# Special Report 2010/12

# Europe leaves its mark on Dutch deposit guarantee scheme

*The case for fundamental reform of the Dutch deposit guarantee scheme (DGS) was set out in Theme Report 2010/12.[1] Since highly risky banks have also started operating under the coverage of the DGS, healthy banks can run into trouble via the DGS as well, which places pressure on financial stability. Addressing this, the study referred to above set out what is needed for a better DGS. The European Commission (EC) recently put forward proposals to amend the European DGS Directive. The EC's plans may still be subject to change by the European Parliament and the Council. This Special Report presents the EC's proposals and examines their capacity to contribute to a better Dutch DGS.*

## European Directive on Deposit Guarantee Schemes to be amended

When the financial crisis hit in the latter part of 2008 the EC decided to implement a number of immediate amendments to the European Directive on Deposit Guarantee Schemes (*Directive 94/19/EC*). The coverage level was raised to € 100,000 per depositor per bank, depositors' co-insurance was eliminated and the payout time limit was cut from 3–9 months to 4–6 weeks (*Directive 2009/14/EC*). The Commission was also given the task of assessing the Directive in a wider context. It presented the proposals to which its broad review gave rise in July 2010. The finalised amendments to the European Directive will form the basis for amendments of the Dutch scheme. The Ministry of Finance had previously already indicated its intention of moving to an ex-ante DGS with risk-based contributions in the Netherlands[2], of further shortening the payout time limit and of examining the options for portfolio transfers.[3]

## DGS according to the European Commission

*Simplification and harmonisation of scope and coverage*

A decision was taken during the crisis that all coverage levels had to be identical in all European schemes. The EC has now concluded from its impact study that the increase to € 100,000 was appropriate. As this serves to cover 95% of all deposits, it provides maximum protection for depositors without – according to the EC – disproportionately increasing the costs for banks and depositors. To achieve a level playing field, the scope of schemes will also be harmonised, extending coverage to the deposits of all businesses except financial institutions and public authorities. In the Netherlands only the savings of private individuals and of SMEs entitled to publish an abridged balance sheet are covered at present. In the EC's view extended coverage will accelerate payouts as banks do not have to identify to which businesses it applies, while the extra costs for the DGS are limited.[4]

The question is whether the protection of the savings of businesses (surplus cash) is reconcilable with the primary goal of a DGS: to protect small depositors in order to prevent bank runs. In addition, coverage in the EC

[1] '*Een beter depositogarantiestelsel*, April 2010, www.rabobank.com/kennisbank.

[2] At present participating banks foot the bill of the failure of any of their number in arrears (ex-post). In an ex-ante system with risk-based contributions, banks periodically pay a premium based on their own risk profile into a fund that can be utilised in the event of a bank's failure.

[3] In a portfolio transfer a healthy financial institution takes over the deposits from a bank that is unable to meet its payment obligations. The acquisition is financed from the DGS and forms an alternative for the payout of deposits via the DGS.

[4] 98.7% of all EU businesses belong to the SME sector (source: EC). The costs of identifying the remaining 1% of businesses and the delays in the payout process are estimated to be higher than the savings expected from barring large businesses from coverage.

proposals extends only to entirely repayable instruments. It therefore excludes products under which the deposit is uncertain as a result of currency or interest rate risks, for example. Coverage does extend to deposits in non-EU currencies, and these also have to be reimbursed in the currency concerned.

*Faster payout of deposits*

Further shortening of the repayment period to one week is very important for the EC. If depositors can firmly rely on a rapid payout of their savings after a bank fails, this can prevent bank runs. Moreover, depositors need to regain access to their money quickly. Achieving this requires payouts via the DGS to be as simple as possible, according to the EC. It therefore proposes, besides coverage for *all* businesses, to eliminate netting by banks.[5] Not having to set off debts and deposits saves time. But it does increase the amount that falls under the DGS coverage and therefore also the adverse financial impact of a failure. In addition, the EC wants banks to set up their schemes in such a way that they can at all times provide information on the aggregate deposits per customer ('*single customer view*').

