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The Role for Deposit Insurance in Dealing with Failing Banks in the European Union

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The Role for Deposit Insurance Funds in Dealing with Failing Banks in the European Union

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ABSTRACT: This paper argues that in the European Union (EU) deposit insurance funds are too difficult to use in bank resolution and too easy to use outside resolution. The paper proposes reforms in three areas for the effective management of bank failures of small and medium-sized banks in the European Union: making resolution the norm for dealing with failing banks; establishing a common DIS for the European Union; and increasing funding and backstops for deposit insurance while removing constraints on their use for resolution measures. Without these changes, the European Union will continue to be challenged by banks that are too small for resolution and too large for liquidation.

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WORKING PAPERS

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Glossary

BRRD	Bank Recovery and Resolution Directive
CP	Core Principles for Effective Deposit Insurance Systems
DGSD	Deposit Guarantee Schemes Directive
DIA	Deposit Insurance Agency
DIF	Deposit Insurance Fund
DIS	Deposit Insurance System
EA	Euro Area
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
ESM	European Stability Mechanism
EU	European Union
FITD	Fondo Interbancario di Tutela dei Depositi
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GFC	2008–09 Global Financial Crisis
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
IADI	International Association of Deposit Insurers
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NRA	National Resolution Authority
OECD	Organisation for Economic Co-operation and Development
P&A	Purchase and Assumption
SRB	Single Resolution Board
SRF	Single Resolution Fund

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Introduction

Deposit insurance plays a crucial role in maintaining depositor confidence and preserving financial stability. The principal public policy objectives of a deposit insurance system (DIS) are to protect depositors and contribute to financial stability.[1] By protecting retail and other small depositors in a bank failure, deposit insurance minimizes the risk of deposit runs and mitigates contagion risk. If depositors trust a DIS, they are less likely to run on a bank and exacerbate liquidity stress, which would undermine recovery or resolution measures. If depositors lose confidence, as happened in some banks during the 2008–09 global financial crisis (GFC)—such as in Iceland, the Netherlands, United Kingdom, and the United States, runs can lead to contagion and banking sector instability. As the IADI Core Principles note, "The evolution of the crisis showed the importance of maintaining depositor confidence in the financial system and the key role that deposit protection plays in maintaining that confidence."

Experience during the GFC illustrated the importance of effective deposit insurance and prompted important enhancements globally (FSB 2008).[2] These include higher coverage levels; elimination of coinsurance; faster payouts; ex ante funding; restrictions on using deposit insurance funds (DIFs) for open bank assistance outside of resolution; and better interagency cooperation (IADI, 2012; IMF, 2020). Prior to the GFC, there had not been an international standard for deposit insurance. The Core Principles for Effective Deposit Insurance Systems were adopted in 2009 and revised in 2014. An Assessment Methodology was adopted in 2010 and replaced in 2016 with an Assessment Handbook. Together, these set a benchmark for establishing or strengthening a DIS, against which countries can judge their own system's effectiveness. In its 2012 peer review report (FSB, 2012), the FSB noted that "the role of deposit insurance in promoting financial stability has taken precedence over concerns about contributing to moral hazard [and that] just over half of all respondents expanded [deposit insurance] coverage…and made structural improvements to their national schemes." A 2014 paper (Demirgüç-Kunt et al., 2014) found that deposit insurance had become more widespread, and with higher coverage since the GFC. These measures sought to ensure that the DIS is not a weak link in the financial safety net (Schich, 2009).

The EU deposit insurance framework was strengthened during the GFC. The framework in place at the onset of GFC entailed substantial differences in coverage and funding arrangements across national DIS, creating an uneven playing field and encouraging regulatory arbitrage (IMF, 2013). In 2009, the European Union amended its deposit guarantee schemes directive (DGSD), increasing the minimum coverage level from €20,000 to €100,000 (phased in with an intermediate step at €50,000) and shortening the payout period to 20 working days. In 2014, national DIS were further harmonized with a fixed coverage level of €100,000 per depositor per bank (with higher coverage for certain life events), a seven-working-day payout of deposits (effective January 1, 2024; reduced from 20 working days in three phases), and risk-based premiums to be paid by banks into their national DIS to reach a minimum level of 0.8 percent—or exceptionally, 0.5 percent—of covered deposits by July 3, 2024.

The European Union also introduced a bank recovery and resolution regime with a key role seemingly intended for deposit insurance. In 2014, the European Union adopted the Bank Recovery

[1] International Association of Deposit Insurers (IADI), Core Principles for Effective Deposit Insurance Systems, November 2014, Core Principle (CP) 1. Consistent with the Core Principles, this paper prefers "deposit insurance systems" to the European Union (EU) nomenclature "deposit guarantee schemes."

[2] While a DIS plays an important role in maintaining financial stability, it should be noted that a DIS typically is not sufficiently ex ante funded to pay out the depositors of a failed systemic bank or deal with a systemic crisis.

and Resolution Directive (BRRD)[3] and established the “banking union” based on common supervisory and resolution mechanisms—centered around the European Central Bank, the Single Resolution Board (SRB), and the Single Resolution Fund (SRF). These provide a foundation to deal with failing banks but without its third pillar—a supranational DIS.[4] The EU resolution regime aims to protect public funds by minimizing the reliance on extraordinary public financial support to failing banks. The regime envisages (Article 11.2 of the DGSD) using DIFs in resolution under the BRRD, up to the net cost that the DIS would have incurred if the failing bank had instead been liquidated and deposit insurance paid (Article 109 of the BRRD). As discussed below, however, the interpretation applied to the BRRD restricts the ability of a DIS to contribute to bank resolutions and, conversely, facilitates contributions from some DIS to support the recovery of weak banks outside of resolution.

