level playing field as benefits apply only in some Member States	Eliminating
12	Contributions into existing mandatory	1 (0)	Nihil (in theory 0.4%)	Potentially important for the UK. Contributes to increasing	Eliminating

NOD	Title [Article in DGSD]	Transposed (Practical experience) - *Number of Member States*	Importance - *Max % covered deposits*	Relevance of NOD	Recommended policy option
	schemes [Article 10(4)]			available financial means, but distorts the level playing field	
13	Financing of failure prevention measures [Article 11(3)]	9 (0)	Nihil	Primarily important for Member States with IPSs recognised as DGS. Contributes to depositor confidence and potentially reduces DGS risk profile. Lack of clarity about compatibility with BRRD and state aid rules	Alternative (eliminate current NOD, separate function of IPS and DGS and strengthen NOD 17)
14	Financing of measures to preserve access of covered deposits [Article 11(6)]	10 (3)	Limited	Important for depositor confidence, limited impact on DGS risk profile, varying practices across Member States	Alternative (harmonisation with modifications to enhance competition, harmonise least-cost test, and assessment of viability of acquirer)
15	Voluntary lending between DGSs [Article 12(1)]	14 (0)	Nihil	Potential implications on available means and risks, but unlikely to be used	Full harmonisation
16	Lower contributions for low-risk sectors [Article 13(1) 2nd subpara]	4 (0)	Nihil	Not used in practice and no relevance for individual Member States	Eliminating
17	Lower contributions for members of IPSs [Article 13(1) 3rd subpara]	5 (3)	45%	Important for Member States with IPSs not recognised DGS. Membership of IPS reduces risk profile of DGS, which is without this NOD ignored in risk-based contribution	Alternative (retain with harmonised methods of calculation)

NOD	Title [Article in DGSD]	Transposed (Practical experience) - *Number of Member States*	Importance - *Max % covered deposits*	Relevance of NOD	Recommended policy option
18	Use of a uniform risk-weights for banks affiliated to central bodies [Article 13(1) 4th subpara]	6 (2)	80%	Enhances efficiency of DGS and level playing field	Alternative (retain with modification to avoid moral hazard by institutions that obtain the uniform risk-weight
19	Minimum contribution [Article 13(1) 5th subpara]	9 (5)	0.01%	Ambiguous impact on DGS risk profile and reduces level playing field	Alternative (retain and align the design to the SRF system of flat contributions for small institutions)
20	Participations by branches from outside the EU [15(1) 2nd subpara]	24 (12)	0.7%	Important for depositor confidence and level playing field. Third-country branches form a risk for DGSs also without being a member	Alternative (harmonisation with maximum threshold on covered deposits collected by third-country branches)
	Transitional provisions				
21	Repayment periods longer than 7 working days [Article 8(2)]	16 (4)	100%	Potential deterioration of depositor confidence and level playing field, but for some DGSs necessary to guarantee the pay-out in time	Full harmonisation
22	Coverage of deposits until the maturity date [Article 19(1)]	10 (3)	2.2%	Important for depositor confidence, impact on the DGS risk profile limited and declining	Alternative (retain only for deposits with explicit maturity date)

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