Towards a Balanced Deposit Guarantee System in Europe

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The prevailing "temporary emergency" deposit guarantee system (DGS) in Europe should be revised and adjusted when the largest turbulences in the banking sector are over. This DGS is not beneficial for financial stability and competition in banking. It seems that the goal of consumer protection has pushed aside the financial stability objective, which leads to moral hazard problems. To correct this imbalance, it is advisable to lower the reimbursement limit from € 100,000 to € 50,000. It would also help to (re)introduce a limited own risk for depositors, but that seems to be politically unfeasible. Differentiations in the contributions of banks to the DGS according to their risk profile should also increase significantly and these funding contributions should be capped for individual DGS participants. Lastly, intensified attention for the risk profile and business models of new and existing DGS participants by supervisors is required. Ideally, supervisors should have the means to impose limitations on banks with risky or one-sided business models in the savings markets[1].

Introduction

The deposit guarantee scheme (in short, DGS) is in the spotlight in the political arena, the financial sector itself and the media. This can be ascribed to the turbulences in the banking industry and the increase of the reimbursement limit to € 100,000 in October 2008 across Europe to maintain confidence among depositors in banks. Some countries even took further steps. In the Netherlands, partial insurance for (smaller) deposits has been removed, whereas the Irish government has guaranteed all savings. Irrespective of country specific characteristics of a DGS, the main objective of every DGS is safeguarding the confidence of small savers in the stability of the financial system[2].

The competitive aspect of a DGS has gained tremendously in importance over the last few months. Certainly, it is positive that a DGS ensures a partly levelling of the playing field between large and small banks in the savings market. But recent turbulent developments in banking could jeopardize the solidity of a DGS, thereby possibly undermining financial stability and confidence among depositors in the financial system in the long run. The issue is that many banks have suffered financial losses, reductions in capital and face problems in attracting capital on the public capital markets. However, banks are obliged by the "market" and supervisors to increase their capital buffers at higher prices for capital market funding. After the collapse of investment and wholesale banking as well as the disappearance of provision generating activities from securitisation and complex structured financial products, many banks are currently reviewing their business model. Therefore, a massive return to retail banking can be expected with a concomitant rise in competition in the savings markets. Moreover, (small) players with risky and/or one-sided business models could enter the savings markets (mainly via direct channels) to tap a necessary and relatively cheap funding source. Apart from the fact that they could be prepared to offer high interest rates, these players would distort the competitive environ-

1. The views expressed in this article are personal and do not necessarily reflect those of Rabobank Nederland. The author wishes to thank several colleagues within Rabobank Nederland for their valuable input (correspondence to: j.m.groeneveld@rn.rabobank.nl).
2. It is acknowledged that the design and implementation of a DGS differ across European countries. For instance, in Germany, the banking system includes three types of banks. Each of the three groups of banks has its own voluntary system of deposit insurance. For instance, cooperative banks have their own DGS in place and do not participate in the DGS of German commercial banks.

ment for other banks, drive up the price of credits and loans, and actually shift the risks of their poorly-diversified activities via participation in a DGS to other banks and eventually the taxpayer. In the current economic environment, these are alarming prospects for the DGS, which call for the application of strict(er) membership criteria for incumbent and new players in the savings market by the supervisors.

Recent studies, reports and policy documents mainly focus on fairly technical DGS aspects like the funding mechanisms, operation, execution and administration (Basel Committee, 2009; European Commission, 2008a)[3]. In my opinion, these aspects are only of secondary importance. The primary focus should now be on the visible and noticeable aspects of a DGS for the general public and entire financial system "at the front". Public discussions should concentrate on the impact of DGS arrangements on issues like financial stability, moral hazard, competition and banking supervision. These interrelations determine the effectiveness and viability of a DGS in practice. In recent publications and European discussions, little attention is paid to these important externalities of a DGS.

