Problems and Opinions

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Towards the enhanced role of deposit guarantee schemes in the European Union crisis management framework

Abstract

Deposit guarantee schemes constitute an important but relatively new element of the financial safety net. Prior to the Global Financial Crisis deposit guarantee schemes in the European Union acted mainly as payboxes with their mandate mostly limited to payout of covered deposits. The crisis experience unveiled many weaknesses in the area of deposit insurance and prompted European lawmakers not only to increase the level of harmonization of regulations in this respect but also to extend the mandate of deposit guarantee schemes. The aim of this article is to present and analyze the evolution of financial regulation related to deposit insurers in the European Union, taking into account their role in crisis management, in particular as regards interventions other than payout. An important part of the article is focused on the critical assessment of the new proposal put forward in 2023 by the European Commission to reform the crisis management and deposit insurance framework (CMDI). The article discusses the potential positive effects of the proposed changes under the CMDI reform as well as

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possible difficulties and challenges related to their introduction. Results of the analysis indicate that the proposed reform would strengthen deposit guarantee schemes giving them a more prominent role in crisis management. Nevertheless, this new broadened mandate might require strengthening financial capacity of deposit guarantee funds.

Keywords: deposit guarantee schemes, crisis management, resolution, financial stability

JEL Codes: G01, G21, G28, H12

W kierunku większej roli systemów gwarancji depozytów w unijnych ramach zarządzania kryzysowego

Streszczenie

Systemy gwarancji depozytów stanowią ważny, ale stosunkowo nowy element sieci bezpieczeństwa finansowego. Przed globalnym kryzysem finansowym, systemy gwarancji depozytów w Unii Europejskiej funkcjonowały głównie w formule paybox, tzn. ich mandat był ograniczony do wypłaty środków gwarantowanych. Doświadczenia kryzysowe ujawniły wiele słabości w obszarze gwarancji depozytów i skłoniły unijnych legislatorów nie tylko do zwiększenia poziomu harmonizacji w tym obszarze, ale także do rozszerzenia mandatu systemów gwarancji depozytów. Celem niniejszego artykułu jest przedstawienie i analiza ewolucji regulacji finansowych związanych z gwarantami depozytów w Unii Europejskiej, z uwzględnieniem ich roli w zarządzaniu kryzysowym, w szczególności w zakresie interwencji innych niż wypłata depozytów. Istotna część artykułu poświęcona jest krytycznej ocenie nowych propozycji przedstawionych przez Komisję Europejską w 2023 r. w ramach reformy ram zarządzania kryzysowego i gwarancji depozytów. Artykuł omawia potencjalne pozytywne skutki proponowanych zmian, jak również możliwe trudności i wyzwania związane z ich wprowadzeniem. Wyniki analizy wskazują, że proponowana reforma wzmocni systemy gwarancji depozytów, nadając im bardziej znaczącą rolę w zarządzaniu kryzysowym. Niemniej, ten nowy rozszerzony mandat, może wymagać zwiększenia zdolności finansowych funduszy gwarantowania depozytów.

Słowa kluczowe: systemy gwarancji depozytów, zarządzanie kryzysowe, przymusowa restrukturyzacja, stabilność finansowa

Kody JEL: G01, G21, G28, H12

Introduction

Deposit guarantee schemes (DGS) constitute an important but relatively new element of the financial safety net. The key aim of DGS is to protect depositors and in that way to contribute to maintaining financial stability (Gortsos 2019). In the European Union (EU) deposit insurance has long been perceived as the main and only function of DGS. However, with subsequent episodes of financial instability and in particular the experience of the Global Financial Crisis (GFC), the perception of DGS has changed. Deposit insurers started to be perceived as important and active participants of the crisis management process. Moreover, with the establishment of the banking union in

2014, discussions on the centralization of DGS function have begun. Initial intensive works on the European Deposit Insurance Scheme[1] (EDIS) as a third pillar of the banking union, has gradually slowed down as there seems to be lack of political will to the "Europeanisation" of DGS.

At its June 2022 meeting the Eurogroup sketched an overall action plan for strengthening and completing the banking union. Although no consensus on EDIS was reached, the Eurogroup agreed on directions for reforms in other areas. Accordingly, the focus has been shifted from EDIS itself to the overall crisis management and deposit insurance (CMDI) framework. In order to strengthen the current EU regulations in that area, the Eurogroup agreed that the reform of the CMDI framework should cover (Avgouleas et al. 2023):

- clarification and harmonization of public interest assessment (PIA);
- enhancement of the resolution framework to include also medium-sized banks;
- further harmonization of national deposit guarantee schemes, in particular as regards their functions other than payout;
- harmonization of certain elements of national insolvency laws in order to facilitate crisis management.

What is striking, is the fact that Eurogroup put a strong emphasis on national deposit guarantee schemes, the role of which is about to be increased. The experience gathered so far in the European Union, and in particular in the banking union, suggests that indeed, the current EU regulatory framework does not allow to use the full potential of DGS as key institutions in crisis management in the banking sector.

