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Unknown Future of the Banking Union's Third Pillar [2]

Abstract. The aim of the article is to evaluate the process of building the third pillar of the banking union. The analysis of the problem required both subject literature studies and descriptive statistics. Time scope of the analysis covers the years 2012 until 2017. The relevant data used came from the European Central Bank and the European Banking Authority. The results of the study suggest that the creation of a European Deposit Guarantee Scheme is inevitable for further financial integration in the Eurozone but more detailed conditions need to be added to its implementation plan in order to have the scheme established. This stems from both the bad financial standing of some of the euro area banks and their dependency on the sovereign debt of their home and host countries. Studies also indicate low operational readiness of the national schemes, so a transition from re-insurance onto co-insurance phase will require increased efforts of both the Member States and the banks themselves.

Key words: banking union, deposit guarantee schemes, European Deposit Insurance Scheme

JEL Classification: G21, G28

Introduction

The banking union project envisaged the establishment of three pillars – Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS). While the first two pillars are already operational, EDIS is still the bone of contention between the EU Member States – this article aims to analyse the reasons for this situation.

The idea of creating an EU deposit guarantee scheme initially seemed logical and far less contentious than the issue of establishing a pan-European solution for the resolution of banks. EDIS was to guarantee the security of deposits entrusted to banks operating on the territory of the Eurozone up to a common threshold, as well as to ensure that credit institutions don't get affected by the insolvency of one of them. Members outside the euro area could join the scheme voluntarily. (European Commission 2015).

Before the last financial crisis of 2008, the subject of establishing deposit guarantee schemes laid exclusively within the jurisdiction of the Member States and a common approach to this matter was not considered. This setup proved to be suboptimal, since national schemes were vulnerable to local economic disturbances (Baglioni 2016). Additionally, the national schemes were very diverse, resulting in a non-uniform level of trust in the banking systems of the Member States from the clients and investors. In other words, the size of the guarantee scheme and its financing method were influencing the competitive position of credit institutions. An analysis by D. Schoenmaker and G.B. Wolff

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(2015) also proved different typical deposit sizes held in each member state and different total guarantee worth of the deposits compared to GDP.

Despite the neutral, consumer-oriented approach proposed in terms of harmonising the deposit guarantee schemes across Europe, the third pillar has met strong resistance not only from certain Member States, but also professionals and academics. Critics stated that EDIS can potentially be strengthening the contagion effect, may result in an unequal distribution of costs and can weaken the existing, national schemes. Not all of these arguments were well founded, yet they were strong enough to block the European Commission's (EC) attempts at completing the banking union. This article will look at the evolution of EC's EDIS proposals over the years and the validity of their critique. The conclusions will be helpful in understanding the disagreement between the EU countries and the prospects for reaching a consensus in the forthcoming negotiation round.

European Deposit Insurance Scheme proposals to date

The idea of setting up a common deposit guarantee scheme was first raised in a report by the President of the European Council, as part of the proposal to establish the banking union (Van Rompuy 2012). Proponents of establishing a pan-European scheme for deposit insurance argued that the fragmentation of the funds was weakening the credibility of the banking system and exposing the national economies to the risk of having to bail out failing credit institutions using public funds (Gros, Schoenmaker 2014). Secondly, a common deposit guarantee scheme was seen as an indispensable element of the banking union, conditioning the success or failure of the aimed financial markets integration (Waliszewski 2016). These arguments, however, could not resolve the differences between the EU countries, but have first led to actions ensuring the minimum level of harmonisation – Directive 2014/49/EU on deposit guarantee schemes obliged all Member States to establish a guarantee scheme of their own. The directive has also set the minimum guarantee value, operational details of the pay-outs and the minimum value of the guaranteed funds that need to be collected ex-ante from the credit institutions.

The consensus established through Directive 2014/49/EU did not satisfy the ambitions of the European Commission, which was expressed in the so-called five Presidents report (Juncker 2015). The official Regulation proposal aiming to establish a European Deposit Insurance Scheme followed not much later (European Commission 2015). According to the Commission's vision, EDIS was to put an end to financing the trouble of the banking sector from public funds (European Commission 2015). This was to bring greater stability and to strengthen the position of national insurance schemes against the largest credit institutions (Schoenmaker 2018).