Against these backgrounds, this article argues that the prevailing "temporary emergency" DGS should be revised and adjusted when the largest turbulences in the banking sector are over. It is acknowledged that some suggestions are politically sensitive or even unfeasible, but they just serve to sharpen the discussion and flag potential risks. Analytically, the current DGS is not beneficial for financial stability and competition. Of course, one should be careful with changing frameworks in periods of financial distress, because this could exaggerate existing concerns.

Principal Starting Points

Many countries and the European Commission are currently revising the crisis resolution system for banks in financial distress, including the DGS. When redesigning the DGS, policy makers and researchers should take into account a number of principal starting points. Firstly, a DGS can never replace responsible behaviour of banks and adequate banking supervision. Secondly, a DGS only enters into the picture in extreme emergency cases (see Dutch Central Bank, 2008). A DGS is not meant to counter a systemic crisis, but is merely a financial safety net for incidental, small bank insolvencies. In times of a threatening global systemic crisis, or of failures of several small banks and/or a major player, the public sector will have to offer a helping hand, for instance through capital injections, financing guarantees and the ultimate means of nationalisation. At the same time taxpayers' interests must be safeguarded and government support must therefore be subject to strict conditions. Another option is to stimulate other parties to acquire – deposit portfolios – of troubled banks.

In addition, for a DGS to be effective, depositors need to understand its limitations and scope. Consumer surveys show, however, that such knowledge can be limited. Thus, simplicity and adequate education are valuable in making the public understand the arrangements. Concerning the scope, a DGS should be limited to banking products and only cover deposits of private individuals and small businesses. Only banks must be covered by the DGS (and not insurers for instance). Insurance products and investment products have a different time horizon, respectively different risks and should therefore be excluded. An explicit DGS is very important in defining the outer limit of the financial safety net. It limits the guarantee to a specific type of creditor ("insured depositors"). Thus, uninsured depositors like other creditors, shareholders, and managers, are exposed to increased risk exposure, thereby encouraging them to monitor and limit the riskiness of the bank.

Lastly, a new DGS should contain the right incentives for depositors and banks to discourage moral hazard and abuse. Concretely, the insurance coverage should be sufficient to safeguard the confidence of depositors in the financial system. On the other hand, the coverage limit should not be too high to provoke moral hazard on the part of depositors as well as the banks accepting or collecting the deposits[4].

Financial Stability

A DGS is above all of great psychological value. Confidence is the main pillar of every financial system. Applying a reimbursement limit in a DGS safeguards this to some extent. This may prevent depositors from withdrawing their money in large numbers in a *bank run*, which causes domino effects and subsequent bank failures. By (partly) guaranteeing funds held by depositors at

3. A notable exception is Schich (2008).
4. Moral hazard means that savers and/or banks have an improper incentive to disregard risk and to pass the risk on to the collective. Depositors and banks only focus on their own returns, which is justified in a market economy, but without additional safeguards conflicting with the financial stability objective. The aspect of moral hazard constitutes a general matter of controversy regarding the desirability of a DGS.

banks, trust is maintained in the financial system, thereby reducing the possibility of contagion or a chain reaction in the banking system as a whole. A DGS also protects bank retail depositors from incurring large losses due to bank failures. This argument relates to the presumed inability of ordinary retail depositors to assess and monitor on an ongoing basis the riskiness of the institutions that are holding their deposits[5].

However, the actual ability of a DGS to absorb shocks is limited and a DGS cannot always prevent a bank run. In the event of a failure of a medium-sized or large bank, other banks can only pay a small part of the entire bill for the DGS, especially with the current reimbursement limit of € 100,000. The remaining banks cannot pay for the billions of savings at this failed bank, because then they would get into great financial troubles themselves. Financial instability would then be the result. Besides, bank failures often occur in challenging times, and that is a bad moment for other banks to provide support. To avoid this situation, the potential annual contribution to a DGS should be maximised per individual banking participant. All costs above this collective limit should be at the expense of the public means of the state. In a market economy, financing of a DGS will often have to be drawn in part from public funds. This will already be required in the event of the failure of a non-system relevant medium-sized or large bank. Otherwise, the solvency and liquidity of all other banks will immediately be endangered. This consideration applies especially to countries with a highly concentrated banking sector, like the Netherlands.

