Introduction

On the 24th of November 2015, the European Commission proposed a euro area wide insurance scheme for bank deposits with a legislative proposal[1]. The proposal was accompanied by a communication that set out further measures to reduce risks in the banking sector in parallel.

The Commission's proposal for a European Deposit Insurance Scheme (EDIS) envisages the creation of a deposit insurance system in three phases:

- A **reinsurance phase** (2017-2019), during which EDIS may provide limited funding for liquidity (20% of its 'liquidity shortfall'), and cover a limited share of the loss (20% of its 'excess loss') of a participating DGS that encounters a payout event or has to contribute to resolution. National schemes could access EDIS funds only after exhausting their own resources.

- A **co-insurance phase** (2020-2023), during which Member States may request both funding for liquidity needs and loss cover from the Deposit Insurance Fund in case they encounter a payout event or need to contribute to resolution. The difference with the reinsurance phase is that funding is provided and loss is covered as from the 'first euro' and the share borne by the EDIS gradually increases over the coinsurance period (from 20 % to 80%).

- After the four-year co-insurance phase, participating DGSs would be fully insured by the EDIS. **Full insurance** (from 2024 onwards) provides full funding of the liquidity need and covers all losses arising from a payout event or a request to contribute to resolution. The mechanism is the same as in the co-insurance phase, but with the EDIS covering a 100% share.

Figure 1 gives a graphical overview of the EDIS proposal and its three phase insurance model.

