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European Commission
Internal Market and Services DG
Financial Institutions

per e-mail: markt-dgs-consultation@ec.europa.eu

your reference

your message of

city_date
Frankfurt/Main, 27.07.2009

Review of Directive 94/19/EC on Deposit-Guarantee Schemes (DGS)

Dear Sir, dear Madam,

The *Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. (bwf)*[1] is a trade association representing securities trading firms and brokers at the stock markets throughout Germany. All its members, insofar as they are not natural persons or supporting members, are investment firms for the purposes of EU law. However, in the recent past, some association members have applied for authorization to conduct deposit-taking business, and in addition to their capacity as investment firms are today also credit institutions for the purposes of EU law. It may also be emphasized that virtually all the bwf member firms deal solely with institutional clients, and thus with clients not eligible for neither (statutory/mandatory) deposit guarantees nor investor compensation.

Nevertheless even those bwf member firms which do not have the status of a credit institution for the purposes of EU law have been – and still are – strongly affected by the design of the highly fragmented architecture of deposit-guarantee schemes chosen by the German legislator and its direct impact on the corresponding structure of the corresponding investor compensation regime.

The bwf therefore expressly welcomes the opportunity to participate in the consultation on the review of Directive 94/19/EC on Deposit-Guarantee Schemes. We would also like to thank Commission Services for the elaborate consultation document which in many ways sets the right accents. Due to the complexity of the issue and the detailed structure of the questionnaire we also understand that Commission Services kindly ask that we maintain the given structure of the consultation document when providing a reply. However the document also asks for

[1] The Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. is registered in the list of interest representatives with the European Commission under Registration No. 1880407752-10

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considerations on issues important in this context which are not yet covered by the questionnaire. Before answering specific questions we therefore would like to begin our comment with some general observations and conclusions about Deposit Guarantee Regimes in the light of the global financial crisis.

Without devaluing the technical complexity and relevance of the consultation document in any way, it cannot be ignored that as a result of active – albeit, not always very well coordinated – crisis management in the EU member states, the original concept of DGS as a solely industry funded[2] protection system for retail banking clients has been put in question. The high – sometimes unlimited – *de facto* state guarantees for deposits given more than once together with expressive or indicative promises that no systemically important institution shall be allowed to fail as a result of the crisis, clearly unveiled that the system of depositor's confidence which should be established by directive 1997/9/EC was no longer considered to be sufficient any more by many EU-member-states.

Besides this, the general structural problem of the limited strength of industry funded national schemes[3] in conjunction with an often highly concentrated banking industry was well known among experts long time before the current crisis. This led to the almost absurd – and mostly concealed – situation that the clients of those banks making by far the largest contributions to the DGS were *de facto* those with the weakest – or non existing – protection since a failure of a major player would very likely overburden the loss bearing capacity of the DGS.[4]

There is another, not only practical but normative reason why the current general concept of solely industry based DGS funding needs to be revisited: The threat to the economy as a whole arising from the current financial crisis has made it plainly clear that the confidence in the banking/financial system is a public good whose importance for society at large has ultimately to be considered as no less material than the benefit for the firms directly active in this sector.[5]

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[2] However, it is worth remembering in this connection, that the Directive does not and can not prescribe a mandatory structure in which DG-schemes are to be financed. Such a prescriptive rule would clearly conflict with Art. 249, sentence 3 of the EC Treaty which limits the prescriptive power of EU directives to the achievement of the objectives formulated therein and leaves the decision regarding the appropriate means for achieving them expressly to the sovereignty of the Member State's national jurisdiction.

[3] Not to mention the additional problems which inevitabley arise if national schemes, as in Germany, are further fragmented and thereby weakened.

[4] A similar problem could arise of course if in a crisis situation a number of mid-size institutions were to fail in a period of time too short for the DGS to generate sufficient funding.

[5] The recent report of the High-Level Group of Financial Supervision in the EU (de Larosière Report) also talks about the *"public good of financial stability"* (loc. cit. p. 21, para. 79) The German Chancellor Angela Merkel expressed this in even clearer terms in her government statement on the state of the financial markets of October 7, 2008, declaring that with regard to the stability of the financial system, for which the confidence of society at large is doubtless an essential precondition, "*(the issue at stake is)*

Furthermore, there is a clear inconsistency between – taxpayer funded – bailouts or (partly) nationalizations of Banks and privately funded compensations for lost deposits. From a depositors point of view, it is simply a "substitute" whether his deposits are (privately) "insured" or the state saves an institution with tax payer's money which otherwise would have failed. [6]

Question 1: Do you agree in general that the current framework of DGS in the EU needs to be revised? Are the areas identified for review the right ones, or are there other priorities?

