EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS

Consultation Document

Review of Directive 94/19/EC on Deposit-Guarantee Schemes (DGS)

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You are invited to comment on the views reflected in this paper. These views are only an indication of the approach the European Commission may take and are not its final policy position nor do they form a formal proposal by the European Commission.

The present consultation addresses one of the issues covered by the Commission Communication **Driving European recovery[1],** which is intended to tackle the most important shortcomings in the markets that have been observed in the current financial crisis. The Commission committed to propose additional measures needed to **reinforce depositor**, investor and policy holder **protection**. In this context, we would welcome the views of **all interested stakeholders regarding the present consultation**.

We would like to ask you to respond to the specific proposals and questions **and to describe any alternative approaches you think would achieve our objectives defined as follows:**

- strengthen depositor confidence,

- enhance financial stability,

- protect a part of depositors' wealth,

- enhance the Internal Market.

Your comments will help the Commission services to develop proposals to review the Deposit Guarantee Schemes Directive. We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on the effectiveness of the potential options, on compliance costs, impacts on competition and other impacts, as well as on other implied costs and benefits. These elements will be taken into account when we prepare our final policy position and the impact assessment accompanying it. In the interest of transparency all contributions will be posted on the Europa website. Where possible, we are seeking both quantitative and qualitative information. **We are also keen to hear from you on any other issues you consider important in the context of Deposit Guarantee Schemes.** In order to timely and properly evaluate your contributions we would appreciate it if you could maintain the structure of this questionnaire in your replies and **make clear to which question you refer to**.

You are invited to send your contributions until **27 July 2009** to markt-dgs-consultation@ec.europa.eu

This consultation intends to gather contributions from the public for the review of the Directive on Deposit Guarantee Schemes.

Deposit Guarantee Schemes reimburse a limited amount of deposits to depositors whose bank has failed. From the depositors' point of view, this protects a part of their wealth from bank failures. From a financial stability perspective, this promise prevents depositors from making panic withdrawals from their bank, thereby preventing severe economic consequences.

In order to ensure greater effectiveness of the Deposit-Guarantee Schemes Directive and to respond adequately to any deficiencies or risks that may have arisen as evidenced in the current financial crisis, the Commission has to submit a report to the European Parliament and the Council and if appropriate, legislative proposals by the end of 2009.

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1 COM (2009)114 of 4th March 2009

1. CONTEXT

No bank, whether sound or ailing, holds enough liquid funds to redeem all or a significant share of its deposits on the spot. This is why banks are susceptible to the risk of bank runs if depositors believe that their deposits are not safe and try to withdraw them all at the same time.

One of the biggest concerns for depositors is the safety of bank deposits, in particular in cases of bank failures. Since 1994, Directive 94/19/EC on Deposit Guarantee Schemes (DGS) has ensured that all Member States have in place a safety net for depositors if banks fail to pay. The DGS established under the Directive protect depositors and help to maintain the stability of the banking system. The schemes are designed to compensate depositors for deposits at banks up to a specified limit (€ 50 000 by end of June 2009 and 100 000 by the end of 2010) when a bank is not in a position to pay out deposits. Knowing that their deposits are protected, depositors should be less likely to rush to withdraw their deposits. This should reduce the likelihood of bank runs that could result in further bank failures and a severe economic crisis.

Events in 2007 and in 2008 exposed deficiencies in DGS and their consequences in terms of depositors' confidence to a new extent. For this reason, on the basis of the Commission's proposals, amendments to the DGS Directive were adopted (final text published on 13 March 2009[2]). This in particular raised the minimum coverage of DGS in the EU, reduced the deadline to decide if a bank has failed, reduced the payout delay, and abandoned the concept of coinsurance. These changes were an important step in response to the immediate challenges of the crisis situation. But a series of other issues were also identified that appeared appropriate for further review in the slightly more medium term. The DGS Directive therefore provides for a review clause and includes a comprehensive list of issues to be reviewed[3]. These issues are dealt with in this consultation paper.

Question 1: Do you agree in general that the current framework of DGS in the EU needs to be revised? Are the areas identified for review the right ones, or are there other priorities?

2. EXISTING DGS FRAMEWORK AND SCOPE OF THE CONSULTATION

First and foremost, bank failures are prevented by the prudential supervision of banks, which is ensured by national supervisory authorities and is harmonised throughout the EU to a high extent. If nevertheless, a bank has to be closed, DGS step in and reimburse depositors up to a certain ceiling, the coverage level. The objective is twofold: to protect a part of depositors' wealth and to ensure financial stability by preventing bank runs.

For a better understanding of the functioning of DGS in a cross-border context, it is essential to know that the sole responsibility to reimburse depositors lies with the DGS of the country where the bank has its registered seat, regardless whether the bank is a stand-alone company or a subsidiary controlled by another company. This responsibility extends to all legally dependent parts of a bank, i.e. its branches, even if they are located in another Member State.

2 Directive 2009/14/EC, OJ L 68, 13.3.2009, see also http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm.

3 See Article 12 of Directive 1994/19/EC as amended by Directive 2009/14/EC (see preceding footnote)

However, there is an important exception to this principle. If, in case of branches, coverage in the host country is higher or more comprehensive than in the home country, the current regime provides the option for the bank to join the host country DGS for the difference in coverage. This is called **'topping up arrangement'** and means that two DGS (home and host country) are involved when depositors of such a branch are to be paid out. Topping up arrangements are very complex because the current Directive has only harmonised DGS on a minimum level and frictions occur if DGS operating under different national rules must cooperate; topping up can also lead to delays in payout (see also chapter 3.1.2).