In order to streamline the process of establishing EDIS, the Commission has proposed to divide it into three phases: re-insurance, co-insurance and full insurance. During the re-insurance phase, EDIS was to serve as a source of backup reserve funds for national schemes. The funds would come from a common Deposit Insurance Fund (DIF) and could only finance 20% of the fund's shortage (NBP 2015). DIF was to be financed by the credit institutions themselves and EDIS management was to become the responsibility of the Single Resolution Board. This was to ensure swift decision making as well as that the cost of guarantee pay-out is taken into account when evaluating the consequence of a credit institution's resolution (NBP 2015).

The co-insurance phase was to move EDIS to a stage, where it was to become the first institution to bear the costs of financing the guaranteed deposit loses. During that phase, the amount guaranteed through the common insurance fund would grow from 20% to 80% over four years (NBP 2015). After these four years, EDIS was to constitute the target European Deposit Guarantee Scheme, based on the national schemes and guaranteeing deposits up to 100 000 EUR. That also meant that EDIS would no longer require separate contributions to the DIF, as it would operate using the contributions to the national schemes (European Commission 2015). Just like the other pillars of the banking union, EDIS was to be obligatory exclusively to the euro area countries. Other Member States could join the banking union voluntarily, provided that they were compliant with the BRRD and have accumulated the required funds in their national deposit insurance scheme (Waliszewski 2016).

The opposition to the initial regulation proposal was strongly emphasised by Germany – they were reluctant to agree to use their national insurance fund for re-insurance of other banking systems, especially during a time of financial instability (Donnelly 2018). Germany feared the contagion effect this international scheme could bring, resulting in general loss of trust in the European banking system in case the DIF got drained in the process of bank resolutions (Krahnen 2013). This has led to an impasse that was addressed only last year, when the Commission announced a revised plan of establishing EDIS (European Commission 2017).

This time the Commission decided to lengthen the process of establishing an international deposit insurance scheme, since they recognized the fact that building trust in the banking union's third pillar requires time. This was to address the concerns about linking deposit guarantee schemes offering very different levels of security. The new proposal now envisages that during the re-insurance phase, EDIS would merely support the liquidity of the national schemes, without participating in loss coverage (European Commission 2017). In other words, during the first phase DIF would serve as a lending facility to the national deposit insurance schemes, covering no more than 30%, 60% and 90% of the liquidity shortage in 2019, 2020 and 2021 respectively.

Transition towards the co-insurance phase under the new proposal would not happen automatically but would need to be backed by an analysis of the economic condition of the banking sector, in order to make sure that the common funds would not finance any legacy assets from previous years. Another precautionary provision envisaged that during the early stages of the co-insurance phase, DIF would only cover up to 30% of the losses incurred. The revised text also did not mention any specific conditions for the transition towards full insurance phase, limiting itself to a statement that EDIS's share in loss absorption would grow over time (Carmassi, Dobkowitz et al. 2018). Nonetheless, the enhanced proposal seems to have failed to convince the Member States and the third pillar of the banking union will not be established on schedule (Stawasz-Grabowska, Grabowski 2018).

EDIS from an academic perspective

The discussion around establishing deposit guarantee schemes has a long story of nearly a hundred years. The arguments against establishing such insurance for deposits were often built around the costs they would impose on the credit institutions, making them unsustainable in the long term. This view was countered by the need to assure the consumers that their funds are secure in the banking system, which was ultimately the main reason for establishing deposit guarantee schemes. The views around the need for providing insurance against deposited funds loss evolved over the years, although the main purpose of their existence remained the same (Kerlin 2016).

