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Interbank Deposit Protection Fund

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Abstract

Depositor preference has come under the spotlight in recent times, given the still on-going financial regulatory reforms in the European Union(EU). It refers to the preferential treatment granted to depositors such that their claims are paid in full before those of general unsecured creditors.

This paper aims to analyse the various criteria to rank depositors in the creditors' hierarchy where insolvency proceedings involve a bank licensed in an EU Member State. Analysis has been extended to all countries participating in the European Forum of Deposit Insurers (EFDI).

After briefly outlining the legislative drafts currently under discussion at the European Parliament, the paper focuses on an overview of the current practices on depositor preference, based on a survey circulated by the Interbank Deposit Protection Fund (FITD) among EFDI members in October-November 2012. Information gathered shows how current practices vary significantly between the two main samples of countries considered in the analysis. A depositor preference regime is more commonly applied in non EU countries and, within the EU, euro member countries show a percentage of application lower than the average. Notwithstanding this, reforms currently underway (or recently adopted) in some EU member States show a trend to incorporate depositor preference.

Later on, pros and cons of depositor preference application are analysed and weighted, also considering the implications of the bail-in tool and the role of the deposit guarantee scheme (DGS), which is not a creditor of the bank in resolution but a loss absorber. The Bank Recovery and Resolution (BRR) draft directive explicitly requires that the deposit guarantee schemes rank pari passu with unsecured non-preferred claims to provide sufficient funding to the resolution process. This raises concerns about the DGS role in resolution and the possibility that its resources are depleted for future interventions and pose the need for appropriate safeguards.

Depositor privilege seems to be preferable from a DGS perspective, since it decreases the amount to be paid (in cash) in resolution and, in so doing, lowers the risk of depleting its resources. But differences across jurisdictions in the use of depositor preference could have a negative impact on bank funding and borrowing and on the effectiveness of cross-border resolutions, also affecting the cost of DGS insurance.

Harmonisation (at least a certain degree of it) seems to be a viable approach to avoid such matters, but there are significant difficulties. The role of DGS in resolution is one of the crucial areas where concerns prevent reaching an agreement on the draft directive among countries and discussion are still underway at an EU Council level.

DISCLAIMER: the views expressed in this working paper are those of the authors and not necessarily the views of the Fund.

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Introduction

This paper aims to analyse the various criteria to rank depositors in the creditors' hierarchy where insolvency proceedings involve a bank licensed in an European Union Member State, in light of the recent financial regulatory reforms. The analysis has been extended beyond the EU to a number of countries in the European Area.

Previously, the issue of depositor preference has been investigated from an international perspective, highlighting the experiences of a heterogeneous set of countries around the world, where different preferential regimes have been enforced for decades (as in the USA). In Europe, the recent financial crisis and the subsequent regulatory reforms have opened the debate on the issue, which is now under the spotlight. As far as we know, this is the first paper based on data collected on the matter of depositor preference from a comprehensive set of countries including all EU members and a significant number of other European area countries.

Following last June's legislative proposal for an EU-wide framework for the recovery and resolution of banks, the international debate has recently focused on how to rank depositors in resolution. Opinions are basically in line with the "no worse-off principle", according to which no creditors should be worse-off in a resolution than they would be in liquidation. The European Commission (EC) seems to be seeking harmonisation of the ranking of depositors in the creditors' hierarchy on such a basis.

The paper is organised as follows. Chapter 1 will briefly outline the background and the legislative drafts presented by the EC that are currently under discussion at the European Parliament (EP). Chapter 2 will provide an overview of the current practices on depositor preference, based on a survey circulated by the Interbank Deposit Protection Fund among EFDI members[1] in October-November 2012. Chapter 3 will analyse and weigh the pros and cons of depositor preference application, in light of the ongoing financial regulatory reforms in the EU, and consider the implications of the bail-in tool and the role of the deposit guarantee scheme. Finally, conclusions will summarise the main outcome of the research. It will also highlight the importance of a harmonised approach in the treatment of depositors, should a bank (especially cross-border) be involved in a crisis requiring either liquidation proceedings or resolution measures.

[1] Deposit guarantee schemes participating in EFDI are 57. They represent 44 countries of the European Area, including the 27 EU Member States.

1. The legislative proposals on DGS, recovery and resolution and Banking Union: implications on a deposit guarantee scheme

Since the onset of the financial crisis, authorities all around the world have been challenged in their capacity to manage banking crises, especially in highly integrated and interconnected markets. As a consequence of that, difficulties in one country can rapidly spread to other markets and involve financial institutions operating there causing a progressive collapse of confidence. In fact, interconnectedness enables the fast transmission of both positive and negative shocks across economies through multiple channels.

Given its severe and global features, the financial crisis demanded global solutions through determined and innovative actions by central banks and governments around the world. Central banks adopted non-standard and unconventional measures. Governments extended existing guarantees or introduced new forms of guarantees to shield their financial systems, as far as possible, from the effects of contagion. Eventually many troubled banks were bailed-out, causing a significant burden on public finances. Then the crisis produced massive repercussions on the real economy and spread from the banking systems to sovereign debts.

As a result of all of these factors, financial stability has become a top priority on the global policy agenda along with economic growth and public debt sustainability. This is why regulators have been working since the onset of the crisis to underpin financial stability and restore confidence through a demanding set of financial reforms. Special attention has been given to the urgent need to improve resolution regimes, as required by the G20 at an international level and stressed by the Financial Stability Board (FSB) in its "Key Attributes of Effective Resolution Regimes for Financial Institutions" (KAs)[2] in November 2011 and in the peer review recently launched on the matter[3]. As part of the implementation of

[2] The Key Attributes set out the core elements that the FSB considers to be necessary for an effective resolution regime and to allow, once implemented, the orderly resolution of financial institutions without massive repercussions on financial stability. They consist of a set of twelve essential features that should be part of the resolution regimes of all jurisdictions, relating to: scope; resolution authority; resolution powers; set-off, netting, collateralisation, segregation of client assets; safeguards; funding of firms in resolution; legal framework conditions for cross-border cooperation; Crisis Management Groups (CMG); institution-specific cross-border cooperation agreements; resolvability assessments; recovery and resolution planning; access to information and information sharing.

[3] The thematic peer review of resolution regimes was launched by the FSB on 3 August 2012 asking for feedback by 28 September 2012. The aim of the consultation was to evaluate FSB member jurisdictions' existing resolution regimes and any planned changes to those regimes using the KAs as a benchmark. The FSB published its report in April 2013.

the KAs, concrete resolution strategies are in the process of being designed and developed around the world. This is especially needed for the G-SIFIs (global - sistemically important financial institutions), to ensure an orderly failure without exposing public funds to loss, producing financial instability and disruption to critical functions that the sudden insolvency of a G-SIFI would otherwise cause.

In the European Union, extensive work is underway to reinforce the existing framework on financial regulation and supervision. Significant improvements have been achieved since the outburst of the crisis in 2008. The financial reform agenda of the European Commission aims at fulfilling the commitments made in the G20 in response to the financial crisis and at fostering stability, competitiveness and resilience of financial institutions and markets in the EU.
To this extent, there are a number of legislations being scrutinised at the moment: (i) the Basel III accord, to strengthen requirements on banks' capital and liquidity structures, along with the relevant amendments to the Credit Requirements Directive (CRD) which should be shortly approved[4]; (ii) the proposed new directive on DGS[5]; and, (iii) the EU-wide common framework for bank recovery and resolution[6], which is particularly crucial as demonstrated by the global financial crisis. This comprehensive framework will provide authorities with a common set of powers, tools and measures and allow them to resolve failing financial institutions effectively without destabilising the financial system, or exposing taxpayers to the risk of loss from solvency support. A crisis management and resolution system built on a sure, agreed legal foundation is essential to an approach that can reduce systemic risk and thus the moral hazard generated by large banks.

Finally, the EC recently presented its legislative proposals for a common bank supervision in Europe[7], the so called Single Supervisory Mechanism (SSM), where

[4] An agreement has been recently reached on the CRD package between EU Council and Parliament and a compromise text adopted on 27 March 2013. The new rules will apply from 1 January 2014 if publication takes place in the Official Journal by 30 June 2013.

5 The legislative proposal was presented by the EC on 12th July 2010 and the text is currently being examined by the Council and the European Parliament in second reading.

[6] The draft directive establishing an EU-wide framework for the recovery and resolution of credit institutions and investment firms (BRR directive) was presented by the EC on 6th June 2012 and is now being discussed by the European Parliament. As declared at its last meeting on 13th -14th December 2012, the EU Council is urging the legislators to speed up the process and agree on the proposed directives relating to both DGS and bank recovery and resolution in the first half of 2013. In its meeting in March 2013, the Council expressed its aim at reaching an agreement on both the BRR and DGS directives before June 2013. Also, the Commission intends to submit by summer 2013 a legislative proposal on a Single Resolution Mechanism for countries participating in the Single Supervisory Mechanism.

[7] On 12th September 2012 the EC presented its proposals to design a single supervisory mechanism for banks in the euro area, which is the core element of a banking union. Once achieved, a banking union would allow to break the link between Members States and their banks, restore the credibility of the financial sector, preserve tax payers' money and make sure that banks serve society and the real economy by improving financial markets' effectiveness, integrity and transparency. Views expressed

the European Central Bank (ECB) is given the ultimate responsibility for supervisory tasks related to the financial stability of all Euro area banks. This is deemed as an important anti-crisis measure and should be finalised in the first part of 2013 in order to enter into force as planned. The reform will change the way such banks are supervised to a significant extent. In the Commission's views, this is an important first step towards a genuine banking union composed of three major pillars: a single bank supervisor, a common bank crisis management and resolution system and a strengthened system for protecting depositors' savings. All these components are to be supplemented by a forth pillar, a single rulebook for financial institutions in the single market[8], which provides a common foundation to the banking union and is needed for the stability and the integrity of the internal market in financial services.