The European Union is reviewing the European bank resolution and deposit insurance frameworks. In early 2021, the European Commission (EC) undertook consultations for its review of the BRRD, the DGSD, and the Single Resolution Mechanism (SRM) Regulation.[5] In a “combined evaluation roadmap/Inception Impact Assessment” document, the Commission discusses five problems with the current frameworks that the review aims to address: incentives to use tools outside resolution; differences across national insolvency regimes; sub-optimal legal certainty and predictability; insufficient market integration, particularly in the banking union and, hence, resilience and efficiency; and discrepancies across member states in the functioning of, and the protection provided by, deposit insurance. The Commission notes, “The main consequences of these problems are un-level playing field and barriers to the single market, persisting risks to financial stability, adverse effects on depositor confidence, inefficient outcomes of handling bank failures in liquidation leading to excessive loss of franchise value; all of the issues may result in persisting risks of taxpayer exposure and (in the worst case-scenario) adverse impact on the stability of government finances.” Many of these issues were highlighted in the Euro Area FSAP (IMF, 2018).

Strengthening the EU bank resolution and deposit insurance framework is particularly important for medium-sized banks. Medium-sized banks could be either “significant institutions” (SIs) or “less significant institutions” (LSIs), using the SRM terminology. While the SRB has developed resolution plans for all SIs, for some of these banks, the authorities have set loss-absorbing capacity equal only to minimum equity (SRB, 2021). As noted by Elke Koenig, SRB Chair, this leaves the authorities “with the risk that this might have been, or rather most likely has been, depleted at the point of failing or likely to fail leaving little room for resolution” (Koenig, 2021). At a recent conference on the ongoing review (European Commission, 2021), Luis de Guindos, European Central Bank Vice-President, noted that experience has shown that the assumption that the failure of small- and medium-sized banks would not raise financial stability concerns, has not proven accurate. Irene Tinagli, Chair of the European Parliament Committee on Economic and Monetary Affairs, observed that the solution to bank failures often had to be found outside the BRRD framework, because rigid requirements of the latter would not ensure financial stability. Most SIs that have failed since the establishment of the banking union have not been resolved, but rather

[3] The KAs include powers to effect a closure and orderly wind-down (liquidation) of a failing firm, which the BRRD considers to be outside of resolution.

[4] The banking union regime applies to the euro area countries and to Bulgaria and Croatia.

[5] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2021-crisis-management-deposit-insurance-review-consultation-document_en.pdf; https://ec.europa.eu/info/consultations/finance-2021-crisis-management-deposit-insurance-review-targeted_en

subject to national liquidation proceedings, and “the BRRD has fallen short of its principal goal of forestalling taxpayer bailouts” (Gelpern and Véron, 2020).

This paper argues that the effective management of bank failures of small- and medium-sized banks in the European Union requires reforms in three areas. Establishing a new common DIS and making resolution—and not liquidation with a deposit insurance payout—the norm for dealing with failing banks should be at the heart of the approach. An administrative liquidation tool that the SRB and national resolution authorities (NRAs) could use,[6] instead of relying on court-based and diverging national liquidation proceedings should be introduced. “The objective should be to introduce a special administrative regime for bank liquidation with the maximum level of harmonization” (Enria, 2021). This should be complemented with increased funding and backstops for deposit insurance and removal of the constraints on the use of DIFs and resolution funds for resolution and liquidation tools, other than deposit insurance payouts. Without these changes, the European Union will continue to be challenged by banks that are too small for resolution and too large for liquidation (Koenig, 2020; Koenig, 2021).

[6] The FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs) list liquidation among powers that should be vested in resolution authorities (KA 3.2(xii)). The IMF proposed this tool in its first assessment of the euro area financial sector (IMF, 2018); it has been gaining traction among EU financial regulators (Koenig, 2020; De Guindos, 2021; Enria, 2021) and caught the interest of academia (e.g., Bodellini, 2020), policy institutes (e.g., Gelpern/Véron, 2019), and political decision-makers (e.g., “Banking Union Workshop on an EU Liquidation Regime,” December 2019, organized by the European Parliament, Committee on Economic and Monetary Affairs.

I. International Expectations for Deposit Insurance Systems

1. **The international standards underline the complementarity and interdependency—within the financial safety net—of deposit insurance, prudential supervision, and bank resolution.** The effectiveness of a DIS depends not only on its own design features, but also the environment within which it operates. It depends to a significant degree on the strength of prudential supervision and regulation, and the resolution regime. Sound governance of the financial safety net agencies—and statutory protection for their decision-makers, staff, and agents—is a requirement in the international standards and identified in the IADI Core Principles as a precondition for effective deposit insurance.[7] In turn, well-developed deposit insurance and prudential supervision are preconditions for effective resolution regimes.

2. **Together with the other financial safety net members, the deposit insurer is expected to play a critical role in developing and executing policy responses to deal with failed banks.** The IADI Core Principles prescribe that DIFs have the option—subject to cost safeguards—to fund resolution measures (CP9, EC8), and that the deposit insurer be authorized to transfer deposits to another bank as an alternative to directly paying out depositors (CP2, EC4; CP15, EC4). Additionally, deposit insurers need to have credible arrangements in place for prompt reimbursements, which requires that they are well funded (by the industry) on an ex ante basis, with readily available borrowing arrangements and fiscal backstops (CP9).

