16 March 2016

EBF Position on the European Commission proposal for a European Deposit Insurance Scheme (November 2015)

The European Banking Federation (EBF) supports the creation of the Banking Union and the objectives of breaking the nexus between sovereigns and banks and overcoming the remaining fragmentation within the Banking Union. As long as national governments are back-stops to banks, a perceived link between banks and sovereigns will remain. ***The EBF supports the principle of an EDIS as the third pillar of a fully completed and harmonious Banking Union.***

While the EBF agrees that an EDIS mechanism is appropriate, the design and timing will have to be carefully considered to ensure it follows a strict order of priorities, allowing enough time and being contingent on all participating Member States overcoming their differences at national level. ***The EDIS proposal should be carefully reviewed to take into account the harmonisation process within the current legal framework of the Banking Union to allow an EDIS to be set up without compromising best practices and the level playing field in the European Single Market and the Banking Union.***

EBF Members favour a step by step approach allowing more time and consideration for the subsequent steps. An evolution towards an EDIS should be dependent on certain prerequisite milestones being clearly defined, legislated and implemented. In terms of sequence the EBF urges that EU Institutions firstly:

- ***Conduct a comprehensive public stakeholder consultation and impact assessment to determine the appropriate design, calibration and evolution of an EDIS;***
- ***Give clear priority to achieving a level playing field by further harmonising banking regulation especially with respect to transposition and implementation of DGSD and BRRD;***
- ***Identify and address any remaining significant risks on banks' balance sheets in the Banking Union not yet subjected to the ECB's Asset Quality Review (AQR).***

The consideration for a step-by-step evolution towards an EDIS must be based on a prior in-depth analysis and impact assessment taking into account the impacts of the new financial regulatory environment and financial stability framework in the EU and Banking Union which have led to a significant reduction of the level of potential losses to insured depositors (notably the introduction of resolution planning, bail-in and depositors' preference). Thus, cost neutrality is an essential condition for the political acceptability of the EDIS and ***there should be no overall increase in individual contributions to deposit insurance (i.e. at national or Banking Union level)***. ***In this regard, our view is that the proposed target level in the DGSD should be re-assessed, to evaluate if a target level of 0.5% –as already foreseen in the DGSD under certain conditions– may be more appropriate than the current 0.8% of covered deposits.***

The EBF would like to outline in further detail the first steps that need to be taken towards an EDIS, as well as key principles and fundamental features that should be taken into account when designing and calibrating an EDIS.

A. Prerequisite steps to pave the way towards an EDIS

I. Comprehensive public stakeholder consultation and impact assessment

Before considering the appropriate design, phasing-in and calibration of an EDIS, it is indispensable for the discussion of an EDIS that a comprehensive impact assessment and public stakeholder consultation be carried out. While the draft regulation by the Commission mentions an impact assessment, the Commission has so far only publicly referred to the Impact Assessment of 2010 for the proposal of the DGSD recast[1]. This impact assessment is clearly out of date given subsequent fundamental changes in banking regulation. In addition, it is not sufficient as it deals (among other things) only with a "pan-EU-DGS." In particular, the 2010 assessment lacks a thorough cost benefit analysis of an EDIS as proposed. An impact assessment should at a minimum reflect on the following aspects:

a.) Principle of subsidiarity and proportionality: ***Policy makers should evaluate in detail different designs and calibration levels to determine the most appropriate and least constraining deposit insurance system that would adequately contribute to the Commission's objective to mitigate the risks between banks and their sovereigns and increase the resilience of the financial system without discouraging best practices.*** In this respect it needs to be demonstrated why an EDIS based on a system of national DGSs, with mandatory cooperation and borrowing agreements, is not sufficient to fulfil the objectives of the Commission proposal. Should it be evidenced that a system of national DGSs is not sufficient, ***the strengths and weaknesses of national DGSs should be carefully considered to determine and clarify where national DGSs should retain some of their present tasks***. Considering the differences in national banking sectors, national DGSs may be better qualified in terms of 'know-how' to evaluate quickly and accurately their member banks' idiosyncratic risk and the likelihood of a pay-out event. An EDIS should not prevent national DGSs from taking measures based on their own risk assessment at their own expense. The separation of monitoring risk and levying contributions should not weaken deposit protection in participating jurisdictions.