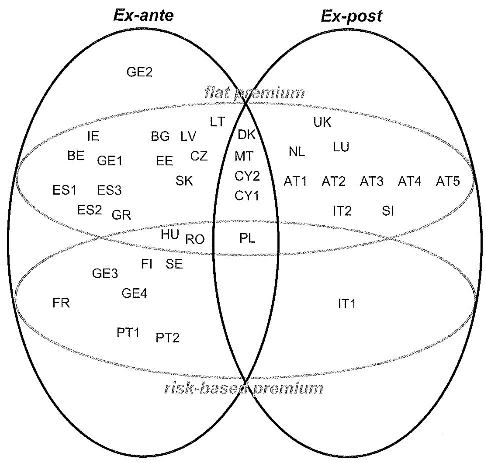
*Harmonisation of DGS funding*

All European schemes must be financed ex-ante, i.e. by a fund.

At present several countries still finance their DGS on an ex-post basis (see figure 1). A major advantage of an ex-ante system is that the bank that goes under will in any case also have contributed towards the costs.

[5] In netting, account holders' debts to a bank (for instance for a mortgage loan) are deducted from their savings at that bank. Depositors are entitled to a payout under the DGS for a credit balance then remaining.

**Figure 1: Financing of European schemes**




Source: Bernet and Walter (2009), *Design, Structure and Implementation of a Modern Deposit Insurance Scheme*, p. 47.

The EC proposes a four-step mechanism to ensure adequate financing of national schemes:

1. *Setting up an ex-ante fund*

The target level is 1.5% of the eligible deposits.[6] This is required to be reached within ten years. Although a fund on the basis of covered deposits is more appropriate as it reflects the actual risk for the fund, this is not yet possible in practice throughout Europe according to the EC. It will reconsider a fund on the basis of covered deposits at the end of 2015.

2. *Ex-post contribution (if necessary)*

If a bank fails and the ex-ante fund is too small, banks pay an additional contribution of at most 0.5% of the eligible deposits.

3. *Mutual solidarity of schemes*

If an additional ex-post contribution is not sufficient, other deposit guarantee schemes are to lend the troubled DGS at most 0.5% of its eligible deposits, prorated to the size of the eligible deposits in each country (*from 31-12-2020 at the latest*).

[6] Eligible deposits are deposits qualifying for coverage under the DGS. Covered deposits comprise the portion of the eligible deposits that are actually covered (capped at € 100,000 per depositor per bank).

4. *Alternative funding arrangements*

If the third step still provides insufficient funds, the DGS can borrow them from other entities (for instance the State or other commercial parties).

The total amount of contributions to be collected by the scheme are apportioned between the banks, in line with their risk profile and the size of their eligible deposits. Banks are attributed a risk coefficient for their risk profile: 75%, 100%, 125%, 150% or 200%. This depends – as currently proposed – on how well the bank scores on the financial ratios of four quantitative risk indicators: capital adequacy, asset quality, profitability and liquidity.[7] The premium for a bank *i* is set using the following three steps.

[1]) Risk-weighted contribution base bank$_i$ ($RC_i$) =eligible deposits$_i$ x risk coefficient$_i$

[2]) $$\text{Risk share for bank}_i\ (RS_i) = \frac{RC_i}{\sum_{i=1}^{n} RC_i}$$

[3]) $$\text{Premium for bank}_i = RS_i \text{ x total amount of contributions to be collected by the scheme}$$

*Extension of the mandate of DGS*

The DGS fund is principally intended for reimbursing depositors, but member states can also use it for early intervention (for instance portfolio transfers) in order to prevent a bank from toppling over. In addition, member states can maintain or introduce separate guarantee schemes for old-age provision products and pensions. The Directive includes a provision relating to this.

*Sound information on DGS for depositors*

The EC's proposals also encompass the harmonised provision of information to depositors. New depositors sign a standardised information sheet and existing depositors must also be informed of the coverage under the DGS. The proposals include an explicit provision that banks may not misuse the coverage under the DGS for marketing purposes.

