

EUROPEAN COMMISSION CONSULTATION

REVIEW OF DIRECTIVE 94/19/EC ON DEPOSIT-GUARANTEE SCHEMES (DGS)

IMF STAFF POSITION ¹

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We welcome the opportunity to provide early input for the intended review of the DGS Directive.

In our view, the following should be the main considerations guiding this review:

- In our view, the EU's single financial market would best be served by a pan-European depositor guarantee scheme. Depending on the political will, a pan-European scheme could be extended to all banks. It might alternatively cover at least all banks with significant cross-border deposit-taking operations. Whatever the scope of the scheme, arrangements for resolution and supervision will need to be aligned, consistent, and incentive-compatible. Care will also need to be taken to avoid the disadvantages of having multiple systems (including potential gaming, competitive distortions, and possible under-funding of smaller national systems).
- We would emphasize that the reform of the DGS should not be considered in isolation from the introduction of a robust EU framework for bank intervention and resolution, especially for large cross-border banks. This framework should be built on the recognition that a mechanism is needed to deal with large banks that are unlikely to be liquidated on account of their systemic importance. In essence, what is needed is an integrated EU-level system of bank resolution and depositor protection. An FDIC-style agency, combining the function of resolution agency and DGS and having a wide range of tools at its disposal to deal with failing banks in a tailored manner, may be the first-best solution. This agency would have to become involved in the resolution of cross-border banks, alongside the relevant fiscal authorities. It should also be represented on the ESFS.
- Moving in the direction of a pan-European DGS (or other fundamental reform) means that the revision of the DGS Directive should be framed in the context of the fundamental review of the EU's framework for cross-border crisis management and

¹ The views expressed herein are those of the staff of the European Department and the Monetary and Capital Markets Department of the IMF. These views should not be attributed to the IMF, its Executive Board, or its management.

resolution that has been requested by the ECOFIN and the European Council. Deposit insurance will need to be an integral part of this framework, and be fully consistent with its other elements. These efforts, along with those on the regulatory and supervisory front, should be framed within a broad rethink of how depositors can best be protected and contingent fiscal exposure to the banking system minimized.

- In any case, important steps can be taken to improve and supplement existing DGSs. However, care will need to be taken to ensure that any short-term reforms are consistent with an eventual move to a system as outlined above. To this end, we offer detailed comments in our question-by-question answers below, which can be summarized as follows:
 - Coverage should be harmonized.
 - Ensuring that payouts are rapid, and known to be rapid, is essential. Payouts also need to be automatic. If possible, one would also wish to ensure rapid pay-out of uninsured deposits that are expected with high probability to be recovered from the failed banks' estate. Putting this in practice requires standardized information systems that allow quick identification and reimbursement of insured deposits.
 - Depositor confidence and banks' incentives, and the feasibility of rapid payouts, are best supported by a pre-funded insurance system.
 - To support the single market, ensure equal trust between foreign and domestic banks, and effectively underpin depositor confidence, access to information about deposit insurance and to pay-outs needs to be greatly facilitated. This can best be done by having host country DGS's act as interfaces between home country DGS (and a possible pan-European DGS) and host country depositors through standardized procedures and communications.
 - DGS should not stand in the way of the rationalization of existing banking operations across borders. This requires rules that allow relatively easy migration on reasonable terms between DGS when operations are consolidated, thus avoiding the kind of problems that have hampered Nordea's adoption of the European Company statute. However, at the same time, DGS must be designed to prevent the risk of opportunistic migrations between DGS.
 - Clear rules are needed on the priority of claims in bank insolvencies. Consideration should be given to giving priority to the claims of depositors and deposit guarantee schemes, so as to reduce the potential cost of depositor

protection. This could also include introducing greater restrictions on the asset side (to avoid that banks pledge all their assets to other creditors).

- Risk-based premia—generally desirable but not essential--should be set on the basis of a risk assessment by the responsible supervisor, while avoiding pro-cyclical effects.
- Membership of an official DGS should be mandatory for all licensed banks in the EU, whether or not a bank is a member of a mutual support agreement.