b.) Appropriate calibration of EDIS objective and mandate: ***When designing and calibrating EDIS, it is essential to clearly take account of the role of deposit insurance in the context of increased capital and liquidity requirements (CRR) and the recovery and resolution framework (BRRD).*** In particular it should be analysed to what extent the BRRD requires DGSs to contribute to resolution, i.e. the likelihood of their use and the level of losses that they are likely to sustain when a bank fails. The EBF notes that DGSs in the new BRRD framework are less likely to be called on to cover losses as the position of insured depositors has improved significantly given the following features:

i. Recovery plans in combination with increased capital and liquidity requirements and enhanced supervision will materially reduce the risk that banks fail.

ii. Resolution plans are required for all banks in the EU with the objective of protecting insured depositors and ensuring the continuity of banks' critical functions. Large and medium-sized banks are likely to be placed into a resolution process rather than in an insolvency process by recapitalising or selling the group or parts of it. Small banks are more likely to adopt liquidation, i.e. ordinary insolvency procedure with depositor pay-out as an appropriate resolution strategy.

iii. Loss absorbing liabilities (Minimum Requirement for Own Funds and Eligible Liabilities (MREL) under the BRRD and the FSB standard on Total Loss Absorbing Capacity (TLAC)) and depositor preference enable banks to be resolved without any loss to insured depositors or taxpayers. Insured deposits are excluded from and have a super senior status to such resources, including DGSs being subrogated to the rights and obligations of insured depositors. Banks placed into resolution would thus have sufficient resources to absorb losses before insured depositors, i.e. the DGS standing in for insured depositors, would suffer any losses. The likelihood of a Deposit Insurance Fund (DIF) suffering losses is very low because losses would have to exceed the value of all capital, MREL/TLAC, senior debt and uninsured deposits.

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010SC0834&from=EN

iv. Resolution funds, when called on to cover losses, provide an additional safety valve to absorb losses in resolution after certain conditions are met.

Given the above, the unlikelihood of DGSs having to cover losses in bank insolvencies, in resolution and liquidation, should be carefully analysed to determine the appropriate design of an EDIS as well as its funding needs, i.e. target level for DGSs, going forward.

II. Need to transpose and implement DGSD and BRRD

Priority should be given to transposing and implementing DGSD in all Member States so that all participating national DGSs are established in accordance with the Directive and are fully equipped with financial resources at the agreed pace. While DGSs should now enter into a complete and running phase, the proposal interferes with several aspects of national systems (mandate, target level, level of contributions, payment commitments, functioning of national DGS funds). The mandatory requirement for banks to hold both at national and also at European/international level sufficient bail-in-able liabilities should be implemented to reduce the likelihood of recourse to deposit insurance funds in resolution. In addition to the full implementation of the directive and guidelines, the EBF is of the opinion that leveraging on previous national experience under the new legal requirements for deposit insurance and bank resolution would be logical, prudent and advisable.

III. Further harmonisation is needed to ensure a level playing field within Banking Union and rest of EU

The different starting positions for DGSs in terms of funding levels and different options and discretions in the DGSD, in the EU as well as in the euro area, need to be eliminated with priority where these distort competition in the market and run counter to the single market idea. If the EDIS proposal were to be implemented without prior and significant amendments and further harmonisation of the DGSD it would create striking differences for Banking Union Member States and non-Members in the EU as it impacts and limits the implementation of the DGSD which is intended for all EU Member States. The following areas should be considered for further harmonisation:

a.) Mandate of national DGSs vs EDIS: The proposed design of an EDIS provides only for a pure pay-out function and resolution related financing. Under DGSD national DGSs are permitted to adopt alternative measures such as monitoring and risk minimisation tools. This would present an "un-level playing field" because DGSs outside the Banking Union can continue to carry out the cost-effective alternative measures. Particular attention should therefore be paid to preventive measures applied by Member States to ***ensure there are no competitive distortions in terms of outcomes achieved under limited pay-box and resolution financing mandates under EDIS and those DGSs in Members States applying alternative measures as granted in Article 11 of the DGSD. In this respect the Commission should also clarify the role of DGS in early intervention to ensure a level playing field.***

