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Danish answers to the Commissions consultative working paper on deposit guarantee schemes

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Recent developments within the EU banking sector have brought to light a number of policy issues relating to the directive (94/19 EC) on deposit guarantee schemes and the functioning of the internal market. In order to achieve the original objectives of the directive member states face the challenge of developing a regulation that is compatible with these developments.

The main objective of a deposit guarantee is to provide protection for consumers of banking services. As the deposit guarantee reduces the risk of extensive withdrawals from banks in case of financial disturbances it also contributes to the institutional framework of preventing financial instability. The motive for establishing common minimum provisions on deposit guarantee at the EU-level is to contribute to the establishing of a level playing field for banking services within the common market.

As the current developments of the common market significantly alters the conditions for the existing deposit guarantee regime it becomes an important task for the EU to keep the deposit guarantee regulation up to date and to find an appropriate level of harmonisation that strikes a balance between consumer protection and financial stability on the one hand and the level playing field on the other.

The key aim of the process of reviewing the directive can be summarized as follows:

- To reduce competitive adversities induced by differences in national deposit guarantee arrangements, and to avoid that the regulation becomes incentives/obstacles for mobility within the common market or an obstacle for company restructuring (e.g. European Statute).
- To maintain a satisfactory consumer protection and to the extent possible, reduce the risks of financial instability.
- legislative measures following this review, must only be pursued where benefits are proven to exceed the costs incurred.

In the following the Danish views on the issues addressed in the Commissions consultative working paper on deposit guarantee schemes are presented.

1. Have the Directive's original objectives been achieved? If not, could you give your opinion as to why this is so?

It can be established that member states have implemented the provisions of the deposit guarantee directive in very different manners. For that reason banks and consumers face different conditions throughout the EU. Up till recent date very few banks have been conducting retail financial services on a pan-European basis. Therefore, such differences have had very little impact on the functioning of the internal market. However, applying a forward-looking perspective on the implications of increased cross-border activities in the banking sector it is likely to assume that the directive may fall short of achieving a "level playing field". To some extent this has already become evident by the European company statute, as banks are seeking to conduct their business in branches instead of subsidiaries. In such case the heterogeneity of the national guarantee schemes becomes an important factor of competition between banks subject to different schemes. In the most extreme cases such differences can even be an obstacle – or an incentive – to mobility within the EU.

As cross-border activities conducted through a branching structure are facilitated by EU-regulation we also may see large movements of deposits between guarantee schemes and, as a consequence, a potential concentration of risks to individual schemes.

In order to minimize the risk exposure to taxpayers and avoid subsidies to the banking sector deposit guarantee financing has to rely on financially sound principles. In this aspect it seems that the present EU-regulation is not working satisfactory.

2. Do the differences in existing rules create barriers or competitive distortions for cross-border/pan EU business? If so, do you have practical experience of any difficulties encountered?

The efforts of the pan-Nordic bank Nordea to transform to a European Company have shown on several problematic issues that have to do with the functioning of the national deposit guarantee schemes concerned and the deposit guarantee directive. This case is however well known to the Commission and need not to be explained further in this paper.

3. Do the differences in existing rules have implications for other stakeholders (e.g. depositors)

Given that the topping up option is not exercised depositors in banks subject to different schemes will face different conditions since coverage level, definition of deposits, etc. vary significantly between member states. When it comes to disparities in guarantee premiums paid by participating banks this will also have implications for the consumer as the cost of the guarantee most likely affects the interest paid on deposits.

As differences in regulation potentially may have implications for the banks choice of location a concentration of risk may occur to certain schemes.

4. Do the differences in existing rules have implications in terms of cross-border supervision, in particular would the present deposit guarantee arrangements allow for the effective handling of bank failures which involved a cross-border dimension?

The close linkage between deposit guarantee and banking supervision should be maintained, so that the home Member State continues to be responsible not only for the supervision, but also for the deposit guarantee. If this were not the case, this would influence the decisions of the home Member State in a major crisis.

At the same time it is essential to realize that, in an increasingly consolidated market, there can be considerable limitations to the home country principle for supervision. For example, applying the home country principle is in practice not self-evident, when it comes to systematically important branches. In this situation the interest of the host authorities remains strong, even if the responsibility and the decision-making power concerning the credit institution exclusively belong to the home authorities. The new home Member State might have little chance of saving the bank even by the extreme measure of using public funds - and perhaps it would also lack major political incentives to do so, either, if the bankruptcy had only a limited impact on its own market given the purely nominal presence of the bank. On the other hand, letting the bank to go under would still put the national deposit guarantee scheme under severe pressure, because it would have to cover the claims made in the host Member States. This was not a part of the discussions when the present rules were adopted. We therefore find it worth considering whether the directive should be updated in this area.

