RECENT DEVELOPMENTS IN DEPOSIT INSURANCE FROM EU PERSPECTIVE

Łukasz Szewczyk*

Abstract

The aim of this article is to present recent developments on deposit guarantee scheme within the EU. These schemes has changed significantly during the financial crisis, which led to adoption of a directive on deposit guarantee schemes in 2014. A strong emphasis will be put on deposit guarantee schemes financing issues. This is a crucial issue, especially at the time when European Banking Authority is working on methods for calculating contributions to deposit guarantee schemes and its funding model. This model may be an important step in mitigating risks generated by banks and may contribute to financial stability in EU.

Keywords: European Union, Safety Net, Deposit Guarantee Schemes, Funding Model

* *University of Economics in Katowice, Poland*

1 Introduction

Deposit guarantee scheme is a very important pillar in every financial safety net. Among its main functions are depositor protection and providing financial stability to the whole financial system. During global financial crisis deposit guarantee schemes had undergone significant changes in jurisdictions all over the world. The process of harmonization of practices between deposit guarantee schemes can be very clearly seen in the EU. Single deposit guarantee scheme was supposed to be one of the main components of banking union and also a substantial institutional innovation within EU. Despite the fact that this particular project was dropped in the nearest future, some important changes were introduced in the new directive on deposit insurance.

The aim of this article is to present recent developments on deposit guarantee scheme within the EU. A strong emphasis will be put on deposit guarantee schemes financing issues. This is a crucial issue, especially at the time when European Banking Authority is working on methods for calculating contributions to deposit guarantee schemes and its funding model. This model may be an important step in mitigating risks generated by banks and may contribute to financial stability in EU.

Deposit guarantee schemes - current issues

Deposit insurance has become a widespread feature of countries' financial safety nets around the world. Theoretically, deposit insurance can be conducive to financial stability, helping to mitigate threats that arise from self-fulfilling depositor runs on banks. At the same time, deposit insurance can also give rise to moral hazard, weakening market discipline exercised by depositors because they are protected and inducing greater risktaking by banks- with potential detrimental effects on stability. The empirical literature investigating the effects of deposit insurance on financial stability stresses that the net effect depends on (Deutsche Bank, 2014, p.2):

– the institutional context in which schemes operate – a strong institutional environment, including high-quality supervision and regulation, tends to reduce potential negative effects.

– the specific design of deposit guarantee schemes, for instance their coverage, financing and organisation, which are important to determine the extent to which moral hazard issues arise and are balanced.

There remains substantial variation worldwide with respect to the design of financial safety nets including –but not limited to –deposit insurance. Historically, financial crises have often triggered the introduction of or changes to deposit guarantee schemes (the first deposit guarantee schemes was established in 1933 in USA as a result of The Great Depression).

It is important to remember that a deposit guarantee scheme has always two main functions (Bernet, Walter, 2009, p.8-9):

– it prevents a run on an illiquid but not yet insolvent financial institution since in this way the spread of the crisis in one individual institution to the other network partners via the interbank market can be prevented,

– it should make good the losses incurred by the depositors caused by an illiquid or insolvent financial institution up to a certain amount, since it is assumed that the majority of smaller depositors of the

bank were hardly themselves able to monitor the risk that they had taken by, for example, opening a deposit account.

The recent global financial crisis tested deposit insurance schemes and their ability to protect household savings in banks. Both country authorities and financial regulators reacted to the unusual circumstances of the crisis by expanding the coverage offered in existing deposit insurance systems or adopting deposit insurance where it was not already in place (Demirguc- Kunt, Kane, Laeven, 2014, p.3).

In an effort to contain the fallout from the global financial crisis, many countries expanded their financial safety net, both by increasing coverage of deposit insurance and by extending government guarantees to non-deposit liabilities (and in some cases on bank assets). The expansion of the safety net was substantial, especially for crisis countries, and extended beyond traditional deposit insurance. The main actions taken to mitigate effects of the global financial crisis were (Demirguc- Kunt, Kane, Laeven, 2014, p.14).:

- increasing statuatory coverage,
- abolishing co-insurance,
- introducing a government guarantee on deposits,
- introducing a government guarantee on non-deposit liabilities,
- introducing a government guarantee on bank assets,
- undertaking significant nationalizations of banks.

