Advocacy coalitions and the lack of deposit insurance in Banking Union

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This paper shows that advocacy coalitions surrounding the establishment of a European Deposit Insurance System lead to spillovers into incompatible areas. Alternative spillovers were to increased public backstops and state aid. Intent to minimize costs, Germany and the Netherlands have pushed for wide-ranging risk reduction measures: that go to the core of financial practices in southern Europe, while Italy has pushed for greater public backstops and state aid within EMU. Unable to break the deadlock in Council, the EU awaits Basel Committee guidance on how to deal with sovereign risk exposures in its 2017–2018 work program.

Keywords: deposit insurance; sovereign risk; Banking Union; EMU; advocacy coalitions

1. Introduction

Banking Union was established as a means of stabilizing the Eurozone after a series of challenges from financial markets from 2010 onward. The strategy was to put an end to the negative feedback, or so-called doom loop in which banking systems and national governments became insolvent and unable to support one another’s existence (Howarth and Quaglia 2013a, 2013, 2016; Leblond 2014; Quaglia and Spendzharova 2017). Enhanced supervision by the European Central Bank would force banks to recognize non-performing loans and write them off, or down, and raise capital to compensate for the losses. It would also ensure that their capital was compliant with European standards in place after the financial crisis. Resolution, as a relatively new tool in Europe after the financial crisis, would ensure that banks could be restructured, sold off, and wound down as an alternative to state aid. And finally, a European Deposit Insurance System (EDIS), headed by a European Deposit Insurance and Resolution Authority (EDIRA), would provide additional funds to compensate ordinary Europeans in the event of a bank closure – funds that could also be used to avert that closure if used wisely, quickly, and prudently.

Of these three mechanisms, supervision has been a relative success, if measured by the establishment of a strong central supervisor for Europe’s systemically important banks (E-SIBs) (Véron 2012; Henning 2015; De Rynck 2016; Epstein and Rhodes 2016a). Modest resolution authority has been established at the Single Resolution Board to coordinate national plans, to advocate the moment of resolution for E-SIBs to the Commission, and to deploy a modest resolution fund paid for by banks (Howarth and Quaglia 2014). Deposit insurance, meanwhile, remains national, subject to more

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robust minimum standards on coverage and payout times since a coordinating directive passed in 2014. There has been no agreement on EDIS, or on the appointment of an EDIRA as a deposit insurance authority like the FDIC in the United States (Gros and Schoenmaker 2014). There has been no want of trying, but a lack of agreement.

This paper focuses on the Italian and German positions over EDIS to demonstrate that advocacy coalitions (Sabatier 1998; Quaglia 2010) have infused discussions about what constitutes proper deposit insurance as well as capital standards and supervision related to differing financial varieties of capitalism (Hall 2014; Gambarotto and Solari 2015; Howarth and Quaglia 2016a). These disputes spillover into institutional mechanisms of oversight, state aid, financial liability, plus the ESM and EMU reform. The fact that each coalition stresses different institutions as a result of their problem definitions makes negotiation over reform (Niemann and Ioannou 2015; Schimmelfennig 2015; Verdun 2015; Epstein and Rhodes 2016b; Jones, Kelemen, and Meunier 2016) difficult and have made agreement elusive (Donnelly 2014; Schild forthcoming).

Advocacy coalitions are politicized groups of countries organized around differences in deep-seated policy preferences and policy-specific proposals for achieving them (including a problem definition, a policy goal, and an articulation of what the government role in achieving it is). In Banking Union, the German and Italian camps differ fundamentally over whether states should adjust to markets (Germany) or vice versa (Italy) – a choice that Schäfer (2016) associates with ordoliberalism for Germany. For Germany in the EDIS debate, in which it is asked to contribute to a common fund, the problem is limiting costs and moral hazard, the goal is to ensure strong resolution and supervision of banks (Single Resolution Mechanism: SRM and Single Supervisory Mechanism: SSM), and the broader public role is to mandate oversight of banks that mirrors its own strong practices. The Netherlands, Austria, Finland, and Spain are allies in this cause. For Italy, the problem is securing a European public backstop that adds resources to those of the Italian state and insurance system, given the fragility of both state and bank finances. The goal is to secure a mutually funded EDIS and European Stability Mechanism (ESM), while the broader public role is to provide national state aid where required in the absence of European institutions. France and southern Europe outside of Spain are allies in this cause.