Incentives for Depositors

A DGS should contain incentives for depositors to limit moral hazard problems and to stimulate own responsibility. Three effective and transparent incentives are conceivable. Firstly, it is important to apply a modest guaranteed limit. A full or very high coverage encourages depositors to place their savings with the most risky banks that often offer the highest interest rates. Savers do not feel the urge to inform themselves of these higher risks, if they are (almost) completely compensated in case their bank becomes insolvent. Against this background, the current coverage of € 100,000 is too high and a limit of say € 50,000 is preferable. Calculations of the European Commission show that 80 percent of the savings is already covered at this lower limit. Secondly, limiting risk taking could be achieved by utilising a DGS consisting of "co-insurance" in which deposit insurance covers less than 100 per cent of individual deposits so that depositors still have some funds at risk. For example, the introduction of an own risk of 10 percent over the tranche ranging from € 25,000 up to the limit of € 50,000 would stimulate their risk awareness. Savers then take the solidity of banks into account[6]. Thirdly, a phased payout may also contribute to increased risk awareness. In that case, the DGS administrator will in the event of a – small – bank failure in the first instance only pay out a relatively small amount and the remainder will follow in due course.

Box 1. Moral Hazard and the "Icesave Debacle" in the Netherlands

Encouraged by comparison sites and "surveys" by the consumer association, for example, depositors until recently sought the highest returns on their savings. In the Netherlands, up to the beginning of October 2008, this route led to Icesave. This subsidiary of Iceland's Landsbanki attracted savings from the Netherlands at very high interest rates and then placed them abroad at high risk. In doing so it referred to the coverage by Iceland's DGS for savings up to around € 20,000 and by the Dutch DGS for the remainder up to € 40,000 (with a co-insured risk of 10%). At that time, the DGS coverage in the Netherlands was more generous than in Iceland. Icesave abused this *"topping-up facility"* and this led to the aforesaid moral hazard[7].For without this *topping-up*, Icesave did not have a viable business case to attract savings in the Netherlands. Icesave engendered unfair competition in the Dutch savings market, but in general terms added nothing to the financial system. This is known as *"freerider behaviour"*: abuse of a shared facility.

In their turn, private depositors were assuming that their savings were covered by the Icelandic and Dutch DGS. In their view, their total savings were

5. Enhancing household financial literacy appears to be difficult and the results take time to materialise.
6. I disagree with the seemingly emerging consensus regarding one of the lessons from the run on mortgage lender Northern Rock in the United Kingdom. It is wrongfully suggested that a DGS with lower levels of coverage and partial insurance, together with likely delays in repayment, may not contribute to financial stability and may even introduce incentives for retail depositors to run (on) a bank (see also Ondo-Ndong and Scialom, 2008). It is mainly about a better explanation of the scope and limitations of a DGS to the general public by the government and supervisor.
7. Topping-up scheme: if the scheme in the host country where the branch operates provides wider coverage than the scheme applying to the branch in its home country's scheme, the branch can opt to participate in the host country scheme, under the provisions of Art. 4 (2) of the Directive and Section 3:266 (3) of the Dutch Financial Supervision Act (Wft).

equally "safe" with all banks. Which was not the case. Hundreds of depositors had placed amounts with this Icelandic bank that were in excess of the limit guaranteed at the time concerned. This was due to a lack of financial literacy in combination with a lack of risk awareness on the part of many private depositors. The fact that many local government authorities also placed substantial amounts with Icesave is highly controversial. Professionals at government institutions should be aware that a DGS does not apply to them and should manage collective funds in an extremely prudent manner. It is rather unpleasant that wise savers in their capacity as taxpayers should to a large extent pay the bill for risk taking banks when they would go bankrupt.

