CEBS/05/81

September 2005

CEBS technical advice on a review of aspects related to deposit guarantee schemes

BACKGROUND, INTRODUCTORY STATEMENTS AND OVERALL CONCLUSION

Call for advice from the European Commission

1. At the 24 November 2004 meeting of the Banking Advisory Committee, BAC members called on the European Commission ("the Commission") to conduct a wide-ranging review of the Directive on Deposit Guarantee Schemes,[1] examining the practical workings of deposit guarantee systems as well as information exchange arrangements between supervisory authorities and schemes. This review is required by the Directive itself: Article 7(5) of the Directive provides for a review of the level of coverage five years after the end of the transitional period which expired on 31 December 1999.

2. The Commission's review will cover:

   a. the level of coverage provided by the Directive;

   b. the definition of deposits;

   c. 'topping-up' arrangements;

   d. financing arrangements, including the implications of operating a mix of ex-ante and ex-post schemes in the EU; and

   e. the division of home and host country responsibilities, including information-sharing arrangements and crisis management procedures.

3. The Commission has asked CEBS for technical advice on a number of these issues. CEBS received a draft call for technical advice on 23

[1] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes ("the Directive").

February 2005 and a final call for advice on 28 June 2005.[2] CEBS was asked to provide its advice by 16 September 2005 which was later extended until the end of September.

4. The timeframe set by the Commission did not permit CEBS to follow its regular procedures for providing advice,[3] and made it necessary for CEBS to adopt fast-track procedures. Consequently, this paper should not be construed as advice to the Commission within the meaning of Articles 4.1 and 5.10 of the CEBS Charter, but rather as the views of the Committee – as the main forum of European banking supervisors – on the questions posed by the Commission.

5. This paper was prepared by the joint BSC-CEBS Task Force on Crisis Management, drawing upon the existing literature on deposit guarantee schemes, and in particular on the substantial previous work of the BSC,[4] which provides a comprehensive overview of the issues. The Consultative Panel was asked to provide initial feedback on an earlier draft of this paper, and provided useful input.

6. It should be noted that the Commission's review of deposit guarantee schemes responds not only to the mandate in Article 7(5) of the Directive, but also to concerns expressed by market participants, supervisors and other authorities regarding the adequacy of current deposit guarantee arrangements. However, these concerns have not yet crystallised into a clear identification of the shortcomings of present regimes, or concrete proposals for change.

Perspective and overall conclusion

7. Deposit guarantee schemes must be considered within the context of the broader EU banking framework, and that framework is currently undergoing rapid change in a variety of areas. Issues that could have an impact on the adequacy of deposit guarantee schemes include the new capital adequacy framework introduced by the CRD implementing Basel II[5], the stability of financial markets in each member state, the new European Company and European Co-operative regulations, asymmetries between countries and their position on ongoing developments, consumer protection, competition issues and their effect on the single market, and the mobility of credit institutions.

8. This volatile environment makes it demanding to provide definitive answers to the questions raised by the Commission. While a case can be made for change, reform might impose disproportionate costs. CEBS'

[2] Call for Advice (No. 3) from the Committee of European Banking Supervisors (CEBS) regarding Directive 94/19/EC on Deposit Guarantee Schemes (www.c-ebs.org/Advice/DGS_mandate.pdf).
[3] See Articles 4.1 and 5.10 of CEBS' Charter and Points 4 and 5 of CEBS' Public Statement on Consultation Practices.
[4] BSC, Deposit Guarantee Arrangements, BSC/05/11, 6 April 2005.
[5] The Capital Requirements Directive which recasts Directives 2000/12/EEC and 93/6/EEC (the "CRD").

experience in other areas suggests that the current diversity of deposit guarantee schemes is not necessarily a hurdle for financial integration. CEBS concludes that the present regime does not currently appear to need significant amendment. However, these conclusions might change – perhaps relatively quickly– as a result of developments in the areas mentioned above, or if additional information becomes available concerning the impact of deposit guarantee schemes (for example, information indicating that current schemes raise barriers to entry for market participants).

9. Finally, these conclusions apply from a pan-European perspective, which CEBS has adopted for obvious reasons. CEBS recognises that there are already some cases at a regional level which might call for more urgent changes.