The problems described below should be looked at from different perspectives: they do not only occur in a crisis situation when a bank or several banks fail and when there is a need for paying depositors back. In "normal", stable times, differences in nature and functioning of DGS in different EU Member States are source of distorted competition and limit the benefits customers and banks could have if the internal market functioned properly.

3. SCOPE AND LEVEL OF COVERAGE OF DGS

3.1. Coverage level

By end of June 2009, coverage of at least € 50 000 is required by EU law. The level will be fixed at € 100 000 (with no possibility for Member States to derogate from that level) by the end of 2010 unless the Commission concludes that this is inappropriate[4].

3.1.1. Appropriateness of coverage levels

A minimum coverage of € 50 000 is estimated to cover about 80% of deposits while a coverage of € 100 000 would cover about 90% of deposits in the EU[5]. If depositors feel that a part of their deposits is not covered (i.e. is at risk of being lost), they might run on their banks. Even if it was argued that it might be sufficient to protect 80 per cent of depositors' wealth, it is rather questionable whether this would already prevent a bank run. If the remaining depositors are not sufficiently covered, the risk of bank runs remains high – and those depositors whose deposits exceed the coverage limit even have a higher impact since they would withdraw very large amounts and thereby dramatically weaken the bank.

Appropriateness of the coverage levels

The following options could be considered:

(a) Revert to a coverage of € 50 000

(b) Coverage of € 100 000 (current approach – from end 2010 onwards)

(c) Coverage of a higher amount

(d) Coverage depending on the actual size of deposits or economic indicators such as the Gross Domestic Product per capita (thus different in each Member State)

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4 Article 7(1a) of Directive 1994/19/EEC as amended by Directive 2009/14/EC.

5 COM(2008)661final, p. 4.

(e) Unlimited coverage

<u>Question 2:</u> Which of the above options would you prefer? Would you prefer another option? Please explain your choice.

See also Question 3 on differences in coverage level and Question 30(e) on a possible de-minimis rule (i.e. deposits below a certain size, e.g. € 10 would not have to be paid out).

3.1.2. Differences in level of coverage

Currently, there are very different coverage levels throughout the EU, ranging from the current minimum of € 50 000 in nine Member States to € 103 291 in Italy[6].

When the financial crisis aggravated in September 2008, most Member States either raised their coverage levels to € 50 000 or € 100 000 or issued unlimited guarantees, sometimes covering not only deposits but all liabilities of banks. Even though most of the latter measures were temporary and in some cases were not enacted in legislation, they led to some unwanted side-effects. Depositors seemed to have quickly shifted money to banks covered by unlimited guarantees. This created a heavy liquidity strain to the banks not covered by such guarantees. Divergence in coverage levels thus further seemed to have jeopardised financial stability.

Topping up arrangements needed to mitigate the impact of differences in scope or level of coverage potentially delay or even obstruct payout. This problem would only become obsolete if differences in level or scope of coverage were completely eliminated, i.e. fully harmonised.

<u>Question 3:</u> Should the coverage level you prefer (Question 2) be a minimum or a fixed level? Or do you think a different solution would be more suitable, e.g. a range with a minimum and maximum level? If so, please describe. Please give reasons for your choice.

Moreover, in times of stability, some depositors might base their choice of product or service not only on its price and quality but on the merits of the DGS that covers it, potentially distorting competition and limiting the benefits of the Internal Market since banks cannot choose their DGS. On the contrary, it could be argued that depositors might, in order to avoid having deposits above the coverage level, split up deposits and open accounts at several banks, which could actually enhance competition. However, it should be considered that such behaviour would seem to highly depend on the product (with savings accounts seeming easier to split than current accounts), on banks' policies on product tying and on the fees that could multiply. In the UK, such behaviour was considered "accidental"[7].

<u>Question 4:</u> Do you have background information or evidence whether depositors have split up their deposits when the financial crisis aggravated in autumn 2008?

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6 In Norway, where Directives 1994/19 and 2009/14 must be transposed pursuant to the EEA (European Economic Area) agreement, coverage is even higher: 2 Million NOK – about € 230 000.

7 UK FSA, Consumer awareness of the Financial Services Compensation Scheme, p. 9 (http://www.fsa.gov.uk/pubs/consumer-research/crpr75.pdf).

Should depositors be actively encouraged to split up their deposits between different banks or is this inappropriate? Please give reasons.

3.1.3. Calculation of the coverage level

All deposits of a depositor at a bank including its branches are aggregated. If a depositor has e.g. a savings account of € 70 000 and a current account of € 50 000 at the same bank, he or she would only receive € 100 000 (from end 2010 onwards). This may lead to problems if, as is the situation in particular the United Kingdom, different products such as savings and current accounts are traded under different brand names even if they are sold by the same bank. In such a case, the depositor may not know that both accounts are aggregated for the purpose of calculating the coverage level.

Question 5: Do you think this problem could be solved with a mere information obligation towards depositors (see Questions 22-25)? Or do you think banks should have the option to ask for coverage per brand name to avoid aggregation of accounts in case of failure? If so, and how, should this be taken into account when the contributions of such banks to DGS are calculated?

3.1.4. Exemptions from a fixed coverage level

The current Directive foresees that from end 2010, Member States will be required to fix coverage of the DGS that are under the Directive at a certain level. In some Member States, particular types of deposits are currently covered or intended to be covered to a much higher extent. This is either for social considerations (e.g. pension deposits in Denmark) or for temporary high account balances resulting from events such as real estate transactions, pension payments or compensations for damages or injuries (if paid as lump sums), or inheritance. Currently, such exceptions are only granted to Member States where they had been in force on 1 January 2008 ('grandfathering'). On the one hand, such exceptions could improve depositor confidence by better protecting their wealth in exceptional circumstances, on the other hand, they may, if optional or even if limited to a few Member States, lead to the same problems as widely diverging coverage levels (see preceding section).

