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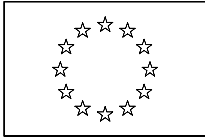

EUROPEAN COMMISSION

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COMMISSION STAFF WORKING DOCUMENT

SUMMARY OF THE IMPACT ASSESSMENT

Accompanying document to the

Proposal for a

DIRECTIVE …/…/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on Deposit Guarantee Schemes [recast]

and to the

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND TO THE COUNCIL

Review of Directive 94/19/EC on Deposit Guarantee Schemes

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1. INTRODUCTION

No bank, whether sound or ailing, holds enough liquid funds to redeem all or a significant share of its deposits on the spot. This is why banks are susceptible to the risk of bank runs if depositors believe that their deposits are not safe and try to withdraw them all at the same time. Since 1994, Directive 94/19/EC on Deposit Guarantee Schemes (DGS) has ensured that all EU Member States have in place a safety net for depositors. If a bank is closed, DGS reimburse depositors up to a certain coverage level. The current DGS system is fragmented: there are about 40 DGS in the EU, which cover different groups of depositors and deposits up to different coverage levels, and impose different financial obligations on banks. Moreover, the schemes have proved to be underfinanced in times of financial stress.

The shortcomings of this fragmented system prompted the European Parliament and the Council to request a comprehensive review of the DGS Directive. This review is part of a package on compensation schemes in the financial sector consisting of DGS, insurance guarantee schemes, and investor compensation schemes.

2. PROBLEM DEFINITION

2.1. Differences in the level and scope of coverage

The 'minimum harmonisation' approach adopted in Directive 94/19/EC has resulted in very different coverage levels in the EU (ranging from €50 000 in some Member States to €103 291 in Italy). On the one hand, in the recent financial crisis, uncoordinated increases in the coverage levels across the EU led to depositors quickly shifting money to banks in countries where deposit guarantees were higher, draining liquidity from banks in times of stress. On the other hand, in times of stability, in a fragmented market depositors may still choose the highest deposit protection rather than the best product, potentially distorting competition in the Internal Market.

Currently, Member States can exclude protection for many types of *depositors*. This is particularly important for 20 million small and medium-sized enterprises (SME), representing 99.8 % of all enterprises in the EU, whose confidence is crucial for financial stability. There are also considerable differences in the scope of *deposits* covered by DGS (e.g. with regard to deposits in non-EU currencies, structured products and debt certificates). Time-consuming verification of eligibility may also delay payout.

2.2. Inadequate payout procedures and depositor information

Currently, depositors must be paid out within three months after a bank failure. From the end of 2010, this time limit has to be reduced to four to six weeks. Such a time limit might still lead to runs on banks since many depositors would not have sufficient funds to pay for their usual expenses (food, bills, etc.) for more than a few days.

Any difficulty before and during the payout process (including the lack of proper depositor information) undermines depositor confidence. Depositors may also hesitate to deposit money in other Member States if they do not know how other DGS work or deal with payout.

Another problematic issue is the option of setting off deposits against the depositor's due liabilities (e.g. mortgage instalments) at the same bank or making counterclaims against the depositor (e.g. for the entire mortgage loan), which is currently allowed in 22 Member States. This may reduce or, in extreme cases, eliminate any payout from a DGS. Depositors may thus cause a run on their banks to get their deposits in full. Moreover, determining liabilities and matching them with deposits is time-consuming and likely to delay payout.

2.3. Inappropriate financing of DGS

Currently, in 21 Member States, bank contributions are paid in advance on a regular basis (ex ante), but in six Member States, banks only contribute after a failure (ex post). The maximum resources available to DGS range between €27 million and €8.1 billion while the amount of covered deposits in the EU is about €5.7 trillion. As a result, some DGS are underfinanced and would not be able to deal even with a medium-sized bank failure. If DGS have insufficient funds, depositors might be paid out after a long delay or not be paid out at all.

Mere ex-post funding is very pro-cyclical since it drains liquidity from banks in times of stress which might have negative consequences for the economy (limiting the supply of credit by banks). Moreover, banks that do not pay ex-ante contributions are able to generate returns on those funds, and this constitutes a competitive advantage vis-à-vis their competitors in Member States with ex-ante funded DGS.