[1] COM(2015) 586 final of 24.11.2015

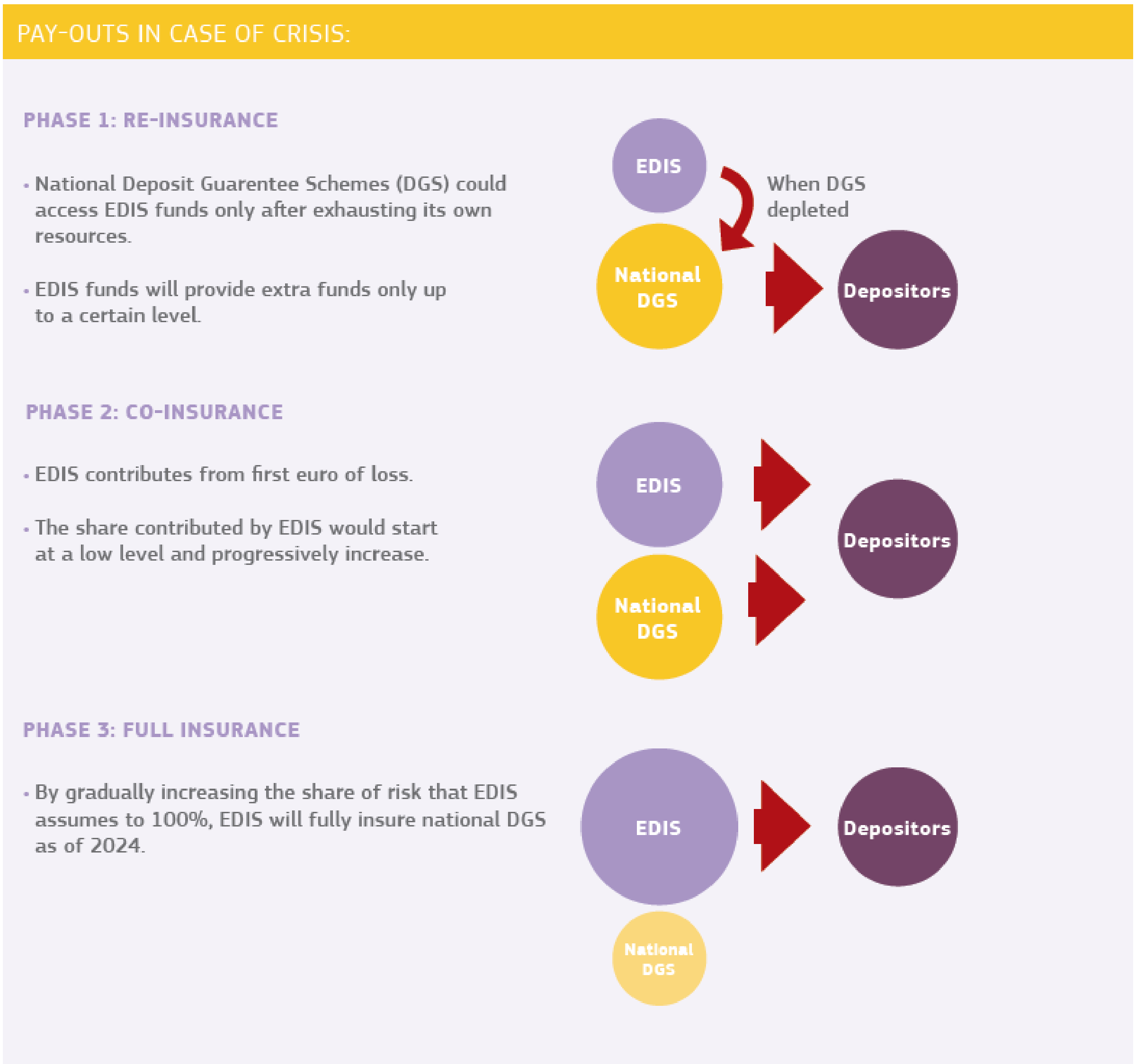

Figure 1: Payouts In Case of Crisis. Source: European Commission

The proposal, which amends the SRM regulation (806/2014), is based on Art 114 TFEU[2] and includes, besides the gradual approach described above, provisions on the constitution of the Deposit Insurance Fund (DIF) and its target levels (0,8% of all covered deposits by 2024), on procedural matters, on the role of the SRB etc. However, the establishment of the risk-based annual contributions to the DIF would under the Commission proposal fall to the Commission through a delegated act.

[2] TFEU Art 114 falls under Chapter 3 (Approximation of Laws) of the Treaty and is the legal basis to adopt measures for the approximation of the provision laid down by law, regulation or administrative action in Member States which have as their object *the establishment and functioning of the internal market*. There is an ongoing debate as to whether or not Art 114 could be used as the legal basis for the EDIS proposal.

With this legislative proposal, the Commission adopted a communication "Towards the Completion of the Banking Union"[3] with a list of issues to reduce risks in the banking sector. Given the simultaneous presentation and the Commission's subsequent remarks that "risk sharing and risk reduction need to go hand in hand" it is clear that the legislative proposal and the communication should be seen as one package, despite their difference in legal nature.

The objectives of this working document are therefore threefold: (i) to describe in general terms the linkages between the EDIS proposal and certain other legislative texts and existing structures; (ii) to explore the relevant key elements in the debate about risk reduction and (iii) to determine a number of key questions for the future handling of this package.

I. General context

The interlinkages between the EDIS proposal and related legislative texts and structures are manifold:

- Structural, because of the positions that the proposal and other texts occupy in the development of the Banking Union: as EDIS is presented as the third and final pillar of the Banking Union, the proposal has been designed to fit EDIS into the structures already in place;
- Institutional, because the EDIS proposal would affect or confer new tasks on bodies regulated or created by other texts (national Deposit Guarantee Schemes (DGS), Single Resolution Board (SRB));
- Economic and financial, because the operation of EDIS is presented as having a positive effect on financial stability and the functioning of the Single Market. EDIS is based on the presumption of having positive economic and financial effects due to the dynamics coming with the law of big numbers in any type of insurance scheme. It aims to improve deposit insurance cover in participating Member States and to anchor trust at a constant level of funding. This should in turn have other positive effects through lower funding costs and a possible desired reduction of the bank-sovereign nexus in these Member States. However, particular attention should be paid to the effects of EDIS on the competitiveness of the banking sector participating in EDIS compared to those who (for the time being) remain outside of EDIS. Also, while EDIS would increase the level of risk sharing, essential elements of risk reduction are not yet addressed and made concrete.
- Political or strategic, in the sense that the co-legislators may wish to condition progress on EDIS on developments elsewhere and vice versa.