The aim of this article is to present and analyze the evolution of financial regulation related to deposit insurers in the European Union, taking into account their role in the crisis management, in particular as regards interventions other than payout. An important part of the article is focused on the critical assessment of the new proposal put forward in 2023 by the European Commission to reform the crisis management and deposit insurance framework. The article discusses the potential positive effects of the proposed changes under the CMDI reform as well as possible difficulties and challenges related to their introduction. The article is composed of four sections. Section 1 discusses the rationale, the role and the evolution of deposit guarantee schemes as an element of the financial safety net. Section 2 presents European deposit insurance regulations from a historic perspective, pointing out to the gradual increase in harmonization and expansion of DGS mandate. Section 3 diagnoses the problems which currently limit a more enhanced use of DGS funds in crisis management in the EU and shows which elements of the CMDI reform could

[1] The proposal for the establishment of EDIS was put forward by the European Commission in 2015. The original idea was that EDIS would be introduced gradually, in three stages: re-insurance, co-insurance and full insurance (Gortsos 2016). However, the European Commission proposal for EDIS turned up to be too controversial and in 2018 Austrian Presidency presented an alternative compromise proposal of a "hybrid model", in which national DGS coexist with EDIS. Nevertheless, due to political deadlock no further progress has been made on establishing EDIS. For more on national preferences and positions regarding EDIS see: (Tümmler 2022).

address them. Section 4 provides a critical assessment of the proposed changes, indicating possible difficulties and challenges related with their implementation. The final section concludes.

1. The evolution of the role of deposit insurers within the financial safety net

There are several reasons speaking for the establishment of a deposit guarantee scheme at the national level. The most important ones relate to the specificity of the banking business and the existence of market imperfections/externalities. Any bank, whether weak or strong, does not have sufficient liquid resources to finance at once the payout of all deposits. Bank clients are also conscious about that and once they start losing confidence in a bank, they are susceptible to run on a bank to withdraw their funds, in accordance with a rule "first come first served"[2]. This, however, aggravates the financial problems of the bank concerned and might even trigger contagion in the banking system as clients of other banks might also start to question the financial condition of other lenders.

The rationale behind establishing deposit guarantee scheme is to contain the incentive for massive withdrawals and in that way contribute to maintaining financial stability (Gortsos 2016). It is assumed that the existence of DGS should prevent banking panics which has the potential to cause systemic banking crisis[3]. This reasoning is related to the characteristic of the banking business which is based on trust and confidence. Loss of confidence quickly spreads within the banking system which risks not only massive withdrawals of deposits by clients but also freezes interbank market. The resulted liquidity problems experienced by a bank might lead to more severe insolvency problems or even its failure.

Having said that, it is important to note that the role of DGS does not limit only to preventing collective withdrawals. It is normal that banks as any other enterprises may face financial problems and in a consequence fall. The failure of a bank is, however, different from a failure of a typical enterprise, in particular, in terms of the impact a bank failure could have on the financial system, depositors and other creditors, and the economy at large. In such situations DGS could play also an important role by preventing bank failures or eventually by mitigating

[2] The March 2023 confidence crisis in the US, in particular the bank run on, and subsequent failure of Silicon Valley Bank, Signature Bank and First Republic Bank, have reminded us how fragile the confidence in the banks can be. Moreover, it also showed that bank runs in a digital era could unfold extremely fast and result in bank failures within hours.

[3] Of course apart from benefits related to setting up DGS, some drawbacks and costs could also be indicated. Two issues should be mentioned here. First, one of the most important side-effects of general deposit insurance is a possible increase in moral hazard. Second, DGS are financed from contributions paid in by banks. Regardless, of whether the financing arrangement is based on *ex-ante* or *ex-post* model, DGS contributions constitute cost for banks. Furthermore, the *ex post* financing model is also considered to be more procyclical.

the financial distress and potential contagion[4] which could be caused by a bank's failure (Brescia Morra et al. 2023). To that end, DGS might be viewed as a measure to indirectly contain systemic risk and proactively manage banking crisis.

Looking at the history of deposit insurance[5], it shows that DGS were set up or reformed as a result of significant external shocks such as financial crises (Kerlin 2015). This is because financial instability periods usually undermine the trust in the financial sector, with particularly painful consequences if consumer mistrust touches banks and causes devastating bank runs. It seems that a particularly significant impact on the development of regulatory approach towards DGS had the GFC. It should also be reminded that prior to the GFC there had not been any international standards on deposit insurance (Arda & Dobler 2022). Only in 2009, the International Association of Deposit Insurers (IADI) adopted Core Principles for Effective Deposit Insurance Systems, which were then revised in 2014. The Core Principles constitute an international standard for deposit insurance, thus on the one hand they provide some harmonized features in order to enhance the deposit insurance worldwide, but on the other hand they are sufficiently flexible to cater for national specificities (Gortsos 2016). This led to the development of different models of DGS with varied tasks and functions. The four main DGS categories could be distinguished (FSB 2012):

- paybox model – DGS mandate is the narrowest and covers only reimbursement of covered deposits which is activated when a bank fails, its license is withdrawn and deposits become "unavailable";
- paybox plus model – DGS mandate includes not only the payout of insured deposits but also some additional functions like providing financial support or some specific resolution functions;
- loss-minimizer model – DGS mandate enables it to actively engage in a range of activities in accordance with least cost principle;
- risk minimizer model – DGS mandate is the widest and covers comprehensive functions that allow it to reduce the risk within financial system, such as early intervention or resolution powers as well as supervisory responsibilities.

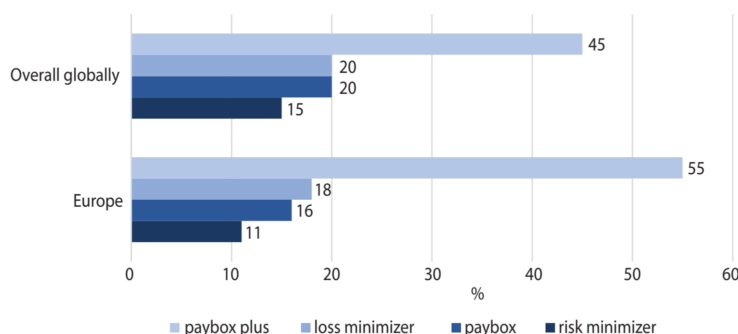
The 2021 IADI annual survey shows that currently the most popular model in the world is "paybox plus", while less common – the most advanced risk minimizer model. Similar trends are also visible in Europe (Chart 1). Following the GFC the mandates of deposit insurers in many jurisdictions have been expanded giving them a more prominent role in crisis management which is in stark contrast to the pre-GFC

[4] The contemporary financial system is characterized by a dense network of interconnections and interlinkages which could result in so called contagion effect, i.e. a quick and wide "spilling over" of problems from one institution to others. For more on the contagion effect and systemic risk in the banking sector see e.g. (Freixas et al. 2015) or (de Bandt & Hartmann 2000).