These three suggestions do not fit into the current discussions in Europe; the European Council has opted for a maximum coverage of € 100,000, "co-insurance" or own risk is abolished and a maximum payout period of just twenty days is proposed[8]. Although these proposals or decisions maximise the certainty of depositors, they invite to take more risks. The fast payout also places banks for large adjustments in their ICT-systems and can reduce the carefulness of determining the rightfulness of eventual claims when activating a DGS. It will consequently become much more difficult to obtain an understanding of the amounts receivable and debts to facilitate proper settlement. Reclaiming amounts paid out in excess from depositors is not realistic.

Incentives for Banks

The height of the coverage influences moral hazard at banks. The coverage of € 100,000 supports risky banks that have to pay a high risk premium for capital market funding. These banks do not have to pay this premium with a generous DGS in the savings market. The higher the limit, the more risks these banks pass on to the less risky competitors and tax payers. In addition, risky banks are often prepared to pay higher savings rates to attract funding and push up the market rates for less risky banks with their higher savings rates. In the end, this will soar prices for credits, thus depressing economic activity.

To limit moral hazard it is suggested to introduce a risk-dependent contribution to the DGS for banks (Garcia, 2005)[9].The higher the risk profile of the bank, the higher the price of participation. Table 1 sets out how various countries apply this kind of risk weighting.

Table 1. Risk-dependent premium levels worldwide

Country	Fund?	Risk weighted on the basis of
Germany	Mix	index (based on "*risk profile*" and "*performance profile*") [a]
Finland	Yes	Solvency
France	Mix	index[b]
Italy	No	index[c]
Norway	Yes	capital ratio
Portugal	Yes	Solvency
Romania[d]	Yes	index[e]
Turkey	Yes	capital ratio and other factors
Sweden	Yes	capital ratio
Canada	Yes[f]	risk index[g]
USA	Yes	capital and CAMEL[h]

[a] Participation in the *Deposit Protection Fund of the Association of German banks* is voluntary; [b] Based on solvency, risk diversification, maturities conversion and profitability ratios; [c] Based on risk, solvency, maturities conversion and performance; [d] Romania is currently working on the introduction of a new system of risk assessment; [e] Based on solvency ratio, *credit and interbank placements risk ratio*, general risk, profitability and liquidity ratio; [f] The fund in Canada serves only to cover the costs of loans as soon as the fund has to proceed to payouts; [g] Based on capital adequacy, profitability, asset diversification and rating by oversight body; [h] CAMEL(S) stands for *capital adequacy*, *asset quality*, *management capability and performance*, *earnings*, *liquidity* (and *sensitivity to risk*).
Source: Bikker en Prast (2001), EFDI (2006), European Commission (2008a) and national sources.

Eight European deposit guarantee schemes adapt their members' contributions on the basis of information obtained by means of indicators (only a single scheme applies an ex-post funded system). Some countries use a simple system to assess risks, while others opt for a complex model. To provide effective incentives, there must obviously be significant differentiation between the contributions paid by banks depending on their risk profile. However, the gap between the premiums of the least and most risky banks is fairly narrow in practice (Garcia, 2005). Between the eight European systems that were examined by the European Commission (2008a), the differences ranged from a minimum contribution of 75% to a maximum of 140% of the standard amount. The system in the US appears to apply a stronger risk weighting, with premiums varying from 0 to 0.27% of the deposits.

Hence, the overall conclusion is that the current differences between the premiums for individual banks according to their risk profile do not provide substantial incentives to influence the risk appetite of banks. Apart from this fact, a risk-dependent contribution has pros and cons (see table 2).

8. However, the European Parliament first wants an impact assessment to determine the optimal level. This approach is preferable, provided that the harmonisation of the amount itself is not called into question again in such an assessment. An uniform amount is extremely important for stability in the European financial sector and for the level playing field in Europe.
9. In principle, premium differentiation by risk profile is also possible for a system with ex post funding, such as the Dutch scheme.

