

European Deposit Insurance: Financing the transition

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6 September 2012

The transition to a new system of deposit insurance is difficult enough during normal times, when ‘the veil of ignorance’ could ensure that there are no clear winners or losers.

However, at the present juncture of the euro crisis, some banking systems or groups of banks clearly represent a higher risk than others. This makes the transition even more difficult. We propose a gradual phasing in of both premia and protection, which should take care of this problem.

Agreement on some underlying principles may be useful to guide the transition. We propose the following:

- Keep total deposit insurance at €100,000 per depositor, as the existing Deposit Guarantee Schemes Directive has adopted maximum harmonisation.
- Build a target fund of 1.5% (as proposed by the European Commission and the European Parliament) of covered deposits gradually over a period of ten years.
- Avoid double payment of premia by banks (national plus EU) to ensure neutral transition.
- Avoid the need to harmonise national funds by letting them continue to operate in parallel.
- Combine the functions of deposit insurance and resolution within one authority to keep things simple.
- Construct the European Deposit Insurance and Resolution Authority (EDIRFA?) as a source of strength (‘credible’ fund) to foster confidence in the European banking system.

Starting with the last principle, full coverage of all deposits in the banks that would fall under ECB supervision (labelled ‘European banks’¹) from day one is not feasible. But the end point also should be clear: a European Deposit Insurance and Resolution Fund – as proposed by Schoenmaker & Gros, 2012 (<http://www.ceps.eu/book/european-deposit-insurance-and-resolution-fund>) – run by a European Deposit Insurance and Resolution Authority (EDIRA) should become the authority that makes decisions on resolution and provides the payments to depositors when required.

¹ A good compromise would be to put all the euro area banks subject to EBA stress tests under the new system. This criterion would imply a very high coverage in the countries under financial stress.

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In more concrete terms, we propose that the protection offered by the EDIRA should be phased in the following way:

- In the first year, the EDIRA will guarantee only €5,000 per depositor. This amount could then be increased each year by the same amount until, after 20 years, the European protection scheme insures the full €100,000 per depositor. It would of course be possible to accelerate the transition by increasing the amount added to the European scheme by more than €5,000 per year. For example, with €10,000 the transition would take only ten years. But as our concern is to show how a phasing-in could work, rather than the precise amount, we will continue with the example of €5,000.
- The coverage of the national deposit guarantee schemes will be reduced by the amounts guaranteed at the European level. Following the first principle, that would keep the total coverage at €100,000. The risk for the national guarantee schemes would of course go down as the European guarantee increases in size. The national schemes would lose their *raison d'être* over time, but in order to diminish their opposition to the new EU-level system, they should be left alone, rather than threatening them with immediate extinction.
- Contributions by the 'European Banks' to EDIRA should of course be phased in as well. Although a totally neutral scheme might reduce opposition, we sketch a slightly quicker phasing-in of the contributions, which may be useful given the weak state of the banking system almost everywhere in the euro area. The premium for the European fund for the first year should be set at 0.0075% of insured deposits (5% of the 0.15% required to build up the 1.5% of deposits over ten years); for the second year at 0.015%, etc.²
- Contributions to national schemes would be reduced correspondingly for the 'European banks', which might then pay only 95% of the national premium.
- After 20 years in the case of a €5,000 increment per year (or ten years with a €10,000 annual increment), the full coverage for the European banks will be provided by the European fund. In our example EDIRA would have collected about 0.8% of covered deposits in premiums after ten years. Because of the gradual phasing in, it will then take another five years to reach the target of 1.5% of covered bonds.³
- Accumulated contributions of the European banks left in the national funds after the transition period can be transferred to the EDIRA, which would then provide a proportional discount on any premia from the banks from these countries.

During the transition, European banks in countries without an *ex ante* fund, like the Netherlands, would gradually reduce their liability to the national fund in steps. After four years, for example, a European bank would only contribute 80% to a local failure, while the national banks would contribute the full 100%.

Once their contributions to the European fund are above a certain level, the European banks may find strong ECB supervision useful to reduce their potential liabilities. If that were to happen, the new European Deposit Insurance and Resolution Authority would truly act as a source of strength for the banking system.

² For the sake of simplicity, we refer here only to the average premium. Actual premia of individual banks could of course be higher or lower, depending on the risk characteristics of the institution.

³ The calculations get more complicated if a national fund already exists, so that national premia can be lowered. An example may clarify this proposal. A national fund applies a 25% discount on its premium. The European bank based in that country would pay 75% of the national premium for €95,000 coverage to the national fund in the first year. The national fund transfers 25% of the fee for the €5,000 coverage to the EDIRA. The relevant banks pay the European fund the fair premium (as calculated above) minus the discount for the national fund transfer (assuming that premiums are not calculated in the same way).

A final question is how to deal with legacy problems at some of the banks, which have bad assets and are weakly capitalised. It is important that deposit insurance and resolution are enacted at the same time. Some weak banks may need to be resolved (partly wound down and/or recapitalized) before they enter the new European supervisory and resolution regime to avoid large contingent liabilities. Countries then would have to deal with any legacy problems of their own weak banks. If needed, countries (like Greece, Portugal and Spain) could apply for support from the European Stability Mechanism (ESM).

Only well-capitalised banks should enter the new European system of supervision by the ECB and resolution by EDIRA. After handling the legacy problems, these sound European banks can make a proper start in the Banking Union.