[5] Over the last decades the perception of the role of DGS has changed substantially which is reflected also in the literature. As pointed by Pruski and Kerlin (2015), there could be distinguished five different periods of research related to DGS, starting with analyses of the mere rational for the existence such institutions, through different elements of their design, and most recent studies on the need for redefining the role of DGS in crisis management and resolution.

period when DGS played rather a minor role in the financial safety net (FSB 2012). Kerlin (2015) notes that the simplest DGS model (i.e. paybox) is slowly disappearing from the financial safety net landscape, while more developed models are being more widely adopted.

Chart 1. Mandate of deposit insurers overall globally and in Europe



Source: Own work based on IADI (2021).

Those changes are taking place due to a growing consensus that the benefits from a more active involvement of DGS in crisis management and resolution outweigh their usage as mere payout boxes only. In a paybox model only covered depositors are protected, while DGS support for non-payout measures could offer wider benefits for financial stability (Costa et al. 2022). The shift in attitude towards DGS started to be clearly visible after the GFC when the resolution framework, which aims to restructure failed banks in an orderly and cost efficient manner, have begun to be widely adopted[6]. As noted by IADI (2022) the abandonment of the paybox model is related to a greater involvement of DGS in resolution. Although the role played by DGS in resolution varies across jurisdictions, a majority of DGS participate in resolution by, at least, contributing to relevant decision making processes. Furthermore, around 40% of deposit insurers worldwide act also as a bank resolution authority[7] and housing deposit insurance and resolution functions in one authority is becoming more popular (IADI 2022).

[6] An important role in popularization of the idea of resolution played the FSB which in 2011 released Key Attributes of Effective Resolution Regimes for Financial Institutions setting out the essential elements necessary for an effective resolution framework.

[7] This is the case in Poland where the Bank Guarantee Fund is not only a deposit guarantee scheme but also an authority responsible for resolution of banks.

2. The evolution of European Union regulations on deposit insurance

In Europe first deposit guarantee schemes were established starting from 1960s, primary as voluntary private-initiative systems. The most intensive period of setting-up such institutions occurred between 1991–2003 (Kerlin 2015). Currently all Member States have in place harmonized deposit guarantee schemes which is a consequence of a legislative action taken at the EU level. The current status is, however, a result of more than 35 years of EU regulations in the area of deposit insurance. Nevertheless, the work does not seem to be completed and continued efforts are still being taken to ensure adequate role of these institutions in the financial safety net.

At the European level works on establishing deposit insurance started in late 1980s, first with the European Commission (EC) recommendation 87/63/EEC concerning introduction of deposit guarantee schemes in the Community. Although this recommendation was legally non-binding and had rather advisory character, its issuance by the European Commission signaled clear support for the setting-up of DGS at the national level. The wording of the EC recommendation was very general and included only four tips to be taken into account by Member States with regard to deposit insurance:

- deposit guarantee should cover depositors who are not capable of properly assessing the financial condition of a bank in which they deposited their funds;
- deposit guarantee should cover depositors of all authorized banks, including branches;
- there should be a clear division between DGS intervention prior to winding-up a bank and deposit payout as a result of bank insolvency;
- there should be clear and transparent criteria specifying conditions for receiving compensation.

Nevertheless, a mere recommendation turned up to be insufficient, in particular it started to be obvious that more issues related to deposit insurance required harmonization. To that end, Directive 94/19/EC was a first legal act that introduced harmonized rules on deposit guarantee schemes, yet also only to some extent (so called minimum harmonization). The adoption of this directive in 1994 pushed Member States to establish DGS at the national level. The key issues regulated by Directive 94/19/EC were the introduction of:

- the requirement to set up at least one officially recognized DGS in each Member State;
- a harmonized minimum coverage of 20 000 EUR;
- the possibility of co-insurance[8];

[8] Co-insurance meant that only a defined percentage (e.g. 90%) of a deposit was insured. However, co-insurance was a national option which meant that there was not uniform approach to this, with some Member States applying co-insurance and other not using this option. This clearly led to differences in depositor protection across the EU. For more information see: (Cariboni et al. 2007).

- certain minimum aspects regarding the scope of protection (i.e. definition of a deposit and broad categories of deposits covered and excluded from the protection);
- payout period (set at three months with possible two extensions of max. three months each[9]);
- information requirements for bank customers on their deposit insurance.

It is also worth mentioning what was not regulated by Directive 94/19/EC. The most important lacking element were provisions on the funding of DGS, which resulted in the adoption of varied DGS funding mechanisms across the EU, either via ex ante or ex post contributions or a combination thereof (Cariboni et al. 2007). This in turn had impact on the financial capacity of DGS and consequently on depositor confidence. Furthermore, Directive 94/19/EC was based on minimum harmonization which led to divergent approaches across the EU Member States as for the coverage level or payout period. In times of financial stability these differences seemed not to be important but once the global financial crisis broke out, it turned out that the adopted solutions were neither sufficient nor effective.