3. **It is crucial that DIFs be able to finance—on a least-cost basis—the transfer of good assets and deposit liabilities from a failed bank to a healthy bank.** The "partial transfer tool" or "purchase and assumption" (P&A) tool, as termed in the United States, is a time-tested and cost-effective resolution tool that gives depositors uninterrupted access to their insured deposits.[8] A deposit transfer, rather than direct payouts in liquidation, can secure higher "going-concern" values for the assets of a failed bank, and may yield a small premium from the purchaser for the deposit book.[9] For failed deposit-taking institutions in the United States, a P&A is the preferred resolution method—for small to even relatively large institutions—of the U.S. Federal Deposit Insurance Corporation (IMF, 2020a).[10]

4. **The deposit insurer should be a full member of a country's national crisis management arrangement.** The international standards require close interagency cooperation, including analysis and information sharing, between all financial safety net agencies (e.g., CP4, BCP3, and KA12.1), and that the deposit insurer be involved in or kept informed of resolution decisions (CP9, EC8a; CP14, EC1). Most importantly, the IADI Core Principles prescribe that the deposit insurer—irrespective of its policy mandate (e.g., paybox or risk minimizer)—be a member of the national crisis management arrangements (CP6 and EC3).

[7] Other preconditions for effective deposit insurance, prudential supervision, and resolution regimes are a sound system for financial stability risk monitoring and policy formulation, a well-developed legal framework, a well-functioning judiciary, and robust accounting, auditing, and disclosure regimes.

[8] Article (38)(1)(b) of the BRRD provides the powers to transfer to a purchaser "…any assets, rights or liabilities of an institution under resolution."

[9] Where the DIA is not the resolution authority, it would be preferable that the latter develops and executes the P&A transactions. In such a case, and as explained in the IADI Handbook, p. 52, the deposit insurer "must be informed about proposals to use its funds for resolution and should be able to voice its view in deliberations."

[10] For use of P&A transactions and direct payouts since 1934, see the "Bank Failures and Assistance Data" section on the FDIC website (https://banks.data.fdic.gov/explore/failures). EBA (2020a) highlighted the economic benefits "of introducing into the DGSD a tool for using the failed institution's assets for a DGS payout," which is economically equivalent to a P&A.

5. **Public deposit insurance agencies (DIAs)—with autonomy from government and industry—may be better placed to contribute to resolution and crisis management.**[11] There are three types of DIS: public (mandated by law and managed by a public DIA); private (established and run by the industry); and hybrid (regulated by law but privately managed). Globally, close to 30 percent of jurisdictions have either private or hybrid DIS. The IADI Core Principles do not rule out private and hybrid DIS, but, arguably, some resolution and crisis management functions may present additional challenges to them, including:

- exchange of sensitive information within the financial safety net (CP4) and internationally (CP5), and participation in early detection and intervention (CP13), resolution (CP14), and contingency planning and crisis management (CP6)—all due to confidentiality and broader governance concerns caused by the DIA's close affiliation with banks;[12] and
- legal protection (CP11) of the DIA's decision-makers, staff, and agents because they are not civil servants.

II. The Current State of Deposit Insurance in the European Union

6. **Deposit insurance and crisis management have featured prominently in IMF Financial Sector Assessment Program (FSAP) assessments in the European Union.** Recurring themes in these assessments are summarized below and include the need for stronger DIS with better governance and ex ante funding (including backstops), a mandate to fund resolution and liquidation tools, other than just deposit insurance payouts, as well as accessing public funds for resolution measures subject to safeguards. Annex I provides an overview of selected recommendations on these matters in 16 country FSAPs that were undertaken during the period 2016–2020; Annex II lists the relevant recommendations from the 2018 Euro Area (EA) FSAP.

National fragmentation…

7. **Due to the EU passporting system for banking and financial services,[13] the size the banking system in a member state could be misaligned with the national DIF's capacity.** Deposit taking by branches could leave DIFs and fiscal authorities in host jurisdictions financially vulnerable when the DIF in the home jurisdiction is unwilling or unable to pay out insured deposits—see, for example, the Icesave case (Baudino et al., 2020). Such vulnerability could also materialize for subsidiaries when a single-point-of-entry resolution strategy cannot be implemented despite planning for it. Consequently, the EU single market for retail banking is still developing. This is exacerbated by national discretion under EU financial legislation which, according to the EBA, renders it "inevitable that some divergences may emerge between jurisdictions [which] alone or in combination, may have negative unintended effects, potentially creating complexities that impede consumer choice and the cross-border provision of services, in turn hampering the functioning of the EU Single Market" (EBA, 2019).

8. **National discretions and differing progress in implementation contribute to a still fragmented DIS in the banking union.** Different speeds of implementation and over a dozen provisions in the DGSD providing for national discretion (Annex III)—including exceptions to scope and coverage, repayment periods, and

[11] For counterarguments, see Salama/Braga.

[12] Removing active bankers and their advisors from DIA boards would mitigate some of the concerns and allow a DIS to become a more integral part of the financial safety net.

[13] Passporting allows banks to offer banking services throughout the EU, either from their home country where they are licensed or via branches established in another EU member state, without the authorization of the host-country authorities.

calculations—have contributed to continued fragmentation.[14] Consequently, the 2018 EA FSAP found the following within the banking union:

- 6 countries opted for a target level of covered deposits below 0.8 percent;
- 12 countries opted for a deadline beyond 2024 for the target level, including the 6 countries with a lower target level;
- 10 countries do not allow their DIS to lend to other national deposit insurers; and
- 12 countries do not allow DIFs to be used to effect deposit transfers in national liquidation proceedings.

…and underfunded DIS

9. **Not all DIFs are well funded, raising questions about adequacy of funding.** The May 2021 update of the EBA Deposit Guarantee Schemes Data shows that while 34 out of 36 DIS in the European Union, Iceland, Lichtenstein, and Norway increased their funds in 2020, only 18 DIS have reached the minimum target level of 0.8 percent of covered deposits.[15] Moreover, the IADI prescribes that the target DIF size be "sufficient to participate in the resolution and payout of a number of small bank failures or several medium-sized bank failures, depending on the size and composition of the banking sector." Considering the concentrated nature of the banking sectors within the EU countries, arguably, even those DIFs that have reached the 0.8 percent target level may not be sufficiently funded.[16] Several EA country FSAPs have also noted that backup credit lines with national governments are not operationalized and readily available to DIS, nor are inter-DIS funding arrangements (IMF, 2018). According to the European Banking Authority (EBA), it is not possible to compare the adequacy of funding and resiliency of each national DIS in the EU (EBA, 2020).[17] In its first peer review of the national DIS stress tests (EBA, 2020),[18] the EBA also concluded that "the divergence in the reported types of tests performed and the way the outcomes of the tests were reported makes it challenging to compare the tests with the desired consistency and draw robust and comprehensive conclusions regarding the resilience of all DGSs."

