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Completing Banking Union? The Role of National Deposit Guarantee Schemes in Shifting Member States' Preferences on the European Deposit Insurance Scheme

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Abstract

The gridlock on the European deposit insurance scheme (EDIS), the missing pillar of the banking union, is most commonly attributed to moral hazard concerns on the side of Germany. However, Member State preferences on EDIS cannot be understood solely based on concerns over pre-emptive risk reduction. Instead, banking sector interests connected to the institutional setup and legal status of national deposit guarantee schemes (DGSs) have also informed these preferences. This article examines the development of preference formation on EDIS for the cases of Germany, Italy and France after the initial 2015 proposal failed. National preferences on the institutional setup of EDIS have become more aligned with a reinsurance system that maintains existing DGS. Hence, current trajectories point to a discussion over how national DGSs are to be linked in a reinsurance system, instead of a discussion about whether it should be abandoned or not.

Keywords: banking union; European deposit insurance scheme (EDIS); financial integration; preference formation; eurozone

Introduction

The European Union's (EU) struggle with the current COVID-19 pandemic and its economic fallout reinvigorated the debate over common European bonds as well as rising levels of non-performing loans (NPLs). For the former, a supranational response was ultimately found in the form of a new common European bond. While the fate of these common bonds remains uncertain beyond the exceptional circumstances of the COVID-19 pandemic, less progress has been made on the side of banking sector reform to brace the eurozone against renewed financial turmoil. Although the eurozone gained a new architecture for banking supervision and resolution with the first two pillars of the European banking union in the aftermath of the eurozone crisis, there has been no new impetus on its third pillar, the European deposit insurance scheme (EDIS).

The European Commission published the initial EDIS proposal in 2015, which proved too controversial due to the entrenched positions of opposing Member State coalitions. Yet, the debate did not remain stagnant, as new drafts were presented in 2016 and 2017 and technical discussions continued in the 'Ad Hoc Working Party on the Strengthening of the Banking Union', which the Council established in 2016 to discuss further initiatives on EDIS (Council of the European Union, 2016). EDIS resurfaced at the government level as a coalition spearheaded by France and Italy, aided by the European Central Bank (ECB), continued their support. Moreover, EDIS also remains on Commission president Ursula von der Leyen's agenda (Berschens, 2019). The 'Eurogroup' briefly

discussed EDIS again in December 2019, before the pandemic, but without result (Fleming and Johnson, 2019).

While no major steps have been made at the government level since late 2019, the technical debates in the Ad Hoc Working Group are more instructive for comprehending the factors driving the EDIS policy debate. In July 2018, the Austrian Presidency of the Council introduced a draft for a 'hybrid model', which retains national deposit guarantee schemes (DGSs), complementing them with a supranational reinsurance fund and mandatory lending among DGSs (High-Level Working Group on EDIS, 2019, p. 2; Council of the European Union, 2020, p. 2). This concept has emerged as the new basis for further discussions, instead of a fully supranational fund. A survey of Member States' preferences on the different design choices entailed in the draft is currently under preparation, which should serve as the basis for a new legislative proposal (Commission Services, 2020; High-Level Working Group on EDIS, 2019, p. 4). This shows that the policy debate has shifted into a discussion about how the institutional design of EDIS could look instead of a fundamental debate over its viability in principle. This is also reflected in a December 2019 position paper by the German Ministry of Finance (BMF), which featured a German proposal on the institutional design of EDIS for the first time (BMF, 2019).

Furthermore, pre-emptive risk reduction has been increasingly linked to the implementation of EDIS over the course of the policy debate. In this regard, a German-led coalition of Member States whose banking sectors weathered the eurozone crisis comparatively well argues that EDIS creates moral hazard for Member States with fragile banking sectors. The latter could reap the benefits of EDIS in terms of financial stability without committing themselves to clean up their domestic banking sectors (Schnabel and Véron, 2018). Thus, progress on EDIS is bound to pre-emptive risk reduction, placing EDIS at the intersection of risk sharing and risk reduction, which demarcates the central fault line in the discussion on further financial and fiscal integration in the eurozone. Consequently, the developments on EDIS depend on its future institutional design determining the scope of risk sharing as well as on progressive risk reduction.