5. In your opinion, is there a need to further converge deposit guarantee schemes within the EEA? If yes, in which particular areas?

- As cross-boarder integration of the banking sector is likely to progress, it becomes increasingly important to consider the interplay between the deposit guarantee regulation and the functioning of the internal market. Based on what is said above (in question 1-3) there are several issues that show that the current regime can be questioned and thus there is a strong case for considering further convergence of the deposit guarantee schemes within the EEA. The overriding objective for such a work is to find a level of convergence that strikes a balance between consumer protection, financial stability and the aim to establish a level playing field. As the existing EU-regulation mainly focuses on the scope of the consumer protection and not on the financing arrangements the most urgent need for harmonization action lies within the design of the financing principles. However legislative measures should as mentioned earlier only be pursued where benefits are proven to exceed the costs incurred.

6. Are the definition of "deposits" in Article 1 and the exclusions in Article 2 and Annex I still valid for the purposes of the directive?

7. Is there a need to further harmonise which deposits are covered under the schemes?

The answer below covers question 6 and 7.

In our opinion, the primary objective in this review process is to find common ground for a further harmonisation of the financing principles. With such principles established the need for harmonisation of the scope and level of the guarantee diminishes. The choice of defining the consumer protection could under such circumstances be left to the discretion of the Member States.

8. Would a capped voluntary de minimis clause (of e.g. €20) be justifiable on the basis that it would improve the efficiency of the scheme?

For the reason of providing a good consumer protection the rationale for a de minimis clause can be questioned. However, for practical reasons it might be unreasonable to pay out very small amounts of deposits. Therefore, a de minimis clause could be considered. It is however important that the limit for such a clause is not set too high and is

voluntary. Such a rule will also make it more difficult to harmonize the rules

9. Does the existence of co-insurance in some Member States but not in others have implications from a cross-border perspective?

See question 4.

10. If so, would it make sense to limit the use of the co-insurance provision to above the €20,000 threshold?

Certainly, as the de facto coverage level otherwise would be € 18,000.

11. Would there be arguments to either abolish the co-insurance mechanism altogether or alternatively to introduce harmonised co-insurance rules in all Member States?

The primary purpose of the deposit guarantee directive is to provide consumer protection. By definition, a coinsurance mechanism makes that protection less extensive. The rationale behind a coinsurance is to reduce moral hazard problems by making consumers careful in their choice of bank. Even though depositors, by the coinsurance mechanism, are given an incentive to evaluate the financial strength of banks it might be difficult for the individual consumer to make such an evaluation. Therefore, it can be questioned if a coinsurance mechanism has the desired effect of preventing moral hazard problems. Incentives to avoid such problems should rather be imposed on the banks by setting fees based on the risks that the individual bank imposes on the deposit guarantee scheme.

Furthermore, since a coinsurance mechanism in fact implies a loss to the consumer it is likely that consumers will withdraw their funds as soon as there are signs of a potential crisis. The contribution of the deposit guarantee scheme to prevent bank runs and thus helping to promote financial stability is therefore seriously reduced. This has been one of the critical arguments not to introduce a coinsurance mechanism into the Danish deposit guarantee scheme. In our opinion it could be considered to abolish the coinsurance mechanism.

12. Given the existing host country topping up rules, is there any need to update current arrangements which stem from topping up (i.e. exchange of information, need for conclusion of binding agreements on cross-border restitution, etc.)?

As put out in the answer to question 4 the differences between guarantee schemes may lead to practical difficulties when managing cross-border restitution where depositors are eligible for compensation from two different schemes. Thus, it is important to carefully explore the need for an update of the current arrangement. However, at this stage we do not have any concrete policy recommendations to provide to the Commission.

13. In the interests of coherence with the overall supervisory regime, could "topping-up" arrangements be successfully managed by the home country scheme?

