The Difficult Construction of a European Deposit Insurance Scheme: A step too far in Banking Union?

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Abstract

The German government refused to accept the development of a European Deposit Insurance Scheme (EDIS) for Banking Union member states. Publicly, the German government was preoccupied with the creation of a moral hazard that common funds would create for banks in those participating countries that had weak banking systems. This paper argues that to understand German moral hazard concerns it is necessary to look beyond the ideational — notably concerns stemming from German Ordo-liberalism — and focus on the existing national institutional arrangements that the German government sought to protect. German moral hazard concerns stemmed from the fear that well-funded German deposit guarantee schemes (DGS) — especially those of small savings and cooperative banks — could be tapped to compensate for underfunded (and largely ex post funded) DGS in other member states. We thus demonstrate that the difficulties facing the construction of an EDIS owe to the weakness of the previously agreed harmonisation of national deposit guarantee schemes (DGS). This failure to harmonise schemes beyond a low minimal standard

can be explained through an analysis focused on national systems. Different existing national DGS stem from the different configuration of national banking systems, the longstanding relationships among national banks and well-entrenched regulatory frameworks.

Introduction

The construction of a European Deposit Insurance Scheme (EDIS) has been presented by the EU Commission and the ECB and a number of economists and economic think-tanks as a crucial pillar to the construction of Banking Union (Wolff 2016; IMF 2013a). For many, it is unlikely that an EDIS would ever have to be called upon, due to the existence of a system for sharing risk should be sufficient to build depositor (and investor) confidence in national deposit guarantee schemes (DGSs) and, consequently, national banks (Wolff 2016).[1] Despite this confidence, a number of euro area member states — led above all by Germany — expressed strong opposition to the creation of an EDIS.

This paper explains why the creation of an EDIS has been so particularly challenging. First, there was concern regarding the financial imposition upon banks of healthier

[1] More specifically, the inclusion of depositor preference in the EU's 2014 Bank Recovery and Resolution Directive (BRRD) means that depositors will only become part of the bank's bail-in if bank losses are very large and claims by more junior creditors are insufficient to fill the gap or if financial stability concerns impose losses on other creditors above those implied by the need to resolve the problem at minimum cost.

national banking systems — first and foremost Germany — which would have to make a contribution to the EDIS. This commitment to potential financial transfer via the banking system as opposed to the public purse — was politically unpalatable for policy-makers in these countries. Second, there was the perception of moral hazard highlighted repeatedly by the German finance minister, concerning the manageability of real and possible bank losses. However, this article focuses upon another explanatory factor of national preferences on the EDIS: the different configuration of existing national DGS. Different national DGS were in turn linked to the different configuration of national banking systems. Different DGS configuration directed both national policy on the difficult revision of the DGS directive and emphasis placed upon moral hazard in the formation of national preferences on the EDIS.[2]

This paper contributes to four main bodies of scholarly literature. First, it adds to a small but growing political economy literature on financial systems — starting with Zysman's (1983) pioneering work, followed by Allen & Gale (2000), Busch (2009), Deeg (1999; 2010), Hardie & Howarth (2013) and Hardie *et al*. (2013) which engage in a comparative analysis of financial (or specifically banking) systems. Second, the

[2] The focus on banking system and DGS configuration as the main explanatory factor of national preferences does not deny the importance of the legal disagreements to the eventual construction of the EDIS. The EU Commission, the ECB and a number of member states argued that EDIS was an extension of EU policies to foster economic integration and that the EDIS's legal basis was therefore Article 114 TFEU. Germany and a number of other member states argued that the EDIS would be a new European financial instrument and thus required Treaty change to adopt. Changing the Treaty required a unanimous vote, thus giving Germany the power to veto any proposal.

paper contributes to the comparative political economy literature on Varieties of Capitalism and the financial and sovereign debt crisis (Hall 2014) and specifically national banking systems and the recent crises (Hardie & Howarth 2013; Quaglia & Howarth 2013) by examining how the specific features of national banking systems directed government preferences on both national DGS, the EU DGS directive and the EDIS. Third, this paper contributes to the emerging literature on the politics and political economy of Banking Union (Donnelly 2014; Howarth & Quaglia 2013, 2014, 2016; Schimmelfennig 2016; Salines *et al*. 2012, Spendzharova 2014) which feeds into the vast literature on EMU and European economic governance, more generally, and national preference formation on EMU, more specifically (for example, Dyson 2000; Dyson and Featherstone 1999; Verdun 2000; Walsh 2000). Fourth, this paper contributes to the literature on deposit guarantee schemes dominated by financial economists and legal scholars (Ayadi & Lastra 2010; Demirgüç-Kunt *et al.* 2005, 2008, 2014; Bernet & Walter 2009).

This paper is organised as follows. We first summarise the main functions and feature of DGS and EU legislation on DGS, prior to its 2014 reform. Second, we summarise the progress of discussion on the EDIS. Third, we examine the main rationalist and moral hazard arguments presented by a number of EU member states to explain opposition to the creation of a pan-EU or euro area / Banking Union scheme. Fourth, this paper presents the main features of existing DGS in six member states which reflect the structure of national banking system. Existing DGS in turn shaped national preferences on the revision of the DGS directive and the creation of a pan-EU scheme — the subject of the fifth section.

The main functions and features of deposit guarantee schemes

Most of the world's wealthier countries had statutory DGS schemes prior to the 1990s, while some also had voluntary schemes (Demirgüç-Kunt *et al.* 2005, 2008, 2014). In the EU, all schemes had to meet minimal standards set in the DGS directive adopted in 1994 and then in the revised version which was finalized in June 2014. The original DGS directive required all member states to operate a scheme for at least 90 per cent of the deposited amount, up to at least €20,000 per person. Most EU member state DGS far exceeded this minimal amount. Despite changes to the 1994 directive in the aftermath of the international financial crisis and the 2014 revision, national DGS specificities continued.