Given this background, it is worth noting how the current EU financial reforms give rise to a number of implications involving deposit guarantee scheme roles and function in the safety-net. First of all there is the proposal concerning the revised directive on DGS, which will put forward great changes to the existing systems and a higher degree of harmonisation. Second, the proposed regulation on bank recovery and resolution, where DGSs are involved in the resolution process, whether they are given the role of financing arrangements under the resolution framework or not. Finally, the designed banking union has one of its main pillars in a strengthened system for protecting deposits, with a foreseen future shift to a single deposit guarantee system.

The protection of depositors in liquidation is an area of bank reform that has attracted increasing interest since the onset of the financial crisis. As a result, this has drawn attention to the issue of depositors' (and DGS's) ranking in the creditors hierarchy in the event a bank is put under liquidation proceedings.

A depositor preference regime, when provided for in the national insolvency law, normally applies in liquidation proceedings, giving depositors a higher ranking in the creditors' hierarchy than they would have otherwise enjoyed. Depositor

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by the Council in its March 2013 meeting is that "concluding the legislative process on the SSM within the coming weeks is a priority". On 19 March 2013 the Irish Presidency of the Council reached a provisional agreement with the EP, which will now have to be endorsed by all Member States, with possible some final technical revisions to the text.

[8] In June 2009 the European Council unanimously recommended the establishment of a single rulebook applicable to all the financial institutions in the single market. Extensive work has been carrying on by the Commission to the purpose, as shown by the process of implementing the new global standards on bank capital (Basel III) at an EU level (CRD 4 package) and by other important initiatives on the financial regulation agenda (among others, the Liikanen expert group to examine reform of the banking sector structure; to regulate shadow banking; to make credit agencies more reliable; to tighten rules on hedge funds, short selling and derivatives). Once defined, rules have to be applied in the same way across the banking union through coherent and convergent supervision of banks by national supervisors and the ECB. The European Banking Authority (EBA) is given a crucial role in achieving this objective by the development of a single supervisory handbook to complement the single rulebook.

preference regimes may differ among jurisdictions depending on the approach adopted. Four different approaches can be outlined: (i) a general depositor preference is granted when all deposits are preferred irrespective of their eligibility for DGS coverage, status of covered deposits or location; (ii) depositor preference can be referred to all deposits eligible[9] for DGS coverage or (iii) to all guaranteed depositors within the scope and limits of the DGS protection; finally, (iv) a national depositor preference regime is applied when only deposit booked and payable within the domestic jurisdiction are taken into account.

The draft financial reforms recently put forward at an EU level, have raised the question concerning which ranking depositors should be given in resolution processes, where the troubled bank is not liquidated and insolvency law cannot be applied accordingly.

In the bank recovery and resolution framework outlined by the EC, resolution constitutes an alternative to normal insolvency proceedings and allows authorities to deal effectively with a problematic bank when public interest[10] is at stake. This implies that the point of entry into resolution is very close to insolvency (i.e. when the bank is failing or it is likely to fail). Results achieved should be similar to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors, who therefore should not be worse-off in resolution than they would be in liquidation.

Following this general principle, the framework provides for the allocation of losses between the shareholders and the creditors of the bank under resolution in accordance with the hierarchy of claims which each national insolvency regime establishes. But financial stability and other public interests concerns are not sufficiently taken into account by such regimes, to which the framework derogates[11] if it is justified by reasons of public interest in the application of all the resolution tools. Concerning the bail-in, there is also an additional and more detailed hierarchy of claims to be applied to complement (and if necessary supersede) the one provided for in the national insolvency regimes.

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[9] To the purposes of this working paper, the following definitions are adopted: eligible (or protected or insured) deposits means deposits repayable by the guarantee scheme under the national law, before the level of coverage is applied; covered (or guaranteed or reimbursable or repayable) deposits means deposits obtained from eligible deposits when applying the level of coverage provided for in the national legislation. Also, specifically for the analysis in this working paper, holders of covered deposits are referred to as either covered or guaranteed depositors, i.e. depositors reimbursed by a DGS in liquidation proceedings up to the coverage level.

[10] Financial stability, continuity of a bank's critical functions and/or the safety of deposits, client assets and public funds.

[11] According to the framework, losses should be first allocated in full to the shareholders and then to the creditors. In addition, creditors of the same class might be treated differently if justified by public interest reasons. In the event of any creditors receives less than if the bank had been liquidated under normal insolvency proceedings, the difference shall be paid by the resolution fund.

As regards to the DGSs, the EC legislative proposal establishes that a DGS may be called to contribute to resolution in two manners: (i) in cash, to ensure continuous access to covered deposits, for an amount equivalent to the losses it would bear in normal insolvency proceedings, and (ii) acting also as a resolution fund, to exploit the synergies among the two funding arrangements.

If the DGS is called to contribute in the resolution of a troubled bank, it is however exposed to the risk of a second disbursement should another resolution process be needed in the future for the same bank or this eventually fails (depositors' payout). Through the reduction of bank failures, resolution is intended to avoid the unavailability of covered deposits and so the involvement of the DGS. More reasonably, the risk of the scheme to be exposed to a double payment seems to be not eliminated but reduced.

Resources provided by a DGS in a resolution should not in any way affect its funding capacities when it would be necessary to repay covered deposits in liquidation of another bank (or the same bank). Also, appropriate safeguards should be introduced to reduce the risk that the DGS has to pay twice and to minimise the risk of depleting its resources.

Another important issue is asset encumbrance, in connection with which depositor preference may determine worth analysing effects. The collateralisation[12] of bank funding sources[13] (except deposits or capital) gives rise to this phenomenon, which tends to naturally increase in distressed market conditions, where investors demand more safety and there is an overall lack of safe assets[14]. Asset encumbrance especially originates from market funding, derivatives and investment claims and progressively decreases the pool of unpledged assets for unsecured creditors. This implies a significant reduction in the volume of assets potentially available to satisfy the failed bank creditors according to the claims' hierarchy in a liquidation proceedings. To this extent, depositor preference could contribute to further reducing the amount eventually available to unsecured creditors. This shows how the position of a DGS in the claims' hierarchy seems to be important, if the target is to get some potential recoveries in liquidation.

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[12] When a bank needs to secure (or collateralise) a claim, certain assets of the bank are specified as those which would be available to creditors in the event the bank fails to comply with its commitments. This is referred to as asset encumbrance or pledging or earmarking assets. See "Sveriges Riksbank Economic Review", 2012/3.

[13] On bank funding, see BIS Working Paper n. 406, March 2013 "Financial crises and bank funding recent experience in the euro area".

[14] See ECB Stability Report, June 2012: "*In recent years there has been a shift in bank's funding towards secured funding, including covered bonds and repo funding, as well as, in some cases, collateral (liquidity) swaps. (…) Furthermore, the recent take-up of Eurosystem liquidity on a secured basis has contributed further to the widespread perception of rising asset encumbrance*." More recently (March 2013), the European Banking Authority (EBA) released a consultation document concerning guidelines on harmonised templates and definitions to facilitate the monitoring of asset encumbrance.

2. Current practices in the EU and beyond: results of a survey

In October-November 2012 the Interbank Deposit Protection Fund circulated a short survey composed of seven questions among the members of the European Forum of Deposit Insurers.

The purpose was to investigate whether EFDI member DGSs have depositor preference in their national legislation concerning insolvency proceedings and, if the case may be, how do they apply it. Further questions concerned the differential hierarchy between resolution and insolvency and either possible planned changes or underway amendments to the existing domestic legislation as a result of the new regulations at a European Union (EU) level.

The findings of the survey are summarised in the following charts and tables, which outline an interesting overview of the current depositor preference regimes in place in the EFDI member countries.

Separate analysis is provided as regards to the 27 EU Member States (plus the 3 EEA countries) and the other systems participating in EFDI.

1.1 An overview in the EU Member States

The analysis concerning EU Member States extends to the three EEA countries (Norway, Iceland and Liechtenstein). Therefore tables and graphs of this section refer to a total number of 30 countries, as shown in the table below.

Table 1 - EU and EEA countries

Austria	Greece	Netherlands
Belgium	Hungary	Norway
Bulgaria	Iceland	Poland
Cyprus	Ireland	Portugal
Czech Republic	Italy	Romania
Denmark	Latvia	Slovakia
Estonia	Liechtenstein	Slovenia
Finland	Lithuania	Spain
France	Luxembourg	Sweden
Germany	Malta	UK

Answers collected through the survey account for almost all the countries of the analysed sample in Table 1.

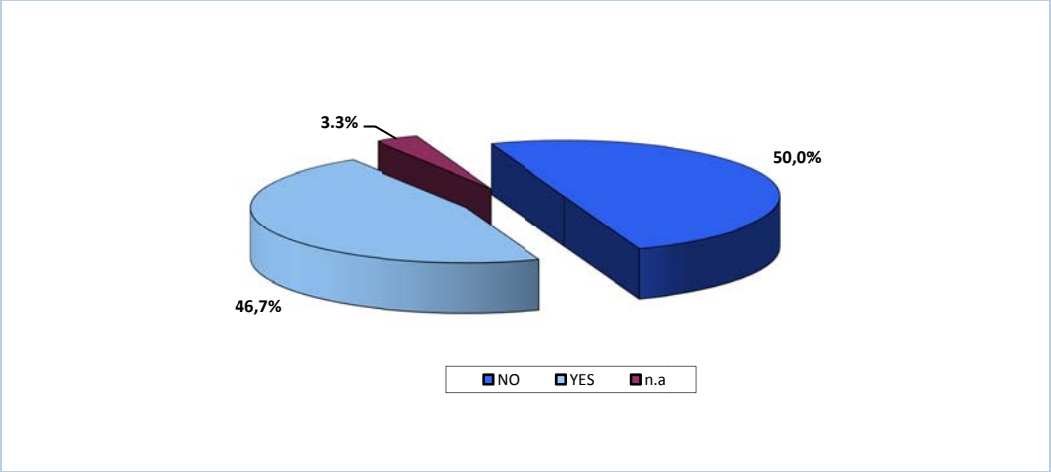
Where missing, information was collected as far as possible from the DGSs official websites. It is worth noting that not all the answering DGSs replied to all of the

questions in the survey. In particular, a higher percentage of missing answers is recorded for questions relating both to the differential hierarchy between resolution and insolvency (Q4-Q5) and to planned or envisaged amendments to the current legislation (Q7) to introduce depositor preference or change the existing regime.

