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THE FINANCIAL CRISIS AND THE REFORM OF DEPOSIT GUARANTEE SCHEMES IN THE EU[1]

INTRODUCTION

When President Franklin D. Roosevelt took office in 1933, during the Great Depression when millions of Americans lost their money because of massive bank failures, he said: *"After all, there is an element in the readjustment of our financial system more important than currency, more important than gold, and that is the confidence of the people themselves"*[2]. A few months later, President Roosevelt established the world's first deposit protection system.

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1 This article has been prepared on the basis of E. Terták's presentation at the Bank Guarantee Fund's conference on 21 May 2010. It is also based on the European Commission's package on the review of the Directive on Deposit Guarantee Schemes (DGS) presented on 12 July 2010 (ec.europa.eu/internal_market/bank/guarantee/index_en.htm). However, the article reflects the views of the authors and not necessarily those of the Commission.

2 F. D. Roosevelt, *First Fireside Chat*, Washington DC, 12 March 1933 [in: J. Grafton (ed.), *Franklin Delano Roosevelt – Great Speeches*, Dover Publications, Mineola, New York, 1999].

After 75 years, when another financial crisis (sometimes compared to the Great Depression) intensified in autumn 2008 and many Europeans lost their confidence in the financial system, the EU ministers of finance stated: *"In the current troubled situation in the financial sector (…), we agree that the priority is to restore confidence and proper functioning of the financial sector"*[3]. As one of the measures to restore confidence of European depositors and avoid bank runs, the ministers agreed that EU Member States must ensure adequate deposit protection.

Both cases highlighted the importance of public confidence for the proper functioning of any financial system.

THE LESSONS OF THE CURRENT FINANCIAL CRISIS

The current crisis has provided a number of lessons for both regulators and the general public, including in relation to deposit insurance. The first lesson was offered by the case of Northern Rock in September 2007. The run on this bank was a clear crisis of public confidence in the banking system: depositors sought to claim back their deposits at the first signs of bank trouble as they were not convinced that their savings were secure. In order to halt the run and prevent a widespread panic, the UK authorities saw no solution other than to announce state guarantees for all deposits with that bank. They also abandoned the rule of co-insurance (which stipulated that deposits were not guaranteed in full) because people were panicked by the prospect that if Northern Rock failed they would lose a considerable part of their deposits. The UK experience confirmed that it is of utmost importance for financial stability to convince depositors that their money at banks is fully protected.

A lesson for the entire EU was learnt a year later, following the collapse of Lehman Brothers Holdings. When the crisis worsened in 2008, most Member States raised the coverage levels significantly or announced unlimited deposit guarantees. First, the Irish government declared in late September 2008 that the level of coverage would be raised to € 100 000 and provided a temporary unlimited state guarantee for the major Irish banks. As a result, many depositors quickly shifted their money to banks covered by higher or unlimited guarantees, and notably from UK to Irish banks. This resulted in heavy liquidity strains for the banks not covered by such guarantees. Accordingly, in early October 2008, the UK authorities were forced to raise the coverage level from £ 35 000 to £ 50 000. In order to prevent the outflow of deposits and avoid competitive distortions, other Member States also felt obliged to increase significantly the level of coverage (see Figure 1). Those unilateral and uncoordinated actions created serious competitive distortions between Member

[3] *Immediate responses to financial turmoil*, Ecofin Council Conclusions, Luxembourg, 7 October 2008.

States, undermined depositor confidence and threatened the overall stability of the EU financial markets.

These events brought into focus some serious drawbacks in the DGS framework existing at that time in the EU. First, the coverage level stipulated by Directive 94/19/EC (minimum € 20 000) had become too low in the intervening fourteen years since it had been agreed. Second, the approach of minimum harmonisation as to coverage levels led to unintended side-effects and jeopardised financial stability.

A further painful lesson of 2008 was the Icelandic banking crisis. Although Iceland is an EEA country where the DGS Directive applies, the Icelandic DGS was not prepared or able to pay out depositors at British and Dutch branches of a failed Icelandic bank. As a result, the UK and Dutch authorities were forced to intervene in order to maintain public confidence in the banks although they were legally not liable for deposits at branches of foreign banks. Those unfortunate events also highlighted the importance of fast payout and proper depositor information, notably for depositors at branches of foreign banks and confirmed the need to facilitate the payout process in cross-border situations.

Moreover, some lessons had to be learnt as to the funding of DGS. When the crisis deepened in 2008, it became evident that several DGS were underfunded relative to their obligations and exposure to risks. The most prominent example was the Icelandic scheme, but it was the same case in many EU Member States. The Commission's research from spring 2008 revealed that DGS in six Member States would not be able to cope with the failure of a medium-sized bank and one scheme had just overcome a deficit in which it had been for years[4]. Besides, in autumn 2008, most Member States significantly raised their coverage levels without any financial strengthening of their DGS. The capacity of (some) Member States to provide for the implicit or explicit guarantee that they had announced was therefore questionable[5].