This article takes a political economy perspective to analyse how preference formation on the institutional design of EDIS has been affected by the institutional structure and legal status of existing national DGSs since the introduction of banking union. Previous studies addressing the failure of EDIS did not foresee how positions could change, as the debate moved towards a reinsurance system (Howarth and Quaglia, 2015, 2016; Donnelly, 2017; Mayes, 2017). They do provide a solid analysis of the risk-centric debate on the initial 2015 proposal, but are less suitable for grasping banking sector interests and government positions linked to the institutional structure and legal status of national DGSs. On the policy side, many contributions argue against new EDIS drafts that preserve national DGSs (Cerrone, 2018; Schoenmaker, 2018; Huertas, 2019; Carmassi et al., 2018, 2020; Panetti, 2020). While their critiques provide strong arguments against moral hazard arising from a joint supranational fund, they too only address the risk reduction facet but fail to account for preferences on the institutional design of EDIS independent from risk reduction. It is precisely interests connected to the institutional structure and legal status of national DGSs that affected national preferences in favour of a reinsurance system after the initial proposal failed, which earlier studies do not reflect. In that, I build on earlier studies by Howarth and Quaglia (2017) and

Mitchell (2020), who emphasize national DGSs as important factors for the German position. However, they only address Germany, just as the studies emphasizing moral hazard concerns refer to Germany and other creditor states to explain the failure of the initial proposal. This article expands on their insights by assessing the impact of national DGSs beyond Germany to show that interests connected to DGSs support a common preference for a reinsurance system.

The political economy literature on banking union is embedded in the overall discussion on the eurozone integration process after the crisis. The body of literature is largely structured around the debate between the classical integration theories of liberal inter-governmentalism and neo-functionalism. Inter-governmentalist studies on the implementation of the single supervisory mechanism (SSM), the single resolution mechanism (SRM) and the failure of EDIS explain integration outcomes based on national preference formation and inter-governmental bargaining. They draw heavily on the divide between creditor and debtor states, arguing that the former are largely successful in imposing their preferences on debtor states (Underhill, 2012; Howarth and Quaglia, 2013, 2014, 2015; Hennessy, 2014; Spendzharova, 2014; Schimmelfennig, 2015; Lombardi and Moschella, 2016; Quaglia, 2017; Schild, 2017). Conversely, the neo-functionalist literature argues that prior integration in the monetary union created spillovers, which increase pressure for further integration in related policy areas. While they recognize the creditor–debtor divide, they identify the crisis-induced pressure for integration and the agency of supranational actors that eventually overcame opposing coalitions and paved the way for banking union (Fehlker *et al.*, 2013; Schimmelfennig, 2014, 2015, 2016; de Rynck, 2015; Niemann and Ioannou, 2015; Epstein and Rhodes, 2016, 2018). In addition, some scholars combine inter-governmentalist and neo-functionalist theories to address the interaction of diverging national preferences and crisis-induced spillovers (Jones *et al.*, 2016; Glöckler *et al.*, 2017; Nielsen and Smeets, 2017; Quaglia and Spendzharova, 2017). Finally, some studies emphasize ideational aspects such as German ordoliberalism to explain banking union (Hien, 2020; Schäfer, 2016). This article draws on inter-governmentalism, as it allows study of the impact of national-level factors such as corporate interests bound to DGSs as a basis for preference formation. Contrary to the prior risk-centric debate, where ideational factors underpinning government positions or spillovers were arguably of greater interest, the debate on the institutional construction of EDIS is bound to the fate of national DGSs and the interests connected to them. I argue that national DGSs constitute banking sector interests that impact national preferences in favour of a reinsurance system.

This article proceeds as follows: the next section outlines the concept of national preference formation before laying out the methodological approach. The following section introduces the development of the policy debate before analysing the impact of the institutional structure and legal status of DGSs on national preferences in Germany, France and Italy. The final section concludes.

I. Analytical Framework and Methodology

This article draws on the concept of national preference formation originally derived from liberal inter-governmentalism. It is particularly useful to trace preferences connected to national DGS, as it links Member States' preferences to domestic corporate interests.