Some EU member states had multiple statutory public or private deposit insurance schemes for different types of financial institutions. The DGS could be organized as a separate legal entity, or could be under the jurisdiction of the banking supervisor, the national central bank, or the Ministry of Finance. Countries could choose to fund DGS *ex ante* by collecting premiums on a scheduled basis, others did that *ex post* from surviving institutions once a bank has failed. Some countries had contingency plans in the case of a shortfall of funds to cover deposits that included government support (Demirgüç-Kunt *et al.* 2005, 2008, 2014). Some DGS used different measures to calculate the premiums for different banks so as to take into account the level of risk. Domestic banks were covered by the DGS, but not necessarily subsidiaries or branches of foreign banks. In the EU, deposits in foreign branches were covered by the home-country DGS and deposits in foreign subsidiaries were covered by the host-country DGS (IMF 2013b). Deposits in branches of non-EU headquartered banks were required to join the host country DGS, unless the home (non-EU) countries were

recognized as having national DGS similar to the EU's (IMF 2013b; Demirgüç-Kunt *et al*. 2008).

DGS usually insured deposits up to a statutory coverage limit. The level of coverage was the level of protection granted in the event of deposits being unavailable under national law, not applying coinsurance. The most common form of DGS coverage was coverage at the 'per depositor per institution' level. However, some countries covered deposits per depositor, or per depositor account. Different types of deposits were affected differently by DGS. Insured deposits were deposits obtained from eligible deposit types when applying the level of coverage provided for in national legislation (Bernet & Walter 2009). Coverage of interbank deposits was less common than that of retail deposits, the assumption being that financial institutions should be capable of monitoring the level of risk of their deposits. However, in times of financial market stress, interbank deposits could be guaranteed to encourage the free flow of liquidity across banks.

The adequacy of national DGS was severely tested during the international financial crisis in 2007-8. In April 2008, the Financial Stability Forum (FSF) (2008) — the predecessor of the G20's Financial Stability Board — pointed out that the global financial crisis demonstrated the importance of effective DGS. In 2009, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) jointly issued some *Core Principles for Effective Deposit Insurance Systems*. Together with the International Monetary Fund (IMF), the World Bank, the European Commission, and the European Forum of Deposit Insurers, they also issued in December 2010 a methodology to enable assessments of compliance

with these core principles. In February 2011, the FSB agreed to include the *Core Principles* in the list of key standards for sound financial systems that deserve priority implementation depending on country circumstances. The IMF and the World Bank included the assessment of the compliance with these standards in their Reports on Observance of Standards and Codes (ROSC) program (FSB 2012: 2-3).

A pan-European scheme: on the agenda and off again

As early as July 2010, as part of its legislative proposal to amend the DGS directive, the Commission called for the establishment of a network of guarantee schemes as a first step towards a 'pan-European deposit guarantee scheme' to cover all EU-based banks (Commission 2010: 5). Such a pan-European scheme however presupposed full harmonization of national schemes and could only enter into force after a minimum fund of 1.5 per cent of eligible bank deposits had been reached in all the member states. One of the most contentious provisions in the Commission's proposed 2010 directive was the establishment in 2020 of a compulsory mutual borrowing facility through which a depleted national deposit guarantee scheme had the right to borrow from another national fund. Several member states — notably the German and Austrian governments — sought to remove this provision during negotiations in the Council. It was feared that the mutual borrowing facility would be the first step towards a pan-EU DGS, as explicitly stated by the European Commission (2010) in its memo accompanying the proposal — which was even more controversial. Indeed, during the preparation of the proposal for the revised directive in 2010, the Commission considered the establishment of a single pan-EU scheme. However, the Commission shelved the plan because of German opposition and legal difficulties — notably the possible need for treaty change (Commission 2010b). The clause adopted

in the DGS directive (Art. 9a) allowed national DGS to transfer credits to other national DGS on a purely voluntary basis. Article 12 of the revised DGS directive stipulated that national DGS could borrow from each other on a voluntary basis if a number of conditions (seven in total) were met. Moreover, the borrowing DGS would be under legal obligation to repay the loan within five years, paying interest on the amount borrowed.

In June 2012, the 'Van Rompuy Report' (also known as the 'Four Presidents' Report') included a European Deposit Insurance Scheme (EDIS) as a key component of Banking Union. The report stated that an EDIS 'would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured' (2012: 4). It also noted that the scheme:

> and the resolution fund could be set up under the control of a common resolution authority. Such a framework would greatly reduce the need to make actual use of the guarantee scheme. Nevertheless, the credibility of any deposit guarantee scheme requires access to a solid financial backstop. Therefore, as regards the euro area, the European Stability Mechanism could act as the fiscal backstop to the resolution and deposit guarantee authority (p. 4).

A deposit insurance scheme provides protection to bank depositors, reimbursing the deposits of clients of a failed bank up to a certain amount. It is designed to prevent a 'bank run' — that is, panic withdrawals by customers of their bank deposits because of fear of collapse. In so doing, it also supports the overall stability of the financial

system (Financial Stability Board (FSB) 2012: 8). The issue of deposit guarantee schemes is related to the creation of a resolution framework for banks. A range of expert observers (including IMF economists) and the EU four presidents argued for an EDIS to be a key component of Banking Union. In July 2012, the IMF Executive Board argued in favour of Banking Union 'comprising a pan-European deposit guarantee scheme and a pan-European resolution scheme — both backed with common resources'. ECB Vice President, Vitor Constâncio (2014) stated that:

> [s]uch a scheme would have several benefits. It would be commensurate to the centralized supervisory regime, and ensure that decisions that are taken on a centralized level affect depositors in all countries in the same way, thus ensuring a level playing-field. Depositors would be treated in a uniform way across countries, independently of their location and the location of the bank to [which] they have entrusted their savings.