In the survey three questions investigate whether deposit preference is applied and how it works (Q1, Q2 and Q3). Results are summarised in the following graphs.

As shown in Graph 1, considering EU+EEA countries, the sample is almost equally split: a depositor preference regime is applied in around 46.7% of cases, corresponding to 14 countries out of 30, while no privilege is provided for in 15 countries (50%). Information is missing in only one case (3.3%).

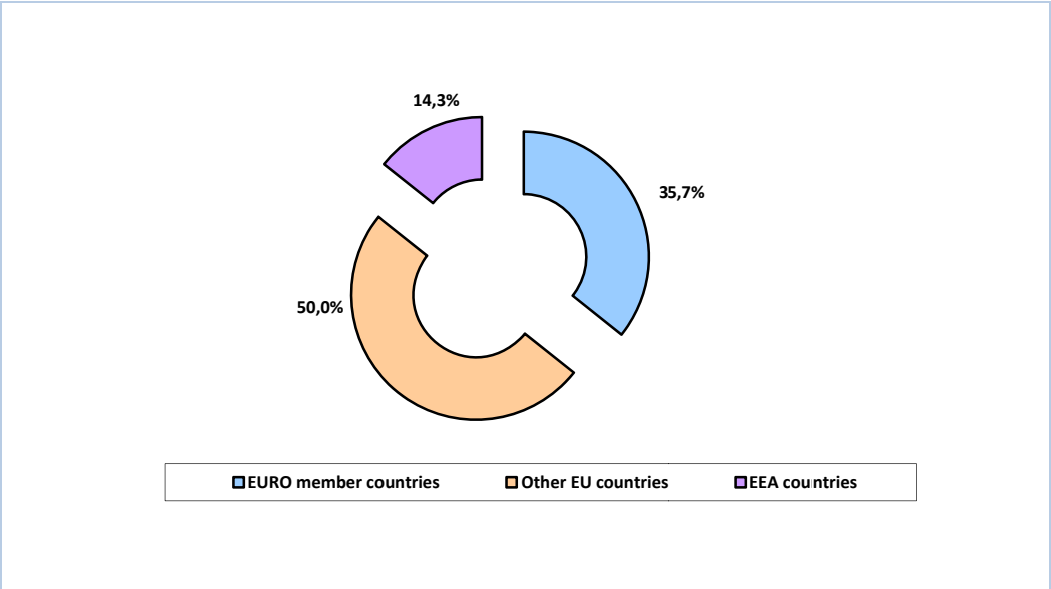
Graph 1 - depositor preference (EU+EEA countries)



In proportion, depositor preference is less applied in the Euro area (5 countries out of 17) than in the other EU countries (7 out of 10). Namely, Euro area countries where a form of preference is applied are Belgium, Greece, Italy, Luxembourg and Portugal. Considering the rest of the EU, such a regime exists in Bulgaria, Hungary, Latvia, Poland and Sweden. Finally, covered depositors are preferred in 2 EEA countries (Iceland and Liechtenstein) out of 3.

Graph 2 highlights how the 14 countries of the sample applying a form of depositor preference are distributed among euro countries (35.7%), other EU member States (50%) and EEA countries (14.3%).

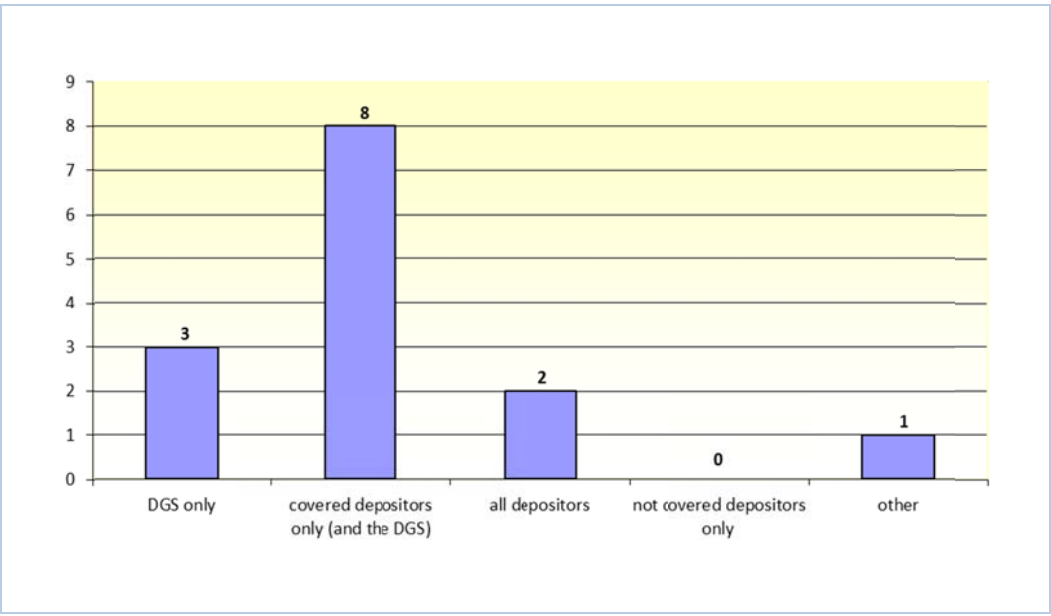
Graph 2 - Current depositor preference regimes per group of countries



It is interesting to analyse how depositor preference works where it is applied. The survey investigated if the preference is given to: (i) the DGS only; (ii) covered depositors only (and to the subrogating DGS); (iii) all depositors; (iv) non covered depositors only, and (v) whether another kind of system is in place.

In all the other countries where depositor preference is not provided for in the legislation, the DGS is given the same ranking as other unsecured creditors in the liquidation proceedings.

Graph 3 - current depositor preference regimes (EU+EEA countries)



As shown in Graph 3, only 2 countries (Bulgaria and Hungary) out of 14 apply the privilege to all depositors, while in the vast majority of current regimes, covered depositors (and the DGS subrogating to them after pay-out) are given a preferred ranking in the creditors' hierarchy in liquidation proceedings. In particular, in Lithuania the preferential ranking provided for by the law to the DGS is such that its claim against the bank is to be paid in full before other creditors, including uninsured depositors (or parts of deposits over the coverage limit) can be indemnified.

In three countries (of which 2 Euro area members) the DGS only is given a preference after pay-out and subrogation: Italy, Luxembourg and Sweden. In Italy the banking law states that the DGS, within the limits of the payment made to covered depositors, has a priority in receiving allotments from the liquidation with respect to depositors who have received such payments[15]; this means that the DGS enjoys a preference over covered depositors for the amount of their deposits exceeding the 100,000 euro limit. Similarly, in Sweden the DGS is given a preference to the extent it has subrogated to covered depositors regarding the payments made to them. In Luxembourg a peculiar system is in place: after the pay-out the scheme enjoys a subrogation right which results in a "priority" subrogation (as opposed to a *pari passu* subrogation) when depositors are only partly reimbursed for their covered deposits up to 100,000 euro; covered depositors accept that the DGS should be reimbursed by the liquidator as a matter of priority for the part of their deposits exceeding this limit.

Finally, in Belgium (qualified as "other" in the graph) the DGS is preferred after pay-out and subrogation over all the total assets of the banks under liquidation proceedings. In the case that covered depositors are only partially indemnified up to the coverage limit by the DGS, they can exercise their right against the bank for the remaining part of their credit enjoying the same preferred ranking as the DGS.

Specifically for countries adopting a form of depositor preference, Q4 in the survey asked whether the preference is going to be introduced in resolution as in liquidation (Graph 4).

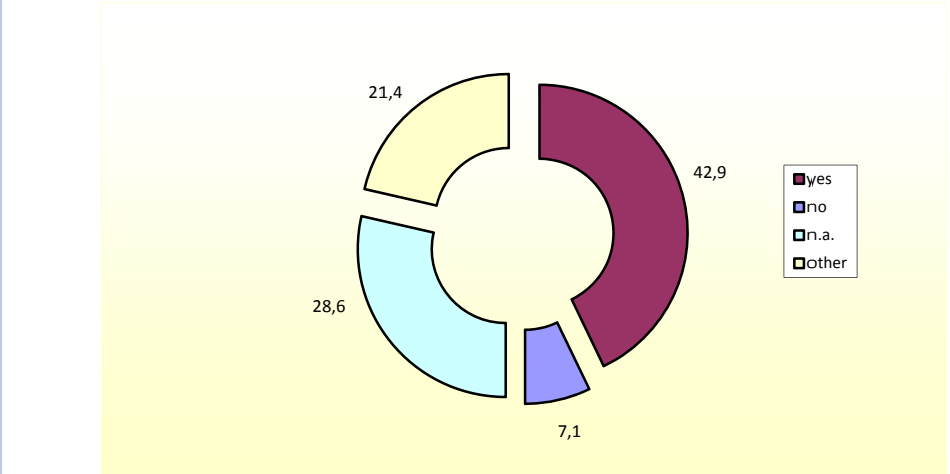
Not all the 14 countries where a preferential regime is in place answered to this question and a significant share of missing information (around 28.6%) is recorded accordingly. Out of 14 countries applying a preferential regime to depositors, 6 replied in the affirmative to Q4 (42.9%). Other 8 are split between "other" (21.4%) and "no answer" (28.6%) categories, while only one negative answer was recorded.