Any new form of deposit insurance affects them directly, as deposit insurance funds are raised from bank contributions.

National preference formation is based on a set of costs and benefits placed on future outcomes of international policy-making, which reflect the economic interests of domestic interest groups that are capable of influencing the state apparatus and that are particularly affected by a policy outcome. Usually, these are corporate-interest groups, because of their strong institutional representation and organizing capabilities. Accordingly, a Member State's preference on a given policy is based on the economic interests of the most influential domestic corporate-interest groups (Moravcsik, 1993, pp. 480–3; 1998, pp. 18–21; Schimmelfennig, 2015, pp. 178–80). A complete bargaining analysis would then go beyond national preference formation to cover governments' bargaining for the integration outcome. However, it is currently impossible to conduct a full-fledged bargaining analysis, as the policy-making process has not yet arrived at inter-governmental negotiations; it is also unnecessary to convey the importance of national DGSs for Member States' preferences.

Methodologically, the article reconstructs the developments on EDIS as a result of national preferences arising from domestic economic interests. The analysis is based on a study of policy documents of banks, banking associations, regulators, governments and supranational institutions published from 2016 to 2020. The analysis of preference formation on EDIS is based on banks' and banking sector associations' positions on the preemptive conditions and the institutional design of EDIS. In countries with banking sectors differentiated between subsectors, corporate interests are likely not aligned across subsectors; thus, one subsector's interests do not directly translate into national preferences. Here, Member States' national preferences are operationalized as the positions of the most influential subsector, or, if this is not possible to discern, as the positions of government and national competent authorities (NCA) on EDIS. To triangulate the information available through published documents, I conducted five guided expert interviews at banks as well as national and supranational institutions in 2018. This study covers Germany, France and Italy as they shaped prior negotiations on banking union overall, and EDIS in particular, and possess *de facto* veto power in the Council.

II. Defining EDIS – Full-Fledged Integration or Subsidiarity

National preferences on EDIS depend strongly on the institutional design and the extent to which national funds are moved to the supranational level. A range of proposals featuring different degrees of integration have been presented over the last several years. This section provides an overview and outlines the differences between a full-fledged EDIS and the reinsurance systems currently being discussed.

The Commission advanced the initial proposal in 2015, which featured progressive introduction of a full-fledged EDIS after two prior tiers of reinsurance and co-insurance. During the first phase of reinsurance, national DGSs would bear the losses, while a supranational fund would provide loans that must be repaid later in case of shortfalls.¹ In the second phase of co-insurance, DGSs and the supranational fund would bear the losses

¹The 2015 Commission proposal also foresaw limited loss absorption by the supranational fund during the reinsurance phase, meaning that the supranational fund would ultimately bear a percentage of losses incurred by national DGSs in the case of insufficient funding.

together from the onset and the supranational share would increase to up to 80 per cent. Ultimately, a full-fledged EDIS was to be implemented consisting of a supranational fund making national DGSs redundant and transferring decision-making to the single resolution board (SRB) (European Commission, 2015, pp. 11–12). The 2015 Commission proposal proved to be politically unfeasible due to German concerns over moral hazard to protract risk reduction and interests to preserve institutional protection schemes (IPS) of savings and co-operative banks (Howarth and Quaglia, 2017).

Technical discussions evolved over the following years, resulting in new drafts in 2016, 2017 and 2018. These drafts diverged from the initial proposal in terms of institutional design and division of competences. National preference formation developed in conjunction with elements introduced by the new drafts, particularly pre-emptive risk reduction and a permanent reinsurance system. In 2016, the European Parliament (EP) rapporteur on EDIS proposed a new draft linking progression from a reinsurance system to a loss-absorbing insurance system (European Parliament, 2016b, pp. 9–11; 2016a). In terms of institutional design, it integrates national DGSs into the final design of EDIS, as contributions are distributed equally between the national and supranational funds (Interview 4, 2018).² Moreover, the latter should consist of national compartments that are filled by single DGSs and a joint sub-fund. In case of a payout, national DGSs would be depleted first, followed by the national compartments (European Parliament, 2016a, pp. 58–9). These alterations aim to mitigate German concerns over moral hazard and preserve national DGSs. Notably, the German position paper published under social-democratic finance minister Olaf Scholz in 2019 mirrors the EP draft, as it preserves national DGSs, features national compartments in a supranational fund and pre-emptive risk reduction (BMF, 2019). The Commission published another draft in 2017 suggesting a two-tier scheme starting with a reinsurance system. As in the case of the EP draft, moving to the second phase is conditional upon risk reduction. In the second co-insurance phase, losses would be gradually covered by the supranational fund up to full loss coverage (European Commission, 2017, pp. 10–11). This differentiates it from the EP draft, while moving closer to the initial proposal, as it ultimately integrates national DGSs into a supranational fund.

