ASOCIACIÓN ESPAÑOLA DE BANCA

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POSITION PAPER ON THE EU'S COMMISSION COMMUNICATION ON EDIS FROM 11TH OCTOBER

"Also, a single banking system is the mirror image of a single money. As the vast majority of money is bank deposits, money can only be truly single if confidence in the safety of bank deposits is the same irrespective of the Member State in which a bank operates. This requires single bank supervision, single bank resolution and single deposit insurance. This is also crucial to address the bank sovereign negative feedback loops which were at the heart of the crisis."

Five Presidents' Report of June 2015[1]

The Five Presidents' Report of June 2015 sets out a number of steps to further strengthen the European Monetary Union (EMU). One of them is to move towards a European Insurance Deposit Scheme or EDIS as a further step to a fully-fledged Banking Union. EDIS would mark an important step towards reinforcing financial stability by further weakening the link between banks and their national sovereigns and by delivering even greater trust in the safety of retail bank deposits, regardless of a bank's location in the Union. Ultimately, greater confidence in bank deposits would enable greater lending to the economy, meaning more growth and jobs for Europe[2].

Following the Five Presidents' Report mandate, the European Commission presented in November 2015 an EDIS design proposal that, basically, established 3 stages before to set up a fully-fledged EDIS, going from reinsurance, to coinsurance and finally to full mutualisation by 2024.

Due to some Member States' reluctance to agree on the text and the difficulty of reaching an agreement at the European Parliament, the European Commission, published on the 11th October 2017, a communication which addressed, among other aspects, a new proposal for the design of the EDIS. It basically consisted on a two step approach: firstly a loan liquidity system (wrongly called reinsurance) for national Deposit Guarantee Schemes (DGS), which does not include any element of direct insurance from EDIS. Secondly, after a certain non-defined period of time and under certain conditions, it would switch into a coinsurance system.

While we firmly support the 2015 proposal from the Commission, we are aware of the political difficulties that it faces to gather support. Therefore, we consider the new Commission's proposal as an appropriate step to move forward, to the extent that it envisages a progress to deliver in the future a fully-fledged EDIS following a process of gradual increase in risk-sharing. That must go hand in hand and in parallel with risk reduction.

Finally, we understand that setting an EDIS should be a priority for the Banking Union. We consider it should be put in place gradually but in a reasonable timeframe. Its main objectives should prevail: (i) to eliminate the feedback loop between sovereign and banks, (ii) to create a genuine Single Market of deposits with equal rights and guarantees for all depositors of the European Union and (iii) and to allow all the Eurozone credit institutions to contribute to the fund according to their risk and not depending on the country in which they are established.

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1 https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf

2 European Commission. Banking Union: restoring financial stability in the Eurozone http://europa.eu/rapid/press-release_MEMO-15-6164_en.htm?locale=en

Here below we elaborate on some arguments in favor of establishing a European Deposit Insurance Scheme according to the proposal of the Commission and along the lines expressed above.

The Banking Union needs an EDIS to be fully fledged. The 2008 crisis pushed Europe into a radical reform of its financial regulation. The Banking Union was created to recuperate the confidence in the financial sector, break the feedback loop between banks and sovereign and consolidate the European Single Market. To achieve this, the Banking Union was drawn around three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance System (EDIS). The first two pillars are already in place since November 2014 and January 2016, respectively, while the third pillar is still in the EU legislative process. Putting in place this last pillar is of utmost importance to balance and complement the two others and should not be put off nor postponed.

The EDIS would be instrumental to deepen the European Single Market, understood as one where the guarantee of depositors does not depend on the economic situation of its own Member State at any given moment. Nowadays the depositors' sense of membership of a single market with a European guaranty of its savings does not exist, since guarantees are fully subject to each Member State's financial conditions. This lack of common rights and guarantees of depositors is inconsistent with the common regulatory, supervisory and resolution framework of deposits entities.

The EDIS would enhance financial stability in all EU Member States, by increasing the confidence and stability of depositors and therefore reducing risks of depositors runs in stressed conditions. This would equally help limiting possible contagion effects within a country and across borders.

The EDIS would enhance cross border capital flows. We believe that, once depositors feel part of a single market for deposits, they would choose freely the entity where they want to hold their savings, based on the entities offer and not their country of residence. This would certainly enhance both competition among European banks and cross border capital flows. At present cross-border deposits do not flow freely and depositors are subject to their different national deposit protection funds and, indirectly to the solvency of their own sovereign.

The EDIS would help breaking the loop between banks and sovereigns, meaning banks risks would be assessed on an individual basis and not under the perspective of their sovereign or their national banking systems. It is a priority that entities' contributions to the future EDIS are made, as proposed by the European Commission, weighted by their level of risk, and calculated in relation to all entities of the Eurozone. There are two alternatives to this approach which, in our view, would not help breaking the feedback loop that nowadays persists between the banks and sovereigns and would be contrary to the level playing field among European banks:

- Contributions made by national DGS to the EDIS, instead of contributions directly from entities, would impede breaking the loop banks/sovereigns. Also, we believe that failing to comply with the obligations to contribute to the European fund must be followed by a penalty to the non-complying entity, and not to national DGS (and therefore, to all entities and depositors of the Member State), and all this regardless the powers of the respective national DGS regarding the collection of contributions (as is already the case with the Single Resolution Fund).