Directive 94/19/EC did not stand the test of the global financial crisis which revealed that there was a substantial room for improvement in the area of deposit protection. The financial turmoil of 2008 pushed many EU Member States to unilaterally increase coverage level or introduce blanket guarantees to restore depositor confidence in their countries[10]. Such uncoordinated actions by the EU national authorities threatened the Single Market and added fuel to the fire. The EU needed to act swiftly. As a consequence of the crisis events, a quick amendment to Directive 94/19/EC was adopted. Directive 2009/14/EC (which amended Directive 94/19/EC) increased the coverage limit from minimum of 20 000 EUR to 50 000 EUR and then finally to 100 000 EUR in order to maintain trust in the banking sector. Furthermore, co-insurance was abandoned and payout period shortened. All these measures could be considered, however, a "quick-fix", and a more thorough review of DGS regulations was needed (Terták & Szeląg 2010).

The global financial crisis prompted European regulators not only to rethink the main parameters of deposit guarantees but also the role deposit insures play within the financial safety net. It became more evident that DGS should play a more active role in crisis prevention and crisis management. It should be noticed that the de Larosière Report (2009), which impacted EU lawmakers to a large extent, stated that EU regulations should not prohibit additional functions of DGS which goes beyond a mere paybox model, but it did not recommend any further harmonization either.

[9] This meant that in extreme cases the Directive allowed the payout to take max. 9 months.

[10] Low coverage might negatively influence trust of depositors in safety of their deposits and thus contribute to sudden bank runs which could destabilize the whole banking sector. This is especially the case during periods of financial instability. The real-life cases were seen during the global financial crisis with one of the most famous example of classic bank run on Northern Rock in September 2007 which was first such episode in the United Kingdom since over a century.

The next Directive 2014/49/EU (so called Deposit Guarantee Schemes Directive, DGSD) adopted in 2014, and which is still in force, took into account lessons learnt from the GFC by introducing further harmonization of the payout function of DGS and by recognizing the additional role that such institutions could play in ensuring financial stability (see Box 1). Importantly DGSD provided for a more active role of DGS via so called preventive and alternative measures, which, however, are not uniformly applied across the EU but constitute so called national options. This is enshrined in Article 11 of DGSD.

Box 1. Main elements of Directive 2014/49/EU

Directive 2014/49/EU harmonizes the main elements of the functioning the deposit guarantee schemes in a comprehensive manner. The directive aimed to reach two important goals: (1) to improve depositor protection and (2) to strengthen DGS as an element of the financial safety net.

The main changes that enhanced the depositor protection and confidence are:
- a harmonized coverage level of 100 000 EUR per depositor per bank;
- a shorter payout period (7 working days);
- clarification on the payout process in the cross-border context (host country DGS acting as "paying agent" on behalf of home country DGS);
- increased information requirements for the DGS in order to raise depositor awareness.

The directive also strengthens deposit guarantee schemes by extending their mandate and increasing their financial capacity by introducing:
- a requirement to finance DGS via *ex ante* risk-based contributions supported by *ex post* contributions and mutual borrowing between DGS;
- a harmonized target level of DGS funds of 0.8% of covered deposits (to be reached by 3 July 2024);
- possibility to use DGS funds also for preventive and alternative measures and within resolution.

Source: Own work.

More specifically, under Article 11(3) it is allowed to use DGS funds for preventive measures to avoid the failure of a bank, so these measures could be taken prior to the state of insolvency. There might be different types of preventive measures and DGSD leaves this topic open and to the discretion of Member States. Possible preventive measures include subsides to the acquiring bank, capital support, loans or guarantees. However, DGSD specifies conditions under which preventive measures could be undertaken[11]. It should be noticed, that on the ground of the current regulations preventive measures could be considered "extraordinary public support" (Mecatti 2022). This in turn, requires authorities to deem such a bank

[11] The most important ones are that the ailing bank is not under resolution, the DGS has appropriate systems and procedures to select and implement those preventive actions and also exercises more stringent risk monitoring of the bank concerned and finally, the cost of such intervention does not exceed the cost of deposit payout.

failing or likely to fail (FOLTF)[12]. Consequently, banks that could be restored via preventive measures are automatically declared FOLTF and in case they don't meet public interest assessment (PIA), they are subject to insolvency proceedings.

Whereas under Article 11(6) it is allowed to use DGS funds for alternative measures taken in order to preserve access to covered deposits once a bank has been declared insolvent. Thus, alternative measures could be taken once a bank has been found FOLTF but there is no public interest in putting it under resolution. This applies mostly to smaller banks, with little significance for financial stability. Alternative measures could include for example transfer of all or selected assets and liabilities (in particular deposit portfolio) to another healthy bank. What is important, least cost test should be applied.

As preventive and alternative actions are national options, only several Member States have implemented them. As of 2020, preventive measures (Article 11(3) DGSD) were available only in nine Member States[13], while alternative measures (Article 11(6) DSGD) were available in twelve Member States[14] (Eule et al. 2022). Only five Member States[15] transposed into national law both national options, giving their DGS possibility to undertake both kind of interventions. The actual cases in which these measures have been applied are even scarcer (Brescia Morra et al. 2023; Ramos-Muñoz et al. 2023). This shows that actually the role of majority of EU DGS is limited.