This document does not deal with linkages which are only of the latter category, but focuses on the first three categories.

The main structural and institutional linkages are summarised in graphical form in the 'bubble chart' at Annex 1. From this can be seen that EDIS will rely strongly on the Single Supervisory Mechanism (SSM) and

[3] COM(2015)587 final of 24.11.2015

the SRB to function, implementing within the Banking Union the 'Single Rulebook' of, in particular, CRR/CRD and BRRD, and that these mechanisms need to be fully functioning and credible. This can also be seen in Figure 2.

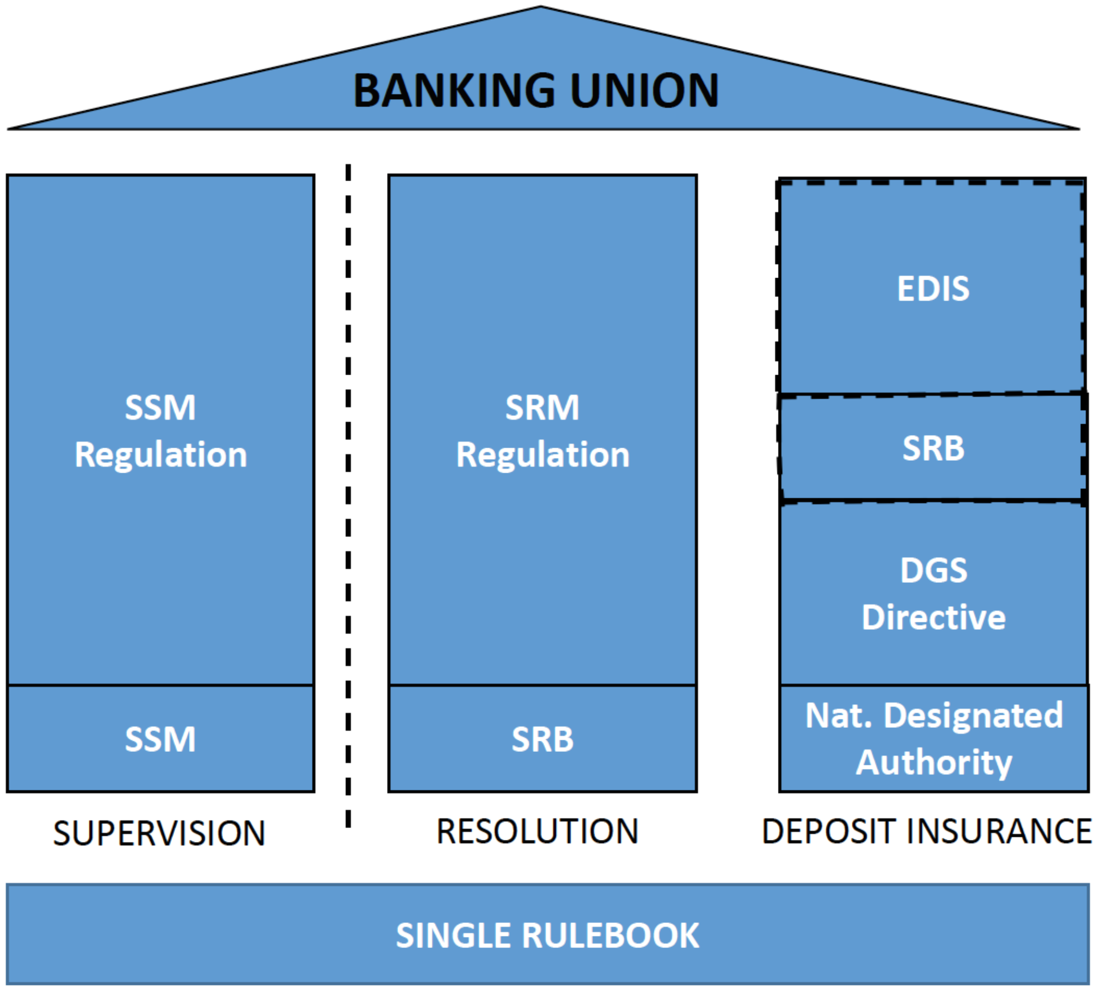

Figure 2: Banking Union Structure

In particular, it can be seen that the functioning of EDIS as proposed, could only be achieved if:

- **The DGS Directive 2014/49/EU is fully implemented**, at a minimum in the Banking Union participating Member States. This is because the EDIS proposal builds on the existence of DGSs in Member States and therefore requires that these schemes meet the provisions of that Directive. These DGSs will remain the schemes to which individual banks adhere and which will be called on to payout or otherwise act in the case of resolution or of deposits becoming unavailable. They will in turn - provided they respect the DGSD and adhere to funding requirements - be eligible to participate in EDIS.

Since the DGS Directive allows numerous national 'options and discretions' to Member States and/or to individual DGSs, there may be a case for further harmonisation (that is, further limiting of these options) given that some of them may vary the risk profile of DGSs. In any case, a stocktaking and evaluation should take place as soon as possible of the currently existing differences between national DGSs, including inter alia the overall coverage level (Art 6), repayment (Art 8), financing (Art 10) and the use of funds for alternative measures such as "deposit book transfers" (Art 11, all DGSD).

Furthermore, it is imperative to underline that trust only comes with funded systems, firstly because funds have to be available in case of resolution and/or a payout event and secondly because EDIS can only be used by a national DGS if it adheres to the funding path.