In 2018, the Austrian Presidency of the Council presented a hybrid model as a compromise and basis for a new legislative proposal. The draft features a reinsurance system combining national DGSs with a supranational fund that is to be filled once DGSs are filled. The supranational fund provides loans to national DGSs and if the central fund should be depleted, it is entitled to borrow from DGSs. In addition, it includes pre-emptive risk reduction and potential loss coverage (Commission Services, 2020). Based on these parameters, the Commission is currently preparing a Member State survey on the allocation of funds, interest for repayment, relationship between the supranational funds and DGSs, national discretions and treatment of sovereign exposure (High-Level Working Group on EDIS, 2019, p. 2). Since the survey should act as a basis for a new legislative proposal, the Commission is unlikely to present another proposal for a full-fledged EDIS, which demonstrates the shift towards a reinsurance system. Meanwhile, the ECB continues to endorse the long-term goal of a full-fledged EDIS but also concedes that this will not be achieved in the near term (Enria, 2018). The

²To ensure anonymity, the interviewees' institutions are not referenced.

following sections cover the development of national preferences focusing on its institutional design.

III. Germany and the Struggle over Institutional Protection Schemes

The idiosyncratic structure of the German banking sector complicates preference formation, as it leads to diverging economic interests. The German position is often explained based on moral hazard concerns, as EDIS would undermine efforts to restructure ailing banking sectors at the expense of their more solvent German counterpart that would have to refill depleted funds. Instead, this article follows Howarth and Quaglia (2017), who emphasize structural determinants arising from the institutional setup of national DGSs. I argue that purely focusing on moral hazard concerns does not adequately represent diverging preferences connected to national DGSs.

The German banking sector is differentiated between few cross-border active commercial banks and a bulk of domestic savings and co-operative banks. The position of savings and co-operative banks is determined by the institutional protection schemes (IPS) they run, which are registered as a DGS but provide comprehensive mutual support beyond deposit insurance in that they safeguard the solvency of participating institutes via supervision and emergency support. The deposit insurance function only applies when an institute defaults despite the IPS, an event that is to be prevented at all costs. This is not to say that moral hazard concerns are non-existent; indeed, they are clearly articulated by the National Association of German Cooperative Banks (BVR), the German Savings Banks Association (DSGV), and the Association of German Public Banks (VÖB) (BVR and DSGV, 2016, p. 1; DSGV, 2018c, p. 1; VÖB, 2018, p. 13).

A full-fledged EDIS replacing IPS by moving deposit insurance funds to the supranational level is a key concern for these banks, as the IPS forms the connecting element between legally separate institutes that utilize a shared brand. Under a full-fledged EDIS, a defaulting institute could harm customer trust in the whole group, constituting a strong interest to uphold IPS that safeguard continuous customer business, instead of paying out deposits (Interview 5, 2018). Moreover, the control over insurance funds would be moved to the supranational level, potentially undermining their ability to prevent defaults (BVR, 2017, p. 1; DSGV, 2018a, p. 8; 2018c; VÖB, 2018, p. 13). A reinsurance system based on liquidity provisioning would be the only potential option; however, these institutes remain highly critical, as they see a compromise as a stepping stone for a full-fledged EDIS (DSGV, 2018b, p. 13; VÖB, 2018, p. 13).