A famous article by J. H. Taggart and L. D. Jennings (1934) has proved how little it would take to insure the deposits that have been lost in the previous years, when compared with the grand total value of the deposits in the US banking system. The evidence provided by the authors proved that at a minor expense, credit institutions could accrue sufficient funds to cover the deposit losses caused even through spectacular bank failures. This conclusion has been used as the main evidence that deposit guarantee schemes do not contribute to any bank failures, while they can protect the consumers and prevent bank runs at a time of a financial crisis.

Subject literature does not indicate any clear preference towards establishing a pan-European deposit guarantee scheme. Some economists indicate that an international scheme has advantages e.g. L. Payne (2015) highlighted costs savings, as well as avoidance of risk of unequal cost distribution in the event of international credit institution's insolvency. For N. Véron (2016) the biggest advantage of having an EU deposit insurance scheme would be reinforcement of trust in the stability of the financial system. Together with I. Schnabel (2018), they have called for a merger of the national schemes into EDIS without delay to ensure impartiality of the system. M. Zaleska (2015) stated that reverting from merging deposit guarantee schemes results in maintained reluctance towards banks resolution, causing delays in the decision-making process that indirectly leads to increased costs of such operation.

Some economists, however, are not very positive about maintaining a common insurance scheme for deposits. L. Schuknecht (2016) indicated that such common mechanism would result in distributing the costs of bad decision-making or weak supervision onto other Member States. He also disagreed that EDIS would have the capacity to break the toxic link between bank insolvency and public funding – he claimed, that regardless of the DIF's capacity, the sector could still reach a point, where public bail-out would be inevitable. No less critical was the analysis of the Bundesbank (2015), where the connection between the public debt and national credit institutions was highlighted. Since domestic credit institutions are often heavily involved in financing the deficit of their home countries, insolvency of the state would be transferred onto EDIS (Bundesbank 2015). Germany's National Bank was also concerned about the fact that since national insolvency laws usually require preferential treatment of the state funds, any associated additional costs would be transferred onto the EU level.

The political impasse regarding the third pillar of the banking union could not be overcome over the last years and it is clear that some of the concerns raised by the critics of the Commission's proposal cannot be easily addressed and quantified. However, it is interesting to analyse the relevant statistics and see how big the threat of bad assets is in the Euro area's banking sector and how strong are the interlinkages between the credit institutions and the sovereign debt.

Quantifying the European deposit scheme impasse

In order to supplement the source documents and literature review, statistics on the Euro area banking system were also analysed to evaluate the scale of the problem causing the political deadlock over the establishment of EDIS. The relevant data were collected from the databases of the European Central Bank (ECB) and the European Banking Authority (EBA) and are referring to the issues raised as potential arguments against establishing a pan-European deposit guarantee scheme. Data availability has narrowed down the analysis scope to years 2014-2017. Before the results are presented it is worth to mention that the ECB statistics on sovereign debt dependency do not differentiate the instruments per issuing country, so the strength of the link between the most indebted Member States and their domestic credit institutions can only by assumed.

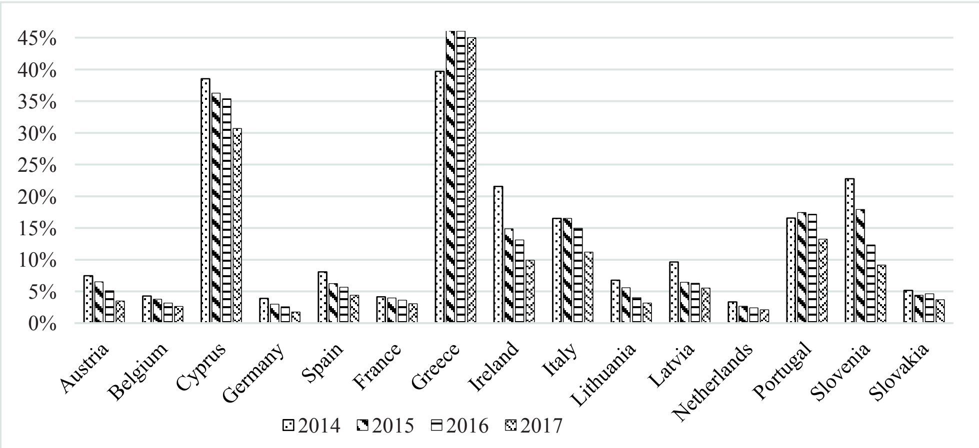

Fig. 1. Gross NPL (% of total gross loans and advances)

Source: self-elaborated based on the ECB data.

