Building a stable European Deposit Insurance Scheme

This version: 9 April 2018

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1. Introduction

A key function of deposit insurance is to provide a credible safety net for depositors, which is beyond doubt, also in times of crisis. At the same time, deposit insurance, like any insurance scheme, raises moral hazard concerns. When depositors are protected by a supranational deposit insurance scheme, participating countries may be less strict with national banking policies. It is important to address these moral hazard concerns (which we do in Section 4).

However, current proposals for a European Deposit Insurance Scheme (EDIS) with national compartments to address moral hazard (e.g. Gros, 2015; Bénassy-Quéré *et al.*, 2018; Schnabel and Véron, 2018) may defeat the purpose of EDIS. The idea of national compartments is that the first part of the loss is borne at the national level, only above a certain threshold losses are shared at the supranational level. The viability of particular national compartments may be questioned during a crisis and thereby worsen the crisis dynamics. A good deposit insurance should be a beacon of stability during a crisis, not a source of lingering doubts.

Moreover, we should keep the Banking Union rationale by designing a full functioning supervisory and crisis management system at the euro-area level (including Emergency Liquidity Assistance (ELA) by the ECB and EDIS), as highlighted in the 'Five Presidents Report' in 2015. Deviations from the Banking Union principle of euro-area level banking policies would preserve the current practices of ring-fencing of capital and liquidity at the national level by national supervisors within the Banking Union. Furthermore, we can simplify the crisis management framework by integrating resolution and deposit insurance in a Single Resolution and Deposit Insurance Board operating a Single Resolution and Deposit Insurance Fund (Gros and Schoenmaker, 2014).

[1] The author would like to thank Michel Heijdra and Nicolas Véron as well as seminar participants at LUISS Guido Carli University for useful comments on an earlier draft.

2. Basics of deposit insurance

In their seminal article, Diamond and Dybvig (1983) show that bank runs can happen in a fractional reserve banking system, whereby banks hold only a fraction of demand deposits in liquid funds and the remainder in illiquid loans. If rumours start about a bank's quality of assets, depositors will run on the bank as they are served on a first come, first serve basis. A credible deposit insurance scheme prevents banks runs, as depositors can rest assured that their deposit is guaranteed up to a certain amount.

A deposit insurance scheme only works if it is beyond doubt for depositors. That is ultimately dependent on a credible fiscal backstop by the government (Schoenmaker, 2018). Once the market starts to question a country's capacity (not only the fiscal capacity but also the political willingness) to support its banking system and related safety nets, then a deposit flight is difficult to stop. We have witnessed that during the euro-sovereign crisis, for example in the cases of Ireland, Portugal and Spain. The same happened during the Great Depression in the United States. State level deposit insurance funds went bankrupt because of lack of geographic diversification and size, intensifying the banking crisis. One of the first actions of the then incoming President Franklin Roosevelt was the establishment of a deposit insurance system at the federal level, the Federal Deposit Insurance Corporation (FDIC), as part of the New Deal legislation in 1933 (Golembe, 1960).

Moving to the banks, it is important to contain the impact of the failure of one or more bank(s) with subsequent deposit insurance payouts on the remaining banks. Such payouts can weaken the banking sector, as banks fund the scheme both ex ante and ex post. A large failure with uncertain payouts (the exact losses at the failing bank(s) are not directly known because of fluctuating asset values in times of crises) can set out a negative trust spiral in the case of smaller deposit insurance funds. A case in point is the failure of the medium sized bank SNS in the Netherlands in February 2013. While the preferred option was a closure with bail-in and deposit insurance payouts, this created potential large ex-post contributions from the surviving banks to the deposit insurance fund as the value of SNS's commercial real estate portfolio was difficult to establish. That could weaken the surviving banks, while the crisis fears were still at work at the time. The government therefore decided to nationalise SNS and imposed a one-off levy on banks to co-fund the rescue. This bank levy was a fixed amount and created no uncertainty for the surviving banks.