b.) Uniform definition of target levels: The EDIS proposal mandates all DGSs within the Banking Union to set a target level of 0.8%. DGSs outside the Banking Union under the DGSD can still apply under specific conditions for a derogation to the target level to 0.5%. Thus, there could be a substantial difference in contributions between DGSs, which would preclude a level playing field. ***Before considering a path towards an EDIS, a common target level should be defined. The impact analysis of the EDIS proposal should consider whether a common target level of 0.5% –as already foreseen in the DGSD under certain conditions– could be adequate given that the likelihood of reimbursement of depositors should become significantly remote in view of the strengthening of banks' loss absorbing capacity (capital, MREL, TLAC), early intervention/recovery capabilities and the depositor preference arrangements. In addition, national funds should have comparable and sustainable prefunding capacities to provide contributions to an EDIS before any risk sharing in EDIS can be introduced.*** National DGSs currently have very different accumulated funding levels, ranging from a deficit to an already full or exceeding funding target levels. It is necessary that these levels are considered during the implementation of the EDIS. Contributions to EDIS from national DGS should be fair and equitable in proportion to the respective level of covered deposits in each jurisdiction.

c.) Use of payment commitments: Financial instruments in the form of payment commitments which were introduced under the DGSD are not provided for in the EDIS proposal. This creates the danger that banks subject to the EDIS regulation are burdened beyond the intention of the DGSD, which in turn would lead to a strong inequality between banks within the European Union. Given the level playing-field reasons and the aforementioned strengthening of the regulatory framework, the introduction of a recovery and resolution framework including depositor preference, ***we are strongly in favour to maintain contributions in the form of fully collateralised payment commitments, to be used in the context of EDIS***.

d.) Temporary High Balances and varying set-off provisions: Significant differences between Member States within the Banking Union would occur through e.g. different definitions of Temporary High Balances (THB) and varying set-off provisions (where a depositor's credit may be balanced against its debts) which would have different impacts on the loss given default and financing requirements for DGSs. The level of additional coverage and the duration for which THBs are covered vary significantly in Member States. This would imply that if EDIS were to be implemented according to the Commission's proposal a higher level of protection would be financed by credit institutions in Member States with lower protection. ***Further and prior alignment on these issues is indispensable, in order to create a level playing field within the euro area and for all the EU Member States.***

e.) National insolvency procedures: ***In addition to the above it would be advisable, at least over the medium and long term, that insolvency procedures in Member States should be considered for further harmonisation*** to seek further convergence of outcomes for DGSs in insolvency proceedings. Key aspects, such as the powers of administrators, right of appeal or the length of proceedings, have not been harmonised to date. This can lead to widely differing insolvency dividends and recovery rates.

IV. Balance sheet review and resolvability assessments of indirectly supervised SSM banks
The EBF urges that banks located in the Banking Union which have not been subjected to an Asset Quality Review (AQR) so far, i.e. as before the start of the SSM, be assessed in terms of their balance sheet and resolution plans. Without this necessary pre-assessment and the accompanying remedial actions, those banks should not be able to benefit from the intervention of an EDIS.

B. Principles and fundamental features for the design and calibration of an EDIS

While working towards ensuring the fulfilment of the above first steps, the EBF would like to highlight the following key principles and features which should be adopted in the final design of EDIS:

1. EDIS as a means to overcome large local shocks and break the link between banks and sovereigns: ***An EDIS should be able to provide liquidity in the form of credit to participating DGSs within the Banking Union*** (and open to other EU schemes wishing to participate) to address the Commission's objective to limit liquidity shortages. The initial aim should be to support vulnerable jurisdictions, which are in the process of implementing the DGSD and building up their national DGS funds, in times of large shocks. The need for further risk sharing and loss mutualisation should be further considered in a thorough and prior impact assessment taking into account the new regulatory requirements to protect insured depositors, ensure financial stability and avoid any liquidity ring-fence practice.

