# Structure of the European Deposit Insurance Scheme - speech by Nicoletta Mascher

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21/06/2019
Speeches
ESM
Frankfurt am Main, Germany

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**A discussion on**
**"Structure of the European Deposit Insurance Scheme"**
**Goethe University, Institute for Law and Finance**

Frankfurt am Main, 14 June 2019

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The purpose of the European Stability Mechanism (ESM) is to safeguard the financial stability of the euro area and of its member states. As a crisis resolution mechanism, in peace times, the ESM prepares for the next crisis. For that, we analyse drivers of financial instability and impact of shocks.

It is clear that the ESM's role would be much easier with a complete banking union and a pan-European deposit insurance. With an identical level of depositor protection across the euro area and a weaker link between banks and sovereigns (i.e. sovereign-bank nexus), financial fragmentation would decrease and so would the risk of bank runs under distressed market conditions.

During the last financial crisis, about a third of our disbursements to ESM programme countries went to the banking sector. Of course, it is not just because we did not have a European deposit protection; we did not have a resolution fund as well, nor a harmonised supervisory approach; interventions covered for recapitalisations, resolutions, liquidations and deposit protection. However, confidence of depositors and credibility of the safety net played a major role in determining the magnitude of ESM support.

Europe has come a long way since the crisis. With its strengthened institutional framework it is now much better prepared for the future than ten years ago. But the system remains fragile without a strong and credible common protection scheme.

A European deposit insurance scheme (EDIS) is essential to complete the banking union. Of course, further risk reduction could help to advance the transition from a first step towards a fully-fledged deposit insurance. But delaying the process to implement EDIS, while waiting for further risk reduction, can be counterproductive in the end: it would create uncertainty and could undermine the credibility of the entire project..

**How can we break the current deadlock in the negotiations on EDIS?**

The focus of this panel is on the structure of EDIS. We consider two main structural features as essential to build consensus and overcome hesitations to implement it.

a. The architecture of EDIS and its gradual implementation in subsequent stages;
b. The risk-based calibration of contributions to EDIS.

Let me start with the **architecture**. The architecture of EDIS is linked to the overall architecture of banking union.

Given the complexity of the banking union project and the number of measures to be completed, the use of a sequencing approach in connection with the phasing-in of

EDIS can help disentangle interwoven links, define a credible path and avoid missteps.

The insurance scheme can actually provide a framework for finding a reasonable sequence of measures to strengthen and complete the banking union, step-by-step, starting from the smallest common denominator.

We could, in fact, give priority to the elements that have a direct impact on the risk of EDIS pay-outs; while carefully considering linkages and spill-overs and preparing, at each stage, the necessary conditions that can make the next step acceptable.

This would go hand-in-hand with a gradual increase in the mutualisation of losses within the insurance scheme, while continuing the implementation of risk reduction measures and further harmonisation and strengthening of supervisory practices and regulations.

Among all necessary measures, the development of the resolution and liquidation framework ranks first. Harmonisation of bank insolvency regimes, full harmonisation of creditor hierarchy, but also transparent and clear rules on precautionary recapitalisation and state aids are essential elements to improve the credibility of the system. This would help all parties involved to take the first little step forward.

Despite being complex, the alignment of insolvency regimes could improve comparability of expected recovery rates on an estate liquidation under national procedures and, all other things being equal, ensure even access to the European scheme.

In phasing in the new insurance framework, another important structural component is the use for alternative interventions (e.g. for the transfer of assets and liabilities or deposit books and for alternative measures to prevent the failure of a credit institution as per article 11 of the Directive on deposit guarantee schemes), namely those tools envisaged under the national schemes to preserve the sound part of a business and depositors’ access to their savings..

The experience of the U.S. Federal Deposit Insurance demonstrates that these forms of interventions are the most effective in preserving the value of the business and minimising the cost for creditors and taxpayers.

If these measures are not administered under the same regime, national deposit insurance schemes will have to maintain their own reserves for these interventions, in addition to EDIS and the Single Resolution Fund (SRF). And the sovereign-bank nexus, which a pan-European insurance should help to loose, would re-emerge.

Of course, risk reduction should continue while moving towards the subsequent stages of EDIS with an increasing level of loss mutualisation. This bring us to the discussion about the risk of moral hazard.

To overcome objections related to the potential increase in moral hazard, we need a robust **risk-based calibration of contributions**. Making sure that banks are fairly charged for the risk they pose to the system, can be a complex exercise. To build consensus, the system should be consistent, transparent and forward-looking.

Consistency with the resolution framework, prudential requirements and supervisory judgement is key to avoid double counting but also flaws or gaps in approach; for instance, in the treatment of large groups where contributions should reflect the higher risk they pose to the system via interconnectedness, while factoring the more likely recourse to resolution and limited reliance on EDIS.

Agreement on the methodology would benefit from a clear design in subsequent steps, laid down from the beginning of the initial stage and clearly linked to the increase in loss sharing in each phase. Transparency will help to set clear expectations on the conditions to move to the subsequent steps and give time to the industry to adapt.

To set the right incentives, calibration could also be linked to the supervisory assessment on an institution risk appetite and to individual risk reduction objectives. This would be in line with the bank-specific supervisory judgement, including, for instance, the non-performing loan reduction targets.

This way the system could internalise the risk specificities of each bank, embedding the forward-looking and qualitative component of the supervisory judgement, and also catering for new, emerging risks. It would even become a vehicle to enhance risk discipline.

If well designed, the methodology would be able to capture institution specific risks, also due to an overexposure to the domestic sovereign, without introducing exogenous correction factors.

Put simply, the three pillars of banking union should evolve together and strengthen each other to foster confidence and promote stability. Opposing views can be overcome if we are ambitious enough in pursuing our long-term objective: a fully integrated market for banking services where resources can be freely and efficiently allocated.

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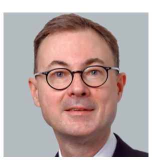


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