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THE TREATMENT OF DEPOSITORS IN THE EU FRAMEWORK ON BANK CRISES: A LATENT CONTRADICTION

1. The treatment of depositors under different provisions of EU law is affected by ambiguity and shortcomings arising from a latent contradiction. I will first recollect the basic rules and their rationale; then, I will discuss the system of incentives created by such rules as regards depositors' contribution to market discipline; finally, I will formulate a policy proposal in order to overcome the highlighted issues.

2. Several recitals of the EU Directive on Deposit Guarantee Schemes ("DGSD") emphasize the link between depositor confidence in the soundness of the banking system and financial stability.

More generally, a significant part of the European financial safety net – not just the DGSs – is built on the assumption that **depositors** are a category deserving **special protection**.

Depositor protection under EU law arise from two sets of circumstances. First, depositors often lack either the skills or the resources to assess and compare the risk profiles of different credit institutions. Second, bank deposits can hardly be considered as "investments". Deposits generally earn low interests, largely eaten into by tax and inflation. Depositors as such do not seek profit; they seek a safe way to park their money, to make payments and to keep their funds accessible at short notice. This also applies to deposits from enterprises, whose accessible deposits are necessary for operating their business.

Moreover, it is well known that **the banking system is vulnerable** to massive withdrawals of cash because of the financial structure of banks: by their nature, banks attract short term deposits and invest in long term loans. At the first sign of trouble, depositors may want to be first in line to get their money back, before a bank's liquidity is exhausted. Hence, massive withdrawals may easily occur and banks are subject to collapsing because of liquidity problems.

Because of these two weaknesses (of depositors; and of the banking system), special protection is afforded to covered depositors (that is, to depositors up to 100.000 euro) under the DGSD, the BRRD and the SRMR. Namely, "*the protection of covered depositors is one of the most important objectives of resolution*" under recital (71) of the BRRD, and covered deposits, among others, are excluded from PSI, insofar as they are out of the scope of the bail-in tool.

The case for insuring deposits and excluding them from bail-in boils down to the prevention of bank runs. Once insured, depositors know (or should know) that they will not lose their money, no matter what happens to their bank: therefore, they will have no reason to run and withdraw their funds at the first sign of trouble.

In brief: insured depositors are purposefully provided by EU law with *incentives <u>not to contribute</u> to market discipline*.

3. In stark contrast, the consideration of depositors beyond the harmonized coverage level provided for in the DGSD abruptly changes under EU law: beyond such threshold, depositors fall under the scope of the bail-in tool under the BRRD, unless exceptional circumstances occur, allowing for case-by-case discretionary exclusions by RAs – which however require stringent conditions and are subject to specific limits.

In this manner, **uninsured depositors are somehow equated to investors** and other creditors: they are expected to monitor the health of the supervised institutions as any other stakeholder; and to prevent banks from taking too much risk: uninsured depositors are expected to sanction excessive risk-taking by banks, by way of transferring their money somewhere safer.

The treatment of uninsured depositors in bank crises is only mitigated by the so-called "**depositor preference**" clause laid down in Article 108 of the BRRD, under which Member States are required to ensure them a higher priority than the ranking provided for the claims of ordinary unsecured, non-preferred creditors.

Contrary to insured depositors, uninsured depositors are then purposefully provided by EU law with *incentives <u>to contribute</u> to market discipline*.

Based on the analysis so far, we may conclude that different items of EU legislation (try to) provide insured depositors, on the one hand, and uninsured depositors, on the other hand, with opposite incentives.

Now, we must be aware that insured depositors and uninsured depositors are mostly *the same persons* (apart from subjective exclusions from deposit insurance). Everyone holding more than 100.000 euros on their bank account is both an insured depositor – as far as the first 100.000 euros are concerned – and an uninsured depositor, for the remainder. As a consequence, **the system of incentives recollected so far may work only upon condition that a single person is sensitive to opposite incentives at the same time and is therefore willing to make different choices regarding different segments of their wealth.**

4. In order to verify if that condition is actually satisfied, let us go back to the text of the law again.

Recital (19) of the DGSD clarifies the case for the harmonization of the level of coverage: the harmonization is expected to prevent covered depositors from transferring their funds across (banks based in) different jurisdictions.

In times of stress, the **financial stability** rationale of the DGSs emerges. Avoiding that depositors transfer money from some credit institutions to others will prevent the draining of liquidity from the former, which would exacerbate their difficulties.

In times of financial stability, the harmonization of the level of protection aims at avoiding the distortion of competition which might arise if bank clients were to choose "*the highest deposit protection rather than the deposit product best suited to them*". Thus, the harmonized coverage also contributes to **fair competition**.

However, the existence of different levels of coverage ensured by the DGS in different countries (once possible, now prohibited) is only one of the possible causes of deposit transfer across jurisdictions. But there are further reasons, not depending on the abstract level of deposit protection throughout the EU.

Among others, a recent analysis (Boccuzzi and De Lisa 2017) shows that around the time of the resolution of the 4 banks in November 2015 in Italy the 4 banks' deposits recorded a sharp fall: not only uninsured deposits but *also insured deposits fled*. And before that, it is well known that during the sovereign crisis banks located in certain European countries with sovereign debt issues had experienced deposit flights to banks located in countries with stronger sovereigns.