Moreover, an EDIS could be more credible and better able to mobilize financial resources than national schemes. An EDIS could also undermine the potential distortions to the Single European Market created by different national schemes, as highlighted during the international financial crisis (see below).

In theory, three main options could have been pursued: a pan-EU DGS for all banks in Banking Union; a pan-EU DGS for all systemically important banks in Banking Union; and a system of 'solidarity' between national DGS, similar to that initially proposed by the Commission for the revision of the DGS directive in 2010. In fact, none of these options was pursued: determined Germany hostility forced the

Commission to drop the EDIS off its agenda in 2012 (*Financial Times*, 12 September 2012; House of Lords 2012b: 37; 2014: 45).

According to the *Financial Times* (13 September 2012), the Commission had prepared a draft proposing a new agency, the European Deposit Insurance and Resolution Authority (Edira), which would control a new European Deposit Guarantee and Resolution Fund. Edira would be financed through a regular levy on euro area banks and would become the ‘single resolution authority’ for Banking Union, replacing national deposit guarantee schemes. Due to German opposition, the proposal for Edira was removed and the final Commission document ‘A Roadmap Towards Banking Union’ only discusses an EDIS briefly (*Financial Times*, 13 September 2012). By December 2012, the establishment of an EDIS had disappeared from the policy agenda. The so-called ‘Van Rompuy Report’ issued in December 2012 only made reference to the ‘Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry’ (p. 4).

The issue returned to the EU agenda only in June 2015, EU leaders — including ECB president Mario Draghi and Commission President Jean-Claude Juncker — endorsed the creation of an EDIS in the so-called ‘Five Presidents’ Report’ on the future of the euro. In the autumn of 2015, the European Commission with the keen support of the ECB reintroduced the creation of an EDIS to the EU-agenda (*Reuters*, 11 September 2015; *Financial Times*, 21 October 2015). Commission Vice President, Valdis Dombrovskis, pledged the launch of draft legislation on the EDIS by the end of 2015 as part of a broader policy package he unveiled designed to reinforce the euro. The

Commission proposal would, as a first step, involve the establishment of a mandatory 'reinsurance' scheme that would 'contribute under certain conditions when national deposit guarantee schemes [DGS] are called upon', thus in effect act as a backstop to national DGS (*Financial Times*, 10 September 2015). In late 2017, the adoption of the EDIS resurfaced on the Commission's agenda (*EU Observer* XX

'I'm alright Jack' and the moral hazard argument

From the Commission's first proposal of a pan-EU DGS and borrowing mechanism, the main line of division was between those countries that feared that their banks would become net contributors to the scheme, notably Germany, and those countries experiencing major problems in their banking system — for example, Spain and Ireland — the banks of which were more likely to resort to the scheme (Howarth & Quaglia 2014; 2016; Donnelly 2014). Member state governments that opposed the creation of an EDIS did so for two main reasons. The first was opposition to the imposition of potential costs to banks (and thus depositors) of member states with more stable banking systems. The second was concern for the creation of a moral hazard for banks (and thus depositors and potentially regulators / governments) which could draw on European funds to support their own schemes.

The German, Dutch, Austrian, Finnish, British and Swedish governments baulked at the prospect of their banks and thus potentially depositors underwriting depositors in other member states with unstable banking systems. The Finnish government (2016) pointed out that: '[d]ifferences between countries in banking sector regulation and risks are, however, so big that the benefits and costs of European deposit insurance would be unevenly distributed'. For several non-euro area member states — including

the UK and Sweden — where the Treasury and / or central bank provided the fiscal backstop to deposit insurance schemes — a pan-EU scheme and borrowing mechanism was also unacceptable because of the potential implications for the public purse and thus taxpayers. The British government opposed the proposal of a mutual borrowing facility in the revised DGS directive on the grounds that it posed 'an unpredictable and unacceptable fiscal risk to the UK Treasury' (House of Commons, European Scrutiny Committee 2010-11: 39).

A number of northern European governments expressed moral hazard concerns indirectly. The Dutch government, for example, pointed out that:

> a final condition for full burden sharing is that banks which are to participate in an EDIS and resolution fund must have equal starting positions. Before banks can qualify for a European resolution and deposit guarantee funding, their financial positions must be comparable (Netherlands government 2012, authors' translation).

However, the most explicit presentation of moral hazard concerns to justify opposition to the creation of an EDIS came from the German government. German opposition to the EDIS paralleled its reluctance on the creation of the three other pillars of Banking Union (Howarth & Quaglia 2016).[3] The German government criticised the EDIS

[3] It should be noted that moral hazard concerns shaped German government reluctance on the creation of the Single Resolution Mechanism (SRM) but did not prevent agreement. However, on resolution the German government insisted that the new Single Resolution Fund (SRF) be created through an intergovernmental side

proposal as an unacceptable step towards debt mutualization (*Financial Times*, 13 September 2012). All the main political parties in Germany opposed it. The coalition agreement between the Christian Democratic Union (CDU), the Christian Social Union (CSU) and the Social Democratic Party (SPD) explicitly rejected the idea (*Koalitionsvertrag* 2013: 94). The German finance minister, Wolfgang Schäuble argued that it was unacceptable that the 'backstopping of depositors [could] become an excuse for banks to behave irresponsibly, potentially leaving German taxpayers to foot the bill' (*Financial Times*, 10 September 2015). Schäuble placed priority on measures to ensure that banks had big enough buffers of capital and debt to absorb financial shocks, and that authorities could force losses on creditors without facing litigation, should 'have priority' (cited in *Financial Times*, 10 September 2015). Schäuble argued that '[the German] objective [was] to further reduce banking risks as well as separate the risks of banks and state. … The creation of a single deposit guarantee scheme [was] not adequate for this objective' (*Financial Times*, 11 November 2015). For Schäuble, 'There [was] a moral hazard problem. As soon as you share risk, the decisiveness to reduce risk is lessened. That is what happened over the past few years' (*Financial Times*, 8 December 2015). In a February 2016 article penned by Ludger Schuknecht for the *Frankfurter Allgemeine Zeitung*, the chief economist of the German Ministry of Finance, labeled the EDIS 'An insurance scheme that only ensures problems' and pointed to the wrong incentives and rising stability risks for

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agreement rather than EU legislation in order to ensure the maintenance of national control over the use of SRF funds to supplement national resolution funding in the resolution of banks. The creation of the EDIS however implied automatic access to European funds to cover insured deposits in the event of exhaustion of national DGS funds.

both national governments and banks that such a scheme would create. In September 2015, the German government produced a non-paper which pointed out several necessary steps forward to make Banking Union a success, without mentioning an EDIS (Federal Government 2015). Despite this strident opposition, the European Commission published its draft directive in November 2015.

