German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Position Paper

How the Banking Union can be strengthened in the short term

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Contact:
Christian Müller
Telephone: +49 30 20225-5237
Fax: +49 30 20225-5325
Email: Christian.Mueller@dsgv.de

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Coordinator:
German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Fax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

For some time now, various bodies at the European level have been addressing the question of how the Banking Union can be strengthened. This strengthening was also an important concern of the German Council Presidency. Its progress report explicitly stresses that this should be done using a 'holistic' approach. Especially in light of the impact of COVID-19 on the European Union as an economic area, the Banking Union is considered to be relevant. The debate centres around the desired overall architecture of the Banking Union. It should be noted that the subject matter is highly complex and there are sharp differences in the ways the Member States see things.

Basically, two broad directions can be distinguished in the political discussion about how the Banking Union could be enhanced or strengthened: first by expanding the resolution regime – together with the much-debated communitisation of deposit insurance schemes – combined with further centralisation, or second, by means of systematic subsidiarity in terms of resolution and the preservation of decentralisation.

Those favouring centralisation focus on the creation of a central authority with a wide range of responsibilities in the field of bank resolution and deposit insurance, regardless of whether the institutions are significant or less significant. The US Federal Deposit Insurance Corporation (FDIC) is usually referred to as a role model that many people would like to adopt in EU, and there is often talk of the 'EU FDIC' in this context.

By contrast, the difference between systemically important and other banks continues to be anchored in the decentralised model. Any resolution of smaller and medium-sized banks by a central European authority would be ruled out.

There are many discussions at a political level on this topic, as well as in the economic literature, some of them making concrete proposals, although - in some cases - these lack any practical relevance. In addition, there seem to be often very rash pleas in favour of centralisation, although it is not economically necessary and the EU does not have the necessary legal foundation to impose it. In our view, the reasons supporting centralisation do not stand up in light of the following discussion of the arguments for and against the relevant approaches.

I. Extension of the resolution regime to all banks and further centralisation of resolution at a European authority

For some time now, discussions have been taking place both at European (e.g. SRB, EP[1], HLWG, AHWP, EGBPI) and international level (e.g. IMF, BSI FSI /Basel[2/3]) about an 'EU FDIC' as part of the plan to complete the Banking Union, or the establishment of a communitised European deposit insurance scheme. At the heart of this debate is the concentration of effective decision-making powers and financial resources from the three blocks of bank resolution, bank insolvency and deposit insurance at a single authority managing a uniform European insolvency and resolution regime, namely for all institutions, not just for important ones.

Various arguments are put forward in favour of the EU FDIC model that need to be considered in more detail:

Argument 1: Centralisation leads to increased financial market integration and greater systemic efficiency.

- **A rational division of powers needs to be taken into account.** In light of the agreed division of responsibilities within the SSM that is only possible on the basis of the Treaty on the Functioning of the European Union (TFEU), any complete allocation of responsibilities for deposit insurance, resolution and insolvency to the SRB for both significant and less significant institutions appears to be neither economically appropriate nor possible under constitutional law.[4] It would be contradictory to establish a division of responsibilities between the ECB and the national authorities (NCAs) within the framework of institutional supervision and to create exclusive responsibility at the SRB for the aforementioned topics of deposit insurance, resolution and insolvency. Additionally, those who call for a centralised EU FDIC ignore the fact that there are numerous authorities and institutions other than the FDIC in the USA that have an official, mandatory role in bank supervision, resolution and depositor protection.

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[1] Economic Governance Support Unit of the European Parliament, In-Depth-Analysis, 'Liquidation of Banks: Towards an "FDIC" for the Banking Union?', published February 2019, authors: J. Deslandes, C. Dias and M. Magnus.

[2] BIS FSI, 'How to improve crisis management in the banking union: a European FDIC?', Lisbon/PT, 4 July 2019, author: Fernando Restoy, FSI Chairman; Financial Stability Institute/FSI Insights on policy implementation no.17, 'Bank failure management – the role of deposit insurance', published August 2019, authors: Patrizia Baudino, Ryan Defina, José María Fernández Real, Kumudini Hajra and Ruth Walters.

[3] BIS FSI, 'Bank failure management in the European banking union: What's wrong and how to fix it', published online in July 2020, authors: Fernando Restoy, Rastko Vrbaski and Ruth Walters.