In the wake of a crisis, the issue of pro-cyclicality always arises. It is often argued that mere ex-post funding is highly pro-cyclical as it drains liquidity from banks in times of stress. It might worsen the overall situation of sound banks and have implications on credit supply by banks. Ex-post systems (still existing in six Member States) have more serious drawbacks. In normal times, banks that do not pay ex-ante contributions have a competitive advantage vis-à-vis banks in Member States with ex-ante DGS. In ex-post systems, unlike in ex-ante ones, the failed bank does not contribute to payout (which increases moral hazard). This was raised by many stakeholders in the public consultation conducted by the Commission last year[6].

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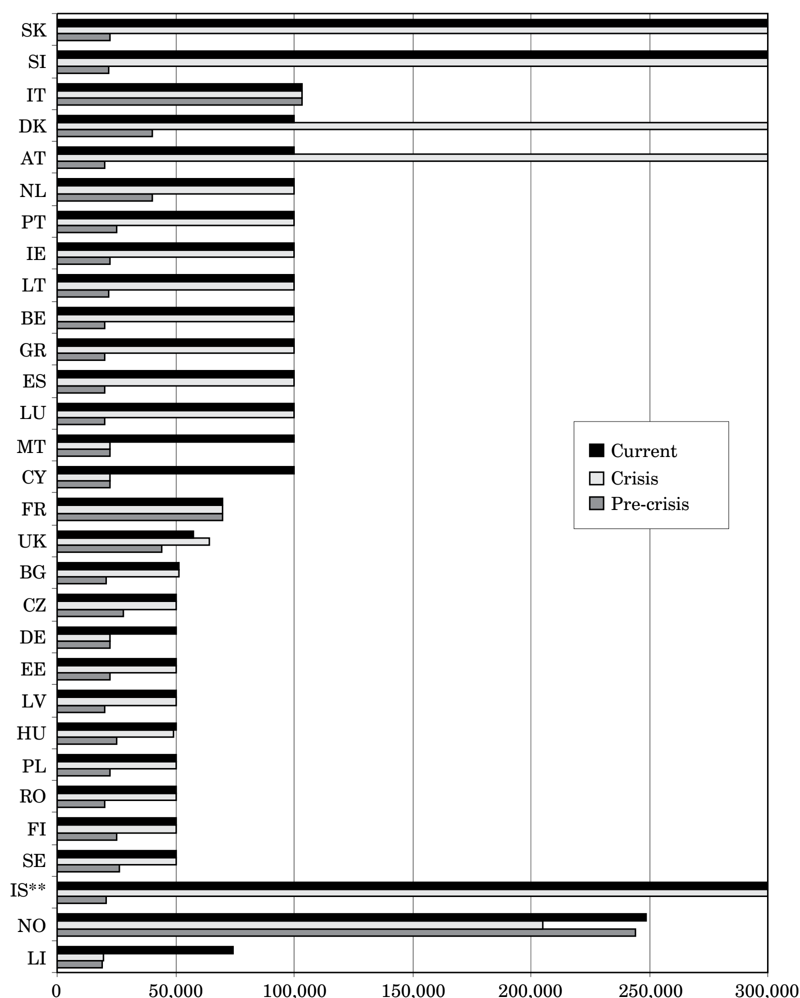
4 *Investigating the efficiency of EU Deposit Guarantee Schemes*, European Commission, Joint Research Centre, May 2008.

5 S. Schich, *Challenges associated with the expansion of deposit insurance coverage during fall 2008*, May 2009 (www.economics-ejournal.org/economics/journalarticles/2009-20).

6 *Consultation on the review of the Directive on Deposit Guarantee Schemes*, May-July 2009 (ec.europa.eu/internal_market/consultations/2009/deposit_guarantee_schemes_en.htm).

Figure 1. Coverage levels in EU Member States and EEA countries before and after the aggravation of the financial crisis (as of 1 October 2010)*



* Note: Pre-crisis period – as of 15 September 2008; crisis – October–December 2008; current situation: as of 1 October 2010. For non-euro area countries, € equivalents have been calculated on the basis of relevant ECB exchange rates. For scaling purposes, the coverage level for Member States with unlimited deposit protection has been shown as € 300 000. Political declarations on increasing coverage levels or unlimited deposit guarantees, which were not followed by any legislative action in autumn 2008, as well as guarantees for selected banks only, have not been taken into account.

