Berlin, January 2016

Credible, sustainable deposit protection

Cooperative Financial Services Network and Savings Banks Finance Group reject proposed EDIS for mutualization of deposit insurance in the eurozone

On November 24, 2015, the European Commission put forward its proposal for a regulation to establish a deposit insurance system for the EU member states that belong to the banking union. Its stated aim is to merge national deposit guarantee schemes to form one European deposit insurance system (EDIS) to create a fully-fledged banking union. Deposit insurance in the eurozone is planned to be fully mutualized in three stages from 2017 to 2024 by creating a centralized European deposit insurance fund (DIF).

The National Association of German Cooperative Banks (BVR) and the German Savings Banks Association (DSGV) are strongly opposed to any mutualization of deposit insurance within the eurozone, because it is neither necessary nor appropriate. Instead, it would create cross-border liability obligations without any adequate means of (risk) control. Given that current conditions in the individual countries, banks and deposit guarantee funds are very different, the redistribution of risk would result in an uncontrolled transfer union in the area of deposit protection. This would be at the expense of depositors and banks, and ultimately also at the expense of taxpayers in countries with functioning deposit guarantee funds because their liability risk within the eurozone would increase. The consequence would not be more stability and security, it would be further conflict in Europe.

The Deposit Guarantee Schemes Directive (DGSD), which was only approved in 2014, represented a big conscious step taken by the EU toward the harmonization of national deposit guarantee schemes. For the first time, based on DGS Directive 2014/49/EU, many countries are having to set up their own ex-ante funded deposit insurance systems, which guarantee to

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protect depositors for amounts of up to €100,000. In other countries – such as Germany – Institutional Protection Schemes with the aim of protecting the entire institution, therefore including bank deposits, have existed alongside deposit insurance schemes for a long time. These alternative Institutional Protection Schemes were explicitly recognized in 2014/49/EU because they have provided effective depositor protection for decades. The EDIS would weaken and effectively abolish tried-and-tested bank Institutional Protection Schemes.

The new draft EDIS regulation, which includes mutualized depositor insurance in the eurozone, will create a further source of potential divisions in the EU because the European Commission is promoting it in the absence of the necessary legal, political and economic framework. By introducing joint liability when current situations and centralized structures are completely different, the EDIS will significantly weaken EU citizens' confidence in the security of their deposits and the stability of the financial system in many member states. A large number of depositors would be in a worse position than they are now. In countries familiar with tried-and-tested institutional protection schemes that have been in place for decades, EU regulation will reduce consumer protection. The proposals from Brussels are likely to increasingly reduce the sense of identification with Europe felt by citizens of various EU member states because European institutions are moving further and further away from the ideas of many EU citizens and as a result are encountering problems of acceptance.

The Volksbanken Raiffeisenbanken Cooperative Financial Services Network and the Savings Banks Finance Group are not willing to use the funds that they have accumulated over many years to safeguard customer deposits, or any funds that this banking group may raise in the future, to secure deposits in other countries, because the political, economic and legal conditions for doing so are not in place.

The Cooperative Financial Services Network and the Savings Banks Finance Group are equally opposed to any reinsurance scheme legally enforced by the EU as well as any further mutualization of liability for third-party deposits.

We would also urge the members of the European Parliament and the German Bundestag to do all they can to ensure that there is no adverse impact on the proven institutional protection schemes recognized by the Deposit Guarantee Schemes Directive (Directive 2014/49/EU) currently in force.

Facts and reasoning

There are compelling arguments in favor of harmonizing deposit insurance systems throughout Europe on the basis of EU Directive 2014/49/EU, a process just in the initial stages of implementation, and consequently arguments against incurring liability risk in the form of reinsurance, coinsurance or comprehensive insurance as part of the EDIS.

Lack of legal basis for the establishment of compulsory joint liability

The European Commission is drawing on article 114 of the Treaty on the Functioning of the European Union (TFEU, harmonization of legislation in the internal market) as the legal basis for the EDIS regulation and would like to have this regulation adopted during the ordinary legislative procedure. In contrast to the European resolution mechanism (SRM), no international agreement is required because the contributions collected would be transferred straight from the banks to the central European deposit insurance fund (DIF) (and not via each member state as is the case for bank resolutions).