European inflexibility…

10. Even if DISs were well funded and backstopped, and national laws vested them with broad mandates, their use in resolution and liquidation proceedings is constrained within the banking union. The Key Attributes require that the legal framework provide for both payouts to insured depositors and transfer of (insured) deposits to another solvent bank in either resolution or in liquidation proceedings. While these options would appear available in the European Union, the use of transfer powers is subject to significant impediments. Not many EU countries used the discretion that the DGSD provides to allow the DIS to fund the transfer of covered deposits in national liquidation regimes (Annex III); whereas, even after the introduction of an EU bank resolution regime and after establishing the SRB, it is these national liquidation regimes that have been far more frequently deployed than the BRRD to resolve failed banks in the euro area. Additionally, the SRB does not consider using DIS funding in resolution, because it does not have legal authority to access

[14] See IMF (2018) for an overview of how EA member states have used their national discretions under the BRRD.

[15] https://www.eba.europa.eu/eba-updates-data-deposit-guarantee-schemes-across-eea

[16] The 0.8 percent in the European Union compares to a 1.35 percent statutory target and a 2 percent long-term target in the United States, for example.

[17] See also EBA Deposit Guarantee Schemes Data (https://eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data)

[18] The peer review considered the results of 135 stress tests performed by 32 DIS from 27 EU member countries, covering, among other things, the DIS' operational and funding capabilities.

national DIS. Furthermore, the European authorities' strict interpretation of Article 109 BRRD (IMF, 2016; IMF, 2018)[19] prevents DIS from providing upfront support greater than its estimated cost (net of recoveries in liquidation) without considering recoveries that could accrue in certain resolutions (most notably, a P&A).[20]

11. **EU state aid rules also discourage using time-tested and cost-effective resolution measures, particularly P&A.** Under these rules, industry funded DIFs—and resolution funds, including the SRF—are considered state aid, unless the DIS is voluntary, instead of mandated by statute. Potential state aid cases hovering over resolution measures render P&A very difficult, or make it much more likely that the transfer is limited to cash and insured deposits—excluding good financial assets and infrastructures—which reduces asset recoveries and increases the costs for DIS. Consequently, the 2018 EA FSAP observed that potential purchasers of the bundle of assets and liabilities are likely to be severely discouraged if the application of state aid rules to the transaction is potentially burdensome, drawn out, and uncertain.

Box 1. EU Rules on State Aid to Financial Institutions

Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) prohibits "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States."

Article 107(2) TFEU provides for certain exemptions (e.g., social aid, natural disasters). Article 107(3) provides that some types of aid may be considered compatible with the internal market, among others, for "common European projects or to remedy a serious disturbance in the economy of a Member State" and for "such other categories of aid as may be specified by decision of the Council on a proposal from the Commission." The "serious disturbance" exception and not the more general exception is currently used. Paragraph 6 of the 2013 Banking Communication considers that "In those circumstances of persisting stress in financial markets and given the risk of wider negative spill-over effects, the Commission considers that the requirements for the application of Article 107(3)(b) TFEU to state aid in the financial sector continue to be fulfilled. The application of that derogation remains possible only as long as the crisis situation persists, creating genuinely exceptional circumstances where financial stability at large is at risk."

Based on Article 107(3)(b) TFEU, the 2013 Banking Communication was adopted, replacing the 2008 Banking Communication and complementing the other five communications: the 2010 and 2011 Prolongation Communications; and the 2009 Communications on Recapitalization, Restructuring, and Impaired Assets.

In a recent assessment of the European Commission's oversight of state aid rules, the European Court of Auditors noted "that the Commission had not properly evaluated its crisis rules since 2013. Consequently, the rules remained unchanged despite the overhaul of the regulatory framework (including the fact that the Bank recovery and resolution directive has restricted the possibilities to grant aid to banks without triggering insolvency proceedings)" (ECA 2020).

[19] Article 109 of the DGSD provides that "In all cases, the liability of the deposit guarantee scheme shall not be greater than the amount of losses that it would have had to bear had the institution been wound up under normal insolvency proceedings."

[20] A simple example may be illustrative. If a failed bank were liquidated and insured deposits of $60 were paid out, the cost net of asset recoveries for the DIS is estimated at €5. A resolution could instead be effected by transferring deposits of €60, backed by assets from the failed bank. But if the transferee would only accept €45 of "good" assets from the failed bank, the current interpretation would prevent the DIS injecting the difference (€15 million), even if the estimated resolution costs for the DGS, net of its recoveries (from its subrogated claim over the remaining assets in liquidation) were €0.

Other constraints bind in the event of a systemwide crisis. One such constraint is the mandatory 8 percent bail-in requirement for accessing the SRF and national public funds, including DIFs and resolution funds.[21] While this might be considered a problem only during the transition period (ending January 1, 2024) for the minimum requirement for own funds and eligible liabilities (MREL), during which the mandatory bail-in requirement applies while banks are still building up loss-absorbing capacity. It could also be a problem in the steady state. Bail-in of debt securities at times of systemwide stress could unleash spillovers, trigger contagion, and exacerbate a systemwide crisis (Dell'Ariccia et al., 2018a). At a time of heightened contagion risk, the failure of several small banks that were previously considered non-systemic could necessitate resolution. Their resolution plans may have envisaged liquidation, but this may not be feasible at times of heightened risk. Yet, without adequate loss-absorbing capacity, it may not be possible to follow an alternative resolution strategy that is more likely to preserve financial stability.

