EFDI-Research Working Group

Risk-based Contribution

EFDI - Comments on
EBA Consultation Paper
"Draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes"

EBA/CP/2014/35 – 10 November 2014

11 February 2015

The European Forum of Deposit Insurers (EFDI) was first established in 2002 supported by the European Commission. EFDI's membership currently stands at 67 Member-Institutions (56 DGS) and Associates (11 ICS) from a total of 44 countries from the Member States of the Council of Europe (Art. 6 EFDI Statutes). EFDI's main purpose is to contribute to the stability of financial systems by promoting European and International co-operation in the fields of deposit insurance, crisis resolution, and investor compensation, and facilitating discussion and exchange of expertise and information on issues of common interest.

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EFDI-Comments

1. General Comments

EFDI welcomes EBA Draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes (Guidelines). These Guidelines make an important contribution in providing incentives to banks to adopt less risky business models (i.e. mitigate moral hazard) by setting out principles for minimum harmonization on the risk component of the contributions calculation methods.

The EBA Guidelines apply to all EU Deposit Guarantee Schemes and constitute a valid framework for those that are not currently using risk models to determine the contribution of their member banks.

The objective of harmonization contribution has been achieved by the EBA Guidelines defining a calculation formula that considers a contribution rate to achieve the target level and defining thresholds for aggregate risk weights with a minimum risk interval (75% - 150%).

EFDI, however, has some concerns about the harmonization efforts with regard to a uniform risk model. Account of the fact that the structure of banking markets is very varied nationally and the individual risk profiles of banks are quite different due to the various existing business models, the Guidelines should be open to risk-based methods of national Deposit Guarantee Schemes. EFDI acknowledges in this context Article 13, Paragraph 2 of Directive 2014/49/EU, that Deposit Guarantee Schemes may use their own risk-based methods for determining and calculating the risk-based contribution by their members.

On the whole, EFDI welcomes EBA´s collection of risk indicators which reflect aspects of the risk profile of banks. We believe that the core risk indicators are a good starting point for developing risk models. Account to the above mentioned fact that the structure of the national banking industries differ quite widely, EFDI requests more flexibility and national discretion to build risk models. Under this aspect a level-model[1] could be considered. The Guidelines as a framework should give Deposit Guarantee Schemes a basic model (core indicators, defined weights) that could be adequate for homogeneous banking structures, a standard approach with higher flexibility to the selection of additional risk indicators and to the definition of weights and an advanced approach as an option to use respectively to develop own risk models based on empirical evidence (historical data, statistical methods) especially for heterogeneous banking structures.

Beside this general comments EFDI wants to address further aspects and concerns about the Guidelines.

[1] EFDI Framework on Risk-based Contribution, EFDI-Research Working Group, 22 May 2014

2. Principles

EFDI considers the principles for developing the calculation methods on the whole as adequate and in accordance with the principles of the EFDI Framework[2], akin to a traditional insurance approach [3]

The implementation, however, of principle 1 (*“calculation methods should, as far as possible, reflect an increased liability incurred by DGS as a result of a member´s participation”*) and principle 8 *("calculations methods should be consistent with relevant historical data"*) does not become completely clear within the Guidelines.

Principle 1

Principle 1 describes that the contribution of each member institution should as far as possible reflect the likelihood of the institution´s failure and the impact this would have on the financial position of the Deposit Guarantee Scheme. If the risk method does not consider the likelihood of institutions failure based on historical data and statistical evidence adequately concerns will raise that the risk model could lead to random results.

The impact of institutions failure is measured by assessing the potential losses stemming from a DGS intervention, on a net basis after potential recoveries from the bankruptcy estate of the failed institution. With regard to this two aspects are relevant from our point of view:

- EFDI wants to state that it would require scenario analyses or stress tests to provide some sort of determination of the potential recovery for the Deposit Guarantee Scheme in a hypothetical scenario where a bank enters receivership or resolution. In practice it will hardly be feasible to make such calculations on a recurring basis. The ratios of risk category "5. Potential losses for the DGS" limit the measurement of the potential loss to a general assessment of potential loss-absorbing capacity. For Deposit Guarantee Schemes

[2] EFDI Framework on Risk-based Contribution, EFDI-Research Working Group, 22 May 2014

[3] With respect to this insurance approach please see "5. Further Comments" as well.

able to estimate unencumbered asset recovery rates on a recurring basis accurately the Guidelines should be open to implement these calculations for contribution purposes.