** Unlimited coverage only for deposits at domestic banks and their branches in Iceland, but not at foreign branches of Icelandic banks.

Source: Commission services.

Regarding bank contributions to DGS, they are set in most Member States as a fixed percentage of deposits (usually eligible deposits). Under such a system, the degree of risk incurred by a given bank is not taken into account. This may be perceived by risk-averse banks as a competitive disadvantage and disincentive for sound risk management.

As a result of the recent experience of various authorities of crisis management, there is a growing body of opinion that DGS should not be a merely passive element of the safety net, with their function limited to pay out to depositors on a bank failure, but they should instead play a more active role in crisis prevention or resolution. Furthermore, the crisis encouraged the idea of establishing bank resolution funds. In this context, there is an ongoing debate on how to ensure DGS involvement in bank resolution while avoiding duplication of the functions of DGS with those of bank resolution funds.

Moreover, in light of the considerable degree of concentration in the EU banking market, the crisis also prompted the idea of establishing EU-wide supervision in the coming years. This, in turn, raised the question of whether a pan-EU DGS should be set up in the future.

THE NEED TO REFORM DEPOSIT GUARANTEE SCHEMES IN THE EU

The EU Directive on DGS was adopted in 1994 and remained unchanged for many years despite of the dynamic development of financial markets in the 1990s and 2000s. The first review of Directive 94/19/EC was conducted by the European Commission in 2005–2006. It was aimed at identifying potential weaknesses and proposing appropriate actions to address them. However, based on the opinion of Member States, the Commission concluded at that time (i.e. good economic and financial conditions in the world, including the EU) that there was no appetite to amend the Directive. Member States preferred to maintain the status quo as to their DGS and avoid expensive investment to change the existing framework in the absence of a firmly established case for doing so[7].

The need for reform was highlighted in autumn 2007 after the run on Northern Rock, but as it was considered to be an isolated episode, changes were only made to the UK DGS. A year later, the worsening of the global financial crisis had an impact on financial systems and deposit protection schemes in the EU as a whole. As already mentioned, the crisis prompted a number of emergency policy measures related to the deposit insurance systems in both the US and the EU. The crisis

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[7] *Communication concerning the review of Directive 94/19/EC on Deposit Guarantee Schemes*, European Commission, COM(2006)729, Brussels, 27 November 2006.

revealed furthermore numerous drawbacks of the DGS framework in the EU and increased the urgency for reform.

First, in order to convince depositors that their money at banks is safe, the Commission proposed a sizeable increase of coverage – from the then minimum of € 20 000, via an interim level of € 50 000, to the ultimate level of € 100 000 (the latter was to be a fully harmonised level in all Member States – in recognition of the fact that the threat to depositor confidence and financial stability would exist as long as there were different levels of coverage in the EU). Second, keeping in mind the lessons of the Northern Rock case, the Commission proposed to abandon co-insurance. Finally, it proposed to reduce substantially payout delay after a bank failure (measured in days and not in months as before)[8].

The above changes, agreed in autumn 2008 and implemented by Directive 2009/14/EC, proved to be successful in restoring depositor confidence and stabilising financial markets. They represented significant progress in comparison with the original Directive. However, as the crisis situation required prompt action, the changes were a 'quick-fix' rather than a reform based on a comprehensive review of the Directive. For that reason, from early 2009, the Commission services worked on a more thorough-going reform of the DGS system in the EU. The relevant legislative proposal was published in July 2010 and the new Directive is expected to be adopted next year under the Hungarian or Polish Presidency of the EU Council. The following sections outline some key aspects of the proposed reform.

BETTER DEPOSITOR PROTECTION TO MAINTAIN DEPOSITOR CONFIDENCE

This section presents issues that are usually of greatest interest to depositors (level and scope of coverage, payout, depositor information), and thereby essential to maintaining depositor confidence.

One of the most visible elements of deposit protection is the level of coverage. It is not therefore surprising that when the crisis deepened in autumn 2008, the Commission proposed a sizeable increase of the coverage level (up to € 100 000) in order to convince depositors that their money was safe in EU banks. However, at that time, due to the urgency of the situation, there was no time to analyse in detail what level of coverage was most appropriate. That analysis was conducted after the financial markets had been stabilised.

[8] *Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay*, European Commission, COM(2008)661, Brussels, 15 October 2008.

In the detailed impact assessment (published in July 2010), the Commission analysed various potential coverage levels from € 50 000 up to € 200 000. It concluded that the harmonised coverage level of € 100 000 is the optimal solution since it would ensure substantial progress in terms of increased deposit protection (see Table 1) without disproportionably increasing costs for banks and depositors. As to the other levels, it would be politically difficult to adopt € 50 000 (keeping in mind that many Member States had already announced higher or even unlimited deposit guarantees – see Figure 1) while the benefits of adopting a coverage level higher than € 100 000 would be very limited. It confirmed that the decision from 2008 was right and the fixed level of € 100 000 would be applied in all Member States from end-2010[9].