Disagreement was driven less about other distributional issues, such as the ex post or ex ante funding provisions of national systems (a gradual shift to ex ante, pre-crisis funded systems had already been agreed in a 2014 EU Directive on minimum standards) and an EDIS per se, than about the economic fragility of some countries’ financial systems and the governments to which they were attached. Focus was directed at assets and liabilities – particularly non-performing loans (NPLs) and assets of national governments, the latter of which are treated by law as having a zero default risk, despite empirical evidence to the contrary (European Systemic Risk Board 2015).

Commission persistence on creating a mutualized EDIS, or mandating borrowing and reinsurance between national systems, therefore focused coalition debates over how to manage the risk of bank insolvency. The German-led answer was to impose adjustment costs on banks and investors through new supervision and capital adequacy rules, while the Italian-led response was to shore up banks with common public backstops. Commission’s proposals leaned in the Italian direction until November 2016, when it conceded to German demands for risk-reduction measures in the Bank Reform Package. The two coalitions remain too far apart for agreement, however.
This paper examines the motivations for Germany, Italy and their respective allies to reject agreement over EDIS, either outright, or by setting conditions that the other side is sure to reject. Germany has responded with demands for minimizing the size of mutual funds, maximizing ex ante funding, introducing new capital rules, and expanding ECB supervision to ensure that southern European banks hold fewer state treasuries from their respective national governments. Italy has pushed for pretty much the opposite: maximized mutualization, minimized ex ante funding, and continuity in banks holding state debt as a core, “secure” asset. The two coalitions are focused on different institutions as well as problems, which makes negotiation and compromise difficult. The strength of this dispute is underlined by the failure of compromise proposals from the ECB and Commission to gain traction.

The rest of this paper is structured as follows. Section 2 provides background into the key mechanisms of EDIS that were designed to strengthen resilience in the European banking sector, and outlines gaps in the existing architecture. It also reviews the literature on why the institutions of banking union developed as they did. Sections 3 and 4 examine the Germany and Italy at the center of two advocacy coalitions on EDIS and related issues, respectively. Section 5 adds the influence of EU institutions. Section 6 concludes.

2. European deposit insurance: function, features, and gaps
Deposit insurance plays an essential role in providing financial stability when a bank is no longer solvent. It acts to prevent bank failures in a number of ways (Baglioni 2016; Howarth and Quaglia 2018). In its most commonly understood role, it provides consumer protection up to certain limits for depositors when a bank is forced to close due to insolvency. In another role, it prevents financial contagion between interdependent banks by softening the ripple effect of a single bank’s collapse on other banks. Through reimbursing deposits of many customers, the likely impact of one bank’s insolvency leading to further ones is contained and minimized. In yet another role, it prevents bank runs as self-fulfilling prophesies. In this context, deposit insurance is designed to contain the number of bank customers demanding payout of their deposits in full because they either fear the bank is already insolvent and close to closure (whether they are sure or not); or more urgently, because they fear other depositors fear the same, and must demand their deposits before the money runs out (irrespectively of whether they view the bank’s finances as sound or not). This latter function applies not only to individual banks, but to the entire banking system, since a self-fulfilling bank failure can easily be replicated system-wide in the absence of insurance, so that general financial crisis results. Finally, reimbursement of deposits fulfills the function of general macroeconomic stabilization during credit events. Deposit insurance, to the extent that it replaces lost deposits during an insolvency, prevents the supply of money and credit from declining as a result of bank failure. And to the extent that banks pay insurance premiums into a fund before a crisis (ex ante), the release of funds plays an important countercyclical function by diminishing the money supply to the economy during fat times and increasing it during lean ones.