- EFDI wants to point out that the relevant ratio (5.1 Potential losses for the DGS – Annex 2: Description of core risk indicators) "unencumbered assets/covered deposits" does not consider the specific asset encumbrance issues of irrevocable payment commitments[4] adequately. The description of the ratio refers to encumbered assets as defined in the EBA Guidelines on disclosure of encumbered and unencumbered assets. Therefore, EFDI suggests to consider assets which are pledged by collateral management as part of irrevocable payment commitments not as an extra burden within the applicable definition of encumbered assets.

Principle 8

Principle 8 describes that where the DGS has access to relevant historical data it should use that data. EFDI wonders why EBA did not use historical data about institutions´ failures or for example events where an institution has been likely to fail but its failure has been avoided by actions of public authorities when building the risk model. There is currently no statistical evidence that the risk model of the guidelines measures bank risk adequately as mentioned at EBA Public Hearing (London, 8 January 2015).

Taking this into account EFDI recommends a greater opening to existing experienced methods (criteria, indicators, weights) based on historical data as some Deposit Guarantee Schemes using already risk-based systems that fully rely on historical data. They periodically recalibrate (back testing and validation) their risk model in order to take into account time-series data. Compliance with principle 8 implies that these Deposit Guarantee Schemes continue to apply their own risk models even if different from those suggested by EBA. Within the Guidelines Deposit Guarantee Schemes should have the fully recognized option to implement risk models based on their experience and data.

[4] Consultation Paper – Draft Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes (EBA/CP/2014/27 – 25 September 2014)

3. Calculation Formula

The calculation formula in the Guidelines (page 14, no. 34) is transparent. EFDI can retrace generally all components – and especially welcome the factor µ as an element of flexibility.

Adjustment Coefficient

The need for an adjustment coefficient follows from the requirement in the DGS-Directive to take due account of pro-cyclicality and the phase of business cycle when determining annual contributions. EFDI wonders if reference could be made to (national) macroprudential bodies which have the required capacity and expertise to provide input for the determination of the adjustment coefficient. So far the practical implementation is not clear and leads to two basic questions.

1. What would be the procedure for the periodic determination for the adjustment coefficient?
2. How will excessive postponement of contribution be avoided?

The actual possible effects of the factor µ are limited under the premise of principle 2, 19, sentence 2: *"Within that time horizon [ten years], contributions should be spread out in time as evenly as possible until the target level is reached, but with due account of the phase of the business cycle and the pro-cyclical impact contributions may have on the financial position of member institutions."* Due to this premise EFDI considers that the calculation formula should include a safeguard to avoid that the application of the adjustment coefficient leads to a sizeable postponement of required contributions to future periods. A safeguard could be to maximize the absolute value of adjustment coefficient at a certain percentage.

Forecast

In paragraph 40, EBA indicates that *the adjustment coefficient (µ) should also factor in the business cycle* and that *the cyclical adjustment may also take into account expected evolutions in the covered deposits base*.

EFDI welcomes a clarification of how the event of a high pay-out may interfere with the process of collecting annual contributions during the 10-year build-up period.

For instance, in case of a payout in year 8 or 9 when you need 90% of the financial means of the Deposit Guarantee Scheme at this point of time (below the 0,8 threshold) the Deposit Guarantee Scheme is forced to collect contributions of almost 0,8 % of covered deposits in one or two years. This could lead to a significant financial burden for banks resulting in a substantial pro-cyclical effect.

4. Risk Indicators

EFDI welcomes EBA´s collection of risk indicators which reflect, on the whole, aspects of the risk profile of banks. The orientation of the ratio systematic to the prudential reporting is an advantage with regard to harmonisation and data collection.