- **The SRB has the capacity and discretionary powers** to carry out both the functions conferred on it by the SRM Regulation and the new functions which the EDIS proposal proposes to add. Under the proposal, the SRB would assume the role of operating the EDIS and also of managing the associated Deposit Insurance Fund (DIF). It can be noted that the combination of resolution and deposit guarantee functions is shared in other jurisdictions, in particular the US Federal Deposit Insurance Corporation (FDIC).

  A discussion may be needed on whether the SRB requires access to greater resources, possibly on a contingency basis (credit lines, etc.) while the SRF is built up. Such questions may also arise in respect of the DIF.

- **The supervision of banks in the Banking Union functions correctly** (and is seen to do so) so that the supervisory information which is transmitted to the SRB by the ECB enables it to assess risks in a timely fashion and to exercise its functions. The system of supervision covers all banks in the Banking Union even if only larger ones are directly supervised by the ECB.

- **The resolution rules, and in particular the bail-in tool under which creditors rather than taxpayers meet the cost of resolution, operate as intended** (and are seen to do so). This is because DGS are required to step in whenever such bailing in would otherwise affect covered deposits. The operation of bail-in will therefore affect the possibility of EDIS being invoked.

  More generally speaking, confidence in the system and in those operating it will be of critical importance in achieving the results intended for EDIS. This requires as a necessary precondition the full implementation and application of the BRRD in all Banking Union Member States.

A proper transposition, implementation and functioning of existing Banking Union legislation (most notably the BRRD and DGSD) can be seen as a conditio sine qua non before the start of EDIS, as this is legislation that should in any case be functioning by now. It is therefore important to gain thorough insight into the current state of affairs in this area and to ensure that those MS who have not yet properly implemented and applied these related pieces of legislation will do so before any start of EDIS.