SPECIFIC CALL FOR TECHNICAL ADVICE

A. HOME/HOST RESPONSIBILITIES, INFORMATION EXCHANGE AND CRISIS MANAGEMENT PROCEDURES

10. Within the EEA, the level of deposit protection differs from country to country in both amount and scope. However, there are reasons to believe that further harmonisation may be inadvisable, and even infeasible, at this stage (see below).

11. The current diversity of deposit guarantee schemes can give rise to home/host problems for groups that operate cross-border. The current approach to these problems is to apply the principle that an institution must participate in the scheme of its home country, combined with 'topping-up' arrangements for institutions that have cross-border branches in jurisdictions that provide higher protection to local customers. Such institutions may 'top-up' their home coverage with membership in the host scheme for the difference. (Subsidiaries follow the home country principle, and thus participate fully in the scheme of the country in which they are incorporated).

12. These 'topping-up' arrangements are potentially inconsistent with the division of supervisory responsibilities, which follows the home country principle. Thus, if a systemically relevant branch were to make use of 'topping-up' arrangements, there would be a mismatch between the host authority's deposit guarantee responsibilities and its supervisory powers with respect to the branch.

13. Thus far, cross-border retail banking has been conducted mainly through subsidiaries, and therefore such mismatches have not yet been relevant. The subsidiary participates in the host country's deposit guarantee scheme, and the host supervisor retains sufficient powers with respect to the subsidiary. 'Topping-up' agreements have been rare, as discussed below. Consequently, CEBS finds no reason at present to reconsider the

current home/host arrangements in the area of deposit guarantee schemes. They may, however, need to be reviewed in the future, in the event that cross-border activity through branches increases and the treatment of systemically relevant branches becomes an issue, especially in the field of crisis management.

Possible changes in home/host responsibilities and 'topping-up'

14. The Commission invited CEBS to consider whether there would be merit in either:

    a. concentrating more deposit guarantee responsibilities with home country schemes; or

    b. abandoning the general principle of home country control for a more host-based system for systemically relevant branches. (This would not apply to subsidiaries, as they already participate in the deposit guarantee scheme of the country in which they are incorporated).

In CEBS' view, there are three distinct alternatives:

(1) Retain the current division of responsibilities, in which primary coverage is provided by the **home country's** deposit guarantee scheme. There are three sub-alternatives for dealing with the supplementary coverage provided by 'topping-up' arrangements:

(1a) Continue to allow cross-border branches to 'top-up' by participating in the host country scheme *(no change to the existing Directive)*.

15. If 'topping-up' is retained, it is important that host authorities receive all relevant information related to foreign branches in their jurisdictions.

16. The legal treatment of counterclaims and the length of time needed to process compensation processes can constitute a practical obstacle. This problem arises because the Directive does not provide sufficiently clear principles for agreements on set-off and retention rights.

17. A depositor may simultaneously hold deposits in the home country of a failing bank and in one of its branches in another Member State. If the branch has signed a 'topping-up' agreement, calculating the amount of compensation can become difficult, particularly if the bank has counterclaims against the depositor. Counterclaims may be calculated differently in different legal regimes, which may lead to different treatment by the national deposit guarantee schemes. These different approaches lead to different results if counterclaims created by the branch exceed the deposits at that branch.

18. In addition, national law in some Member States prohibits setting off deposits against counterclaims. This makes 'topping-up' agreements even more difficult to administer.

19. Moreover, 'topping-up' can involve lengthy delays before the depositor is fully compensated, since compensation must first be made through the home deposit guarantee scheme, and only then can compensation through the host deposit guarantee scheme be carried out. This delay could be shortened by compensating depositors completely through the home deposit guarantee scheme. The host deposit guarantee scheme would then reimburse the home scheme for the cost of 'topping-up.'

20. Processing time might also be shortened by 'topping-up' through the home country's scheme, as laid out next.

(1b) Allow cross-border branches to 'top-up' by obtaining supplementary coverage from their home country scheme *(amend the Directive to reinforce the home country principle, while retaining the Directive's mechanism for correcting cross-border differences in coverage).*

21. CEBS believes that having the home country scheme provide the supplementary coverage to 'top-up' the primary coverage of cross-border branches would, in principle, solve many of the problems[6] that have been associated with the current regime. In particular, it would keep supervisory responsibilities and deposit guarantee responsibilities in alignment while preserving a level playing field within the host jurisdiction. However, this approach could raise significant legal complications, because the home country deposit guarantee scheme would offer different levels of protection to customers depending on their country of residence. This could lead to unjustifiable differences in the treatment of different groups of customers by a single scheme.[7]

