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Review of Europe’s deposit insurance framework: harmonization is not enough

Jan Pieter Krahnen and Tobias Tröger: The pending review of the European crisis management and deposit insurance framework offers a welcome opportunity to make real steps forward since it is high time to act

As the European Union prepares its reform proposal for the European crisis management and deposit insurance (CMDI) framework at the moment, the failure of the Silicon Valley Bank (SVB) has highlighted once more that the European banking union has remained incomplete to this day. As a consequence of the Global Financial Crisis and the European Sovereign Debt Crisis, the EU undertook sweeping regulatory reforms to provide for a sustainable and reliable banking sector.

The first two pillars of the banking union are now in effect: the Single Supervisory Mechanism (SSM) guarantees the EU’s biggest and most important banks are monitored by the ECB and the Single Resolution Mechanism (SRM) has – in principle – established a regulatory framework for orderly bank resolution on the supranational level, including industry provided funding. The third pillar of the European banking union in the form of a common deposit insurance is still missing and there has been little progress since the European Commission’s proposal for a European Deposit Insurance Scheme (EDIS) in November 2015 due to opposition from member states in the European Council and the Eurogroup.

A European deposit insurance scheme as a supranational solution to cover risks

While the European Parliament has reemphasized its commitment towards EDIS as a supranational solution to cover risks in a letter to Commission and Council in November 2022, the member states have called for a more cautious approach and favor harmonization of national deposition insurance schemes over their partial replacement. This approach was outline by the Eurogroup in July last year and recently reiterated at the Euro Summit in March 2023. This issue will now take center stage again as the European Commission is going to publish the CMDI package which was originally announced for 2021.

The CMDI package will be discussed by the Commission on 18 April and the European Parliament simultaneously between 17 and 20 April and will include a review of the deposit guarantee schemes directive (DGSD). As it coincides with the current banking turmoil and in the light of our recent proposal to extend coverage to all uninsured deposits, we urge European legislators to be ambitious and push towards EDIS. The harmonization of national systems is not enough.

Why EDIS? Overcoming the sovereign-bank doom loop

Banks and sovereigns are highly connected, which leads to vicious cycles in times of crisis. The so-called doom-loop works both ways where banking crises pull down sovereigns via costly bailouts and sovereigns pull down banks via their extensive government bond holdings. To break this loop, risk sharing among European Union states is essential. To this end, EDIS serves as one of the key tools and is therefore inevitable to complete the banking union.

In its original proposal, the Commission outlined three steps to move from fragmented national deposit insurance systems to a fully supranational European insurance. In a first step, a European authority would establish a reinsurance for national deposit insurance schemes. This would reduce the financial exposure of sovereigns and banks alike via risk-sharing while it would also address concerns over moral hazard and shared liabilities. One recent proposal to break the political deadlock wants to limit a European framework to the reinsurance component. In a second step, the Commission suggested moving towards co-insurance of deposits whereby the national deposit guarantee systems and the European deposit insurance fund would share losses from the first euro. Finally, a fully-fledged EDIS with a single mandatory rule book should be established as a functional third pillar of banking union.

It’s time for the “real deal”

We outlined three possible deals for the future of banking union in reaction to the Eurogroup Development Plan for the banking union last year: An “incremental deal” which leaves national systems in place while expanding coverage of the CMDI framework to small- and medium-sized banks looked like the most promising and most realistic scenario in 2022 given the reluctance of member states to hand competences to the European level. Additional proposals such as working towards standardized disclosure of holdings of bail-in debt, data sharing among national supervisory agencies, would also be clear improvements. However, in the current situation, we should be more ambitious and aim for the “real deal” which would bring additional financial stability by cutting ties between banks and sovereigns.

Not only does the SVB failure remind us of the looming threat of a new financial crisis, but, crucially, it also exposes a dangerous gap in the EU CMDI framework. Bank deposits of more than 100,000 euros are unprotected, regardless of whether the failed bank is resolved according to supranational legislation or liquidated under national insolvency regimes. The idea behind this is that holders of private capital should bear the costs of bank resolution and thus monitor and price bank risks adequately. However, under the current regime, unprotected demand deposits may cause bank runs, which undermine orderly resolution efforts. Besides the existing minimum requirements, it urgently needs maximum requirements for an effective bail-in. As presented in our current SAFE Policy Letter No. 98, all deposits which are prone to bank runs need to be covered by EDIS. A required increase in the loss absorbing capital of banks and a reduced likelihood of bank failures caused by bank runs will compensate for the increased liability amount.

Jan Pieter Krahnen is Founding Director emeritus of SAFE and Professor emeritus of Finance at Goethe University Frankfurt.

Tobias Tröger is Director of the Research Cluster Law & Finance at SAFE and Professor of Private Law, Commercial and Business Law, Jurisprudence at Goethe University Frankfurt.

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Prof. Dr. Jan Pieter Krahnen

Founding Director emeritus

Prof. Dr. Tobias Tröger

Director Research Cluster "Law and Finance"

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Leibniz Institute for Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080
Fax: +49 69 798 30077
Email: info@safe-frankfurt.de

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