Specific questions:

Question 1. We agree that the current framework for DGS in the EU needs to be revised. As argued above, a fundamental rethink is needed in the context of an overhaul of the EU's crisis management and resolution arrangements.

Question 2. In our view, coverage needs to be harmonized across the EU, to avoid distortions within the single financial market. Coverage should be high enough to reassure depositors and protect small, unsophisticated depositors, but low enough to encourage depositor discipline and limit potential fiscal exposure. Harmonization somewhere in the €50,000-100,000 range (options a and b) seems broadly appropriate and would cause the least transition problems. It could also be used to accomplish a coordinated exit from the blanket guarantees currently in effect in some member states.

Question 3. We see a fixed level as most appropriate, in order to avoid complications and competitive distortion within the single market (see also below). There should be no coinsurance.

Question 4. Depositors should not be “encouraged” but the incentives of any system must be understood in the design, and the system must be clearly communicated. There is clear evidence that depositors (particularly large, sophisticated depositors) have split up deposits to ensure that they remain covered, but we do not regard this as a major problem.

Question 5. Clear ex ante communication and consistency are essential, and coverage should be the same for similar instruments. Changing the “brand name” of a product should not change the coverage. Banks should not have the option to ask for coverage per brand name. This would significantly complicate calculations for premium assessment and insured deposits repayment in the event of bank failure.

Question 6. This should be the subject of a political choice. However, as also argued above, there is a lot to be said for harmonization. If governments want to provide extra protection to state-owned pension accounts, for example, it could do so with fiscal policy.

Question 7. Coverage of temporary high account balances could be considered. However, this would have to be subject to severe time restrictions (no more than one month) and should be harmonized across Member States. The accounts should be “tagged” and analyzed prior to payment. The benefits of protecting depositors’ wealth must be weighed against the possibility for abuse.

Question 8. Mutual guarantee schemes should not be considered an alternative to participation in an official deposit guarantee scheme, and restrictions on their marketing are advisable. For GDS purposes, mutual guarantee schemes must be assessed on their credibility and legal enforceability. If such a scheme implies full joint liability, the financial institutions that are part of it should be treated as an integrated entity for deposit insurance purposes (and also for at least some supervisory and governance purposes). They should still be part of the general deposit insurance arrangements to cover the possibility of collective failure and in this case should be subject to the coverage limit. This must be clearly communicated to depositors. If a mutual guarantee scheme does not imply full joint liability, it should be taken into account in assessing the solidity of an institution for purposes of calculating risk-based insurance premia, but should not cause exemptions from general deposit insurance arrangements.

Question 9. A harmonized approach is needed within the EU. Deposits should be clearly defined so there is little room for interpretation. Structured deposits should not be covered.

Question 10. It does not seem appropriate to equalize debt certificates with ordinary bank deposits. Since debt certificates are usually not redeemable before maturity, a run on debt certificates is not possible, which renders a large part of the logic for an insurance system invalid.

Question 11. Foreign exchange deposits should be covered (in line with all the other coverage and exclusion criteria), but repaid in local currency at a predetermined rate. Discriminating against foreign currency deposits does not serve the purposes of a DGS.

Question 12. We are in favor of harmonizing the eligibility criteria, consistent with the broader effort to harmonize systems. Affordability, credibility, and the need for sophisticated market participants to exert market discipline argue in favor of narrow eligibility criteria.

Question 13. Financial sector enterprises can be expected to exercise market discipline and determine if a bank is safe for its deposit. Their deposits should therefore not be covered. The coverage levels are presumably insignificant for them.

Question 14. Deposits from central or local authorities should be subject to regular coverage. No special protection is needed, as such authorities can negotiate their own

security arrangements with their banks (e.g., requiring the banks to fully secure the deposits with highly marketable securities).

Question 15. Insiders and their families should not be covered. Although it is possible that some parties did not contribute to the bank's failure, it is more prudent to wait for the legal process to run its course rather than trying to recover wrongly reimbursed funds.