By contrast, France and euro area periphery countries regarded an EDIS as the final pillar of Banking Union, necessary to sever the doom loop between banks and sovereigns, preventing deposit flights in countries hit by the sovereign debt crisis (*Reuters*, 11 September 2015). For example, the Italian authorities repeatedly pointed out that the SSM should be complemented by a SRM and an EDIS because 'coherence was needed between the centralisation of supervision and the management of financial difficulties' in order to achieve the objectives of Banking Union (Szego, 2013: 7, authors' translation). Similarly, the Spanish government emphasized the need to agree the basis and the date for the EDIS to complete Banking Union (Rajoy 2013). However, prior to mid-2015, these countries focused their efforts on the creation of the SRM (and SRF) (Saccomanni 2013), on which there was a proposal under negotiation — rather than lobby for an EDIS, which was seen as a lost battle.

National preferences and divergent DGS across the EU

In Europe, most national DGS were set up as a consequence of a series of banking failures in the late 1970s and early 1980s, although some countries, for example Germany, had set up their system earlier.[4] In 1994, the EU issued the DGS directive,

[4] Between 1977 to 1983, France, the Netherlands, Spain, and the United Kingdom set up national DGS, and Germany revised its existing system. Following the European

which was based on minimum harmonization. The directive also established harmonized rules concerning the compulsory participation of branches of non-EU banks in national DGS in the host country and the non-participation of branches of EU banks in national DGS in the host country, unless they sought to opt in with the aim of obtaining extra coverage. However, member state implementation of the directive was largely undertaken in ways that were suitable to national banking systems and the existing national DGS. Hence, the national DGS remained distinctive (see Garcia and Prast 2003; 2004). Table 1 summarises the main differences among national banking systems and among the national DGS.

Germany

The most obvious examples of national banking systems shaping national DGS were in EU member states with distinct banking pillars — and notably Germany and Austria — where separate DGS and institutional protection schemes were set up by commercial, savings, cooperative and other public banks. Furthermore, the German and Austrian schemes were largely funded through *ex ante* bank contributions — that is, in advance. This funding model reflected the small size of the savings and cooperative banks where *ex ante* contributions helped to build confidence in the deposit guarantee and *ex post* contributions might be financially unmanageable (IMF 2011b).

Commission's (non-binding) recommendation concerning the establishment of national DGS, Italy set up a voluntary scheme for commercial banks in 1987, while Italian cooperatives had set up their own voluntary scheme in 1978 (Garcia and Prast 2004).

Germany had two mandatory DGS (private / public banks), two voluntary DGS (private / public banks), two institutional protection schemes (one for saving banks, Landesbanks and Landesbausparkassen, with several regional and national sub-schemes, and one for cooperative banks), and one voluntary DGS for building and loan associations (Bausparkassen). Commercial banks were part of a statutory, legally enforceable, but privately-run scheme supervised by the German Federal Financial Supervisory Authority (BaFin) — the coverage provided for deposits was €100,000 and estimated at more than 90 per cent of retail deposits with commercial banks. The German Banking Association offered its private commercial bank members additional coverage through a private voluntary scheme amounting to 30 per cent of the bank's capital per depositor, constituting a *de facto* full compensation scheme. This voluntary system did not have administrative powers or legal claim to compensation and was not supervised by BaFin.

Savings banks and Landesbanks had largely *ex ante* funded (risk-based) institutional protection schemes which were set up under regional arrangements and were coupled with additional *ex post* burden-sharing provisions (Bülbül *et al.* 2013). Further, support could be provided through an inter-regional arrangement among the regional schemes and an additional arrangement (that included the Landesbank schemes and the state building society schemes), although there was no legal obligation to provide assistance (IMF 2011b). Cooperative banks (Volks- and Raiffeisenbanks) were members of their own institutional protection scheme run by the Association of German Cooperative Banks, which took the lead in resolving failed member banks. *Ex ante* funding (risk-based) could be complemented by *ex post* funding from member banks, although there was no legal obligation to provide assistance. Savings and

cooperative banks did not participate in the statutory national DGS except if the national supervisor (BaFin) decided that their own schemes failed to fulfil required conditions.

The ratio of retail deposits protected under the institutional protection schemes of savings and cooperative banks was even higher than in the private sector (IMF 2011b). The total coverage under these schemes was also very high in comparison to other countries and very broad — it included all the liabilities of participating institutions. The institutional protection schemes attracted criticism for weakening market discipline and lacking close oversight by BaFin due to their private legal nature (see, for example, IMF 2011b). The IMF (2011b) and Financial Stability Board (FSB) (2012) both recommended the move towards a more uniform statutory deposit insurance regime — strongly resisted by both the savings and cooperative banks, and German regional and federal governments.

German (and Austrian) banking associations and individual banks feared that an EDIS would impinge upon their sectoral institutional protection schemes (*Handelsblatt* 7 November 2012; Kaiser 2012). Moreover, German banks with their well-funded ex ante schemes, feared that they would likely become net contributors to an EDIS — bailing out depositors in other euro area member states given the widespread reliance on ex post funded DGS. This structural reasoning thus also shaped Wolfgang Schäuble's moral hazard concerns regarding banks in those participating countries that had underfunded (and largely ex post funded) deposit guarantee schemes.