Table 1. The amount and the number of covered deposits in relation to the eligible deposits in the EU

Ratio	As of end--2007	Coverage level			
		€ 50 000	€ 100 000	€ 150 000	€ 200 000
Amount of covered deposits / Amount of eligible deposits	61.1%	58.6%	71.8%	81.0%	88.4%
Number of fully covered deposits / Number of eligible deposits	88.8%	91.0%	95.4%	96.5%	97.2%

Source: Commission's Joint Research Centre (JRC).

While harmonizing the level of coverage is of utmost importance, this is not enough. In order to create a level playing field, the scope of coverage should be harmonised as well (see Table 2). In this context, the Commission is of the view that all enterprises (regardless of their size) should be covered by DGS. Covering the deposits of all enterprises means adding medium and large firms (only 1.3% of EU firms) since roughly all micro and small enterprises (98.7% of EU firms) are currently covered. It would eliminate the need to make time-consuming verification of the size of firms (staff, turnover, assets, etc). In turn, it would allow for considerably faster payout, which would increase depositor confidence in DGS.

In contrast to enterprises, which should be treated in the same way as individuals, all financial institutions and all public authorities (central and local ones) should be excluded from coverage. For financial institutions, the coverage level of € 100 000 is irrelevant, and authorities have easy access to other financial resources.

[9] As an exception to this general rule, it may be justifiable to offer (subject to some restrictions) higher coverage for so-called 'temporary high deposit balances' stemming from real estate transactions and some specific life events.

As regards products, deposits in non-EU currencies should be covered by DGS in all Member States. This is important for both individuals and enterprises, notably those involved in import and export business. On the contrary, for example, structured products not repayable in full should be excluded from coverage (rather, because of their investment nature, they should be covered by investor compensation schemes).

Table 2. Harmonised scope of coverage proposed by the European Commission (key examples)

	Covered	Not covered
Depositors	all enterprises (micro, small, medium and larger)	financial institutions, public authorities
Products	deposits in non-EU currencies (USD, CHF, etc.)	debt certificates, structured products

Source: Commission services.

As mentioned above, one of the key factors for depositors is the length of payout. As people today barely keep cash reserves, it must be as short as possible. After the crisis in autumn 2008, the Commission proposed to shorten it to three days[10]. Finally, it was agreed that it would be reduced from 3–9 months to 4–6 weeks from end-2010 onwards. However, the Commission strongly believes that even this shortened payout period is still too long and needs to be substantially reduced – preferably to one week (after a transitional period)[11].

Rapid payout is crucial for individuals: according to a consumer research, depositors would be likely to suffer financial difficulties after a few days[12]. Continual access to bank accounts is also important for enterprises (especially for smaller ones) since the lack of it may cause problems with liquidity and eventually lead to bankruptcy. If depositors have fear that they will have to wait several weeks after the DGS steps in, this substantially increases the risk of a bank run if there are any signs of deterioration in the overall situation of the banking sector.

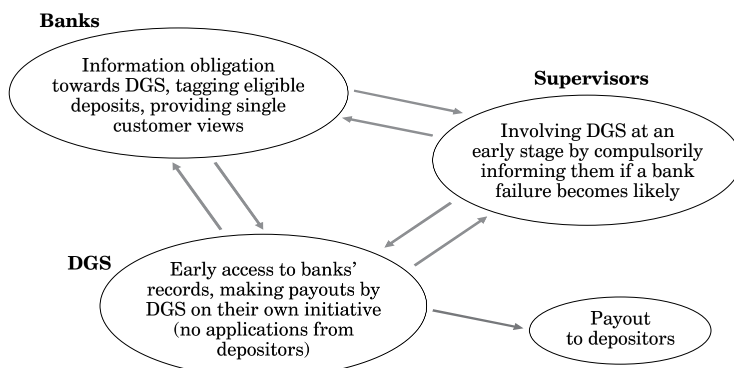
[10] It is worth mentioning that the US deposit insurance scheme (FDIC) usually makes payouts within two business days. However, the FDIC (acting as deposit insurer, supervisor and receiver) has a much broader mandate than DGS in the EU. Moreover, it makes payouts after a 90-day pre-closing period.

[11] The same payout delay has been considered in recent years in the UK and is to be applied there next year. See www.fscs.org.uk/industry/single-customer-view-for-faster-payout/rules/; see also *Financial Services Compensation Scheme reform. Fast payout for depositors and raising consumer awareness*, FSA, Consultation Paper 09/3, January 2009; *Fast payout study. Final report*, Ernst & Young, November 2008 (report commissioned by the FSA, BBA and FSCS).