In addition, risks incurred by banks are not taken into account when calculating contributions. This may be perceived by risk-averse banks as a competitive disadvantage and as a disincentive to sound risk management. This may also make the financial system more vulnerable and induce adverse selection.

2.4. Limited cross-border cooperation between DGS

The fragmentation across the EU leads to uneven distribution of risk, in such a way that DGS with fewer resources would be hit harder by a bank failure than a DGS with more resources; this is aggravated by the lack of solidarity between schemes. Taxpayers would thus have to step in if a DGS had insufficient financial resources.

Banking supervisors usually decide whether a bank should be saved or the DGS be triggered. Thus, the fragmentation of DGS does not provide incentives for supervisors to reach a solution in the interest of all depositors of a banking group and to take account of the potential impact on financial stability in all Member States involved.

2.5. Limited mandate of DGS

The powers to manage bank crises are split between various domestic authorities (supervisors, central banks, governments, judicial authorities, and — in 11 Member States — DGS) and differ according to national systems. This makes cross-border bank resolution inefficient. The payout funds of DGS with a bank resolution mandate are not ring-fenced against being used for bank resolution purposes. This may impede their primary function of providing quick payout of deposits in the event of a bank failure.

Currently, mutual and voluntary DGS are exempt from the Directive. Depositors often have no claim against such schemes, which may make them vulnerable if such schemes cannot cope with a failure and the failed bank is not a member of a DGS governed by the Directive.

3. SUBSIDIARITY

Only EU action can ensure that banks operating in more than one Member State are subject to similar requirements concerning DGS, ensuring a level playing field, avoiding unwarranted compliance costs for cross-border activities and thereby promoting further Single Market integration. Harmonisation in many areas (e.g. coverage, payout, funding) cannot be achieved by Member States alone because it requires the harmonisation of many different rules existing in the national legal systems and can therefore better be achieved at EU level. This has been acknowledged in the DGS Directives[1].

4. OBJECTIVES

The overarching objectives enshrined in the Directive are to maintain financial stability by preventing bank runs and to protect depositors' wealth. In addition, the principles of the Internal Market, such as ensuring a level playing field between EU banks, must be upheld and banks' freedom to decide whether they want to operate directly in another Member State or establish branches or subsidiaries must remain unaffected.

5. PREFERRED POLICY OPTIONS AND THEIR EXPECTED IMPACT

Given that minimum harmonisation has proved to be ineffective as a way of protecting depositors' wealth and inconsistent with the Treaty objective of ensuring the proper functioning of the Internal Market, the approach of maximum harmonisation has been chosen, so as to create a level playing field for all Member States.

5.1. Level and scope of coverage

Maintaining the current approach, i.e. the fixed coverage level of €100 000 to be applied in all Member States from the end of 2010, as compared with lowering or increasing the coverage level, would ensure substantial progress in terms of increased deposit protection without disproportionably increasing costs for banks and depositors. In comparison with the pre-crisis period, it would increase the *amount* of covered deposits from 61% to 72% of eligible deposits and the *number* of fully covered deposits from 89% to 95% of eligible deposits. It seems that the level of €100 000 is the optimal solution; the cost-efficiency benefits of adopting a coverage level higher than €100 000 are very limited.

However, taking into account an appropriate coverage for certain life events and the current house prices, it might be justified to consider a higher coverage level for so-called temporary high deposit balances stemming from some specific life events and real estate transactions. At the same time, exemptions from the fixed coverage level might impede a smooth and timely payout process. It might also affect the Internal Market if depositors choose the bank with the best deposit protection but not the most suitable product. This risks could be mitigated if the coverage of such deposits was limited to a certain time period.

As to the eligibility of depositors, full harmonisation of the scope of coverage has turned out to be the most effective solution to create a level playing field. Excluding financial institutions would take into account the insignificance of the amount covered for them. Excluding

[1] Recital 17 of Directive 2009/14/EC and recitals (not numbered) of Directive 94/19/EC.

authorities seems cost-efficient, since they have easy access to other financial resources. Covering the deposits of all enterprises (i.e. including the remaining 1.3% of enterprises in addition to the small and microenterprises now covered, which account for 98.7% of all EU enterprises) would save considerable resources and the time needed for verifying the size of businesses during payout proceedings. It would thus considerably speed up payout and increase depositors' confidence in DGS.