[15] The Banking Law provision (Article 96-bis, paragraph 8) has been transposed in Article 27, paragraph 5 of FITD Statutes. A special bankruptcy regime applies to banks in Italy as per the Banking Law.

To sum up briefly, the ranking of claims (hierarchy) in Italy is: (i) preferential payments (workers, bankruptcy administrator costs, secured creditors, tax obligations of the failed bank (…..); (ii) unsecured creditors and DGS; and, (iii) depositors who have received payments up to 100,000 euro from the DGS, only for the amount of their deposits exceeding the 100,000 euro limit.

Taking into account the whole sample (30 countries), although not outlined in a graph the percentage of missing data is significantly higher (56.7%) and positive replies are 7 and account for 23.3%. Some DGSs gave different replies either being in favour of introducing in resolution the same preference enjoyed in liquidation or not being aware of any specific work on the issue at a domestic legislative level. Also, this category includes countries where a resolution regime has been recently introduced (e.g. Spain) although no depositor preference is provided for in the national legislation. On the whole, this refers to a portion of the sample equal to around 17%. To complete the picture, it is worth noting that positive replies were also gathered from countries where at present no depositor preference regime is in place, but there are plans or discussion underway to introduce it in the future, mainly after the outcome of the EU directive on bank recovery and resolution (e.g. Malta).

Graph 4 - introducing same preference in resolution as in liquidation (14 countries)



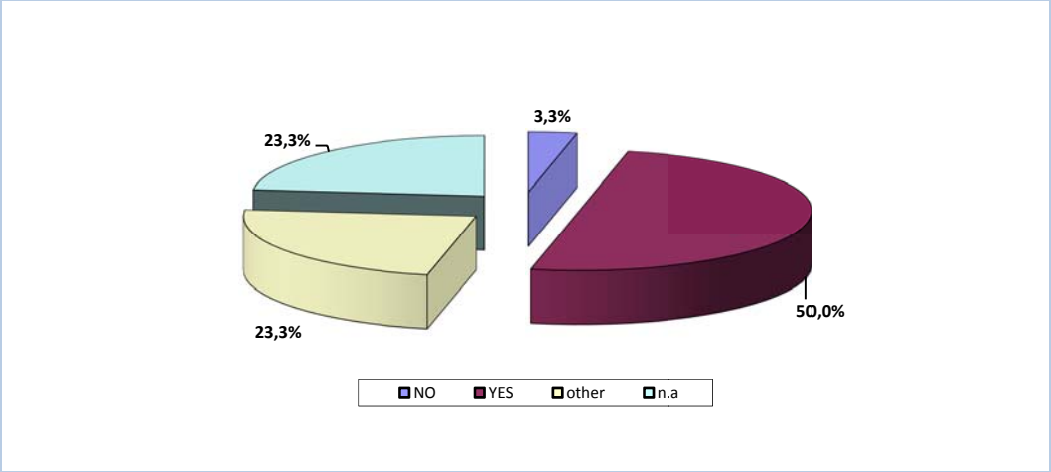
Another interesting issue investigated through the survey (Q5) concerns the ranking that the DGS should be given in resolution, whether it should be the same as in liquidation. The main function of a deposit guarantee scheme is to protect retail depositors against losses, taking their place in complex liquidation proceedings in case of a bank failure, while avoiding bank runs and maintaining confidence and stability. So, the focus is mainly on banking crises ending in liquidation, when the conditions for triggering the DGS are met.

The recent financial crisis, due to its magnitude, forced to find different solutions other than liquidating troubled banks, in order to avoid even further disruptions in the financial system caused by contagion. As a result, banks were bailed out giving rise to huge burden on public finances.

A DGS is not a creditor of the bank in resolution but a loss absorber. According to the proposed directive on bank recovery and resolution, it is required to pay in resolution an amount in cash not exceeding the total amount of covered deposits it would have to reimburse in the case of liquidation of the bank placed under resolution. This is because no creditor should be worse-off in resolution than in liquidation.

Graph 5 highlights the way collected answers are split among different options. A significant share of respondents (50%, corresponding to 15 countries) is in favour of giving covered depositors and the DGS the same ranking both in resolution and in liquidation. This is consistent with the "no creditor worse-off" principle and it does not necessarily mean giving a preference. Also, positive replies not necessarily come from countries where a deposit preference regime is applied.

Graph 5 - same ranking in resolution as in liquidation



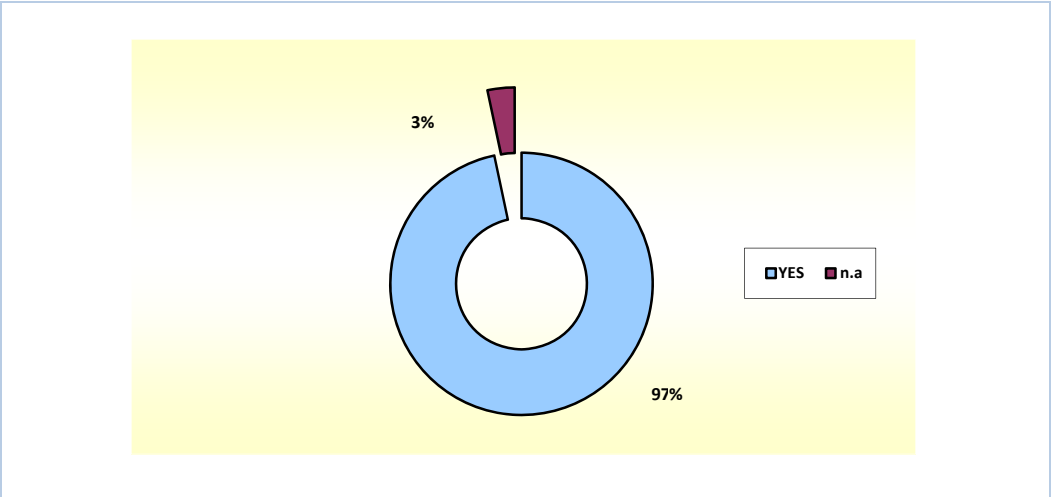
In general, those in favour of a preferred ranking both in liquidation and in resolution maintain that this would enhance depositor protection and support their assertion with reference to the above mentioned "no worse-off" principle.

Positive answers are shared among countries where no preference regime exists (Austria, Cyprus, Czech Republic, Finland and Spain), and countries where a form of preference is applied (Bulgaria, Greece, Italy, Latvia, Lithuania, Poland and Sweden) or is likely to be introduced in the near future (Malta and UK). Finally, the portion labelled as "other" in the graph refers to different answers given in the survey, including no present opinion or planned action on the issue.

Finally, an important issue linked to depositor pay-out by a DGS was analysed in Q6 in the survey, which investigated whether the DGS subrogates to covered depositors after the pay-out. Findings are summarised in Graph 6.

Subrogation is provided for in almost all the countries included in the analysed sample. However, it is reasonable to say that the small share of missing information shown in the graph is in line with the general trend, given article 11 of directive 94/19/EC which states that schemes making payment under guarantee shall have the right of subrogation to the rights of depositors in liquidation proceedings for an amount equal to their payments.

Graph 6 - subrogation



1.2 An overview in the other EFDI countries

This paragraph aims at highlighting where and how depositor preference is applied in a second group of countries, namely those not participating in the EU but however joining EFDI. Table 2 below shows the 14 EFDI members which the analysis is focused on.

Table 2 - Other EFDI member countries

Albania	Jersey	Serbia
Armenia	Macedonia	Switzerland
Azerbaijan	Montenegro	Turkey
Bosnia and Herzegovina	Russia	Ukraine
Croatia	San Marino	

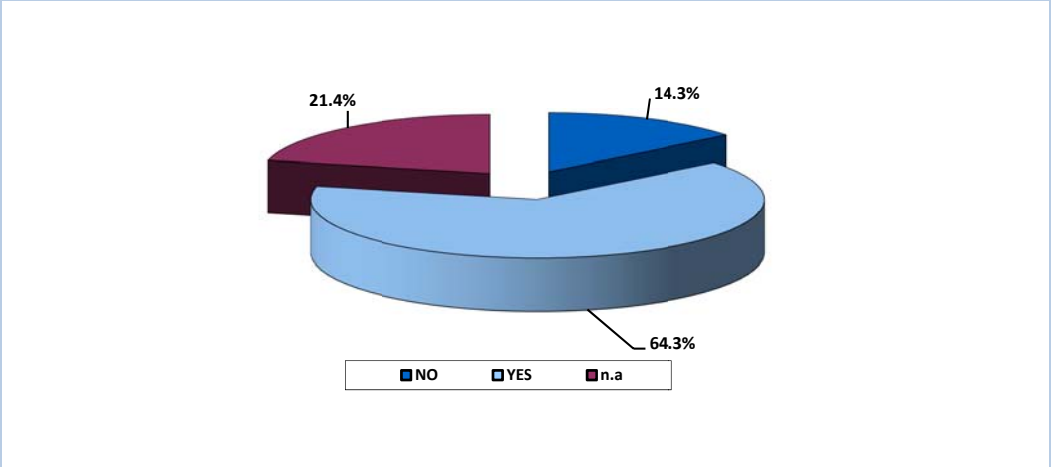
As pointed out in the previous paragraph, also for this second group of countries not all the answering DGSs replied to all of the questions in the survey. Where missing, information was collected as far as possible from the DGSs official websites.

Questions which recorded a higher percentage of missing answers are those relating both to the differential hierarchy between resolution and insolvency (Q4-Q5) and to planned or envisaged amendments to the current legislation (Q7) to introduce depositor preference or to change the existing regime.