Table 2. Pros and Cons of Risk Elements for Banks in Guarantee Scheme

Pros	Cons
Market conformity A risk-related apportionment formula mitigate unintentional subsidies for risk-seeking banks.	**Feasibility** A risk-related system of passing on costs is more difficult to operate than the current allocation system based on the deposit market share.
Financial stability A risk-dependent contribution to a DGS promotes financial stability by preventing banks that do not have a sound business case without DGS from being unjustly protected. In the long term, this could reduce the chance of failures.	**Constraint competition** Major differentiations in risk premiums and reductions could hamper competition. Some – smaller – banks could decide to discontinue their activities if faced with the prospect of having to contribute relatively much in the event of a bank's failure; their activities are usually not as widely diversified as those of large(r) banks. But a healthy small bank will be able to remain competitive without any problems.
Warning indicator Risk-related differentiation of the contribution can be a signal for the extent of risk-seeking by a bank, provided the risk weighting is disclosed.	**Adjustment of risk profile** Any change in a bank's risk profile must be communicated immediately. This requires the cooperation of the supervisor as the implementing agent of the DGS. Downward adjustments can result in unrest among depositors. In uncertain times, an outflow of savings at riskier banks may occur directly (*flight to safety and security*), bringing these banks as a *"self-fulfilling prophecy"* into troubles.

Source: Rabobank analysis.

An important disadvantage of risk weighting is that eventual changes in risk profiles of banks should be communicated by the administrator of the DGS. With a downward adjustment, this could lead to an immediate shift away from more risky banks (*flight to safety and security*), which consequently run into problems by way of a *self-fulfilling prophecy*.

Risks for governments

By increasing the reimbursement limit to € 100,000, European governments run great financial risks. Since banks cannot bear the eventual financial burden of a DGS with a high coverage, the government will always have to support or intervene. This prospect can reduce the creditworthiness of the state and possibly deteriorates its rating. Unfavourable financing terms (higher interest rates) are the consequence. For example, guaranteeing all deposits by the Irish government has large repercussions for its creditworthiness, and consequently its funding costs.

Another aspect relates to banks attracting deposits from abroad via foreign branches. These are covered by the national DGS. However, there are major differences between DGS's, licence policies and banking supervision in Europe. An important result is that the protection available to customers differs between countries and there is no level playing field for banks. That is another reason why the harmonisation of DGS's referred to previously is important. In addition, the resilience of national economies and the affordability of the DGS should be taken into account. This holds particularly for smaller countries with a relatively large banking sector that attracts a considerable amount of savings abroad which are partly or fully covered by the national DGS[10].

Competition

A DGS partly levels the playing field between large and small(er) banks. Owing to their size, large banks are deemed to be *"too big to fail"*. This implicit assumption has proven to be correct, as, for instance, attested by the nationalisation of Fortis and ABN Amro and the state support for ING, Aegon and SNS Reaal in the Netherlands. But it does unintentionally give large banks a competitive advantage over smaller players in the banking sector. Without a DGS, savings are safer with large banks than with small banks. A DGS largely redresses this and provides smaller banks some support in their competition with the large players.

A DGS should not subsidize banks that would not have a viable business model without such an arrangement or could only attract means on the capital markets against high costs (see Section "Supervisory issues"). In addition, the functioning of the market is seriously distorted when banks hitch with a DGS which is more generous than that their own home country (see Box 1). Fortunately, a full harmonisation and the elimination of topping-up in a new European DGS are within reach. Hopefully, arbitrage on differences between national guarantee schemes is soon no longer possible.

There is also the competition issue regarding foreign banking via branches or subsidiaries. A retreat within Europe to national financial systems would not be the right way. If governments would for example decide to apply the DGS to residents only, the freedom of banking services within Europe would be impeded. Banking via branches would become unattractive and competition would be reduced. The host country may not be willing to assume the guarantees, as it does not exercise prudential oversight over the foreign branches. The drawback of

10. ING Direct has been successful in attracting savings abroad. However, around € 60 billion of its savings obtained outside the Netherlands are covered by the Dutch DGS. Note that this issue touches upon the question of the size of banks versus national economies.

exposing the national taxpayer to risks of attracting savings from abroad must be weighed against the potentially adverse effect on competition in European banking. A solution could be to transform foreign branches of banks into foreign subsidiaries, that would then be supervised in the host country and of which the deposits would be covered by the DGS of the host country (see Arnold, 2008).