2. Membership scope of the scheme: ***All banks collecting deposits in the Banking Union or in jurisdictions wishing to participate in the scheme should contribute to the funding of their respective national schemes and thereby indirectly to an EDIS.*** The EDIS funding target level and allocation of contributions should ***duly reflect the scope of institutions which would benefit from the EDIS***. In particular, no exceptions should be made for specific banks depending on their affiliation to certain parts of the banking sector. We would like to point out that the Commission's proposal does not provide any guidance regarding joining the EDIS by countries adopting the euro or by countries concluding agreements to participate voluntarily

in the Banking Union. *The proposal should indicate specific procedures and transition periods for accession candidates to the EDIS scheme* safeguarding an equal treatment vis-à-vis existing EDIS participants.

3. Cost neutrality: Cost neutrality is an absolute condition for the political acceptability of an EDIS and *there should be no overall increase in individual contributions or administrative burden to deposit insurance*. The Commission proposal stipulates that Member States may allow national DGSs to compensate or reimburse credit institutions from the contributions paid to EDIS, if the DGS has funds in excess after respecting the funding path described in the Article 41 (j). Such a mechanism, however, if legally possible at all, fails to ensure cost neutrality given that the decision to compensate/to reimburse is at the discretion of the Member State and of the national DGS. EDIS thus threatens to be not cost neutral for banks when national governments do not decrease DGS contributions, which they are not obliged to. In those countries where the protection fund is not fully independent, changes in DGS contribution levels have an immediate impact on national budgets, thus making it unlikely that these governments decrease them.[2] On this most critical issue we strongly believe that the compensation/reimbursement should be mandatory instead of optional i.e. *by imposing the decrease of DGS contributions in the regulation itself, or by changing the rules on accounting of government budgets, adding EDIS contributions as an income*. A more effective alternative to achieve cost neutrality would be for contributions to be paid by national DGS's to EDIS rather than by individual banks (see below).

4. Payment of contributions to EDIS: Banks are supposed to pay their contributions directly to EDIS (see Article 74 (c) (2) of the Commission proposal), while also contributing to their national deposit guarantee fund during the first building up phases. For cost efficiency and operational purposes, we believe that *banks should pay both contributions to their national DGS* which will in turn forward them to the EDIS. Having two separate systems of contributions will create an unnecessary additional and complex administrative structure and burden to calculate individual bank contributions, which will lead to dual invoices, different contributions dates, financing paths and means. National DGSs are already well equipped to raise contributions.

5. Conditions for drawing on funding: In the reinsurance phase *EDIS interventions should be limited to strictly predefined cases which should be exceptional in nature and subject to strict conditions and consequences to limit moral hazard*, i.e. only in cases where national means are fully depleted and the DGS is compliant with the DGSD and its implementation timetable. The conditions for drawing on the liquidity facility from the reinsurance scheme are not specified in the proposal. We suggest incorporating these conditions into a regulation.

6. Drawing of the funds should bear strict consequences: If and when the reinsurance is activated, *it should be considered how the DGS which is using the facility repays the borrowed money back* taking into account recoveries, affordability and procyclical impacts of ex-post contributions for its members. Also, *drawing events should trigger heightened supervisory vigilance* with regard to similar or interconnected banks and if necessary require enhanced supervision and reporting to determine whether further preventive or resolution measures are needed to avoid further bank failures in the Banking Union.

7. Ensuring fast pay-out: EBF Members are sceptical about the process to trigger and to operate the deposit guarantee by an EDIS. At first, the participating national DGS should inform the SRB of the likelihood of a pay-out event (Article 41 (k-l)). Then the Board should decide on the coverage (Article 41 (m)). Further, EDIS should disburse the funds to the DGS that will ultimately operate the pay-out (Article 41(n)). In light of the obligation to cover the deposits in seven working days (DGSD), *we believe that the process should be improved to ensure the effectiveness of the fast pay-out objective.*

[2] Eurostat Manual on Government Deficit and Debt - Implementation of ESA 2010, pr. 43: Due to EU calculation methods of government deficit and debt, DGS contributions are treated as fiscal income for the state and remain there when the protection fund is not fully independent according to the 'rather high' ESA 2010 standards.