Question 6: If the coverage level is fixed, should there be exemptions that allow a higher coverage of certain products for social considerations? If so, for which products should there be exemptions and up to which amount? Should this be harmonised or should Member States have the discretion to decide on this? In the latter case, which elements should be within the discretion of Member States (e.g. amount and duration of coverage)?

Question 7: Should temporary high account balances be covered? If so, up to which amount and for how much time? In which situations should these balances be covered? Should this be harmonised or should Member States have the discretion to decide on this? In the latter case, which elements should be within the discretion of Member States (e.g. situation, amount and duration of coverage). Should, in order to facilitate payout, such balances be transferred to special accounts that are 'tagged'? Do you see other solutions to protect temporary high balances?

3.1.5. Mutual guarantee schemes and voluntary DGS

Currently, mutual guarantee schemes[8] are exempt from the Directive if they fulfil certain criteria[9]. Such schemes aim at avoiding failures of their member banks "at all cost" – thus offering a kind of "unlimited" protection without the need for a coverage limit. There are also voluntary DGS that so far have not been covered by the Directive and offer a quasi unlimited protection. Maintaining the status quo could lead to competitive distortions if from end 2010 onwards all DGS under the Directive were prohibited to increase their coverage level. It should be noted that banks adhering to mutual guarantee schemes often emphasise "unlimited coverage" in their advertisements[10].

Question 8: **Should mutual guarantee schemes and voluntary schemes be integrated into the Directive so that the same rules would apply for them as for 'classical' DGS? If so, how? Should there be restrictions on advertising for these schemes? Please provide reasons.**

3.1.6. Scope of covered products

There are considerable differences in scope of deposits and depositors covered by DGS across the Member States. The definition of 'deposits' in Article 1 of the Directive[11] currently leaves some room for interpretation e.g. whether structured deposits are covered[12]. The coverage of debt certificates issued by a credit institution (Annex 1 no. 12 of the Directive) and deposits in currencies of non-EU countries (Annex 1 no. 13 of the Directive) is subject to the discretion of Member States.

Scope of deposits covered by DGS

The scope of eligible deposits could be in the discretion of Member States or harmonised. If it is harmonised, it could be considered to fully cover certain deposits, to cover them only up to a certain percentage of the normal coverage level, or not to cover them at all. *(continued on the next page)*

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8 A Mutual Guarantee System protects the credit institution itself and ensures its liquidity and solvency: if necessary to avoid a failure, the other members of the system step in and support the bank or reorganise it. Such systems have in particular been established by the German and Austrian Cooperative and Savings Banks.

9 See Article 3(1) of Directive 1994/19/EC.

10 Deutscher Sparkassen- und Giroverband (http://www.gut-fuer-deutschland.de/?id=47); Bundesverband der Deutschen Volks- und Raiffeisenbanken, (http://www.bvr.de/public.nsf/index.html!ReadForm&main=4&sub=60).

11 *"'Deposit' shall mean any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution."*

12 A structured deposit is a combination of a deposit and an investment product, where the return is dependent on the performance of some underlying financial instrument such as market indices, equities, interest rates, commodities, foreign exchange.

A. Structured deposits:

Question 9: Which solution(s) would you prefer as regards structured deposits? Please provide reasons. Would you prefer another option? Please describe.

B. Debt certificates issued by a credit institution:

Question 10: Which solution(s) would you prefer as regards debt certificates? Please provide reasons. Would you prefer another option? Please describe.

C. Accounts in non-EU currencies:

Question 11: Which solution would you prefer as regards accounts in non-EU currencies? Please provide reasons. Would you prefer another option? Please describe.

3.1.7. Scope of covered depositors

As to the eligibility of depositors, there are even greater differences among DGS. Annex 1 of Directive 1994/19/EC allows Member States to exclude protection for many different types of depositors. This variety entails problems. While the inclusion of certain products or types of depositors could improve depositor confidence by better protecting their wealth, their exclusion would save money.

Currently, Member States exclude most deposits and depositors enumerated in Annex 1[13].

The wide range of discretion may lead to the same problems as widely diverging coverage levels: market distortions if depositors choose the most comprehensive scheme, not the best product. Furthermore, the verification of eligibility criteria can be complex and time-consuming and thus potentially delays payout.

Question 12: Should the eligibility criteria as regards depositors (provided for in Annex 1 no. 1-11 of the Directive) be fully harmonised or should Member States retain some discretion to decide about eligibility of depositors? *(If you prefer that Member States retain discretion, please skip questions 13-16)*

The discretionary exclusions can be categorised as follows:

- Other enterprises in the financial sector, i.e. financial institutions, insurance companies, investment funds, pension funds (Annex 1 no. 1, 2, 5, 6). As referred to above, banks are ineligible anyway. Not only can they be considered professional depositors who unlike non-professionals have to assess the risk of their actions and therefore have other liquid assets than deposits, the covered amount would only seem to represent an insignificant fraction of their overall deposits.

- Authorities on central and local level (Annex 1 no. 3 and 4). They are not only expected to act responsibly but could even be instructed not to run on a bank and therefore would not seem to need the same protection as individuals. Moreover, in many cases, the covered amount would only seem to represent an insignificant fraction of their overall deposits.