In general, a depositor preference regime is more frequently applied in this second sample of countries than in the one including EU member States plus Norway, Iceland and Liechtenstein.

As a matter of fact, Graph 7 points out that depositor preference is currently provided for in 9 countries out of 14, corresponding to around 64% of cases, while in 2 countries only (14.3%) guaranteed depositors and the DGS rank *pari passu* with all other unsecured creditors in the liquidation proceedings. A significant share of missing information (21.4%, corresponding to the remaining 3 countries) does not allow a complete picture of the matter.

Graph 7 - depositor preference (other EFDI countries)

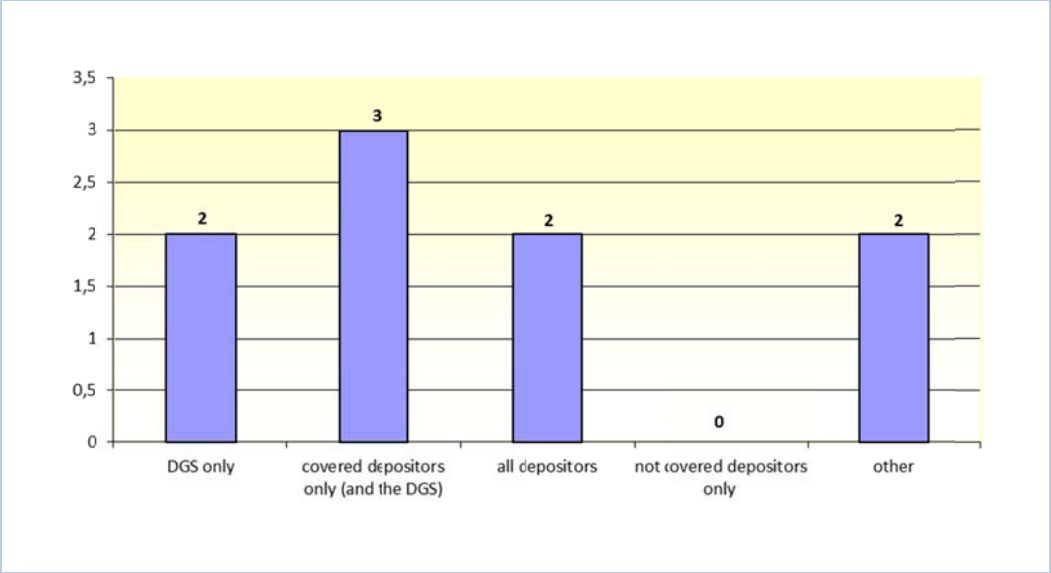


The survey later investigated if the preference is given to: (i) the DGS only; (ii) covered depositors only (and to the subrogating DGS); (iii) all depositors; (iv) non covered depositors only, and (v) whether another kind of system is in place.

This evidence is given in Graph 8 as follows. Current regimes are equally split among those giving a preference either to the DGS only (Croatia and Montenegro) or to all depositors (Russia and Serbia) or those having other peculiar systems in place (Switzerland and Turkey). On the whole, these three categories account for 22.2% of the sample each. A higher percentage (33.3%) goes to regimes (Albania, Armenia and Jersey) giving covered depositors a preferred ranking in the creditor hierarchy. In general, comparing this second sample of 14 countries to the one outlined in the previous Graph 3, it is worth noting how trends are similar, notwithstanding all the specific peculiarities of the two samples.

As regards to the category labelled as "other", there are peculiarities both in Switzerland and in Turkey.

Graph 8 - current depositor preference regimes (other EFDI countries)



In Switzerland, the creditors of a failed bank are divided into three categories according to bankruptcy proceedings legislation. Deposits (both covered and not covered) up to 100,000 Swiss Francs enjoy preferential treatment and are included in the second class of creditors when the bank goes bankrupt. This is of great advantage to depositors as usually the first two creditor classes only represent a small portion of the claims against the failed bank, while the largest portion of claims is allocated to the third one. No account is taken of these latter claims until those ranked in the first (pledged debts and employment salaries) and second classes have been settled. The preference is applied per depositor and per bank. The amount of preferential deposits exceeding the threshold of 100,000 Swiss francs are ranked in the third class and treated *pari passu* as all other not preferred claims.

It is worth noting that, according to Swiss legislation, the category of preferential deposits consists of various items, namely: (i) balances on accounts held in the name of the bank client; (ii) medium-term notes held in the name of the bearer at the issuing bank, even if these are claims by the bearer against the bank; (iii) restricted pension deposits; (iv) contributions of vested benefits foundations; and, (v) deposits held at foreign branches of the bank. All other claims not relating to the professional activity of a bank, as well as bearer deposits and securities accounts, are not deemed preferential claims in the creditors' hierarchy and are included in class three. When a bank goes bankrupt, there is a payout priority using the remaining liquidity of the failing institution and the other banks adhering to the DGS will immediately provide the DGS the required funds in order

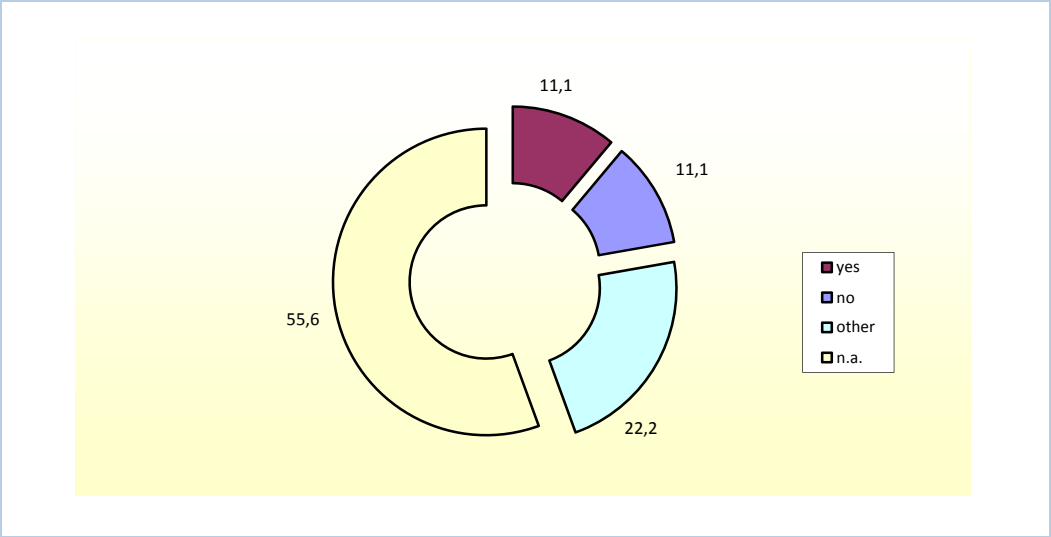
to payout covered deposits of the failed bank within one month. They will then be reimbursed of the contributions paid following the liquidation proceedings. As a result of the payout, the DGS enjoys a pledge for the amount paid and is reimbursed with priority in the liquidation proceedings.

In Turkey the DGS, subrogating to covered depositors after payout, has preference over other unsecured creditors for sums paid to covered depositors. Also, any part of the deposit not protected by the DGS enjoys a priority under the deposit preference regime, although subordinated to the claim of the DGS for the amounts paid to covered depositors. According to the Turkish Banking Law, the DGS is allowed to start the payout once a bank's licence has been withdrawn by the supervisor and the management and control of the bank transferred to the DGS itself, which reimburses covered depositors and requests the bankruptcy of the failed bank directly to the court on behalf of the depositors. If accepted by the court, SDIF participates in the bankruptcy estate as a privileged creditor and liquidates the bank, with duties and powers of the bankruptcy office, creditors meeting and bankruptcy authority as provided for in the Execution and Bankruptcy Law. If the court rejects the bankruptcy, the SDIF Board may decide to start voluntary liquidation of the bank.

Finally, where depositor preference is not applied (2 countries out of 14, namely Macedonia and San Marino), the DGS is given the same ranking as other unsecured creditors in the liquidation proceedings.

The following Graph 9 shows answers given in the survey to Q4, which was devoted to countries adopting a depositor preference regime and investigated whether the preference is going to be introduced in resolution in the same way as in liquidation.

Graph 9 - introducing same preference in resolution as in liquidation (9 countries)

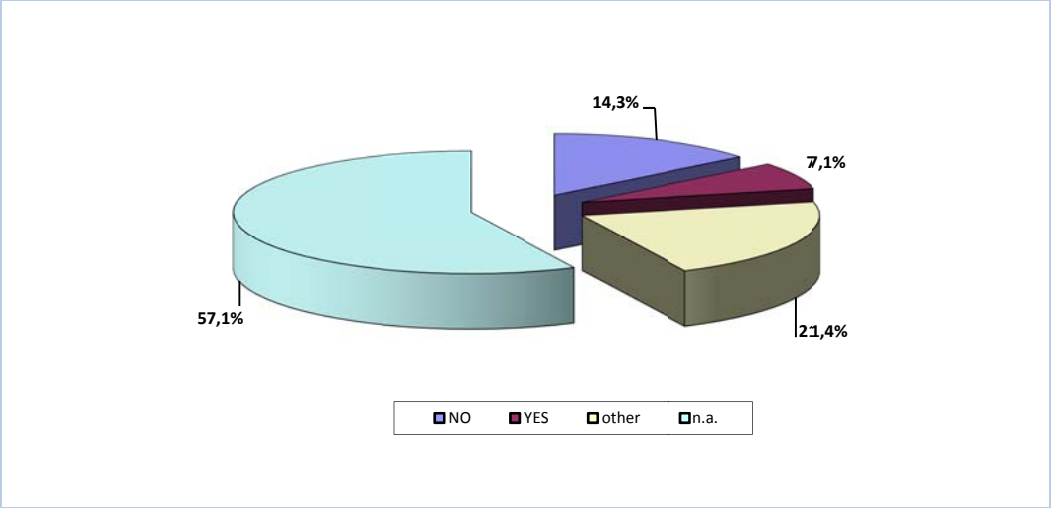


As highlighted by the yellow area, a high percentage of not available information (55.6%, corresponding to 5 countries) is recorded for this question. The four answers are less equally split between "yes" and "no" and "other".