France

The French DGS reflected the highly concentrated French banking system, dominated by five large banks, principally in terms of the 'pay box' and the limited amount of ex ante funds. The DGS in France was managed by the Fund for the Guarantee of Deposits and Resolution (FGDR) which, prior to 2013 was the *Fichiers des Guichets Domiciliatires*. The French DGS operated through three mechanisms created to protect both depositors and investors: a 'pay-box' scheme for pay-outs to depositors in failing insured banks up to a maximum of €100,000 per depositor within 20 days, which was in line with but potentially far more generous than the existing EU legislation on DGS; a resolution mechanism for ailing banks, designed to reduce the risk of loss to depositors; and an investment guarantee scheme providing compensation to clients affected by fraud or other losses.

The FGDR was a privately-owned institution funded by approximately 582 participating banks (end 2014 figures). Banks paid in a one-time contribution to the Fund, a yearly fee based on the amount of deposits covered in each institution by the Fund, and exceptional contributions if the Fund was depleted due to pay-outs. The FGDR could also raise funds in the financial markets. There were no contingency credit lines from the government. At the end of 2010, the Fund held slightly above €2 billion or 0.21 per cent of total covered deposits, rising to just above €3 billion at the end of 2014 (IMF 2012b; FGDR 2015). The implementation of the revised DGS directive was to raise the recommended *ex ante* funding target level significantly.

Prior to the implementation of the revised DGS directive agreed in late 2014, the FGDR was limited in relation to the total amount of covered deposits. The Fund took the view that resolution of a systemically important French bank would not lead to a

pay-out to indemnify depositor claims, but rather to resolution measures — for instance, facilitating a sale of some assets and liabilities (FGDR 2015). This requirement of selling off assets (rather than raising the deposit cover provided) was a reflection of the large size of the biggest French banks, which were better positioned to sell off assets, than, for example, small German banks. Financial support from the FGDR could be used either for compensation to depositors or for recovery actions in order to prevent the disorderly failure of a bank. This financial support was not subject to an explicit 'least cost' criterion — whether the cost of providing financial support was likely to be lower or higher than that of a pay-out to depositors in liquidation. However, in practice, a 'least cost' consideration was seen as inevitably shaping Fund decisions (IMF 2012b).

The Netherlands

The Dutch DGS, the Collective Guarantee Scheme, was established in 1978 and existed until reforms in mid-2013 designed to implement the revised DGS directive (Garcia and Prast 2003). Similar to France, the design of the scheme reflects the highly concentration of the Dutch (retail) banking system. The Scheme was funded *ex post* (through a 'pay-box' system) and in the event that available funds were insufficient for the full coverage of insured deposits, public authorities were not explicitly authorized to provide additional funding. As in France, insured depositors were not given priority right over shareholders. Ex-post assessments were made case-by-case based on several items of data reported to the central bank. The contribution amounts were determined after consultation with the Bankers' Committee. Only deposits of small enterprises, small foundations, and households were protected. The coverage limits were €20,000 from 1998 to 2008, conforming to the minimum established in EU legislation, and

then expanded with the adoption of the revised DGS directive to follow the revised required EU minimum amounts. The Netherlands, with its few big banks, only just met the EU legal minimum and only *ex post*. The Rabobank ran its own institutional protection scheme with its component banks (small cooperatives), thus rendering less necessary additional deposit guarantee requirements, and making the Dutch authorities less well disposed towards an EDIS.

Italy

As in Germany and Austria, the Italian DGS for banks consisted of two schemes covering different banking types. One DGS, the Interbank Fund for Deposit Guarantee (*Fondo Interbancario di Tutela Dei Deposit*) was set up by banks incorporated as joint-stock companies and cooperative banks; a second the Fund for Deposit Guarantee of Cooperatives (*Fondo di Garanzia dei Depositanti del credito cooperative*) was set up by mutual banks. The two DGS were initially established as private-law consortia and voluntary systems supervised by the Bank of Italy but membership became compulsory with the passage of the first DGS directive in 1994. As of 31 December 2012, there were 241 banks participating in the Interbank Fund for Deposit Guarantee and 398 in Fund for Deposit Guarantee of Cooperatives (IMF 2013c).

The two sectoral schemes were primarily entrusted with depositor pay-out in the context of bank liquidation, but had a broad mandate to provide guarantees, credits, acquire equity and fund purchase and assumption transactions (which concern resolution), provided that they were less costly than a pay-out. Such interventions were subject to Bank of Italy approval. The DGS were both *ex post* funded, with

contributions provided by participating banks as and when required. For the Interbank Fund for Deposit Guarantee, this amount varied between 0.4 per cent and 0.8 per cent of the total covered deposits (end 2012 figures). The total value of covered deposits as a percentage of eligible deposits covered by the Interbank Fund for Deposit Guarantee was 68.7 per cent, while that of the Fund for Deposit Guarantee of Cooperatives was 65 per cent (end 2012 figures; IMF 2013c). The revised DGS of 2014 changed the level of covered deposits and some bank contributions became *ex ante* in Italy.

The Italian national DGS was one of the few nation-wide schemes providing deposit guarantees in excess of €100,000, thus well in excess of the original DGS directive, although with no *ex ante* bank contributions, which meant that the de facto coverage was likely to be lower than the nominal amount guaranteed. The comparative generosity of the Italian national system was ascribed to the 'Italian saving culture' and the fact that the DGS could transfer assets and liabilities and provide financial support to banks placed under special administration, as an alternative to the reimbursement to depositors, on the basis of the 'least cost' principle (Commission 2007: 64). Moreover, in Italy, the DGS for cooperatives could intervene even when a procedure had not been formally initiated (De Polis 2015). The Italian government sought to amend the Commission's proposal revising the 1994 directive in order to preserve these distinctive features of the national DGS, and specifically their 'social functions' and 'their ability to engage in early intervention in case of crisis' (Sabatini 2013, authors' translation; De Polis 2015).