As a general remark, we nevertheless observe that EBA risk criteria are close to those retained for contributions to Resolution Funds with respect to their definition, while Deposit Guarantee Schemes and Resolution Funds are generally not to be called for the same cases.

Indicators

While the draft guidelines cap the relative weight of each specific additional risk indicator at 15%, an exemption is given for additional qualitative risk indicators. This is welcomed by EFDI as it enables Deposit Guarantee Schemes to attach significant weight to qualitative risk indicators which are more forward looking than accounting ratios and enable Deposit Guarantee Schemes to incorporate information on, e.g., risk management and sustainability of business models. Under the aspect that due to the Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes the calculation of contributions shall be proportional to the risk of the members and shall take due account of the risk profiles of the various business models (Article 13 2 Calculation of contributions to DGSs) EFDI is requesting a higher flexibility to composition of risk indicators and to the consideration of the risk profile of the various business models with respect to a holistic view on the risk profile and viability of the institutions. In particular that a Deposit Guarantee Scheme has the organizational structure and the ability (experience) to assess the quality of management, internal governance arrangements, internal processes and controlling systems, our suggestion is to increase the extent to which national Deposit Guarantee Schemes can make use of additional risk indicators and criteria by the option to decrease the sum of minimum weights from 75% to 50% (table 2, page 24) in the favour of qualitative risk indicators.

This would lead to the scope of a standard approach model within a three-level model, as briefly described at "1. General Comments".

Specification

The Guidelines run up to a certain degree into a specification conflict. On one side especially the core indicators and the weighting systematic are quite strictly defined but on the other side the Guidelines lack definitions as to specific ratio components like non-performing loans, underling curves, mapping of score values to risk buckets and minimum/maximum definition to the following ratios:

- Return on Assets (RoA) – Annex 2: Description of core risk indicators 4.2[5]
  ((+)/(-) Negative values indicate higher risk but too high values can also indicate high risk).
- Return on Equity (RoE) – Annex 3: Description of additional risk indicators 4
  ((-)/(+) Negative values indicate higher risk however too high values can also indicate high risk)
- Cost to income ratio – Annex 3: Description of additional risk indicators 4
  ((+)/(-) Too high values of the ratio indicate higher risk however too low values may also indicate high risk)

Within a three-level model, as briefly described at "1. General Comments", for a basic model more details could be an advantage while for a standard approach model respectively an advanced approach model no further definition would be required.

5. Further Comments

Distinction bank risk / fund risk

EFDI basically agrees on taking into account the criteria "potential losses for DGS".

EFDI, however, does not fully agree on the calculation method that the Guidelines apply to combine fund risk and bank risk. From the viewpoint of methodology the distinction between risk indicators for bank risk and fund risk (potential losses for the DGS) within the calculation formula and their separate presentation would lead to a higher transparency of the contribution effects. The four bank risk categories (capital, liquidity/funding, asset quality and business

[5] This ratio does not reflect the risks taken by banks. It reflects neither the probability of default of the institution, nor the loss given default of the fund.

model/management) yield the probability of default (PD) of a bank that should be distinguished from the potential losses (loss given default – LGD) for the Deposit Guarantee Scheme. This derives from both literature and risk management practice. Summing the two factors could biased the results and is methodologically not appropriate.
Because of this reason the EFDI Framework Paper proposed the following approach[6] :

I) Definition of the DGS´s standard contribution under assumption of average risk (*target level, EAD-approach*).

II) Calculation of the risk-based contribution under DGS´s risk classes respectively premium classes (*bank risk, PD-approach*).

III) Consideration of further DGS specific factors like asset encumbrance issues (*fund risk, LGD approach*).

Considering the aspect of moral hazard a clear bank risk indicator set would encourage less risky business models (limit risk appetite) and would therefore be preferable to a mixed (bank risk and fund risk) approach.