Similar consideration may apply to Q5, as explained in Graph 10.

On the whole, DGSs replying to Q5 are 6 out of 14 and missing information accounts for more than half of the sample (57.1%). Only one positive answer (Russia) and two negative ones (Macedonia and Montenegro) are recorded. "Other" includes different situations: Armenia, where no analysis has been made yet on the issue; Jersey, which underlines the complexity of the matter depending also on the resolution tool used; finally, San Marino, where the DGS is going to become a pay-box only system with no resolution powers as a result of some amendments in the process of being passed through legislation.

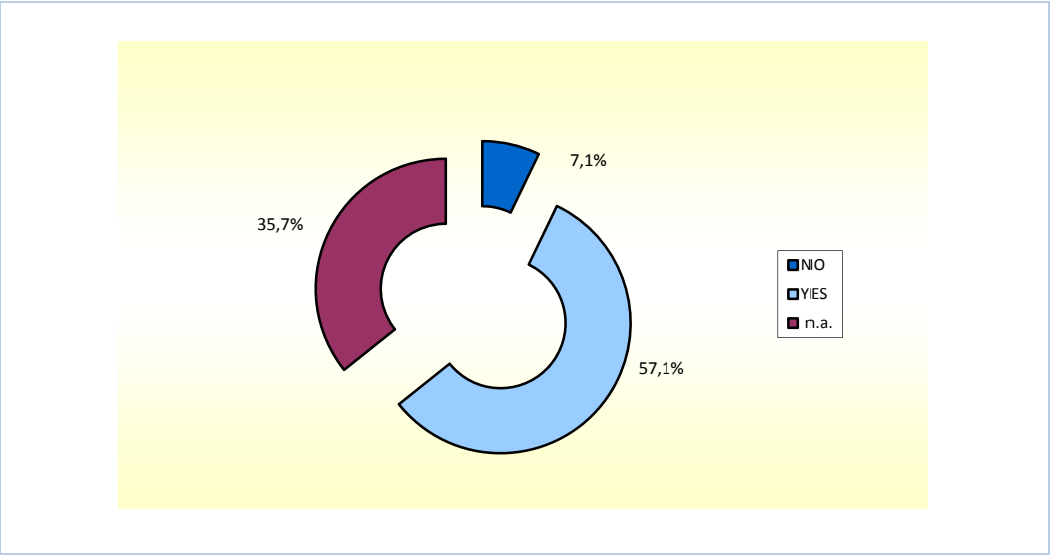
Graph 10 - same ranking in resolution as in liquidation



Finally, Graph 11 draws attention to Q6, which asked whether the DGS subrogates to covered depositors after payout or not, according to national legislation.

This is the case for 8 countries out of 14, corresponding to 57.1%, but the significant share of missing information (35.7%) does not allow to complete the picture concerning the sample under analysis.

Graph 11 - subrogation



1.3 Planned changes to the existing regimes

The last question of the survey (Q7) was aimed at collecting information on the recently adopted or planned changes to the current legislation concerning depositor preference. Separate analysis is provided for the two samples of countries discussed in the previous paragraphs.

With reference to the EU member countries plus Norway, Iceland and Liechtenstein, Graph 12 shows how different answers are distributed. Negative answers account for 40% (12 countries), while the share of missing information is 20% (6 countries). Nine countries gave various answers, which are classified in the category labelled as "other". Finally, 3 countries responded in the affirmative to Q7 (10%), namely Malta, Slovenia and the UK.

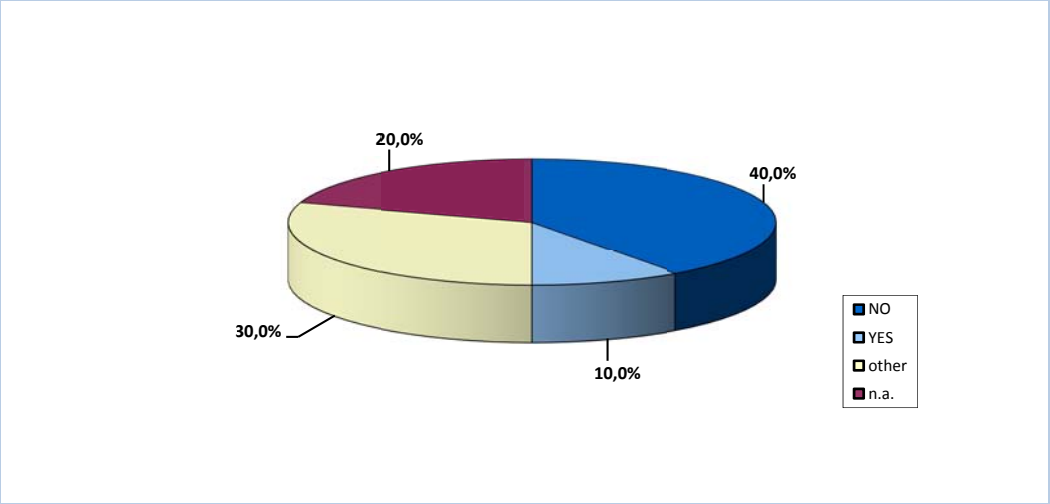
Concerning positive replies, Malta does not have any specific plan in this respect at present, but it is in favour of having depositor preference in place for the DGS in both liquidation and resolution proceedings; however, a decision will be taken depending on the final outcome of the recovery and resolution directive now under scrutiny at the European Parliament.

Similarly, in Slovenia discussions are underway to incorporate depositor preference in legislation, although at present there is no concrete plan and the ministry of finance and the Parliament will have the final say.

As regards to the UK, the Final Report of the Independent Commission on Banking (ICB) has proposed amendments to the creditor hierarchy making (at least some) deposits rank senior to other unsecured claims. The draft Bill on Banking Reform, which is currently being examined by Parliament, has the purpose of implementing the recommendations of the ICB with regard to ring-fencing and

depositor preference. Concerning the latter, deposits covered by the DGS would become preferential debts within the creditor hierarchy in insolvency. This will allow authorities to ensure that in the event of a bank failure, bank's wholesale creditors (investors who should be better placed to exert market discipline on banks to prevent them taking excessive risks) will be exposed to losses ahead of retail depositors, and the DGS that protects them. However, policy on depositor preference is not to be introduced until 2019 and it is dependent on the final outcome of the proposed recovery and resolution directive which is currently being negotiated.

Graph 12 - Planned changes (EU+EEA countries)



Among those replying in the negative to Q7 (12 countries on the whole, corresponding to 40%), there are countries already applying depositor preference in liquidation proceedings, which would presumably consider the introduction of the same regime in resolution depending on the outcome of the relevant proposed directive to be consistent with the “no creditor worse-off” principle.

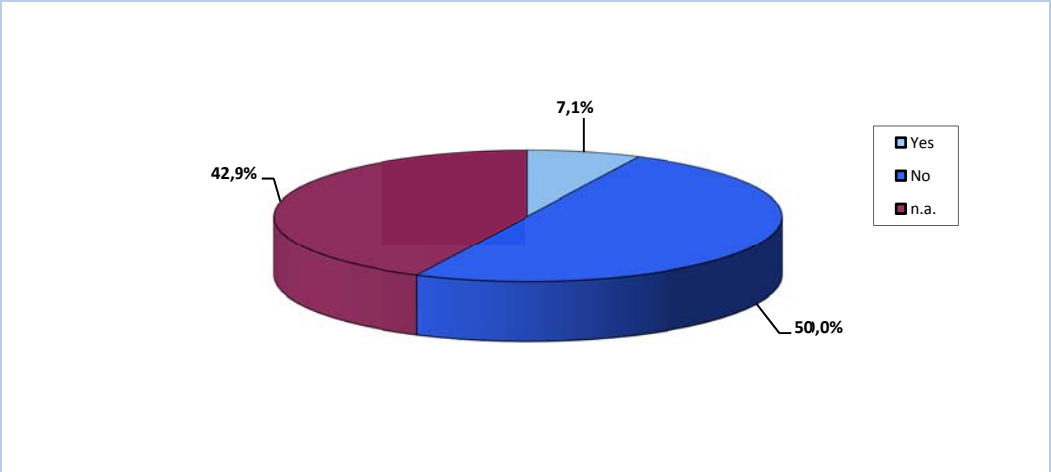
Depositor preference regimes were already introduced in Greece in 2011 and more recently in Portugal, where the legislation will be changed again to give the same preference in resolution as in liquidation. However, these two countries gave negative answers to Q7, meaning that there is no concrete plan at least at this stage to go further. Also, Norway said that at present there is no plan to make changes as regard to depositor preference, but the matter will be carefully discussed if other countries change their preference rules, due to the implications on the situation of other creditors and on the possibility for the bank to borrow money. While waiting for the BRR directive final outcome, resolution frameworks have been more recently presented to be introduced also in France and Germany, but without incorporating depositor preference.

The significant share (30%) of answers which is shown as "other" in Graph 12 groups together 9 countries giving comments or various replies. Among them, are countries already providing for a form of depositor preference in liquidation (Italy, Latvia, Luxembourg). They are basically in favour of giving the DGS the same preference both in liquidation and in resolution, in order to prevent the DGS from being "worse-off". In Liechtenstein the likelihood of changes in banking and bankruptcy/insolvency law is high although concerning the discussions of depositor preferences, there are no plans to change yet. Other four DGSs are either not aware of any decision on the matter made by national authorities or they deem any national developments might depend on results achieved on EU regulation and assert that discussions are underway, although no specific plan has been formalised yet. Moreover, Spain is included in this category since it replied to Q7 giving information on the national regulation for bank resolution[16] adopted in July 2012.