Finally, the adverse selection and moral hazard aspects of deposit insurance should be addressed to minimise the exposure of the government as fiscal backstop of deposit insurance. To counter adverse selection, weak banks should not be allowed in. Existing banks need to be cleaned by removing, or full provisioning of, non-performing loans. New entrants should be checked before a licence is granted. Once banks are in, supervisors should monitor them in the day-to-day supervision. These licencing and supervisory powers are now in the hands of the ECB as central banking supervisor in the Banking Union.

So smaller deposit insurance funds are more vulnerable as witnessed in the early 1930s in the US and more recently in Europe, while a large fund with a credible fiscal backstop stabilises the banking system (Schoenmaker, 2018).

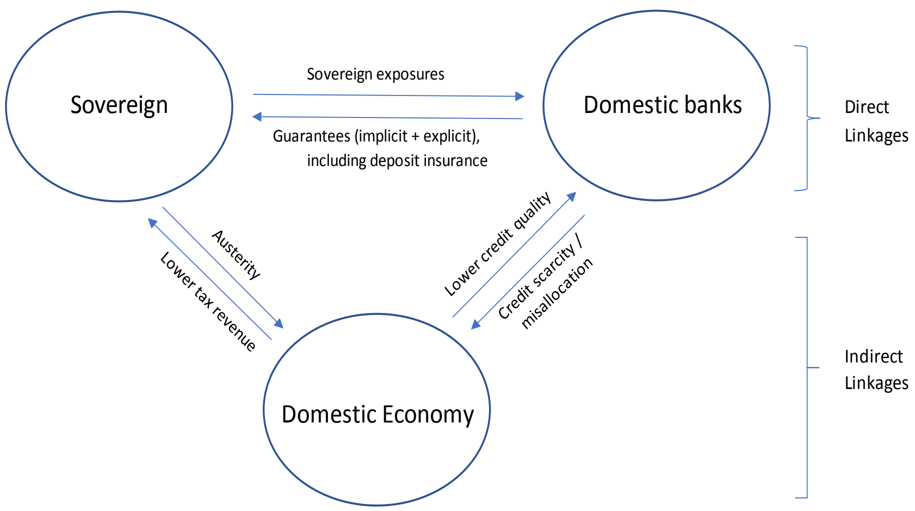
3. National compartments are destabilising

Notwithstanding the weakness of smaller funds, several authors (Gros, 2015; Schnabel and Véron, 2018) propose to keep national compartments in EDIS. The idea of national compartments is to limit cross-border solidarity, because of lack of political support for a full EDIS. It means that the first part of the loss is borne at the national level, including partial clawback (Gros, 2015) or ex-post fees (Schnabel and Véron, 2018).

As banks often fail in times of recession, payouts typically happen when the surviving banks are also not in a very strong shape. The surviving banks have to refill the national compartment through future contributions (regular contributions and ex-post contributions). This could destabilise the national banking system, also in comparison with the other banks in the Eurozone. So, a national compartment may be self-defeating and reduce the stability of the national banking system.

A second round effect may be that the credit function of banks is hampered as they become capital constrained (credit crunch). This has a negative impact on the economy. Figure 1 shows the vicious cycle between a national banking system and the domestic economy (Véron, 2017).

Figure 1. Bank – sovereign linkages



Source: Véron (2017)

A final consequence of national compartments (and the current provision of ELA by national central banks) is that there is a remaining need for national banking supervision. Countries or banks in these countries will ask for it to reduce their potential exposure to the national deposit insurance fund. The result is that ring-fencing practices, such as local liquidity and capital requirements, continue. There are no free cross-border banking flows within the Banking Union and the gaming between banks and national supervisors - banks threaten to convert cross-border subsidiaries into branches when local requirements become too burdensome - (see Schoenmaker and Véron, 2016).