Alternative Option

While the Guidelines follow a classic method for calculating contributions, EFDI recommends that this should not prevent Deposit Guarantee Schemes from using alternative methods within the requirements made by the DGS Directive.
When a Deposit Guarantee Scheme decides to stabilize fund volume after reaching its target level, the proposed formula leads to virtually stop raising contribution. This would significantly limit its ability to capture the evolution of the market shares of its member banks, respectively risk or new entrances. The Deposit Guarantee Scheme could also hardly address moral hazard issues any more, in spite of IADI´s Core Principles.

In those cases where there is a ceiling for the size of the fund, an issue can arise with the formula used for the calculation of contributions once the target level – determined as a percentage of covered or eligible deposits – is reached. In such a case, total annual contributions need to be roughly equal to the target level times the difference in total covered deposits. This in order to stabilize the size of the fund. If contributions are then still based on

[6] EFDI Framework on Risk-based Contribution, EFDI-Research Working Group, p. 28, 22 May 2014

the amount of covered deposits of an institution, an unintended consequence would be that the additional insurance costs of deposit growth are shifted from the individual institution to the banking sector as a whole.

With such objectives in mind, some Deposit Guarantee Schemes may be willing to consider alternative methods, stock-based rather than flow-based, where the individual contribution would be set each year through a comparison between a target for the current year and a target for the year before, each target based on covered deposits and risk indicators.
EFDI recommends that such methods could be developed and authorized by the Guidelines on an optional basis.

About EFDI

The European Forum of Deposit Insurers (EFDI) was first established in 2002 supported by the European Commission. In June 2007, EFDI adopted the legal status of an International Non-profit Association under Belgian law (INPA - AISBL). Its registered office is in Brussels (B-1000 Brussels, 56 Avenue des Art, Belgium).

EFDI has a close working relationship with major European and International organizations and academia, especially with the European Commission (EC), the European Central Bank (ECB), the European Banking Authority (EBA), the World Bank (WB), the International Monetary Fund (IMF), the European Financial Services Roundtable (EFSR), the European Banking Federation (EBF) and the International Association of Deposit Insurers (IADI).

EFDI EU-Committee

EFDI has established an EU Committee comprising all its members from the EU-member-states. The EU Committee deals with the policy of EFDI concerning the legislation of the European Union on deposit insurance, the submission of any responses or statements of policy to the European Commission (or any institution of or related to the European Union), the reporting of any discussion of the members regarding the policy of EFDI to the European Commission (or any other institution of or related to the European Union) and with the representation of EFDI vis-à-vis the European Commission (or any other institution of or related to the European Union) with respect to the policy of EFDI.

The EFDI EU Committee is presided over by the EFDI Chairman (Dirk Cupei) (according to Art. 31 EFDI Statutes). The EFDI Board nominated Alex Kuczynski as EU Committee Coordinator.

Contact

Dirk Cupei, Chairman EFDI Board
secretariat@efdi.eu
Alex Kuczynski, EFDI EU Committee coordinator
secretariat@efdi.eu

Members of the EFDI Research Working Group Risk-based Contribution

Members	System, Country
Benna Dr., Ralf (Co-Head of Working Group)	BVR Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, Germany
Bretschneider, Bernd (Co-Head of Working Group)	GBB-Rating Gesellschaft für Bonitätsbeurteilung, Germany
De Lisa Prof. Dr., Riccardo	Head of EFDI Research Working Groups, Italy
Fernandez Martinez, Fernando Jose	Fondo de Garantia de Depósitos de Entidades de Crédito, Spain
Irimea-Veghes, Corina	Fondul de Garantare a Depozitelos in Sistemul Bancar, Romania
Kiriazidis, Theo	Hellenic Deposit & Investment Guarantee Fund, Greece
Pierrou, Hannah	Riksgälden National Swedish Debt Office, Sweden
Ralinska, Elena	Investors Compensation Fund, Bulgaria
Tsekov, Dimitar	Bulgarian Deposit Insurance Fund, Bulgaria
Veccia, Alessio	Fondo Interbancario di Tutela dei Depositi, Italy
Zettler, Dr., Hilmar	Entschädigungseinrichtung deutscher Banken, Germany