EU REVISION OF DEPOSIT GUARANTEE SCHEMES DIRECTIVE: 2008-9

The EU has a system of mutual recognition of credit institutions: credit institutions which are authorised in one Member State are allowed to carry on business throughout the EU on the basis of their home state authorization.[1] The EU has established harmonized rules for bank regulation, including harmonized capital adequacy rules which are based on the Basel framework.

Part of the EU's harmonization of banking regulation has related to deposit insurance. In 1994 the EU adopted a **Directive on deposit-guarantee schemes.**[2] The Commission's 1992 proposal[3] which led to the directive chose not to propose complete harmonization. For example, the proposal suggested that having a number of different levels of protection applicable to depositors in one country could work well, especially if the level of protection for small depositors was sufficient. Failure to respect the principle of home country control in this area would have been regarded as problematic. The level of protection should not be set at too high a level (as in the US) because this would mean that depositors would be indifferent to the soundness of their credit institutions. The proposed levels of protection were based roughly on those in force in Member States at the time (excluding Germany and Italy which had the highest levels of protection).[4] The proposal aimed to ensure prompt payouts to depositors.

The 1994 Directive required a minimum level of deposit insurance protection of 20,000 ECU to be achieved by the end of 1999. Member States were allowed to provide higher levels of protection for depositors with the banks they authorized. The Directive also provided that "Member States may limit the guarantee ... to a specified percentage of deposits. The percentage guaranteed must, however, be equal to or exceed 90 % of aggregate deposits until the amount to be paid under the guarantee reaches [20,000 ecu]..." A bank which carried on business in a Member State with higher levels of deposit protection than its home Member State was allowed to join the host state's scheme.

In 2005 the EU Commission reviewed the Directive, and noted some differences between the provision of deposit insurance across the EU.[5] In the Consultation paper the Commission wrote that "[e]fforts should .. be made to ensure that nationally operated deposit guarantee schemes neither act as a barrier nor an incentive to the decisions of market participants to change

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[1] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, OJ No. L 177/1 (Jun. 30, 2006); Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, OJ. No L 177/201 (Jun. 30, 2006).

[2] OJ L. 135/5 (May 31, 1994) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML

[3] Com (1992) 188 (Jun. 4, 1992) http://aei.pitt.edu/9355/01/317350552801051_1.pdf ..

[4] Greece and Portugal had no deposit protection.

[5] See generally http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm .

the location of their company seat."[6] Some commentators argued that differences in the application of the different national schemes affected the ability of banks to compete effectively with banks established in other Member States. The Commission noted a range of approaches with respect to funding and risk assessment, that only 4 Member States had coverage significantly above the minimum and that 11 Member States provided for co-insurance. The Commission stated:

> any further harmonisation of deposit guarantee schemes may entail considerable costs for scheme members and ultimately for depositors as well. The differences between deposit guarantee schemes may, on the other hand, entail a different set of costs which, in the absence of major bank failures, is more difficult to evaluate, but which may have implications both for depositors as well as from a broader systemic perspective. The costs to business of adhering to a fragmented pan EU regime also need to be considered. These aspects would need to be thoroughly evaluated before any decision about possible harmonisation could be taken.

The Consultation exercise produced a range of reactions. The Commission found that reactions on balance favoured no change (the Commission had suggested the setting up of a pan-regional scheme, which commentators rejeected), although it expressed some concerns:[7]

> it is the Commission's view that failure to keep pace with the increased degree of cross-border financial integration in Europe could ultimately prove very costly in the longer run, should the lack of standardised rules contribute to the inability of the supervisory safety net to function adequately in a cross-border crisis situation. The costs to the economy and the undermining of confidence in the single financial market could ultimately prove far higher than the level of investment needed to ensure satisfactory functioning of the pan-EU safety net.
> Furthermore, failure to address some of these issues may ultimately prove harmful to consumers: even though direct cross-border deposits may still be at a relatively low level, recent research indicates that a rising number of EU citizens are considering acquiring financial products abroad. This includes a rising demand for opening bank accounts in another Member State....
> A convincing case has still to be established as to whether a more fundamental change to the existing regulatory framework will be necessary in a longer term perspective and whether or not the expected benefits of such change outweigh the costs. The Commission recognises that there is insufficient evidence of tangible progress on the broader safety net issues at the present stage to be able to undertake those changes aimed addressing some of the more specific and

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[6] http://ec.europa.eu/internal_market/bank/docs/guarantee/consultationpaper_en.pdf .

[7] Communication from the Commission concerning the review of Directive 94/19/EC on Deposit Guarantee Schemes (Nov. 28, 2006).

fundamental shortcomings in the Directive. Addressing these shortcomings would require an important legislative effort to harmonise the funding of national schemes with significant financial consequences for a number of Member States' banking sectors but with few apparent immediate benefits. Any further legislative change will depend on ongoing work in other connected areas ...as well as on sufficient support from Member States and stakeholders and will be preceded by appropriate impact assessments. In particular a clearer picture is needed of the division of supervisory responsibilities and, if necessary, more consistency in "burden-sharing" approaches (i.e. who foots the bill) in the event of a cross-border EU banking crisis.