Taking into account the observations and considerations given above, there is little doubt that the current system of DGS should be given a comprehensive review. One key priority which has been mentioned but has not been given the necessary level of attention yet is the question of the general funding structure. Here the lessons to be learned from the experiences in the cause of the financial crisis should be that a purely industry funded DGS is objectively or at least in perception of depositors too weak to provide the intended level of confidence. What is needed therefore is an open discussion as to what degree future deposit guarantee arrangements should be finance by the industry, a public/private co-financing-model or by government funds alone.

Question 2: Which of the above options would you prefer? Would you prefer another option? Please explain your choices.

As the consultation document states in its introductory text, the purpose of DGS is to protect a part of the depositor's wealth from bank failures and by doing so, create a level of confidence, preventing depositors makin panic withdrawals from their bank in times of crisis. In other words, a failure of a bank should not leave its customers impecunious and bankrupt. On the other hand, it cannot be the sense and purpose of any deposit guarantee scheme to release depositors completely from their duty of care in regard to their own basic responsibility for their financial arrangements.

Furthermore, it can be assumed that with any given funding structure, the level of confidence in a DGS is – at least from a certain point – negatively correlated to the level of promised guarantees. If depositors have no trust in the scheme because the level of protections seems to be unrealistically high compared to its funding basis then a higher guarantee level may make bank runs even more likely.

Consequently, we think that coverage levels should be "as high as necessary" and "as low as possible". We therefore do not believe that any amount higher than the 50.000 EUR individual guarantee currently in place, which according to Commis-

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no more and no less than the confidence in our economic and social order" (Bundestags Drucksache BT16161, p. 21).

[6] Above the level guaranteed by the DGS a publicly funded bailout even offers a higher benefit.

sion’s estimates provided in the consultation document already covers 80% of deposits, would be necessary or helpful.

Question 3: Should the coverage level you prefer (Question 2) be a minimum or a fixed level or do you think a different solution would be more suitable, e.g. a range with a minimum and maximum level? If so, please describe. Please give reasons for your choice.

For the reasons given by Commission Services themselves, namely the distorting effects on competition of national and or sectoral variations of coverage levels, we are strongly in favor of a fixed unitary coverage level for mandatory DGS in Europe.

Question 6: If the coverage level is fixed, should there be exemptions that allow a higher coverage of certain products for social considerations? If so, for which products should there be exemptions and up to which amount? Should this be harmonised or should Member States have the discretion to decide on this? In the latter case, which elements should be within the discretion of Member States (e.g. amount and duration of coverage)?

With a level of minimum guarantees covering 80% of eligible deposits already in place, we don’t see any need for exemption rules granting higher protection levels for certain products or specific social groups. – With respect to product categories, any privileged treatment of certain products would be more or less arbitrary and with respect to social considerations we think that DGS shall provide the same basic safety-net for every person living in the EU.

Question 7: Should temporary high account balances be covered? If so, up to which amount and for how much time? In which situations should these balances be covered? Should this be harmonised or should Member States have the discretion to decide on this? In the latter case, which elements should be within the discretion of Member States (e.g. situation, amount and duration of coverage). Should, in order to facilitate payout, such balances be transferred to special accounts that are ‘tagged’? Do you see other solutions to protect temporary high balances?

We think that any special provision regarding temporary high account balances is neither necessary nor desirable. Not only would it lead to a privileged treatment of a single asset class (cash deposits) but also to *de facto* different insurance levels for different socio-economic groups and *ceteris paribus* higher funding requirements for the DGS themselves.

Question 8: Should mutual guarantee schemes and voluntary schemes be integrated into the Directive so that the same rules would apply for them as for 'classical' DGS? If so, how? Should there be restrictions on advertising for these schemes? Please provide reasons.

In our view, the coexistence of mandatory and mutual/voluntary schemes, even more if they are funded basically by the same group of banks (in case of a complementary voluntary DGS) or possibly create a group of banks which does not contribute to the mandatory DGS at all (for mutual DGS under the exemption rule in Article 3 clause 1 of Directive 94/19/EC), represents a serious structural problem of the existing European DGS structure.