22. In addition, in a home-based 'topping-up' system, home countries will have difficulty in applying the rules of other Member States. Note that the characteristics of host-based and home-based 'topping-up' systems are not symmetrical. Consider the case of a bank authorised in Member State A which operates a branch in Member State B:

    a. In a home-based system, the deposit guarantee scheme in Member State A needs to have knowledge of the rules of the deposit guarantee scheme in Member State B in order to apply them. In case of default, deposit guarantee scheme A would have to deal with depositors in Member State B according to B's rules - and, possibly, in B's courts, in the event of a legal challenge.[8]

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[6] Problems related to the uneven level of coverage. Problems arising from other features of deposit insurance schemes might, however, remain unaddressed.

[7] The current system of 'topping-up' by the host scheme implies different treatment for different groups of customers of the same institution, but it does not result *in the same scheme* providing different compensation to different groups of customers. The customer who receives greater compensation gets it partly from the home scheme and partly from the host scheme, not entirely from either of them.

[8] This is unclear, since one of the many issues that would need to be resolved is how to deal with the relationship with customers in another country. For example, would customers or other interested parties in Member States B have a right to sue deposit guarantee scheme A in B's courts, or would A's courts be competent?

b. In a host-based system, scheme B needs to calculate the payout under its own rules, and then subtract the compensation already paid out by Scheme A. In principle, it does not have to concern itself with rules of A as such.[9]

23. Finally, as pointed out in comments from the industry, 'topping-up' via the home country scheme would not solve the problem of distortion in competition resulting from the different methods used to fund different schemes.

(1c) Abolish topping-up *(amend the Directive to reinforce the home country principle, and eliminate the Directive's mechanism for correcting cross-border differences in coverage).*

24. Abolishing topping-up arrangements would solve the misalignment between supervisory and deposit guarantee responsibilities, but could place institutions with cross-border branches at a competitive disadvantage (even though deposit guarantee may not be used for soliciting purposes) when deposit guarantee coverage is higher in the host country than in the home country. The limited use that has been made of 'topping-up' arrangements to date suggests that repealing the general provision, while leaving open the possibility of bilateral, ad-hoc 'topping-up' agreements between Member States, could be a more efficient solution. This approach would, however, have the disadvantage of introducing, at least potentially, even more heterogeneity into the framework. This should not be seen as a fundamental objection to ad-hoc agreements, which appear to be permissible under current EU legislation. Ad-hoc agreements, either temporary or permanent, may be necessary, and could be the most feasible solution for a variety of problems. However, there is likely to be a lack of support for ad-hoc agreements as the *sole* mechanism for addressing differences in national deposit guarantee schemes, since this would result in a very unharmonised framework.

25. In conclusion, although the option of having branches 'topped up' by the home country scheme appears attractive, CEBS has serious doubts about its legal feasibility in some jurisdictions. The alternative of simply repealing the 'topping-up' clause of the Directive, while possibly not harmful in practice (given its limited use), would not address the problem of competitive distortion, and would thus create a need for other solutions which, while efficient, could conflict with the primary objective of greater convergence. It should be noted, however, that some CEBS members advocate this last solution.

(2) Reinforce the host country principle by adopting the principle that deposits are guaranteed by the **host country's** deposit guarantee schemes.

26. Although deposit guarantee schemes are also a consumer protection tool (and thus are closely linked to local market conditions, which may be an

[9] This does not mean that host-country 'topping-up' does not raise any legal issues in practice. See § 26.

argument in favour of shifting towards a more host-country focus), CEBS believes there is a strong case for maintaining the alignment between supervisory and deposit guarantee responsibilities. Since supervisory responsibility for branches lies with the home supervisor, shifting to a more host-country based deposit guarantee system would increase the divergence between the administration of deposit guarantee schemes and the rest of the prudential architecture. Therefore, while acknowledging that systemically relevant branches pose a very significant issue, this option does not appear to be advisable.

(3) Create a **pan-European deposit guarantee scheme**

27. In addition to the two alternatives mentioned by the Commission, a third option has been mentioned in some discussions: the establishment of a pan-European deposit guarantee scheme (a so-called 26th regime). The proponents of this alternative argue that the increasing role of cross-border banking activity might require such a step, in order to ensure a level playing field. However, the same result might be achieved by establishing a more harmonised EU framework for national deposit guarantee schemes, especially on key parameters. CEBS also notes that a 26th regime may require, as a prerequisite, a more harmonised prudential supervisory landscape than currently exists. Since schemes in different countries have different features, replacing them with a pan-European scheme could have negative consequences from the point of view of some depositors. And a pan-European deposit guarantee scheme would also present significant fiscal challenges.

