Proposal for a European Deposit Insurance Scheme (EDIS)

Key considerations for the design of EDIS

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Introduction

AFME supports the objectives of establishing an effective Banking Union and reinforcing public confidence in deposit insurance as part of a comprehensive framework for dealing with failing banks.

Effective deposit insurance is an important part of the work to ensure that all banks can fail without threatening financial stability. The Commission's proposal to establish a European Deposit Insurance Scheme ("EDIS") should support this goal by further reducing the perceived link between banks and their sovereigns and increasing public confidence in deposit insurance within the Banking Union.

The proposal should complement the Single Supervisory Mechanism ("SSM") and the Single Resolution Mechanism ("SRM") and build upon the important progress made through the Bank Recovery and Resolution Directive ("BRRD") and the Deposit Guarantee Schemes Directive ("DGSD"). Centralisation of deposit insurance alongside resolution within the Single Resolution Board ("SRB") should also assist with the integration of deposit insurance in the recovery and resolution framework within the Banking Union. In this regard, the BRRD, DGSD, SSM and SRM should be fully transposed as a matter of priority and timely implementation should be a condition for Member States to benefit from increased risk-sharing under EDIS. EDIS will only work effectively if national schemes are harmonised and funded equivalently according to their target level. It is also important that steps have been taken to assess the asset quality and resolvability of those banks which did not participate in the ECB comprehensive assessment before they are covered by co-insurance under the EDIS.

We set out below some important considerations in relation to the Commission's proposal, including the importance of putting EDIS in the context of the bank recovery and resolution framework, the need to ensure that contributions to the Deposit Insurance Fund ("DIF") are calibrated to effectively reflect the risk of loss to the fund and ensuring that EDIS does not result in increased costs to the industry.

The importance of the recovery and resolution framework

When designing an appropriate framework for EDIS, it is essential to ensure that the role of deposit insurance is considered in the context of the recovery and resolution framework under the BRRD. This has made a number of important changes to the circumstances in which deposit guarantee schemes ("DGS") are utilised, the ways in which they are applied, the likelihood of their use and the level of losses that they are likely to sustain when a bank fails. Importantly, the likelihood of the use of a DGS and the level of any losses incurred by a DGS is reduced.

1) The existence of credible recovery plans approved by the authorities, combined with increased capital and liquidity requirements and regular stress testing will materially reduce the risk that banks fail and therefore reduce the likelihood of a DGS being used.

2) There will now be a resolution plan in place for the failure of every bank in the EU. The objectives of the resolution plan include protecting insured depositors, ensuring the continuity of the bank's

critical functions and avoiding adverse effects on the financial system.[1] For large and medium-sized banks the resolution strategy will involve the bank, or part(s) of its group being placed into a resolution process rather than an insolvency process, avoiding any interruption or loss to insured depositors. This could be achieved by recapitalising the group to enable it to continue its critical functions including servicing deposits or transferring deposits to a purchaser or bridge institution. For some small banks where liquidation is an appropriate strategy, the bank will be wound up under an insolvency process. However, liquidation is unlikely to be used for banks with substantial insured deposits in transactional accounts.[2] Banks are required to remove any impediments to the relevant resolution strategy, ensuring that they are resolvable.[3]

3) The resolution framework has brought a fundamental change to the liability structure of banks to ensure that they have sufficient loss absorbing liabilities to enable them to be resolved without any loss to insured depositors or taxpayers. Both the Minimum Requirement for Own Funds and Eligible Liabilities ("MREL") under the BRRD and the FSB standard on Total Loss Absorbing Capacity ("TLAC") will require banks to hold significant amounts of capital and long-term debt that can absorb losses. Insured deposits are excluded from and senior to such resources. The clear intention is to ensure that, at least for banks which would be placed into resolution in the event of their failure, in no circumstances would a bank suffer losses that would be so significant that insured depositors (and therefore the DGS standing in the shoes of insured depositors) would suffer losses.

4) The BRRD brought an important change to the insolvency hierarchy to give super-priority to insured deposits, so that they rank senior to all capital, loss absorbing capacity, other senior debt and uninsured deposits.[4] We set out in the annex an example demonstrating the impact of this change. When combined with the very significant increases in capital and loss absorbing capacity (at least for larger banks), the likelihood of the DIF suffering losses is significantly reduced because losses would have to exceed the value of all capital, MREL/TLAC, senior debt and uninsured deposits.

5) The BRRD established resolution funds which can be utilised to absorb losses in resolution after certain conditions are met, but before any losses would be imposed on insured depositors.

