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Proposal for a three-stage deposit guarantee scheme with limited European liability

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Deposit insurance suitable for Europe: Proposal for a three-stage deposit guarantee scheme with limited European liability[1]

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In this note, a new concept for a European deposit guarantee scheme is proposed, which takes account of the strong political reservations against a mutualization of the liability for bank deposits. The three-stage model for deposit insurance outlined below builds on existing national deposit guarantee schemes, offering loss compensation on a European level and at the same time preventing excessive risk and moral hazard taking by individual banks.

1. Background

In the context of the banking union presently being discussed, three major institutional projects are planned in addition to a European supervisory regime. First, there is the creation of a European legislation on bank restructuring. Second, a recovery and resolution authority as well as a fund, i.e. an authority responsible for the planning and implementation of bank restructuring, for which the funds needed to recapitalize individual banks, are also available. The third major institutional project under the overall banking union program involves the creation of a European deposit guarantee scheme.

The reform project on bank restructuring is already well advanced – the *Recovery and Resolution Directive* modeled on the German Restructuring Act is now under discussion at the European Parliament in Strasbourg. An ECON Committee vote took place in April 2013, and final adoption by the Parliament is expected in September 2013. In contrast, with regard to the issue of "European Resolution authority (ERA)" and a "European deposit protection" only limited progress has been seen so far.[2] The main reason why the reform of the European deposit guarantee scheme has been lagging behind is the explosive nature of this topic in the political debate. For many observers, the Europeanization of deposit insurance appears to be a direct step towards the mutualization of liability commitments.

The debate on the introduction of Eurobonds has already made it very clear that joint and several liability beyond national borders – be it with regard to the liabilities of individual states or the protection of bank depositors – faces significant political opposition. From an economic perspective, there are also strong reasons against a comprehensive mutualization of liability. Here, in particular, there is the danger that a general assumption of liability by a

[1] This document is an (updated) translation of the German Policy Letter No. 16, 2012: "Europataugliche Einlagensicherung: Vorschlag für eine dreistufige Einlagensicherung mit begrenzter europäischer Haftung".

[2] At the time of writing this note (late April 2013) the German government has been retreating from some of the earlier stances. In particular, the introduction of an ERA is currently seen in the context of a treaty change – which itself is not likely to happen anytime soon.

European structure would negatively impact the efforts necessary at the national level to control and contain banking risks.

However, over and above the strong arguments against a general mutualization of liability at the European level, it should not be forgotten that there are also important reasons in support of a merger of national deposit guarantee schemes. The limited credibility of a national deposit guarantee scheme must be mentioned here – especially if the economies concerned are small or cover only a few individual institutions (which is true for many EU Member States, but not for Germany). The weak protection offered by small states to their depositors creates the risk of a (in)solvency nexus between banks and states. Furthermore, due to the increasing number of institutions active in retail banking across Europe – one would think of ING DiBa, Santander, HSBC, Unicredit and also of Deutsche Bank here – there is a growing risk of crisis-related contagion effects that extend beyond national borders; and these must also be taken into account in the area of deposit insurance.

Arising from the above is the demand for a solution to the European liability problem that meets two requirements: first, the deposit guarantee scheme should present a credible protection of deposits, also in view of the growing interconnections between national deposit and credit markets. Second, the mutualization of liability must be designed such that moral hazard is minimized.

Below, it will be argued, firstly, that the existing model for a European deposit guarantee scheme – the so-called "two-stage model" – only meets the first of these two requirements and that, secondly, both requirements can be fulfilled simultaneously under a three-stage system. Hence, this three-stage model could be the basis of a European political initiative with realization prospects.

2. The current two-stage model of a European deposit guarantee scheme

Today, among the general public, the idea prevails that a Europeanization of deposit insurance, as addressed under the banking union, inevitably leads to a more or less direct mutualization of banking risks. The liability of German savings deposits for present or future risks undertaken by banks in other countries was recently the subject of an advertising campaign by public sector banks. A simple assumption of the liability for the savings deposits of all of Europe's banks by a European fund would indeed have a liability mutualization effect – including the above-mentioned negative risk incentives.

For this reason, one-stage European deposit insurance in terms of the replacement of a national deposit guarantee scheme by a comprehensive European solution is to be rejected just as much as a two-stage solution, whereby European protection is second to the existing national protection. This is because, under a two-stage solution, moral hazard is not only particularly high, but also related to a lax first stage of national deposit insurance – and is thus particularly problematic. Both a one-stage and a two-stage concept for a European deposit guarantee scheme rightly meet with great political resistance and probably have little prospect of realization.

3. An alternative concept: a three-stage deposit guarantee scheme (DGS) with limited European reinsurance

The alternative three-stage model presented here includes two essential structural innovations: a European reinsurance at the second stage of insurance, and a national government insurance for major losses at the third and ultimate stage of the insurance scheme.

Stage 1 of the 3-stage DGS consists of the existing national deposit guarantee model in a largely unchanged manner. Bank deposits of up to a certain amount – e.g. EUR 20,000 – are insured under this scheme. The national fund charges risk-related fees from its member banks and accumulates capital in a special fund. The fund is backed by a guarantee of the national government.. Furthermore, subsequent to a damage incidence, it can raise contributions by way of special charges (pay-as-you-go).

Stage 2 of the 3-stage DGS takes over the excess losses up to a pre-specified maximum amount per account, or per account holder.. For example, the liability of this 2nd stage European deposits fund could be limited to EUR 100,000. Over time, sufficient guarantee assets will also be built up in a dedicated reserve fund, financed via risk-related fees and, where necessary, special charges. With an insurance covering deposits between EUR 20,000 and EUR 100,000, this second *European* stage of the alternative proposal operates similar to a disaster reinsurance scheme: damages beyond those assumed by the primary insurance will be covered *up to a predetermined maximum amount*.

Stage 3 of the alternative concept involves those major damages arising from bank insolvencies which exceed the scope of the national primary insurance plus the European reinsurance. For these cases, it is foreseen that claims above the coverage provided are, in turn, charged to the national treasury. In other words, the first and last stages of the alternative proposal will be covered by national funds. The middle stage of the European deposit guarantee concept, in contrast, will be covered at the common, European level.

The extent of the European liability should vary in size according to the home state of an institution, for example, being a multiple of the national deposit guarantee provided under the first stage. If this multiple were to be "four", then the European protection would account for a further EUR 80,000 above the EUR 20,000 secured at the national level.

4. Other considerations

- The build-up of an asset base: the two lower stages of the alternative proposal, namely the first and the second stages, would each charge their own premium, which allows for the build-up of an appropriate asset base. Over time, these fund assets would lend credibility to the commitments made under the deposit guarantee scheme.

- For a transitional period, the provisioning of the asset base could be made possible by a loan from the ESM. The loan would be paid off gradually whilst the asset base is slowly built up via premiums and special charges.

- With regard to national deposit guarantee schemes (the first stage of the alternative concept), it should be ensured that there is a *level playing field*. All national organizations should feature comparably high premiums and a building up of asset volumes in order to ensure that recourse to European reinsurance first follows a comparably high own contribution on the part of the national deposit guarantee schemes.

- Especially in a national context, significant changes in existing deposit guarantee schemes may be needed, namely when one or more of the above-mentioned requirements are not met. This is probably also true for financial groups, an organizational structure common among cooperative banks or savings banks in some countries, e.g. Germany.