Here, the highly fragmented German DGS landscape established under the *Einlagensicherungs- und Anlegerentschädigungsgesetz*, or *EAEG* for short (Deposit Insurance and Investor Compensation Act) of July 16, 1998 gives a striking example:

Since Germany – in deference to the interests of the German banking industry –at this time basically opposed the Deposit Guarantees Schemes Directive which was implemented by the EAEG with significant delay after an appeal filed with the European Court of Justice was dismissed on May 13, 1997.

It is therefore not surprising that, in implementing the rules of EU law that were felt to have been *"dictated"* upon it, it was Germany's openly declared intention to orient itself strictly to the minimum requirements set by the directives, with greatest possible consideration being given to the mutual & voluntary deposit insurance structures that were already in place.[7] In other words, the mandatory German DGS structure based on Directive 94/19/EC had right from the beginning more or less a "fig-leaf-function". Aside from the reduced loss bearing capacity of the different schemes as a result of sectoral fragmentation which will be addressed later in this statement, the most obvious problem of the coexisting mandatory and voluntary schemes lies in the fact that laying claims to one scheme necessarily weakens the funding capacity of the other since the basis of contributing banks is to a high degree identical.

If the same banks are funding a voluntary guarantee scheme with an almost unlimited coverage level[8] it is pretty clear that any large loss event will hit the mandatory as well as the voluntary scheme which "tops up" the basic mandatory guarantees, thereby weakening the ability of the mandatory scheme to raise additional funds – especially in times of crisis. The problem is further aggravated if the eligibility criteria under the voluntary scheme differ significantly from those under the mandatory scheme. The German "Lehman-Case" which is also referred to in the consultation document illustrates the problem in a very clear way:

The German subsidiary of Lehman-Brothers basically had no retail clients which would have been eligible for deposit guarantees under the private bank's mandatory DGS. However, the voluntary private banks guarantee scheme did compensate the Lehman clients: institutionals, municipal authorities and other legal enti-

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[7] See Deutscher Bundestag, 13th Electoral Term, bill presented by the CDU/CSU and FDP parliamentary parties, Entwurf eines Gesetzes zur Umsetzung der EG-Einlagensicherungsrichtlinie und der EG-Anlegerentschädigungsrichtlinie, Drucksache 13/10188 dated March 24, 1998, p. 2.

[8] In our case up to 30% of the failed bank's own capital per depositor!

ties with an overall sum of 6.7 billion EUR. Obviously the scheme would not have been able to raise this amount among its members easily without the blessings of modern structured finance, namely a state guaranteed bond issued via a "SPV" which was founded specifically for this purpose.[9] The bond was subscribed by members of the scheme and due to the "credit enhancement" granted by the German Special Fund for Financial Market Stabilization (SoFFin) became eligible for refinancing transactions with the central bank.

It is obvious that the failure of Lehman Brothers brought the voluntary private DGS to the limit of its loss bearing capacity. Since the mandatory private DGS and its voluntary counterpart share basically the same funding base, there can be no real doubt that the funding power of the mandatory guarantee scheme was negatively effected by the high financial burden the voluntary DGS had to carry.

Not to be misunderstood, it is understandable that the private sector banks in Germany have established (and are trying to pursue) a voluntary scheme with an almost unlimited coverage level since they have had and still have to face a strong competition from the public banking sector which at times when the scheme was established operated under a comprehensive state guarantee (so called "Gewährträgerhaftung").

However these clear interdependencies between mandatory and voluntary schemes ought to be given the necessary attention in the process of revising the original directive, whereby a simple integration of mandatory and voluntary schemes would not solve the underlying problem that the funding capacity of the system as a whole might be exhausted by high "voluntary" pay outs. What is needed is a strengthening and protection of the funding base of the mandatory DGS. Therefore, a stricter separation of mandatory and voluntary schemes, rather than their integration would be desirable. Furthermore, we think that all banks providing deposit services to clients eligible for compensation should without exception contribute to a single mandatory scheme of basis guarantees. Since the basic safety-net provided by a reasonably designed mandatory DGS is beneficial to society as a whole, the overall contribution to be made by the banking industry in a given period should be clearly limited and the remaining "tail-risk" of unexpected large loss events should be absorbed by public co-funding and state guarantees.

Question 18: Would you be generally in favour of a pan-EU DGS? (If you disagree, please skip questions 19-20.) If so, should there be a transition period until a pan-EU DGS should be operational? If so, how long? Please provide reasons.