In the aftermath of the Great Financial Crisis of 2007–2009, practical experience followed up with deliberate international policy learning concluded that a number of features were essential to a good deposit insurance if it were to fulfill these functions. A great deal of this process was supported by the International Association of Deposit Insurers (IADI), which itself is supported by the Bank for International Settlements in Basel, and since 2013 includes interaction with academics, industry associations, and
non-DI institutions like central banks and financial stability boards, plus non-state policy-makers like the European Commission. Insurance should cover most depositors, and a significant degree of their deposits, without making the coverage unlimited. This would ensure that no large groups of depositors remained that could drive a process of bank runs and general economic decline. In determining what the coverage ceiling should be, many participants agreed that the benefits of DI should be capped in a way that “rich” depositors would devote the resources to monitor bank behavior and demand changes if required to avoid losing their assets. Payments to depositors would have to be quick, simple, easy to understand and well communicated if they were to both prevent financial problems and support general depositor confidence. Finally, it was also agreed that while deposit insurance would ideally be paid in advance by banks themselves (thereby minimizing the likelihood of states becoming insolvent as they tried to prevent expensive collapses, which was at the heart of the doom loop driving the Eurozone crisis), that public backstops – the provision of public funds to a deposit insurance system that had exhausted its reserves – would be necessary in any systemic crisis involving a number of banks (Mayes 2014). Agreement was easy on harmonization but a backstop created linkages that the coalitions fought over.

In the EU, these insights translated into Commission proposals in 2010, 2012, 2014, and 2015 for a European Deposit Insurance System, and in parallel, improvements to national systems in line with IADI standards. The latter were successful, culminating in the Deposit Guarantee Systems Directive (DGSD: Directive 2014/49/EU) of 2014. Standard minimum coverage rose from 20 000 euros to 100 000, and reimbursement times would be reduced to 20 days by December 2018, 15 days by December 2020, and 7 days in 2024. Commission proposals for a mutualized EDIS in 2015 and 2017 stalled. Why?

The main points of the 2015 proposal were plans for the phase-in of a fully mutualized deposit insurance fund, which could make payments anywhere in the Banking Union area. Phase 1 would be mandatory reinsurance: national deposit insurance systems would pay into a common fund based on premiums calibrated to the risk of default among national banks, to be used if national systems had been depleted. Phase 2 would be mandatory lending between national DI systems: if a national system had depleted its mandatory funds (covering 0.8% of covered deposits), other national systems would be required to lend up to an additional 0.5%, increasing available liquidity. The management of funds would remain national, however. Phase 3 would be a fully mutualized fund (European Commission 2016b). In addition to these funding proposals, the Commission considered EDIS to be a tool that could be used during restructuring, reorganization and sale of bank assets during a resolution process as a supplement to national resolution funds, and the Single Resolution Fund (SRF) of the EU’s Banking Union.

But proposals for two truly European institutions, an EDIRA and a common fund, encountered resistance both in the Council (especially from Germany and Italy on opposing sides) and then in the European Parliament. The next sections test the argument that advocacy coalitions more than expertise or drive debates about EDIS. Core attitudes toward state-market relations, the necessity or depravity of state aid and public backstops to the banking system followed by arguments about institutional design are visible, with grave consequences for the likelihood of agreement. Although economic implications of adjustment are strong, belief structures show how conflict spreads – where and how – into supervision, resolution, state-bank relations, and even the European Stability Mechanism – far beyond the immediate debate.
3. Germany

The German position on deposit insurance for the Eurozone was significantly influenced by policy ideas for institutions that could lead to prudent management or moral hazard. Distributional implications followed as a consequence and could not be sensibly divorced from the calculation. But proposals to minimize economic costs to Germany and others have not budged the coalition’s insistence on risk-reducing rules and institutions.

Chronologically, the first line of objection to a common EDIS from 2010 is found in the philosophy behind the institutional nature of the German DIS, and the effect institutions are thought to have on the willingness of bankers to take unnecessary risks (whether in lending, borrowing, or exposing themselves to other financial liabilities, including providing insurance for other banks). The German banks have institutional insurance that primarily intends to keep banks from getting into trouble in the first place, and preventing them from closing if they unexpectedly do. Banks take part in an institutional insurance system with similar institutions that provides financial assistance in the case of insolvency, or often prior to it. The emphasis is on preventing bank failure, not reacting to it. Depositors are thus insured indirectly. In addition to premiums, other member banks can be held liable for shortfalls in the insurance fund. There are two additional features holding the financial end of the system together to prevent contagion: reinsurance of the insurance fund; and ultimately public backstops, particularly by local and regional governments (for local public-sector savings banks – Sparkassen and state Landesbanken, respectively). Private cooperatives and large banks have their own systems alongside the public one.

