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THE FUNDING MODEL OF DEPOSIT GUARANTEE SCHEMES IN EU. LESSONS FROM THE CRISIS

Summary: The aim of this article is to present recent changes that take place in the issue of deposit guarantee schemes funding mechanism in EU. These are motivated by the new regulations within EU and the need for providing a stable funding for the schemes, so they can achieve their main goals: depositor protection and contribution to maintaining the stability of financial system.

Keywords: funding model, deposit guarantee schemes, European Union.

Introduction

European Union has taken important steps to overcome the crisis and to reinforce the Economic and Monetary Union. Much attention has focused on financial safety nets and their proper functioning. Important pillar of every safety net is deposit guarantee scheme. It performs two main functions: protects depositors and contributes to financial stability. To do so it must be properly designed. One of the important aspects of every deposit guarantee scheme is its funding. This problem has been widely discussed on the international level for years. It can be noticed that the problem of financing methods has not been regulated at a EU level for a very long time. This situation has changed significantly during financial crisis.

The aim of this article is to present recent developments of financing issues of deposit guarantee schemes in EU, caused primarily by the introduction of the new directive on deposit guarantee schemes.

1. Deposit guarantee schemes during global financial crisis – selected problems

The recent financial turbulence provides supervisory, regulatory and other financial authorities with an opportunity to review existing regulatory structures underlying the operation of financial markets, including those related to financial safety nets. One important aspect of financial system policy that has been in the spotlight is deposit insurance. Episodes of bank runs has been rare since the introduction of deposit guarantee schemes, the specific aim of which is to protect depositors and prevent bank runs [Schich, 2008, p. 55].

Implementing changes to existing regulatory and policy frameworks in some areas, where significant shortcomings are identified, may be facilitated during and in the close aftermath of a crisis, given that a sense of urgency for action tends to be widely shared. In other areas, however, changing the existing frameworks may be more difficult, especially if the changes foreseen have direct implications for the losses incurred by different market participants. Changes in frameworks could also affect risk perceptions, perhaps exagerrating existing concerns. In any case, it is important on efficiency grounds for policy makers to carefully assess the potential benefits against the likely costs of policy intervention and to refrain from unnecessary activism [Schich, 2008, p. 57]

According to de Larosiere Report published in 2009, recent financial crisis demonstrated that the organization of deposit guarantee schemes in Member States was a major weakness in the regulatory framework in EU. Among these weaknesses can be mentioned [The High-Level Group of Financial…, 2009, p. 34]:

- unsustainable funding – the lack of sophisticated and risk sensitive funding arrangements involves a significant risk, that governments will have to carry the financial burden indented for the banks, or worse, that the schemes fails on their commitments,
- limited use in crisis management – even if a scheme had that capacity, the pay box nature of most schemes makes it unlikely that they ever will be utilised for systemically important financial institutions, because of the large externalities associated with letting such institutions fail,
- negative effects on financial stability – reliance on ex-post funding and lack of risk sensitive premiums weakens market discipline (moral hazard), distort the efficient allocation of deposits, as well as it may be a source of procyclicality,
- obstacle to efficient crisis management – due to incompatible schemes (trigger points, early intervention powers etc.) and diverging incentives among members.

One of the most important issue addressed in this report is funding problem connected with risk sensitive funding arrangements. The financial crisis showed that depositor confidence depended in knowing that adequate funds would always be available to ensure the prompt reimbursement of their claims [Financial Stability Board, 2012, p. 21]. The primary responsibility for paying the cost of deposit guarantee schemes should be borne by credit institutions. This is compatible with one of the core principles for effective deposit insurance systems published by Basel Committee on Banking Supervision with International Association of Deposit Insurance in 2009. This principle says that a deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems utilising risk adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately [Basel Committee on Banking Supervision, 2009, p. 14].

According to International Monetary Fund the recent financial crisis has led to a substantial increase in coverage and harmonization among some dimensions. After the 2008 financial crisis, and in particular the failure of Lehman Brothers, several EU member states announced in rapid succession increases in deposit insurance limits or blanket guarantees to forestall the possibility of a bank run [International Monetary Fund, 2013, p. 4].

One of the most important issues connected to deposit guarantee schemes are funding arrangements. Policymakers can choose between ex-ante, ex-post and hybrid funding (table 1).

Table 1. Deposit guarantee schemes funding mechanisms

Type of funding mechanism	Characteristics
Ex-ante	accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure occurring
Ex-post	funds to cover deposit insurance claims are only collected from member banks when the bank fails and the need to cover claims develops
Hybrid	combined ex-ante and expost

Source: Own work.