Financing Schemes

Basically, two different financing systems of a DGS can be distinguished: ex-ante or ex-post. The pros and cons of ex-ante and ex-post DGS funding are summarised in table 3. Most EU countries have an ex ante fund. In the Netherlands, the remaining banks pay ex post for the DGS-costs of a failed bank, related to their market share in the savings market.

The existence of a fund could be a comforting thought for depositors: some money has been reserved in advance for bad times. However, the coverage ratio of ex ante funds in the EU just amounted to 0,7% of all eligible deposits (European Commission, 2008a). In most cases, this is by far not enough to pay out all savers in case of a bank failure, implying that the State has to step in pretty often. The drawback of the ex post system is that the party triggering the use of the DGS does not share in the costs, which it does in the case of an ex ante fund. The contribution of this party in advance to the fund will presumably have been rather modest compared to the costs of its failure[11]. An advantage of an allocation system is that all means remain available for productive use in the economy, like investments and credits. With ex ante financing, the money cannot be used very productively for the economy. So, weighting the pros and cons and selecting the “winning” financing scheme are difficult.

Table 3. Pros and Cons of ex post and ex ante Scheme

	Ex post	Ex ante Fund	Winner	Comments
Money is available for productive use in the economy	+	–	Ex post	In an ex post system, all resources remain available for risk-bearing investments and lending. In a fund system the resources can only be used for low-risk investments, such as government bonds[1]
Differentiation in apportionment formula for contributions	+	+	None	Differentiated and risk-based contributions can be agreed (in advance) in both systems
Failed bank shares in costs	-	+	Ex ante	The institution with the highest risk – *i.e.* the bank that fails – does not share in the costs with ex-post funding
Account holders quickly receive their insured amounts	+	+	No difference (with small failures)	In an allocation system, the implementing agent mostly has sufficient means to make “speedy” payouts. A fund contains money, but this will quickly turn out to be insufficient, as experience in many EU countries has shown
Stabilising effect of system	0	+	Ex ante	A fund is slightly more effective in challenging times, which present a greater chance of failures; it could give banking supervisors somewhat greater freedom to let (small) troubled banks fail. For major failures, the chosen system does not make a great deal of difference, as state support is required
Costs of fund management	+	-	Ex post	Funding ex-post has the evident advantage that costs of managing the fund are avoided

1. 90% of existing ex-ante schemes invests their money in national/EU bonds or in short term deposits (EC, 2008a).

Source: Author’s analysis/opinion.
Note: a + or - means that a system scores well or poorly on the criterion concerned. Accordingly, a “0” represents a neutral score for the system concerned.

Supervisory Issues

By providing deposit insurance, there is even greater need to ensure proper oversight of deposit-taking institutions to defend those safety nets and to contain moral hazard. It underscores the need for a sound regulatory and supervisory (and legal) framework in place to deal with excessive risk taking by DGS participants. According to the Financial Stability Forum (2001), a financial safety net consists of three elements: prudential regulation and supervision, a lender of last resort, and deposit insurance. If a country has established a well-developed mechanism in only one or two of these three areas, it is still likely to face difficulties in finding effective solutions for preventing or resolving serious problems in its banking system.

In the current turmoil, this wisdom is more topical than ever. Some institutions face difficulties in obtaining funding on the public capital markets and/or are

11. In the case of Icesave the amount concerned was € 1.6 billion.

supported by national governments with capital injections. Capital has become very scarce and expensive. Savings have become a very tempting funding source, which attracts new players. It cannot be excluded that new specialised foreign banks and non-banks, *e.g.* telecoms or retailers, will discover the savings market as a cheap funding source in due time. And European savings markets are open, large and easy accessible. Depositors increasingly just pay attention to the savings interest rates parties offer and hardly take the risk profile of the players into consideration with a high reimbursement limit. A serious risk exists that parties with a non-diversified business model, a low creditworthiness or high risk profile access the DGS[12]. These business models introduce additional risks in the financial system and hence in the DGS. If one of the institutions in question would fail, well-diversified banks would have to foot the bill and confidence among depositors would be damaged.

