## First steps towards European unification of deposit guarantee schemes

Deposit Guarantee Schemes (DGS) are a mechanism of financial stability whose main aim is to protect depositors through a guarantee on cash deposits and securities(1) held with financial institutions. At a European level, any deposit holder would currently recoup up to 100,000 Euros of their deposits or financial instruments should their financial institution fail. In addition, DGSs usually have the power to intervene in institutions should this offer a cheaper solution than returning deposits, so that they must be completely coordinated with bank intervention and resolution mechanisms.

(1) In Spain, the Fondo de Garantía de Depósitos de Entidades de Crédito covers depositors (natural or legal persons) with balances in credit held on account and nominative deposit certificates. It also covers securities and instruments that investors have entrusted to a credit institution for their deposit or registration or to carry out an investment service. This scheme covers the non-restitution of securities or instruments belonging to the investor affected but in no case does it cover losses in the value of the investment or any credit risk. For more details on guaranteed deposits and/or securities, consult the website of the Fondo de Garantía de Depósitos de Entidades de Crédito (www.fgd.es).

Therefore, guarantee schemes are a key element for any financial system because they are a last resort guarantee for all depositors but, as they are not accompanied by strict supervision or market discipline, incorrect incentives might be established for institutions.

There are great national latitudes in the current European Directive that governs DGSs.(2) In Europe, there are around 40 guarantee schemes that cover different groups of depositors and deposits, up to different levels, and impose different financial obligations on institutions. Some are financed ex ante, i.e. via periodic contributions from institutions to the fund that manages the assets, while others are financed ex post, only when the fund requires resources in order to act. But all schemes share the fact that they are implicitly supported by their national Treasury should private funds not be enough to cover all depositors.

There is therefore a clear link between bank risk and sovereign risk in this respect. The structure and financing of DGSs are fundamental, together with bank supervision and resolution mechanisms, in the attempt to achieve greater banking union at a European level that breaks this link, helps Europe to exit the crisis and makes the zone more stable in order to prevent future crises.

Already along these lines, in July 2010 the European Union proposed a new DGS Directive which, among other things, requires that, within 10 years, all countries have a fund financed ex ante with up to 1.5% of the deposits insured; ex post contributions could represent a further 0.5% of these deposits. Moreover, the door has been opened to alternative financing methods, such as debt or loans between funds from different countries, although the precise circumstances or conditions have yet to be determined. Lastly, the Directive also proposes that, at the end of 2013, the deposit payment period should be reduced to just 7 days (compared with the current period of 20 days).

However, several key questions have still to be answered: what degree of DGS centralization must be achieved? How should they be financed? And, if necessary, how would the transfer of resources between schemes be managed? The answer to these questions differs, depending on whether we consider the medium/long-term or think short-term, in which urgent measures need to be taken to solve the pressing problems of the current crisis.

A complete centralization of DGSs at a European level is the only solution that would definitively break the link between bank risk and sovereign risk, at the same time as improving the management of joint funds (economies of scale). However, for countries this would mean their absolute loss of sovereignty in supervising and taking decisions on banking policy, in order to avoid negative incentives. In short, this solution would represent a step towards a model similar to that of the United States, where there is a single guarantee scheme, the FDIC. Moreover, it might require progress towards some kind of fiscal integration or to establish very clearly how and when extraordinary contributions should be made (how they should be distributed between countries, subsequent recovery, etc.) to ensure there is a back-stop or implicit guarantee that covers depositors under any circumstance.

Arriving at this solution is neither easy nor fast as it requires negotiations and very clear definitions regarding the contributions and role of each institutions and/or country. Because of this, in the short term an intermediate solution will have to be employed between the unsustainable current situation of diverse national schemes and complete integration. In this intermediate situation, national guarantee schemes would be maintained while, at the same time, a transfer system or supranational guarantee scheme would be set up.

(2) Directive 1994/19/EC of the European Parliament and of the Council, of 30 May 1994, amended by Directive 2009/14/EC with regard to coverage level and payout delay.

To this end, firstly it is essential to harmonize criteria at a national level: type of financing, criteria to calculate contributions made by institutions, guaranteed deposits, level of insurance, etc. As established by the new European Directive, financing should be ex ante in all countries, although this does not exclude the possibility of extraordinary ex post contributions. On the other hand, contributions can be made by institutions based on their deposit market share (as is currently the case in Spain) or, as seems more reasonable, based on the institution's level of risk (as proposed by the new European Directive). This latter approach avoids institutions with lower risk paying the price for institutions that have taken on greater risks but, on the other hand, makes this regulation more procyclical.

Secondly, it is necessary to establish how funds can be coordinated at a European level. One alternative would be to define a model for loans between national DGSs, as proposed by the Directive. But this method will not be effective in the case of Europe-wide crises or co-related crises between countries. Moreover, it might be problematic for countries that enter the crisis later and need to resort to the scheme once loans have been made and have not yet been recovered. It would be very complex to establish which fund must make the loan or how it should be shared out among countries and under which criteria.

It seems more feasible to set up a supranational guarantee scheme compatible with current national schemes, which only acts when a national fund has run out of resources. The phase of defining the financing and powers of this scheme would be very important. In this respect, a very clear definition would be required beforehand of the criteria and conditions for its use and for returning funds, in order to avoid negative subsidies and incentives. In short, this option would appear desirable insofar as it would be the start of the first few steps towards creating a single European DGS, with very well-defined contributions from each institution and/or country.

Lastly, it should be stressed that, irrespective of how these schemes are set up and financed, it is necessary to very clearly define when they can be used. The recent proposal by the European Directive on crisis management and resolution establishes mechanisms for early intervention and resolution of institutions with problems in order to find a cheaper and less traumatic solution for the system than having to replace client deposits (see the box «The crisis resolution framework: a first step towards banking union»). Therefore, the two systems (deposit guarantee scheme and resolution fund) will have to be coordinated before establishing to what extent restructuring of an institution avoids having to replace deposits and, consequently, determining the level of financing required for the deposit guarantee scheme.

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