Whether article 114 TFEU is an adequate legal basis for EDIS is a question raised by the German government and others. Such a radical step as mutualized EU deposit insurance can only be adopted unanimously by the EU member states, the German government believes, or would require explicit intergovernmental legislation. We endorse the German government's critical assessment.

It would not be appropriate if German institutions operating at a purely local or regional level were held liable for deposits held by banks in the entire eurozone as envisioned under EDIS. They might thus be forced to pay substantial contributions and provide additional capital in order to support the domestic budgets of other member states and fund remedies for the consequences of local/regional shocks in other banking union countries. Liability of this type is likely to encounter obstacles in EU and constitutional law.

Furthermore, the abolition of proven deposit guarantee and Institutional Protection Schemes by the EDIS is disproportionate and conflicts with the principle of subsidiarity. In the context of legal issues, it also raises difficult governance problems. It is not appropriate that all 28 EU countries would vote on the EDIS with its far-reaching consequences despite only the 19 members of the banking union being affected by the mutualization of deposit insurance. It should not be possible for governments that are not affected to take part in decisions on such a serious step.

Banking Union must not become a transfer union

The substantial differences in the stability and performance of the individual banking systems within the eurozone did not just start with the outbreak of the financial crisis. A large proportion of non-performing loans, for example, are concentrated on a few countries that frequently have below-average economic growth and high unemployment. Given the very different current conditions, any mutualized deposit insurance system would inevitably entail a transfer union between banks and deposit guarantee schemes. Stable and efficient banking systems and their protection funds would be compelled to assume liability for unstable systems without any influence over other countries' risks. Beyond banking risk in the narrow sense, any country's economic policy mistakes and political risks in general that have an impact on financial stability would be borne by foreign deposit guarantee funds. Misguided economic policy would significantly increase the risks inherent in the EDIS because compensation events for depositors would be much more likely to occur. The Commission's proposal fails to achieve one of the key objectives of banking union – decoupling the link between countries in Europe and their national banks. Risks may spill over from countries to banks and then to the EDIS with the unacceptable consequence of deposit insurance providing liability cover for political failure.

Mutualization of deposit insurance is no substitute for substantial progress toward political union

The proposed mutualization of deposit insurance stands in sharp contrast to eurozone countries' willingness to achieve real progress on the road to political union in Europe. It is clear that the five Presidents in their initial paper of June 2015 did not manage to agree on the goal of political union - not even as a longer-term objective. However, the proposal to mutualize deposit insurance via the EDIS cannot be a substitute for taking the eurozone forward toward political union, or a precursor. The lack of willingness on the part of member states to strive for political union, while willingly adopting biased mutualization in financial terms, such as in the area of deposit protection, is leading to increasing tensions within the eurozone. This is not making Europe more stable, it is making it more vulnerable to serious conflicts and may boost parties at the margins of the democratic spectrum.

National rights to intervene in client/bank relationships are excessive

Member states, including those within the eurozone, continue to have far-reaching rights to intervene in the relationships between banks and end customers and they are not restricted in any way by the EU. Interventions of this type can have a hugely adverse effect on the credit quality of banks, with consequences for the entire financial sector of a member state. The most recent example was the intervention of states such as Greece in private real-estate loans. If large numbers of citizens can no longer pay back their real-estate loans and have overreached themselves financially, there is a great temptation for political parties and governments to solve problems of this kind at the expense of their banking systems. This may result in the destabilization of some institutions or even the entire national banking sector. In such cases, the risk for the deposit insurance systems of other member states becomes greater because they are ultimately jointly liable for these political decisions. This type of bail-in for populist political decisions in member states must not be to the detriment of depositors and savers in other member states.

Mutualization creates serious moral hazard for the conduct of banks and governments, leading to greater systemic risk

The EU Deposit Guarantee Schemes Directive to be transposed into national law by the beginning of July 2015 has enshrined in legislation a statutory protection limit of €100,000 for depositors throughout Europe and has set stringent quality standards for the schemes. The national transposition of the deposit guarantee schemes directive, which has only just started, should first be carried out consistently throughout the entire EU, should be fully funded and should be reviewed in due course.