28. CEBS concludes that it is too early to introduce a 26th regime.

29. To sum up, **CEBS would favour keeping the current regime [option 1(a)[10]].** While this may only be a second-best solution on theoretical grounds, it is functioning reasonably well in practice.

30. Some argue that the current regime could, however, be improved by providing room for 'tailor-made' solutions, for example by the adoption of 'grandfather clauses' under certain precise and specific conditions.[11] A major obstacle to this solution brought forward is that branches using the grandfather clause, and thus remaining entirely in the host country's scheme and not merely for topping-up purposes, would create a split between deposit guarantee and supervisory responsibilities. From a harmonising perspective, the advantages appear minor compared to the risk of case-by-case arrangement and diverging deposit guarantee solution on the level of individual institutions.

[10] See § 15 to 20.

[11] A grandfather clause would provide that under certain precise and specific conditions, legal entities with a considerable market share might temporarily remain in the local scheme following their transformation into branches within a European company.

Information exchange

31. The issue of information exchange is implicit in any consideration of home-host relationships, including where deposit guarantee schemes are concerned.

32. Thus far, the need for information exchange between supervisors on matters relating to deposit guarantee schemes, and between the deposit guarantee schemes themselves, has been fairly limited. On the whole, information exchange between deposit guarantee schemes and their local supervisors appears to be working well. There would seem to be merit in maintaining these national links, while relying on existing networks established among supervisors for the cross-border exchange of information. An extension of information exchange arrangements to the direct cross-border exchange of information between deposit guarantee schemes may not be necessary at this stage, and might function less efficiently than existing channels. The same would apply to information exchange between deposit guarantee schemes in crisis management procedures.

CEBS' VIEWS ON HOME/HOST RESPONSIBILITIES, INFORMATION EXCHANGE AND CRISIS MANAGEMENT PROCEDURES

33. CEBS is of the view that current arrangements should be kept in place, if only because there is not yet a clear course for reform.

34. The alternative of 'topping-up' by the home country deposit guarantee scheme, despite its theoretical advantages, would require analysis to deal with legal concerns that might make it very difficult to implement in practice. The alternative of re-enforcing the host country principle would imply a divergence between the administration of deposit guarantee schemes and the rest of the prudential architecture. Although deposit guarantee schemes are also a consumer protection tool (and thus are closely linked to local market conditions, which may be an argument in favour of shifting towards a more host-country focus), CEBS considers that maintaining the alignment between supervisory responsibilities and deposit guarantee schemes should be regarded as a fundamental goal.

35. Information exchange mechanisms, both in normal times and in crisis situations, currently feature a European network of national prudential authorities (supervisors and central banks) and a series of bilateral links between each of those authorities and their respective deposit guarantee schemes. These mechanisms provide efficient channels for communication, and appear to have worked well thus far, in part due to the limited need for information exchange between the deposit guarantee schemes themselves. There appears to be no pressing need for change at this stage. It may be worthwhile, however, to consider

ways of creating incentives for more information exchange between national DGS.

36. Because CEBS regards the alignment between deposit guarantee schemes and supervisory responsibilities to be fundamental, the issue of systemically relevant branches, important though it may be, should not imply any modification in the division of responsibilities between home and host supervisors (as modified by the CRD), or between home and host deposit guarantee schemes. The issue of systemically relevant branches should instead be addressed through other means: mainly through re-enforced co-operation or ad hoc agreements.

B. LEVEL OF COVERAGE

The case for harmonisation

37. Many, if not all, of the issues raised in the discussion of deposit guarantee schemes stem from the fact that national practices are not fully harmonised (the Directive provides only for minimum harmonisation), and therefore not all schemes offer the same level of protection. Greater harmonisation is desirable from the perspective of the level playing field and the single market, but might be difficult to achieve.