Spain

The DGS in Spain was administered by the Deposit Guarantee Fund (*Fondos de Garantía de Depósitos*), which was a private law entity wholly prefunded by the member credit institutions. Until 2011, there were three Deposit Guarantee Funds one for each sector of the banking industry (commercial banks, savings banks, and credit cooperatives). In the context of Spanish banking crisis, the three sectoral funds were merged into a single fund and the premiums were made uniform across the board. From 2011, the Deposit Guarantee Fund Management Board consisted of 12 members: six from the Bank of Spain and two from each of the three banking sectors, with the Bank of Spain Deputy Governor serving as chair (IMF 2012a).

The Deposit Guarantee Fund could be funded in four ways: by ordinary annual contributions, extraordinary contributions, by issuing bonds, or by borrowing from third parties, including the government or Spain's Fund for Orderly Bank Restructuring created in 2009 to transfer public funds to Spanish banks. When the Deposit Guarantee Fund assets reached a level equal to or greater than one per cent of total deposits (approximately €10 billion), bank contributions were to be discontinued. The accumulated assets of the Deposit Guarantee Fund remained low because of the poor state of the Spanish banking system. In 2012, the IMF recommended an explicit backstopping from the Spanish state (IMF 2012a).

The Deposit Guarantee Fund had the objective of guaranteeing bank depositors either through pay-outs or through financial support — subject to approval of the Bank of Spain based upon a 'least cost' analysis — aimed at restoring the viability of banks. The range of financing mechanisms that the Deposit Guarantee Fund could deploy was broad and included both liquidity and solvency support (IMF 2012a). Such financing

varied from credit lines, guarantees, subordinated loans or subsidies to a bank, to the acquisition of bad assets, to the injection of capital for mergers take-overs, or support for asset and liability transfers. In case of bankruptcy, the Deposit Guarantee Fund was to appoint the liquidator, thus controlling the pay-out process. In case of bank liquidation, neither the Deposit Guarantee Fund nor depositors enjoyed any preferential rights over the estate of a failed bank (IMF 2012a) — at least prior to the implementation of the revised DGS directive.

The UK

The Financial Services Compensation Scheme (FSCS) was independent of both government and the financial industry but accountable to the Prudential Regulatory Authority of the Bank of England (and prior to 2012, the independent Financial Supervisory Authority). The FSCS managed five protection schemes for different categories of customers, one of those being insured depositors in deposit-taking institutions (IMF 2011a). As in France, there were no distinct schemes for specific categories of banks, reflecting the domination of the national retail banking market by a small number of institutions. Also, reflecting the high concentration in retail banking, the scheme for insured depositors was *ex post* funded in that when it incurred costs, the member banks would be required to cover these costs on a pro-rata basis (a share of protected deposits up to the compensation limit per individual depositor per authorized bank). In a pay-out situation, the FSCS also had unlimited access to borrow from the National Loans Fund administered by the Treasury with the accounts maintained at the Bank of England. Thus, unlike the euro area member state DGS, the FSCS had a fiscal backstop, as with the Federal Deposit Insurance Corporation (FDIC) in the United States.

FSCS funds could be used to: pay-out to depositors if a bank failed; finance the transfer of insured deposits to another institution under the bank insolvency procedure; and, using the Scheme's stabilization powers, contribute to a non-payout resolution of a failed bank. In this last case, the FSCS could only act upon the order of the UK Treasury and intervention had to be based on the 'least cost' option (IMF 2011a). In the context of bank resolution, the FSCS ranked *pari passu* with unsecured creditors. As in France and the Netherlands (and a number of other EU member states), the UK did not have official depositor preference prior to the finalization of the DGS directive in June 2014 — that is, the FSCS did not give depositors a preferential ranking in insolvency (PRA 2014). However, the Bank of England's Special Resolution Regime's tools and powers were expected to be used so as to achieve a similar outcome to depositor preference. All banks were required to have account systems allowing a 'single depositor view' — i.e., that all deposits pertaining to a depositor could be easily summed up and presented in a list (IMF 2011a).

Negotiating the revised DGS directive

The DGS directive of 1994 set the minimum level of deposit protection schemes in the EU at €20,000 per depositor. However, as the 1994 directive was based on minimum harmonization, national deposit guarantee schemes continued to differ in several important respects, such as the definition of eligible deposits, the level of cover, the types of funding mechanism and the calculation of bank contributions. The global financial crisis that accelerated in late 2008 brought into the spotlight the inadequacy of the 1994 directive (Ayadi & Lastra 2010).

To begin with, the minimum level (€20,000) was considered by many to be too low to placate fears of a bank run, especially given that a number of member states provided a considerably higher legal minimum (Ayadi & Lastra 2010). Deposit protection coverage varied markedly across the EU, ranging from the legal minimum in most of the new member states and the UK to more than €100,000 in Italy and France. Furthermore, uncoordinated decisions on deposit guarantees taken by some member states at the height of the crisis in late 2008 (notably in Ireland and Germany) worsened the crisis (Quaglia *et al*. 2009). It became evident that different national schemes across the EU potentially distorted level playing field competition and created the potential for bank runs because, in the event of financial crises, customers in some member states were prone to shift deposits to banks headquartered in those member states with more generous guarantee schemes.

