EDIS: is a political agreement nearer?

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Common policies against common shocks

History tells us that crises happen. Some of them can be more easily anticipated. The Coronavirus outbreak, which is spreading around the globe, has little to do with economic fundamentals or the quality of economic governance. In addition to the huge stress it is placing on healthcare systems, it combines elements of supply and demand shocks which require measures to prevent the closure of firms and to support firms' and households' expenditure. It has also caused a confidence shock in financial markets, unleashing fire sales, a hurried search for liquidity and flows towards safe havens. This situation is likely to be transitory, but the speed and the scale of our response to the crisis and our ability as policymakers to work together will determine the strength of the recovery.

These events underline the need to strengthen EMU with a comprehensive package of common safety nets, robust joint policy tools, and a reinforced and effective coordination of national policies. Notable among common actions are those aimed at effectively materialising the capacity to share budgetary risks within EMU, and more broadly the EU. Joint fiscal actions in the face of this common shock would not only ensure maximum efficiency in our response, but also embody the solidarity values underpinning the European project. A common safe asset would be ideal, providing a neutral source of funding and simultaneously sending a strong signal of unity and goodwill. The world is watching. If not now, when?

We also need to conclude the Banking Union. The sizeable monetary policy and liquidity provisioning measures already taken will surely mitigate the risks in the banking sector. But we should not be complacent when it comes to raising a firewall against further deterioration of the crisis.

Regarding the current resolution framework, we need to accelerate the entry into force of its final stage. A fully centralised resolution mechanism will weaken the doom loop because it alleviates the burden of bank resolutions for national sovereigns. Given the observed progress in risk reduction, Member States should summon up the political resolve to bring forward the full mutualisation of the SRF, duly reinforced by the ESM as the common backstop. This is an essential step that would ensure that the SRM/SRF is fully operational.

A stable banking system also requires a credible safety net for depositors, especially during confidence crises. It is what prevents liquidity shocks such as the current one from morphing into banking crises and, eventually, bank runs. More generally, it allows for higher private risk-sharing, by increasing confidence in the European banking framework.

The current institutional arrangements of the Banking Union do not provide the required level of credibility. Banking activity transcends national frontiers, but the guarantee on deposits is still borne by Member States. The two pillars already in place have reduced moral hazard concerns by transferring supervisory and resolution power to common institutions. On the one hand, the Single Supervisory Mechanism provides a strong and neutral institutional framework for bank supervision across Member States. On the other, the Single Resolution Mechanism covers the uniform enforcement of resolution frameworks when a bank is failing or likely to fail. But, by retaining responsibility for deposit protection at the national level, an additional and important problem may arise, namely one of discredit of the banking framework. The alignment of power, responsibility and accountability is what provides the necessary legitimacy of any institutional arrangement.

Current circumstances are highlighting even more the need to strengthen our Union. Completion of the Banking Union and the deployment of mutualised fiscal instruments will contribute to the stability of the European Union, enhancing the necessary private risk-sharing channels and helping European citizens to overcome current and future crisis.

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EDIS: completing the Banking Union

The banking union project began in the summer of 2012, after a first semester in which the capital outflows of some countries – only balanced out by the Target2 program – had nearly led to a rupture of the monetary union. Thus, it can be stated that the banking union was launched at a critical moment for the Eurozone, during which the general banking risks were absorbed by sovereign governments. This triggered a surge in public deficit and hence the debt in some countries.

These increments in public liability fed an uncertainty in the markets concerning their ability to repay, and, therefore, the sustainability of pegged interest rates and the integrity of the monetary union. In order to minimize the risks of rupture, countries had to adopt pro-cyclical fiscal policies, in the short-term, and these policies narrowed the possibilities of recovery due to the absence of a common budgetary instrument that would be able to counter public national deficit reductions in a supplementary way. Precisely for this reason, the "banking union" was commenced, with the aim to avoid similar spiraling in each member state and to prevent the transfer of general banking risks to national sovereignty.

The journey began with the creation of the single-rule book, a European supervisor (SSM) and the design of a shared mechanism in order to manage the banking crises (SRM and SRF). However, this boundary between sovereign and banking risks has not been completely due to the maintenance of national deposit insurances, which continue to be managed by national authorities. It is not consistent that the national tax-payers would assume the risk of a banking crisis whose regulation is not the competency of the national legislature, as not even the supervisory organisms are controlled by their respective parliaments.

The European Commission presented its regulatory proposal for the creation of a European deposit insurance scheme in 2015 – nearly 5 years ago. While progress on the negotiations in the Parliament and the Council has been scarce, the excuses have been abundant.

Within this period, I have identified at least two types of obstacles to the negotiation. The first argument is based on the necessity of reducing the general banking risks in all national systems before merging the assurance at the European level. The second argument centers on the heterogeneousness of the current deposit insurance models, including various systems within a certain countries.