In principle, a home country management of topping up has several attractive features. For example, as home country management of topping up gives full responsibility to the home country full consistency between supervision and deposit guarantee is achieved. Home country topping-up would also entail a simplification for both institutes and depositors as they are treated within the same scheme paying premiums or applying for compensation. However, an introduction of home country topping up would under present circumstances amplify the competitive imbalances for banks subject to schemes with different financing arrangements. From our horizon the elimination of such competitive imbalances is one of the most important objectives for reviewing the directive, and therefore, we cannot support a home country topping up mechanism unless we see a far-reaching harmonisation of financing principles.

14. If so, what specific arrangements might need to be introduced (e.g. exchange of information, need for conclusion of binding agreements on cross-border restitution, etc.)?

As home country topping up implies that the full responsibility is within the home country the need for specific arrangements would probably be different compared to the arrangements needed under the present host country principle. As far as we can see such arrangements would be limited to the exchange of information.

15. Are "topping-up" arrangements still relevant, or would there be any merit in abolishing them altogether? If so, would their abolition be feasible only in the case of a fully harmonised coverage level?

As cross-boarder consolidation is likely to increase the competitiveness rationale behind topping up arrangements is still valid. The topping up option is to be seen as a consequence of minimum harmonisation. If

further harmonisation is taking place the rationale for topping up is reduced.

However, under the circumstance that the present situation with highly differentiated definitions of deposits and coverage levels remains the topping up option must not be abolished.

16. Do you agree with the principle set out in paragraph 4 of Article 4 of Directive 94/19/EC whereby deposits with a branch which has not complied with the obligations incumbent on it as a member of a deposit guarantee scheme and which has therefore been excluded from voluntary membership in a host deposit guarantee scheme should be protected until the day on which they fall due? If not, would you prefer to abolish this principle and/or replace it by another measure (for example, a duty of the branch to allow all depositors to withdraw their deposits without any sanction)?

The present rule seems adequate. The consumers should not be penalized by the fact that their bank is not complying with the obligations set out by the host scheme.

17. What are/could be the consequences of having differences between funding systems?'

As we have pointed out in the answers to question 1 the diversity of the deposit guarantee schemes within the EU causes several adverse implications. In particular, this applies to the different arrangements on financing. First of all, such differences may lead to competitive imbalances between banks belonging to different schemes. Second of all, differences may affect the mobility of banks (either as an incentive or as a barrier to restructuring). This may lead to a concentration of risk to certain schemes, which in turn, if having insufficient financing capability, may impose a large burden on taxpayers of the country at hand, when dealing with a restitution case.

18. Is there a case for harmonising the way in which schemes are funded?

Probably(based on the issues explained in the answers to question 1 and 17).

19. If so, what would be the optimal funding system in order to achieve an appropriate balance between the cost of the system and establishing the necessary level of financial stability and confidence?

- Deposit guarantee schemes could theoretically be priced so that the premiums correspond to the expected losses within the scheme. Thus, premiums collected and cost of restitutions will be balanced over time.
- Risk-based premiums should be an integrated part of the funding arrangements so that moral hazard problems can be avoided and that "unfair" pricing does not influence the competitive conditions between banks within the same scheme.
- Premiums should In principle be collected ex-ante, preventing moral hazard problems and that the schemes by themselves aggravate financial instability.

By establishing such principles on a community level competitive adversities between banks are eliminated. At the same time the ability of schemes to manage their commitments are improved and, in addition, banks are given the correct incentives to manage their risks. Altogether, introducing sound financing principles would certainly help to achieve a better regulation both with respect to financial stability and the level playing field. Furthermore, a development in this direction would be consistent to the current developments of seeking to stimulate institutes to improve risk management by giving legal incentives (e.g. CAD III).

20. Should use made of funds held in ex ante schemes be harmonised?

In some EU Member States deposit guarantees may not only be used for the restitution of deposits, but also for restructuring purposes. Denmark supports this possibility subject to strict conditions and especially to the condition that it is identified to be the less costly solution. The use of deposit guarantees would in this situation be similar to granting state subsidies and it is sometimes argued that it would have to be approved by the Commission. This is to all experience a lengthy procedure, whereas bank crises must be resolved in a very short timeframe. It should be ensured that restructuring is possible under these conditions.

21. Would it be worth considering the creation of a European deposit insurance scheme, in particular for "systemically significant" banks?

The idea of a common European deposit guarantee might have attractive features. For example, the issue of entry/exit of schemes is eliminated. Furthermore, a common European scheme would probably also contribute to an enhanced risk management as the financial commitments of the individual schemes are pooled into one. However, we also recognize several complicated issues that need to be debated before going further in the discussion of a single deposit guarantee scheme, such

as for example the implications for crisis-management procedures and supervision.