Although a necessary starting point for progressing towards the start of EDIS, these elements only are by no means a guarantee for EDIS' viability. This will require parallel progress on both risk sharing and further risk reduction to continue during the preparation for and build-up of EDIS. This issue will be discussed in part II.

II. Parallelism of risk sharing and further risk reduction

Besides the transposition and full implementation of existing Banking Union legislation, one of the key questions surrounding the debate about EDIS is when and how much further risk reduction and/or harmonisation is needed while taking steps towards a harmonised European framework for deposit insurance. Some argue that enough has been done on risk reduction and no further measures would be needed. Others argue that further risk reduction is an absolute precondition before any agreement even on starting the gradual process towards a full EDIS can commence. Many underline that, as the creation of EDIS is foreseen as a gradual process, it is logical to continue work on risk reduction in parallel. Positions vary as to the conditionality between the different steps in these two processes, but a majority seems to be of the opinion that risk sharing and risk reduction need be taking place at least "hand in hand". This means that further steps of risk sharing can only be taken if preceded and accompanied by the necessary steps in risk reduction.

Central in the debate about risk reduction is the issue of moral hazard. This concept is used to describe the risk of an imbalance in the likely outcome of a system of risk sharing, as is proposed under EDIS (in particular from the second phase onwards), which might lead to perverse or unintended incentives and adverse selection. Parties to the discussion may be reluctant to advance because of such effects. It can be observed that a degree of moral hazard is common to all insurance systems and in particular deposit insurance[4], however, the goal should always be to minimise it. What is notable in the EDIS proposal is the pooling of institutions and individual DGSs with different risk profiles (and sovereigns) and uneven distribution of risks, who have not previously pooled these risks and may have different perceptions of the riskiness or otherwise of their new partners. In some cases, the way in which a DGS operates enables banks to run / have oversight of the DGS and its fellow members which they would no longer have at the level of the EDIS as a whole.[5] Addressing these issues and perceptions appears key to building trust and gathering broad support for the EDIS proposal.

The Commission lists a number of risk reduction measures in the Communication adopted at the same time as the EDIS proposal which would be "needed in parallel with work to establish EDIS". In brief these are:

1. Options and discretions (ONDs) in respect of micro-prudential rules (i.e. in the CRDIV/CRR);
2. Harmonisation of national deposit guarantee schemes;

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[4] See for example http://bruegel.org/2016/02/european-deposit-insurance-a-response-to-ludger-schuknecht/

[5] See below the reference to the ECB's consultation on IPS

3. SRB start-up and MREL/TLAC (since the SRB is close to be fully up and running, only the latter is addressed below);

4. Consistent application of bail-in rules under BRRD / SRM and of EU State Aid and Fund Aid rules;

5. Convergence in insolvency law and restructuring proceedings across Member States, handling of non-performing loans (NPLs) (these 2 issues are separated out in Annex 2);

6. Prudential measures addressing identified weaknesses, in particular leverage, stable bank funding and comparability of RWAs;

7. Prudential treatment of banks' exposures to sovereign risk.

In Annex 2 these measures are worked out further, alongside a table with more concrete information on the state of play of these measures.

III. The way forward

The need to create synchronicity between the three pillars of the Banking Union and to ensure that deposits of European citizens are protected independently of where these citizens live are some of the central arguments underpinning the positive reception of the proposal.

However, given the many interlinkages with other, often highly sensitive issues, the EDIS proposal is a controversial one and large differences remain as to which conditions need to be met for EDIS to advance as well as with regards to the design of EDIS. Overcoming these differences will be a matter of **timing, conditionality and content**: which steps can be taken when and under which conditions. The absence of an up to date impact assessment for this proposal is highly regrettable. Your rapporteur still expects the Commission to come forward with a thorough and up to date impact assessment. It is of vital importance to ensure that no Member State participating in EDIS is (perceived to be) worse off compared to its starting position.