It is important that within the EU the funding models are different in various Members States, both in terms of type of the fund and adaptation of risk- adjusted premiums. Ex-ante funding is present in 21 countries and only 8 jurisdictions use risk- adjusted premiums, as of 2012. IMF states that banks should pay a fee commensurate to their relative risk of failure, a higher premium for higher insurance risk. With correct risk pricing, the benefits of increased risk-taking can be taxed away which helps to restore an element of market discipline. While appropriately assigning bank risk is not straightforward, efforts should be made to adjust premiums for risk, for example, by assigning banks to risk buckets and charging different premiums for banks in each bucket [International Monetary Fund, 2013, p. 9]. Risk-adjusted premiums are consistent with the Basel Committee on Banking Supervision and International Association of Deposit Insurers „Core Principles for Effective Deposit Insurance Systems".

2. Deposit guarantee schemes proposed funding model – main issues

The new model of deposit guarantee schemes funding was proposed in a proposal of Directive of the European Parliament and of the Council on Deposit Guarantee Schemes in 2010, although the works on such a model started earlier. In 2009 European Commission published a report [European Commission, 2009] in which two possible models (based on single indicator and multiple indicator) were presented. These models were based on approaches applied by some deposit guarantee schemes in Member States and it relies on the use of accounting- based indicators to assess the risk profiles of deposit guarantee scheme members. According to European Commission a funding model based on risk adjusted premiums should be [European Commission, 2009]:

- simple – the model should be understandable to all deposit guarantee scheme members,
- accurate – the model should accurately reflect the relative risk that the deposit guarantee scheme members pose to the fund,
- reasonable – in terms of the amount of information required, the model should avoid unduly burdening deposit guarantee scheme members,
- affordable – the model should not cause insolvency among credit institutions,
- flexible – the model should be adjustable to different countries,
- open and transparent – credit institutions should know why they fall in one class and should be able to verify it,
- equitable – banks with different characteristics should be treated similarly.

In the proposal of the directive five options were taken into account concerning funding mechanisms [Proposal for a Directive of the European Parliament…, 2010, p. 52-53]:

- no harmonization of funding mechanisms and no requirements on deposit guarantee schemes funding levels,
- harmonized approach to selected elements of funding:
  - a target level for the total funds that should be available to the scheme,
  - a limit for ex-post funds,
  - a limit for borrowing by deposit guarantee scheme,
- harmonized approach to funding mechanisms and levels, for example making ex-ante fund mandatory supported by ex-post funding- to be achieved within specific period of time,
- using the liquidity remaining in a bank at a time of failure to reimburse depositors,
- limiting the annual maximum contribution to deposit guarantee scheme.

In a proposal for a Directive on Deposit Guarantee Schemes presented in 2010 the problem of deposit guarantee schemes funding is widely described, among other important issues relating to deposit insurance, such as [Proposal for a Directive of the European Parliament, 2010, p. 8]:

- simplification and harmonization (scope of coverage, arrangements for payout),
- reduction of the time limit for paying out depositors,
- mutual borrowing between systems.

According to this proposal the financing of schemes were supposed to be based on the following steps [Proposal for a Directive of the European Parliament, 2010, p. 2–3]:

- in order to ensure sufficient funding, deposit guarantee scheme in every Member State must have 1,5% of eligible deposits on hand after a transition period of 10 years (so called „target level”),
- banks must pay extraordinary ex-post contributions of up to 0,5% of eligible deposits if necessary,
- a mutual borrowing facility allows a fund in need to borrow from other funds (they have to lend a maximum of 0,5% of their eligible deposits); the loan must be repaid within 5 years,
- as a last line of defence against taxpayers' involvement, a fund must have in place alternative funding arrangements.

According to directive proposal contributions from credit institutions should be calculated according to their risk profiles in a harmonized way. The contribution should be calculated on the basis of several indicators reflecting the

risk profiles of each credit institution. The propose indicators cover the key risk classes commonly used to evaluate he financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity (table 2).

Table 2. Parameters for evaluating the risk generated by a credit institution

Risk category	Indicator
Capital adequacy	Capital adequacy ratio
Assets quality	Performing loans ratio
Profitability	Return on assets
Liquidity	Loan to deposit ratio

Source: Own work.

Taking into account differences between banking sectors in Member States, the proposal for a directive ensures some flexibility by developing a set of core indicators (mandatory for all Member States) and another set of supplementary indicators (optional for Member States) [Proposal for a Directive of the European Parliament, 2010, p. 8].