22. Alternatively, would it be worth considering a region specific deposit insurance scheme for "systemically significant" banks, taking account of the considerably higher level of banking market integration and concentrations in certain EU regions?

A region specific deposit guarantee scheme would have the same benefits as a common European scheme, but only within that region. The issues of different regulation would remain between the stakeholders within the regional scheme and stakeholders subject to other European scheme.

We believe that Member States should not be prohibited to establish regional schemes. However, the possible emergence of regional schemes does not reduce the need of further harmonisation of the directive and is therefore not to be seen as a substitute for a harmonisation process.

23. Does the potential for increased cross-border consolidation in the European banking market necessitate harmonisation of provisions on entry/exit of schemes and transferability of funds? If so, what implications might this have for the design of the rest of the Directive?

See answer to question 24

24. Should provision be made in directive 94/19 for the partial transferability of contributions between like (i.e. ex-ante funded) schemes? If so, to what extent should transferability of funds be restricted?

Under the financing arrangements (question 19) entry and exit of schemes would be greatly facilitated and no transferability mechanism would be necessary. Nevertheless, if a transferability mechanism is to be considered one has to be aware of the adverse consequences that will occur under the present situation with highly differentiated financing mechanisms in the European schemes. For a transferability mechanism to work satisfactory a complete harmonisation of financing arrangements is required.

25. Do you agree that deposit guarantee schemes should be financed according to risk-based principles?

See question 19.

26. If so, what should those principles be, should they be harmonised and how could this be achieved?

Credit risk modelling or similar methods could be used for such calculation. Alternatively, the new capital adequacy framework might serve as guidance on how to set risk-based fees.

27. Does the current mix of home/host responsibilities as regards deposit guarantee schemes pose any problems from a business or regulatory perspective?

Due to the topping up option the responsibility of deposit guarantee is split between home and host member states. However, the supervision is concentrated to the home state. This split of responsibility implies a problem to the host state since it partly bears the responsibility of compensating depositors in a bank that they have no supervisory authority over.

From a supervisory perspective the management of a failure or insolvency situation in a bank depends on the size and importance of operations in that bank, and what costs, explicit and implicit, a failure would result in to the country. Since member states may have different incentives to act on a potential crisis, depending on the nature of the bank in the countries concerned, conflicts of interests may occur in the situation of failure. To illustrate, one can consider a branch of a bank that has limited operations in the home state but is systemically important in the host state. The home states only concern in an insolvency situation in the bank would be the bill for compensating depositors. For the host state however, it possibly would be appropriate to take other measures to handle the situation rather than to let the bank fail. In this case it is however the home state that has the ultimate powers on deciding on the measures taken.

28. Given the link with crisis management procedures and day-to-day supervision of branch operations by the home Member State authorities, should all responsibility for deposit guarantees be concentrated on the home country scheme? If so, what would be the consequences?

The question proposes a full home country responsibility for the deposit guarantee. In relation to current arrangements that implies a transition of the topping up responsibility to the home. This question has already been treated in question 13.

29. Alternatively, are there reasons that could justify a change from home to host country management of deposit guarantee schemes?

Within EC legislation regarding supervision, crisis management and winding-up of financial institutions, home-country responsibility has developed as the guiding principle. This is essentially also an outflow of the single authorization for banks in the Member States. It seems natural that the country that supervises the solvency of a bank and handles crisis management and winding-up also is responsible for the deposit guarantee. The country providing the guarantee thus pays the price for inadequate supervision. A split between the two might cause serious conflicts of interests between Member States when handling a common crisis.

30. Besides a change to a host country responsibility, do you see any alternative arrangements that might ensure the efficient management of deposit guarantee for cross-border operations (such as for example voluntary arrangements including responsibility for both home and host countries)?

See question 19.

31. Could exchange of information arrangements between deposit guarantee schemes themselves, between home and host supervisory authorities, and between the schemes and supervisors in other Member States be improved? If so, how?

See question 12 and 14.

32. Does the relationship between the State, the National Central Bank and the Deposit Guarantee Schemes have any cross-border implications, for depositors, for credit institutions and or from a supervisory perspective?

If subsidized by government funds the deposit guarantee would most certainly have cross-boarder implications.

Yours sincerely

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