Deposit guarantee schemes reforms undertaken during global financial crisis within EU addresses both the consumer protection and financial stability functions. The first one is connected with the harmonization of coverage. The revised rules adopted by a directive from 2009 (Directive 2009/14/EC) raised the coverage level up to 100 000 EUR. It is worth noticing that coverage levels in terms of GDP per capita continue to differ across the EU (table 1). From the financial stability perspective both levels an changes of coverage matters. The coverage offered by the schemes must be designed carefully, balancing consumer protection, financial stability and market discipline. Theoretically, deposit guarantee schemes must cover a sufficient number of depositors and deposits to prevent bunk runs effectively (Deutsche Bank, 2014, p.2).

The recent financial crisis confirmed these views and focused attention on the need to review and reevaluate the determinants of coverage. It became clear that the objective of promoting financial stability outweighed concerns about limiting moral hazard. Many countries that had emphasized the importance of allowing markets to function freely and raised concerns about the moral hazard implications of deposit insurance, introduced measures that enhanced depositor protection arrangements, including expanded coverage limits—both level and scope—and modifications to their deposit insurance systems. In many cases, coverage was sharply expanded to fully protect virtually all depositors, irrespective of the proportion of deposits fully covered. Many authorities concluded that coverage levels had been too low, even for stable periods, exposing most retail depositors to excessive risks and chose to permanently maintain higher coverage limits (International Association of Deposit Insurers, 2013, p.9).

Table 1. Coverage level/GDP ratio in selected EU countries (as of 2013)

Country	Indicator value
France	3,08
Germany	3,02
Italy	3,91
the Netherlands	2,78
Spain	4,51
UK	3,35
EU countries average	3,44

Source: own work

The next issue important from a depositor perspective that has been changed is the faster payout. The maximum payout period will be cut from 20 to 7 days with a reduction following a stepwise schedule (table 2). It is worth remembering that quick access to funds is obviously valuable for households but can also help to avoid spreading uncertainty if a bank becomes insolvent.

Table 2. Repayment periods

Period	Payout time
Up till 31 December 2018	20 working days
1 January 2019 until 31 December 2020	15 working days
1 January 2012 until 31 December 2023	10 working days
1 January 2024	7 working days

Source: (Directive 2014/49/EU, 2014)

The new directive also requires that that banks provide customers with more information about deposit insurance. This includes information on customers' account statement about the deposit

guarantee scheme protection of their deposits and mandatory information sheets in a standardised format that must be countersigned by consumers when placing deposits and regularly updated (Deutsche Bank, 2014, p.9)..

Selected issues on deposit guarantee schemes funding

Financing issues connected with deposit guarantee scheme have played very important role in a discussion within EU. The main reason for this was the fact that it have been said that deposit guarantee schemes don't have a proper financing. In de Larosiere report it was pointed out that preference should be given to schemes which are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty (de Larosiere, 2009, p.34). Unstable funding without the lack of proper risk sensitive funding arrangements involves a significant risk that governments will have to carry the financial burden indented for the banks, or worse, that the scheme fails on its commitments (de Larosiere, 2009, p.34).

On 12 July 2012 European Commission adopted a legislative proposal for a thorough revision of thorough revision of Directive 94/19/EC on deposit guarantee schemes. In this document some proposals were made, among them (Directive Proposal, 2010, p.7) :

- deposit guarantee scheme in every EU country must have 1,5% of eligible deposits on hand after a transition period of 10 years,
- banks must pay extraordinary contributions of up to 0,5% eligible deposits if necessary,
- a mutual borrowing facility will be created to allow a deposit guarantee scheme to borrow money from another scheme in EU.

When a directive 2014/49/EU was adopted in 2014 some changes were made, among them the most important one, concerning the level of the fund. EU countries shall ensure that by 24 July 2024 the available financial means of a scheme shall at least reach a target of 0,8% of the amount of covered deposits of its member. The fund size of selected EU countries is presented in table 3.

Table 3. Fund size of selected EU countries (as of 2010)

Country	Indicator value
Belgium	0,32
France	0,21
Germany	0,37
Italy	0
Malta	0,13
the Netherlands	0
Slovakia	0,14
Spain	0,37
UK	0

Source: (Demirguc- Kunt, Kane, Laeven, 2014, p.43).

It can be seen that in these selected countries the level of the fund is on a very low level and the adjustment to the new directive will lead to high costs that banks will have to bear.