[13] http://ec.europa.eu/internal_market/bank/docs/guarantee/annex1_en.pdf

– Depositors having a relationship with the failed bank, like managers, directors, important shareholders (>5%), auditors (and their close relatives), companies in the same group, depositors that obtained special conditions aggravating the financial situation of the bank (Annex 1 no. 7, 8, 9, 11). The farther such exclusions go, the more it will lead to unnecessary payout delays due to a need of verification. It can also be highly unfair since not all of them may have contributed to the failure.

– Depositors who opened their account anonymously (Annex 1 no. 10). Any decision here could have an impact on the occurrence of tax evasion and money laundering.

Eligibility of depositors

If the eligibility criteria in Annex 1 no. 1-11 are harmonised, it could be considered to fully cover all depositors, to cover them only up to a certain percentage of the normal coverage level, or not to cover them at all.

A. Enterprises in the financial sector (Annex 1 no. 1, 2, 5, 6):

Question 13: Do you have background information or evidence whether a covered amount of € 100 000 is relevant for these enterprises?

Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

B. Authorities on central and local level (Annex 1 no. 3, 4)

Question 14: Do you have background information or evidence whether a covered amount of € 100 000 is relevant for authorities?

Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

C. Depositors having a relationship with the failed bank (Annex 1 no. 7, 8, 9, 11)

Do you have background information or evidence on how many depositors are actually concerned by this?

Question 15: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

D. Depositors who opened their account anonymously (Annex 1 no. 10)

Do you have background information or evidence on how many depositors are actually concerned by this?

Question 16: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

– Companies that are not permitted to draw up abridged balance sheets (Annex 1 no. 14). This definition deviates from the Commission Recommendation on micro, small and medium-sized enterprises (SMEs)[14]. (Please note that there is a difference between the notions of companies and enterprises[15].) The Commission has been tasked to examine whether the coverage of SMEs is appropriate. It could be preferable to use the same definition as the one in the Recommendation because a consistent definition may lead to an easier identification of SMEs and therefore reduce the payout delay. The different categories can be compared as follows:

Category	Calculation	Staff	Annual Turnover (€)	Balance sheet total (€)
Micro Enterprise	None of the limits must be exceeded.	< 10	< 2 million	< 2 million
Small Entreprise		< 50	< 10 million	< 10 million
Medium-sized Enterprise		< 250	< 50 million	< 43 million
Company with abridged balance sheets	One of the limits may be exceeded.	< 50	< 8.8 million	< 4.4 million

<u>Coverage of companies/enterprises</u>

The following categories could be used: Companies that cannot draw up abridged balance sheets; micro-, small, medium-sized enterprises or all enterprises)

The following options could be considered:

(a) No coverage for any company or enterprise (i.e. no coverage of accounts used for professional purposes)

(b) Include certain categories of companies or enterprises but exclude others in a harmonised way

(c) Include certain categories and leave exclusion of other categories to the discretion of Member States (similar to current approach)

(d) Coverage for all enterprises and companies regardless of their size

(e) Limited coverage according to the category

<u>Question 17:</u> Do you have background information or evidence whether a covered amount of € 100 000 is relevant for companies or enterprises above a certain size?

Would you prefer to keep the current approach (companies that cannot draw up abridged balance sheets may be excluded by Member States)? If not, which solution would you prefer?

Please specify, which category/-ies should be used to distinguish and if so, to which amount you would limit the coverage. Please provide reasons. Would you prefer another option? Please describe.

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[14] Commission Recommendation 2003/361/EC of 6 May 2003.

[15] The term ‘company’ in the DGS Directive refers to Article 1 of Directive 1978/660/EC and varies between Member States. However, in all Member States, public and private limited companies are included, and partnerships normally excluded. ‘Enterprise’ includes any undertaking, regardless of its legal form.

4. STRUCTURE AND MANDATE OF DGS THROUGHOUT THE EU

4.1. Fragmentation of DGS

Currently, there are about 40 DGS in 27 Member States. Several problems are inherent to this fragmentation. Since DGS are of a very different size as regards the number of members and their human and financial resources, some schemes can better cope with failures than others. The degree of efficiency a claim for reimbursement will be dealt with may depend on the country where the bank has been licensed.

Moreover, it is complicated for depositors who have their deposits at a branch of a bank from another Member State to deal with a foreign scheme, possibly using another language or to be subject to two different deposit guarantee regimes

The high degree of fragmentation also means that DGS with fewer resources would be hit more by a big failure than a DGS with more resources. Currently, there is no solidarity between schemes of different Member States and sometimes not even between schemes within the same country. As a result, it is likely that the taxpayer would have to step in if a DGS has insufficient financial resources.

In the context of the revision of the EU financial supervisory architecture[16] it has become more and more obvious that the supervisory cooperation for cross-border banking groups must be improved. Since banking supervisors are involved in the decision whether a bank should be saved or the DGS be triggered, the fragmentation of DGS does not provide incentives for supervisors to reach a solution that is in the interest of all depositors and takes into account the potential impact on the financial stability of all Member States concerned[17]. On the contrary, the current degree of fragmentation would set incentives to deal separately with each subsidiary which could favour creditors in one country compared to others.

A possible solution would be the establishment of a pan-European DGS.

Question 18: Would you be generally in favour of a pan-EU DGS? *(If you disagree, please skip questions 19-20.)* **If so, should there be a transition period until a pan-EU DGS should be operational? If so, how long? Please provide reasons.**

[16] COM (2009)114 of 4th March 2009.