Figure 1 represents the share of non-performing loans (NPL) in the total loans granted by the credit institutions in a given country. This indicator was chosen to verify the value of the toxic assets on the balance sheets of the credit institutions in the Eurozone, as a potential threat to the common insurance fund. The statistics are unsurprisingly most worrying in countries who have been struggling with or recovering from a serious financial crisis during the time of the analysis i.e. Cyprus, Greece, Ireland, Italy and Portugal. Similarly, significant credit amount was at risk also in Slovenia. The share of NPL of 10% or more signalled a threat of serious liquidity gap that had the potential of destabilizing the entire sector. It is therefore not that surprising that some countries were reluctant to expose their deposit insurance funds to this risk. Nonetheless, it should be noted that virtually every country of the Euro area has seen an improvement in the performance of the banking loan portfolio over the analysed period.

Figure 2 depicts the value of sovereign debt held by the Monetary Financial Institutions (MFI) in a given country, compared to that country's GDP. This indicator is to show the level of the banking sector's dependency on the solvency of governments – this link was quoted to be one of the risks transferred through the establishment of EDIS. The data confirms significant value of sovereign debt in the banking sector portfolio. It is worth to underline that this dependency is particularly high in countries like Portugal and Italy, where the state budgets were already overburdened with the cost of previous bail-outs. In this context, however, in the author's opinion it is still hard to argue that EDIS would have the potential to worsen the economic turmoil caused by the bankruptcy of any of the euro area governments. The author also believes that it is beyond any doubt, that the other countries in the Eurozone would participate in financing the debt of the failing government in an attempt to defend the value of their common currency.

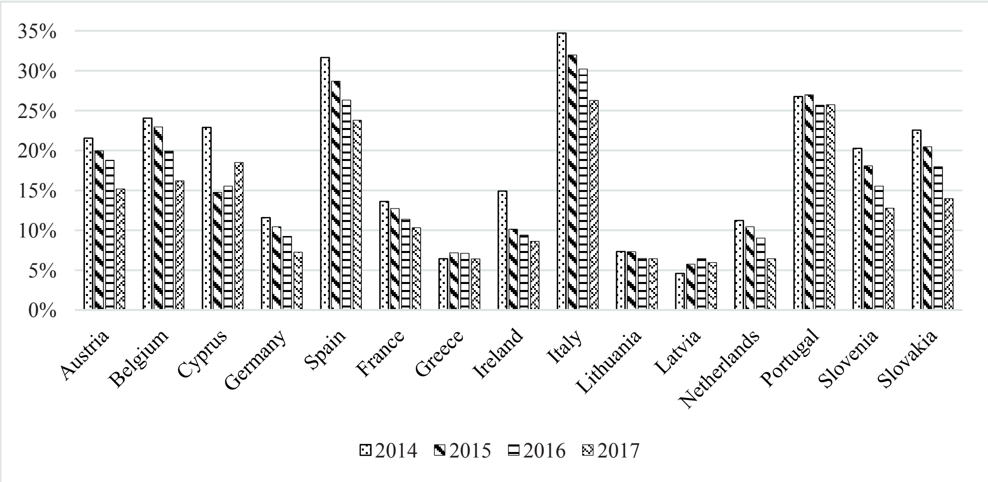

Fig. 2. MFI holdings of government debt securities to GDP

Source: self-elaborated based on the ECB data.