A pan-EU DGS would certainly have some "actuarial" advantages since it would widen the funding base of the scheme and spreads the risks to be covered to a

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[9] Sicherungseinrichtungsgesellschaft deutscher Banken mbH; also see: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/114&format=HTML&aged=0&language=EN&guiLanguage=en

higher extent. Such a structure would also reflect the fact that the largest banks, representing the highest amounts of guaranteed deposits are mostly internationally active entities. On the other hand, in a framework where regulatory provisions become more and more European but prudential banking supervision – for the time being - still remains a mainly national responsibility, we assume that political support for such a far reaching structural reform is likely to be limited. Despite its general attractiveness in abstract terms, we therefore currently do not consider a pan-EU DGS a realistic option.

Level of funding of DGS

On top of improving the financing mechanism (Question 39) and a possible introduction of a pan-EU DGS (Questions 17-19), it could be considered to recommend or require a target level (certain percentage of deposits) for ex-ante funds, ex-post contributions and and alternative means of financing (e.g. borrowing). A maximum level for the contribution of banks could also be considered.

Question 37: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

As already mentioned above, we think a "paradigm shift" is needed when discussing possible changes to the funding mechanism of existing DGS. The hasty "race" among EU member states to promise *de facto* unlimited deposit guarantees as result of the financial crisis and the experience of the Northern Rock bank run has made clear that any solely industry funded DGS not only is very likely to lack the capacity to absorb the failure of a major bank but therefore is unable to establish the required level of confidence among depositors to avoid the danger of bank runs in crisis situations.

Accordingly EU citizens currently face a twofold - and where industry-funded complementary voluntary systems are in place even threefold - DGS architecture whereby the existing schemes based on directive 94/19/EC are supplemented by sets of political commitments with an often unclear legal binding character. Such a nonuniform and confusing situation might be understandable as a result of rash political actions taken in an "emergency situation" but clearly can and should not be a permanent condition. Therefore, it should be made clear on a European level that a sound DGS funding structure which is able to provide the necessary level of certainty among depositors requires a binding obligation for public (co)funding, at least in times of crisis and in the case of exceptional high loss events. Besides entering into firm funding commitments member states should also take an obligatory function of "lender of last resort" for the mandatory DGS system(s) in their jurisdiction. Such a borrowing option would help to insure the DGS capacity to pay and make its liquidity situation more independent from periodic contributions from the banking industry.

Such a system at the same time obviously would require the definition of general limits of contribution of the banks supporting it. These limits should be defined as

a percentage of *guaranteed* deposits which give a general indication of the risk represented by as well as the financial strength of an institution. Ideally, in order to avoid competitive distortions, the contribution levels should be consistent on a European level and be made subject to periodic comparative empirical analysis.

With respect to the question of *ex-post* via *ex-ante* financing we think that there are sound arguments in favour of an *ex-ante* pool capable of covering average loss events. One advantage of *ex-ante* financing is its reduced procyclical impact and the simple fact that a failing bank, whose depositors need to be compensated, made at least some prior contributions to the fund. Predefined and transparent *ex-ant* funding structures could also help alleviate potential "crowding out" effects between contributions made to voluntary schemes and the remaining funding power of the mandatory DGS.

Nevertheless, any *ex-ant* funding structure needs to be built with a sense of proportion[10]; it can and ought not be designed to cover "low frequency high impact" claims. Accordingly, in a situation where predefined contribution limits and *ex-ant* reserves are exhausted, the public (co)financing obligation would take effect. - A desirable side-effect off a public (co)funding obligation would be to create an incentive for national legislators to (re)design the mandatory DGS landscape in a most efficient sustainable way with the maximum loss bearing capacity in mind. This could help to avoid the fragmentation of mandatory DGS structures for reasons not conducive to furthering the actual regulatory objective of guaranteeing individual deposits and improving the confidence in the stability of the financial system.[11] [12] - However, it would be even more convincing if a revised directive

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[10] Which holds true not only for deposit guarantees but as well for the complementary investor's compensation.