It should also be mentioned that in 2015 together with the introduction of Directive 2014/59/EU (so called Bank Recovery and Resolution Directive, BRRD) and resolution framework in the EU, DGS have been engaged also in an additional type of activity, namely participation in resolution financing. According to Article 11(2) DGSD and Article109 BRRD DGS funds should be used to finance resolution. As one of the resolution objectives is to protect depositors, the activation of resolution procedure aims at ensuring depositors have continued access to their deposits. In such situations DGS funds do not have to be used for the payout. However, EU legislators decided that DGS should instead contribute to the financing of resolution. The amount of DGS financial contribution depends on which resolution tool is used. In case bail-in is applied, DGS should contribute with the amount by which covered deposits[16] would have been written down, had covered deposits been included in the scope of bail-in and taking into account their position in the creditor hierarchy of national insolvency law. In case other resolution tool is used, then the amount contributed by DGS corresponds to the amount of losses that covered depositors

[12] Conditions for declaring bank failing or likely to fail are provided in Art. 32 (4) BRRD.

[13] Article 11(3) DGSD was transposed in Austria, Croatia, France, Germany, Ireland, Italy, Malta, Poland and Spain.

[14] Article 11(6) DGSD was transposed in Belgium, Croatia, Denmark, Finland, Greece, Ireland, Italy, Luxembourg, Lithuania, Malta, Poland, Slovenia.

[15] These are: Croatia, Ireland, Italy, Poland and Malta.

[16] In accordance with Article 44(2)(a) BRRD covered deposits are excluded from the application bail-in tool.

would have suffered, had they not benefitted from DGS protection but covered losses to the same extent as creditors with the same level of priority under national insolvency law.

In addition BRRD provides for important safeguards which are meant to protect DGS from depleting its funds. According to Article 109(5) BRRD deposit insurer's liability is capped at the 50% of its target level. This limit might, however, be increased by Member States, if they deem it necessary taking into account characteristics of the domestic banking sector. In any case, the financial engagement of DGS towards resolution financing may not be higher than losses it would have suffered in a hypothetical scenario of winding up a failed bank under national insolvency proceedings (i.e. in a situation where there would be a payout event).

In case of DGS interventions other than payout so called least cost test (LCT) applies. This rule has been inserted in the regulations to minimize the losses for the DGS fund. According to the least cost test DGS funds could be used only if this will not result in losses for the DGS higher that in case of payout. Currently there are no detailed rules on the LCT which means that it is applied heterogeneously across the EU.

The amount that DGS could contribute for preventive or alternative measures or towards resolution depends on many aspects, including direct and indirect cost and recoveries. Costa et al. (2022) distinguish five elements which could be included in the LCT methodology[17]:

- cost of reimbursing covered deposits (which is treated as a default option);
- operational expenses of DGS related to the insolvency proceedings;
- recoveries (which reduces the net cost of insolvency);
- consequential expenses of deposit payout (such as borrowing expenses or opportunity costs);
- systemic costs (related to e.g. the impact on banks of the increased contributions to replenish the DGS funds or possible contagion effect).

An important factor which also impacts the results of LCT computation is a recovery rate in insolvency which in turn depends on the DGS ranking in the creditor hierarchy. Currently, DGS in the EU enjoy the super-preference status as they subrogate into the rights of covered depositors. The high ranking of the DGS was introduced to shield DGS from losses connected with reimbursing of deposits as super-preference status usually means a high recovery rate for deposit insurer, and thus finally very low costs in the event of bank liquidation. As a consequence, this automatically decreases the amount which could be contributed towards interventions other than payout (Mecatti 2022; Costa et al. 2022; Ramos-Muñoz et al. 2023). As rightly pointed by Avgouleas et al. (2023) it is illogical that DGSD provides for additional functions (i.e. preventive and alternative measures) while at the same time having in place rules which hinder their application by DGS.

[17] It should be noted that many of those elements require judgement as authorities possess incomplete information and must make assumptions. For more on the different approaches applied in LCT calculation in practice see (Costa et al. 2022).

Table 1. DGS functions and their character under current EU regulations

DGS functions	Character	Legal basis
Payout of covered deposits in case of their unavailability (so called paybox)	mandatory	Article 11(1) DSGD
Contribution to resolution financing	mandatory	Article 11(2) DGSD and Article 109 BRRD
Preventive measures	optional	Article 11(3) DGSD
Alternative measures	optional	Article 11(6) DGSD

Source: Own work based on (Gortsos 2019).

To sum up, the current European regulations provide for four DGS functions, among which two are mandatory and two are facultative (see Table 1). The facultative functions are, however, not commonly used and one could even say their application is constrained by the regulations. Nevertheless, those facultative functions would enable deposit insurers to take active part in crisis management, in case resolution procedure does not apply.

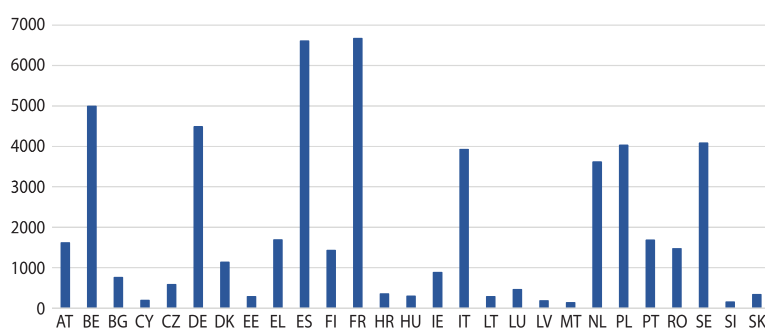
3. New EU proposals to enhance deposit insurers' role in crisis management