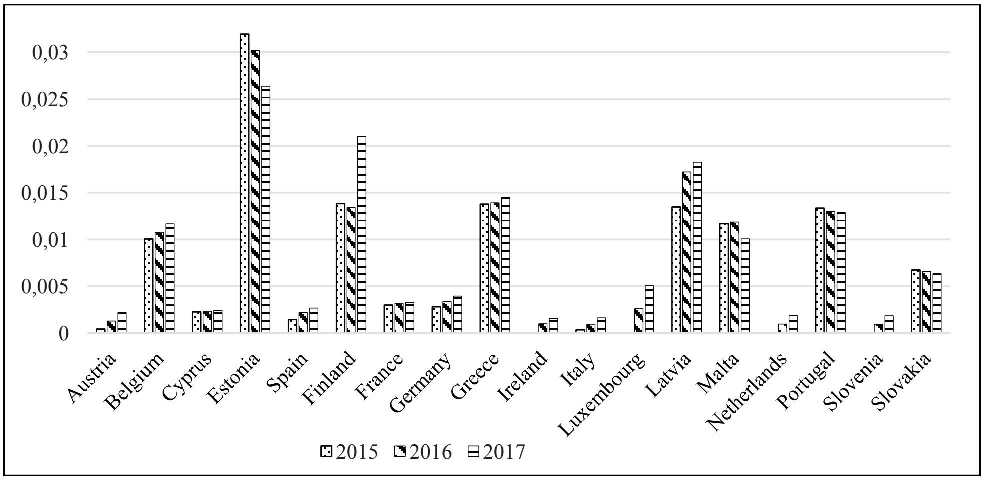

Fig. 3. DGS - available funds coverage of eligible deposits (in %)

Source: self-elaborated based on the EBA data.

Figure 3 presents information on the progress in setting up and enhancing the national deposit guarantee schemes as envisaged by Directive 2014/49/EU. This progress is measured by comparing the value of the funds readily available under the deposit guarantee scheme to the total value of the guaranteed deposits. The directive has set a threshold for this ratio at 0,8% and the data presented makes it clear that none of the euro area countries is close to achieving this goal. The analysed countries have either never had a deposit guarantee scheme before implementing Directive 2014/49/EU, or the guarantee funds were collected ex-post, once they became needed.

The result of this set-up was that over the time of the analysis, the national deposit guarantee schemes maintained only a fraction of the guaranteed value in cash (or cash equivalents). The information on Figure 3 also shows that the coverage ratio was not improving. The establishment of EDIS would therefore require a tremendous increase in efforts from the Member States in order to allow them to achieve the required deposit coverage.

Summary

In the author's opinion, establishing a European Deposit Insurance Scheme is inevitable for the banking union to reach its goals. Harmonizing the rules according to which deposits are guaranteed and paid out is an important step towards financial integration but establishing a pan-European fund serving this purpose would enhance the credibility of the entire banking system. Full integration of national funds into a single scheme should serve as the target model that could allow making the decision on a bank's resolution truly impartial.

The analysis made for this article, however, does some justice to the critics of the project in the sense that EDIS cannot be established overnight. The legacy assets still constitute a large part of many bank's balance sheets and many credit institutions rely strongly on the solvency of their home and host countries. This could put the common Deposit Insurance Fund at a threat of financing the failure of institutions already at the verge of insolvency at the time of its establishment. If the insolvency law is not in any way harmonised across Europe, this would also mean that the DIF could be indirectly used to satisfy the claims of the home country first. It is also clear that if EDIS was established within the next few years, its available funds would fall short of the desired threshold by a large amount, possibly creating issues with credibility of the insurance system rather than solving them.

As a way forward, the author would recommend the Regulation proposal to include more detailed provisions on the conditions for gradual transition from national schemes to a European Deposit Insurance Scheme. This might include ring-fencing institutions that the ECB would consider unstable and not ready for participating in a common scheme to any extent. Apart from analysing the asset quality before moving onto the co-insurance phase, the Commission should also verify the available funds value held by the deposit insurers in the Member States. This could ease the worries about merging schemes that represent a very different degree of credibility, whereas the threat of exclusion of certain banks would motivate them to improve the quality of their portfolio. Further analyses of legal nature would be required to explore the possibility of addressing the issue of harmonising insolvency laws of different Member States.

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