The Directive also stipulates that the contributions to deposit guarantee scheme will be based on the amount of covered deposits and the degree of risk incurred by the respective member. Without such risk-adjusting banks with the same amount of covered deposits would pay the same amount of contributions to the scheme. If risk-adjusting is applied, those banks may pay different contributions (potentially, to a large extent), depending on whether their activity – measured by a set of specific indicators – is deemed more prudent or more risky. Riskier banks imply a higher likelihood of failure and, in turn, the need to trigger the scheme. Therefore, such banks should pay more contributions to the scheme (European Commission Memo, 2014, p.4). The European Banking Authority was supposed to issue guidelines on payment commitments. On 28 May 2015 European Banking Authority published a set of guidelines on payment commitments of deposit guarantee schemes and on methods of calculating contributions to deposit guarantee schemes (European Banking Authority, 2015). These guidelines will contribute to providing incentives to institutions to operate under a less risky business model. To that end, these guidelines set out principles on the risk component of the calculation method. In addition, they capture various aspects of the institutions' risk profile by specifying a number of core risk indicators pertaining to capital, liquidity and funding, asset quality, business model and management, and potential losses for the deposit guarantee schemes. The publishing of these guidelines was preceded by a test exercise among EU countries on three different systems for calculating risk-based contributions. The test systems were developed so that EU countries could verify how different combinations of mandatory

elements of calculation methods could be applied to their national banking sectors. Each of the three test systems used a fixed set of risk indicators and proposed calibration of thresholds for particular risk indicators and risk classes to be applied in all EU countries (European Banking Authority, 2015, p.5).

These guidelines specify five categories of risk indicators in order to ensure that a sufficiently wide range of key aspects of institutions' operations are reflected in the risk classification. Among them are indicators connected with capital, liquidity and funding, asset quality, business model and management and potential losses for the deposit guarantee scheme. Indicators in each category are presented in table 4.

Table 4. Indicators in each of the risk category

Risk category	Indicators
Capital	• leverage ratio • capital coverage ratio • common equity Tier1 ratio
Liquidity and funding	• liquidity coverage ratio (LCR) • net stable funding ratio (NSFR) • liquidity ratio
Asset quality	• non-performing loan ratio (NPL)
Business model and management	• risk weighted assets (RWA)/ total assets ratio • return on assets (RoA)
Potential losses for the deposit guarantee scheme	• unencumbered assets/ covered deposits

Source: (European Banking Authority, 2015, p.38-40).

It is important to notice that these indicators are based on historical data, which come from financial statements and may not properly assess future risks connected to bank failures. It is worth mentioning that the adoptions of the new directive on deposit insurance and EBA's guidelines is an important step in the introduction of common deposit guarantee schemes' funding model. The work on this subject have been going on for a long time. An important step in this process was a publication of a report prepared by a Joint Research Centre at the request of European Commission in 2010 (Joint Research Centre, 2010). The aim of this report was to give some advices on a possible funding models within EU, that could be introduced in the future. It can be seen that current solutions are based on conclusions made in this report.

Conclusions

Deposit guarantee schemes in EU have undergone significant changes during global financial crisis. The milestone of this process was the adoption of a new directive on deposit guarantee schemes in 2014. Before that among important actions taken to contribute to financial stability, the harmonization of the coverage level and shortening the period of payout process may be mentioned.

Nowadays what is the most significant in improving the construction of deposit guarantee schemes within EU is the adoption of the new funding model. This model, that will use risk-based contributions, may contribute to reducing the risk caused by participants of the system in every country, mitigating moral hazard and thereby may positively influence the financial stability in European Union.

Refereneces

1. Bernet B., Walter S. (2009), Design, structure and implementation of a modern deposit insurance scheme, SUERF- The European Money and Finance Forum, Vienna
2. de Larosiere Report (2009)
3. Demirguc- Kunt A., Kane E. Laeven L. (2014), Deposit Insurance Database
4. Deutsche Bank (2014), Deposit guarantee reform in Europe: A systemic perspective, Current issues, Global financial markets
5. Directive 2009/14/EC of the European Parliament and of the Council of 11 march 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay
6. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes
7. Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes
8. European Banking Authority (2015), Guidelines on methods for calculating contributions to deposit guarantee schemes
9. European Banking Authority (2015), Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes
10. European Commission (2014), Memo on Deposit Guarantee Schemes, Brussels
11. International Association of Deposit Insurers (2013), Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage, Basel
12. Joint Research Centre (2010), JRC Report under Article 12 of Directive 94/19/EC as amended by Directive 2009/14/EC, Ispra
13. Proposal for a Directive of the European Parliament and of the Council on deposit guarantee schemes, (2010).