A. <u>Conditionality</u>

Parties in the debate have expressed different and sometimes opposing views as to the amount of risk reduction needed in parallel to the gradual establishment of EDIS and the conditionality between steps in the field of risk reduction and those in the area of further risk sharing. However, most parties to the debate have acknowledged that risk reduction needs to increase during the gradual setting up of EDIS. This would require clarity beforehand as to the risk reduction measures that are deemed relevant for the establishment of EDIS, as well as regular assessments to determine whether the risk reduction agenda is still on track and in parallel to the process of gradual and increased risk sharing through EDIS.

1. *Preliminary steps*

In your rapporteur's view, a proper transposition, implementation and functioning of *existing* Banking Union legislation (most notably the BRRD and DGSD) can be seen as a conditio sine qua non for the start of EDIS, as this is legislation that should in any case be functioning by now. It is therefore important to gain thorough insight into the current state of affairs in this area and to ensure that those MS who have not yet (properly) implemented and applied these related pieces of legislation will do so before any start of EDIS. In this regard, a number of preliminary steps have been put forward by various parties to the debate, including inter alia a stocktaking and evaluation exercise concerning the differences between the national DGSs and a review (some arguing for a full Asset Quality Review) of all the banks under the SSM.

The lack of an impact assessment continues to be a complicating factor in this sensitive dossier. The Commission non-paper "Economic benefits of the EDIS proposal" only partially fills this omission. The significant need for a proper consultation-based impact assessment remains. In line with the Commission principles in the Better Regulation Agenda, your rapporteur reiterates the request for an impact assessment. Your rapporteur suggests that until that assessment is published, the (shadow) rapporteurs and other interested ECON members address their questions concerning the impact of the EDIS proposal to the European Commission (comparable to the working method based on "surveys" as used in the Ad Hoc Working Party of the Council[6].

As for the legal base, it is clear that there will be an ongoing debate whether or not Art 114 TFEU is a suitable legal base for the proposal. Art 114 TFEU has been used for Banking Union legislation before, for example the SRM regulation, in that instance combined with an Intergovernmental Agreement (IGA) for the funding of the Single Resolution Fund.

Your rapporteur is aware of the opinion of the Legal Services of the Council regarding the legal base, which concludes that Article 114 TFEU is an adequate legal base for the EDIS proposal. An opinion of the Parliament's Legal Service could be requested, if deemed necessary, especially regarding the use of an IGA, which has been signalled as a possibility by the Council legal opinion and is opposed by the European Parliament which wishes to safeguard the community method.

2. *Measures to be taken alongside the creation of EDIS*

Your rapporteur emphasises that the measures discussed in Annex 2, let alone the following points, are not to be seen as an exhaustive list. That being said, your rapporteur underlines the importance of the following elements.

a. TLAC and MREL
   The bail-in tool is generally regarded as one of the vital tools to address the sovereign-bank nexus and the issue of too-big-to-fail. Regarding the EDIS proposal specifically, it is a key element to protect the DIF from being called upon and the same holds true for the SRF. The availability of bail-inable liabilities is therefore key.

[6] Regrettably, neither Council nor Commission have shared these documents with the European Parliament via any official channel.

Summing up, one could argue that sufficiently high MREL requirements are needed to protect EDIS, in particular for medium-sized and big banks, the latter possibly requiring a substantially higher binding MREL than 8%. It is important for the Commission to take this into account with regards to their TLAC implementation proposal later this year. In any case it is important that the setting of MREL is left to the discretion of the Resolution Authority / SRB, which needs sufficient intervention and monitoring tools are at its disposal to ensure adherence by all banks to the set requirements.

b. OND and harmonisation DGSs

Temporary high balances (Art 6(2) DGSD), being one of the most significant national options under the DGSD. Member States are currently free to set the conditions, level and duration of the (additional) coverage provided. This is an issue which needs resolving, as the DGS Directive sets no upper limit to the amount above the compulsory €100.000 which can be covered by a DGS. As a consequence this differs significantly per Member State.