Because the banks and, where applicable local authorities, are ultimately liable for losses through the fund, submitting to supervision by peers is an integral component of the institutional insurance system (Bernet and Walter 2009). Risky behavior is first discouraged with higher insurance premiums, or even prohibited if the peer supervisors rule that loans and investments are hazardous to the institution’s health. Peer supervision does not replace national authorities, but keeps supervision as close to the bank as possible.

With the exception of state-owned Landesbanken (Deo et al. 2015), the system has performed well. Sparkassen, cooperatives, and large banks have been vocal political advocates of keeping the system intact, and attacking EDIS as inferior for lack of supervision and commitment to institutional continuity. Riskier banks would fail more frequently, conservative banks would subsidize risk-taking institutions, and rich national systems subsidize poor ones (DSGV). Sparkassen particularly remained unwilling to share money with anyone not using their own model, replicating their own conservatism.

This insistence on risk reduction through peer control has implications for German demands on risk reduction in other national systems, and explains the wide-ranging extension of German demands into supervision and capital adequacy issues. The tenacity of those concerns was underlined when the Commission amplified them in 2015. In an attempt to get the German Government to support a mutualized EDIS, it proposed that the EU agree to phase in mutualization and maintained that the proposals could be passed into EU law with a qualified majority vote. This attempt at speeding up legislation and threatening circumvention of Germany’s objections backfired, leading the German Government to insist on new preconditions for EDIS talks, which the Council adopted in 2016.
The German Government’s position on EDIS from 2015 onward ruled out agreement, but in demanding preconditions for talks. Government spokesperson Seibert underlined in December 2015 that Germany had “made its rejection clear regarding proposals for European deposit insurance, and that it would continue to do so”. In contrast, Finance Minister Schäuble viewed the proposal of the Commission, promoted by Luxembourg’s Presidency of the EU, as flawed and only open to debate after a number of preconditions had been fulfilled. He indicated having attempted to convince the Commission to write these conditions into its proposals in October 2015, before their release in December, but to no avail (Orlowski 2015). On 27 April 2016, Chancellor Merkel herself publicly assured the Sparkassen at their own annual meeting that “the time has not yet come [for EDIS]. Attention must be paid, not to mutualizing risks, but reducing risks first”. Her speech made it clear that there were many weak banks in Europe and that they and governments still had a great deal of homework to do (Bundesregierung 2016).

By 17 June 2016, the German Government prevailed in moving the Council to adopt extensive pre-conditions for EDIS negotiations in line with Schäuble’s previous announcement. A key victory for Schäuble was “a substantial reduction of risk in the banking sector” (Reuters 2016). The Council’s list included a review of the levels of capital banks must hold that can be bailed in (total loss-absorbing capacity: TLAC and a minimum requirement for own funds and eligible liabilities: MREL); implementing Basel Committee restrictions on bank borrowing (leverage ratio and net stable funding ratio); a (minimum) harmonization of insolvency law to hasten the write-off of non-performing loans (NPLs) held on bank balance sheets; and a re-evaluation of sovereign risk weights in bank capital. Southern European banks invested heavily in treasuries of their home countries could no longer be considered fully safe since the Eurozone crisis of 2011–2012. The Council could not agree on a solution, or to task the Commission with a proposal, but agreed to wait until the Basel Committee had made a recommendation to resolve this last dispute (European Council 2016b). The Committee was slated to do so at some point during its 2017–2018 work schedule (Basel Committee 2017). However, in a 2014 BIS review of EU compliance with its standards, the Bank concluded that EU rules allowed banks to value sovereign exposures internally, which meant that they were typically rated as having zero risk, which was materially untrue and needed to be changed (Basel Committee 2014, 20).