6) The BRRD also made changes to the way in which DGSs are used in resolution and limits the liability of the relevant deposit guarantee scheme to the lower of the losses that insured depositors would have suffered and the losses that the DGS would have suffered in a liquidation. The DGS is also prohibited from contributing to the costs of recapitalising an institution.[5]

The position of insured depositors has improved very significantly in light of these changes and accordingly the likelihood that DGSs suffer losses has significantly reduced.[6]

In the unlikely event that a DGS is called upon, it is most likely to be for small banks with few insured deposits which are placed into liquidation. Therefore, while DGS could still play an important role in liquidation - and in some cases resolution - and putting in place EDIS will support the completion of banking union and breaking the sovereign-bank nexus, the role of the DGS in such circumstances is likely to be

[1] See article 31 BRRD.
[2] The Bank of England has stated that it expects firms that provide more than 40,000 accounts to be placed into resolution rather than liquidated: see The Bank of England's approach to setting MREL, available at http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf.
[3] See articles 15 to 18 BRRD.
[4] See article 108 BRRD.
[5] See article 109 BRRD, article 79 SRMR.
[6] Recent research conducted by the Bank of England concludes that resolution arrangements "are expected to improve market discipline, and thereby reduce the probability of a future financial crisis by around a third" and separately the Bank of England estimates "that systemically-important banks could become around one third less likely to fail": See Bank of England, Supplement to the December 2015 Financial Stability Report: The framework of capital requirements for UK banks and Brooke et al (2015) "Measuring the macroeconomic costs and benefits of higher UK bank capital requirements", Bank of England Financial Stability Paper no. 35, December available at http://www.bankofengland.co.uk/financialstability/Pages/fpc/fspapers/fs_paper35.aspx and The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL): Consultation on a proposed Statement of Policy, December 2015, available at http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf

primarily a source of liquidity. This is because it would recoup the value of the claims of insured depositors, which are now senior to almost all other liabilities. These factors have important implications for the design of the EDIS including:

1) The target level of ex ante funding for the DIF and deposit guarantee schemes in non-participating Member States should be reviewed in light of the significant reduction in the risk of loss to the DGS. The impact of depositor preference and loss absorbing capacity requirements on the need for ex ante funding of DGS has been considered in a recent academic assessment which concluded that “the case for ex ante risk related fees for deposit insurance is considerably weakened by depositor preference arrangements and also by requirements for [loss absorbing capacity]” and found that “under tiered depositor preference arrangements and with moderate use of non-deposit funding by banks, the “fair value” of explicit insurance approaches zero”.[7] The reduced need for ex ante funding was also recognised in the DGSD which provided for the ability to have a lower target level where banks are “likely in case of failure to be subject to resolution proceedings.”[8] We suggest that at a minimum the target level should be reviewed to take account of increases in the loss absorbing capacity of banks over the next four years.

2) The credibility of a firm’s recovery plan, resolution strategy and loss absorbing capacity should be key drivers in the risk assessment of contributions to the DIF. These should reflect the risk to the DIF and incentivise banks to increase their loss absorbing capacity. This approach should also be applicable to the bank subsidiaries of larger banking groups.

3) The focus of EDIS should be on increasing public confidence in deposit insurance by de-linking the DGS from a sovereign state and providing liquidity to enable quick payout to insured depositors of banks that would be liquidated under their resolution strategy.

Alongside EDIS, the additional security provided to insured depositors through the recovery and resolution framework should be better communicated by the authorities to support the objective of public confidence in the financial system and the safety of deposits. Greater clarity to depositors on the resolution strategy for a group and the loss absorbing capacity of banks should also support this objective.

Funding of the DIF

In light of the recovery and resolution framework including the super-priority of insured deposits discussed above, it is likely that the DIF will be primarily used where the resolution strategy for a bank involves liquidation. The DIF would enable a speedy payout to insured depositors and recoup this through the liquidation. There should be a low risk of the DIF suffering losses provided that the SSM and SRM are performing their roles effectively, as this would require losses to exceed the value of all capital, subordinated debt, senior debt and uninsured deposits.

We therefore consider that rather than a large standing pool of ex ante funding, the focus of the proposal should be to ensure that the DIF has a credit line for liquidity purposes, with the ability to recoup any losses that it might suffer from the industry ex post. We suggest that sources of liquidity for the DIF should include, as proposed, borrowing from other DGS and the market. The DIF should also adopt the option under the DGSD to include payment commitments of up to 30% of any ex ante funding.[9] In addition, a public backstop should be put in place to provide liquidity to the DIF if necessary, again backed up by the recovery of any

[7] See Davis (2015), Depositor Preference, Bail-in and Deposit Insurance Pricing and Design, http://kevindavis.com.au/secondpages/workinprogress/2015-09-06-Depositor%20Preference%20and%20Deposit%20Insurance.pdf
[8] See Article 10(6) DGSD.
[9] See Article 10(3) DGSD.

losses from the industry. This would provide additional confidence and make it easier for the DIF to obtain private liquidity sources.