The following Graph 13 summaries results as regards to the second sample of countries composed of the other 14 EFDI members.

Missing answers to Q7 account for a significant percentage (42.9%, corresponding to 6 countries out of 14), while 7 negative replies are recorded. On the whole, only one country answered in the affirmative, namely Jersey, where amendments to legislation to introduce depositor preference should be entered into force in Autumn 2012.

Graph 13 - Planned changes (other EFDI countries)



[16] According to this new legislation, when a resolution measure is decided, the Agency created for the purpose in 2009 takes the administration of the bank under resolution. The DGS can decide to give a financial support and this amount cannot exceed the total amount of covered deposits of the bank under resolution. The decision is taken by the DGS on a voluntary basis and independently, not following any suggestion from the Central Bank/Supervisor.

3. Pros and Cons of the application of depositor preference

This chapter aims at analysing the interaction between the deposit preference regime, where applied, and the domestic deposit guarantee system, while investigating pros and cons of the application of depositor preference in liquidation and its possible extension to a resolution process. This issue is especially crucial at an EU level in light of the upcoming new regulation on recovery and resolution. At present the ranking of depositors is not harmonised across jurisdictions, as shown by the survey discussed in the previous chapter.

When a bank is put under liquidation by the competent authorities as a result of its irreversible crisis, the DGS is triggered to reimburse depositors up to the coverage limit. Also, it usually (as seen in chapter 2) subrogates to the rights of reimbursed depositors against the failed bank in the liquidation proceedings, where the highest-priority creditors are paid first and lower-priority classes are repaid only to the extent that there are enough funds available from the residual assets[17]. In the absence of depositor preference, depositors (and the subrogating DGS) have no greater claim than all other general unsecured creditors.

But, the ranking of claims in insolvency differs across jurisdictions. The guarantee scheme may be entitled to recoveries from the residual assets of the failed bank prior to other classes of unsecured creditors, depending on the class depositors and the subrogating DGS are assigned to in the creditors' hierarchy by national legislation. Such recoveries may be seen as an additional source of funding for a DGS enjoying a preferred ranking. And this could result in a reduction of the eventual loss of deposit guarantee.

It is worth analysing whether this is replicable in resolution, as an alternative to normal insolvency proceedings.

Obviously, the DGS in resolution should enjoy the same ranking[18] than guaranteed depositors are given in liquidation, having respect for the no creditor worse-off principle on which the EU resolution framework relies.

Pursuing a harmonised approach, the BRR draft directive requires the DGS to rank equally as all other unsecured ordinary creditors. What if the DGS of a country enjoys priority in liquidation proceeding? To comply with the directive, the DGS could not be given the same preference in resolution as it enjoys in liquidation.

[17] The typical descending order of priority includes: secured creditors, liquidation expenses, other preferred creditors, general unsecured creditors, unsecured subordinated debt holders, shareholders.

[18] Mirroring in resolution the creditors' hierarchy applied in liquidation implies that, when a resolution tool is chosen, an implicit privilege is given to the highest-priority creditors, whose claims suffer losses only residually and after all other creditors.

Instead, legislation should be amended to remove the preference from insolvency proceedings, otherwise it would result in a breach of the "no worse-off principle". This obviously raises concerns and reluctance to reach an agreement on the draft directive among countries and shows one of the crucial issues on which discussion are still underway at an EU Council level.

Role of the DGS in the EU resolution framework

The European Commission legislative proposal for an EU-wide common framework on bank recovery and resolution outlines two ways a DGS may be called to contribute to resolution: (i) in cash, to ensure continuous access to covered deposits, for an amount up to the losses it would bear in normal insolvency proceedings, and (ii) acting also as a resolution fund, to exploit the synergies among the two funding arrangements.

Contribution under (i) is mandatory and means that the DGS assumes losses as a substitute for guaranteed depositors, paying an amount equal to the total covered deposits of the bank under resolution. However, the DGS is not a creditor of the bank in a resolution process, since it assumes such status only in liquidation proceedings as a result of the pay-out of depositors and the subrogation to their rights against the failed bank. Being a "substitute" for guaranteed depositors, means being a loss absorber: when a resolution tool is applied, the DGS absorbs the losses that depositors eligible for its coverage would bear in liquidation. This is a key point and the definition of the role and the ranking of a DGS in resolution should be carefully tackled in legislation, in order to avoid uncertainty and regulatory arbitrage implying potential distortions to competition.

The amount of the DGS disbursement in cash depends on how it ranks in the claims hierarchy. Whether it is given a preference or not may result in a different share of losses to be covered by shareholders and other creditors. It can also be argued that depositor preference is important to allow the transfer of covered deposits to a bridge bank to preserve the vital function of the bank under resolution without breaching the no creditor worse-off principle.

DGS and bail-in

Given the DGS role in a resolution process, concerns are consequently raised about the ranking that depositors and the DGS should be given in such a context, especially when the bail-in tool[19] is in use. Covered deposits rely on confidence and their uninterrupted availability constitutes one of the most important

[19] Bail-in plays a central role in the BRR draft directive and its inclusion in the toolkit for resolution authorities has been also endorsed by the FSB. Especially for systemic banks (both global and domestic), whose operations are too large, complex or interconnected to split without threatening the bank critical services and financial stability, the recourse to the bail-in tool may ensure that creditors are exposed to losses without disrupting critical functions.

systemic functions to be preserved in a resolution process. Therefore, it can be argued that guaranteed depositors should neither be bailed-in nor should their deposits be otherwise affected by the resolution of a bank.

On the matter, the BRR draft explicitly excludes covered deposits from the scope of bail-in and requires that the deposit guarantee schemes rank *pari passu* with unsecured non-preferred claims[20] in order to provide sufficient funding to the resolution process.

If the DGS enjoys depositor preference in resolution and the bail-in tool is applied to restructure and restore the bank's viability while ensuring the continuity of its systemic functions, the amount of losses is apportioned respecting the hierarchy established in article 43 of the draft legislation[21]. Firstly equity and subordinated debt are entirely written down, then the remaining amount is distributed *pari passu* among the other creditors (excluding covered depositors, not included in the scope of bail-in). Only if there is a residual amount of losses, then the DGS (as a substitute for covered depositors) would be called to contribute in cash. Otherwise, should there be no depositor preference, the DGS would pay a higher amount to cover the losses. Obviously this may depend on the specific features of a certain country's banking system and of the bank under resolution (in terms of the impact of the bank's covered deposits over its total liabilities), but the main points of the DGS contributions do not change.

Depositor privilege seems to be preferable from a DGS perspective, since it decreases the amount to be paid (in cash) in resolution (as its contribution follows the allocation of losses among shareholders and other subordinated and unsecured creditors), consequently lowering the risk that its resources are depleted for future interventions.

Labelling certain liabilities as potentially usable for the purposes of the bail-in tool can result in a lower demand for these instruments and higher costs for banks to

[20] On this point see Article 99, paragraph 2 of the EC draft directive.

[21] Pursuant to Art 43, paragraph 1: "*Member States shall ensure that, when applying the bail-in tool, resolution authorities exercise the write down and conversion powers respecting the following requirements: (a) Common Equity Tier 1 instruments are written down first in proportion to the losses and up to their capacity and the relevant shares are cancelled in accordance with Article 42; (b) if, and only if, the writing down pursuant to point (a) is less than the aggregate amount, authorities reduce to zero the principal amount of Additional Tier 1 instruments that are liabilities and Tier 2 instruments in accordance with subsection 2; (c) if, and only if, the total reduction of liabilities pursuant to points (a) and (b) is less than the aggregate amount, authorities reduce the principal amount of subordinated debt that is not Additional Tier 1 or Tier 2 capital to the extent required, in conjunction with the write down pursuant to points (a)and (b) to produce the aggregate amount; (d) if, and only if, the total reduction of liabilities pursuant to points (a), (b) or (c) of this paragraph is less than the aggregate amount, authorities reduce the principal amount of, or outstanding amount payable in respect of, the rest of eligible liabilities, pursuant to Article 38, that are senior debt to the extent required, in conjunction with the write down pursuant to points (a), (b) or (c) of this paragraph to produce the aggregate amount*".

obtain them. Moreover, unequal conditions may be the likely outcome of differences in the hierarchy of creditors across jurisdictions.

It has been argued that, where deposits are not bailinable liabilities (as it is the case in the BRR draft), bail-in could be seen as a kind of depositor preference[22], bearing in mind that the latter usually subordinates all other unsecured creditors to depositors while bail-in establishes a form of priority for depositors and the other classes of claims which are not subject to it.

One of the key distinctions between the two relies on their specific objectives, which are somehow comparable but not identical: depositor preference is backed by a DGS and creates confidence in retail depositors improving financial stability and preventing retail bank runs; on the other hand, bail-in gives confidence to trading counterparties avoiding wholesale runs. Given that, if harmonization would mean to agree on giving trading counterparties the same level and kind of protection enjoyed by retail depositors, then it would be unlikely.

Depositor preference is certain as deriving from the official creditor hierarchy set by national insolvency laws and applies in liquidation. Conversely, the recourse to bail-in is in a resolution process, which is prior to liquidation, and it is discretionary, depending on the decision of the authority in charge to apply the tool and on the specific situation and characteristics of the bank subject to the procedure; its effects on creditors result from the application of a possible different hierarchy of claims set by the resolution regulation specifically for tool purposes (as in the BRR draft directive). Moreover, should a bank subject to resolution (and bail-in) eventually fail, there could be a lack of resources to satisfy creditors according to the hierarchy of claims set in liquidation.

Pros and cons in different depositor preference regimes

Problems may arise from a depositor preference regime depending on its specific features, following the different approaches briefly outlined in chapter 1.

