Analysis

# Construction of a risk-based European Deposit Insurance Scheme

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The completion of Banking Union is an important objective from the perspective of financial stability. Reaching an agreement on a common deposit insurance scheme is a key component in achieving that objective. The purpose of a deposit insurance scheme is to strengthen confidence in uninterrupted access to bank deposits. The size of the Deposit Insurance Fund must be sufficient to credibly withstand possible problem situations. Banks' deposit insurance contributions should be calibrated based on risks. This would reign in individual banks' incentives to benefit from a common deposit insurance scheme to which all banks have contributed. Studies show that a common deposit insurance scheme would be quite resilient.



The further development of EMU and the completion of Banking Union necessitates the creation of a common European Deposit Insurance Scheme (EDIS). Currently, covered deposits are within the scope of the national deposit guarantee schemes of the bank's country of location. The common deposit insurance scheme would have more resources than national deposit guarantee schemes, which would increase the stability of the euro area banking system significantly compared with the current situation. The aim is to achieve an equally strong level of confidence in the liquidity of bank deposits across the euro area.

According to the European Commission proposal, the size of the joint Deposit Insurance Fund would be 0.8% of the amount of covered deposits.[1] The ECB has examined the sufficiency of the European Deposit Insurance Scheme proposed by the Commission, based on a quantitative analysis which takes into account the realisation of different risk scenarios.[2] The study considers a fully fledged deposit insurance system, based on end-2015 data from 1,675 euro area banks.[3] The results of the ECB analysis indicate that a deposit insurance scheme in line with the Commission's proposal would be sufficient to cover the risks even in the more conservative scenarios[4]. The sufficiency of the deposit insurance scheme would be threatened only in the event that banks' losses were to rise to very high levels. Other safety net tools are necessary for dealing with such extensive systemic crises.

The Commission proposes that the deposit insurance contributions be calibrated based on the banks' risk profiles. A detailed calibration of banks' deposit insurance contributions ensures that banks with the highest likelihood of having to use deposit insurance pay the highest share of the contributions. In other words, the banks most likely to cause risks would pay a higher share of the contributions to compensate for the risks caused. This will also ensure that individual banks will not benefit from contributions paid by other banks, by taking higher risks and, if their plans are unsuccessful, leaving the losses to be borne by the other banks.

The European Banking Authority's Guidelines on the creation of national deposit guarantee schemes can be considered a starting point, but the Guidelines must be applied on the level of the Banking Union. A bank's deposit insurance contribution would be calibrated based on its risk profile relative to its peers in the Banking Union.[5]

The ECB has analysed the calibration of risk-based contributions to the deposit insurance scheme in different alternatives. When assessing banks' balance sheet risks and calibrating deposit insurance contributions the volume of non-performing loans could also be utilised. The amount of MREL[6]-eligible liabilities, which strengthen banks' risk resilience, could in turn decrease the amount of contributions. MREL-eligible liabilities are used in bank resolution when a bank's creditors are bailed in. The purpose of these liabilities, which are within the scope of bail-in, is to ensure that the costs of future problems in the banking sector will not be borne by taxpayers. The larger the amount of a bank's MREL-eligible liabilities, the smaller the likelihood of the bank having to resort to the deposit insurance scheme.

The size of a risk-based deposit insurance fund would thus, as a rule, be sufficient to cover the risks in a non-systemic crisis, but not in a systemic crisis. By combining the risk scenarios and risk-based contributions, one can investigate the possible existence of cross-subsidisation[7] between banking

sectors in different Member States. The results of the ECB analysis show that the risk of unwarranted cross-subsidisation appears to be low. This follows from the bank resolution process, in which bank losses are covered in accordance with the principle of bail-in. Calculations show that only a small amount of losses would have to be covered by deposit insurance scheme. In the most conservative scenarios, in which the assumed losses may be considerable, there is a possibility of cross-subsidisation. In these scenarios, banks in some countries could benefit from the deposit insurance scheme more than they have originally contributed.

Assessments of the usefulness of a common deposit insurance scheme should also take into account that the situation and capital position of banks vary across countries and over time. A banking system or banks that are solid today may over time turn out to be quite weak if the situation deteriorates. Banks that are weak today may, in turn, prove to be solid and profitable if the time horizon is sufficiently long. An example of this is the comparison of the current condition of the Finnish banking system to the situation in the mid-1990s.

## Notes

1. A European Deposit Insurance Scheme (EDIS) – Frequently Asked Questions. ↑
2. ECB Macroprudential Bulletin, Issue 3, June 2017. ↑
3. The covered deposits of the banks analysed in the sample totalled some EUR 4,700 billion, corresponding to approximately 83% of covered deposits in the euro area. ↑
4. For the scenario, the probability of default (PD) is calculated for each bank. The analysis assumes that banks fail in the order of their probability of default. The analysis considers crises of a different magnitude, where the riskiest 1% or 3% of banks fail simultaneously. The most conservative estimates assume bank losses to be larger than in the 2007–2010 financial crisis. ↑
5. The ECB analysed also alternatives in which national specificities – e.g. effectiveness of bankruptcy legislation – would be reflected in deposit insurance contributions. The impact of country-level differences on deposit insurance fees is highlighted also in a working paper published by German and French economists. ↑
6. Minimum requirement for own funds and eligible liabilities (MREL). ↑
7. Here subsidisation refers to a situation in which banks in a certain country use, in a loss scenario, more of the Insurance Deposit Fund's resources than they have contributed. ↑

## Keywords

banking union, deposit insurance scheme