Conversely, a full-fledged EDIS reduces costs for cross-border active institutes, which run regular DGSs limited to deposit insurance. Accordingly, they lack a structural interest to oppose EDIS (Interview 1, 2018). As the largest commercial banks' representative, Deutsche Bank did not strictly rule out EDIS and referenced its economic viability in principle (Deutsche Bank, 2017c, pp. 5–6). However, Deutsche Bank puts a similar emphasis on pre-emptive risk reduction in the eurozone reflecting moral hazard concerns (Deutsche Bank, 2017a, pp. 3–4; 2017b, p. 13; 2017c, pp. 5–6). Cross-border active banks stand to benefit from a full-fledged EDIS, as it would decrease compliance costs and give them a competitive edge over domestic institutes, which cannot reduce their compliance costs through a full-fledged EDIS (Interview 1, 2018; Interview 3, 2018; Interview 4, 2018).

Nevertheless, savings and co-operative banks defined the banking sector position after the initial 2015 proposal. This is reflected in the positions of the umbrella association, the German Banking Industry Committee (DK), which were drafted by the co-operative bank association and oppose EDIS in general (DK, 2017). The commercial bank association BdB provided tacit support for the anti-EDIS stance despite the potential benefits, as it referred to the DK position. This can be attributed to the high amount of risky legacy assets throughout the eurozone during this time and to a strategic aspect of the DK position, because a unanimous position in the banking sector is a long-standing lobbying strategy towards the government (Interview 2, 2018; Interview 3, 2018).

Intermediately, the BdB signalled its willingness to accept a liquidity-based reinsurance system coupled to risk reduction (BdB, 2018; Berschens, 2019). This shift reflects cross-border active banks' increasing interest in financial integration instead of prolonged national banking sector protection, which benefits particularly domestic institutes (Culpepper and Tesche, 2019). Furthermore, the period between the publication of the first proposal and the COVID-19 pandemic saw significant progress in reducing NPLs (European Commission, 2019). This is important for commercial banks, as their resistance to EDIS is linked to risk-sharing concerns, instead of protecting national DGSs, in that their advocacy for a reinsurance system can also act as a first step to push for a full-fledged EDIS later on, which would disproportionately benefit them. While the German banking sector unanimously demands pre-emptive risk reduction, there is no uniform voice concerning the future institutional design of deposit insurance. Rather, interests diverge between savings and co-operative banks' general opposition to EDIS and cross-border active commercial banks' acceptance of a liquidity-based reinsurance system.

In addition to commercial banks' deviation from savings banks' opposition to EDIS, the BMF also amended its position in November 2019. The 'Position Paper on the Goals of the Banking Union' includes the first explicit proposal on the institutional design of EDIS. It concludes that after further substantive risk reduction, including a range of ambitious topics beyond NPLs, EDIS could be introduced in the form of a reinsurance system that would amend national DGSs with a supranational fund providing loans to DGSs should these be depleted. Additionally, EDIS should provide limited loss absorption (BMF, 2019). The continuous demand for further risk reduction clearly reflects the common interests for risk reduction across the German banking sector, while it deviates from savings and co-operative banks' categorical opposition (Scholz, 2018; BMF, 2019). The shift in the BMF's positions can be related to different factors: while pre-pandemic progress in risk reduction mitigates moral hazard concerns and commercial banks began supporting a reinsurance system, the BMF's ideological shift from the conservative Schäuble to the pro-integration social democrat Scholz is another factor helping the pro-integration position.

However, in terms of the institutional design of EDIS, the BMF paper upholds the key limitation to a reinsurance system also after an extensive list of risk-reduction measures spanning from cyclical factors, such as NPLs, to structural factors, most controversially banks' sovereign exposure. While moral hazard concerns do explain the German insistence on risk reduction beyond ideological changes, the insistence on retaining national DGSs beyond ideological changes can be understood based on savings and co-operative banks' strong interest in preserving their IPSs. Although commercial banks abandoned

savings banks' fundamental EDIS opposition and the BMF leadership has become significantly more pro-integration, the insistence on retaining DGS remains. To understand this persistence, it is instructive to look at the structural links between savings and co-operative banks and German politics, which arise from unusually direct links – elected politicians hold the majority of board chairmanships and most state-level politicians are involved in savings banks (Markgraf and Véron, 2018; Markgraf and Rosas, 2019) – besides savings banks' key role in financing the German *Mittelstand* (Interview 4, 2018; Interview 5, 2018). Hence, they do retain a particularly strong lobbying position, which accounts for the BMF's insistence on retaining national DGS, which explains why the economic interests of savings and co-operative banks drive the German preference formation on the institutional design of EDIS.