[4] The decision by the Federal Constitutional Court of 30 July 2019 (2 BvR 1685/14 and 2 BvR 2613/14) should be noted in this context. According to this decision, the current legal framework expects there to be a clear and comprehensive component of national responsibility in the areas of banking supervision, bank resolution and deposit insurance. It is predictable in this respect that any further restrictions on BaFin's responsibilities as the national resolution authority in favour of the SRB, or even a centralised European deposit guarantee scheme, would not comply with the requirements of the German constitution (Basic Law).

- **The efficiency of the US FDIC is largely attributable to the uniform legal framework within which it operates.** A '1:1' transfer of the US FDIC model would not take the structure of the European Union into consideration. In contrast to the US model, the Banking Union does not have a uniform legal framework because there is no federal state. Where the resolution of important or cross-border banks is concerned, it may make sense to leave resolution to a central authority. However, in cases where the resolution of medium-sized and smaller banks is involved, only the law of the Member State in which the bank has its registered office will normally apply. Resolution by the SRB would not bring any advantages here. On the contrary: a national competent authority would be in a much better position to carry out a resolution because of its knowledge of the market.

  If there are plans to extend the target group to all institutions, regardless of whether they are significant or not, it should also be considered that not all financial institutions are centrally supervised by the US FDIC. The same applies to resolution and depositor compensation. For example, smaller credit unions are treated differently than major bank holding companies. A one size fits all approach, therefore, does not exist in the US, and it is, hence, neither appropriate nor compelling in Europe.

Argument 2: Concentrating resolution and deposit insurance at a central authority increases the predictability of decisions and the authority's operational credibility.

It should be borne in mind that the Single Resolution Board (SRB) is mostly brought into action as the central authority. This seems logical in light of the fact that the SRB is already the central resolution authority for significant banks. However, there are significant concerns, with regards to transfer of tasks and functions to the SRB.

- **Before extending the SRB's mandate, it must first be ensured that it can sufficiently fulfil its existing mandate.** Unlike national deposit guarantee schemes, which have proven their value for decades, the SRB has not yet been able to demonstrate its effectiveness, in particular in real-world stress situations. Especially in light of the current economic situation, we must be sure there is no doubt that the SRB is not already operating at full capacity or even overburdened with its current mandate under the SRM Regulation. The reason for this is that resolving significant institutions represents a considerable challenge in practice. We need to avoid a situation in which the SRB is overstrained in the event of a major crisis. This is not merely a question of resources, but also – crucially – of practical experience in deposit insurance, including alternative measures, and in the deployment of resolution tools. In particular, transferring additional deposit insurance functions could cause an overstress of the SRB. Consequently, this could weaken the financial stability.

- **The legal legitimacy and social acceptance of a European authority may not be stretched too far.** Legitimacy must be strong especially when it comes to interfering with the rights of companies and individuals. Any bail-in of creditor claims in a Member State at a purely national bank or a bank that only operates locally without any systemic importance should not be imposed by a central authority on EU level. If involving creditors is in itself a challenge, such an allocation of responsibilities would run counter to the principle of subsidiarity and could significantly increase Euroscepticism.

Argument 3: Where resolution measures are concerned, centralisation enables EU-wide bidding processes so that assets of a failing bank can be transferred across borders in the event of its resolution.

This argument assumes that a central agency would be better placed to dispose of a company's assets. In this case, too, however, it must be considered that this type of transaction has already been executed smoothly in many cases in practice by many deposit guarantee schemes. In particular, in the case of smaller and medium-sized banks, it is reasonable to presume that, if there is a lack of interest by foreign institutions, assets will generally be transferred to banks from the Member State in which the failing bank has its registered office. The uniform legal framework in place in the US, in contrast to the EU, coupled with the special status of the FDIC, enable it to keep advance lists of interested parties to which assets or even an entire bank can be transferred in the event of the imminent insolvency of a bank. The transfer itself is handled by the FDIC, which basically does not need the cooperation of the parties involved, due to its extensive rights to push through its decisions. The FDIC model is also not transferable to the EU in this respect.

Finally, it must be considered that, despite its almost unlimited powers, even the FDIC was **unable to prevent** the developments in the US that led to the emergence and outbreak of the global **financial market crisis in 2008/2009**. This fact alone makes it obvious that this institutional approach would not be a magic bullet.

II. Advantages of a decentralised structure

The advantages of a decentralised system with national 'firewalls' are that such a system has the effect of promoting stability, it reduces the risk of contagion effects and it can therefore act more credibly – not least in the way it is perceived by the customers of the relevant banks.