Question 16. Anonymous or "bearer" deposits should not be covered, as this could result in overcompensation of the holders of such accounts (if they have multiple accounts) and it would provide an incentive to open such accounts in order to circumvent the coverage limit.

Question 17. Enterprises should not be excluded. There is some evidence for the US that transaction accounts held by firms run faster than retail deposits. There is therefore a financial stability rationale for including these accounts. In addition, small and medium sized enterprises have, just like individuals, only limited means to exert market discipline and need liquid resources.

Question 18. We believe that pan-European depositor protection arrangements are needed, and should be established on an ambitious timescale (see also our opening comments).

Question 19. A pan-European system is needed to cover cross-border banks. Banks without significant cross-border operations could be covered either by the same (in this case single) system, or by harmonized national systems. We do not think that assistance between systems can work as a practical matter. It would also lead to misalignments between financial liability and prudential authority.

Question 20. Systemic banks and cross-border banks that raise concern in either the home or host country should be covered by an EU-wide arrangement.

Question 21. Several approaches are possible. In principle and under one conception, a pan-European DGS could provide funds needed to facilitate the resolution of a cross-border banking group, provided this was less costly than paying out deposits in liquidation. It might also assume a role in negotiating the resolution path, alongside the relevant national authorities. Less ambitiously, the pan-European DGS might serve just as a "paybox," although this conception leaves open the crucial issue of establishing a resolution agency or some organization of supervisors that can take the lead in bank resolution. In any case, the European (or national) DGS should not provide liquidity assistance. Nor should the DGS provide funds for an ailing bank in advance of its resolution.

Question 22. We agree that standardized information provision, through a local point of access and in depositors' own language, would be useful. A standardized

information template could facilitate this, and should as a minimum cover the level of coverage, instruments that are covered or not covered, and basic conditions.

Question 23. What is important is that there is ex ante clarity about what is covered by deposit insurance and what is not. This might best be done through information on account statements and by identifying insured deposits (e.g., as a sub-account).

Question 24. Information on DGS (as specified under Question 22) should be provided through multiple channels:

- in account statements and in advertisements (options b and c);
- on signs at every place of business of a bank, unambiguously and in a legible size font;
- banks should be required to provide brochures to customers explaining the DGS system and coverage;
- DGS's should develop and maintain websites that provide information and could also provide additional information regarding the banking sector and other relevant information;
- DGS's should consider public awareness campaigns to inform the public of the existence, purpose, and conditions of deposit insurance. They may want to consider efforts to include deposit insurance as a subject in schools and universities where financial topics are taught;
- national authorities, who know their depositors best, should be provided discretion to require information provision through additional channels provided this does not create unreasonable hurdles for cross-border banking.

Question 25. Host country schemes seem best placed to handle communications with local depositors.

Question 26. Set-off arrangements create various problems with (i) equality of treatment; (ii) liquidity management for the bank's customers; (iii) asset-liability management of the estate in receivership; (iv) adverse incentive problems (including to run on deposits, stop servicing loans, and run down credit lines as a way to get term deposits out of the bank); and (v) additional complexities in administering the bank insolvency and depositor payouts. Therefore, they would best be discontinued (Option b). The asset side (where time is often needed to extract maximum value) needs to be dealt with separately from the deposit side (where speed is needed to limit the impact on depositors and instill confidence in the deposit insurance system).

Question 27. To be effective in preventing bank runs, payout delays have to be minimal. The medium-term objective should be to shorten the delays to one week or less (option b). This will require a significant improvement in the technical basis for bank resolution and information sharing, which will take time to put in place. An escape clause should be provided allowing longer payout delays for cases in which there are significant practical obstacles (e.g., dormant accounts).

Question 28. Such options should only be considered as interim solutions pending resolution of the technical and legal hurdles to a minimal standard payout delay. Note that, in the absence of special bank insolvency regimes both of these alternatives pose problems in terms of reversibility if a judge were to overrule the license revocation.

Question 29.