As a matter of fact, the DGSs sometimes fail to achieve insured depositors' confidence. The reasons for this arise from recent events.

In the past, some DGS turned out to be unable to fulfill their reimbursement obligations, due to the simultaneous failure of several institutions in the same country. Under such circumstances, sovereigns usually step in and back up their DGS. But sometimes the burden is too cumbersome even for the State: for instance, this has been the case with Iceland in 2008, when Landsbanki went down – together with two more Icelandic banks – and depositors (with Landsbanki on-line branch "Icesave") from the UK and the Netherlands were neither repaid by the Icelandic DGS nor by the Icelandic government.

Moreover, in other countries public authorities stated that losses could be imposed on occasion also on insured depositors. This has been the case with Cyprus, where the government *declared* in 2013 that an extra-ordinary tax between 6% and 7% on insured deposits would be introduced, in order to limit the size of external financial assistance provided to Cyprus. A statement by the Eurogroup in March 2013 confirmed that this one-off stability levy on deposits, including insured deposits, would have been consistent with the EU legal framework. Although in the end such tax did not materialize and losses were actually imposed only on uninsured depositors, the initial decision to charge a levy on insured depositors damaged depositors' confidence and stills stands there as a warning.

Also based on the Cyprus and Iceland experiences, it is common opinion that deposit insurance is only suitable for crises of small banks, occurring one at a time, while large bank failures or system collapses are a different matter. In such cases, small depositors are only safe if their sovereign has both the ability and the willingness to intervene with public funds. As a consequence**, incentives on insured depositors to run still exist: despite the existence of the DGSs,** they may fear that (i) the available resources of the relevant DGS are not enough to offset their losses, and that (ii) the relevant sovereign, in turn, will not be able or willing to intervene (not to mention the circumstance that depositors might be discouraged by the DGSs' repayment period, albeit reduced by the DGSD).

Now, where we are we getting at, with this? **There is an issue of credibility of deposit insurance in the EU**. In the absence of a single European DGS, depositors – be them covered or not – will be likely to flee to the most solid EU countries in times of trouble.

At the present stage of EU integration, where the third pillar of the Banking Union is still incomplete, **the choice under the BRRD to include uninsured deposits in the scope of the bail-in tool is likely to interfere with the goal of deposit insurance under the DGSD**.

Once incentivized to monitor banks' risk-taking behavior, in times of trouble uninsured depositors may be expected not only to transfer their funds exceeding the threshold of protection, but to transfer all of their money.

5. This last remark adds on to concerns already raised in the academic literature regarding the scope of the bail-in tool.

First, it has been noticed that individuals and SMEs beyond the level of insured deposits are poor bank governance monitors (Tröger 2018) and, at the same time, stable sources of cheap funding: therefore, it is not wise to force them to pay the penalty of bank failure (Avgouleas and Goodhart 2015).

Second, the bail-in tool, as an alternative to State funded bailouts, is intended to spare taxpayers from bearing the costs of bank resolution. However, it is not clear whether and why uninsured depositors should have broader backs and should be better placed to bear losses than taxpayers (Avgouleas and Goodhart 2015).

Third, when deposits held by enterprises are wiped out, large segments of private business are wiped out too, creating significant collateral damage (De Grauwe 2013).

Fourth, once a bank's bail-in is triggered, depositors in other weak banks may flee, fearing that the national DGS would not be able to reimburse them in the event of multiple failures (Boccuzzi and De Lisa 2017).

Fifth, large depositors who sense trouble in advance might migrate to other schemes offering higher interest rates (such as money market or investment funds: Avgouleas and Goodhart 2015).

Based on the discussion so far, it might be reasonable, from a policy perspective, to reshape the scope of the bail-in tool.

A comprehensive approach is currently followed under the BRRD, whereas a wide range of liabilities are in principle within the scope of the bail-in tool, and only under exceptional circumstances RAs have the power to exclude certain liabilities from being written-down or converted.

This approach has been criticized, in so far as discretionary case-to-case decisions hinder the appropriate pricing of bail-inable liabilities (Tröger 2018) – whilst the proper pricing of bail-inable liabilities is a pre-condition for market discipline (Tröger 2019).

A targeted approach to bail-in might turn out to be preferable, whereas all brands of deposits were excluded as such and *ex ante* from the scope of the bail-in tool (Boccuzzi and De Lisa 2017; Tröger 2019). Under such an approach, the risk of generalized funding flights to safety would be mitigated. And the proposed exclusion would not amount to a substantial loss of market discipline, given that most depositors are not sophisticated enough to be effective bank monitors.

Since depositors' exclusion from bail-in would eliminate a possible source of resolution financing, additional funding from other sources would be required. This could be achieved through a higher level of write down or conversion applied to other eligible liabilities (provided that the NCWO principle is respected); through enhanced support from the resolution funds; or even through public support, as a last resort.

One might argue, from a civic perspective, that a retail depositor (with – say – 40.000 euros) needs to be better protected and treated different than a corporate depositor (with – say – 300.000 euros or more). But this would still happen, because depositors under 100.000 euros would remain both insured by DGS and excluded from bail-in, while – under the proposed policy option – larger depositors beyond 100.000 euros would only be excluded from bail-in, but would remain uninsured: as a consequence, in the event of a liquidation, they would only be satisfied under national insolvency law.

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