- Risk based contributions calculated in relation to the entities of the same national DGS, instead the whole set of Eurozone participating banks, are not consistent with the Banking Union, do not break the banks/sovereign link and maintain an unlevel playing field among the eurozone banks.

We don't think the EDIS would introduce moral hazard in the system, beyond what the Banking Union represents itself, as others argue. It does not seem that a complete Banking Union leads to greater moral hazard that an incomplete one if appropriate safeguards are in place. In this context, the effects of EDIS should not be considered in isolation, but rather as a part of the complete set of pillars that constitutes the Banking Union.

The EDIS proposal contains a series of safeguards to protect the scheme against potential moral hazard problems. For instance, national DGS have to comply with the pre-set yearly target levels before they can access EDIS funding. Moreover, the risk-based contribution system will further deter a potential moral hazard problem.

We do not believe that, for instance, the level of moral hazard is greater in the US[3] (with a single deposit guarantee system for 50 states and multiple supervisors), than the one which would represent the EDIS in the Eurozone (with a single supervisor and a resolution authority). Moreover, there is also no empirical evidence that moral hazard increased when the European Union raised the guarantee up to 100,000 Euros.

Added to the above, moral hazard is a concept frequently used too vaguely and without specifying it properly: to whom does it refers to? Supervisors, entities, their managers, depositors...? how is it measured? Unfortunately, such a vague argument has been used frequently as against the implementation of EDIS.

The risk reduction vs. risk sharing debate should not limit progress on EDIS. As the ECB President, Mario Draghi, said recently, "*It is quite clear that risk reduction and risk sharing should go in parallel*"[4]. We agree with this approach. The European Commission's proposal contained a period of 8 years to build a fully-fledged EDIS. We believe this is an appropriate time horizon. From a risk reduction perspective, this period of time will be needed to materialize banks efforts to adjust their balance sheets when need be and comply with the different initiatives coming from the Council, the European Commission, the ECB and the SSM aimed at reducing current NPL levels. This period should also be sufficient for the SSM and, under its supervision, national authorities, to carry out AQRs of entities, especially of those to which an AQR has not yet been made.

On the other hand, risk sharing should also be considered as a progressive process. Not in vain the approach proposed by the Commission has always been presented as a step-by-step approach, where progress is subject to the appropriate conditions and with increasing levels of ambition.

We believe efforts under the two perspectives should coexist and the commitment to implementation should be ensured to guarantee a comfortable balance between risk sharing and risk reduction. We support also the use of risk based methodology proposed by the Commission for the calculation of contributions, so banks with high NPL levels contribute in

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[3] In fact, the Federal Deposit Insurance Corporation, the US deposit insurance, which became national in the US after the great depression in 1933, has been one of the main sources of financial stability in the US. The deposit insurance it provides has helped to maintain confidence through two subsequent banking crises when the US experienced hundreds of bank failures. One of the main features of the FDIC that contributed to financial stability is that the FDIC is funded by ex-ante contributions paid by the banking industry to satisfy claims as they arise, reassuring depositors and taxpayers and thereby promoting confidence and enhancing financial stability.

These funds are considered reasonable and sufficient at all times to pay depositors claims. It does not hold funds that are not needed and that could be better used by banks for lending. The system ensures that adequate funds are readily available to respond to problems as they arise and avoid delays in closing failed banks. US experience has been that delays in closing failing banks increase the ultimate cost of failure.

The funding arrangement includes risk-based pricing that serves to minimize moral hazard issue that too often accompanies even the most carefully designed insurance scheme.

[4] https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp171120_1_transcript.en.pdf

proportion to its higher risk. Nevertheless, if at some point undesirable legacy issues persist, implementation and commitment should be reinforced; this should not constitute an excuse for refraining from progressing on EDIS.

National execution and bankruptcy laws cannot prevent progress on EDIS. Both aspects, being important, must be addressed by the European and national legislators to increase efficiency and harmonization within the EU. Evidence shows that, within the same Member State, the level of NPLs significantly varies between entities subject to the same legal regime, so it could be hardly consider as a factor that impedes legacy adjustment.

Furthermore, it is difficult to understand that some technical issues, such as legal aspects or contingent conditions have been used as impediments for the EDIS when, after two years from its beginning, the same issues have been resolved successfully by the Single Resolution Mechanism.

Finally, we believe the use of EDIS will be unlikely and have a very limited scope of activation. The SSM is nowadays the sole supervisor for the Eurozone banks. The ECB has approximately 120 significant banks, which represent 85% of total bank assets in the Eurozone, under its direct supervision. In the case of Spain, the significant entities under ECB's direct supervision represent around 95% of the total assets of the deposit institutions.

It could be considered that in case an entity directly supervised by the ECB finds itself in a situation of "failing or likely to fail", the Single Resolution Board will most probably adopt resolution measures, given the significant impact that its liquidation would have in terms of financial stability domestically and across the EU.

Under this assumption, the probability of using the EDIS, would be limited to a very small part of the European banking system (only the 15% outside SSM direct supervision) and would certainly be very exceptional.