38. The minimum level of protection is currently set by the Directive at € 20,000 per depositor. Actual protection levels show some dispersion. Three Member States which recently joined the EU are still in transition towards the minimum, while a few Member States offer a much higher level of protection. Nevertheless, most Member States fall within a range of € 20,000 to € 25,000. The effective range is even narrower when the use by some Member States of provisions such as retentions and *de minimis* clauses is taken into account. The situation can be described, then, as reasonably homogeneous but with significant outliers. However, this homogeneity must be qualified: although levels of protection may be similar, they do not always apply to the same definition of deposits, as discussed below.

39. According to the findings of the BSC, the minimum corresponds to roughly 60-70 % of household deposits in the EU 15.[12] However, in several jurisdictions – especially Member States which recently joined the EU – the minimum is well above the average size of deposits, thus providing 100 % coverage to most depositors. In theory, very high coverage is inadvisable from a prudential point of view because it can lead to moral hazard problems. In this respect, the BSC figures would seem to imply that the current level of coverage in Europe is not too

[12] BSC, Deposit Guarantee Arrangements, BSC/05/11 page 4.

low. However, a moderate increase in the level would be unlikely to result in a significant increase in moral hazard.

40. In practical terms, full harmonisation of the level of deposit protection faces two significant obstacles. First, the present situation of the financial systems of the various Member States differs in some respects. Full harmonisation of the level of protection should come only after other elements (such as set-off clauses) have been harmonised, and not vice versa. Second, unless harmonisation took the form of raising the minimum level to the level of the Member State that currently has the highest level of coverage – which would likely result in disproportionate costs, and would not be in line with the economic features of some Member States – it would imply that some systems should actually lower their current level of protection. This would be difficult in practice, since other national priorities, such as consumer protection, would be affected.

Other features: *de minimis* clauses and retentions

41. Although *de minimis* clauses and retentions both have the same result – not all of the deposits nominally covered are actually fully reimbursed – they have different objectives. Each may improve the efficiency of deposit guarantee schemes, and thus each deserves consideration.

    a. A *de minimis* clause provides that deposits below some (generally very low) materiality threshold are not reimbursed.

    b. A retention clause provides that depositors do not recover 100 % of their deposits, but are obliged to share a given percentage – however low – of any loss. Retention clauses may be combined with *de minimis* clauses.

42. *De minimis* clauses are essentially a means of saving administrative costs: since immaterial deposits may represent a significant number of accounts, there may be room for some saving of resources.

43. Retention clauses encourage customers to pay attention to the risk profile of the institutions where they bank, since they require the customer to bear part of the risk, whatever the level of deposit protection. Retention clauses can therefore mitigate moral hazard. However, special consideration must be given to their possible use in Member States where the average size of deposits is well below the minimum level of coverage, although even here some level of retention would reduce moral hazard.

44. Whatever their theoretical merits, the introduction of such clauses in systems where they have not existed before may be unacceptable to consumers and their associations.

CEBS' VIEW ON THE LEVEL OF COVERAGE

45. Although greater harmonisation in the level of coverage is attractive – and would by itself solve many of the problems addressed in the Commission's call for advice – it does not appear feasible without further harmonisation of other elements. The current level of protection covers roughly 60-70% of household deposits in the EU15 – well above the average size of deposits in the new Member States – which suggests that it is not too low.

46. Harmonising the level of coverage would be a complicated task, given the current dispersion (which is perhaps not that great, but with significant outliers). Member States now offering a level well above the minimum would find it troublesome to move to a lower amount, while harmonisation at or close to the level of the Member State that currently has the highest level of coverage would be regarded as unacceptable, especially by countries where the current minimum is already considered high.

C. DEFINITION OF DEPOSITS

The issue of harmonisation of scope

47. It might appear that the 'level of coverage' depends exclusively on the coverage limit (the maximum deposit amount that is covered by the deposit guarantee). However, differences in the *scope* of protection can introduce significant differences between schemes. Two schemes with similar coverage limits may provide different effective levels of protection due to differences in their definition of 'deposits.' Experience in the Nordic countries indicates that the definition of deposits can be a more important issue than the coverage limit. That is, the fact that some banking products may be covered in one country and not covered in another might matter even more to institutions and their customers than the amount of coverage.

48. The discussion concerning the scope of the coverage is fundamental, since the decision on scope depends largely on the objectives of the scheme and, how those objectives are ranked. The decision on scope has an important bearing on other features of the scheme.