To tackle the former of these two problems, the Union has continued legislating to raise capital and liquidity requirements and clarifying resolution payment models. A massive task certainly lies ahead as there cannot possibly be a new requirement at each juncture of the process before beginning the negotiation of the EDIS. Naturally, this would seriously erode the levels of confidence among negotiators. In order to resolve the latter of the problems, and to provide a reasonable amount of time to achieve larger amounts of risk mutualisation, the S&D Group in the European Parliament has proposed an alternative model to the European Commission text, referred to as the "bi-insurance model".

> *S&D has unveild a new EDIS proposal to solve some political disputes: «bi-insurence model».*

The proposal of the S&D Group entails the maintenance of current national insurance schemes alongside a European scheme. The banking entities must contribute to both funds, subject to a limit of 0.8% of covered funds. In the case of "accident", the national insurance would cover the liquidity requirements until their exhaustion before being supplied directly to the entity or depositors by the European insurance. As such, it is not a model of the reinsurance of national systems, but rather a 'double insurance' of the entities themselves.

Under this system, the level of mutualisation would depend on redistributing the contributions of each entity to each insurance scheme and, naturally, must be an open issue in the negotiations. In such a system, with a previously agreed level of mutualisation, the framework of security deposits would cease to depend – whether explicitly or implicitly – on the respective national treasuries. And this, in turn, would allow us to achieve the original objective of the banking union. ●

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Banking Union already established

The European Commission argues that the Banking Union is incomplete without a European Deposit Insurance Scheme (EDIS) as its third pillar and that EDIS would contribute to the financial stability in the EU. However, the Banking Union is already complete with the introduction of the Deposit Guarantee Scheme Directive (DGSD). The DGSD ensures that all depositors in the EU enjoy the same level of protection by introducing a common set of rules. The DGSD requires that all Member States progressively fill up their guarantee schemes to the required target level. Consequently, the DGSD makes EDIS redundant.

Many alternatives to the Commission's original proposal have been discussed since its publication in 2015. The Commission itself presented a two-phased insurance scheme in its Communication on Completing the Banking Union in 2017. However, the communication only is a variation of the original proposal, since the objective of centralization and full mutualisation remains.

> *EDIS conceals hazards to the financial stability in the European Union.*

The DGSD takes account of the diverse banking sector in the EU Member States allowing options of national discretion. Hence, this enables Deposit Guarantee Schemes (DGS) to use their funds for alternative and preventive measures. In sharp contrast, EDIS would prohibit such measures. This is especially detrimental to Institutional Protection Schemes (IPSs) that are recognized as DGSs in accordance with the DGSD.

Small and locally active credit institutions, such as the German Savings Banks, have been using IPSs for decades. IPSs protect member institutions and avert emerging or existing financial difficulties for these institutions by deploying alternative measures. In order to be able to use funds for that type of measures, it is indispensable that decision-making powers remain with national DGSs. Contrary to that, EDIS would deprive national DGSs and IPSs of these powers, since it would not only centralize and mutualize funds, but also centralize decision-making powers on the EU level. There are inherent differences between IPSs and EDIS. While the latter is merely a paybox that is triggered in an event of a bank's insolvency, IPSs prevent such a situation by ensuring their members' solvency and liquidity. This allows the continuation of business relationships at all times.

EDIS would abolish national DGSs. This would have severe negative effects on small and regional credit institutions, their clients and ultimately on the EU`s financial stability.

Especially in times where we see a fundamental shock to the whole European economy, it is important to understand the risks that are attached to EDIS. Firstly, EDIS would decouple risks and responsibility. Credit institutions with a high-risk affinity would be encouraged to continue to do so knowing that they would be supported by EDIS. This would be at the expense of banks having less risky business models. Another issue to be adressed is the sovereign-bank nexus, which may prove to be a significant burden in the difficult economic situation to be faced. In the same vein, it is almost inevitable that the ratio of Non-Performing Loans (NPLs) will increase as a consequence of the Corona pandemic, which will probably exacerbate - despite recent efforts - the very significant differences from one member state's banking system to another.

In light of the above, three conclusions have to be drawn:

- EDIS conceals more hazards to the financial stability in the European Union than it does provide appropriate tools to prevent a bank crisis.
- the diversification of funds in the different DGSs in the EU member states is an important feature to avoid the spreading of a potential loss of confidence in the banking sector within all of the EU.
- Looking at the third pillar of the banking union alone is not the right way. More elements have to be analysed in order to set up the banking union appropriately.

Looking ahead, there is no doubt that with the DGSD a well-functioning deposit protection framework already exists in the European Union. Not only it ensures the EU's financial stability, but also takes account of unique national features. ●