At the peak of the international financial crisis in late 2008, the Commission proposed legislative changes to the DGS directive. These changes — agreed hurriedly in 2009 — represented an emergency measure designed to restore depositors' confidence by raising the minimum level of coverage for deposits from €20,000 to, initially, €50,000 and subsequently to €100,000. The need for swift action meant that several controversial issues were not tackled and hence the directive contained a clause providing for a broad review of all aspects of deposit guarantee schemes. By 2010, schemes continued to vary markedly across the member states and only 16 out of 27 applied the coverage level of €100,000, or had legislation in place to do so (Commission 2010). When the sovereign debt crisis broke out in the euro area in late 2009, the operation and limited harmonisation of national DGS came back onto the agenda. In July 2010, the Commission put forward a legislative proposal to amend

again the DGS directive with a view to promoting the 'harmonization and simplification of protected deposits, a faster pay-out, and an improved financing of schemes' (Commission 2010: 5).

The German government opposed the Commission's harmonisation efforts to the extent that they menaced the country's self-regulated voluntary DGS (Moloney 2011). German commercial, savings banks and cooperative banks, which each had their own sector-specific institutional protection schemes which also provided funds for deposit guarantees, opposed the Commission's proposal because they feared that they would be forced to establish a second fund based on ensuring deposits (Donnelly 2014). These voluntary sectoral schemes provided indirect protection to depositors, whereas the Commission's proposal called for the creation of funds that specifically covered depositors.

The Commission's push in favour of *ex ante* funding for DGS stemmed from widespread economic opinion (IMF 2013b). The IMF (2013b) discouraged schemes based on *ex post* funding on the grounds that failing banks would not contribute to the guarantee of their own depositors. Moreover, the IMF (2013b) feared that *ex post* schemes could be damaging to a banking system, hitting up banks for contributors to support depositors of a failed bank in difficult economic times when banks could least afford it. Opponents of the introduction of *ex ante* schemes argued that *ex ante* payments would hit banks hard during a difficult period and would further destabilize euro area periphery banking systems (IMF 2013b). Moreover, the UK, Italy, and the Netherlands, which had national DGS based on *ex post* funding, were unhappy about the Commission's proposal on the compulsory adoption of *ex ante* funding for DGS,

as this would have meant having to raise funding from the national banking industry, hence imposing extra costs for the banks (interviews, Commission officials, Brussels, May 2013).

Finally, all member states, but particularly those with low existing coverage and *ex post* funded DGS, opposed the target level and transition period proposed by the Commission. The initial Commission's proposal had been 1.5 per cent of eligible deposits in 10 years, whereas the European Parliament sought a target level of 1.5 per cent of covered deposits in 15 years, and the compromise text agreed by the Council indicated a target level 0.5 per cent of covered deposits in 15 years. On pay-out, the Commission proposed 7 days, the Parliament 5 working days, with some national discretion until 2016 and an immediate emergency payment of €5000, while the Council agreed a pay-out in 15-20 working days. The initial Commission proposal contained 'risk-adjusted premiums' with a strict EU-wide model. Most member states (and the Council) argued in favour of full flexibility in the choice of model, with different degrees of European Banking Authority (EBA) involvement in the establishment of DGS guidelines. The Commission proposed a limited use of funds, whereas most member states (and the Council) sought unlimited use.

The final stage of the negotiations on the revision of the DGS directive took place in 2013 in a trialogue between the Council, Parliament, and Commission, with several controversial issues outstanding. The revised directive was eventually agreed in April 2014 by including several compromises in order to iron out the most controversial issues between the European Parliament and the Council, as well as among member states. The target level for ex ante funds of DGS was set at 0.8 per cent (in between

what was proposed by the EP and the Council) of covered deposits (i.e., about €55 billion) to be collected from banks over a ten-year period. Repayment deadlines were to be gradually reduced from 20 working days to 7 by 2024 (here again the gradualness was a compromise) (Commission 2014).

The target funding level of 0.8 per cent of covered deposits was the minimum level required by EU law. Member states were left free to set higher target levels for their national DGS. In 2014, schemes in about half of member states had already reached the target level (or were above or relatively close to it). According to the Commission (2014) in one-third of member states, DGS funds were above one per cent of covered deposits, and in a few of them, they were even above two per cent. Upon approval of the Commission, member states could set a target level lower than 0.8 per cent (but not lower than 0.5 per cent of covered deposits) if the characteristics of the banking sector (for example, concentration of most assets in a few banks) made it unlikely that banks would be liquidated using the DGS — rather they would be resolved (Commission 2014). This was a concession to the Netherlands, with its highly concentrated banking system, as well as to France, with its five very large banks (*Bloomberg*, 18 December 2013).

In order to appease those member states with *ex post* payment systems — notably the UK, Italy, and the Netherlands — the revised directive envisaged the possibility of 'payment commitments' of a bank towards a DGS fully collateralized by low risk assets. The total share of payment commitments was not to exceed 30 per cent of total DGS funds. In order to appease countries such as the UK that had adopted bank levies

in the aftermath of the international financial crisis, member states were allowed to consider bank levies as equivalent to *ex ante* funds.[5]

In order to cater for the needs of sectoral protection schemes in place in Germany and Austria, the revised directive gave them the choice of being officially recognized as a DGS (and thus be subject to all provisions of the DGS directive), or they could continue their activity as purely institutional protection schemes. In the latter case, they would not be subject to the directive, but member banks would have to also contribute to an official DGS in that member state. In order to appease banks that were members of voluntary sectoral schemes, their lower risk linked to mutual protection could be taken into account when risk-based contributions to DGS were calculated.

The contributions to DGS were to be based on the amount of covered deposits and the degree of risk incurred by the respective bank member. Member states could set lower contributions for low-risk sectors governed by national law. In order to ensure consistent application of the DGS directive in member states, the European Banking Authority (EBA) was to issue guidelines to specify methods for calculating the contributions to DGS. These guidelines were published in May 2015 (EBA 2015). In its 'feedback on the public consultation' (pp. 66*ff*), the EBA noted that respondents supported the mandatory *ex ante* collection of contributions on the grounds that this would work to strengthen confidence in DGS across EU member states.