[12] *Consumer awareness of the Financial Services Compensation Scheme*, FSA, Research Paper no. 75, January 2009.

However, a short payout deadline is only feasible if several conditions are met (see Figure 2). First of all, it is necessary to ensure early access of DGS to information on deposits. In this context, it is important to involve DGS at an early stage by requiring supervisors to inform the relevant DGS if a bank failure becomes likely. DGS should make payouts on their own initiative (without being prompted by applications from depositors) and verification of claims should be simplified (inter alia, by abandoning time consuming set-off, i.e. netting customers' deposits against their liabilities (e.g. loans) at the same bank). Banks should tag eligible deposits, provide single customer views, etc. It would entail some one-off administrative costs for banks, but they would be more than counterbalanced by increased depositor confidence that would reduce the probability of bank runs and contribute to overall financial stability. Finally, it should be noted that although it may not be feasible to make rapid payout in some complicated cases, DGS should be able to ensure it for a vast majority of depositors.

Figure 2. Conditions for faster payout of deposits after a bank failure



Source: Commission services.

In view of the Icelandic crisis, and notably the serious problems with payouts at foreign branches of a failed bank, there is also a need to facilitate the payout process in cross-border situations. To this end, the host-country DGS should act as a 'single point of contact' for depositors at branches of foreign banks. This includes communication with those depositors, but also acting as a 'paying agent' on behalf of the home-country DGS (coupled with an obligation for the home-country scheme to reimburse the host-country one or to provide the latter with relevant financial means in advance). It would bring several advantages for depositors at branches: information would be provided in their country and in their language, quick payout, etc. It would involve some administrative costs for the host-country DGS but they

would be marginal in comparison with the gain in depositor confidence and would be reimbursed by the home-country DGS (for which this option is cheaper than if it had to operate cross-border).

In order to maintain and strengthen public confidence, DGS should inform the general public, including depositors, about the benefits and limitations of key deposit protection aspects (on an ongoing basis and via various tools and channels of communication).[13] To this end, before making a deposit, depositors should have to countersign a special information sheet including brief information on all relevant aspects (coverage level, payout deadline, DGS contact details, etc.). Depositors should also be informed about coverage on their account statements. There should be a mandatory reference to DGS coverage in advertisements if an advertised product is covered. Mandatory depositor information should be complemented by more general financial education, and DGS should be among institutions which play an active role in raising financial awareness and literacy of both bank customers and non-customers (so-called 'unbanked' or 'underbanked'). Better financial education of society in general, along with proper regulation and supervision of financial institutions, is one of the key factors in maintaining stability of the financial system[14].

ENHANCED FINANCING OF DEPOSIT GUARANTEE SCHEMES

As mentioned, several DGS turned out to be underfunded in the financial crisis. Several schemes in the EU still do not have funds adequate to meet the level of deposit protection offered under the EU regime. This situation may undermine depositor confidence and the credibility of DGS. Moreover, the lack of harmonised funding of DGS may lead to significant differences in bank contributions to their schemes, which may in turn create an unlevel playing field within the EU single banking market. A significant enhancement of DGS funding is also necessary to support the other reforms: the higher coverage level, faster payout, broader mandate of DGS, etc.

For those reasons, in July 2010, the Commission suggested a four-step approach (see Figure 3), consisting of several elements, each of which would be called upon only once the preceding one had been exhausted:

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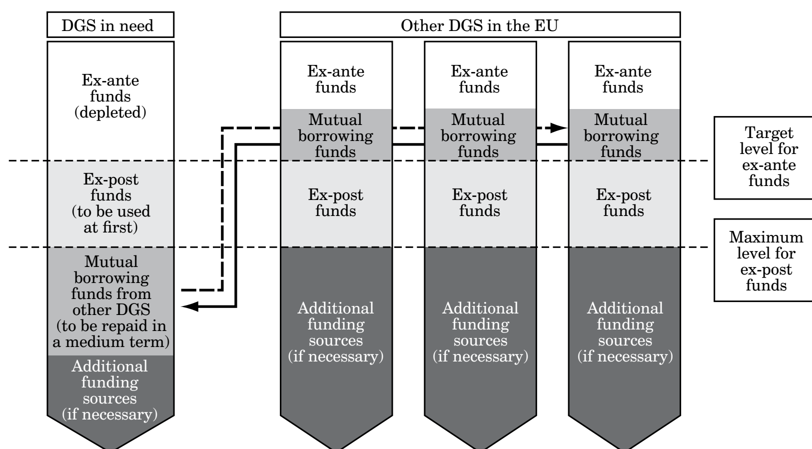
[13] *Core principles for effective deposit insurance systems*, Basel Committee on Banking Supervision & International Association of Deposit Insurers, Basel, June 2009.