These key questions on the relationship of IPSs and EDIS are also reflected in the discussion of the Ad Hoc Working Party (Council of the European Union, 2020) and in the latest Commission survey on a hybrid model, which addresses how IPS can be included in EDIS (Commission Services, 2020).

IV. France: Special Benefits for a Concentrated Banking Sector

The French banking sector poses a very different starting point for preference formation to Germany, as it is dominated by a small number of large, cross-border active banks. Their structural interests are largely aligned with other cross-border active banks throughout the eurozone, but preference formation in France has some unique features. The French universal banking model has produced a highly concentrated sector dominated by a few large banks, which have the biggest impact on preference formation, as there is no subsector that could eclipse their influence. While French cross-border active banks generally share interests with their German counterparts, they enjoy a stronger financial stance (Interview 1, 2018). Thus, low NPL ratios in both Germany and France aligned banks' interests for risk reduction before implementing any shared deposit insurance (Interview 4, 2018). This is also reflected in the publications of the French Banking Federation (FBF) (2017a, 2017b, 2018).

A full-fledged EDIS does not pose a fundamental challenge to the institutional setup of French banks, as is the case for German savings and co-operative banks. In fact, French cross-border active banks could benefit from a full-fledged EDIS, just as their German counterparts would, due to reduced compliance costs (Interview 1, 2018). But French banks indeed developed a different position, as the current 2014 DGS Directive grants a lower target level for highly concentrated banking sectors such as the French.³ This should offset the supposedly low likelihood that a higher target level becomes necessary in these banking sectors, as they consist of large banks that would be resolved under the SRM by using the single resolution fund. Accordingly, compared to banks in other countries, French banks benefit from lower contributions, forming a major lobbying success that is unlikely to be given up easily (Interview 3, 2018; Interview 4, 2018; Interview 5, 2018).

³Instead of the 0.8 percent of eligible deposits set as the regular target level in the DGS Directive, the target level can be reduced to 0.5 percent after approval by the Commission. Currently, this legal status has only been granted to the French DGS.

Congruently, the FBF recommends ‘a reinsurance system in which national deposit insurance funds can be maintained’ (FBF, 2017a) and with them the exemption for French banks. It also actively worked towards changing the government position on EDIS, as was reported in a 2016 *Handelsblatt* article citing an FBF letter, in which its president distances himself from a full-fledged EDIS and instead proposes a reinsurance scheme (Berschens, 2016). Besides the FBF, the banking sectors’ interests are of particular importance for government preference formation, because, in France, high-level civil servants and private bankers are closely linked through informal policy networks (Hardie and Howarth, 2009; Jabko and Massoc, 2012, pp. 566–9). Their shared social and educational backgrounds underpin the strong interactions between the French banking sector and government officials with the result that preference formation in France is strongly shaped by banking sector interests also beyond crisis situations (Woll, 2014, p. 125). This is particularly the case for more technical issues, to which the institutional design of EDIS arguably belongs, as there are practically no other actors involved in discussions with the government (Fontan and Saurugger, 2020, p. 14). Furthermore, the positions taken by the French Prudential Supervision and Resolution Authority (ACPR), the French banking supervisor, as well as François Villeroy de Galhau, President of the Banque de France, also aligned more closely to the banking sector position by proposing a reinsurance system (ACPR, 2016; Villeroy de Galhau, 2017, 2018). These are traditionally part of said policy networks (Fontan and Saurugger, 2020, p. 7), which further emphasizes that implementing EDIS as a reinsurance system has become a prominent position within the networks determining French preference formation (Interview 5, 2018).