The 2023 European Commission proposal[18] to amend the crisis management and deposit insurance framework could be perceived as a continuation of the reform begun after the GFC. Indeed, the presented package of new regulations tries to fix the weaknesses of the current crisis management framework. It has been noticed that in order to be effective resolution framework should be applied to a wider set of banks. Resolution has so far been applied only to a limited extent, in particular in the banking union. During almost 10 years of its existence, the Single Resolution Board (SRB) has initiated resolution only twice, in 2017 towards Spanish Banco Popular and in 2022 towards two subsidiaries of Sberbank Europe A.G., while directing the parent bank for insolvency proceedings. In many cases, however, national authorities decided to resolve the problematic banks with the use of public funds within the State aid framework as laid out in the 2013 Banking Communication which imposes less strict requirements than BRRD. Since 2015 more than 58 billion EUR was spent to bail-out banks (European Commission [EC] 2023). The overwhelming majority of banks in distress have been dealt with outside resolution, using alternative paths. According to EC data, since 2015 around 60% and since 2016 (when bail-in tool came into force) 75% cases were managed

[18] The EC proposal contains three legislative proposals: amendments to Directive 2014/59/EU, amendments to Directive 2014/49/EU and amendments to Regulation 806/2014.

outside resolution in the EU. These numbers are even higher for the banking union. At the same time, large amounts of money are kept idle not only in resolution funds but also in national deposit guarantee funds. Total available funds of all national DGS amounted to 52 billion EUR as of 2022 (Chart 2).

Chart 2. DGS available funds as of 2022 (in million EUR)



For AT the figure represents cumulative available funds for all three recognized Austrian DGS. For IT the figure represents cumulative amount of two recognized Italian DGS.

Source: Own work based on (EBA 2022).

It is generally recognized that DGS financial capacity is sufficient to finance the payout of covered deposits in case of a failure of a medium-sized bank, but it would be too small to cope with a reimbursement of guaranteed deposits in case a systemically important bank fails (Dijmărescu 2011; Spitzer 2022). J. Eule et al. (2022) using data covering 2 455 European banks show that in each Member State in the banking union at least one bank operates the failure of which could deplete national DGS. Nevertheless, even in case of a medium-sized banks more cost efficient is to arrange, with assistance of DGS, a deposit portfolio transfer to a healthy buyer than to pay out covered deposits. Thus, there is a growing consensus that a more flexible use of DGS funds for interventions other than payout would be more effective than putting banks under a piecemeal liquidation (Brescia Morra et al. 2023). However, the current DGS regulations combined with BRRD and 2013 Banking Communication on state aid rules provide a complex framework which restricts using DGS resources for preventive or alternative measures, which traditionally had been their functions in managing banking crisis (Mecatti 2020). In particular, as advocated by Ramos-Muñoz et al. (2023) with regard to small and medium-sized banks transfer strategies supported by DGS would be mostly relevant.

The CMDI framework reform aims to enhance the role DGS play in crisis management by facilitating the use of DGS funds for interventions other than payout. To that end, several changes have been proposed. The most important ones are the following:

a. Permission to use DGS financing to meet 8% TLOF[19] requirement for access to resolution fund, but only in case of transfer strategies with market exit.
b. Introduction of general depositor preference and removal of DGS super-preference status in the creditor hierarchy.
c. Harmonization of the least cost test for all DGS interventions.
d. Clarifications as regards preventive and alternative measure.

Ad a. In order to widen the scope of resolution and include also small and medium-sized banks it is proposed to allow for DGS bridge financing in case a bank does not have sufficient funds to meet 8% TLOF requirement for accessing resolution fund. This might be particularly relevant for banks with a high prevalence of deposits as there is a risk that in order to meet 8% TLOF requirement some categories of uncovered deposits might need to be bailed-in which would have negative consequences for depositors trust and financial stability. Nevertheless, to constrain potential moral hazard several conditions are proposed. First, before DGS financing would be used, the internal loss absorbing capacity of a bank would have to be used to the maximum extent, and the exclusion of uncovered deposits from bail-in should be justified by financial stability reasons. Second, DGS would contribute only the missing amount that is necessary to reach 8% TLOF requirement. Third, the DGS bridge financing would only be possible in case of transfer strategies with market exit. And finally, DGS intervention would be allowed only if according to the least cost test the amount provided by the deposit insurer is not greater than in case of deposit payout.

Ad b. As already noted, the amount DGS is allowed to contribute towards interventions other than payout depends on the determination of the least cost test, the result of which is dependent on the DGS ranking in the creditor hierarchy. Strict application of the LCT together with a super-preference status of DGS ranking limit the possibilities of DGS to contribute to interventions other than payout (Avgouleas et al. 2023). In order to unlock the DGS funds it is proposed to introduce a general depositor preference under which all deposits (and as a consequence DGS too) would rank higher than ordinary unsecured claims. At the same time all deposits, whether covered or not, would be at the same level, i.e. pari passu. In its Impact Assessment Report, the EC (2023) provides that the introduction of single depositor preference would unlock on aggregate almost 1 billion EUR which is 20 times more DGS funds than currently available under super-preference of covered deposits (i.e. 0.05 billion EUR). It seems that the removal of super-preference of DGS together with revision of the LCT methodology are essential for allowing DGS to proactively engage in interventions other than payout (Avgouleas et al. 2023).

Ad c. Preventive and alternative measures as well as DGS contribution within the resolution are conditional on a positive outcome of the least cost test assessment. Currently, there are no detailed rules how least cost test should be conducted, which

[19] According to Art. 44(5) BRRD, before tapping resolution funds, bank shareholders and creditors have to cover losses by making contribution amounting to at least 8% of total liabilities and own funds (TLOF) of the bank subject to resolution.

elements should be included and how it should be calculated. Therefore, it is proposed to harmonize the LCT methodology. The harmonized least cost test would provide the elements which should be taken into account when estimating costs related to DGS intervention as well as costs of deposit payout. A specific methodology is to be provided by the European Banking Authority (EBA). Nevertheless, according to the amendments to DGSD, LCT should capture both direct and indirect costs[20]. Generally speaking, broader inclusion of costs in calculation of LCT should increase the scope of DGS funding for interventions other than payout (Costa et al. 2022).