[17] See Article 40(3) in the Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (latest version as negotiated in the Council: http://register.consilium.europa.eu/pdf/en/09/st08/st08726.en09.pdf).

<u>Structure of a potential pan-EU DGS</u>

There seem to be at least the following options concerning the possible structure of a potential pan-EU DGS:

(a) Single entity replacing the existing DGS

(b) A DGS that is complementary to existing DGS that would support the existing DGS if needed ("28th regime")

(c) "European system of DGS" (i.e. a network of schemes in the Member States that provide each other mutual assistance if needed, e.g. by borrowing from each other)

<u>Question 19:</u> Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe. If you support option (c), please indicate how in your view, such mutual assistance should be provided. Should mutual guarantee schemes and voluntary schemes (see question 8) be integrated into a pan-EU DGS? If so, how?

<u>Scope of a potential pan-EU DGS</u>

With regard to the scope of a potential pan-EU DGS, there are at least the following options:

(a) All banks should contribute to a potential pan-EU DGS

(b) Only large cross-border banking groups (i.e. banks with a certain systemic relevance that have subsidiaries in other Member States)

(c) All cross-border banks (i.e. those who operate directly or by means of branches in other Member States than in the one where they are licensed)

<u>Question 20:</u> Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

4.2. Limited powers of Deposit Guarantee Schemes

The current financial crisis has shown that when banks were bailed out, this has in most cases happened to a large extent with taxpayers' money. At the same time, the funds of a soundly financed DGS originate from the banks themselves. Currently, only in a few Member States DGS have varying powers allowing their funds to be used to support ailing banks[18]. In some of these countries, DGS have contributed significant amounts to the support of ailing banks in the past, such as liquidity assistance or restructurings. In most Member States, the funds of DGS are either not sufficient to play this role or lack the power to participate in early interventions aiming at preventing a failure. If DGS powers were to be extended, safeguards should be in place to prevent a double impact of an ailing bank on a DGS: first, by providing support and if this has been unsuccessful, by a payout to depositors.

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[18] See Annex I of the JRC report on the funding of DGS See Annex I of the JRC report on the funding of DGS:
(http://ec.europa.eu/internal_market/bank/docs/guarantee/annex1_en.pdf).

Different roles of DGS throughout the EU may also lead to difficulties when banks are bailed out or reorganised. If in one Member State the DGS can use its funds to support a bank but not in another Member State, this would seem to render the resolution of financial crises more complex since the private sector in one country may not be willing to participate if there is no private sector funds participation in the other country. A reorganisation[19] of a bank could fail for such a reason, leaving the taxpayer to pay or cause financial and economic turmoil when a bank has to be liquidated. It may, in some cases, also be helpful if a DGS plays an active role in the winding-up[20] of a bank.

Mandate of DGS

The following options could be considered:

(a) Retain current approach (other DGS functions than paying out depositors within discretion of Member States)

(b) DGS provide liquidity assistance to banks in need

(c) DGS participate in the reorganisation of banks

(d) DGS play an active role in the winding up of banks

Question 21: Which solution would you prefer? Should this solution be recommended or mandatory? Please provide reasons. Would you prefer another option? Please describe. Would a broader mandate fro DGS require a different funding mechanism or a higher level of funding? If you prefer a pan-EU DGS (Question 18), please precise which options you would prefer in that case.

5. FUNCTIONING OF DGS

5.1. Insufficient depositor information

Currently, actual and intending depositors must receive the information about the DGS covering their deposits including the amount and scope of the cover and whether their deposits are eligible or not. That information must be made available in a readily comprehensible manner. Information must also be given on request on the conditions for compensation and the formalities which must be completed to obtain compensation. All information must be given in the languages of the Member State in which the bank or the branch is established. How exactly the information is provided, is within the discretion of Member States.

[19] As defined in Article 2 of Directive 2001/24/EC: "measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims"

[20] As defined in Article 2 of Directive 2001/24/EC: "collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure"

If depositors do not know whether and to what extent their deposits are protected, there is a risk that they will run on their banks. They may also hesitate to deposit their money at foreign banks or branches if they do not know how other country schemes function. They might be concerned that in case of a bank failure, they might not get their money back since they might not know or understand the procedures to follow. Depositors might be susceptible to financial losses if they discovered only after their bank has failed that they are not eligible or that not all their financial products are covered or that all their deposits at one bank are aggregated in order to determine whether they are covered. And if they are uncertain about any of these aspects of deposit protection, such uncertainty could lead to a lack of confidence in a DGS, thus contributing to a possibility of a run on banks.

For instance, depositors at branches of Icelandic banks complained to the Commission that the distinction between branches and subsidiaries, which can lead to different DGS dealing with the payout, was confusing. Those depositors preferred one point of contact in their country of residence and consequently, in their language. Others were worried that payout might not include interest payments if the interest payments would only be due after the time of failure. Currently, these issues are indeed not dealt with by the Directive. This lack of clarity compromises depositor confidence.

A lack of information about what products are covered by DGS and to which extent may also lead to choosing products on a not fully informed basis and consumers may thus not fully exploit all options offered by the Internal Market.

Harmonisation of the information for depositors

In order to ensure that all depositors throughout the EU get the same information, it could be considered to recommend or prescribe a template for standardised information. This template could be annexed to the Directive or be developed by stakeholders.

Question 22: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

Advice to split up deposits between banks (See also Question 4)

Currently, depositors do not have to be informed that it is safer to split up deposits if the coverage limit is exceeded.

Question 23: Should such information be required or recommended? Please provide reasons. Would you prefer another option? Please describe.

When and how should depositors be informed?