Definition of deposits: wealth vs. transaction funds only

49. The question of the appropriate definition of deposits – whether it should cover only transaction accounts, or the full range of customers' wealth materialised in bank accounts of any kind, including (for example) savings accounts and retirement accounts – is closely linked to the

fundamental objectives of deposit guarantees. If deposit guarantee schemes are conceived mainly as a tool for financial stability in the narrow sense of maintaining basic processes for the economy (the functioning of payment systems and payment flows), and for protecting the funds that consumers are obligated to keep in banks in order to be able to take an active part in the modern financial economy, then the narrower definition might apply. If DGS are also intended to protect consumers' wealth (protection of that part of their assets that they hold in the form of deposits, for whatever reason), or financial stability in a broader sense, then a wider scope could be needed.

50. In practice, many, if not all, deposit guarantee schemes in the EU cover deposits other than transaction accounts, making it difficult to move to a system that protects only transaction funds. Whether on theoretical or practical grounds, the decision has been made to also use deposit guarantee schemes as tools for consumer protection, and thus the limitation of protection to transaction accounts appears inappropriate. CEBS concludes that a possible common definition of deposits would need to cover a broad set of instruments, including both transaction and non-transaction accounts.

CEBS VIEW ON THE DEFINITION OF DEPOSITS

51. **CEBS believes that the harmonisation of scope (i.e. the definition of deposits) is more fundamental than the harmonisation of the coverage limit, and may be more feasible at this stage. A common definition of deposits should encompass a broad set of deposits and not only transaction accounts.**

D. 'TOPPING-UP' ARRANGEMENTS

52. A previous section of this paper discussed the role of 'topping-up' in the deposit guarantee framework,[13] and the advantages of retaining this feature as a means of overcoming, at least partially, the lack of harmonisation in the amount and scope of coverage. As noted in that section, thus far cross-border retail banking has been conducted mainly through subsidiaries rather than branches. With a few exceptions, 'topping-up' arrangements have not been widely used, and are virtually non-existent in several jurisdictions. Thus there is insufficient experience to support a sound opinion regarding their performance, their potential, or how they might be better managed.

53. However, there have been a few examples of Member States instituting topping-up arrangements not only to increase the coverage limit to the level in the host market, but also to extend the scope of covered products (the definition of deposits) when there are items covered in the

[13] As noted above, 'topping-up' arrangements apply only to branches.

host market that are not covered by the home deposit guarantee scheme. These examples suggest that 'topping-up' can be practical and useful in certain cases.

CEBS' VIEW ON 'TOPPING-UP' ARRANGEMENTS

54. **Since most cross-border retail banking has until now been conducted through subsidiaries rather than branches, very limited use has been made of 'topping-up' agreements. Thus there is very little practical experience upon which to base a sound opinion on how they have worked and how they might be improved. The few cases in which 'topping-up' has actually been paid out, point to practical problems in their implementation, though, according to CEBS' view do not yet give rise to a clear course for reform (see section A above)**

E. FINANCING OF SCHEMES

The ex ante vs. ex post debate

55. A majority of European systems are either ex ante funded (that is, banks contribute to the deposit guarantee schemes before the compensation mechanism is activated) or mixed.[14] Pure ex post funded schemes are less common. Moreover, deposit guarantee schemes are ultimately supported by public funds, either explicitly or implicitly. Thus, in practice, the distinction between ex ante and ex post funding is not always clear.

56. On purely prudential grounds – that is, without taking into account other variables such as the cost of the scheme – ex ante schemes seem to have the following advantages:

    a. Prior availability of funds. The depositors of relatively small credit institutions can be compensated quickly after a (potential) failure.

    b. Continuous contributions. There is less effect on the volatility of the outflows of banks.

    c. Possible reduction in moral hazard. All banks contribute to the system, including poorly managed and failing banks.

57. However, in an ex ante or mixed scheme, the optimum size of the fund becomes an issue, both for competition and for financial stability. A larger fund offers greater protection for depositors, but no fund can

[14] The category of 'mixed' schemes includes a large number of alternatives.

absorb the costs of a major group failure. And larger funds impose higher 'deadweight' costs on contributing institutions (and their depositors). They may also imply larger disparities in relative contributions, which could impede competition.

58. Ex post schemes create incentives for closer inter-bank monitoring, but may lack the advantages associated with immediate availability of funds. However, ex post schemes with adequate borrowing arrangements, or schemes which anticipate the cost of compensation in the following year, may provide availability of funds similar to that of pure ex ante schemes.