Deposits in non-EU currencies should be covered by DGS — in contrast to debt certificates and structured products not repayable in full. This would avoid favouring banks as bond issuers over non-bank issuers. It would also reduce payout delay and the administrative cost of verifying eligibility, while only moderately increasing bank contributions to DGS.

5.2. Payout deadline, modalities and depositor information

In order to maintain depositors' confidence and avoid bank runs, the payout deadline needs to be substantially reduced — preferably to seven calendar days (after a transition period). Such a short payout deadline would only be feasible under several conditions, i.e. imposing some obligations on supervisors (involving DGS at an early stage by compulsorily informing them if a bank failure becomes likely), DGS (making payouts by DGS on their initiative without being prompted by applications from depositors) and banks (tagging eligible deposits, providing single customer views). The latter would entail one-off administrative costs EU-wide of about €1.2 billion annually within five years. They would be more than counterbalanced by a gain in depositors' confidence that would reduce the probability of bank runs and contribute to financial stability. If eligibility criteria were radically simplified, those costs could be considerably reduced.

As regards payout modalities, discontinuing set-off would persuade depositors with high liabilities not to cause a run on their banks. It would also be effective in reducing payout time.

Only depositors that have been properly informed about key aspects of deposit protection (the level/scope of coverage, payout deadline, DGS contact details, etc.) can be confident in DGS. This would be ensured by means of a template to be countersigned by a depositor before depositing money in a bank and by a mandatory reference to DGS in account statements and advertisements, if a product is covered. The cost of such operations is deemed insignificant.

Regular disclosure of information by DGS (e.g. ex-ante funds, ex-post capacity, results of regular stress testing) would ensure transparency and credibility at insignificant cost.

5.3. Funding mechanisms and levels

Ex-ante funding is much more efficient because of its counter-cyclical nature (it imposes most costs on banks in good times) and it should be dominant (e.g. ¾ of the total fund) and supported by ex-post funds to be collected if necessary (e.g. ¼ of the fund). Borrowing by DGS should be allowed but not necessarily harmonised.

Setting a target level for DGS funds would ensure that schemes are credible and capable of dealing with medium-sized bank failures. The most cost-efficient target level for total DGS funds would be 2% of eligible deposits — to be achieved within 10 years. After this period of time, DGS in the EU would be much better financed than they are now. They would collect about €150 billion in ex-ante contributions and could call for €50 billion of ex-post contributions if needed (compared to total ex-ante and ex-post funds of €23 billion in 2008).

It would require bank contributions to DGS some four or five times higher than at present and would reduce banks' profits by about 2.5% in normal times. For depositors, it would mean a maximum reduction in interest rates on savings of less than 0.1% or increasing current account fees of less than €7 per year per account. This scenario would be more cost-efficient than the other scenarios analysed, since a much higher target level (enough to cover a failure of one of the 10 largest banks in a Member State) would likely lead to a 30% decrease in banks' profitability (or even more than 40% in a crisis situation). It would also be a more effective option since a lower target level (based on an average DGS payout) would not allow schemes to cover medium-sized bank failures.

Moreover, a more harmonised approach to bank contributions, consisting of risk-based elements, would help better reflect the risk profiles of individual banks and provide incentives to operate under a less risky business model. Developing a set of core indicators mandatory for all Member States and another set of optional supplementary indicators would introduce such harmonisation gradually, avoiding sudden adaptation costs.

5.4. The mandate of DGS

An effective and cost-efficient solution to ensure that DGS funds cannot be drained for bank resolution measures to the benefit of uninsured creditors is to require that DGS funds should principally be used for paying out depositors. However, in order not to deprive depositors of the benefits of bank resolution measures (e.g. the transfer of deposits to a healthy bank), it would be effective to allow the use of DGS funds for resolution only up to the amount that would have been necessary to pay out covered deposits. To a limited extent, Member States could also allow DGS to use their financial means in order to avoid a bank failure without being restricted to financing the transfer of deposits. If DGS had an even broader mandate, i.e. including not only bank resolution but also early intervention measures (e.g. recapitalization, liquidity assistance, guarantees, etc.), they would need to be adequately funded. This is because bank resolution is alternative to payout while early intervention does not always prevent payout later on. However, in order to avoid situations where DGS funds could serve as an important contribution to an otherwise difficult early intervention measure, they could be used for such purposes under some restrictions.