The final text of the Directive was accepted on 16 April 2014. In this final version it is determined that credit institutions are required to make biannual contributions to their deposit guarantee schemes. Those schemes should reach a total amount of financing equal to at least 0.8%[1] of the total covered deposits of their members by 3 July 2024. If the ex-ante financing of a scheme is insufficient to repay depositors in the case of a bank failure, additional contributions may be required from the member banks of the DGS, up to a maximum amount of 0.5% of the covered deposits [C'M'S' Law Tax website, 2015].

In terms of methods for calculating contributions paid by credit institutions the directive does not specify a model that should be used in such calculations. It is only said that this model will be risk-based and it will be based on specific financial indicators, as the article 13 of Directive says [Directive 2014/49/EU of the European Parliament, 2014]:

- contributions paid by credit institutions are compulsorily based on the amount of covered deposits and the risk profile of each member institution,
- deposit guarantee schemes are allowed to develop and use their own calculation methods in order to tailor contributions to market circumstances and risk profiles,
- Member States may provide for lower contributions for low-risk sectors regulated under national law.

[1] This level is lower than in the proposal for the Directive (1,5% of eligible deposits).

On the 10 November 2014 European Banking Authority published a consultation paper [European Banking Authority, 2014] that seeks stakeholders' views on guidelines pursuant to article 13 of Directive which specifies methods for calculating contributions to deposit guarantee schemes.

The guidelines set principles and specify necessary elements for calculating risk-based contributions to deposit guarantee schemes, with a view to curbing moral hazard while building up the necessary financial resources for the schemes. The guidelines foster convergence in contributions practices across the EU, promoting level playing field for banks within the Single Market. The proposed guidelines put forward methods for calculating ex-ante contributions to deposit guarantee schemes, and particularly the methods for adjusting contributions to banks' risk profiles in order to motivate sound risk behaviours [European Banking Authority website, 2015]. These guidelines should be implemented by local authorities no later than by 31 May 2016.

The draft guidelines presented by European Banking Authority has two targets [European Banking Authority, 2014, p. 48]:

- the aim to establish a framework for calculating risk-based contributions to deposit guarantee schemes that would be used in all Member States. This framework should be based on risk indicators reflecting institutions' risk-profile and ensuring a fair treatment of institutions in calculating contributions. In order to ensure objective risk assessment the indicators should reflect a sufficiently wide spectrum of aspects of institutions operations,
- the aim to ensure that the elements fundamental to the effective functioning of the deposit guarantee schemes contribution schemes are consistent across Member States.

Objective of those European Banking Authority guidelines are presented in table 3.

Table 3. Objectives of guidelines issued by EBA

Operational objectives	Specific objectives	General objectives
Ex-ante contributions to DGS are calculated as a function of risk parameters.	Institutions fully internalise the cost associated with risk taking.	Reduce moral hazard and promote fairness among institutions in calculating deposit guarantee schemes contributions.
Common methods and criteria are set for risk-based contributions to the schemes.	Methods and criteria in the schemes contributions framework are consistent and comparable across Member States.	Create a level playing field and information symmetry across Member States.

Source: European Banking Authority [2014, p. 48].

Conclusions

The risk-based model proposed by the EU authorities has a lot of advantages. The main thing is the use of different indicators that can be helpful in the risk assessment and in the construction of a financial institution's risk profile. Such a model is more equitable and may encourage financial institutions to lower their risk, because the lower the risk, the lower the contribution paid to a deposit guarantee scheme. The use of financial indicators makes the model more transparent and simple which is consistent with a current approach of European Commission.

Although the final shape of this model has not yet been specified it is certain that such a model will be an important step in the convergence of practices among deposit guarantee schemes in Member States and this model may contribute to financial stability in the whole European Union.

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MODEL FINANSOWANIA SYSTEMÓW GWARANTOWANIA DEPOZYTÓW W UNII EUROPEJSKIEJ. WNIOSKI Z KRYZYSU

Streszczenie: Celem artykułu jest prezentacja ostatnich zmian, jakie zaszły w obszarze finansowania systemów gwarantowania depozytów w Unii Europejskiej. Są one efektem nowych regulacji prawnych przyjętych na poziomie Wspólnoty, a wynikają z potrzeby zapewnienia stabilnych źródeł finansowania systemów. Efektem zmian ma być umożliwienie gwarantom depozytów realizacji ich dwóch podstawowych celów: ochrony deponentów i przyczyniania się do zapewnienia stabilności systemu finansowego.

Słowa kluczowe: systemy gwarantowania depozytów, model finansowania, Unia Europejska.