59. On the whole, the existing bias in favour of ex ante or mixed systems appears to be justified on prudential and financial stability grounds.

60. Apart from these prudential considerations, there are also issues of *consumer confidence* and the distortion of *competition*.

61. A deposit guarantee scheme is just one element of a Member State's arrangements for maintaining consumer confidence. Different Member States may find it appropriate to choose a different balance of regimes, in the design of their supervisory regime and their deposit guarantee scheme. The two elements should be regarded as complementary. There is still sufficient variation in the circumstances of Member States to make this factor relevant.

62. In theory, ex ante funding might raise entry barriers, or, stated differently, ex post funding systems might be more favourable to competition, since institutions can join without cost. However, CEBS has not found any evidence that ex ante funding constitutes a significant obstacle to cross-border consolidation, or that any institution has been prevented from entering a market because of the way in which a deposit guarantee scheme is funded. This can be explained by the fact that the cost of premiums in ex ante systems are ultimately passed on to consumers (who are the actual beneficiaries of the protection) via lower remuneration of deposits.[15]

63. Ex ante funding imposes exit as well as entry costs, since institutions are not normally entitled to recover their prior contributions when they leave the system. This is in contrast with ex post systems, which do not require contributions if there have been no failures that must be covered by the scheme in the meantime. (If, because of a bank failure, institutions must contribute, such contributions are as unlikely to be recovered as in an ex ante system). However, the appropriateness of allowing institutions to recover premiums when they leave a scheme is open to question. Banks' contributions to a deposit guarantee scheme

[15] Differences in deposit guarantee schemes have been cited as a potential barrier to cross-border consolidation in the banking sector – see, for example, paragraph 8 in CEBS' Advice to the Commission on mergers and acquisitions (CEBS/05/76) – but the reasons for this claim and the concrete aspects of the regime that might actually create a barrier have not been clearly identified, to the best of the CEBS' knowledge. This might be further explored in future surveys.

are like insurance premiums (see below). Insurance premiums are not normally recovered after the insured period ends, precisely because insurance has been provided in the meantime. The same principle could be applied to deposit guarantee schemes by analogy. While participation in deposit guarantee schemes is mandatory, it still provides the institution – and its customers, as beneficiaries – a benefit that is economically measurable. Moreover, as in the insurance business, contributions to deposit guarantee schemes are calculated on a bank-specific basis, taking into account the amount of deposits or assets. Finally, full transferability of funds (full recoverability or zero exit cost) could undermine the stability of deposit guarantee schemes and increase the volatility of premiums.

64. The ex ante/ex post debate is usually linked to the merits of having a deposit guarantee fund, and several of the disadvantages that advocates of ex post systems attribute to ex ante systems are actually related to the existence and management of that fund. CEBS is of the view that the choice between ex ante and ex post funding is independent of the scheme's institutional arrangements (i.e., whether it takes the form of a fund, an insurance company, a public guarantee, etc.). Hence, the question of whether banks should contribute ex ante can be considered in relative isolation from other issues.

65. **CEBS tends to conclude that, from a prudential perspective, ex ante or mixed funding of deposit guarantee schemes is preferable to pure ex post funding.** However, decisions on the funding model need to consider a number of factors, including incentives for sound management of institutions, the quality of consumer protection provided, the complementary relationship between schemes and national prudential supervision, and the impact on competition.

The insurance perspective

66. As outlined above, some of the issues raised by deposit guarantee schemes can be better understood by looking at deposit guarantee schemes as 'insurance,'[16] and at contributions to the scheme as similar to the payment of insurance premiums. This, in CEBS' view, may be a very good way to understand its true nature, although it should not distract from the essential solidarity basis of every deposit guarantee scheme, which depends critically on contributions from large institutions with low risk. From this perspective:

67. The issue of funding becomes straightforward: all systems should be ex ante, or, at least, institutions should acquire an obligation towards the system before failures occur.

[16] The term 'insurance' is used here not in a strict sense, but as an analogy. It refers to the risk-based elements of deposit guarantees, and should not be understood in the sense of a pure insurance-based approach.

68. Exit costs are no longer an issue, as discussed above. If a member of the scheme is considered to be 'insured' (i.e. the scheme is rendering it a service), there is no reason to allow it to recover premiums.

69. This perspective is compatible with various ways of structuring the scheme, ranging from a fund (the current model), to an insurance company in the strict sense, which could be either publicly or privately owned (or mixed).