The following options could be considered:

(a) Retain current approach (details left to the discretion of Member States)

(b) Mandatory reference to information on DGS in advertisements

(c) Mandatory reference to information on DGS on account statements

(d) Require depositors to countersign information on DGS before entering into a contractual relationship and to receive a copy.

Question 24: **Which solution(s) would you prefer? Please provide reasons. Would you prefer another option? Please describe.**

Information in case of a bank failure

With regard to the question, from which DGS depositors should receive information when their bank fails, the following options could be considered:

(a) Retain current approach (Home country scheme must inform)

(b) Host country DGS must inform depositors at branches in another Member State

(c) Individual agreement between DGS about who informs depositors

Question 25: **Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe. Which approach would you prefer in case of a pan-EU scheme not being a single entity (see question 19)? Please explain.**

5.2. Set-off arrangements

Currently, Member States may allow (and some do so), that deposits are set off against any liabilities of the depositor (e.g. mortgages) at the same bank, which is not the case under normal circumstances if instalments are duly paid. In such case, if liabilities reach or exceed deposits, set off eliminates any payout from a DGS.

If depositors know that their deposits and liabilities will be set off, they will prefer to run on their banks in order to get their deposits paid out in full. Those who do not do so might be paid out nothing, putting them under financial stress when they need to get food, pay bills etc. Moreover, determining liabilities and matching them with deposits is time consuming and therefore likely to delay the payout.

However, in order to fully assess the problem, it is necessary to explain the legally complex follow-up to a bank failure. According to the Directive, DGS subrogate to depositors' claims against the bank. In order to refinance themselves, DGS then try to get at least a part of these claims in the insolvency procedure.

Pending national insolvency legislation, the following situation may occur. If the liability of the customer (i.e. the claim the bank has against him) is sold by the insolvency practitioner to another entity, nothing changes for the DGS since the price paid by the buyer of the claim will be used to pay the creditors of the failed bank (i.e. also the DGS). However, in some Member States the insolvency practitioner can opt to set off liabilities of the bank (i.e. deposits now claimed by the DGS instead of the depositor) against claims of the bank (i.e. the claim against the depositor). If the insolvency practitioner exerts this right, the DGS would not receive the amount that has been set-off and might thus have refinancing problems, leading to higher funding needs. The payment of the DGS to the depositor would remain untouched. DGS would in such a case have paid off the liability.

Set-off arrangements

The following options could be considered (please note that the options below are not mutually exclusive):

(a) Retain current approach (unlimited set-off; within discretion of Member States)

(b) Discontinue or limit set-off for the payout of depositors

(c) Discontinue or limit set-off in the insolvency procedure (when the DGS has subrogated into the depositors' claims against the bank)

(d) Limit set-off to claims that have fallen due or are delinquent

(e) Limit set-off to a certain amount or percentage of covered deposits but leave it optional

(f) Encourage depositors to split deposits and liabilities between different banks (rendering set-off obsolete if this encouragement is effective)

Question 26: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

5.3. Procedures for payout

5.3.1. Payout delay

Under the current regime, depositors must be paid out within 3 months after the bank has declared to be unable to repay deposits. This period can be extended twice, to a maximum of 9 months. From end 2010 on, this delay has to be reduced to 20 working days with a possible extension of a further 10 working days (i.e. 4 to 6 weeks). Currently, competent authorities must determine the "inability to repay deposits" (i.e. the triggering date) within 21 days and from end 2010 on within five working days (i.e. one week). These delays must be taken into account for calculating the actual payout delay. The maximum delay from 2010 on will thus be 7 weeks. However, there is better practice. The United Kingdom envisages shortening the payout delay to one week[21] and the US scheme pays out after two working days[22].

If depositors have the choice to withdraw their deposits before the DGS is triggered or to wait several weeks after the DGS steps in, they will run on their banks since most of them would not have the funds for their usual expenses available for more than a few days[23]. Thus, there is the possibility of long delays prompting a run on a bank even if deposits were 100% covered. Furthermore, in case of current accounts, bank customers need access to basic banking services.

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21 Bank of England, HM Treasury, FSA, Financial stability and depositor protection: further consultation, July 2008, p. 74 (http://www.fsa.gov.uk/pubs/cp/jointcp_stability.pdf); Ernst&Young, Fast payout report, p. 56 (http://www.fsa.gov.uk/pubs/other/fast_payout_report.pdf).

22 *"It is the FDIC's goal to make deposit insurance payments within two business days of the failure of the insured institution."* http://www.fdic.gov/consumers/banking/facts/payment.html.

23 UK FSA, Consumer awareness of the Financial Services Compensation Scheme, p. 14 (http://www.fsa.gov.uk/pubs/consumer-research/crpr75.pdf).

A time limit of 7 weeks is therefore too generous. Moreover, DGS argue that long payout delays are caused by late access to information about deposits and a lack of human and technical resources.

At any rate, the forthcoming deadline being calculated in working days entails additional problems. Since there are different national holidays, this calculation is not only opaque for depositors but can also lead to different payout delays in cross-border cases.

5.3.2. Payout modalities

In their correspondence to the Commission, depositors raised concerns about the modalities of payout. Many depositors were concerned that in some recent bank failures there was no information from the DGS at all, only late or outdated information or no information in their language about the state of play and on how to submit claims. The mere need for a submission of claims – often still required on paper and possibly requiring information that in case of 'internet banks' may not be accessible when web pages of a failed bank are not operational – annoyed depositors. Any difficulty and lack of transparent processes before and during the payout procedure undermines depositors' confidence in DGS.