These differences would lead to an unlevel playing field in case of a call on the DIF. Possible ways to address this matter are either to include provisions on this issue in the EDIS proposal or to amend the DGSD, while taking due account of cost-neutrality and level playing field issues inside and outside the Banking Union.

Alternative measures (Art 11(3), and also 11(6) DGSD). While it should be clear that alternative measures can by no means be used to save a bank when it is against the public interest to do so, the use of alternative measures can have advantages from the perspective of the client and are often exercised by those DGSs that are also an IPS. It should therefore be discussed whether the use of alternative measures should be harmonised further, be kept as a possibility at the national level or be added as tools at the European level. This also raises the question whether and how these measures continue to be / will be financed.

c. Insolvency

These measures centre mainly around the interlinked issues of resolution - insolvency - deposit insurance. All sides of this ‘triangle’ need to be sufficiently developed and efficient in order to make bank failure safer and the least cumbersome on the consumer / client / depositor / other creditors. A framework to address the issue of NPLs should be seen as a vital feature of this triangle. This also includes the problems that many banks endure with regards to other non-performing assets.

d. Sovereign Debt

While any and all measures to address the issue of banks’ exposure to sovereign debt should be approached and handled very carefully and gradually, this has to be and will be a key issue in moving towards a fully-fledged European deposit insurance scheme. In the end, a better regulatory framework, be it European or international, would be needed.

As a general remark it should be noted that the best way to deal with banks’ exposure to sovereign risk and the bank-sovereign nexus, is not any regulatory approach for the banking sector, but for

Member States to reduce sovereign debt levels. A strict and coherent implementation and enforcement of both the Stability and Growth Pact and the economic governance framework has the ability to reduce banks' sovereign exposure risk significantly. It is, however, a reality that further steps of risk reduction need to be taken, especially when moving towards further mutualisation of risks between the Member States as is the case in the EDIS proposal.

B. Timing

Several elements are at play when it comes to the timing of the EDIS proposal, not only the start and the gradual phasing-in of the proposal itself, but also the progress of the respective risk reducing measures that are linked to the proposal. There are several options to be looked at, of which three seem to have gained adherence.

1) To start and progress with EDIS as proposed by the European Commission in full;
2) To forego the reinsurance phase of the proposal and start in 2020 (as planned) directly with the co-insurance phase, albeit based on strict conditionality;
3) To start EDIS as planned or soon after the planned date, but with a (possibly lengthened) reinsurance phase and conditional transition to further phases.

Realistically, it seems unlikely that EDIS could start and progress completely according to the Commission proposal.

To forego the reinsurance phase, however, and start under strict conditionality in 2020 with co-insurance would mean the full insurance phase could start as planned in 2024. Yet, with the mutualisation of risks the co-insurance and full insurance entail, this also brings the need for strict conditionality with regards to risk reduction. With foregoing the reinsurance phase, this could mean - if not enough steps are taken - that European citizens will not have the possible benefits of a European deposit insurance scheme. An example would be in the case that the Basel Committee decided to take no further prudential measures on the exposure of banks to sovereign debt. It would be difficult to then address this issue only within the Banking Union or the European Union. The consequence then could be that we could also not start with the co-insurance phase of EDIS.

In that regard, the reinsurance phase could still prove useful as it would provide liquidity support to national DGSs during the period in which they can make progress with the risk reduction agenda. Although for the reinsurance phase there are good parts already present in the Commission's proposal, there then would be the need to redesign it, since there are several elements that would not enable it to fully function and function well.

In relation to timing, the case of the IGA on the transfer of funds to the SRF has shown the additional uncertainty that can stem from the need for ratifications by MS regarding the timing and even the overall entry into force of the legislation.

C. <u>Other Issues</u>

These issues are all highly interlinked.