8. Need for monitoring and risk based contributions: The ECB since the fall 2014 directly supervises a number of systemically important banks in the Banking Union. However, the national supervisors are still responsible for thousands of other (i.e. smaller) banks, albeit with a 'back-up' responsibility and competence of the ECB. Due to this two-layer structure of banking supervision in the euro area, the possibility of varying supervisory approaches and risk exposures remains. To compensate for this potential structural mismatch of prudential supervision and deposit insurance at Banking Union level, *banks should be given incentives by EDIS to reduce risk taking along with other regulatory risk minimising measures. To minimise moral hazard, the risk assessment of contributions should be focused on the risk of loss that each bank poses to the EDIS including as evidenced by its prudential capital and liquidity levels and resolvability and bail-in capabilities.*

The proposal empowers the European Commission to determine by means of delegated acts the criteria for spreading out in time the contributions to EDIS, as well as the criteria for establishing annual contributions (Article 74 (b)). Given that ex-ante funding, as well as the constitution of a DIF at Banking Union level, represent the essence of an EDIS, *it is of utmost importance to further define and calibrate the criteria for these contributions in the proposal to be agreed by the EU Institutions.*

9. Investments: Recital 32 of the EDIS Regulation calls for the assets of EDIS to be invested in a diversified manner. The assets of EDIS are to be invested in accordance with Article 75 of the SRM Regulation. Unfortunately, Article 75 of the SRM Regulation emphasises the obligations issued by "the Member States" as the primary investment instruments, thereby potentially causing the EDIS to merely fund governments of the Member States. This is in sharp contrast with the objective of breaking the feedback loop between sovereigns and banks. Consequently, *it would be prudent to ensure that the investments of EDIS and the SRF be adequately diversified in geographical terms to highly liquid, top-rated sovereign bonds also outside the EU area (any currency risk flowing from such diversification could be hedged to the extent desirable).*

10. Consumer/depositor awareness/confidence: Currently, there is no mention in the proposal with regard to depositor information. Depositor awareness is one of the core principles (Principle 10) prescribed by the International Association of Deposit Insurers (IADI), an international standard setter, for effective deposit insurance systems in order to foster trust and confidence.[3] Depositors across the EU need to understand and be made aware that their money is protected to the same level regardless of where they deposited it, thereby ensuring depositor confidence and thus contributing to financial stability and the integration of banking markets. *An EDIS should not heighten the distance between the individual depositors and the deposit protection scheme which could entail comprehension problems for depositors. The possible recourse to EDIS should be communicated and explained to depositors of banks within the Banking Union to foster depositor confidence. An EDIS therefore needs to maintain close link and be accessible to local and ordinary depositors.*

11. Authority to manage deposit insurance: While *the majority of EBF Members support the proposal for the Single Resolution Board (SRB) as the authority to manage or support an EDIS*, we are aware that this choice could lead to potential conflicts of interest, as the SRB would be responsible for two different pillars of the Banking Union, including their respective funds. *Proper firewalls and divisions of governance should be put in place to ensure independent decision-making within the SRB and avoid conflicts of interest.*

12. Ensuring access to back up funding: *An EDIS needs to be backed by a guarantee in form of a common back-up financing facility at the Banking Union level.* An EDIS, when implemented can only function well in an area where the perceived health and risk of individual government is inconsequential for banks in the Banking Union.

[3] IADI Core Principles for Effective Deposit Insurance Systems: http://www.iadi.org/docs/cprevised2014nov.pdf

13. Legal basis for a European Deposit Insurance Scheme: ***The EBF is strongly in favour of ensuring a sound and indisputable legal basis for any stage of EDIS to ensure legal certainty.*** In particular it should be ensured that the proposed legal basis of Article 114 of the Treaty on the Functioning of the European Union (TFEU) is sufficient to *de facto* merge national systems and funds into one.