In October 2008 the Commission proposed revising the Directive in the light of the crisis.[8] A Directive was adopted in March 2009.[9] The Proposal stated:

Events in 2007 and in 2008, and in particular the current turmoil on the financial markets, have exposed these deficiencies and their consequences in terms of depositors' confidence to a new extent.
Crucially, there is also increasing awareness that many savers could be caught out, and not reimbursed in the event of a bank failure because their savings exceed the coverage levels in their country. The minimum coverage level of €20.000 has not been adjusted since 1994 and is no longer adequate in a number of countries given the distribution of savings. There is evidence suggesting that the competitive distortions created by different national measures are having a real and disturbing impact on deposit taking.
Moreover, the current payout delay of three months does not meet depositors' needs and expectations.
The Council of the European Union agreed on 7 October 2008, that it is a priority is to restore confidence and proper functioning of the financial sector. It committed to take all necessary measures to protect the deposits of individual savers and welcomed the intention of the Commission to bring forward urgently an appropriate proposal to promote convergence of deposit guarantee schemes. Therefore, the Directive should be revised in three key areas:
• Increase of the minimum coverage level
• Reduction of the payout delay to a maximum of 3 days
• Termination of co-insurance

2. Impact Assessment and Public Consultation
Due to the urgency of the matter, neither an impact assessment nor a public consultation could be carried out for the current proposal.
However, the Commission gained important insights from its review process of Directive

[8] Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay, COM (2008) 661 (Oct. 15, 2008).

[9] Directive 2009/14/EC OJ No. L 68/3 (Mar. 13, 2009).

94/19/EC. In the context of the Commission communication of 2006, the Commission notably asked the Commission's Joint Research Centre for submitting reports on the coverage level (2005), the possible harmonisation of funding mechanisms (2006/7) and the efficiency of deposit guarantee schemes (2008). This work was supported by the European Forum of Deposit Insurers (EFDI), in particular concerning obstacles to a rapid payout to depositors. This work has been taken into account for the current proposal...

4. Legal Elements of the Proposal

A Directive amending the current directive is the most appropriate instrument. The proposal is based on Article 47(2) of the Treaty, which is the legal basis to adopt Community measures aimed at achieving the Internal Market in financial services. In accordance with the principles of subsidiarity and proportionality as set out in Article 5 EC, the objectives of the proposed action, cannot be sufficiently achieved by the Member States and can therefore be better achieved by the Community. Its provisions do not go beyond what it is necessary to achieve the objectives pursued.

Only Community legislation can ensure that credit institutions operating in more than one Member State are subject to similar requirements concerning Deposit Guarantee Schemes, which ensures a level playing-field, avoids unwarranted compliance costs for cross-border activities and thereby promotes further single market integration. Community action also ensures a high level of financial stability within the EU.

5. Detailed Explanation of the Proposal

5.1. Reduction of payout delay

The current payout delay of three months, which can even be extended to nine months, is detrimental to the confidence of depositors and does not meet their needs. Many depositors can be expected to face significant financial difficulties already within less than one week. Therefore, the payout delay should be reduced to three days, without a possibility extension.

However, the deadline should commence only when either the competent authorities have determined that the credit institution appears to be unable to repay the deposit or a judicial authority has ruled that the claims of depositors are suspended. The decision of the competent authorities may take up to 21 days after first becoming satisfied that a credit institution has failed to repay deposits. In the interest of a rapid payout, this period of 21 days should be reduced to 3 days.

Currently, only inter-bank deposits and deposits linked to money-laundering activities are excluded from payout under Article 2.

Under Article 7(2) in conjunction with Annex 1, Member States can choose to further exercise 14 additional exclusions from payout. These include, inter alia, deposits from the financial and public sectors, close relatives of the bank's auditor and deposits by companies which are of "such a size that they are not permitted to draw up abridged balance sheets pursuant to Article 11 of Directive 78/660/EEC". It seems obvious that most of the exclusions create significant obstacles in any attempt to make a rapid payout. It is thus imperative that such exclusions should no longer apply. For the purposes of rapid payout, a scheme should cover only retail deposits. However, Member States should have the option to include other depositors provided that this inclusion does not impede rapid payouts.

5.2. Co-insurance

The current Directive allows an optional co-insurance of up to 10%, i.e. a certain percentage of losses that is borne by the depositor. This has proven counterproductive for the confidence of depositors and may have exacerbated the problems. The argument of moral hazard (depositors should be 'punished' if they deposit their funds at a bank offering high interest rates but incurring high risks) is not tenable since retail depositors cannot, in general, judge the financial soundness of their bank. Consequently, this option should be discontinued.

5.3. Coverage level

The current minimum coverage level is set at EUR 20 000 with the option for Member States to determine a higher coverage. However, this does not reflect the current average deposits of approximately EUR 30 000 per EU citizen. In order to maintain depositors' confidence, the coverage level should be raised significantly. The Council of the European Union agreed on 7 October 2008 that all Member States would, for an initial period of at least one year, provide deposit guarantee protection for individuals for an amount of at least EUR 50 000, acknowledging that many Member States determine to raise their minimum to at least EUR 100 000.

Therefore, the minimum coverage level should be first raised to at least EUR 50 000 and, after one year, to at least EUR 100 000. According to estimates, about 65% of eligible deposits are covered under the current regime. The new amounts would cover an estimated 80% (with coverage of EUR 50 000) and 90% (with coverage of EUR 100 000) of deposits.

Changes of the coverage level should be subject to the standard comitology procedure. However, in emergency situations, prompt action, coordinated across the Community, would be needed to increase the level of coverage to address any sudden loss of depositor confidence. Therefore, an emergency comitology measure is critical. Such emergency measures should be restricted to 18 months.

5.4. Cross-border cooperation

A deposit guarantee scheme does not only cover depositors in the Member State where the bank is authorized (home country) but also covers depositors at the bank's branch in another Member State (host country). If the host country's deposit guarantee scheme offers a higher level of coverage than the home country's scheme, the branch may also join the host country's scheme to offer the same coverage as the banks that are authorized in the host country.

Whether or not the bank has joined the host country's scheme, it is essential that 'home and host' schemes cooperate with each other to ensure rapid payout. The proposal, therefore, explicitly introduces a general obligation for schemes to cooperate with each other.