No overall increase in costs to the industry

While the Commission stated in its press release accompanying the proposal that EDIS will be "overall cost-neutral for the banking sector", the proposal is not accompanied by any substantive impact analysis demonstrating that this will be the case. It is important to consider the impact of the EDIS proposal on banks across the industry and to ensure that it does not adversely impact individual banks, a sector, business model or the overall industry. Further increases in the cost of contributions could create a level playing field issue with respect to banks based outside the banking union and could potentially have an impact on the cost of deposit accounts. A full impact assessment of the proposal should be conducted and made publicly available.

Despite the Commission's statement regarding cost-neutrality, the proposal itself does not ensure that this will be the case because national authorities have the option of reducing national contributions but are not obliged to do so. This deduction should be made mandatory to avoid banks paying duplicative contributions to more than one deposit guarantee scheme. Furthermore, the proposal will directly increase the contributions paid by banks in Member States where the target level for ex ante funding could be 0.5% of covered deposits under the DGSD.[10]

Contributions to the DIF

We support the risk weighting of contributions to the DIF. To minimise moral hazard, the risk assessment of contributions should be focused on the risk of loss that each bank poses to the DIF. Banks should be incentivised to reduce the risk to depositors, for example by reflecting improvements in recovery capability and increases in loss absorbing capacity in reduced contributions to the DIF.

The risk assessment of contributions should reflect the new recovery and resolution framework discussed above. The risk of loss should be based upon the probability of failure and the likelihood that the DIF would suffer a loss upon its failure, based upon the resolution plan for the relevant bank. In particular this should consider:

- The level of capital that the bank maintains and whether the particular bank would be placed into resolution or liquidation upon its failure.
- If the bank is to be liquidated, the quantum of liabilities that would suffer losses ahead of the DIF.
- If the bank is to be placed into resolution:
    - the quantum of loss absorbing capacity and other liabilities that would suffer losses ahead of the DIF; and
    - whether under its resolution plan the DIF would contribute to resolution under article 109 of the BRRD.

These principles should be set out clearly in the regulation and reflected in the delegated acts on the calculation methodology for the reinsurance and subsequent phases. In addition to reflecting the risk of the institution, these principles would also incentivise banks to take steps to reduce the risk to depositors, for example by holding additional loss absorbing capacity. As the Single Resolution Board is the resolution authority, it should be well placed to consider these factors when assessing the risk that a particular institution poses to the fund.

[10] See Article 10(6) DGSD.

Other considerations

We have the following further comments on the proposal:

- We support the proposal for EDIS to be administered by the Single Resolution Board, which should increase its efficiency and facilitate alignment between the DIF and resolution planning.
- It is important that there is transparency and accountability over the use, investment and funding levels of the DIF, both to the public and to the banks which are funding the DIF.
- The information required from banks for the administration of the DIF should be harmonised and sourced where available from existing information held by the SSM and SRB.
- The role of national DGSs after the reinsurance phase should be clarified.
- The meaning of Article 77a(3) should be clarified. It should be ensured that making the use of the DIF contingent upon compliance by a credit institution with its obligations to the DGS does not create uncertainty for depositors or undermine confidence in the system. Insured depositors cannot be expected and should not be required to monitor whether a credit institution has met its obligations in order to assess whether they benefit from insurance through the DIF. We suggest instead that the SRB ensures that credit institutions meet their obligations, with potential sanctions for non-compliance, but that this should not affect coverage for depositors.

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Annex
Impact of depositor preference on the risk of loss to DIF

The example below demonstrates the impact of depositor preference on the risk of loss to the DIF for a hypothetical bank suffering a catastrophic loss of 40% of its assets.

Assets

Book value	100
Realisable value	60
Loss	40

Liabilities:

Equity	5
Subordinated debt	5
Senior debt (excluding preferred deposits)	30
Uninsured preferred depositors	25
Insured depositors	25
Secured liabilities	10

Recoveries with no depositor preference (deposits ranking pari passu with senior debt)

	Claim	Recovery
Equity	5	0
Subordinated debt	5	0
Senior debt (excluding deposits)	30	18.75 (62.5%)
Uninsured depositors	25	15.625 (62.5%)
Insured depositors	25	15.625 (62.5%)
Secured liabilities	10	10 (100%)

Under this scenario, the DIF would suffer a loss of 37.5% of insured deposits. The DIF would suffer losses as soon as losses exceeded the value of equity and subordinated debt (i.e. 10% of assets) in this example.

Recoveries with depositor preference under BRRD

	Claim	Recovery
Equity	5	0
Subordinated debt	5	0
Senior debt (excluding preferred deposits)	30	0
Uninsured preferred deposits	25	25 (100%)
Insured depositors	25	25 (100%)
Secured liabilities	10	10 (100%)

Under this scenario, the DIF would suffer no loss. Losses would have had to be greater than 65% of assets before the DIF suffered any loss.