Continuing to strengthen existing national deposit guarantee and institutional protection schemes (e.g. as regards preventive and alternative measures) in the near-term, is therefore more important than any reflections on an EU FDIC, whose implementation is uncertain. The premature creation of an immature EU FDIC could significantly impair well-functioning responsibilities and procedures in deposit guarantee and institutional protection schemes. A correspondingly connected weakening of national schemes would have a counter-productive impact in the event of a crisis. This is all the more true in these times of the coronavirus pandemic. Preventive intervention rights of an EU FDIC in advance of a (probable) default would also have to be rejected in this respect.

A number of concerns have been expressed about preserving decentralised structures, in particular that the current system is not fully operational. This is primarily due to the following obstacles:

- the conceptual difference between resolution and insolvency
- different national insolvency laws
- financial limits on contributions by deposit guarantee schemes to resolution actions

However, the arguments mentioned only appear to be convincing at first glance, if at all. On closer examination, many of the arguments prove to lack any substance:

<u>1) The conceptual difference between liquidation and insolvency</u>

- In the current discussion, it is argued that the boundaries between "resolution and insolvency" and "deposit protection" cause dysfunctionalities. It is argued that these dysfunctionalities are based on the fact that, due to different national insolvency laws, the ***No Creditor Worse Off principle*** (NCWO principle) to be observed by the SRB is applied differently in each case. Furthermore, the triggers for insolvency are different in the Member States and, in particular, court-based insolvency proceedings, which are not specifically tailored for banks are inefficient and too lengthy. This is particularly problematic in the case of cross-border transactions

  However, this criticism ignores the fact that the political debates are aimed precisely at centralising responsibilities for less significant institutions that generally operate only nationally or even regionally. For these local banks, only one (sole) insolvency law would already have to be observed today when the SRB complies with the NCWO principle. Moreover, these banks would not be resolved at all, which is why the NCWO principle plays no role for these banks. In light of the criticism of national, in particular court-based, insolvency proceedings, this is not understandable in regard to German insolvency law at least. It should also be noted that there is no uniform insolvency law for banks even in the USA, so the question arises why there should be one in Europe.

- Moreover, under the current EU resolution regime, banks are only resolved if resolution is in the public interest (the 'public interest' test). If there is no public interest, which will typically be the case for smaller and medium-sized banks, national insolvency law applies. If a bank becomes insolvent, the statutory deposit protection scheme intervenes and depositors receive a compensation payment in the amount of their covered deposits within seven working days. Any extension of the public interest test that is currently being discussed at the European level, for example by making the local importance of a bank a sufficient reason for resolving as many banks as possible, must be rejected. This is in particular true, because the intention behind the public interest test is to ensure that the SRB will only intervene if this is justified after considering the aspects of subsidiarity and proportionality, and if there is a market-wide risk of system destabilisation.

- It should also be noted that merging deposit insurance and resolution funds might create additional risks. In a crisis, excessive recourse to the resources of a single fund could lead to the erosion of depositor confidence. This applies in particular to cases in which funds are used for resolving large institutions, considering that the SRB has repeatedly stressed that the resources of the resolution fund, including the ESM common backstop, might not be sufficient to eliminate liquidity problems in the case of failure of larger institutions.[5]

  It needs to be emphasised that, even without an EU FDIC, Europe has financial clout and operational scope for action that are at least on a level with the US. Calculatively adding together the resources already available or in the process of being developed in the SRF and in the national guarantee schemes in Europe, Europe will have at its disposal a triple-digit billion amount for bank resolution on the one hand and for DGSD-compatible measures on the other (especially for depositor compensation and to implement preventive/alternative measures) at the latest by the target date of mid-2024. This is nearly 2.0% of the covered deposits (minimum 1% for the SRF target volume and 0.8% for the target volume of the deposit insurance funds), which is more than the FDIC's current funding level (minimum target funding of 1.35%, actual funding as at 2019: 1.41%). This shows that sufficient resources are available and that it is up to the authorities concerned, first and foremost the SRB, to use the tools and resources.

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[5] see e.g. https://srb.europa.eu/en/node/621.

2) Different national insolvency laws

- Different national insolvency laws only apply to banks with cross-border operations. However, as already explained, smaller and medium-sized banks in particular normally do not have cross-border operations, with the result that differences in national insolvency laws are of downstream relevance. To the extent that national insolvency regimes allow government support payments, it is still up to the European Commission whether or not to approve them. Therefore, even if there are differences between the national insolvency regimes, state aid does not result in any distortion of competition, or it is subject to the discretionary approval of the European Commission.