Ad d. Finally, the possibility to engage DGS in actions outside resolution, such as preventive and alternative measures are to be maintained. However, both types of measures are slightly amended. Preventive interventions of DGS would be better framed and dependent on new conditions. The main aim of this kind of interventions should be to provide necessary support for a viable bank, i.e. which has not met any conditions qualifying it as FOLTF. It is proposed that a requesting bank would submit a note with measures to strengthen its financial position or, when necessary, to restore the compliance with supervisory requirements. Depending on the type of preventive measure requested (capital support or liquidity support), this note should also specify either ways to raise capital or repayment schedule of a loan. In case a bank would fail to deliver on its commitment made in the note, or to repay the preventive support granted by DGS, the supervisory authority would have a power to request the bank to submit a remediation plan outlining how the bank plans to restore compliance with supervisory requirements, ensure long-term viability and repay the preventive liquidity support. In case DGS would grant capital support it ought to sale its stake to a private sector purchaser as soon as possible. For banks which have been subject to national winding-up procedures leading to a market exit, deposit insurer would still have the possibility to provide support within alternative measures aimed at preserving the access of depositors to their deposits. The new provisions specify the transparency conditions for a marketing process of assets and liabilities of the bank concerned.

Preventive and alternative measures under the EC proposal remain, however, national options. It might be argued that it would be more beneficial to make them a standard tool of the crisis management framework. Brescia Morra et al. (2023) and recently the ECB in its Opinion (CON/2023/19) propose that both preventive and alternative measures should be made available across the EU, while J. Eule et al. (2022) focus only on alternative measures and argue that wider application of these measures can limit DGS upfront outlays, ensure uninterrupted access to deposits and banking services and contain the risk of destabilizing bank runs, thus benefiting DGS, depositors and financial stability. It should be noted that making alternative measures a mandatory feature of the crisis management framework would mean that banks for which resolution is not an option (due to negative PIA) would also be

[20] As pointed out by De Aldisio et al. (2019) although calculating indirect costs would be more difficult than direct costs, these cost could be material, thus having a great impact on the outcome of the LCT assessment.

liquidated in an orderly and cost-efficient manner. The portfolio transfer supported by deposit insurer would be far more beneficial than a piecemeal liquidation because transfer strategies allow to maintain value of the banking business, minimize risks for financial stability and protect depositors (not only covered but all) as deposits are transferred to an acquirer (Ramos-Muñoz et al. 2023).

4. A broadened DGS mandate – potential difficulties and challenges ahead

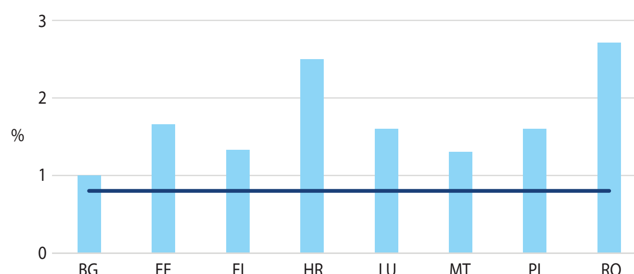
The proposed CMDI reform aims at widening the scope of resolution to include also small and medium-sized banks. This is to be achieved by facilitating access to industry-funded safety nets, i.e. deposit guarantee schemes and resolution funds. Although the above mentioned changes should facilitate DGS involvement in interventions other than payout, there still could be some difficulties and challenges related with their introduction.

First, while the DGS bridge financing mechanism to reach 8% TLOF threshold to access resolution fund would have positive impact on managing resolution of smaller deposit-funded banks, it would basically mean that DGS covers to (some extent) losses that, in the absence of this mechanism, would have been borne by uncovered depositors. Although providing financing to support transfer strategies will certainly be least costly than payout of covered deposits, it still will be costly for DGS, in particular in case of "larger" medium-sized banks. It has to be noticed that the population of small and medium sized banks is very heterogenous with regard to both their size measured by assets as well as to their business models, which determines their funding sources. The assets of this group of banks in the banking union vary from 100 million EUR to almost 30 billion EUR (SRB 2023). As the threshold to reach resolution fund is defined in percentage of total liabilities and own funds of a given bank, it means that the absolute amount contributed by DGS would depend on (1) the remaining internal loss absorbing capacity of a bank (i.e. amount of own funds and eligible liabilities which could already be used to cover losses in the run-up to resolution) and (2) the size of the bank, i.e. the larger bank, the larger absolute amount of TLOF and 8% of it.

Providing gap financing risks also more frequent usage of DGS funds, and thus their faster depletion. In such a situation DGS will be required to replenish its funds by collecting ex post contributions which might be procyclical, in particular in times of system-wide tensions. These additional contributions would constitute burden on banks which in turn might impact their profitability. Nevertheless, it seems that the broadening DGS mandate necessitates more DGS funds. This could be done either via collecting ad hoc ex post contributions each time a shortfall in DGS funds occurs or via strengthening DGS financial capacity gradually by setting a new higher target level and providing transition period to reach it. Currently the minimum target level to be reached by 3 July 2024 is 0.8% of covered deposits of banks belonging to

the given DGS. DGSD allows to set both a higher and a lower level (but not lower that 0.5%), if deemed necessary by the national authorities. Eight Member States introduced a higher target level ranging from 1% to 2.71% (see Chart 3), while only one Member State decided for a lower (0.5%) target level (Spitzer 2022).

Chart 3. EU Member States which set a higher DGS target level



The navy blue line marks the minimum target level at 0.8%.

Source: Own work based on (EBA 2022).