Another well-articulated German concern prior to this debate had made its way into the Macroeconomic Imbalances Procedure after 2011: there was a large gap between banks in Germany and those in other countries with regard to the level and conditions of mortgage lending. The result was that German households had to save for a substantial down payment on a house purchase of at least 20%, which kept real estate bubbles contained, while Spain, for example, had lent mortgages in excess of property values, without down payments, and without constraining links to income, which it blamed for the bubble of the 2000s and the crash that followed (Buti and Carnot 2012). Given this larger exposure and greater financial and economic fragility, Schäuble outlined that national governments would also have to demonstrate that they were ready to impose costs for closing a bank on private investors first, before deploying deposit insurance, in line with the newly in force BRRD. This meant that insurance systems would have a lighter load to carry during a credit event. At the very least, all governments would have to adopt the rules before talks could begin.

Germany’s second specific condition was that the Deposit Insurance Fund be the subject of an Intergovernmental Agreement like the Single Resolution Fund, a demand
that the Council agreed to (European Council 2016b). Releasing money from the fund would therefore require unanimity, and provide Germany and others with veto powers. This demand was in contrast to Commission proposals to decide on the establishment of the fund and its gradual mutualization by qualified majority vote (Reuters 2016).

4. Italy

Italy’s core beliefs, found also in French ideas for banking union, rest on the state sector shaping the market, establishing common European institutions to do this (ESM and EDIS), and preserving room for national state aid as a (traditional) alternative. Italy’s main focus on EDIS has consistently been on the mutualization of contributions. For the government, this meant providing a more robust financial backstop to the Italian deposit insurance system than the national system. Within the country, the continuing and increasing weakness of regional and cooperative banks has kept successive governments preoccupied with keeping them alive as long as possible, followed by the transfer of accounts and assets to one of the country’s large commercial banks, then protecting retail bondholders from the effects of a mandatory bail-in through forms of state aid that bend European rules (Deeg 2012; Deeg and Donnelly 2016), and finally, in 2017, by decisions to defy state aid rules altogether (Donnelly 2018). In this process of ensuring bank continuity and when that proves impossible, protecting depositors at any cost, deposit insurance can be seen as a tool within the government and central bank’s toolkit – one that does not appear to be intended to fulfill the functions of deposit insurance on its own. It therefore continues to rely on an assumption of state aid.

A new focus in light of German demands to link insurance with risk reduction has been to defend relatively high bank holdings of Italian state treasuries. The Italian deposit insurance system at the outbreak of the Great Financial Crisis was the most generous of all European systems, covering up to 100 000 euros per depositor, based in two systems, one for cooperatives and another for larger banks. It is an ex ante for the larger banks but at half the level (0.4%) proposed for EDIS, and is primarily used to resolve (transfer of assets) or restructure a bank (Pistelli 1999, 43–46). This enables the flexible, early and generous use of public funds for providing financial assistance to insolvent banks, before they are closed down, often in combination with additional incentives to the banks that take over parts of the defunct competition. Since January 2016, however, such state aid is illegal without bail-ins of private investors, though Italy stands out as a country that has used in anyway.

Supervision in Italy is of lesser importance at all levels than providing room to manage problems with discretion. Unlike the German system, banks are not in any further way collectively and individually responsible for the losses of another. It is therefore unsurprising that peer supervision along a German model is absent. However, the dubious quality of supervision by the Bank of Italy and the Ministry of Economics and Finance, in the interest of ensuring bank continuity for as long as possible, even if that means ignoring problems, means that banks have been under less pressure than they might otherwise have been to restore their balance sheets after 2008. The effects are visible in that half of all ECB Asset Quality Review failures in 2014 were Italian, revealing specific problems that were unknown to the IMF as recently as 2013. The IMF had pointed out general problems with the robustness of Italian supervision, however, at the Ministry for Economic Affairs, the Bank of Italy and the securities regulator. (International Monetary Fund 2013, 9).
The Italian state appears to have a preference for getting around the official rules for an ex ante funding system by banks themselves, by allowing the state to provide advances to the system fund in case of extraordinary stress on the financial system, or simply to save an insolvent bank. Indeed, the Italian Government has found itself very willing to apply to the Commission to approve state aid and advances to private systems, with the argument that the Italian economy is in a general state of economic distress. This extends beyond moments in which the Italian state was effectively cut off from financial markets (2011–2012, for example), to effectively cover any time at all, given the flat economic growth levels, and a high level of non-performing loans within banks that make them nearly or imminently insolvent, without access to interbank lending markets to keep them afloat (European Central Bank 2016).