- Different national legal systems play an important role in particular with regard to the insolvency quota. In this regard, there are still significant differences, for example relating to the hierarchy of creditors and consumer protection. If deposit guarantee schemes make compensation payments to depositors, their claims pass to the deposit guarantee scheme. For deposit guarantee schemes, it is therefore crucial to know when and in what amount they can expect to receive recoveries from insolvency proceedings. The insolvency quota may be lower in Member States with a particularly high level of consumer protection.

- The claim that insolvency law is generally unsuitable to liquidate banks is unfounded. Recent compensation cases in the EU show that the insolvency of a bank can certainly be a valid means of ensuring a market shake-out. If there are deficiencies in national insolvency laws that run counter to efficient and rapid proceedings, these should be eliminated by means of targeted modifications.

- The belief that insolvencies destroy corporate assets is also incorrect. It has often been demonstrated that a company’s assets can certainly be recovered at a profit.

- The further harmonisation of insolvency law must therefore focus on the objective of keeping the liquidity requirements of deposit guarantee schemes as low as possible. Any liquidity requirements must be covered by the banks allocated to the guarantee scheme. This applies irrespective of whether the deposit insurance scheme is organised at a national or European level. In all cases, high additional coverage requirements of deposit guarantee schemes will lead to increased contribution payments by the member banks. At the same time, however, the high standards of the proven and well-functioning German insolvency law may not be lowered in favour of progressive harmonisation.

3) Financial limits on deposit guarantee schemes`contributions to resolution actions

- The criticism revolves around the fact that the amount of any contributions by deposit guarantee schemes to resolution actions carried out by the SRB is limited to the hypothetical loss that the deposit guarantee scheme would have incurred at the end of insolvency proceedings. Due to the priority afforded to the claims of the deposit guarantee scheme, it could be assumed that the hypothetical loss would be small. The fact that deposit guarantee schemes are only at the bottom of the bail-in cascade should not be ignored. Claims against them – in place of the depositors – therefore, are in any case highly unlikely.

- The current discussion of abolishing the priority of deposit guarantee schemes in insolvency proceedings, which was only recently introduced by the BRRD, in order to achieve an additional payment by the deposit guarantee scheme, is based on a wrong approach. One the one hand, this approach would increase the amount of potential losses of deposit guarantee schemes and counteract the special protection of depositors. On the other, deposit guarantee schemes are in any event only at the bottom of the bail-in cascade.

- The effect of abolishing creditor priority for deposit guarantee schemes would be to ensure that bank resolution would become the norm when examining whether an alternative measure to the insolvency of a credit institution should be given preference (a reversal of the sentence coined by Dr König:"resolution for the many, not the few"). The least cost principle was introduced precisely to protect the funds of the deposit guarantee schemes. Artificially weakening the least cost principle and hence deposit insurance would therefore mean putting the cart before the horse and weakening consumer confidence in deposit insurance schemes.

III. Lender of last resort

A **lender of last resort** is a relevant aspect in guarantee schemes, not only for bank resolution, but also for the debate about a European deposit guarantee mechanism. The issue of a resilient backstop that is capable of acting, is key to ensuring the credibility of the ability to act. It is essential, in this context, to avoid the lender of last resort function being attributed to monetary (rather than fiscal) policy, which could run counter to the primary monetary policy objective of ensuring price stability. However, this risk exists directly in the case of guarantee mechanisms at the European level, since a fiscal lender of last resort function can only be exercised by the ESM – and in that case according to its rulebook.

The question of the lender of last resort illustrates why there is no advantage in communitising financial means. A communitised deposit guarantee scheme would be forced to rely on the financial means of the national deposit guarantee schemes. The idea in play here is that a European central deposit insurance fund could provide financial support when a national deposit guarantee scheme reaches its financial limits. This may hold true in cases where only a single bank is in difficulty or where only one Member State is affected. However, the impact of the coronavirus pandemic is currently demonstrating the consequences that a widespread crisis can have. No European deposit guarantee scheme can be developed if the banks in the euro area are already exposed to significant financial stress or are subjected to a symmetric shock.

There is also a significant risk of contagion and moral hazard. If the financial means of a communitised deposit insurance fund (DIF) are not sufficient to provide the necessary financial means to all deposit guarantee funds, only those national schemes that first call on the DIF for assistance would benefit, while the other schemes would have to top up the DIF up to their own maximum limit. This means that deposit guarantee schemes whose own financial means are actually adequate would ultimately be severely disadvantaged and weakened by a DIF.

Advocates of an EDIS often argue that a widespread financial crisis will not happen because of the SSM and the SRM. However, this assumption ignores the fact that the causes of financial crises are not the same every time. Nothing illustrates this more clearly than the current economic situation.