Some depositors were worried that they would receive their reimbursement in the currency of the bank's home country even though their deposits were denominated in Euro. The possibility to pass on currency risk to the depositor can undermine confidence into DGS and could – at least together with other problems – induce a run on banks. Others were worried that payout might not include interest payments if the interest payments would only be due after the time of failure. Since both issues are not dealt with by the current Directive, it might be useful to clarify them.

These issues can be tackled by a number of categories of measures:

- Reduce payout delays as such (Question 27)
- Alternative solutions (Question 28)
- Clear and fair payout modalities (Question 29)
- Facilitate verification of claims (Question 30)
- Facilitate application of depositors for claims (Question 31)
- Involve DGS at an early stage (Question 32)
- Improve information exchange between banks and schemes (Question 33)
- Ensure that DGS are capable to deal with payout situations (Question 34)

Payout delays

In order to reduce payout delays as such, the following options could be considered (Please note that the options below are not mutually exclusive):

(a) Retain current approach (4-6 weeks from end 2010 onwards)

(b) Reduce payout delay to one week after a certain transition period

(c) Differentiate payout delay, i.e. a longer payout delay only for depositors where set-off has to be calculated or whose eligibility has to be thoroughly examined

Question 27: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

Alternative solutions

As an alternative (or supplementary) to a mere reduction of the payout delay, it could be considered to transfer deposits to another bank or to have an emergency payout procedure in place (e.g. € 10 000 within 3 days).

Question 28: Would you prefer such solutions? If so, on a voluntary or mandatory basis? Please provide reasons. Would you prefer any other option? Please describe.

Payout modalities

In order to achieve clear and fair payout modalities, the following options could be considered (please note that the options below are not mutually exclusive):

(a) As regards the calculation of payout delay, it could be considered to calculate the payout delay and the delay to determine a payout situation in calendar days

(b) As regards the currency of payment, it could be considered to leave this within discretion of Member States (current approach) or in the same currency as the deposits were paid in.

(c) As regards interest payment, it could be considered to leave this within the discretion of Member States (current regime) or to pay interest that has not been credited at the time of failure.

Question 29: Which solution(s) would you prefer? Please provide reasons. Would you prefer any other option? Please describe.

Verification of claims

In order to facilitate the verification of claims, the following options could be considered (please note that the options below are not mutually exclusive):

(d) 'Tag' eligible depositors when account is opened and then regularly keep up to date this information on account statements.

(e) Payout under reserve of later reclamation – verification only after payout

(f) Simplify eligibility criteria (see Questions 13-16)

(g) Harmonise eligibility criteria (see Question 12)

(h) Introduce a de-minimis rule (i.e. deposits below a certain size, e.g. € 10 would not have to be paid out)

(i) Limit or abandon set-off (see above)

Question 30: **Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.**

Application for reimbursement

In order to facilitate the application for claims, the following options could be considered:

(a) Retain current approach (depositors may have to take initiative, to fill in application forms and send them – electronic processing and own initiative payment within discretion of Member States)

(b) Payments by DGS on their own initiative without need for applications – only electronic request to depositors asking them to indicate new account or payment to the same account whenever feasible

Question 31: **Would you prefer one of these solutions? If so, on a voluntary or mandatory basis? Please provide reasons. Would you prefer another option? Please describe.**

Involving DGS at an early stage

In order to involve DGS at an early stage, it could be considered to require competent authorities to inform DGS either if appropriate (current approach) or by default when triggering of DGS becomes likely.

Question 32: **Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.**

Information exchange between banks and schemes

In order to improve information exchange between banks and schemes it could be considered to recommend or require that DGS have access to relevant banks' records when DGS are informed by competent authorities and that DGS and their member banks have a common interface to quickly exchange information

Question 33: **Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.**

<u>Proven capability of DGS to handle payout situations effectively</u>

In order to ensure that DGS are capable to deal with payout situations, the following options could be considered:

(a) Retain current approach (stress testing required in general)

(b) Require DGS to regularly disclose the amount of ex-ante funds, their workforce and the result of regular stress testing exercises

(c) Make such disclosure (as referred to under point b) a precondition for cross-border services or establishment of branches

(d) Regular peer review among DGS

<u>Question 34:</u> Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

5.4. Cross-border cooperation

5.4.1. Topping Up

The current form of topping up arrangements (see chapter 2) is not only a result from varying level and scope of coverage but is a problem on its own. It impedes a smooth payout, causes confusion for depositors who do not understand why they have to deal with two DGS for one account and leads to a different treatment of depositors. Depositors at the same bank but having their account with different branches can be treated in a different way in case of a failure. In extreme cases, depositors at a branch and a subsidiary in the same Member State could be treated differently. Such results would seem to contravene the aim of the Internal Market.

<u>Topping-up arrangements</u>

The following options could be considered:

(c) Retain current approach (topping up within discretion of Member States; host country topping up regulated in some detail by the Directive (Annex 2) but home country topping up permitted)

(d) Make topping up mandatory in whatever form

(e) Recommend home country topping up

(f) Making home country topping up mandatory

(g) Making host country topping up mandatory

(h) Discontinue topping up

<u>Question 35:</u> Do you consider topping up a problem? If so, which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

5.4.2. Lack of efficient cross-border cooperation between DGS

Mutual cooperation of DGS must also be improved in general and not only if there are topping up arrangements in place. This is illustrated by the failure of a bank in Iceland, which operated mainly via Internet and had a branch with 30 000 depositors in Germany without having been subject to a topping up arrangement. Many depositors complained that German authorities and German DGS referred depositors to the Icelandic DGS. This is why already a general obligation to mutually cooperate has been introduced. However, this obligation is rather generic and does not require a DGS to assist depositors whose deposits are with a branch of a bank from another Member State. Such a facility has been requested in many complaints and in a petition from depositors.