A more effective solution would be to ring-fence DGS against any use for other purposes than payout and to require that all DGS would have to be equipped with sufficient funds for this role. However, this solution would not be cost-efficient. It would cost banks between €121 billion and €352 billion and it is unclear whether this would be compensated by benefits in terms of depositor confidence and financial stability. Moreover, this option would seem inconsistent with ongoing Commission work on bank resolution to prescribe a mandatory bank resolution mandate for all DGS.

The integration of mutual and voluntary guarantee schemes under DGS would effectively ensure that bank depositors adhering to such schemes enjoy the same rights and have the same confidence as other depositors. It is estimated that the cost to banks would be outweighed by the benefits of boosting depositor confidence.

5.5. Cross-border cooperation between DGS and a pan-EU DGS

In order to facilitate payout in cross-border situations, host-country DGS should act as a single point of contact for depositors at branches in another Member State. They would provide depositors with information in the host country's language. The host-country DGS

should act as a post box and a paying agent for the home-country DGS. Administrative costs for the former would be marginal in comparison with the gain in depositor confidence.

Another option to improve cross-border cooperation among DGS would be setting up a network (an 'EU system of DGS') and introducing a mutual borrowing facility. This would mean that if the financial capacity of one DGS became depleted, it could borrow money from the other schemes. In order to allow an additional facility of 0.5% of eligible deposits for the borrowing scheme (i.e. the equivalent of ex-post contributions referred to under Section 5.3 — one quarter of 2%), all DGS would only have to lend up to 0.08% of eligible deposits, i.e. about 1/25 of their funds at target level. This is effective and efficient.

This could be considered the first step towards establishing a single pan-EU DGS in the future, which would save administrative costs of roughly EUR 40 million per year. This idea seems to be economically the most effective solution to the fragmentation of the DGS market, but there are some legal issues that have to be further investigated. The idea of a pan-EU DGS is a longer-term project and should be in line with developments and progress on the new supervisory architecture in the EU and developments in the field of bank resolution.

5.6. Overall impact on stakeholders

The main benefit of the above policy options is that depositors' confidence is expected to be significantly enhanced by a higher level of coverage, faster payout, sound DGS funding, etc. It will make depositors confident that their deposits are safe and they will get back up to €100 000, even if their bank fails. It would inevitably involve substantially higher bank contributions which, in turn, reduce bank operating profits, but this is a basic condition of having sufficiently funded DGS in place. The cumulative impact on banks stemming from the preferred policy options on the level and scope of coverage, the harmonised approach to DGS funding and faster payout would be the following: an average 4% decrease in bank operating profits at EU level during the first five years, and a 2.5% decrease in the remaining five years (or 7.5% and 6% respectively in a crisis situation when ex-post contributions are collected as well). Some banks may try to pass those costs on to depositors but even in the worst case (assuming all bank costs are passed on to depositors, which is rather unlikely in a competitive environment), the overall impact during the ten years should not exceed a 0.1% reduction in interest rates on saving accounts or an increase of bank fees on current accounts by about €7 per year per account (or €10-12 in a crisis situation). Depositors will benefit from increased competition as a result of a level playing field and all stakeholders will benefit from the overall financial stability to which the proposed DGS reform is expected to contribute.

6. MONITORING AND EVALUATION

The transposition of any new EU legislation on DGS will be monitored under the Treaty. Since bank failures are unpredictable, the functioning of DGS cannot be regularly monitored on the basis of how real bank failures are handled. However, regular stress tests of DGS would show whether they are, at least in an exercise scenario, capable of complying with legislative requirements. This could be done as part of a peer review conducted by the European Forum of Deposit Insurers (EFDI) and the proposed European Banking Authority (EBA)[2].

[2] See COM(2009) 501.