IV. Conclusion: Drive forward the strengthening of the existing Banking Union

A coordinated European economic policy is important in light of the strained economic situation in the EU. However, this does not require any complete overhaul of the crisis management arrangements or a fundamental restructuring of the Banking Union. It would be more sensible, but also necessary, to continue implementing the Deposit Guarantee Schemes Directive fully, as this already provides for a comprehensive, albeit often unused, set of tools. These include the use of preventive and alternative measures by the deposit guarantee schemes.

The focus should therefore not be on expanding an untested centralised scheme, but rather on strengthening the existing, proven structures.

To conclude, an EU FDIC does not appear to be necessary from an economic, legal or consumer protection perspective. Instead, the tried and tested and extremely logical legal separation between resolution for the important institutions (with the BRRD and the SRF) and deposit protection for the depositors (with the DGSD and its financial means) should be retained. Consumers have become very confident in their national deposit guarantee schemes, based on a harmonised EU framework.

An EU FDIC also lacks political agreement on a European federal state, which is also the basis for the activities of the FDIC in the USA. For this reason, there is no legitimate and credible lender of last resort function, which is a basic condition for such an authority to function.

Finally, the contributions to the discussion on the EU FDIC are not convincing, because it remains unclear how the fully functional and established deposit guarantee and institutional protection systems, which have been operating successfully for many years in the EU Member States on the basis of the principle of subsidiarity, are to be dissolved and centralized in a way that is credible and accepted by depositors and consumers without losing their stability-promoting effect. The sum of all parts is therefore greater than the centralized whole.

Appendix: Core elements of the US FDIC

Before one can assess any European copy of the US FDIC[6] (Federal Deposit Insurance Corporation), we need to take a closer look at the US FDIC and its relevant elements:

- The FDIC is an independent agency created by the United States Congress under the Glass-Steagall Act of 1933 to maintain stability and public confidence in the nation's financial system.

- The FDIC was initially funded by the United States Treasury and the Federal Reserve System.

- The FDIC's areas of activity include deposit insurance and resolution activities, examination and supervision (including reporting), receivership of failed banks and, over time, also working to make even large and complex institutions resolvable.

- Credit institutions that are not members of the Federal Reserve System are not required to be members of the FDIC. At the end of 2019, there were 5,256 insured institutions (excluding credit unions, for which the FDIC is not responsible). The FDIC has more than 5,666 employees at various locations throughout the USA.

- Only about 17% of all insured institutions are also supervised by the FDIC; the rest are supervised by the OCC or the FED. Thus, the supervisor and the applicable insolvency regime depend on the type of institution and are not uniform across all institutions.

- The FDIC's resources are pooled into a "Deposit Insurance Fund (DIF)" and amount to $110.3 billion as of the end of 2019 (≈ 1.41% of a statutorily defined reserve ratio as the ratio of fund volume to secured deposits, with a long-term target range of approximately 2%) plus statutorily defined public backup resources.

- A key aspect of the US FDIC is its financial room for manoeuvre, which generates credible depositor confidence because of its federal background: since 1991 (FDIC Improvement Act), the FDIC has been granted a permanent credit line of USD 30 billion by the US Treasury, in addition to its available funds. This was increased to USD 100 billion in 2009 and can be further extended to a maximum amount of USD 500 billion if required, with the approval of the Fed and the US President. This means that the US federal government acts as the lender of last resort.

- The level of deposit insurance protection is generally USD 250,000 per depositor and bank and for each account ownership ('product') category. This means that, if a client

[6] Various sources from the FDIC home page at https://www.fdic.gov/

has distributed his/her deposits over several ownership categories, the legally guaranteed level of protection increases significantly (e.g. up to USD 3.5 million for a correspondingly well-off family with three children).

- The level of FDIC deposit insurance funding, therefore, has to be higher than the 0.8% in Europe, because the guaranteed level of protection per depositor is significantly higher and a 'dual role' has to be fulfilled (deposit insurance and bank resolution).

- On the topic of deposit insurance, the FDIC has been working for a number of years with 'prompt corrective actions' and resolution tools to prevent actual compensation from being paid (this has tended to be the exception for a good ten years).

- The FDIC is required to act in compliance with a least cost principle (LCP) with respect to the resolution mechanism. Accordingly, the FDIC must always select the tool that represents the least direct cost for the FDIC's DIF. However, the macroeconomic (indirect) costs, which are primarily incurred in the state in which the credit institution concerned is resident, are not taken into consideration in the decision about whether compensation or resolution measures should be implemented.