## Do the proposals provide the conditions for a good DGS?

The emphasis in the EC proposals is on consumer protection. The EC argues that this also benefits financial stability, as it sharply reduces the likelihood of bank runs. The potential *negative* effect of the measures on financial stability is not sufficiently foregrounded, however. The high coverage level and short repayment period mean that the incentive for depositors to consider a bank's solidity is eliminated entirely. Empirical research by Demirgüç-Kunt and Detragiache (2002)[8], which the Netherlands Bureau for Economic Policy Analysis CPB refers to in a recent publication[9], supports this conclusion: the adverse effect of a DGS on financial stability increases in proportion to the coverage level it provides. Therefore, Special Report 2010/12 emphasised the need for good organisation at the back (= the financing) of the DGS now that the front-end incentives have disappeared. This means, in the first place, stringent risk assessment for entrants to the DGS, including a critical review of the bank's business model. In addition, strict ongoing supervision of all banks is a must. This supervision, which is implemented at a national level, falls outside the scope of the EC but is crucial to prevent the DGS from turning into a major source of trouble and disruption in the coming years (see Theme Report 2010/12).

Risk-based contributions is another significant condition for a properly organised DGS, owing to its disciplining effect on banks' risk profiles. It also ensures that the scheme is fairly

[7] These proposals are discussed in the next section.

[8] Demirgüç-Kunt, A. and E. Detragiache (2002), Does deposit insurance increase banking system stability? An empirical investigation, *Journal of Monetary Economics*, vol. 49(7), p. 1373-1406.

[9] CPB (2010), *Systemic risk in the financial sector, A review and synthesis*, CPB document No. 210, p. 68.

funded. Risk-based contributions are included in the EC proposals. But a first numerical run-through of the EC proposal for the Dutch banks shows that the current proposal does not (yet) adequately reflect the differences in banks' risk profiles in the premiums for the DGS. Qualitative elements such as an opinion on the earnings model, profile of activities and funding are not included in determining the risk profile, which is therefore incomplete. Quantitative indicators are, in addition, not always unambiguous. For instance, high profitability does not usually imply that a bank's risk appetite is lower – quite the contrary. By contrast, a low but stable profitability is often a sign of a moderate risk profile.

## Impact on Dutch banks

By contrast to the incidental spending for the present ex-post DGS, the introduction of an ex-ante system entails a recurrent expenditure for Dutch banks in the form of the six-monthly DGS premium. On the basis of the present EC proposals, Dutch banks would have to accrue a fund of several billion euros within a period of ten years. That is a considerable amount, compared to the expected costs of some 600 million euros for the DSB bank failure. The opportunity costs of a large fund are moreover high since the money cannot be used for lending. The costs of the DGS will also (partly) be reflected in savings and/or loan rates. The EC could suffice with a smaller fund and/or a longer period for it to be accrued, the more so as schemes can also borrow from each other. The EC should also take more account of the tilted playing field now being created because some countries already have a (small) fund and other countries do not yet. Banks in current 'ex-ante countries' will have to contribute relatively less to reach the target level of the fund than those in 'ex-post countries'.
The expenditure for the fund is not the only financial consequence of the proposals faced by banks, however. Many banks will also have to invest significantly in IT, processes and reporting to make possible a further shortening of the repayment period.

## Conclusion

*The EC's DGS proposals show that it continues to maintain a high level of consumer protection after the crisis. With its proposed extension of the coverage to large businesses it is even going beyond the primary purpose of a DGS: to protect small depositors. The EC proposal for risk-based contributions can contribute to a better Dutch DGS, but has not sufficiently been worked out yet, as banks' differing risk profiles are not properly reflected in the DGS premiums. Incorporating qualitative elements in determining risk profiles could contribute towards a better outcome. If the present EC proposals are green-lighted, this will have a significant impact on Dutch banks. They will have to accrue a fund of several billion euros within a period of ten years and make additional investments in IT, processes and reporting. The opportunity costs are high because the money cannot be used for lending. In addition, the DGS costs may be reflected in savings or loan rates. A fund that is not larger than necessary and a suitable period for accruing it are hence required, the more so as DGS schemes will also be able to borrow from each other in the future. Lastly, a stable and well-designed DGS is not just important for financial stability but is also in the interest of the government, which would in any case ultimately have to foot the bill of any large bank failure.*

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