…and undesirable national responses

12. **To circumvent the inflexibility in the SRM/BRRD on the mandatory 8 percent bail-in requirement, some countries may resort to national liquidation regimes.** As noted earlier, most bank failures, since the establishment of the banking union, were addressed under national liquidation regimes with financial support from the government. The 2018 EA FSAP observed that diverging national liquidation regimes for banks are subject to less stringent loss-sharing requirements under state aid rules, rather than the stricter loss-sharing requirements in the BRRD/SRM. These regimes may deliver substantially differing outcomes for bank creditors and provide incentives for member states to establish less restrictive in effect "parallel resolution regimes," in cases where they did not pre-exist.

13. **To circumvent the constraints of the EU state aid rules, some countries may also resort to using privately run, voluntary DIS.**[22] Such DIS may pre-exist, or be established, in addition to the mandatory (typically publicly run) DIS to circumvent state aid rules. However, this increases costs and risks for the banking sector. Moreover, a voluntary DIS offering (unlimited) guarantees exposes the state to contingent fiscal risks if the guarantees ultimately need to be backstopped by the government to preserve financial stability. The use of DIFs for bank failure prevention outside of resolution or liquidation should also be avoided. Fund staff would typically recommend that such support (also known as "open bank assistance") should not be extended by DIS, as it exposes their funds to significant risk. Such support should instead, if required, be extended by the fiscal authority. Accordingly, the EBA recommended that the Commission consider amending the 2013 Banking Communication ("State aid rules to support measures in favor of banks in the context of the financial crisis"), and addressing the potentially different consequences for DIS depending on their legal status and/or governance structure (EBA, 2020; EBA, 2020a).

Lack of EDIS…

14. **In 2015, the Five Presidents called for the establishment of a common DIS—a European Deposit Insurance scheme (EDIS).**[23] They observed: "As the current set-up with national deposit guarantee schemes remains vulnerable to large local shocks…common deposit insurance would increase the resilience against future crises. A common scheme is also more likely to be fiscally neutral over time than national deposit guarantee schemes because risks are spread more widely and because private contributions are raised over a

[21] Another constraint is the five percent cap on SRF financing of resolution measures.

[22] In Italy, for example, the Fondo Interbancario di Tutela dei Depositi (FITD) founded a voluntary scheme in 2015, following the decision by the European Commission that the provision of financial support by the FITD to a bank under administration (Banca Tercas) constituted unlawful state aid (IMF, 2020b). In March 2019, the General Court of the European Court of Justice annulled the Commission's decision; in March 2021, the Grand Chamber of the Court dismissed the Commission's appeal.

[23] "Completing Europe's Economic and Monetary Union," report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz, 2015, presidents of, respectively, the European Commission, European Council, Eurogroup, the European Central Bank, and the European Parliament.

much larger pool of financial institutions."[24] In response, the Commission proposed to establish, after a transition period, an EDIS managed by the SRB, though the national DIS would continue to be the local interface with banks and depositors for contributions and payouts.[25] The Commission's November 2015 EDIS proposal was structured in several stages: re-insurance; co-insurance; and full insurance. To address some member states' concerns about risk reduction, in October 2017 the Commission suggested introducing EDIS in a more gradual manner and subject to more conditions.[26] Under the updated proposal, the liquidity and loss-absorbing phases would be split with the aim of having a fully functional EDIS by 2024. Subsequently, several Presidencies of the EU Council have tried to further the establishment of EDIS with progress on technical matters, including through an Ad Hoc Working Party on the Strengthening of the Banking Union.[27] However, when in December 2020, the Euro Summit invited the Eurogroup to prepare "a stepwise and time-bound work plan on all outstanding elements needed to complete the Banking Union," it did not mention EDIS,[28] nor did the Eurogroup's April 2021 agenda, where it discussed the "outstanding elements needed to complete the banking union."[29] The Eurogroup's High-Level Working Group on EDIS was expected to deliver the work plan in June 2021; however, the Eurogroup meeting of June 17, 2021[30] concluded that "that more work is needed to reach consensus on a work plan."

15. **While the banking union awaits completion with EDIS, inter-DIS lending arrangements have not been fully operationalized.** Funding collected by national DIS from the industry sits in the DIFs without being readily available for inter-DIS lending.[31] The 2018 EA FSAP found that, although the voluntary arrangements to allow DIS to lend to each other are meant to supplement the low balances in most DIS—and nine member states have taken advantage of this national option—not all of them have operationalized the lending arrangements.

…and no comprehensive European crisis management arrangements

16. **There are no governance and legal arrangements to bring together all agencies that would need to be involved in responding to a systemwide crisis at the EU level.** While the GFC was a systemwide crisis, the EU response, by way of the BRRD and the SRM, implements a bank-by-bank regime that involves decision making by myriad actors. The resolution of a bank involves the SRB in two different board compositions (one for the resolution itself and one for use of the SRF), the relevant NRAs, two directorates of the European Commission (DG FINMA and DG COMP), the ECB in its capacity as supervisor, any relevant DIS (be it mandatory or voluntary DIS), in certain cases the Council of the European Union if there is a deadlock between the SRB and the Commission, as well as the ESM as the SRF backstop. Nor is there a complementary framework bringing together fiscal and all financial safety net agencies in the event of a systemic crisis. The

[24] Reportedly, a Commission analysis showed that the probability of a liquidity shortfall in a crisis similar to the GFC would be 87 percent without EDIS, and 46 percent with full-fledged EDIS (https://www.euractiv.com/section/banking-union/news/commissions-leaked-study-beefs-up-arguments-to-complete-banking-union/).