[11] The fragmented DGS landscape in Germany serves as an impressive example that political considerations based on commercial preferences and "sectoral reservations" among private and public banks can lead to at least "suboptimal" structures. Not only did Germany (by drawing on the exemption rule – initiated by Germany –in Article 3 clause 1 of Directive 94/19/EC) exclude about two thirds of all banks, namely the public sector saving banks and cooperative banks, from the scope of the DGS directive, but also divided the remaining banks into two different (public-sector and private) mandatory compensation schemes with a ratio of banks assigned to the different schemes of 1:10 (sic!). The Deutsche Bundesbank already came to the conclusion in 2000 that, in view of the small number (actually less than 20) of institutions assigned to the Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschland GmbH (German public-sector banks compensation scheme), a reasonable risk diversification was *"impaired"* (*"erschwert"*). – A statement, which considering the extremely reserved diction typical of central banks generally, can probably not be interpreted in any other way than as a clear criticism of the economic parameters chosen in the EAEG implementation; see Bundesbank, monthly report, July 2000, p. 38. An added factor is that with the small number of institutions the risks are by no means of the same *"granularity"*; a large part of the contributions (and the risks) is attributable to one institution. See J. Bigus, P.C. Leyens, Reform der Anleger-entschädigungseinrichtungen und Einlagensicherungssysteme in Deutschland, expert opinion commissioned by the Federal Ministry of Finance (unpublished), March 2008, p. 52. – The very small num-

would prohibit a fragmentation of national DGS or at least require member states to give a valid justification in the light of the directive's regulatory objective.

Risk-adjustment of contributions to DGS

It could be considered to introduce risk-based contributions on a voluntary or mandatory basis. Particular models could be recommended or required.

Question 38: Would you prefer introducing risk-based contributions? Which models would you envisage? Please provide reasons. Please describe.

At its very basis "risk based contributions" should insure that any funding obligation is based on the amount of *eligible* deposits. A higher sophistication of risk based contributions, while generally desirable, sees itself confronted with the problem of adequately measuring the risk of failure for an institution. Due to the high methodological problems and the fact that the risk assessment itself therefore is subject to a high degree of "estimation risk", we are rather sceptical with respect to the objective and consistent application of more complex risk based contribution schemes.

We also think that while a general risk sensibility of the DGS funding mechanism is clearly desirable, it should not be the core responsibility of the scheme to set *"incentives for sound risk management"* which remains the primarily task of the prudential supervision of the competent authorities.

Funding mechanisms

It could be considered to make ex-ante funding mandatory and to require alternative short-term (interim) financing or long term borrowing in case of need.

Question 39: Which solution would you prefer? Please provide reasons. Would you prefer another option? Please describe.

If you prefer interim financing, please describe how and by whom such financing should be provided.

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ber of institutions belonging to the compensation scheme is due to the fact that most of the public-sector institutions were excluded from the scope of the law as members of so-called *"institution continuity guarantee schemes"* (mutual DGS) as already outlined above.

[12] The Executive Board of the International Monetary Fund also drew attention recently to the problem of the stability-threatening fragmentation of the German protection schemes and called on Germany to reform its schemes: "*Directors called for strengthened deposit insurance, a critical element of the financial safety net, given the risks associated with the existing multiple protection schemes that have typically relied on ex post burden-sharing. A base layer of mandatory deposit insurance -ex-ant funded by contributions from all banks – would provide unified terms of protection for depositors and reduce incentives to shift deposits among the existing schemes. The evolving European Union rules should provide guidance on coverage limits.*"; IMF Executive Board, 2008 Article IV Consultation with Germany Public Information Notice (OPIN) No. 09/05, January 22, 2009.

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Please see answer to question 37

Question 40: Are there any other issues that have not been mentioned above but should be dealt with in the context of the review of the DGS Directive? If so, please describe the problem and its different impacts as precisely as possible.

There are at least two additional topics which ought to be given adequate attention in the revision process:

The first is the governance of the schemes themselves: Due to their continuous funding obligations banks assigned to a DGS are exposed but also because of their expertise in managing and analysing the business risks which in last consequence can result in a failure, we suggest, that there should be appropriate provisions ensuring the adequate representation of the industry on advisory boards and monitoring groups which control the activities and the management of such schemes.

The second issue is transparency: In our view, due to the high level of systemic importance of the DGS and the political implications arising from it, clear provisions ensuring the adequate and sufficient information of the general public – and the protected depositors in particular – about the structure, operation and financial capacity of the mandatory DGS are necessary. While information of this kind is already available in some member states, other DGS regard themselves as "areas of confidentiality". We think that in the light of the public responsibility of mandatory DGS such secrecy is fundamentally wrong. Without sufficient information about the financial situation of a mandatory DGS depositors - on an individual level - are unable to adequately asses the risks born by their financial transactions and - on a political level - EU citizens are unable to judge whether their national government and legislator have put in place adequate structures in this systemically important area.

Yours faithfully,

Michael H. Sterzenbach
Geschäftsführer

Dr. Hans Mewes
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