- (b): all insured deposits should be repaid in local currency so that the depositor bears the exchange rate risk, not the DGS.
- (c): interest-bearing deposit accounts should have interest accrued and paid through date of failure. If there is an assuming bank, they should pay the contract rate for 14 days and can alter the rate only after notifying the depositor.

Question 30. To ensure quick interventions and payouts, and full transparency, systems are needed that continuously track insured deposits. This means that insured deposits should be tagged in the information systems of the banks, as proposed in option (d). This should be combined with abolishing set-off (option (i)). A de-minimis rule might help to simplify the handling of the pay-out without meaningful cost in terms of confidence and effectiveness of the system.

Question 31. Insured deposits should be paid out automatically, without intervention by the depositor, i.e., option (b). Transferring to an assuming bank via a purchase and assumption transaction will often be the easiest solution. Often stronger banks will pay a premium to increase market share inexpensively. If no strong bank can be found, then checks should be mailed or the funds should be made available electronically at another financial institution.

Question 32. DGS need to be involved at an early stage, working in close coordination with the receiver and/or acting as the receiver. The trigger point should be when it becomes clear that a bank may possibly fail. The DGS will then need to begin planning for insured deposit repayment, and analyze the impact of a potential bank failure on the reserve fund (whether emergency funding will be needed). DGS personnel should be permitted to go on-site to banks and should be subject to the same level of confidentiality as bank supervisors.

Question 33. To ensure quick pay-out, banks need to keep records in a format and information system that allows this (see also question 30). The suitability of these systems needs to be verified on a regular basis, these systems should be used for regular reporting to the DGS on covered deposits, and early DGS access to the records should be ensured when pay-out becomes likely. A common interface could greatly facilitate this process. DGS will likely need access to selected supervisory data, subject to confidentiality provisions, to allow accurate monitoring of the risks it faces.

Question 34. Coverage levels and stress testing exercises for national schemes could be monitored by the European authorities, e.g. the ESRB.

Question 35. Harmonization of coverage levels should remove the need for topping up. Elimination of topping up (option (h)) is also desirable from the point of view of aligning potential liabilities and prudential responsibility.

Question 36. In the absence of a pan-European scheme, having the host country DGS act as a single point of contact may provide the best guarantees for the interests of host country depositors and for smooth communications with those depositors.

Question 37. Ex-ante funding is recommended, to allow for faster intervention and support confidence. Ex-post financing should be avoided (and in any case capped), so as to reduce the potential burden on surviving banks in times of stress, limit the risk of opportunistic bank migrations within the single market, and avoid pro-cyclicality. One guideline to establish a reserve fund target is to ascertain the level necessary to cover 4-5 smaller banks or 2-3 medium sized banks. For added flexibility and efficiency, the target could be specified as a range, rather than a specific, hard target (e.g., 5% of insured deposits). Provisions for emergency funding should be made.

Question 38. Risk-based premia, while not essential, generally have advantages in terms of incentives and equity. However, they could further weaken a bank that finds itself in difficulties (as its premia are increased at a time when it can ill-afford them), and therefore may have a pro-cyclical effect. Moreover, risk-based premia require an accurate method for assessing risk, which should be consistent with the regulatory and supervisory regime. The easiest approach would be to request supervisors to rate the riskiness of banks for this purpose. If adopted, risk-based premiums should be based on simple calculations. Implementation should include a test period and a transition period.

Question 39. Ex-ante funding should be made mandatory (see also question 37). Additional financing arrangements are also needed.

Question 40.

A DGS's investments should emphasize safety and liquidity over return. Therefore, investments should consist only of government debt securities and similar instruments.

New banks entering the system and scheme should be charged an entrance fee as a fixed amount, or a percentage of the bank's capital. All banks' contributions should be non-refundable, i.e., a business expense.

The governing board of the DGS should be comprised of experienced and knowledgeable individuals who meet the "fit and proper" test. Strategic planning, risk-management and good internal control and audit systems are critical to proper governance. DGS operations should be transparent, with clear oversight to ensure proper accountability.