4. Addressing moral hazard

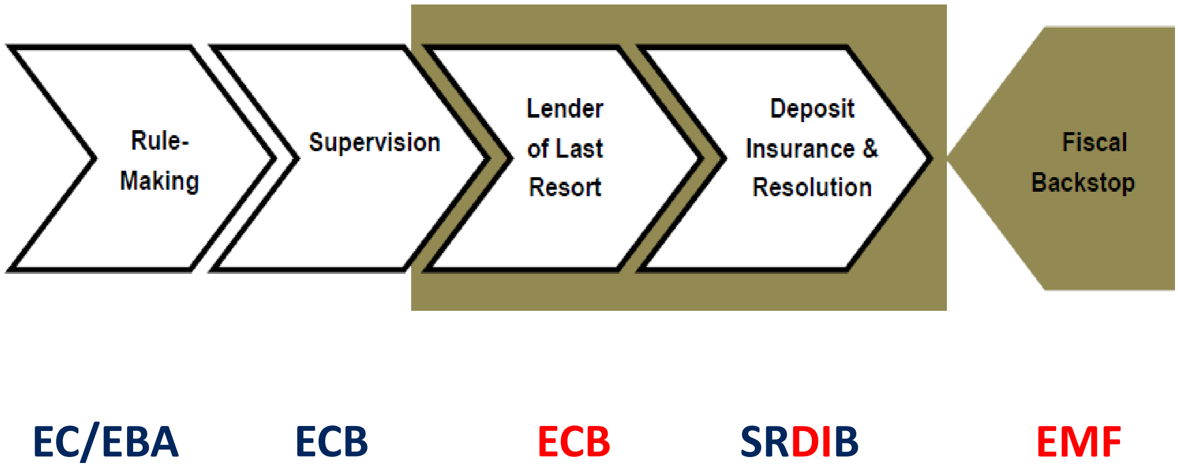
Moral hazard can be addressed in several ways. First, concentration limits on banks' sovereign bond holdings are crucial to reduce the sovereign risk in bank balance sheets (Véron, 2017). Second, current efforts of the ECB and European Commission to reduce the share of non-performing loans (NPLs) should be pursued with vigour. Banks should come 'clean' before they enter a fully mutualised EDIS. A transition period is instrumental to reduce sovereign concentrations and NPLs, while building up the mutualisation of risks in EDIS. Third, the ECB as central supervisor in the Single Supervisory Mechanism should be tough in their licensing and supervision of banks (ex ante prevention). For future NPLs, the ECB should, for example, lay down tough provisioning rules (with mandatory write down after a few years).

A final mechanism to mitigate moral hazard concerns is the introduction of a country component in the risk-based premium for deposit insurance, as proposed by Schnabel and Véron (2018). If a country has weak banking policies, such as weak creditor rights, lengthy insolvency procedures, lax provisioning policies or permissive housing finance, the country risk premium can be higher for that country (providing an incentive to improve banking policies and phase out differences). The risk-based premium, which is already foreseen in the Commission's original EDIS proposal, would then have a bank specific risk component and a country specific risk component. Importantly, the risk premium should be set by the integrated Single Resolution and Deposit Insurance Board, outside the political arena. Moreover, the proposed range for risk differentiation in the Commission's EDIS proposal, from 0.75 to 2 times the calculated premium, should be widened.

5. EDIS integrated in Banking Union

EDIS should become an integral part of a completed Banking Union. Figure 2 provides a schematic view of such a completed Banking Union. In earlier work (Sapir and Schoenmaker, 2017), we propose that the ECB should become the lender of last resort providing ELA and the European Stability Mechanism (ESM) should become a European Monetary Fund (EMF), providing a credit line to the new Single Resolution and Deposit Insurance Fund when needed (in addition to its main task of backstopping countries in need).

Figure 2. European institutions for financial supervision and stability in a Banking Union.



Note: The framework illustrates the five stages from rulemaking to the fiscal backstop. The bottom line shows the agency for each function.
Source: Schoenmaker (2013).

Here, we elaborate on the idea to integrate the Single Resolution Board (SRB) and EDIS into a Single Resolution and Deposit Insurance Board (SRDIB). Moreover, we also recommend to integrating the two funds, the Single Resolution Fund (SRF) and the European Deposit Insurance Fund (EDIF), into a Single Resolution and Deposit Insurance Fund (SRDIF) in line with our earlier proposal (Gros and Schoenmaker, 2014). This would follow the practice of the FDIC in the United States and the Deposit Insurance Corporation of Japan (DICJ) in Japan, which combine the resolution and deposit insurance functions and run one fund.