In conclusion, while more recent government positions explicitly addressing the institutional structure of EDIS are lacking, significant actors belonging to the policy networks that shape French preference formation have come to support a reinsurance system, in line with banking sector promotion of a reinsurance system. This can be traced to the French banking sector’s interest in safeguarding the lower DGS target level granted to it, which underlines that the legal status of national DGSs needs to be considered. Without this, a one-sided focus on the more prominently discussed aspect of risk reduction fails to grasp how national preferences develop.

V. Italy: The Case of Alternative Measures

Preference formation in Italy is driven by the continuous vulnerability of the Italian banking sector to the sovereign–bank nexus. However, Italian banks’ position also evolved in conjunction with their experiences under the banking union framework and legal disputes with the Commission over the use of deposit insurance funds for alternatives measures besides depositor payout.

Italy’s banking sector has a comparatively high number of banks, but small savings and co-operative banks are less dominant than in Germany and consolidation is ongoing, particularly among co-operative banks (Quaglia, 2014, p. 223; Bilotta, 2017). While NPL ratios remain high with respect to historical averages, they have been considerably reduced after 2016. The COVID-19 pandemic is currently reversing this trend, however (European Banking Authority, 2020). In addition, the banking sector features large sovereign exposure, making it particularly vulnerable to the sovereign–bank nexus (Gros, 2019). Thus, the Italian banking sector has supported policies uncoupling state

and bank finances without posing any additional burden. The Italian Banking Association (ABI) argues, contrary to its northern counterparts, that risk reduction has been sufficient and that EDIS in itself contributes to risk reduction via sharing risks (ABI, 2016, 2017, pp. 3–4). Furthermore, the sovereign–bank nexus constitutes a link between bank interests and government preferences, as government finances depend on banking sector stability and its continuous holding of sovereign bonds. Correspondingly, the Ministry of Economy and Finance (MEF) and the Bank of Italy back the banking sector's pro-EDIS position (Bank of Italy, 2018, pp. 14–16; de Polis, 2016, p. 13; MEF, 2016, pp. 4–5) and also argue that EDIS is necessary to sever the sovereign–bank nexus (MEF, 2019, p. 78; Panetta, 2018b, 8–9; Presidenza del Consiglio dei Ministri, 2018, 9–10; Panetta, 2018b, 8–9; Visco, 2018). Thus, the Italian preference for EDIS can be traced to risk levels in the banking sector and exposure to the sovereign–bank nexus in line with existing literature.

However, the Italian preference on the institutional design of EDIS has evolved since the inception of banking union due to interests bound to national DGSs. What makes Italian DGSs stand out is their emphasis on alternative measures besides deposit insurance to recapitalize ailing banks, but legal disputes with the Commission led to concerns over the future usage of deposit insurance funds. In 2014, the Commission considered measures taken by an Italian DGS in support of Banca Popolare di Bari during its acquisition of a small regional bank to be state aid (Bank of Italy, 2019). Furthermore, during the December 2019 bailout of Banco Popolare di Bari, the DGS was used to recapitalize an ailing bank (Krieger, 2019). Moreover, during the bailout of two co-operative banks in 2017, only a last-minute re-evaluation by the SRB and Commission paved the way for the state bailout (Donnelly and Asimakopoulos, 2019). Under a full-fledged EDIS, decisions over the use of DGS funds would be shifted to the supranational level, which would likely impede the use of alternative measures, as the above examples demonstrate. Italian banks assess this as a substantially negative outcome, as options for recapitalization would be diminished in line with the banking union framework (Interview 5, 2018). Thus, while a full-fledged EDIS is an option to weaken the sovereign–bank nexus by uncoupling state and bank finances, it would pose an additional burden for Italian banks by preventing the use of alternative measures. For example, the co-operative bank association argues for a version of EDIS that retains their DGSs, which is similar to German IPS (BCC, 2016: 6–7).