If all depositors are preferred irrespective of either the eligibility for coverage by a DGS or covered status or location of their deposits (general depositor preference), possible benefits could be related to[23]: (i) additional protection and potentially higher recoveries to depositors (and the subrogating DGS); (ii) less incentive to bank run for non-guaranteed depositors and more effective discipline over banks' risk taking attitude by non-deposit liabilities holders; (iii) easier implementation of some resolution options; and, (iv) enhanced cross-border resolution resulting from a more uniform treatment of depositors across jurisdictions. Conversely, it

[22] See "Depositor preference issues", Clifford Chance, September 2011.

[23] See FSB, "Consultative document: Effective resolution of Systemically Important Financial Institutions (SIFIs)" - Annex 7: "Discussion note on creditor hierarchy, depositor preference and depositor protection in resolution"

could be argued that preferences raise the risks for financial stability, since giving depositors (or certain classes of depositors) a higher ranking could increase the potential loss exposure of the lower ranking creditors, who would be induced to exert more market discipline and run on banks. Non-deposit unsecured creditors would benefit from much lower recoveries then in the case depositor preference is not applied. Those against preferences draw a clear distinction between depositor coverage through existing DGSs and depositor preference over other senior creditors, maintaining that the essential protection to retail depositors should be provided by DGSs only (up to a certain level). After subrogation, their claims should rank equally with other unsecured creditors, otherwise a preferential treatment above the coverage limit would lead to moral hazard.

In a national depositor preference regime, all domestic depositors' claims (on the assets of the failed bank) are elevated over the claims of foreign depositors and other creditors. Consequences may derive as a result of the unequal treatment of foreign depositors. The foreign country might perceive such a hierarchy as unfair and be less willing to cooperate in a resolution led by the home country, ring-fencing the assets of the failed bank's branches located in its territory. This would make it more complicated for the home country to manage the crisis of a large cross-border bank with a substantial presence abroad and increase systemic risk, while lowering the resolution tools effectiveness. Such problems could be reduced or eliminated either by giving foreign depositors the same ranking as domestic ones or by giving a preferred ranking to guaranteed depositors only, who would all be treated equally (domestic or foreign).

Since differences in ranking across countries can make cross-border resolutions more complex and less effective, the FSB consultation on the effective resolution of SIFIs[24] sought comments on whether different treatments of depositors in liquidation across different jurisdictions could be an obstacle to the effective resolution of a SIFI.

Contributions collected in the consultation expressed concerns on the issue of local legislations discriminating against creditors on the basis of nationality, residence or jurisdiction of where a deposit is held. The Key Attributes accordingly provide against such discrimination and require transparency in the treatment and rankings of creditors. Nevertheless, the KAs reflect the view that, in applying resolution powers, the creditors' hierarchy should be respected but it acknowledges also to treat creditors of the same priority class differently in justified cases and depending on transparent principles and safeguards. This

[24] The Consultative document was published on 19 July 2011 asking for contributions by 2 September of the same year. It consisted of a comprehensive package of policy measures aimed at improving the capacity of authorities to resolve SIFIs avoiding systemic disruption and taxpayers' exposure to losses. The overview of responses to the public consultation was published in November and the final release of the "*Key Attributes of Effective Resolution Regimes for Financial Institutions*" (KAs) followed shortly afterwards. KAs are intended as a common standard for resolution frameworks for all financial institutions. Recently, a progress report on the resolution of SIFIs was published in November 2012.

flexibility should be allowed if necessary to limit the potential systemic impact of the failure or to maximise the value for the benefit of all the creditors. This could be the case of depositors and other parties providing critical funding to a bank with a systemic relevance.

Reasons for harmonisation

The EC view is that the DGS should be given the same ranking in all Member States to ensure the resolvability of cross-border banks and equal conditions in the internal market. This implies that the same harmonised approach within the creditors' hierarchy should be applied in liquidation proceedings.

As seen in chapter 2, around 43% of EU member countries currently applying a form of depositor preference in ordinary liquidation (14 out of 27) are in favour of having it in resolution as well.

The introduction of depositor preference in some countries and not in others could impact on bank funding and create problems for the possibility for the bank to borrow money and in some way hinder effective cross-border resolutions. Also, the cost of DGS insurance would be perceived as different depending on whether depositor preference is in place in the home/host countries where a bank establishes a branch or a subsidiary.

Harmonisation (at least a certain degree of it) seems to be a viable approach to avoid such matters, but it should be acknowledged that there are significant difficulties.

Surely, the more convergent the treatment of depositors (an DGSs) within the creditors' hierarchy across jurisdictions (whether in the direction of depositor preference or not), the better the cross-border cooperation and enhanced management of cross-border crisis, which would prevent any ring-fencing measure.

Moreover, the envisaged harmonised approach would require a shared definition of deposits (both covered and eligible depending on the features of the preference applied). But currently both existing depositor priority regimes and definitions vary significantly across jurisdictions, making harmonisation a very tough task. Greater consistency in the statutory ranking of all creditors would be desirable in principle, but it would not have significant effects without a more comprehensive (and complex) convergence of various legal systems and insolvency regulations across countries.

At present it is not clear how the issue of depositor preference will be settled in the BRR directive on-going discussion, whether in the direction of harmonisation (either providing for it or not) or leaving the choice to member States. The latter

obviously would not solve the problems arising from a different treatment of creditors across jurisdictions.

Maybe a solution could be to give the DGS only (and not the depositors it guarantees) the ranking of privileged creditor both in liquidation and in resolution where, respectively, the DGS is a creditor of the bank for the amount paid to covered depositors and absorbs losses taking depositors' place.

In the event of a bank failure, depositors receive compensation up to the coverage level following the unavailability of their deposits and prior to any other creditor of the bank. The DGS subrogates to depositors' rights and, enjoying a preferred ranking, could more likely recover the amount paid and have in this way an additional source of funding.

In resolution, a preferred rank could allow the DGS, acting as a loss absorber and a substitute for covered depositors, to pay a lower cash contribution to finance a resolution tool[25]. The priority ranking given to the DGS would minimise the amount paid in cash and, with reference to the "no creditor worse off principle", and would justify why covered deposits are transferred to another entity prior to other claims, which rank lower in the hierarchy. As a result, the risk of depletion of DGS resources, which could eventually result in a burden for public finance, would be minimised.

[25] When bail-in is in use, as discussed above, but also when the resolution authorities recourses to other tools: transfer of deposits to a bridge bank or to another existing institution (sale of business) or to an asset management vehicle (asset separation tool, in conjunction with one of the other tools).

4. Conclusions and policy options

The survey discussed in chapter 2 highlights how depositor preference is not provided for in all countries in liquidation proceedings and how current practices differ across jurisdictions. Where applied, it is justified on economic, social and public interest reasons and shows an interaction with the national deposit guarantee system. A priority ranking given to the DGS in liquidation might result in an additional source of funding and influence the cost of guarantee across countries. Also, positions are not convergent in the perspective of whether a privilege should be introduced in resolution processes (as an alternative to liquidation) or not.

Pursuing a harmonised approach, the BRR draft directive requires the DGS to rank *pari passu* with all other unsecured creditors in resolution, thus implicitly implying that national insolvency legislations providing for a privilege are amended to remove it accordingly (the "no creditor worse-off" principle would be otherwise affected).

Obviously, the DGS in resolution should be given the same ranking as covered depositors enjoy in ordinary liquidation, having respect for the "no creditor worse-off" principle which the EU resolution framework relies on.

The cash contribution the DGS is asked to pay in resolution (as a loss absorber), in practice depends on how it ranks in the creditors' hierarchy. The higher the ranking, the less the amount, especially where the bail-in tool is applied. It is worth noting that the recourse to bail-in in a resolution process depends on the discretional decision of the resolution authority and its effects on creditors result from the application of a hierarchy of claims possibly different from that applied in liquidation. Reasons to support a preferred ranking when the bail-in is in use are linked to the opportunity to limit the recourse to DGS funds if possible, to minimise the risk of depletion for future interventions. Resources provided by a DGS in a resolution should not in any way affect its funding capacities when it would be necessary to repay covered deposits in liquidation of another bank (or the same bank).

Depositor preference would assist authorities to use resolution tools aimed at preserving bank essential functions/operations, such as deposit taking and payment systems. In the event of the recourse to the bridge bank tool (or to other tools similarly requiring a transfer to another entity), depositor preference allows the transfer of covered deposits to it, without giving rise to any worse treatment for other creditors compared to an ordinary liquidation. The preferred ranking would justify why covered deposits are transferred to another entity prior to

other claims, which rank lower in the hierarchy, on the basis of the "no worse-off" principle.

Given that, a greater convergence in the statutory ranking of creditors is highly desirable in the EU. Surely, the more convergent the treatment of depositors (and DGSs) within the creditors' hierarchy across jurisdictions, the better the cross-border cooperation and enhanced management of cross-border crisis, which would prevent any ring-fencing measure.

Convergence and harmonisation should move towards the creation of a depositor preference, provided that it is on a non-discriminatory basis (i.e. not on the basis of national preference) and possibly given to the DGS, which is a creditor of the bank for the amount paid to depositors in liquidation and absorbs losses taking depositors' place in resolution.

Accordingly, the BRR draft directive should be amended and the ranking currently given to the DGS reversed. Countries not in favour of the DGS involvement in resolution might be willing to accept it where the scheme is given a preferred ranking, since this would contribute to protecting its resources and functions.

The risk that DGS resources are depleted for future interventions would be lowered and confidence in the banking system would be enhanced, allowing the DGS to perform its main functions: protect deposits, improve financial stability and prevent retail bank runs. However, it is crucial that a harmonised definition of deposits (both eligible and covered) is adopted to have a uniform treatment across countries and avoid distortions and possible arbitrage in the single market.

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