Interestingly, five[21] of those Member States who introduced a higher DGS target level have also implemented preventive or/and alternative measures into their national legal frameworks. This shows that widening the spectrum of DGS tasks requires at the same time securing appropriate financial capacity of the deposit guarantee fund. Chart 3 shows that the most common higher level adopted by these Members States is around 1.6%. However, in case such an amendment is introduced within DGSD the calibration of a new target level would require an in-depth analysis. Ensuring appropriate financial capacity of DGS is of crucial importance as any shortfalls of DGS funds could not only constrain the ability of a deposit insurer to effectively perform its functions but also undermine depositors confidence. To that end, it seems that in order to safeguard sufficient, credible and effective firepower of DGS with its new broadened mandate, it might be appropriate to set a higher target level of deposit guarantee fund.

Second, although introduction of a general depositor preference is a welcome change as it would unlock funds for DGS intervention other than payout, this change, however, would not be beneficial for DGS in cases of bank liquidation and subsequent deposit payout. The CMDI reform aims at broadening the scope of banks subject to resolution but it does not mean that all banks would be resolved in that way. In particular, it cannot be excluded that some banks might have a negative public interest assessment and would be liquidated under standard insolvency proceedings, which would entail deposit payout. In such cases a general depositor

[21] As noted earlier Greece and Luxembourg implemented alternative measures, while Croatia, Malta and Poland implemented both preventive and alternative measures.

preference would worsen the DGS position. This is because under the current regulations DGS has super-preference status in the hierarchy of claims which means that it is satisfied from the proceeds of an insolvent bank before other creditors and in particular before uncovered depositors. Under the general depositor preference approach DGS would rank pari passu with other depositors regardless of their eligibility and coverage, which basically means that it would have to bear losses to the same degree as all deposits (Dobler et al. 2020). To that end, there might be some concerns about introducing a single-tier depositor preference.

A possible alternative way forward, which would be more beneficial for the DGS in case of insolvency proceedings and at the same time allow to unlock more DGS funds for interventions other than payout, could be the introduction of a two-tier depositor preference. In this approach all deposits would rank above ordinary unsecured claims, however, there would be two tiers (layers) of deposits: (1) covered and preferred deposits and (2) non-preferred and non-covered deposits. Deposits in the first tier would rank pari passu and above deposits in the second tier, while deposits in the second tier would rank pari passu and above ordinary unsecured claims (see Figure 1). According to the EC (2023) estimates introducing a two-tier depositor preference would enable to unlock 0.21 billion EUR of DGS funds, which is five time less than under a general depositor preference, but four times more than currently. However, in comparison to a general depositor preference, a two-tier depositor preference would ensure a better protection to DGS, i.e. higher recoveries, in case of bank liquidation.

Figure 1. DGS position in hierarchy of claims under single and two-tier depositor preference

Creditor hierarchy	**General depositor preference (single tier)**	**Two-tier depositor preference**
senior	Secured liabilities	
↑	All deposits (covered deposits/DGS, non-covered preferred deposits, other)	Covered deposits/DGS and non-covered preferred deposits
		Other non-covered and non-preferred deposits
junior	Ordinary unsecured liabilities	

Source: (EC 2023).

Another challenge might relate to the methodology of the least cost test. According to the EC proposal both direct and indirect costs should be included in the LCT. However, it might be challenging to calculate indirect costs such as e.g. potential systemic impact of a bank's failure or contagion effect. There might be also some political issues related with the CMDI reform. Although the proposed changes to the

CMDI framework have been widely supported by the European institutions, like the ECB or the SRB[22], it is still possible that at the national level some objections might arise. In particular, in the absence of the pan-European deposit insurance (EDIS), the cost of this reform will be mostly borne by the national deposit guarantee schemes. Thus, it is possible that there might be some resistance towards e.g. removal of super-preference status of covered deposits/DGS.

Conclusions

Deposit guarantee schemes should be allowed to intervene in a broad and flexible manner. This is particularly important for smooth crisis management of smaller banks which either could have problems with meeting 8% TLOF requirement within the resolution procedure or could not qualify for resolution at all. In such situations initiating national insolvency proceedings and conducting piecemeal liquidation with a payout of covered deposits could be less efficient than allowing DGS to support resolution or to take alternative measures.

To that end, extending the role played by DGS in crisis management is a step in the right direction. This could be done by making current national options included in Art. 11(3) and 11(6) DGSD more uniformly available in the whole EU. However, this would not be enough. Further reforms are necessary to make those DGS functions operationally available. First, ranking of covered deposits and subsequently DGS (which subrogates into rights of covered depositors) has to be changed, i.e. the current super-preference of covered deposits should be replaced by single or two-tier depositor preference. Second, least cost test has to be modified and harmonized so that both indirect and direct costs are taken into account. All these changes implemented together would have a potential to unlock DGS funds and make deposit insurers proactive participants in crisis management. Nevertheless, broadening DGS mandate risks also more frequent usage of DGS funds. Therefore, in order to avoid shortfalls in DGS funds, it might be necessary to strengthen its financial capacity by gradually raising DGS target level from the current 0.8% of covered deposits.

Having said that, the 2023 proposal of CMDI reform published by the European Commission should be assessed positively as it tries to address all identified obstacles in a greater involvement of DGS funds in crisis management. Nevertheless, some challenges or costs of the proposed measures could also be identified. What is important now, is to ensure that all these amendments are appropriately balanced to deliver the optimal result. So far, works on the CMDI proposal are on-going in the European Council and in the European Parliament.

[22] Both institutions expressed their support from the CMDI proposal in a joint press release published on 18 April 2023, available at: ECB and SRB welcome European Commission's legislative proposals for bank crisis management and deposit insurance framework (europa.eu)

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