Another important supervisory aspect of a DGS concerns cross border banking of European banks. When banks have a banking licence in one EU member state, they are allowed to operate freely in all the other EU member states. The supervision is exerted by the country where the licence is provided. The current differences in national guarantee schemes and supervisory regimes are abused and provoke free rider behaviour. The foreseen European harmonisation concerning the height and scope of the DGS does not solve problems with respect to banking supervision and the international coordination of supervision. The Icesave case has demonstrated that national supervision on the use of the attracted domestic savings by and the underlying business model of branches of foreign banks should be intensified. The position of the supervisor in the country where the branches of foreign banks are located must be strengthened. It has become clear that the Dutch supervisor neither had nor acquired enough knowledge of the internal situation at Landsbanki.

Conclusions

If the situation in the European banking sector is somewhat normalized, a DGS should be established that is clear and transparent to savers, does not cause competitive distortion between European banks, and leaves no room for abuse ("EU-proof"). The European proposals go in the right direction, but unfortunately tend towards the creation of total certainty and minimal risk awareness on the part of depositors. In the current situation, a serious imbalance exists between the main goals of a DGS. Currently, consumer protection seem to have pushed aside the financial stability objective. In the long run, financial stability and healthy competitive conditions are served by a substantially lower reimbursement limit with a limited own risk for depositors. The actual € 100,000 provokes risky behavior of depositors and banks and endangers the creditworthiness of national governments. Introducing phased payouts in cases of depositor reimbursements would also stimulate risk awareness on behalf of depositors and support financial stability. In all EU-countries, differentiations in the contributions of banks to the DGS according to their risk profile should increase significantly (irrespective of the *ex ante* or *ex post* funding method).

Since savings have become a very attractive funding source in these financially turbulent times and the risk profiles of certain financial players have deteriorated, new threats for the viability and sustainability of the DGS could emerge. The current DGS is not equipped for this new situation and requires intensified attention for the risk profile and business models of new and existing DGS participants by supervisors. Ideally, supervisors should have the means to impose limitations on banks with risky or one-sided business models in the savings markets. Such adjustable membership criteria would not only reduce the potential risks for the other banks and the State, but would also enhance the confidence of depositors in the financial system in the long-run.

At present, European harmonisation at the "back end" of a DGS appears neither necessary nor desirable. National flexibility is required to create policy room for responding to specific market conditions and banking environments in EU Member States. This applies for instance to the apportionment of the financial consequences and settlement procedures in the event of a bank's failure. Such a discretionary scope is necessary to prevent a DGS from itself becoming a risk factor for the financial stability in a crisis situation.

In this respect, capping the funding contribution for individual participants in the DGS is desirable. This serves primarily to avoid endangering the financial solidity and stability of the banks and their continuity as a going concern. It is undesirable to subject banks to an unlimited funding obligation from the DGS that will bear down on

12. Cases in point are subsidiaries of banks in European countries which business models are largely based on trade financing for firms, funded by savings. Of course, it is positive that these institutions contribute to diversity in national savings markets. But generally speaking, a limited diversification and the high risk profile of core activities render banks vulnerable, whereas the risks end up with the collectivity of banks via the DGS. Besides, the credit crisis and worldwide recession heighten these risks.

healthy banks for many years. And in addition a cap will mitigate the potentially destabilising effect of the scheme in the event of a failure of a large institution. The cap should apply per year and for instance could be linked to a specified percentage of the balance sheet total or net profit. The rest of the payouts or the shortage will therefore be paid by public funds (state). Again, this will always be tailored to the situation, with safeguards for taxpayers[13].

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13. In countries with a strongly concentrated banking sector, the charges arising from a failure will be much more onerous for the other banks than in countries with a lower degree of concentration. In the latter, charges will be more evenly apportioned.