The stand-off with the Commission made the Italian government wary of shifting further decision-making powers to the supranational level, as this would very likely impede the current use of alternative measures (Interview 5, 2018). Regarding alternative measures, the sovereign–bank nexus also constitutes a link between bank interests and government preferences, as recapitalization prevents banks from being liquidated and thus the institutions holding significant proportions of sovereign bonds (Gros, 2019). The Bank of Italy also played a key role, as it argued for retaining the possibility of alternative measures (de Polis, 2016, p. 15; Panetta, 2018a, pp. 9–11; Visco, 2017, p. 10) and proposed the introduction of IPSs for small co-operative banks similar to the German model, which implies the further existence of national DGSs (Bank of Italy, 2018). It further endorsed the use of DGS funds for recapitalization during the bailout of Banco Popolare di Bari (Bank of Italy, 2019). This is instructive for the Italian preference on EDIS, as its expertise is an important reference for the government (Morlino and

Sottilotta, 2019, p. 18). Overall, this demonstrates that the Italian preference on EDIS has shifted towards a version of EDIS that allows the future use of alternative measures.

To conclude, while the sovereign–bank nexus still constitutes a strong Italian preference for EDIS, there are clear indicators that a full-fledged version has fallen out of favour. Focusing solely on the risk reduction aspect provides no insight into banking sector interests to retain the use of DGS funds for alternative measures such as recapitalization. In addition, considerations about risk reduction do not explain preferences on the side of the Italian government to retain decision-making over DGS funds at the national level (Interview 5, 2018). Hence, Italy's national preference is aligned with solutions that retain national DGSs as a reinsurance system (Council of the European Union, 2020). The importance of alternative measures to find agreement with EDIS is also reflected in the discussions of the Ad Hoc Working Party, which addressed alternative measures and preventive measures besides depositor payouts (Council of the European Union, 2020, p. 5; High-Level Working Group on EDIS, 2019, p. 3). Furthermore, the latest Member State survey includes alternative measures in the questionnaire (Commission Services, 2020).

Conclusion

This article analyses the development of national preference formation on EDIS since the failure of the initial proposal in 2015, for the cases of Germany, France and Italy. I show that a sole focus on moral hazard concerns over pre-emptive risk reduction on the side of Germany and other creditor states is insufficient for understanding how national preferences developed. Instead, banking sector interests connected to the institutional setup and legal status of national deposit guarantee schemes (DGSs) need to be considered. Preference formation in Germany remained most stable because savings and co-operative banks strongly oppose a full-fledged EDIS in order to maintain their IPS. In this regard, commercial banks' support for EDIS also increased and an ideological shift favouring further integration at the German ministry of finance did not outweigh the preference to maintain national DGSs. In the French case, the banking sector pressed for a reinsurance system that maintains national DGSs, instead of a full-fledged EDIS to retain the lower target level and the lower costs for the French banking sector. In Italy, adverse experiences with the transfer of decision-making competence under the banking union framework and legal disputes with the Commission over the use of deposit insurance funds have dampened the enthusiasm for a full-fledged EDIS, especially as this could restrict the use of funds for alternative measures. Thus, national preferences have started to align towards a reinsurance system that maintains national DGSs, which is also reflected in the technical discussions in the Ad Hoc Working Group on EDIS.

Concerning pre-emptive risk reduction, divergence remains. While the interests of the German and French banking sectors are aligned due to shared moral hazard concerns, Italy seeks to minimize costs for risk reduction. However, new draft versions factor in risk reduction by introducing conditionality for a successive introduction of EDIS. Thus, the question of risk reduction is no longer whether it must occur, but rather, what kind will be a precondition to proceed with EDIS? Hence, the current trajectories point to a discussion over the way national DGSs are to be linked in a reinsurance system, which is in line with the current Member State survey by the Commission. Nevertheless, any progress in negotiations is strongly contingent upon the kind and extent of risk reduction deemed

necessary for finding a compromise on EDIS. This would be an incremental reform step. Moreover, while it is a risky endeavour to adopt a wait-and-see approach by testing the current banking union framework in the next crisis, this also remains a likely outcome. Overall, EDIS will most likely become a major point of contention in the upcoming debates over the handling of the European economy and particularly its banking sector in the aftermath of the COVID-19 pandemic.

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- Interview 1: The political and economic developments on EDIS (London, 2018).
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- Interview 3: The political and economic developments on EDIS (Frankfurt am Main, 2018).
- Interview 4: The political and economic developments on EDIS (Telephone Interview, 2018).
- Interview 5: The political and economic developments on EDIS (Berlin, 2018).