[14] K. Szeląg, *Recent reforms of the deposit insurance system in the United States: reasons, results and recommendations for the European Union*, National Bank of Poland, Working Paper no. 59, May 2009.

(1) *Ex-ante funds* (as a strong basis) – financed from regular contributions of member banks. The target level for the funds should be 1.5% of eligible deposits.
(2) *Ex-post funds* – additional contributions collected from banks if necessary (in a crisis situation). In order not to impose excessive burdens on sound banks in bad times, these contributions may not exceed 0.5% of eligible deposits.
(3) *Mutual borrowing facility* – if the financial capacity of one DGS was depleted, it would be able to borrow a limited amount from the other schemes (up to 0.5% of eligible deposits for the borrowing scheme). The loan should be repaid within 5 years (until full repayment, the debtor scheme would neither borrow from nor lend to other DGS).
(4) *Other funding sources* (as the last resort) – for example, unlimited borrowing by DGS on the financial market (e.g. by issuing bonds).

Figure 3. Structure of potential DGS funding (including mutual borrowing facility)



Source: Commission services.

Because ex-ante funding is counter-cyclical (as it imposes most costs on banks in good times and in such a way the failing banks also contribute to the costs caused by them), it should be dominant (¾ of the total fund), but supported by ex-post funds to be collected if necessary (¼ of the fund) (see Figure 4a). Setting the above target level for DGS funds would ensure that schemes are credible and capable of dealing with at least medium-sized bank failures. Enhancement of funding should contribute to preventing (or at least minimising) the need to use taxpayers' money in the event of a bank failure.

The proposed system of DGS funding is expected to be established within about 10 years, i.e. by the end of 2020. After this period of time, DGS in the EU would be much better financed than they are now. According to the Commission's estimates, they would collect about € 150 billion in ex-ante contributions and could call for additional € 50 billion of ex-post contributions if needed – compared to total ex-ante and ex-post funds of € 23 billion in 2008 (see Figure 4b). Inevitably, it would require much (four to five times) higher contributions paid by banks to DGS. This increase, however, is the consequence of past and current significant underfunding of DGS and the price of creating financially sound DGS in the future. Higher contributions may reduce the level of operating profits of banks, but this effect should not be significant. Given the competition between banks, it is unlikely that these additional costs for banks would be fully passed on to their customers. The length of transition time (about a decade) is related to the fact that the other ongoing reforms of prudential regulation will also impose additional burdens on the banks, and an excessive aggregation of new or increased charges must be avoided.

As regards bank contributions to DGS, it should be emphasized that in the future they must reflect the risk incurred by individual institutions. The premiums should be calculated on the basis of a number of indicators reflecting risk profiles of the banks. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity[15] (for example, similar classes are applied in the US supervisory rating system – CAMELS). The data necessary to assess those indicators are available under existing reporting obligations. Taking into account differences between banking sectors in Member States, the Directive ensures some flexibility by developing a set of core indicators (mandatory for all Member States) and another set of supplementary indicators (optional for Member States). Proportions of the core and supplementary indicators would be ¾ and ¼ respectively. The approach to risk-based contributions proposed by the Commission provides incentives for sound risk management and discourages risky behaviour by clearly differentiating between the levels of contribution paid by the least and most risky banks (from 75% to 200% of the standard amount respectively). The current proposal is however only a starting point. Full harmonisation of the calculation of risk-based contributions should be achieved at a later stage (possibly under the auspices of the new European Banking Authority that is to be established soon).

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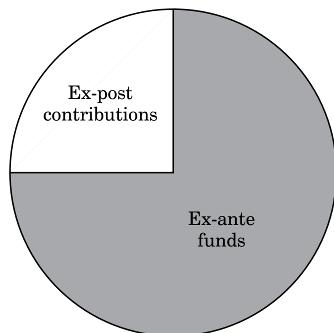
15 *Possible models for risk-based contributions to EU Deposit Guarantee Schemes*, European Commission, Joint Research Centre, June 2009; see also *Risk-based contributions in EU Deposit Guarantee Schemes: current practices*, European Commission, Joint Research Centre, June 2008.