This state view of deposit insurance as part of a larger toolkit that channels state aid to depositors ex post rather than controlling risks ex ante, runs against the spirit and sometimes the rules of the BRRD, and indicates that the Italian Government is far from accepting German demands on EDIS, much less the BRRD itself. This has been seen in negotiations over state aid and resolution in the cases of Banca Marche, Banca Etruria, Cariferrara, and CariChiete in 2015, Monte dei Paschi (BMPS) in 2016, and Intesa’s supported takeover of Veneto Banca and Banco Popolare di Vicenza in 2017. In all of these cases, the state found ways to reimburse bank customers who held subordinated debt instead of retail deposits, that the deposit insurance system didn’t cover, and which the BRRD insisted on wiping out first before deposit insurance could be deployed (Barnabei and Za 2015; Politi and Sanderson 2015; Fitch Ratings 2016). In the BMPS case, the state made deals with the Commission to allow such payments in the case of mis-selling (Romano 2016). But World Bank research reveals that Italian banks have relied heavily on such finance for a long time, to avoid depending on others (World Bank Group 2016). This suggests a useful scapegoat and legal loophole. Further legal-financial acrobatics in the MPS and later cases involved converting junior debt to senior debt with state assistance. Merler (2016) argues that the Italian state would simply prefer to have EU rules that allow unlimited public backstops to deposit insurance and a flexible interpretation of what is covered. Open defiance of the resolution rules to ensure that public expectations of large and dependable public deposit insurance backstops are available underlines the poor prospects for breaking the doom loop in Italy or agreeing with Germany over core beliefs or policy proposals. An EDIS is very welcome to supplement Italian resources financially, however.

There are also capital adequacy practices related to supervision (based on the risk associated with certain financial practices) as well as deposit insurance on which the Italian banks and government have firm opinions. The first of these are the use of Italian treasury bills as safe assets by Italian banks. This is a common practice worldwide, and approved by international regulators and their guidelines on financial stability as a safe, interest-bearing asset within banks’ portfolios. The IMF reveals that bank exposure to sovereign debt in Italy is about 9% of assets, which is comparatively high (International Monetary Fund 2013, 20). Although banks proved more independent after privatization in the 1990s, the state still pressures them if necessary to purchase and hold these bonds, in return for explicit or implicit state guarantee of the bank in time of financial distress (Deeg 2005).

Normally a source of mutual stability between banks and the state, the investment strike on Italian treasuries in 2011 turned it into instability, meaning that banks had to raise capital to compensate for the decline in value of these assets. They further suffered a withdrawal of foreign deposits (International Monetary Fund 2013, 12–13) and
an austerity-induced decline in repayment of other debts leading to rising NPLs) from the country’s small- and medium-sized enterprises (International Monetary Fund 2013, 21). Time was bought by ECB loan programs (Long-Term Refinancing Operations), announcements (Outright Monetary Transactions), and the establishment of the European Stability Mechanism, but NPLs remain an enormous drag on Italian banks that cannot be tackled without further economic decline.

While this weakens the credibility of states arguing to keep sovereign risk weights at zero, a consequence for Banking Union and for EDIS is that Italian treasury bills became less secure assets, without a clear national substitute (German Bunds as alternatives, for example), a realistic means to diversify without inciting a collapse in the value of their remaining Italian bonds, an alternative to further purchases that would not push the Italian state into insolvency, or an alternative lender of last resort in time of financial distress. In other words, the historical legacies of state-bank links in Italy make a significant transformation difficult, if not impossible (Quaglia and Royo 2015).