[25] https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en

[26] https://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf

[27] https://data.consilium.europa.eu/doc/document/ST-8335-2020-ADD-1/en/pdf

[28] https://www.consilium.europa.eu/media/47298/11-12-20-euro-summit-statement-en.pdf

[29] https://www.consilium.europa.eu/en/policies/banking-union/risk-reduction-european-deposit-insurance-scheme/; https://www.consilium.europa.eu/en/meetings/eurogroup/2021/04/16/

[30] https://www.consilium.europa.eu/media/50901/summing-up-letter-eg-in-inclusive-format-17-june-2021.pdf

[31] It should be noted that while the EBA Deposit Guarantee Schemes Data shows around €60 billion in available financial means in all national DIFs together, some are nominal amounts not held by the DIFs, rendering them dependent on the country's fiscal space at the time of a banking failure.

European Union lacks a fiscal authority akin to a national Ministry of Finance, and there is no EDIS or official mechanism to represent the national DIS.[32]

III. Toward A Stronger Role for Deposit Insurance

Mainstreaming resolution…

17. Resolution—and not liquidation—should be the default approach for banks. This requires making the sale of business tools and DIS funding available to resolution authorities. To this end, the SRB and the NRAs could, in the first instance, make a policy decision that all bank failures could potentially meet the public interest test under the SRMR and the BRRD.[33] This should be complemented with an administrative bank liquidation tool vested in the SRB and the NRAs, which can be used to transfer assets and liabilities, and used potentially for all banks. Consistent powers would help ensure that residual parts of the resolved bank are liquidated in similar ways throughout the banking union (and the European Union).[34]

...strengthening DIS

18. **In January 2020, the EBA proposed improvements to the DSGD (EBA 2020a).** The EBA's recommendations include setting an appropriate deadline for the reduced (0.5 percent) DIF targets, clarifying whether there is a hierarchy or sequence in which the different funding sources can be used by a DIS (as there are different interpretations across the European Union), clarifying what costs should be considered, in case DIFs are used for interventions other than payouts (e.g., preventive and other alternative measures),[35] and the use of a failed banks' assets for depositor payouts.

19. **It is critical that DIFs are well funded and backstopped.** This is particularly important because, according to the SRB, "resolution is only for the few," requiring liquidation and payouts for the overwhelming majority of banks. Following the EBA's advice and using its criteria, the Commission and the European Parliament should assess the sufficiency of the 0.8 percent target level for DIFs, favoring a more prudent approach. Furthermore, all member states should ensure that their national DIS is authorized to lend to any other national DIS. These inter-DIS lending facilities should also be operationalized and readily available.

…establishing a common DIS

20. **EDIS should be implemented.** Risk pooling through a banking-unionwide DIS would help member states avoid disruptions that may overwhelm their individual capacities; risk sharing would also be more effective in protecting confidence and in diversifying risks across banks (Goyal et al., 2013). Moreover, EDIS would help address host authorities' concerns about domestic subsidiaries in the event the parent group needed to be resolved, potentially affecting the viability of the subsidiary, and triggering a need for the host DIF to protect

[32] Besides, as noted earlier and observed by several national FSAPs in the EU, not all member states have national crisis management arrangements, and if they do, the DIA is oftentimes not part of these arrangements.

[33] This approach already exists in Denmark where the resolution authority has decided that small- and medium-sized banks generally would also pass the public interest test (IMF, 2020c).

[34] To improve the credibility of both resolution and liquidation scenarios, a wider set of banks should be required to hold MREL over and above equity.

[35] For a discussion of preventive and other alternative measures see EFDI (2019).

domestic depositors. EDIS will require a fiscal backstop that could be provided by the European Stability Mechanism (ESM) as agreed by the Eurogroup.[36]

…reducing constraints

21. **The interpretation of relevant directives and regulations should be changed to allow a DIS to disburse gross funding upfront in a resolution.** The proposed change would allow a gross contribution from the DIS up to the value of covered deposits—that is, the amount the DIS would have paid upfront in cash in a liquidation—if the estimated cost to the DIS, net of recoveries in resolution, would be no higher than if, instead, a liquidation and payout had been pursued. Without such flexibility, the partial transfer and bridge bank powers may not work, especially in a precipitous failure when due diligence could be curtailed, or during a crisis where banking assets may not be sold easily, and cash must be injected to back deposits.

22. **DIS funding for certain resolution measures should be facilitated under state aid rules.** At a minimum, it could be clarified in the 2013 Banking Communication, subject to the least-cost safeguard, that a partial transfer that protected only insured depositors (and could be backed by good assets) would be automatically compatible with the state aid rules. After all, DIFs are funded by the industry and not by the state. "Fair and open" procedures for sale of business operations could be determined in advance between the Commission, resolution authorities, and the DIS, mitigating any risk of distorting competition between financial firms and member states. Consideration should also be given to paring back procedures for state aid oversight, or preferably a presumption of clearance for resolution decisions taken by the SRB rather than national authorities, given the lower risk of distorting competition for national interest reasons.[37] This is because the use of the SRF, or a future EDIS by the SRB, would involve supranational (rather than national) decisions using common funds paid for by the industry and subject to a financial stability mandate.

…introducing flexibility

23. Critical flexibility should be achieved by introducing a financial stability exemption to the mandatory bail-in requirement to access resolution funds, DIFs, and the government financial stabilization tools. This exemption should be subject to strict conditionality and a decision-making structure that appropriately balances banking union and member state interests. The conditionality would be based on documented, severe risks to the financial system of a member state as a whole, or of the euro area. The exemption would also have to apply to restructuring and burden-sharing requirements under the 2013 Banking Communication. The governance arrangements for such an exemption could evolve while the banking union is further completed.