Responsible behavior by countries, banks and their deposit guarantee schemes in the eurozone should not be deterred by reallocation mechanisms such as those provided by the EDIS. Instead of reallocating risk, a substantial reduction in the risks inherent in financial systems, the real economy and government budgets is required. The EDIS has the potential to produce uncontrolled **moral hazard** because it creates the wrong system of incentives. Moral hazard has been a key trigger for many crises. The proposed regulation relies solely on effective European banking supervision and, for the transition phase, and on a minimum level of national funds (albeit low) as prerequisites for joint liability. However, the proven stabilizing effect of the existing Institutional Protection Schemes and their incentive structures has been completely disregarded.

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Mutualization would negate the wide range of business models and risk profiles

At the outset of European banking union, the ECB started to differentiate between the categories of *significant institutions* and *less significant institutions (LSIs)* in Europe. Some 120 significant banking groups (consisting of approximately 1,200 individual institutions) are directly monitored by the ECB, while 3,400 less significant institutions (LSIs) continue to be supervised by their national regulator. One of the reasons for this differentiation lies in the diverse business models and risk profiles of banks in Europe. Regional banks in particular – such as the German cooperative banks and savings banks – are noted for their responsible behavior and support for the local economy. Any mutualization within the eurozone will have an especially negative impact on small, risk-averse institutions because they can only compete in the market if the current system of Institutional Protection remains in place. However, the regulation proposed by the European Commission no longer provides for any form of Institutional Protection following the mutualization of deposit insurance. The principles of proportionality and subsidiarity will be violated by the mutualization specified in the proposed regulation. The EDIS project would be uniquely harmful to certain small and medium-sized banks, despite the fact that they had a stabilizing effect during the financial crisis and continued to lend to companies. Deposit guarantee schemes that have worked well for many decades, such as the Institutional Protection Schemes in Germany, should not be effectively abolished in favor of a mutualized European system that is neither theoretically credible nor compatible with the current status of integration in the eurozone.

EDIS undermines Institutional Protection and places an unacceptable burden on German cooperative banks and savings banks

No less worrying for the cooperative banks and savings banks, their customers and members is the European Commission's lack of understanding of the way in which Institutional Protection works and its benefit to the economy as a whole. If banks that belong to an Institutional Protection Scheme are also required to provide funds to compensate depositors in the form of contributions to the deposit insurance funds (DIF) under the EDIS, this would be an unsustainable double burden. As a result the EU would effectively make Institutional Protection impossible, immediately after including it in the DGS Directive. The EU regulation would abolish the familiar level of depositor protection that has stood the test of time so well.

Contrary to what the European Commission maintains, the EDIS would give rise to additional costs for the German cooperative banks and savings banks, particularly after the introduction of a requirement to replenish the DIF when funds have been withdrawn for compensation or resolution. Banks with upstream Institutional Protection would never receive funds from the DIF provided Institutional Protection remains in place. As a result, the EDIS creates a system for cooperative banks, savings banks and other institutions with Institutional Protection in which they merely pay in with no prospect of any benefits for the banks involved at any time. Politically, financially and legally such a system obeys none of the rules of a market-based economy.

Mutualization will undermine people's trust

The safety of bank deposits is a highly prized good not only for banks and their customers but also for politicians. Under the proposed regulation, the mutualization of liability risk among banks at the expense of existing deposit guarantee schemes that proved their worth in the financial crisis will mean that all banks from the beginning of 2017, and some banks from 2020 onward, will have to pay exclusively into a European crisis fund and thus would be forced into financial solidarity with other European countries that many of their citizens believe is too far reaching.

The steady scaling back of national systems from 2020 onward and their substantive integration into the European system from 2014 onward would impair the safety of deposits in Germany and other EU countries and, consequently, weaken depositors' trust. More than anything, the fact that large-scale claims in other European countries will erode the deposit guarantee funds previously set aside for bank customers in Germany is disconcerting many depositors and savers in Germany. The net assets of the 1,500 or so institutions in the Cooperative Financial Services Network and the Savings Banks Finance Group in Germany would also be adversely affected, because they would have to assume additional liability risk. Depositors and members of the cooperative banks and savings banks oppose EU intervention in their assets. Effective stabilization of crisis-hit areas requires problems to be regionally contained and any spillover into other protection systems prevented. National protection systems are needed above all in order to promote greater stability.