

DEPOSIT INSURANCE

Proposal COM(2023) 228 of 18 April 2023 for a **Directive** amending Directive 2014/49/EU as regards the scope of deposit protection, use of deposit guarantee schemes funds, cross-border cooperation, and transparency

cepPolicyBrief 12/2023

SHORT VERSION [Go to Long Version]

Context | Objective | Interested Parties

Context: In the wake of the global financial crisis, the European legislature adopted the Deposit Guarantee Schemes Directive (DGSD) in order to enhance the protection and trust of depositors. As part of a package of proposals that includes the review of legislation on bank resolution, the Commission also wants to revise the DGSD. It has voiced concerns regarding the scope of depositor protection, the conditions for the use of DGS funds, the operational effectiveness of DGSs and the wide latitude for Member States to interpret the rules.

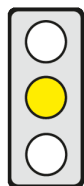
Objective: The Commission wants to clarify the scope of depositor protection, establish clear rules regarding the different options for DGSs to intervene, simplify the existing administrative procedures of DGSs, improve coherence of DGS practices, and strengthen the cross-border cooperation between DGSs.

Interested Parties: Banks, DGSs, Financial institutions, Depositors, Competent authorities.

Brief Assessment

Pro

- ▶ The “harmonized least cost tests” may prevent DGS funds from being used excessively and reduce the risk of distortions of competition.
- ▶ In various fields, the proposed Directive overcomes administrative barriers and provides legal certainty for banks, DGSs and supervisors.
- ▶ Policy efforts to ensure that money launderers are not afforded depositor protection are warranted to uphold the trust of honest depositors in deposit protection.

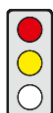


Contra

- ▶ Deposit protection for public authorities may encourage them to carry out less strict assessments of the risk profiles of banks.
- ▶ Differences in income and wealth may justify different levels of depositor protection with regard to temporary high balances. Furthermore, harmonised thresholds limit competition for “adequate” depositor protection.
- ▶ Preventive measures may give rise to moral hazard risks. If banks can count on being supported, this may encourage them to choose riskier business models.
- ▶ The results of the harmonised least cost tests can never be exact and could therefore lead to arbitrary decisions.
- ▶ Pushing for the early use of alternative funding arrangements sets wrong incentives as the costs are not usually borne by the failing bank but by other member banks of a DGS or the taxpayer.

Treatment of the deposits of public authorities [Long Version A.2.1]

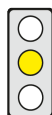
Commission proposal: In future, the deposits of public authorities shall no longer be excluded from depositor protection and generally be protected up to the coverage level of € 100,000.



cep-Assessment: This change of course is double-edged. On the one hand, it may remove existing administrative hurdles and reduce several legal uncertainties. On the other, it could disincentivise public authorities from adequately assessing the risk profiles of different banks. Furthermore, the argument that most of these authorities are not sophisticated depositors is unconvincing. And even if so, it should be the primary task of the legislature to ensure that they become savvy depositors, since they handle taxpayers’ funds.

Treatment of temporary high balances [Long Version A.2.2]

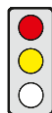
Commission proposal: In future, Member States must ensure that certain deposits are protected as a minimum to an amount of € 500,000 and for 6 months. This applies to deposits (1) resulting from and intended for real estate transactions relating to private residential properties, (2) that serve social purposes, i.e. deposits linked to retirement, and (3) that serve purposes such as the payment of insurance benefits.



cep-Assessment: The proposed specification of a minimum amount of € 500,000 and a maximum duration of six months contributes to a standardization of the requirements and thus reduces the administrative burden for DGSs. However, differences in income and wealth in the Member States may justify different levels of depositor protection with regard to temporary high balances. Furthermore, harmonization limits competition for "adequate" depositor protection.

Preventive measures [Long Version A.3]

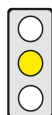
Commission proposal: If Member States allow it, the available financial means of DGSs may be used to finance "preventive measures", i.e. measures to support a bank in distress to prevent its failure. In future, the conditions for using those measures will be further harmonised and specified in various ways, i.e. by forcing banks to present a "note" containing the measures which they commit to undertake to strengthen their liquidity and capital position.



cep-Assessment: Preventive measures could give rise to moral hazard risks. If banks can count on being supported by preventive measures when in crisis, this may encourage them to choose riskier business models. Furthermore, distortions of competition cannot be ruled out. For example, distressed banks in similarly acute situations may be supported in different ways. Finally, there is a risk that banks whose exit from the market would be compelling from an economic perspective, will be bolstered. Thus, although the costs to DGSs of preventive measures may be lower than the cost of a depositors' payout, such measures should not be promoted.

Harmonised least cost tests [Long Version A.3.5]

Commission proposal: In future, DGSs must perform harmonized "least cost tests". Such tests shall determine the cost-efficiency of the use of DGS funds and compare the estimated costs of a depositors' payout vis-à-vis the estimated costs of resolution financing, alternative measures and preventive measures respectively.



cep-Assessment: The "harmonized least cost tests" may prevent DGS funds from being used excessively, reduce the risk of distortions of competition, and may reduce moral hazard risks because they signal to markets that such measures are not being used in every case. However, the costs can often only be estimated and the estimation very much depends on which cost categories are or are not included. Thus, decisions based on such tests may be arbitrary. Secondly, other factors beyond the pure cost comparison are left out.

Alternative funding arrangements [Long Version A.12]

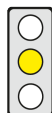
Commission proposal: If a DGS has to intervene it can currently draw on its available financial means, on ex-post contributions collected from member banks at short notice, or on alternative funding arrangements (e.g., loans, issuance of debt securities). In future, DGSs should specifically be allowed to use "alternative funding arrangements" prior to using their available financial means and prior to raising contributions from member banks.



cep-Assessment: Early recourse to alternative funding arrangements contradicts key ordoliberal principles. This is because the failing bank would regularly be exempt from making or having to have made a contribution of its own. The costs of using alternative funding arrangements are borne in particular by the other member banks of a DGS or, if the state serves as a source, also often by the taxpayer. This, however, gives rise to misaligned incentives so legislators should not expressly push the early use of alternative funding arrangements.

Prevention of money laundering [Long Version A.8]

Commission proposal: In future, banks will have to conduct a money-laundering-related customer due diligence assessment at the time that they fail or are likely to fail and share the results of the assessment with their designated authority. The authority must inform a DGS within 24 hours of the outcome of the assessment. DGSs must suspend repayments to depositors that have been charged with a money laundering offence, pending judgment of the court.



cep-Assessment: Policy efforts to ensure that money launderers are not afforded depositor protection are warranted to uphold the trust of honest depositors in deposit protection. However, stringent due diligence requirements will tie up resources at the very time when seamless and prompt compensation of eligible depositors is important. Furthermore, there are legal obstacles. These especially relate to DGSs or supervisory authorities not being notified about the commencement of investigations. Additional requirements to ensure a smooth exchange of information between the various parties involved are, therefore, necessary.