…and designing a comprehensive crisis management framework

24. **To complement the bank-by-bank resolution framework, EU authorities should consider how a systemwide crisis would be managed, regardless of the financial stability exemption discussed above.** The 2018 EA FSAP recommended that within the banking union, it would be essential to establish a mechanism or a committee with a holistic perspective, integrating the crisis-related work of the European Supervisory Agencies, the European Systemic Risk Board, the ECB, the SRB, the European Commission, and the banking-union funding facilities (that is, at a minimum, the SRF and the ESM). While the Commission

[36] https://www.consilium.europa.eu/en/press/press-releases/2020/11/30/statement-of-the-eurogroup-in-inclusive-format-on-the-esm-reform-and-the-early-introduction-of-the-backstop-to-the-single-resolution-fund/ Such backstop mandate will require a change in the ESM Treaty with ratification by all member states.

[37] This would be similar to earlier treaty changes in the state aid rules to introduce new exemptions (Treaty of Maastricht, 1992), unless Article 107(3)(e) of the Treaty on the Functioning of the European Union could be used for this purpose, which provides that "such other categories of aid as may be specified by decision of the Council on a proposal from the Commission" may be deemed compatible with the internal market.

"endeavors to take a coordinated approach in its assessment of individual banks' restructuring plans so as provide for a systemwide response… where large parts of a Member State's financial sector need to be restructured,"[38] it cannot be a substitute for a multi-agency arrangement. Such arrangement will require an appropriate governance framework bringing together pertinent agencies to effectively cooperate in formulating credible responses to a systemwide crisis.

[38] Paragraph 10, 2013 Banking Communication.

IV. References

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Annex I. Selected Recommendations on Deposit Insurance and Crisis Management from FSAPs in EU Countries (2016-2021)

Austria (2020)

- Explicitly provide for purchase and assumption transactions in the bankruptcy regime.
- Consider the provision of ELA and continue to engage the SRB on policies and procedures for use of the SRF as a source of liquidity funding in resolution.
- Seek legislation for standing authority to implement government stabilization measures.
- Explore mechanisms under which a MOF guarantee could be prepositioned to support borrowing by either deposit insurance systems.
- Assign a senior-level interagency body the mandate to ensure adequate contingency planning and testing of plans at the individual authority and national level.

Denmark (2020)

- Strengthen the autonomy of the Financial Stability Company (FSC) (which is also responsible for the DIS), including by prohibiting “active” bankers to sit on its Board of Directors.
- Expand the banks’ Single Customer View to ensure tracking of temporary high balances.
- Measure public awareness levels of the DIS regularly to assess the effectiveness of public awareness activities.
- Revive the Coordination Committee on Financial Stability and advance crisis preparedness with (i) a systemwide contingency plan; (ii) a crisis communication plan; and (iii) regular multi-agency financial crisis simulation exercises; in addition, expand the Committee’s membership with the FSC.

Italy (2020)

- Avoid the use of DIF resources for failure prevention outside of resolution or liquidation as much as possible, only using it in exceptional circumstances with strong prospects for ensuring successful rehabilitation and long-term viability.
- Review the adequacy of funding targets for deposit insurance, strengthen backstop arrangements, and shorten the statutory payout period for the Fondo di Garanzia dei Depositanti del Credito Cooperativo.
- Remove active bankers from the boards of the deposit insurers and extend legal protection to their board members and staff, as well as directors and officers of entities in resolution.
- Operationalize an inter-agency forum for crisis management and strengthen the deposit insurers’ role in the financial safety net coordination arrangements.

France (2019)

- Remove active financial sector executives from the Board of the Fonds de Garantie des Dépôts et de Résolution [i.e., the DIS], which should only include independent members.

Malta (2019)

- Ensure an explicit statutory basis for transferring selected assets/liabilities in insolvency.
- Clarify in writing the deposit insurer's interpretation of current laws and policies on its ability to finance the transfer of assets and liabilities in insolvency, and to finance the use of resolution measures.
- Ensure a legal basis for replenishing the DIF, and additional funding sources, ideally from commercial banks but, as a last resort, a borrowing facility from the government; clarify that the Minister of Finance has the authority to lend to the DIF.

Poland (2019)

- Amend legislation to ensure the independence of the deposit insurer.
- Conduct purchase and assumption transactions in lieu of deposit payouts.

Belgium (2018)

- Segregate the DIF from government funds to ensure ready access to deposit insurance and resolution funds.
- Publicly commit to shortening the deposit pay-out period to seven days by 2019 to increase depositor confidence; establish credit lines with the MoF for the DIS.
- Mandate a committee of the NBB Resolution Board [which includes the DIS/DIF] with proactively overseeing national financial crisis preparedness, including organizing regular intra- and inter-agency contingency planning and financial CSEs.

Romania (2018)

- Prepare and conduct a simulation exercise that includes all members of the National Committee for Macroprudential Oversight and the DIS.
- Formalize contingent documentation between the DIS and the MoF to allow financing support, allow the DIS to have accounts at the central bank, and eliminate the constraint to cover the DIS' operational expenses only from the yield of the Fund.

Bulgaria (2017)

- Continue implementing the timeline agreed with the World Bank Group for the disbursement-linked outcome indicators to strengthen the DIS.
- Under the oversight of the Financial Stability Advisory Council with an expanded mandate (including contingency planning) and membership (including the DIS]), strengthen the crisis management framework.

Luxembourg (2017)

- Allow the transfer of assets and liabilities during liquidation.
- Arrange for backstop funding for the DIF.

Netherlands (2017)

- Implement an SRM-wide deposit insurance scheme.
- Commit publicly to a seven-day payout period for insured deposits by 2019.
- Allow the DIS to finance deposit transfers both in resolution and in insolvency.
- Ensure that the DIS has timely access to back-up funding.