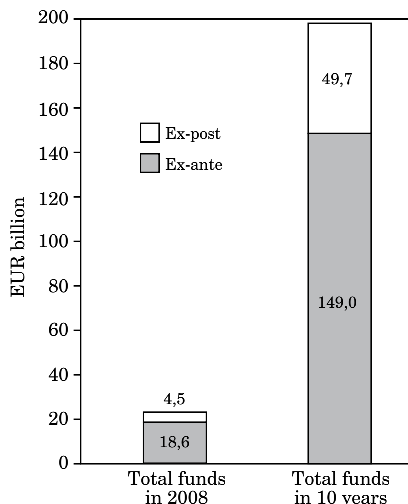
Figure 4. Ex-ante and ex-post funding as proposed by the European Commission

(a) Proportions of ex-ante and ex-post funding*



* Target level for ex-ante funds: 1.5% of eligible deposits; Maximum level for ex-post funds: 0.5% of eligible deposits.

(b) Expected amounts of ex-ante and ex-post funding after reaching the target level**



** As of 31 December 2020.

Source: Commission services.

DEPOSIT GUARANTEE SCHEMES VS. BANK RESOLUTION AND EARLY INTERVENTION

Prior to the crisis, most Member States had DGS with narrow mandates, i.e. limited to payout of deposits after a bank failure (so-called 'paybox' function). DGS in 11 Member States had broader mandates, including liquidity or restructuring support, liquidation powers, etc. During the Commission's public consultation last year, a slight majority of stakeholders was in favour of maintaining DGS as mere 'payboxes'. However, as previously mentioned, during the crisis, there has been growing support for transforming DGS from a merely passive element of the safety net to a more active player in crisis prevention or resolution.

This idea was acknowledged by the Commission in its communication on crisis management published in October 2009,[16] where it was suggested that DGS could include the possibility of funding bank resolution measures, with the advantage that the banking sector would contribute directly to ensuring its own stability. A typical resolution measure is the transfer of deposits from a failed bank to another (healthy) bank or a temporary institution (so-called 'bridge bank'). This is an alternative to payout. It is important to have such an alternative since a 'classical' payout may be quite expensive, notably if paid in cash as this is the case in quite many EU Member States (in the US, cheques are used for payout but they are not popular in Europe). The transfer of deposits has significant advantages also from the point of view of depositors as it ensures the continuity of banking services and uninterrupted access to deposited money.

It should be noted that such an option (transfer of deposits) is similar to mechanisms – insured deposit transfer (IDT) and purchase and assumption (P&A)[17] – that have been in use in the US since the 1980s as alternatives to the straight deposit payoff. P&A is generally the preferred resolution method used for failing banks in the US (before and during the current crisis, the FDIC made extensive use of such transactions). Deposit payoffs are only used when no acquiring institution can be found or if a bid for a P&A transaction is not the least costly option for the insurance fund (so-called 'least-cost principle'). Also some DGS in the EU are already tasked with funding the transfer of deposits from the failing entity. For example, the UK Banking Act 2009 created the 'Special Resolution Regime' that allowed the UK authorities to transfer all or part of a bank to a private sector purchaser, and to transfer all or part of a bank to a bridge bank (a subsidiary of

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16 *An EU framework for cross-border crisis management in the banking sector*, European Commission, COM(2009)561, Brussels, 20 October 2009.

17 See FDIC Resolutions Handbook and FDIC Claims Manual (www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf, www.fdic.gov/bank/historical/reshandbook/ch4payos.pdf, www.fdic.gov/about/freedom/DRRClaimsManualVol1.pdf).

the Bank of England) pending a future sale. Under that regime, the UK scheme (FSCS) can be used to finance such a transfer up to the net amount it would have failed to recover in insolvency if there was an actual payout.

Of course, the use of bank resolution measures (such as the above transfer of deposits) is only justified for the DGS if its cost is lower than the total cost of payout of deposits (in line with the above 'least-cost principle'). Nevertheless, resolution measures could be applied even if they were more expensive than payout. However, in such a case, DGS funds could only be used up to the amount corresponding to the potential cost of payout; the rest would have to be covered from another source. It was confirmed in the communications on bank resolution funds and crisis management published in May and October 2010[18], where the Commission stated that the use of DGS funds for bank resolution purposes should be limited to the amount that would have been necessary to pay out covered deposits (and costs beyond this limit should be borne by resolution funds). It was also confirmed in the Commission's legislative proposal on DGS published in July 2010.

Some experts take the view that DGS should have even broader mandates, i.e. including not only bank resolution but also early intervention (bank rescue) measures, such as recapitalization, liquidity assistance, guarantees, etc. If such functions are given to DGS, this would require additional funding. It means that additional funds would need to be collected beyond the target level because bank resolution is alternative to payout while early intervention does not always prevent payout later on. The Commission's proposal provides that DGS funds could be used for such purposes (subject to some restrictions). Member States may allow DGS to use their financial means in order to avoid a bank failure provided that the financial means of the scheme (which, in principle, should amount to 1.5% of eligible deposits) exceed 1% of eligible deposits after such rescue measures. In exceptional situations, and subject to the consent of the supervisory authorities, DGS funds may be used to a greater extent (up to half of the target level, i.e. 0.75%) (see Figure 5). The above rules as to financing early intervention are to be introduced gradually (in 2014, 2017 and 2020).