A first advantage is that we simplify crisis management. There are currently too many players, which makes crisis management more difficult. Experienced crisis managers know that crisis management complexity increases quadraticly with the number of players and the speed of action slows down accordingly. The SRDIB could apply the least cost principle, which requires the resolution authority to choose the resolution method in which the total amount of the expenditures and (contingent) liabilities incurred has the lowest cost to the resolution and deposit insurance fund (Gros and Schoenmaker, 2014). The three basic resolution methods for failing banks to choose from are liquidation with a deposit pay-off, a take-over with public support and direct public support. The lowest cost solution can be selected within the SRDIB instead in a protracted fight between the SRB and EDIS. In most cases, this would result in liquidation with deposit insurance pay-out (as the Banking Recovery and Resolution Directive created preference for the deposit insurance fund over other creditors -except for covered-creditors- on banks' assets), unless there is a public interest to keep certain critical functions of a troubled bank open.

A second advantage is that an integrated fund fully exploits the pooling potential of insurance. Not only national funds, but also resolution and deposit insurance funds are pooled into one fund. After a transition period, we should have a proper functioning Banking Union with a fully funded Single Resolution and Deposit Insurance Fund. We propose a 2 per cent target fund ratio for the joint fund of SRDIF, similar to the FDIC. The current target fund ratios are 1 per cent for SRF and 1.5 per cent for EDIF (see Table 1).

Table 1. Target size of the Single Resolution and Deposit Insurance Fund (end-2017).

	SRF	**EDIF**	**Total**	**SRDIF**
Target fund ratio (as % of covered deposits)	1%	1.5%	2.5%	2%
Target size (in € billions)	54.6	81.8	136.4	109.1
Available funds (in € billions)[1)]	17.4	20.1[2)]	37.5	37.5
Available as % of target size	32%	25%	28%	34%

Note: Covered deposits of the Eurozone banks amount € 5,456.6 billion at end-2017. The figures are for end-2017, except 2) available funds at DIF are for end-2016. 1) Some countries have only recently converted their ex-post funded deposit insurance scheme into an ex-ante funded scheme, which explains the limited available funds. During the build-up of the ex-ante schemes, these countries can still impose ex-post contributions on the participating banks.
Source: Author calculations based on EBA (2017) and SRB (2017).

While the current national funds are typically too small to deal with one large bank failure, the new fund, once fully up and running at € 109 billion (Table 1), can handle up to two large bank failures (or multiple smaller failures) in the euro-area without problems. A conservative assumption is that the equity capital needs to be replenished in a rescue operation (Schoenmaker, 2018). The average equity of the top 10 Euro-area banks amounts to around € 60 billion (updated from Schoenmaker and Véron, 2016). These estimates are based on the upper range of support operations during the Global Financial Crisis. The (partial) application of the new bail-in regime would reduce the potential size of public support, allowing the fund to deal with more large failures.

A final point is the scope of the SRDIF. The less significant institutions (LSIs) are already covered by the Single Resolution Mechanism (all euro-area banks) and the Single Supervisory Mechanism (the ECB is end-responsible for all euro-area banks). We suggest to incorporating the LSIs in the SRDIF, as separate funds for LSIs in each country will by inclination be small and thus instable, as argued in Sections 2 and 3 (see Schnabel and Véron (2018) for a similar view). A different and politically contentious issue is what to do with the current institutional protection schemes (IPS), which imply mutual risk sharing among its members (small savings banks or cooperatives).

6. Conclusions

We need to address moral hazard concerns arising from European deposit insurance. These justified concerns can be alleviated through a country specific component in the risk-based premium for deposit insurance and limits on sovereign bond exposures on bank balance sheets. But proposals to maintain national compartments in a new European Deposit Insurance Scheme are self-defeating, as such compartments can be destabilising in times of crisis.

This paper proposes to integrate not only the two agencies for resolution and deposit insurance into a Single Resolution and Deposit Insurance Board, but also the underlying funds into a Single Resolution and Deposit Insurance Fund. That simplifies crisis management procedures and reduces the required funding.

Finally, we argue to keep the Banking Union rationale throughout the framework. The bonus would be a fully integrated Banking Union market, whereby current ring-fencing practices are phased out.

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