Cross-border cooperation between DGS

It could be considered that a DGS in a host country acts as a single point of contact for depositors at a branch in the host country. This could encompass features such as post box services, advice in the host country's language or being a paying agent for the home country DGS.

Question 36: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

6. FINANCING OF DGS

6.1. DGS funding mechanisms[24]

6.1.1. Funding mechanisms and level of funding

In order to fulfil their tasks, DGS need financial means. DGS are principally funded by banks paying contributions to them. Currently, in 21 Member States such contributions are paid in advance on a regular basis (ex-ante) while in six Member States banks only contribute after a failure (ex-post). Other financing sources are loans taken by the DGS or direct state interventions.

Consequently, the level of funding is very different throughout the EU. Obviously, ex-post funded DGS have no funds available when there is no bank failure. In terms of the ratio between covered deposits and ex-ante funds (where applicable), there is a wide range. The access to funding beyond ex-ante funds is different, too. All ex-ante funded DGS can request supplementary contributions from banks in case of need but the extent is very different. Nearly all DGS can borrow money from different sources, but some only to a limited extent. However, even if unlimited borrowing from the capital market is permitted, in times of crisis this may be difficult in practice.

Research has shown that not in all Member States, DGS would seem capable to cope even with small or medium-sized bank failures. In one Member State, the scheme has been in

[24] See the JRC report on efficiency of deposit guarantee schemes (http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm).

deficit. In another Member State, a voluntary DGS had to apply for a state guarantee of € 6.7 billions following the failure of a subsidiary of Lehman Brothers[25].

Even if a single DGS might never be able to cope with a failure of a large cross-border banking group, they should at least be able to deal with medium-size failures. If DGS have insufficient funds, depositors may not be paid out or only after a very long delay. If depositors are aware of this, they will lose confidence and may potentially run on their banks.

However, if banks were required to contribute without limitation to DGS, this could drive them into illiquidity or even insolvency, which would of course be counterproductive. A similar case occurred when the funds of the German Investor Compensation Scheme (ICS) were emptied and extraordinary contributions were temporarily suspended by a court order because it considered that there was a risk that contributors (i.e. investment firms) could also be driven into insolvency. Such a situation could also happen at a DGS since the financing mechanism of DGS and ICS is the same. In some countries, however, there are limits to the contributions of banks[26].

Even without considering the quantity of funds available to DGS, the variety of funding mechanisms causes problems. Mere ex-post funding would be procyclical: it encourages risk-taking in good times, but drains liquidity from banks in times of stress which might have implications on the level and conditions of credit supply by banks. Moreover, unlike in ex-ante schemes the failed bank does not contribute to the payout.

Level of funding of DGS

On top of improving the financing mechanism (Question 39) and a possible introduction of a pan-EU DGS (Questions 17-19), it could be considered to recommend or require a target level (certain percentage of deposits) for ex-ante funds, ex-post contributions and and alternative means of financing (e.g. borrowing). A maximum level for the contribution of banks could also be considered.

Question 37: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

6.1.2. Contributions to DGS not adjusted to the risk incurred by banks

If not all DGS are equally sound and capable to deal with a bank failure of a certain extent, there may also be repercussions for the functioning of the Internal Market. In the Internal Market, banks from Member States with a very weak DGS can freely establish branches in another Member State. However, if the home country DGS is considered incapable by the host country to deal with a bank failure, the host country may not like to rely solely on the prudential supervision exercised by the home country. This could lead to Member States

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25 Press release IP 09/114 (http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/114&format=HTML&aged=0&language=EN&guiLanguage=en)

26 See Annex III of the JRC report on the efficiency of DGS (http://ec.europa.eu/internal_market/bank/docs/guarantee/deposit/an3_en.pdf).

considering to take additional measures which might create obstacles to the freedom of establishment (i.e. to set up branches), implying a less open Internal Market[27].

Moreover, in most Member States banks pay their contributions to DGS as a fixed percentage of deposits. The degree of risk incurred by the bank is not taken into account. Banks offering high interest rates just because they operate on the margins of prudential regulation may therefore have a competitive advantage over others whose pricing is more conservative as a result of a less risky business model. Such lack of incentives for sound risk management may also make the financial system more vulnerable and induce moral hazard.

Risk-adjustment of contributions to DGS

It could be considered to introduce risk-based contributions on a voluntary or mandatory basis. Particular models could be recommended or required.

Question 38: Would you prefer introducing risk-based contributions? Which models would you envisage? Please provide reasons. Please describe.

6.1.3. Differences between funding mechanisms

Banks that do not have to pay ex-ante contributions are able to generate returns on these funds, which seems to constitute a competitive disadvantage vis-à-vis their competitors in other Member States with ex-ante funded DGS.

Funding mechanisms

It could be considered to make ex-ante funding mandatory and to require alternative short-term (interim) financing or long term borrowing in case of need.

Question 39: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

If you prefer interim financing, please describe how and by whom such financing should be provided.

7. ANY OTHER ISSUES

Question 40: Are there any other issues that have not been mentioned above but should be dealt with in the context of the review of the DGS Directive? If so, please describe the problem and its different impacts as precisely as possible.

[27] Financial Supervisory Authority (UK), The Turner Review – A regulatory response to the global banking crisis, March 2009, p. 100 et seq. (http://www.fsa.gov.uk/pubs/other/turner_review.pdf).