In summary, it seems that DGS are well placed to play a more active role in crisis prevention or resolution, but a broader mandate means that it is necessary to ensure adequate financing for DGS to undertake those additional tasks. Currently, however, DGS in many Member States are not sufficiently funded to even fulfil their narrow ('paybox') role. Moreover, it should be kept in mind that the primary function of DGS is providing quick payout of deposits in the event of a bank failure. Therefore, it is necessary to ensure that this function cannot be jeopardised by the cost of rescue or restructuring measures.

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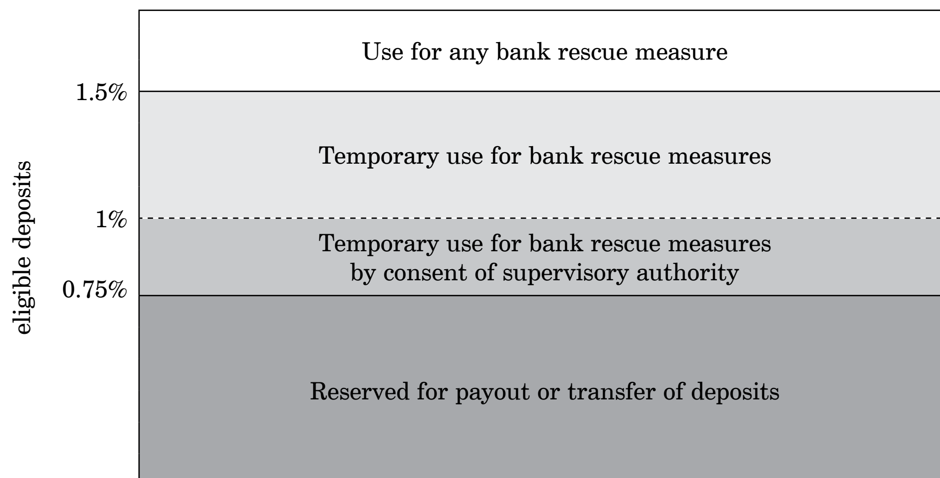
[18] *Bank resolution funds*, European Commission, COM(2010)254, Brussels, 26 May 2010; see also *An EU framework for crisis management in the financial sector*, European Commission, COM(2010)579, Brussels, 20 October 2010.

Figure 5. Limits for potential use of DGS funds for payout and bank rescue measures



Source: Commission services.

A PAN-EU DEPOSIT GUARANTEE SCHEME?

As it is known, DGS in the EU are highly fragmented – there are 39 schemes in 27 Member States. This is aggravated by the lack of adequate cooperation between DGS, which may impede coordinated actions on a cross-border basis, notably in crisis situations (it should be noted, however, that EFDI[19] makes considerable efforts to improve and strengthen the cooperation among EU DGS and to promote best practices[20]). The idea of establishing a pan-EU DGS appears attractive in the light of such fragmentation. In economic terms – based on the Commission's estimates – it would be the most effective option, as it could save administrative costs of roughly € 40 million per annum. However, there are some complicated legal aspects which have to be further investigated. Moreover, one could argue that considering the large number of small local banks, a pan-European institution would have some drawbacks.

Therefore, the idea of a pan-EU DGS is a longer-term project. However, the proposed closer cooperation between DGS in a crisis situation based on the

[19] EFDI (European Forum of Deposit Insurers) – a voluntary professional organisation with 55 members representing 40 countries (more information: www.efdi.net).

[20] See EFDI reports of 2008 and 2009 related to payout delay, scope of coverage, depositor information, exchange of information between DGS, risk-based contributions, etc (available at www.efdi.net).

'principle of solidarity' (i.e. mutual borrowing facility) could be considered as the first important step towards a single pan-EU DGS in the future. Progress towards a pan-EU DGS should be in line with progress on the new supervisory architecture in the EU and developments in the field of crisis management, including early intervention and bank resolution. The Commission will analyse this issue again and present a detailed report by the end of 2015.

CONCLUDING REMARKS

The institution of deposit guarantee has been controversial in the past and was sometimes even blamed for increasing moral hazard. The recent crisis, however, taught us that they are indispensable for depositor confidence and thus for maintaining financial stability. Moreover, some other important lessons had to be learnt: namely that the framework of deposit insurance in the EU as established in 1994 needs substantial modernisation to reflect the developments of the past sixteen years as well as to meet the challenges of the future. We are convinced that the proposals brought forward by the Commission represent a significant enhancement of the post-crisis financial architecture and regulation.