Both government and Bank of Italy are clear that the main answer to sovereign risk lies in stabilizing EMU rather than forcing banks to dump treasuries. The Renzi government pursued this line in talks with Germany, France and the Commission designed to allow for more social spending and economic recovery (Bastasin 2014). Meanwhile the Banca d’Italia underlined in summer 2016 that sovereign risk reduction had already been provided for in response to German demands: through developing the European Semester and Macroeconomic Imbalances Procedure in 2011–2012 (Balassone et al. 2016, 42–43), and that further measures would be unreasonably difficult (Lanotte et al. 2016).

5. **EU institutions: compromise attempts and leniency**

In contrast to its proposal of December 2015, the Commission’s subsequent work followed the German lead to sequence supervision and capital standards before a mutual fund for EDIS. The Commission introduced a Banking Reform Package on 23 November 2016. The risk reduction measures stressed included: more risk-sensitive capital requirements; a binding Leverage Ratio (LR) to prevent institutions from excessive borrowing; a binding Net Stable Funding Ratio (NSFR) to further limit excessive reliance on short-term wholesale funding and to reduce long-term funding risk; and a requirement for Global Systemically Important Institutions (G-SIIs) to hold higher minimum levels of capital and other instruments which bear losses in resolution (European Commission 2016a). In line with this new movement toward reduced reliance on EDIS funds, The European Banking Authority advocated on 14 December 2016 an increase in the volume of instruments that could be bailed in during a resolution, thereby averting a bail-out with public funds, in line with German demands (European Banking Authority 2016).

In the European Parliament, meanwhile, in March 2016, the economic affairs committee rapporteur, Conservative Dutch MEP Esther de Lange (Christian Democratic Appeal), floated a proposal that mimicked German demands, going even further. She had both institutional and distributional demands. This included dominance of national funds in the Single Resolution Fund (SRF): with 50% of contributions deployable within national compartments only (making cross-national subsidization impossible), 25% a risk-based sub-fund (in which the “safer” countries would pay less and the “riskier” countries would pay more, based on the polluter pays principle), and 25% in a joint-risk fund (European Parliament 2016; Kröner 2016).
De Lange’s proposal also supported German and Dutch calls for the Fund to be built on a Council discussion from January 2016 in which risk reduction in the banking sector would be a pre-condition of discussing EDIS, and the fund in particular. The De Lange proposal also explicitly named the possibility that any negotiations and legal structures on EDIS emanating from those talks would be based on an Intergovernmental Agreement (IGA) outside EU law of the type used in the SRF (Asimakopoulos 2018).

But Commission leniency in June 2017 on the terms of state aid for two troubled cooperatives underlined that the Italian intent to keep banks afloat without bailing in bond holders in defiance of EU law remained as firm as ever, and that the Commission was unwilling to enforce resolution as laid out in the Bank Recovery and Resolution Directive (BRRD). By allowing the Italian government to provide Intesa with 5 billion euros to take over good parts of Veneto Banca and Banca Popolare di Vicenza (V&V), plus another 12 billion to ensure that V&V bondholding depositors would not feel the pinch of resolution, the Commission chose immediate support for interventionist government and local financial stability over the prospect of upholding EU law and the hope of an EDIS deal in the Council.

For its part, a February 2017 working paper from an official at the ECB, working through the European Systemic Risk Board, sought a solution to this division in the form of hybrid securities known as European Safe Assets. He found that it was essential for financial stability to ensure that there was an ample supply of eurozone sovereign debt that provided a safe asset for the banking sector. This not only meant that there had to be a more reliable means of identifying safety than the status quo, but that there would have to be some mechanism for ensuring it. And for this reason it proposed a compromise between leaving sovereign bonds rated at zero risk and having all of them compromised, which would unleash financial devastation in southern Europe.

In the absence of any mutualization of financial obligations through common treasury bills (Eurobonds), national treasury bills could be divided into senior and subordinated debt, and turned into ESAs as synthetic Eurobonds (securitizations) comprised of senior safe assets and junior risky ones, based on a portfolio of national bonds. This would service cyclical stabilization requirements and provide additional borrowing capacity (Brunnermeier et al. 2016; Van Riet 2017). While the ECB generally proved to be tougher on banks than the Commission, it also showed a willingness to be flexible in its approach given an architecture unable to provide sufficient public backstops to weaker links in the system. It suggested that in the absence of a mutualized fiscal capacity for the EU and continued fragility, the ECB could continue to absorb safe assets into its balance sheet without significant risk (Coeuré 2017). In this context, the Commission proposed a Sovereign Bond-Backed Securities program on 31 May 2017 that it wanted discussed in 2018, after Council talks about EDIS.