Spain (2017)

- Establish a cross-institutional entity for risk evaluation and crisis management.

- Include the DIS in any cross-institution entity for crisis management and ensure that the DIS has a voice in any use of its funds for resolution.

- Enhance the ability of the DIS to payout deposits in a timely manner, and establish an emergency/back-up liquidity system for the DIS.

- Consider making the DIS a fully owned government institution and remove private bankers from its Board.

Finland (2016)

- Commit publicly to a seven-day payout period for insured deposits by 2018.

- Strengthen the legal and operational framework for legal protection of officials, staff, and agents of all financial oversight agencies, including the Finnish Financial Stability Authority (FFSA) that manages the DIF.

- Under the oversight of the FFSA Advisory Council, ensure agency-specific and national financial crisis planning, including a national crisis management communication plan and regular single- and multi-agency crisis simulation exercises.

- EU: Develop a more effective use of deposit insurance to fund resolution tools and implement an SRM-wide deposit insurance scheme.

Germany (2016)

- Develop contingency plans for a systemic wide crisis and test plans via a simulation exercise.
- Define a coordination mechanism including the SRB, ECB and MOF in a systemwide crisis.
- EU: Establish a credible common permanent backstop for the Single Resolution Fund.

Ireland (2016)

- Commit publicly to a seven-day deposit payout period, ideally by 2018.
- EU: Allow a more flexible use of the DIS to fund resolution tools.
- EU: Implement an SRM-wide deposit insurance scheme.

United Kingdom (2016)

- Introduce risk-based contributions and update the lending protocol between Treasury and the DIS to reflect the new target level.

- Re-examine the appropriateness of introducing an ex ante deposit insurance fund with a target level adequate for the U.K. banking system.

- Include the Financial Conduct Authority and the Financial Services Compensation Scheme in the Crisis Management MoU, as well as in the periodic high-level discussions between the Bank of England and HM Treasury on contingency planning

Annex II. Selected Recommendations on Deposit Insurance and Crisis Management from the Euro Area FSAP (2018)

- Establish EDIS, with a backstop arrangement.
- Introduce a financial stability exemption from (i) the 8 percent mandatory bail-in for accessing the SRF and public funds; (ii) the 5 percent cap on SRF funding; and (iii) the proposed stricter state aid burden-sharing rules.
- Subject to a financial stability exemption, align the state aid burden sharing requirements in liquidation with the BRRD/SRMR.
- Ensure effective DIS financing of deposit transfers in both resolution and liquidation.
- Operationalize in all EA countries lending facilities between DIS.
- Pare back state aid oversight of SRB resolution decisions and the use of the SRF and DIS funding on a least-cost basis.
- Adopt a system-wide crisis preparedness and management framework.

Annex III. DGSD: Use of Selected National Options in the Euro Area

	AT	BE	CY	DE	EE	EL	ES	FI	FR	IE	IT	LT	LU	LV	MT	NL	PT	SI	SK
Art 5(2): coverage pension schemes and local authorities	Orange	Orange	Purple	Orange	Orange	Orange	Purple	Orange	Orange	Purple	Orange	Orange	Purple	Purple	Orange	Orange	Purple	Orange	Orange
Art 5(3): immovable property loans excluded	Orange	Purple	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange
Art 7(5): set-offs repayable amounts	Purple	Purple	Purple	Orange	Purple	Purple	Purple	Orange	Purple	Purple	Purple	Orange	Purple	Purple	Orange	Purple	Orange	Orange	Purple
Art 7(8): social purpose deposits excluded	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Purple	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange
Art 8(3): longer repayment period some deposits	Purple	Purple	Purple	Purple	Purple	Purple	Purple	Orange	Orange	Purple	Orange	Purple	Purple	Orange	Purple	Orange	Purple	Purple	Purple
Art 9(3): repayment claim period limited	Purple	Purple	Purple	Purple	Purple	Purple	Purple	Orange	Purple	Orange	Purple	Purple	Purple	Orange	Purple	Purple	Purple	Purple	Purple
Art 10(2): target level deadline beyond 2024	Purple	Purple	Orange	Purple	Orange	Purple	Purple	Orange	Purple	Purple	Purple	Purple	Orange	Orange	Orange	Purple	Purple	Orange	Purple
Art 10(6): target level below 0.8%	Orange	Purple	Orange	Orange	Orange	Purple	Purple	Orange	Purple	Orange	Purple	Orange	Orange	Orange	Orange	Purple	Orange	Orange	Orange
Art 11(3): using deposit insurance funds to support alternative measures to prevent the failure of a credit institution (“open bank assistance”)	Purple	Orange	Orange	Purple	Orange	Orange	Purple	Orange	Purple	Purple	Purple	Orange	Orange	Orange	Purple	Orange	Orange	Orange	Orange
Art 11(6): using deposit insurance funds in national liquidation proceedings to fund deposit book transfers	Orange	Purple	Orange	Orange	Orange	Purple	Orange	Purple	Orange	Purple	Purple	Orange	Purple	Orange	Purple	Orange	Orange	Orange	Orange
Art 12(1): lending to other EU deposit insurers	Purple	Orange	Purple	Orange	Purple	Orange	Orange	Orange	Purple	Orange	Purple	Purple	Orange	Orange	Purple	Orange	Purple	Purple	Orange
Art 13(1): lower fees for low-risk sectors and IPS	Purple	Orange	Orange	Purple [2]	Orange	Orange	Purple	Purple	Purple	Purple	Purple	Orange	Orange	Orange	Orange	Orange	Purple	Purple	Orange
Art 19(4): grandfathering higher coverage through 2018	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange

Source: IMF 2018.

[1] Purple: yes, made use of the option; Orange: no, did not make use of the option.
[2] Except subparagraph 4 of Article 13(1).

PUBLICATIONS

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