1. Funding / contributions

As a general starting point, the gradual move from national DGSs to EDIS should be cost-neutral. Furthermore, specific work is needed concerning (risk-based) contributions. Besides the fact risk-based contributions will always have a limited spread and can thus only do so much, your rapporteur regrets that the Commission has suggested with their proposal to leave this to level 2 measures.

Regarding the types of contributions accepted, in particular the issue of payment commitments, it is worth underlining that not including them makes the resources of the DIF more liquid and therefore more reliable in case they are called upon. On the other hand, payment commitments are already under the DGSD and the SRF and may give the banking sector some added flexibility. If the possibility of using payment commitments is maintained, they will need to fully credible and thus always have to be directly and immediately payable.

On the principle of cost-neutrality, the wording of Article 74c as proposed by the Commission has raised some concern and needs further clarification.

2. Remit

Certain options for use of funds (in particular Art 11(3) and Art 11(6) DGSD - “alternative measures”) are not payout events for the purposes of EDIS under the Commission's proposal. As previously mentioned, while it should be clear that alternative measures can by no means be used to save a bank when it is against the public interest to do so, the use of alternative measures can have advantages from the perspective of the client and are often exercised by DGS which are also IPS. It should therefore be discussed whether the use of alternative measures should be harmonised further, be kept as a possibility at the national level or be added as tools at the European level.

If the (possibility of using) alternative measures are to remain at the national level, as this is the level with most direct contact with the affiliated entities, the funding of such measures and consequences for the need for budget-neutrality for the banking sector should be clarified.

3. Governance issues

It will be important to have the best possible arrangement for the stewardship of the funds collected in the DIF, whatever the legal basis for its establishment. Its investment strategy would need to be prudent, and arrangements for collecting contributions to be sound and efficient. Most of all, any expenditure by the DIF would need to be subject to appropriate controls. Finally, the rights of the DIF to subrogate to the rights of depositors in any insolvency or restructuring proceedings would need to be exercised thoroughly and in full.

4. Structure / design

In general your rapporteur is of the view that if a system works well, there is no need to change it. Whether or not this would mean that national systems could co-exist alongside of a possible European deposit insurance scheme in a role beyond that of a mere paybox is to be debated.
Once again, certain elements of the national DGSs have proved to create stability and anchor the desired trust in the safety of deposits. In that respect, it is laudable that the Commission is taking the approach that national options, such as referred to in Art 11(3) and 11(6) BRRD, remain as available tools. These systems, however, would then need financing and this would question the budget-neutrality of the proposal for the banking sector.

Another issue is that the introduction of EDIS would lower the perceived advantage for DGSs to increase their funding levels beyond the target level of 0,8%. The EDIS proposal is envisaged by the Commission to harmonise deposit insurance within the Banking Union, but there should always be an incentive to go beyond 0,8% financing of covered deposits.

IV. Conclusion

This Working Document has tried to describe in general terms the linkages between the EDIS proposal and certain other legislative texts and existing structures, to explore the relevant key elements in the debate about risk reduction and to determine a number of key questions for the future handling of this package. Many ECON members have expressed the willingness to work towards a completion of the third pillar of the Banking Union, but most of them have also argued that certain conditions need to be fulfilled if progress is to be made. It has become clear that concrete positions vary widely and finding agreements on this highly sensitive dossier will require the right balance in terms of timing, conditionality and content. This task is further complicated by the lack of a proper impact assessment. Ensuring as much as possible cost-neutrality for the banking sector and a level playing field between Banking Union Member States and non-Banking Union Member States will be, among others, two key elements.

Next steps proposed by the rapporteur:

- *An impact assessment from the European Commission*
- *Concrete steps in the area of risk reduction*
- *More clarity on the calculation of the risk-based contributions*
- *Finding a broad majority position in both Council and Parliament on:*
    - *Concrete timing of the phasing in of EDIS*
    - *Conditionality of the risk reduction*
    - *Content / design of EDIS*