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[5] The term 'bank levies' refers to, for example, the mandatory contributions paid by banks to the State budget for the purpose of covering the costs related to systemic risk, failure, and resolution of institutions.

However, the EBA also noted the importance that respondents placed upon flexibility, 'due to the variety of national banking structures throughout the Union' (2015: 66). The EBA 'acknowledge[d] the difficulty of developing a methodology which [would] cater for the specific features of banking structures of all Member States' (2015: 66). There was also concern that the EBA guidelines would not allow sufficient flexibility for voluntary sectoral protection schemes (as for German savings banks) since the formula for the guidelines were based predominately on covered deposits. The EBA (2015) responded by promising further modification to the guidelines so that they would be amended to take into account important features of institutional protection schemes (for example, their business model and risk profile).

In 2015, there were ongoing debates as to the composition of EU-wide core risk indicators which were to determine bank contributions to DGS. Differing bank and government positions stemmed from bank business models and structural differences in national banking systems and / or different regulatory and supervisory practice. The absence of a universal definition of the nonperforming loan ratio was seen as a major problem that could undermine harmonized implementation. The EBA had initially proposed a non-risk weighted leverage ratio (in addition to risk-weighted measures). However, several member state governments and numerous banks criticized this proposal, especially given that the introduction of a non-risk weighted leverage ratio would disadvantage undercapitalized banks and notably alternative banks that did not issue equity, thus hitting different EU banking systems unevenly — notably, Germany more and the UK less. There were similar debates on the respective merits of Return on Assets measures (adopted by the EBA) — which might disfavour alternative banks — versus Return on Equity. It was also argued that using risk-weight assets would

favour banks that used the Internal Ratings Based (IRB)-approach and disfavour banks that use the standardized approach when calculating risk-weight assets (EBA 2015: 67). In each case, the precise standard adopted would have significant effect upon the contributions of individual banks and member state banking systems more generally.

Conclusion

This paper has examined the principal missing component of Banking Union. The EDIS was initially listed as one of the four pillars of Banking Union — along with the single rule book, supranational supervision and resolution — but was subsequently shelved because of disagreement amongst the member states, and notably because of German opposition. In 2014, the 1994 directive harmonizing national DGS was substantially revised. Although relaunched by the Commission in a November 2015 draft directive, at the time of writing (autumn 2017), the directive has yet to be agreed by the member states.

Journalistic reporting on German preferences on the EDIS has stressed moral hazard concerns and the feared imposition of costs upon banks in healthier banking systems, and ultimately the manageability of real and potential bank losses. Ostensibly, in countries with ailing banking systems, the risk of having to resolve banks by resorting to resolution funds and national DGS was much higher than in countries with healthier banks. For Germany the poor state of public finances in the euro area periphery also increased the likelihood that the costs of resolving ailing banks would have to be mutualized and born by all the euro area member states, not just by the home country.

However, this paper also presents the argument that national preferences on the EDIS, were determined largely by the structure of existing national DGS, which in turn were closely linked to the configuration of national banking systems. All this made EU negotiations on both the revised DGS and the EDIS difficult. The German (etc.) government's moral hazard concerns also stemmed from the fear that a number of member states would have difficulty meeting the target level for *ex ante* contributions from banks to national DGS agreed in the 2014 revised directive. The German government feared pressure to construct an EDIS even though some member states had very little in the way of *ex ante* funds. For the German government, the potential for moral hazard for both depositors, banks and governments in euro periphery countries was clear.

The German government was also in effect opposed to imposing a potential burden upon the joint liability schemes of small German (etc.) alternative banks to support the DGS in other member states, and thus to fund depositors of potentially large banks. The importance of banking system structure also becomes clear in the European Commission's efforts to diminish German opposition to the EDIS. The Commission proposed that savings and cooperative banks be made exempt from having to contribute to the EDIS (*Reuters*, 2 November 2015). Commission President Juncker argued that it was 'people who did not follow the virtues of a social market economy' who caused the financial crisis and that savings banks and cooperative banks were not to blame (*Frankfurter Allgemeine Zeitung,* 2 November 2015). However, this concession did not result in a shift in German policy, given ongoing concerns about the funding arrangements of DGS in a number of euro area member states.

This political economy analysis contributes to the growing body of academic literature on Banking Union by explaining national preferences on both the revised DGS directive and the EDIS. These preferences are derived not only from the overall health of national banking systems. They also reflect the structure of national banking systems and pre-existing national DGS. Despite more than sixty years of financial integration in the EU and significant strides forward in the single financial market in recent years, national banking systems remained very distinct, complicating the negotiations on both the revised DGS directive the EDIS and ensuring the persistence of national variation.

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Table 1. National banking systems and deposit guarantee schemes (DGS); government positions on revised DGS directive and EDIS

	Concentration of banking system	Presence of alternative banks	DGS system-wide or sector-by-sector	Ex ante or Ex post funding (pre-2014)	Position on revised DGS directive	Position on EDIS
France	Very high	High but in semi-consolidated groups	System-wide	Ex post ('pay-box')	Opposed to ex ante increase, but accepted with qualifications	In favour
Germany	Very low	High (over 50% of bank deposits)	Sector-by-sector	Principally ex ante with ex post	Ex ante increase	Opposed (firmly)
Italy	Very low	Low	Sector-by-sector	Ex post (and generous)	Opposed to ex ante increase	In favour
Netherlands	Very high	Moderate (Rabobank) but in semi-consolidated groups	System-wide	Ex post	Ex ante increase accepted with qualifications	Opposed (moderately)
Spain	Mid-range	Low, cajas operate as commercial banks	System-wide	Ex ante but under-funded	Opposed to ex ante increase	In favour
United Kingdom	Very high (retail banking)	Very low	System-wide	Ex post	Ex ante increase accepted with qualifications	Reluctant; UK non-participation