While the SBBS proposal does not touch on German demands for risk reduction through institutional changes, the Bank Reform Package (pending) does. But reassurances to Germany are weakened by further proposals to use the ESM to provide lines of credit to sovereigns (reflecting French and Italian proposals) (European Commission 2017a), and to use the EDIS fund to insure banks provided they had passed an Asset Quality Review by the ECB (European Commission 2017b).

These proposals from the various institutions have not yet relieved the impasse in intergovernmental bargaining over ramping up movement on sovereign risk weights as a pre-condition of discussing a common backstop to EDIS. At the same time, intergovernmental talks were unable to effect other increases in capital requirements. European
rules on capital standards do not have authoritative ways of dealing with sovereign risk. While Germany, the SRB and the ESM push for banks and regulators to have to consider the risk of default for government bonds on bank balance sheets (Lenarcic, Mevis, and Siklos 2016), France and southern European governments, and Italy in particular, remain reluctant to do so for fear of re-initiating the Eurozone crisis that banking union was supposed to put an end to (Guarascio and Jones 2016). The EU Council postponed a decision on whether sovereign bonds should be rated as having a zero risk of default until the Basel Committee recommends in 2018 (Quijones 2016).

6. Conclusion

A mutualized European Deposit Insurance System (EDIS) for the Eurozone was designed to provide a critical public backstop for financial stability that has proven elusive. Why? The Commission has largely followed international state of the art policy learning in making its proposals, but had difficulty promoting agreement between two competing advocacy coalitions, whose positions are entrenched beyond mere distributional gains. An ordoliberal camp led by Germany seeks to reduce the risk of default (and the need for deposit insurance to be used) by promoting a series of new regulations on capital standards, strengthened supervision, and robust resolution of insolvent banks, particularly by bailing in private creditors. An embedded liberal camp (Ruggie 1982) involving Italy and France sees cushioning default with public money as essential and desirable, both to preserve local financial stability in an open international environment and consumer protection (Cerrone 2018). Their differing understanding of the broader public policy issue at hand led them to understand completely different things regarding how EDIS fits into the bigger picture of financial stability, and as a consequence, which institutions had to be developed next and policies carried out (Mayes 2018).

Each camp’s demands clash at the basic level of whether states must adjust to markets, or vice versa. They then move on to policy ideas that move in directions that are difficult to find common ground on. Since the German camp sees bank failure as the consequence of poor bank management and sloppy oversight, it links prospects for a mutualized EDIS on limited funds, plus new capital adequacy standards, stronger supervision, stringent resolution proceedings, and harmonization of insolvency law to reduce risk of default. In contrast, since the Italian camp sees bank failure as a something that can happen in the context of general economic fragility, it not only supports full mutualization of EDIS, but further measures that embed deposit insurance in a broader set of public backstops and automatic stabilizers, (so the expansion of the ESM as a backstop to EDIS), strengthened by French proposals in 2017 for EMU reform. Italy is a pace-setter on willingness to take further steps by also providing generous state aid to banks and consumers, either in accordance with EU law, in negotiation with the Commission or in face of it, as seen in Intesa’s subsidized takeover of V&V. The poor traction to date of Commission and ESRB proposals that would provide a win–win solution for both camps (reducing risk without shrinking banks and economies) merely underlines the continued and principled polarization of the two camps.

Germany and Italy were examined as countries representing the biggest challenges in finding an agreement on deposit insurance. Commission proposals ran up against two complaints by member states in the Council. Germany, and like-minded countries, demanded a link between deposit insurance and more stringent capital regulations and
stronger supervision for banks. This demand effectively meant that banks in southern Europe shed their holdings of (national) state treasury bills before they will consider sharing risk and financial liability.

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