70. **But the most important conclusion that can be drawn from the analogy to insurance is that premiums should be risk-based, a conclusion that CEBS supports.** Other aspects of the prudential framework distinguish between institutions based on their risk profile. Deposit guarantee schemes should be no different in this respect: the premiums paid by institutions should ultimately be related to their likelihood of failure.

71. If such a proposal were adopted, extensive technical work would be needed to arrive at simple, sensible, and reasonably harmonized methods for calculating premiums. Models could be developed along the lines of the CRD's capital requirements. Such models would need to reflect country specific banking communities.

Funding and the restructuring process

72. The Call for Advice asked whether funds collected in an *ex ante* fund should cover part or all of the costs of bank restructuring processes, or whether they should be used exclusively for the restitution of deposits. This question can be reworded more broadly: what should be the room for manoeuvre of deposit guarantee schemes: how early can they intervene when a bank might end up in distress? It should be noted that this question deserves attention regardless of what the actual funding mechanism or the institutional framework is. While *ex ante* funding may be the most typical model and thus can be used as the basis for discussion, a similar reasoning might apply to *ex post* systems.

73. It might at first seem logical that funds collected to pay back deposits in case of a bank failure cannot be applied to a different use. But the answer may not be so straightforward, considering how deposit guarantee schemes work in practice. In a crisis, the deposit guarantee scheme normally reimburses depositors and takes their position as creditors of the bank. The cost for the deposit guarantee schemes will ultimately be the difference between the amount of deposits covered by the guarantee (paid to depositors) and the assets the scheme is able to recover, through the liquidation of the bank or its sale to other institutions after restructuring.

74. When a bank fails, the deposit guarantee scheme will always bear some, if not all, of the cost of restructuring, at least indirectly as a result of the recovery process after paying back deposits. If, instead, the deposit guarantee scheme bears these costs directly, by participating in a

restructuring process before insolvency process and the repayment of deposits begins, the overall cost to the scheme may be reduced.

75. It is important, however, that any such early intervention should always be based on an analysis that shows the procedure to be beneficial for the fund. It should be available only in situations that would require the intervention of the deposit guarantee scheme in one way or another, and the decision to use funds for restructuring proceedings should be based on a cost-effectiveness analysis.

76. While the use of deposit guarantee funds for restructuring might reduce costs, it may create a situation similar to granting subsidies, and may raise legal concerns. Funds provided by publicly managed deposit guarantee schemes could be considered state subsidies, while the funding provided by deposit guarantee schemes organised in other ways could be considered similar to granting cross-subsidies. Legal arguments aside, there are various schools of thought on the merits of paying financial aid to companies in financial difficulty. Other market participants are likely to oppose having their contributions used to rescue a competitor. Above all, the use of deposit guarantee funds for restructuring may result in disproportionate draws on the funds, which should always be used exclusively for the interest of depositors.

77. Finally, whether ex ante funds should be used for restructuring depends on the objectives of deposit guarantee schemes, which may also include consumer protection. The wider use of deposit guarantee schemes as a financial stability instrument in the early stages of systemic financial crises may endanger the fulfilment of consumer protection in cases where the initial crisis resolution is not successful, or the crisis spills over to non-systemic financial institutions and deposit guarantee schemes are required to compensate depositors.

CEBS' VIEW ON FINANCING OF SCHEMES

78. From a prudential perspective, ex ante/mixed funded deposit guarantee schemes, which are used by a majority of European Member States, appear preferable to pure ex post funded schemes. However, deposit guarantee schemes are ultimately supported by public funds in varying degrees , either explicitly or implicitly, so the distinction between the two is not always clear.

79. CEBS sees some merit in exploring the issue of risk-adjusted premiums, and, more broadly, in adopting an 'insurance perspective' when addressing issues related to deposit guarantee schemes. If deposit guarantee schemes are regarded as insurance-like schemes, issues relating to funding and entry and exit costs become easier to solve.

80. It should be kept in mind, however, considering the different banking structures in the member states, that substantial changes in this field may result in important disadvantages for a

number of Member States. A substantial adjustment period might be needed.

81. CEBS' view is that the issue of using funds in ex ante systems for the sole purpose of restitution of deposits should be carefully discussed, bearing in mind that excessive restrictions might increase the cost of crisis resolution. The present situation, which leaves room for national discretion, should be maintained.